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Jason S. Johnston
University of Pennsylvania Carey Law School

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THE RETURN OF BARGAIN: AN ECONOMIC THEORY OF HOW STANDARD-FORM CONTRACTS ENABLE COOPERATIVE NEGOTIATION BETWEEN BUSINESSES AND CONSUMERS†

Jason Scott Johnston[*]

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[*] Robert G. Fuller, Jr. Professor of Law, University of Pennsylvania Law School. A.B. 1978, Dartmouth; J.D. 1981, Ph.D. (Economics) 1984, University of Michigan. —Ed. The initial version of this Article was presented at the Penn Law Faculty Retreat in September, 2004. I am grateful to Omri Ben-Shahar, Gerry Faulhaber and Kristin Madison for exceptionally helpful comments, and to participants of the University of Arizona Law School's faculty colloquium for their helpful comments as well. Stephen Weil provided helpful research assistance on this project.

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Introduction

Among attorneys, judges, and legal academics, there is virtual consensus that the widespread use by business firms of standard-form contracts in their dealings with consumers has completely eliminated bargaining in consumer contracts. I believe that this perception is false, that rather than precluding bargaining and negotiation, standard-form contracts in fact facilitate bargaining and are a crucial instrument in the establishment and maintenance of cooperative relationships between firms and their customers. On this view, which I elaborate below, firms use clear and unconditional standard-form contract terms not because they will insist upon those terms, but because they have given their managerial employees the discretion to grant exceptions from the standard-form terms on a case-by-case basis. In practice, acting through its agents, a firm will often provide benefits to consumers who complain beyond those that its standard form obligates it to provide, and it will forgive consumer breach of standard-form terms. Firms do this because they have an interest in building and maintaining cooperative, value-enhancing relationships with their customers. Were firms legally required to extend such benefits or forgiveness—as would result either from judicial invalidation of the tough standard-form performance terms or legislatively mandated generous standard-form performance terms—then both firms and their customers would be worse off.

Most of my analysis here is concerned with standard-form terms of performance: contract terms that set out, for example, the amounts and repayment dates on a consumer loan, or an airline passenger's rights to be upgraded to a first-class seat. While my main concern is with such standard-form performance terms, I also discuss what may be called standard-form breakdown terms—terms that determine where and how an "endgame" dispute over breach of the performance terms will be resolved.[1] Unlike performance terms, which firms intend to forgive or expand upon when so doing is consistent with building and maintaining valuable customer relationships, breakdown terms are not meant to be varied, since breakdown

[1] My discussion of these "endgame" standard-form terms relies, for its inspiration and terminology, on Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 Mich. L. Rev. 1724 (2001).

signals that no mutually beneficial customer relationship exists. Moreover, the optimal breakdown terms are those that maximize the firm's incentives to pursue discretionary, cooperative tailoring of its customer relationships. By systematically overcompensating consumers with large claims against business firms, and undercompensating those who have relatively small claims against such firms, the civil justice system blunts or eliminates such incentives. By offering a more predictable and more uniform schedule of damages, private arbitration can offer a form of endgame dispute resolution that allows firms to focus more on business value and less on litigation risk in negotiating the terms of their ongoing consumer relationships.

My analysis of both standard-form performance and standard-form breakdown terms generates some advice for courts employing common law contract doctrines. Courts should presume that standard-form contract terms are a valid and enforceable part of the bargain between business firms, their customers, and their employees. At the same time, however, courts must recognize that opportunistic firms will use standard forms to renege on promises to offer the tailored and flexible forgiveness and accommodation offered by good firms. To prevent such behavior, courts should enforce additional promises or concessions made by agents of the firm that go beyond standard-form obligations, provided that there is clear evidence that such promises were actually made. Courts should also ensure that standard-form arbitration clauses do indeed offer uniform and predictable remedies, rather than no remedies at all.

Part II of this Article presents empirical evidence demonstrating that firms routinely grant their agents the authority to exercise their discretion to forgive the breach of and extend benefits beyond standard-form consumer-contract terms. Such a strategy of using ex-ante clear and unconditional standard-form contract obligations together with discretionary ex-post forgiveness or ex-post benefit conferral comprises what I call a "two-part standard-form contract." Part III develops an economic, game-theoretic explanation for such two–part standard-form contracts, how firms determine the optimal combination of standard-form terms and ex-post discretion, and why they could not accomplish the same socially desirable strategic goal if they were not permitted to exercise the discretion to vary standard-form terms. Part IV discusses the model's implications for traditional legal concerns about the distributive impact of standard-form consumer contracts. Part V explains implications for doctrines that determine the enforceability of promises that vary or add to the terms of standard-form contracts. Part VI analyzes how standard-form breakdown terms determine the viability of the optimal two-part standard-form contract. I begin in Part I with a brief intellectual history of academic and judicial thinking about standard-form contracts.

I. From Contracts of Adhesion to Market Assent

As Friedrich Kessler famously observed over sixty years ago,[2] the late-nineteenth-century development of mass production and mass distribution of consumer goods brought with it the standardized mass-consumer contract.[3] Just like consumer goods, standardized contracts are mass marketed. On the traditional story told by legal scholars,[4] a firm's attorneys write the terms of these contracts, which then accompany the sale of all the firm's products (or, increasingly, services). Between the consumer and the sales agent (or retailer), there is no bargaining over the terms of such contracts. They are automatically bundled together with the sale of the good or service.

In its core doctrines, the common law of contracts was already well developed when standardized consumer contracts appeared on the scene. One of those core doctrines is that a legally enforceable contract requires "a manifestation of mutual assent to the exchange,"[5] or, in somewhat more colloquial terms, an agreement. Induced from a body of case law dealing largely with non-standard, negotiated transactions, the common law's paradigm for the "manifestation of mutual assent" is that of a bargaining process which culminates when one party makes an offer that the other finally accepts.[6]

The paradigmatic standardized consumer transaction does not, however, involve an individualized negotiation over price and other terms, but rather the posting of set prices for goods and services with standardized (albeit typically varying) characteristics. In the modern economy, consumer sales occur not through the haggling and dickering of the market bazaar, but rather through the cool, calm efficiency of mass retailing. While it is possible to uncover (create?) an "offer" and "acceptance" pattern even in common, standardized consumer transactions, it must be conceded that those sales do not emerge from the kind of individualized bargaining process that gave rise to the offer and acceptance paradigm. While common-law judges understood that mass production and marketing brought consumers a once unimaginable diversity of products and services delivered by producers who were pressured by constant competition to keep prices and costs down, they found it hard to see how consumers were legally assenting to the standard-form contract used in such a world. Indeed, judges and legal scholars viewed market-driven uniformity in standard-form contract terms with alarm, perceiving that even in reasonably competitive markets, consumers

[2] Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 631 (1943).

[3] Standardized product warranties, for example, were apparently found as early as the late-nineteenth century. *See* George L. Priest, *A Theory of the Consumer Product Warranty*, 90 Yale L.J. 1297, 1299 (1981).

[4] For one statement of this story, see Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1174, 1225 (1983).

[5] Restatement (Second) of Contracts § 17 (1981).

[6] The various rules on offer and acceptance are found at Restatement (Second) of Contracts §§ 24–70 (1981).

often had no choice of contract terms, so that a consumer's apparent contractual assent to such terms was really "but a subjection more or less voluntary to terms dictated by the stronger party, terms whose consequences are often understood only in a vague way, if at all."[7] Uniform standardized contracts became subject to the epithet "contracts of adhesion."[8]

By the 1970s, both courts and commentators had reached a virtual consensus regarding the evil of form contracts. As recounted by George Priest,[9] academic commentators viewed standard-form consumer-product warranties variously as a form of fraud[10] or as evidence that consumer product manufacturers had unbridled discretion to draft standard-form terms such as warranties simply to minimize their costs.[11] Courts across the country followed the New Jersey Supreme Court's famous decision in *Henningsen v. Bloomfield Motors, Inc.*[12] refusing to enforce the terms of a standard-form warranty disclaiming the implied warranty of merchantability and excluding liability for consequential damages in a case involving serious bodily injury. That court's reasoning is worth quoting in detail, for its tone perfectly captures the view of standard-form contracts that prevailed during this period:

> The warranty before us is a standardized form designed for mass use. It is imposed upon the automobile consumer. He takes it or leaves it, and he must take it to buy an automobile. No bargaining is engaged in with respect to it. In fact, the dealer through whom it comes to the buyer is without authority to alter it . . . . The form warranty is not only standard with Chrysler but . . . it is the uniform warranty of the Automobile Manufacturers Association. . . .
>
> The gross inequality of bargaining position occupied by the consumer in the automobile industry is thus apparent. There is no competition among the car makers in the area of the express warranty. Where can the buyer go to negotiate for better protection? . . . Because there is no competition among the motor vehicle manufacturers with respect to the scope of protection guaranteed to the buyer, there is no incentive on their part to stimulate good will in that field of public relations. . . .[13]

[7] Kessler, *supra* note 2, at 632. Such a perception was widespread across the ideological spectrum, with Lord Devlin, hardly someone whom one would consider a great progressive, arguing stridently that "[i]f the modern lawyer had to single out the contract which now bears most marks of oppressive and unfair dealing, I think he would probably select one in the mass of small print which the large concern thrusts upon the small man in a 'take it or leave it way.'" Patrick Devlin, The Enforcement of Morals 49 (1968, 1972 reprint).

[8] This term, as Kessler recounts, originated quite early in the twentieth century, with Edwin W. Patterson, *The Delivery of a Life-Insurance Policy*, 33 HARV. L. REV. 198, 222 (1919). Kessler, *supra* note 2, at 632 n.11

[9] Priest, *supra* note 3, at 1300–02.

[10] W. David Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1, 12 (1974).

[11] William C. Whitford, *Law and the Consumer Transaction: A Case Study of the Automobile Warranty*, 1968 WIS. L. REV. 1006.

[12] 161 A.2d 69 (N.J. 1960).

[13] *Id.* at 87.

This basic reasoning—stressing the uniformity within an industry as showing lack of consumer choice—was applied by courts in refusing to enforce standard-form terms similarly limiting the liability of mass-product and service providers in other fields, such as landlords.[14]

Such reasoning suffered from two very basic weaknesses. On the one hand, the theory underlying it—what Priest aptly labeled the exploitation theory of the consumer standard-form contract[15]—did not have any explanation for uniform standard-form contract terms other than that they reflected the untrammeled power of firms to maximize profits at consumers' expense. And with such a weak explanation for the supposedly problematic observed empirical regularity, it was perhaps not surprising that courts never really fashioned a coherent doctrinal test for when they would enforce standard-form terms and when they would not. On the one hand, it seemed as if courts were only really concerned with standard-form adhesion terms if they appeared in contracts for goods or services—such as autos or housing—that judges thought were really important or necessary.[16] On the other hand, what courts really seemed to worry about when determining whether the standard-form terms would be enforced or instead struck down as unconscionable was not the importance of the good or service, but the relative sophistication of a particular consumer, her education and income level, and the circumstances under which the standard-form terms were presented for her perusal.[17] The suggested solutions of some academics, such as Todd Rakoff's proposal that (under circumstances identified by a seven-factor test) courts impose a fiduciary obligation on sellers of consumer goods and services to act only in the consumer's interest, rather than in the interest of their own firm's profit and sales goals, apparently represented too great a departure from the background principles of free markets for the courts to adopt.[18]

Into this explanatory and doctrinal gap strode the law-and-economics scholars of the 1980s. Early in that decade, Schwartz and Wilde demonstrated in a general theoretical setting how even a quite small proportion of smart consumers who actually read and shopped for good standard-form contract clauses could put enough competitive pressure on firms so that they would adopt efficient standard-form terms (terms whose cost to the firm was

[14] *See, e.g.*, Galligan v. Arovitch, 219 A.2d 463 (Pa. 1966).

[15] *See, e.g.*, Priest, *supra* note 3, at 1309.

[16] For instance, in *Ciofalo v. Vic Tanney Gyms, Inc.*, 177 N.E.2d 925, 927 (N.Y. 1961), the court enforced a liability disclaimer in a gym membership agreement, stating that "[h]ere there is no special legal relationship and no overriding public interest which demand that this contract provision, voluntarily entered into by competent parties, should be rendered ineffectual."

[17] With the classic statement of this attitude, leading to invalidation of a standard-form consumer-installment sales contract's cross-collateralization clause, being *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.D.C. 1965).

[18] *See* Rakoff, *supra* note 4, at 1248–83.

less than the value that consumers placed upon them).[19] In a quite different, but equally persuasive, methodological spirit, Priest[20] showed that the observed variation across product types in the scope and length of consumer warranties could be explained as optimally allocating responsibility for product malfunction between the producer and the consumer. By the end of the decade, it seemed that both uniformity and variation in standard-form mass-transaction contracts could be explained as the product not of consumer ignorance and firm power, but of (sufficiently) informationally efficient markets. Regardless of whether any particular consumer had ever read, understood, or bargained over the terms of the standard form, informed consumers generated a form of hypothetical market assent, which would bind all consumers.

The theory of market assent has always had its academic skeptics,[21] but by the 1990s (in large part through the influence of opinions written by law-and-economics scholars turned federal judges), this theory of market assent had even been accepted by the Supreme Court. In upholding the enforceability of a standard-form forum-selection clause in a consumer cruise-line ticket (under a "fundamental fairness" test it had set up under its admiralty jurisdiction), the Court was untroubled by the uniformity of the clause within the industry, and remarkably confident in the reality of market assent:

> [R]espondents' passage contract was purely routine and doubtless nearly identical to every commercial passage contract issued by petitioner and most other cruise lines. In this context, it would be entirely unreasonable for us to assume that respondents—or any other cruise passenger—would negotiate with petitioner the terms of a forum-selection clause in an ordinary commercial cruise ticket. Common sense dictates that a ticket of this kind will be a form contract the terms of which are not subject to negotiation, and that an individual purchasing the ticket will not have bargaining parity with the cruise line. . . .
>
> . . . . [Still, i]ncluding a reasonable forum clause in a form contract of this kind well may be permissible for several reasons: First, a cruise line has a special interest in limiting the fora in which it potentially could be subject to suit. Because a cruise ship typically carries passengers from many locales, it is not unlikely that a mishap on a cruise could subject the cruise line to litigation in several different fora. Additionally, a clause establishing *ex ante* the forum for dispute resolution has the salutary effect of dispelling any confusion about where suits arising from the contract must be brought and defended, sparing litigants the time and expense of pretrial motions to determine the correct forum and conserving judicial resources

[19] The seminal presentation of this claim to the legal academy is 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).

[20] Priest, *supra* note 3, at 1298.

[21] *See, e.g.*, Jeffrey Davis, *Revamping Consumer-Credit Contract Law*, 68 VA. L. REV. 1333, 1345 (1982) (arguing that some credit suppliers are immune to market pressures, which are in any event significantly attenuated because too small a proportion of consumers shop for desirable credit terms).

> that otherwise would be devoted to deciding those motions. Finally, it 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.[22]

As the twentieth century ended, the confidence of the Court and academic commentators was tested by both new theories and new practices. In practice, during the 1990s, a new kind of standard-form contract clause, the mandatory arbitration provision, swept the world of standard-form consumer and employment contracts. While the Court reacted sympathetically to the advent of standard-form mandatory arbitration clauses—as representing not only a market-driven efficiency, but one that Congress had endorsed in enacting the Federal Arbitration Act[23]—lower state and federal courts struggled with whether or not such clauses were unenforceable as unconscionable. In legal academia, a new and rising body of scholarship applying findings from experimental psychology of widespread and serious human cognitive limitations gave new life to the old exploitation theory of standard-form terms.[24]

Like existing economic models and judicial doctrine, recent scholarship applying experimental psychology takes it for granted that standard-form contracts are not designed to encourage bargaining, but to preclude it. Below I construct a model that grants (indeed is built upon) the fact that most if not all individual consumers and employees will never read, let alone understand, all the terms in a firm's standard-form contract. What my model reveals, however, is that while this fact may mean that firms and individual consumers and employees do not bargain over standard-form terms, they actively bargain in the shadow of those terms.

II. Bargaining around Standard-Form Terms: Some Evidence

My understanding of the economic function of standard-form contracts begins not with breakdown terms, but with the terms of performance. Virtually every firm that sells goods or services or extends some form of credit to consumers has certain standard-form contractual terms governing such things as when and how payment is due, when and if a good can be returned, whether charges are made for services beyond those originally contracted for, and other related matters. While set out in contractual forms that are standard in all the firm's dealings, the evidence shows that the actual

[22] Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 593–94 (1991) (citations omitted) (relying on and citing the reasoning in Nw. Nat'l Ins. Co. v. Donovan, 916 F.2d 372, 378 (7th Cir. 1990)). For an argument that the market assent reasoning in Shute and similar cases is consistent with classical contract notions of assent, see Randy E. Barnett, *Consenting to Form Contracts*, 71 Fordham L. Rev. 627 (2002).

[23] Codified at 9 U.S.C. §§ 1–14, 201–08.

[24] *See, e.g.*, Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. Rev. 429 (2002); Russell Korobkin, *Bounded Rationality, Standard-form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203 (2003).

implementation of these various policies must be done on a case-by-case basis, whether by firm employees who work at particular stores, or by staffers in centralized call centers. The common practice among firms is to give their employees the discretion to depart from these standard-form terms and to deliver more than the firm has actually promised if deemed in the firm's best interest to do so. Typically, the firm's standard-form terms set out clear and unconditional consumer obligations but allow firm discretion that is exercised by a supervisory (and sometimes lower level) employee who is given the authority and discretion to forgive. In this part of the Article, I set out some selected evidence on the pervasiveness of this pattern of contracting, which I call a two-part, or discretionary, standard-form contract.[25]

A. *Hospital Bills*

A major problem for hospitals and ambulatory-care facilities is nonpayment of medical bills by outpatients. A *USA Today* article noted that "[h]ospitals can raise charges to any amount the market will bear, but it's an odd market because most hospital customers negotiate discounts off charges."[26] This statement is borne out by exchanges on The Dollar Stretcher, a mediated online-discussion board,[27] where a patient who inquired about negotiating over hospital bills received a variety of responses.

One woman noted that after she and her husband got a hefty hospital bill, she called the accounting department immediately to negotiate. "The thing to do is immediately upon receiving the bill is [sic] call the accounting office at the hospital and doctors [sic] offices ([if] they send their own bills) [and] explain that you do not have the funds to pay in full but would like to make monthly payments."[28]

Following the recommendations of industry consultants,[29] many, probably most, hospitals have dedicated "assistance officers" or "financial counselors," whose jobs are to work out payment plans with patients. A hospital employee noted that hospital financial counselors "often will negotiate

[25] I stress that this is merely a selection. A closer look at many other industries would, I believe, reveal the same pattern. There is, for instance, evidence that people negotiate with their cell phone carriers, post-contract. CBS online encourages people to "[n]egotiate with your carrier. If you see a cheaper deal somewhere else, call your carrier and see if it will offer you something similar. Carriers are anxious to keep you as a customer, so it never hurts to ask for a better deal." *Become a Happier Cell Phone Owner*, CBS News, Mar. 10, 2005, http://www.cbsnews.com/stories/2005/03/10/earlyshow/living/money/main679246.shtml.

[26] Julie Appleby, *Hospital Bills Spin Out of Control*, USA Today, Apr. 13, 2004, at A1.

[27] Reducing Hospital Bills, Dollar Stretcher, http://www.stretcher.com/stories/980923c.cfm (last visited Nov. 20, 2005).

[28] *Id.*

[29] *See, e.g.*, Roger J. Hull, *Screen Outpatients for Better Collections*, Hosp. Fin. Mgmt., Nov. 1978, at 32, 32. The author recommends having the computer select out nonpayers from the patient population and then interviewing such patients individually before treatment to try to identify their ability to pay and to work out individualized monthly payment plans as a precondition for receiving treatment (excepting, of course, the "obviously ill"). He estimates that one account representative can conduct about forty ten-minute interviews per day and that such interviews conservatively will bring in 10% of past-due accounts that would otherwise not come in. *Id.* at 33.

the charges . . . . [P]hysicians will do the same thing, especially if they know you don't have insurance."[30] Another hospital employee stated, "My job requires me to negotiate with medical providers. I can assure you that hospitals can, and will, negotiate charges. They would rather get paid by you than turn the bill over to a collection agency, or worse, write the charges off." The employee went on, "I would explain your financial situation, and offer a lowball sum, mayby [sic] 25%. I would not expect to pay less than 50%. They will often discount to 2/3. if [sic] they want you to pay more than 75% ask for the person's supervisor."[31] The website for the American Academy of Family Physicians goes so far as to recommend negotiating payment plans with hospitals and doctors. In a section of their web page entitled "Financial Management During Crisis," the AAFP recommends,

> As soon as possible, call doctors' offices, billing departments, hospital business offices, creditors, and lending institutions to explain the change in your family's situation. Most people are willing to work with you, but they won't know that you need help unless you tell them.
>
> . . . .
>
> Creditors can be lenient—arranging payment schedules, accepting partial payments, and so on—but they need to hear from you. Even if you can only make a portion of a payment, it will show an attempt to keep up your side of the obligation.[32]

In the case of hospital bills, there is systematic survey evidence that confirms the anecdotal evidence of widespread negotiation around standard-form payment terms. A Harris Interactive survey shows that while negotiating over hospital bills is not quite ubiquitous, it is common:[33]

> [Question:] "In the last 12 months, have you ever talked to any of the following to see if you could pay a lower price than they had billed you, or wanted to bill you? [sic]
>
> Base: All adults

[30] The Dollar Stretcher, *supra* note 27.

[31] *Id.* Another former employee noted, "[Hospitals] don't want to have to send you to collection—it's much better for them to get the full amount, even if it takes longer (collection agencies take a percentage). I've seen payment plans as little as $25 a month." *Id.*

[32] Familydoctor.org, Am. Acad of Family Physicians, Financial Management During Crisis, http://www.kidshealth.org/PageManager.jsp?dn=familydoctor&lic=44&article_set=21736 (last visited Nov. 20, 2005).

[33] Harris Interactive, "Haggling" with Health Care Providers About Their Prices Likely to Increase Sharply as Out-of-Pocket Costs Rise (Mar. 6, 2002), http://www.harrisinteractive.com/news/allnewsbydate.asp?NewsID=443. The questions and charts in the body of this Article are excerpted directly from the website.

		Health Status		
Have talked to:	All Adults	*Excellent*	*Pretty Good*	*Only Fair/ Poor*
	%	%	%	%
Pharmacist	17	10	18	27
Doctor	13	10	12	20
Dentist	12	12	12	13
Hospital	10	7	9	20

> . . . .
>
> [Question:] "Were you successful in getting to pay a lower price?"
>
> Base: Talked to (provider) about Medical Bills

	Was Successful	(As A Percentage of All Adults)
	%	%
Pharmacist	48	(8)
Doctor	54	(7)
Dentist	47	(6)
Hospital	45	(5)

The polls also showed that if hospital costs continue to rise, many more people would contemplate negotiating over their medical bills:[34]

> [Question:] "In the last two years, if the out-of-pocket cost to you of your medical bills, that is, after whatever your insurance pays for, increases substantially, how likely would you be to negotiate a better price for a medical bill?"
>
> Base: All adults

		Health Status		
	All Adults	*Excellent*	*Pretty Good*	*Only Fair/ Poor*
	%	%	%	%
Very likely	32	33	32	33
Likely	21	21	21	23
Somewhat likely	22	24	23	16
Not at all likely	12	16	10	15
Not sure	12	6	15	14

[34] *Id.*

B. *Consumer Credit Cards*

The consumer credit-card industry is a foundation of the American economy, with outstanding revolving credit-card debt standing at over $800 billion[35] and over 44% of American families relying on credit-card borrowing to finance purchases.[36] Credit-card contracts are full of terms that epitomize the pairing of bright-line borrower obligations with discretionary lender forgiveness. A typical credit-card contract[37] grants a grace period during which time balances may be repaid without the borrower incurring the stated finance charge, and grace periods are typically stated as, for example, "not less than 20 days," thus giving the issuer the option to extend the grace period beyond twenty days. Similarly, the default rate "equals the U.S. Prime Rate plus up to 23.99%," with "[f]actors considered in determining" the default rate including "how long your account has been open, the timing or seriousness of a default, or other indications of account performance." Although there is no preset spending limit, "[e]ach charge that causes your balance to exceed your revolving credit line will be evaluated based on account usage and performance, other account relationships with us and your experience with other creditors." Finally, the contract allows the issuer to "change the rates, fees, and terms of your account at any time for any reason," where, controversially, such a reason may include "information in your credit report, such as your failure to make payments to another creditor when due, amounts owed to other creditors, the number of credit accounts outstanding, or the number of credit inquiries."[38] Clearly, in a number of key terms, the consumer credit-card contract is written with minimal bright-line borrower guarantees but lots of room for what I have called "tailored forgiveness" by the issuer.

While I have not yet found any systematic empirical data on how often credit-card issuers renegotiate debt, the existing informal and anecdotal evidence suggests that this practice is common. A raft of best-seller books on consumer finances recommend negotiating around credit-card contract terms including the interest rate, annual fee, late payment fee, payment

[35] This figure reflects total outstanding revolving debt as of January 2005. Fed. Reserve, *Consumer Credit: January 2005*, FED. RES. STAT. RELEASE, Mar. 7, 2005, *available at* http://www.federalreserve.gov/releases/g19/20050307/g19.pdf.

[36] As reported in the most recently available *Survey of Consumer Finances. See* Anna M. Aizcorbe et al., *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, 89 FED. RES. BULL. 1, 24 (2003).

[37] The examples used here are the terms, available online, of the Citi Gold/AAdvantage World Mastercard. *See* Citi Cards Products, Terms and Conditions, http://www.citibank.com/us/cards/cardserv/worldcard/gold.jsp (follow "Terms & Conditions" hyperlink) (last visited Nov. 20, 2005).

[38] *Id.* The so-called "universal default" provision has recently come under intense criticism from consumer groups and some members of Congress, and the Comptroller of the Currency has issued an advisory letter calling for more transparent disclosure of the universal default term. *See* Andrew Blackman, *Personal Business: Universal Default Can Snare Cardholders*, WALL ST. J., Feb. 20, 2005, at 4; Linda Punch, *Getting Tough?*, CREDIT CARD MGMT., Feb. 2005, at 42.

moratoria, and repayment schedules.[39] The frequency with which repayment obligations are renegotiated is perhaps most strongly evidenced by the fact that repayment negotiation—consumer credit-card "workouts"—has been prominent among several credit-card industry practices that have recently been under very high-level regulatory scrutiny. In July of 2002, the four federal regulatory agencies with jurisdiction over credit-card issuers put out a draft "Account Management and Loss Allowance Guidance" ("Draft Guidance").[40] This document criticized credit-card companies for a variety of practices that extended credit to borrowers beyond the borrowers' ability to pay, increasing creditor risk exposure to very high levels. The Draft Guidance criticized credit-card issuers for issuing borrowers too many cards and too liberally allowing borrowers to exceed their credit-line limits. It also criticized the way that issuers were handling their "workout" programs, programs set up to allow borrowers to pay off the outstanding balances on formerly open-ended (and now closed) credit cards. As noted in the Draft Guidance, workouts are used "when a customer is either unwilling or unable to repay the open-end credit card account in accordance with its original terms, but shows the willingness and ability to repay the loan in accordance with its modified terms and conditions."[41] The Draft Guidance criticized credit-card issuers' workout programs for not reducing interest rates, fees, and finance charges sufficiently to allow borrowers to extinguish their debts within "reasonable time frames."[42] The Draft Guidance urged that since consumer credit counseling services typically try to get borrowers to repay credit-card debt within forty-eight months, credit-card lenders should reduce or eliminate interest rates and fees so that repayment terms for workout programs were also "generally" forty-eight months, "with exceptions clearly documented and supported by compelling evidence that less conservative terms and conditions are warranted."[43]

[39] *See, e.g.*, BETH KOBLINER, GET A FINANCIAL LIFE: PERSONAL FINANCE IN YOUR TWENTIES AND THIRTIES 62 (2000) (encouraging negotiation with credit-card issuers for lower rates); SUZE ORMAN, THE MONEY BOOK FOR THE YOUNG, FABULOUS & BROKE 88–89 (2005) (encourages using the threat of transfer to get a lower credit-card rate); STEVEN STRAUSS & AZRIELA JAFFE, THE COMPLETE IDIOT'S GUIDE TO BEATING DEBT 81–90 (2000) (an entire chapter on negotiating with creditors); ERIC TYSON, PERSONAL FINANCE FOR DUMMIES 76 (4th ed. 2003) (encouraging negotiation with creditors).

[40] Office of the Comptroller of the Currency et al., Credit Card Lending (2002) (draft guidance) [hereinafter Draft Guidance], *available at* http://www.ots.treas.gov/docs/4/48908.pdf. The final version is now available. OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., CREDIT CARD LENDING (2003), *available at* http://www.occ.treas.gov/ftp/bulletin/2003-1a.pdf.

[41] Draft Guidance, *supra* note 40, at 3 n.1.

[42] *Id.* at 3.

[43] More precisely, the Draft Guidance stated:

> Workout programs should be designed to maximize principal reduction. Debt management plans developed by consumer credit counseling services generally strive to have borrowers repay credit card debt within 48 months. Repayment terms for workout programs should be generally consistent with these time frames, with exceptions clearly documented and supported by compelling evidence that less conservative terms and conditions are warranted. To meet these time frames, institutions may need to substantially

Credit-card issuers responded almost immediately to the Draft Guidance. They correctly noted that it was essentially calling for a dramatic change in credit-issuer operations, from one focused on "portfolio review and management of the millions of consumer loans . . . to an increasing supervisory review of individual loans."[44]

Issuers complained that, even as they seemed to require such costly individualized management of millions of consumer loans, financial institution examiners would interpret the Draft Guidance's recommendations as bright-line rules barring over-limit authorizations under any circumstances and requiring repayment of borrower workouts within forty-eight days.[45] Their existing policy of offering over-limit authorizations in certain circumstances was, the issuers claimed, an important customer-relations tool in getting and keeping the business of good, low-credit-risk customers who occasionally had emergency credit needs that caused them to exceed their limits. Without such discretionary over-limit authorizations, issuers would need to grant higher initial credit lines or else risk losing their best, lowest risk customers.[46] Similarly, the issuers argued against a bright-line forty-eight month repayment period in workouts, and in favor of a "reasonable and prudent timeframe[]" that would retain issuer discretion to "address each consumer's individual needs and circumstances."[47] The majority of consumers in debt-workout programs could not repay their outstanding balances within a forty-eight month period, the issuers argued, so if forty-eight months was made into a mandatory cap on repayment terms, issuers would have to respond by increasing interest rates and relaxing participation standards.[48]

C. *Home-Mortgage and Home-Equity Lending*

A similar pattern is revealed in home-equity and mortgage lending workouts. Home-loan workouts typically involve either a repayment plan in which a borrower in default is allowed to pay back the past-due amount over time, provided that she resume making contractually required periodic payments, or an actual modification of the loan in which the past-due amount is

> reduce or eliminate interest rates and fees so that more of the payment is applied to reduce principal.

Id.

[44] Letter from Paul A. Smith, Senior Counsel, Am. Bankers Ass'n, to David D. Gibbons, Deputy Comptroller for Credit Risk, Office of the Comptroller of Currency, et al. 2 (Sept. 23, 2002), *available at* http://www.aba.com/NR/rdonlyres/DC65CE12-B1C7-11D4-AB4A-00508B95258D/26583/CreditCardLendingGuidancefinalcmt9230993.pdf; *see also* Letter on Behalf of the Financial Services Roundtable (Sept. 23, 2002) (on file with author).

[45] Letter from Paul A. Smith to David G. Gibbons et al., *supra* note 44, at 4, 5.

[46] *Id.* at 5.

[47] *Id.* at 6.

[48] Letter on Behalf of the Financial Services Roundtable, *supra* note 44, at 2.

repaid over the life of the loan.[49] The adjustable rate mortgages that have, with low interest rates, made homes affordable to so many also put borrowers at risk for increases in monthly payments of between 50% and 90%, should interest rates rise, and over the last two years, the number of home-loan workouts nationally has increased from 155,495 over the entire year of 2004 to 89,741 in the first quarter of 2005 alone.[50] Online businesses now offer homeowners workout services and advice,[51] and large banks advertise on their websites that they will explore the full variety of workout strategies before foreclosing.[52] Just as with credit-card debt workouts, the need for home-loan workouts has seemed most acute with higher risk, subprime loans.[53] Indeed, Fannie Mae, whose statutory mission is to facilitate home-ownership by low- and middle-income families, has proclaimed a goal of working out mortgages with all of its borrowers "who run into trouble on their mortgages because of some temporary hardship, such as illness or unemployment," and states that in 2003, it completed workouts on fully one half of all its "troubled" loans.[54] The state of Massachusetts's Neighborhood Housing Rehabilitation Loan Program, which has the goal of making home-improvement loans to low- and moderate-income property owners, states that "[f]oreclosure should be viewed as a final option, and only when all other reasonable alternatives have failed," and has detailed guidelines on types of workout agreements that should be negotiated.[55]

[49] *See The Federal Housing Administration Single Family Program Property Disposition: Hearing Before the Subcomm. on Hous. and Cmty. Opportunity of the H. Comm. on Banking and Fin. Serv.*, 105th Cong. (Apr. 1, 1998) (Statement of Michael A. Quinn, Senior Vice President, Credit Loss Management, Fannie Mae), *available at* http://financialservices.house.gov/banking/4198quin.htm (last visited Nov. 20, 2005) (describing home-loan workouts).

[50] Terri Cullen, *"Workout" to Prevent Home Foreclosures*, REAL ESTATE J., July 22, 2005, http://www.realestatejournal.com/buysell/mortgages/20050722-cullen.html.

[51] *See, e.g.,* Foreclosureaid.com, http://www.foreclosureaid.com (last visited Nov. 20, 2005) (proclaiming itself the "[l]eading [f]oreclosures [s]ite on the [n]et"); Steven Wolpern, *A Basic Guide to Families Facing Foreclosure*, DOLLAR STRETCHER, http://www.stretcher.com/stories/990517m.cfm (last visited Nov. 20, 2005).

[52] For an example of large lenders' promises, see Ameriquest Mortgage Co., Ameriquest's "Best Practices" Policy, http://www.ameriquestmortgage.com/press.html (last visited Nov. 20, 2005) ("We want customers to stay in their homes. Specially trained home retention-associates [sic] evaluate all loans before the foreclosure process begins to ensure that a variety of workout options have been explored. Their sole responsibility is to make home retention strategies work."), and Wells Fargo, Responsible Lending for Non-Prime U.S. Real Estate Loans, http://financial.wellsfargo.com/responsible (last visited Nov. 20, 2005) ("We work diligently using our workout and repayment plans to help bring accounts current and mitigate losses.").

[53] Wells Fargo, *supra* note 52.

[54] Fannie Mae, Expanding the American Dream Commitment, http://www.fanniemae.com/initiatives/adc/index.jhtml?p=Initiatives&s=Expanding+the+American+Dream+Commitment (last visited Nov. 28, 2005).

[55] NEIGHBORHOOD HOUS. SERVS., MASS. DEP'T OF HOUS. AND CMTY. DEV., DELINQUENCY POLICIES AND PROCEDURES GUIDE, *available at* http://www.mass.gov/dhcd/components/cs/1PrgApps/NHS/DelProGd.pdf (last visited Nov. 19, 2005).

D. *The Rent-to-Own Industry*

A final example is provided by the rent-to-own industry. The rent-to-own business has grown from its beginnings in the 1960s to become a significant part of the American retailing market, with at least 8,000 stores in the United States generating revenues of over $5 billion.[56] In a typical rent-to-own contract, in exchange for paying a monthly or weekly rental fee, a consumer gets immediate possession of a durable good, such as an electric appliance, plus delivery, set up, and service without any down payment or credit check. At the end of each monthly (or weekly) period, the consumer can return the goods to the store without any further obligation. Consumers can also obtain ownership of the goods, either by paying rent for a specified period of time (usually eighteen to twenty-four months) or by making early payment of a fraction (usually 50–60%) of the remaining lease payments. If a consumer acquires ownership by making payments over the entire eighteen-to-twenty-four-month term, she will typically have paid two, three or even a higher multiple of retail price.[57]

Consumer advocates have criticized the high prices and other terms of rent-to-own contracts as exploiting low-income consumers. The industry has rebutted by arguing that the high prices are necessary to cover the costly services provided to rent-to-own customers, the cost of allowing consumers to return the merchandise at any time, and the high risk of doing business with customers who are poor credit risks and who have provided no down payment. Consumer advocates have attempted to get federal legislation passed that would regulate rent-to-own contracts as a form of consumer-installment contract.[58] Since rent-to-own contracts do give consumers the option of simply using and then returning the merchandise, they are not contracts in which consumers necessarily acquire title to goods by making payments over time, and so they are not, strictly-speaking, installment contracts. On the other hand, rent-to-own consumers do have the option of buying goods over a period of time, and so to this extent, these contracts do appear to be functionally the same as installment contracts. The hybrid nature of rent-to-own contracts has triggered an empirical debate over the relative frequency of rent-to-own consumer purchase versus return, with a 2000 Federal Trade Commission study finding that the majority of rent-to-own customers intend to and do buy the goods, while studies based on in-

[56] James M. Lacko et al., *Customer Experience with Rent-to-Own Transactions*, 21 J. PUB. POL'Y & MARKETING 126 (2002). The description of the rent-to-own contract that follows is also drawn from this article.

[57] *See* Brian J. Zikmund-Fisher & Andrew M. Parker, *Demand for Rent-to-Own Contracts: A Behavioral Economic Explanation*, 38 J. ECON. BEHAVIOR & ORG. 199, 201 (1999) (based on their survey and existing evidence, rent-to-own purchase payments are generally two to four times the purchase price with an implicit interest rate well over 100%; demand for rent-to-own even at these prices is a response by low- and moderate-income consumers to income and expense shocks and also a personal financial management tool to overcome myopic preferences).

[58] *See* Alix M. Freedman, *Peddling Dreams: A Marketing Giant Uses Its Sales Prowess to Profit on Poverty*, WALL ST. J., Sept. 22, 1993, at A1.

dustry data find that most customers rent but do not buy.[59] State courts in Minnesota, Wisconsin, and New Jersey have not waited for the empirical evidence and have simply ruled that rent-to-own transactions in those states are consumer-credit sales governed by their state consumer-credit-sales laws. The rent-to-own industry has reacted by introducing federal legislation that would preempt such state law decisions by declaring that nowhere are rent-to-own transactions a form of consumer-credit sale.[60]

What is most important about rent-to-own contracts for my purposes is that in the midst of this battle over precisely how and if rent-to-own contracts should be regulated, there are two key points of consensus among both industry and independent observers: that the vast majority of rent-to-own customers are indeed poor or middle-income, but that when consumers are late in making their rental payments (as have roughly half), the vast majority have felt that the treatment they received in dealing with the late payment situation was either "very good" or "good."[61] Indeed, a common practice in the rent-to-own industry is to give store managers the discretion to forgive renters who fall behind on their payments and to work out repayment plans so as to keep the business of valuable customers.

E. *Retail Sales Return Policies*

Legally, a consumer's default contract with a retail seller is *caveat emptor*, and the customer has no right to return items for a refund of the purchase price.[62] However, the vast majority of large retailers have varied the default by adopting a standard-form policy that grants consumers a right of return. Until recently, retailers also generally granted their on-the-ground

[59] *Compare* JAMES M. LACKO ET AL., FED. TRADE COMM'N, SURVEY OF RENT-TO-OWN CUSTOMERS (2000), *available at* http://www.ftc.gov/reports/renttoown/renttoownr.pdf; Lacko et. al., *supra* note 56; *and* Signe-Mary McKernan et al., *Empirical Evidence on the Determinants of Rent-to-Own Use and Purchase Behavior*, 17 ECON. DEV. Q. 22 (2003); *with* Michael H. Anderson & Raymond Jackson, *A Consideration of Rent-to-Own*, 35 J. CONSUMER AFFAIRS 295 (2001), *and* Michael H. Anderson & Raymond Jackson, Rent-to-Own Agreements: Purchases or Rentals? (U. Mass. Dartmouth, 2003), *available at* http://www.apro-rto.com/legalchannel/pdfs/studies/JABR_paper.pdf.

[60] For a discussion of the state decisions and proposed federal legislation, see Ed Winn III, *Capitol Steps*, PROGRESSIVE RENTALS, July-Aug. 2004, at 31; Ed Winn III, *States vs. Feds: Preemption Demystified*, PROGRESSIVE RENTALS, May-June, 2003, at 46; and Ed Winn III, *The Hill is Alive with the Sound of RTO*, PROGRESSIVE RENTALS, July-Aug. 2002, at 35.

[61] *See* Lacko et al., *supra* note 56, at 133; McKernan et. al., *supra* note 59, at 34. Thus it would be a grave error to take the furniture company in Williams v. Walker Thomas Funiture Co.—which had filed close to one hundred writs of replevin each year for a decade prior to that litigation, Eben Colby, What did the Doctrine of Unconscionability do to the Walker-Thomas Furniture Company?, 34 Conn. L. Rev. 625, 656 (2002)—as representative of the average rent-to-own firm today. This is yet another instance of the well-known unrepresentativeness of legal disputes that generate published appellate opinions, and a caution against basing legal reforms on the very unusual facts of such disputes.

[62] In New York, for example, retail stores may establish and enforce a no-cash and no-credit-card refund policy, but the retailer must announce its policy with "conspicuous signs" visible from each cash register or from the store entrance for the policy to be enforceable under state consumer protection statutes. *See* Baker v. Burlington Coat Factory Warehouse, 673 N.Y.S.2d 281, 283 (N.Y. City Ct. 1998).

employees vast amounts of discretion in liberalizing their official return policies so as to please consumers. So much discretion, however, that opportunistic consumers were taking advantage of the liberal return policies to obtain free product rentals. Retail-return policies thus not only dramatically illustrate the reality and significance of two-part standard-form contracts, but also how the profitability of such contracts depends crucially upon the ability of employees to screen for consumer type.

Return policies appear to run the gamut, both in whether they impose return costs and processing fees on the consumer and in time limits and product restrictions (for example, returns may be allowed only if product packaging is unopened).[63] Wal-Mart has a "satisfaction guaranteed" policy that allows consumers to return anything at virtually anytime, with or without receipt, and get back the full amount of purchase, while Saks Fifth Avenue has a policy granting a full refund of the purchase price only if the item is returned within sixty days in a "saleable condition" with proof of purchase.[64] Official return policies are not easy to enforce, however, and as actually implemented by on-the-ground employees, many retailers' official return policies have become ones of "liberal and almost unlimited returns," with consumers often given a full refund even without proof of purchase.[65] So liberal have return policies become that in the consumer electronics area, over seventy percent of products returned were found to have "no significant defect."[66]

Return policies clearly and dramatically illustrate both the advantages and disadvantages of the firm strategy of giving employees the discretion to expand upon standard-form customer rights. Even though a consumer may have no idea what a retailer's formal return policy may be,[67] consumers clearly like liberal return practices such as allowing long return periods, giving cash rather than just store credit, and allowing for the return even of sale items.[68] A recent poll found that 91% of customers considered return policies and processes as very important to their decision about where to make a purchase[69] (though only about 25% of customers make returns at all).[70] Lib-

[63] Stacy L. Wood, *Remote Purchase Environments: The Influence of Return Policy Leniency on Two-Stage Decision Processes*, 38 J. MKTG. RES. 157, 159 (2001).

[64] *See* Charles Passy, *Cranky Consumer: Get Set for Many Unhappy Returns*, WALL ST. J., Nov. 12, 2002, at D2; *see also* Lisa Kalis, *Catalog Critic: Bathrobes Get the Spa Treatment*, WALL ST. J., Aug. 20, 2004, at W4 (reviewing sellers of high-end, spa-quality bathrobes whose return periods vary from thirty to ninety days).

[65] Tony Sciarrotta, *How Philips Reduced Returns*, 7 SUPPLY CHAIN MGMT. REV. 32, 33 (2003).

[66] *Id.*

[67] *Id.* at 36 (discussing new policies by retailers, such as posting their return policy in plain sight of consumers).

[68] Wood, *supra* note 63, at 157.

[69] *See* Evan Schuman, *The War Against Retail Return Abuses*, EWEEK, Dec. 17, 2004, http://www.eweek.com/article2/0,1759,1743671,00.asp; *see also* Michele Chandler, *Retail Return Fraud Wearing Thin: Technology Helps Weed Out Abusers*, MESSENGER-INQUIRER, Mar. 13, 2005, http://www.messenger-inquirer.com/features/business/8207494.htm.

[70] Schuman, *supra* note 69.

eral returns are thus a way for retailers to keep consumers happy,[71] thereby generating repeat business and positive word-of-mouth.[72]

Liberal returns practices are also, however, subject to abuse by opportunistic consumers who "buy," use and then return a product, thus obtaining what is essentially a free product rental.[73] Such consumer abuse is hugely costly not only to retailers, but also to product manufacturers, who end up stuck with products that are not defective and whose secondary market value is only a fraction of product cost.[74] To reduce such customer abuse, retailers have recently undertaken measures to both identify and refuse return requests by opportunistic consumers and to limit employee discretion in granting returns. Retailers such as Kmart and Target have started to strictly enforce their standard-form policy of granting returns within the specified return period and only if the customer has the product receipt.[75] Retailers have begun to implement point-of-sale information systems that allow them to quickly identify repeat returners.[76] A company called The Return Exchange[77] has created a Windows-based SQL-Server database that creates customized rules to identify customers whose buying patterns make them look like return abusers. The system works as follows: when a customer attempts to return a product, the clerk asks for identification and enters that information (via the magnetic stripe on drivers' licenses) into a company-wide system. The data is automatically sent to The Return Exchange's server. The profile of a potential return abuser is based on complicated algorithms that are customized for each client, and is based on characteristics like time, duration, dollar amount, and frequency of return behavior. If the database spots abuse, it will send back a signal denying the return.[78] The technology is being used by Guess, Express, Sports Authority, Staples, and

[71] There has long been clear evidence that firms generally respond to consumers' product complaints in ways that consumers consider to be satisfactory. *See* Jean Braucher, *An Informal Resolution Model of Consumer Product Warranty Law*, 1985 WIS. L. REV. 1405, 1447–57. For more formal models of how firms use return policies to lower the consumer's risk of buying a defective product and thereby keep the business of high value, repeat consumers, see Yeon-Koo Che, *Customer Return Policies for Experience Goods*, 44 J. INDUS. ECON. 17 (1996) and Claes Fornell & Birger Wernerfelt, *A Model for Customer Complaint Management*, 7 MARKET. SCI. 287 (1988).

[72] For evidence on how customer satisfaction generally leads to repeat business and positive word-of-mouth communications, see Amy Wong & Amrik Sohal, *A Critical Incident Approach to the Examination of Customer Relationship Management in a Retail Chain: An Exploratory Study*, 6 QUAL. MKT. RES. 248, 249 (2003).

[73] *See* sources cited *supra* note 66.

[74] *See* Sciarrotta, *supra* note 65, at 33 (recounting how on DVDs sold at liquidators, Philips was recovering only 20 to 30 cents per dollar of factory costs). My focus here is on retailer-return policies, but those policies are of course directly affected by manufacturer-return policies. There is a quite substantial theoretical literature demonstrating how, by accepting retailer returns, a manufacturer lowers retailer risk and can induce retailers to more truthfully reveal information about the actual strength of consumer product demand. *See, e.g.*, Anil Arya & Brian Mittendorf, *Using Return Policies to Elicit Retailer Information*, 35 RAND J. ECON. 617 (2004).

[75] Sciarrotta, *supra* note 65, at 36.

[76] *Id.* at 37.

[77] The Return Exchange, http://www.returnexchange.com (last visited Nov. 20, 2005).

[78] Schuman, *supra* note 69.

KB Toys.[79] At the end of the day, says The Retail Exchange, it rejects only one-tenth of one percent of all the reviewed returns.[80]

While as I explain in more detail below, the way that stores have responded to return policy abuse makes consumers better off—by generating lower prices and better service—like other negotiating practices, it has become a target for regulation. Senator Schumer of New York has argued that the practice amounts to blacklisting customers who return "a bit too much," and is proposing to restrict the practice or make stores state the qualifications for "blacklisting" up front.[81] It is also being criticized and tracked by privacy rights groups.[82]

F. *Only the Tip of the Iceberg: Can Everything Be Renegotiated?*

The standard-form contracting situations that I have discussed above are those where there is at least some systematic evidence for the frequency of the two-part standard-form contract. The practice is, however, almost surely not confined to these particular industries or transactions. Most consumer goods are sold on a fixed- or posted-price basis, and it is typically assumed by legal scholars that consumers do not negotiate over price. Yet there is clear evidence that during economic recessions, sharp consumers recognize and seize the opportunity to bargain over price and payment terms (cash versus credit) for consumer durables.[83] A fascinating recent journalistic experiment, moreover, indicates that bargaining around standard-form terms and policies may be a very general and widespread possibility.[84] For three months, freelance journalist Tom Chiarella attempted to negotiate over price and terms on every transaction he engaged in, from the smallest—buying a hot dog from a street vendor—to the largest—replacing a lost remote rental car key that was originally supposed to cost $1200 to replace. What Chiarella found was that while some prices are indeed fixed, other terms—such as the $1200 cost replacing the remote automobile key—can be negotiated. Indeed, by working his way up the managerial chain, and eventually reaching the regional manager, he succeeded not only in avoiding the $1200 replacement cost but in getting a two-week rental for free. While obviously anecdotal, this journalistic experience dramatically depicts bargaining around standard-form terms and policies: by incurring the costs of negotiating, the consumer eventually reaches an employee with the discretion to

[79] Chandler, *supra* note 69.

[80] Schuman, *supra* note 69.

[81] *Id.*

[82] *See, e.g.*, Privacy Rights Clearinghouse, Alert: The Return Exchange—Have You Been Denied the Ability to Make Returns or Exchanges with Large Retailers? We Want to Know (Nov. 17, 2004), http://www.privacyrights.org/ar/ReturnExchange.htm.

[83] Jeffrey A. Trachtenberg, *Let's Make a Deal: A Buyer's Market Has Shoppers Demanding and Getting Discounts*, WALL ST. J., Feb. 8, 1991, at A1.

[84] Tom Chiarella, *Haggling for Hot Dogs (and Other Real-Life Adventures in the Neglected Art of Negotiation)*, ESQUIRE, Feb. 2005, at 115.

decide that the consumer's loyalty and future business is sufficiently valuable that a departure from standard terms is in the firm's economic interest.

III. Explaining Observed Behavior: Designing Standard-Form Terms that Are Meant to Be Forgiven

In all of the empirical examples, a business uses a standard-form contract that establishes a clear, bright-line obligation, but the business gives its supervisory employees the discretion to do more for the customer than the standard-form obligations require. A very strong economic logic motivates this very common contracting practice: the desire of firms to maximize not only short-term profits, but also long-term value.

Growing earnings over time requires either continually decreasing costs and/or continually increasing revenues. On the revenue side, growth comes from increasing sales, either by getting existing customers to buy more or by attracting new customers. While decreasing the price of a product or service is sometimes crucial to growing revenues, for firms who produce differentiated products and services (which is by far and away most firms), the real key to growing revenues is to continually improve the quality of the product or service they offer, and to do so in a way that attracts new customers while not causing the loss or defection of existing customers. The strategy of allowing employees the discretion to grant case-specific benefits beyond those that are required by the standard-form contract can be seen to be a sophisticated way for the firm to grow its revenues by gaining the loyalty of existing customers and establishing a good reputation that will attract new customers. There are in fact two slightly different aspects to this strategy. These are captured by the examples set out earlier, which actually comprise two different situations. In the first, the good or service provided was not up to the customer's expectation, and the customer complains seeking some kind of compensation from the provider. I shall refer to this as the strategy of awarding discretionary benefits. In the second type of case, the customer has not lived up to her obligations under the standard-form contract, but the provider forgives her technical breach and renegotiates. I shall refer to this as the strategy of discretionary forgiveness.[85]

[85] There is an interesting contrast between the pattern that I explain in this section—one where firms intentionally adopt relatively clear, bright-line standard-form terms which they intend to bargain around—and the pattern that Bernstein found in the cotton industry, where cotton merchants and traders work out their problems cooperatively subject to bright-line industry trade rules. Bernstein, *supra* note 1, at 1732–35, 1776–81. Unlike Bernstein's cotton-industry norms, which are driven by the desire of industry participants to develop and maintain good reputations for efficiently performing and resolving disputes, the incentive for firms to negotiate around bright-line terms is driven by the desire to attract some kinds of consumers and to avoid others, a more precise screening function than is apparent in Bernstein's study of the cotton industry. There are some similarities between my analysis and that presented by Bebchuk and Posner in this volume, and I note these at various points below. Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 Mich. L. Rev 827 (2006). Gilo and Porat believe, as do Bebchuk and Posner and I, that standard-form contracts are important instruments for firms to screen or select different consumer types, but they believe, contrary in my view to the existing evidence, that standard-form terms themselves confer precise benefits on consumers who have the sophistication to

A. *Discretionary Forgiveness as Ex-post Customer Screening*

The key to understanding why a firm can benefit by allowing its employees to forgive some customers' contract breaches lies in the recognition that not all existing customers are worth keeping. Some consumers are honest, some are not. Some consumers have a highly secure economic base and ability to pay, while others have jobs and income flows that are much more uncertain. An opportunistic consumer who really wants a new coat may deliberately damage the coat if she thinks that she'll get a discount that makes the coat affordable by so doing; an honest consumer may unknowingly select a damaged coat from the rack. A naïve consumer may run up enormous credit-card bills and be surprised to learn that she has accumulated a repayment obligation that she cannot carry; a more sophisticated (and wealthier) consumer may use her credit card only for the convenience of cashless monthly interest-free loans. An honest patient may fully expect to pay her hospital bills but lose her job; an opportunistic patient may demand a medical procedure today, even though she knows that she cannot pay for it.

A firm interested in steadily growing its earnings will seek to build and maintain relationships with good customers and to avoid or terminate relationships with bad customers. It will seek, in other words, to build a loyal and profitable customer base.[86] As the credit-card companies stated in their trade association's formal response to the 2002 Draft Guidance, the overriding business goal of consumer lenders is to build and retain a profitable, long-term relationship, and the best way to do so is to get customers "back on track with a repayment agreement with a low probability of default."[87]

The strategy of adopting bright-line standard-form terms and then granting discretionary forgiveness allows businesses to identify or screen for good, high-value customers under circumstances when they could not do so with the contract term itself. To see why this is so, consider the very important example of repayment terms. Lenders and creditors more generally renegotiate these when their employees have determined that there is a good reason for the borrower's failure to make timely payment. A "good" reason is something beyond the borrower's control, such as an illness or loss of a job (or for a business, a sudden downturn in market conditions). A borrower who has fallen behind only because of such an unusual and extraordinary event is a valuable customer, someone who is basically a very good credit risk and on whom the lender will on average make money.

read them, so that standard-form terms are themselves used to screen consumers. David Gilo & Ariel Porat, *The Hidden Roles of Boilerplate in Standard-Form Contracts*, 104 MICH. L. REV. 983 (2006). In my model, precisely the opposite is true: standard-form terms offer little, and firms then allow their employees to exercise discretion in identifying those consumers with respect to whom it is profitable to go beyond standard-form obligations.

[86] For empirical evidence that it is indeed those firms with large fixed capital and hence a large stake in building enduring customer relationships who are most interested in minimizing and responding cooperatively to customer complaints, see Sharon Oster, *The Determinants of Consumer Complaints*, 62 REV. ECON. & STAT. 603 (1980).

[87] Ken Maynard, *Customer Service: The Key to Collection Success*, CREDIT MGMT., Oct. 2003, at 44.

A lender can successfully screen for such "good" types by setting clear standard-form terms that are sometimes waived (or not enforced) when it could not do so by using a simple standard-form contract without renegotiation. Suppose, for instance, that the lender eliminated its managers' discretion to forgive and altered the standard-form terms to require a shorter repayment period and/or a higher interest rate. By demanding such harsh terms up front, in the standard-form contract, the lender would lose the business of "good," lower-income borrowers who will keep their promises to make timely repayments while doing nothing to lose the business of "bad," opportunistic borrowers who borrow with no intention of repaying on schedule. By the same reasoning, we can see the tradeoff that the lender confronts in arriving at the optimum, profit-maximizing combination of standard-form terms and discretionary forgiveness. On the one hand, the lower the standard-form interest rate and the longer the standard-form repayment period, the greater the number of good, honest borrowers who sign on and the lower the probability of costly, forgiving renegotiation with such borrowers. On the other hand, a lower interest rate and longer repayment period mean lower revenues from such borrowers. Conversely, were the lender to raise the interest rate and shorten the repayment period, it would increase revenues from good borrowers, but also decrease the proportion of good borrowers and increase the probability of costly renegotiation with good borrowers. The optimal terms result from solving this trade-off.[88]

What necessitates the two-part contract—clear standard-form terms plus managerial discretion to renegotiate—is a fundamental economic problem known as adverse selection (or hidden information).[89] Adverse selection refers to the problem of designing a contract when the contract may attract different types of contracting parties—some honest, some opportunistic, for example—who bring correspondingly different costs and benefits to the relationship. Tailored forgiveness deals with the problem of hidden customer types. In dealing with the hidden type problem, tailored forgiveness is a substitute for ex-ante screening. That is, a firm that has tough standard-form terms and then delegates discretion to renegotiate when its managers believe that the customer has not behaved opportunistically does not have to worry so much about identifying opportunistic types before entering the contract. If it turns out that the customer behavior was indeed opportunistic, its manager will insist upon adherence to the unforgiving standard-form terms.

More concretely, under the two-part contract—standard-form terms plus discretionary forgiveness—a seller does not need to rely upon price and other standard-form terms to screen buyer types, and these terms will generally be more generous to the buyer than they would if the seller was denied the discretion to renegotiate. A lender, for example, will set a lower stated interest rate and more generous repayment terms than it would if denied the

[88] This result is demonstrated in the appendix. *See infra* App.

[89] This important general result is due to Joseph Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981).

legal ability to use its discretion to forgive breach of the standard-form terms.[90]

Interestingly, although economists have recognized the adverse selection problem confronting creditors and other providers of consumer goods and services, they have failed to discuss two-part contracts as a market solution to this problem. Rather than ex-post forgiving renegotiation, economists have focused on ex-ante mechanisms that creditors use to screen out bad credit risks, such as requiring collateral, or lending only to consumers with whom they have had ongoing personal contact (referred to generally in the lending context as "credit rationing").[91] Compared with ex-post renegotiation, such ex-ante screening has the disadvantage of making it hard for "new" consumers—those without an established reputation—to obtain credit. Rather than screening ex ante on the basis of wealth or relationship, two-part contracts in effect say, "we do not know you, but we will give you a chance." In this light, it is clear that two-part contracts serve a very important social as well as economic function: they make it economically rational for creditors and other providers to do business with consumers who, because of their age, ethnicity or nationality, have not yet had an opportunity to establish either accumulated wealth or valuable personal relationships.

B. *Individualized versus Algorithmic Renegotiation*

In the several empirically important examples discussed above, the seller or lender does not incur the high cost of having its employees individually renegotiate forgiveness, but rather relies upon general rules of thumb or algorithms that all employees use in determining whether or not to forgive breach. Indeed, the credit-card industry, in its highly negative reaction to recent regulatory guidance, complained that the guidance both required costly individualized renegotiations while also seeming to set up bright-line rules for the terms of those negotiations (such as requiring that repayments be made within forty-eight months).[92]

On my analysis, there is no reason for regulators to insist upon such individualized bargaining at the forgiveness stage of a two-part standard-form contract. After all, a seller or lender is using the second stage to determine whether or not the buyer or borrower is or is not worth keeping as a customer. The entire point of the two-part contract is to efficiently get information about a buyer or borrower type, and efficiency in information acquisition necessarily involves a trade-off between accuracy and cost. From

[90] Note that even if firms are able to quite accurately assess consumer type at the negotiation stage, it may be that courts are unable to verify consumer type. This problem—types are privately observable but not verifiable to third party enforcers—is a standard law-and-economics explanation for contractual incompleteness. I discuss in some detail below the limits to judicial verification of both consumer and firm opportunism, but my basic approach is to presume that consumer opportunism is not verifiable and so firms have to solve it on their own.

[91] See, for example, DAVID S. EVANS & RICHARD SCHMALENSEE, PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING 104-05 (2d ed. 2005).

[92] *See supra* notes 44–48 and accompanying text.

the evidence discussed earlier, providers that have a relatively small number of accounts to manage—such as hospitals—seem to find it economic to engage in a more individualized forgiveness[93] renegotiation than do providers—such as credit-card issuers—who have millions of accounts and rely upon generalized algorithms that, for instance, extend additional credit *x* number of times automatically.[94] In reasonably competitive markets, the lower the cost of forgiveness, the better off both the provider and its consumer clients are.

Were regulators to make it too costly for providers to engage in ex-post forgiveness, they might well make the two-part contract uneconomic for providers. As just argued, if restricted to a one-part contract in which only price and other standard-form terms may be used to screen customer types, it is on my analysis very likely that providers would increase price and toughen payment terms. Thus as the credit-card issuers argued, adoption of regulations that make forgiveness of late or inadequate payments too costly would indeed likely cause a "number" of institutions to stop making new credit loans to subprime borrowers, thus restricting credit availability to many low- and moderate-income families.[95]

C. *Discretionary Benefits and the Potential Instability of Consumer Screening through Two-Part Standard-Form Contracts*

Another version of the two-part contract involves the awarding of discretionary ex-post customer benefits. For many firms, the most important type of customer to keep happy is the customer who is relatively knowledgeable, persuasive, and strategic—a sharp bargainer. Such customers are likely to be a lucrative source of repeat business if they remain satisfied with the firm's services. By the same token, if they terminate their relationships with the firm because they are dissatisfied with the quality of the firm's services, they are likely to be an especially influential source of negative word-of-mouth advertising. Such customers are also more likely to complain than is the typical customer. The strategy of allowing its employees to respond to such complaints with various forms of compensatory benefits is a cost-minimizing way for the firm to increase the probability that it will keep the business of such consumers. By waiting for the consumer to make the first move—by complaining—the company effectively lets the high-value, high-information consumers identify themselves. That is, the consumers who will complain most often and loudest are presumably those who are most inconvenienced by the failure of the product or service to meet their expectations. Other consumers may not even be aware of the possibility of obtaining relief by complaining to the company. Rather than seeking out customer

[93] *See supra* Part II.A.

[94] *See supra* Part II.B.

[95] Letter on behalf of the Financial Services Roundtable, *supra* note 44, at 2.

complaints, a policy of awarding complaint-based benefits allows the company to satisfy those consumers who are most demanding.

Under the economic terminology introduced above, awarding complaint-based benefits is a strategy to deal with the hidden type problem that the firm faces when customers differ in their sophistication and in the value they attach to the firm's performance. Simply put, the firm would like to attract and keep the business of high-value, high-sophistication customers without giving every customer the same benefits as it gives these high demanders. That is, were the benefits extended to complaining high-value customers part of the firm's standard-form package, the firm would have needlessly increased its costs by offering benefits to lots of customers who do not expect them and who would buy the firm's product or service regardless of whether those benefits were offered.

As for the demanding consumers, it is theoretically possible that they would be better off with a more expensive, higher-quality good or service. However, when sophisticated, demanding consumers are in a minority and there are lots of naïve, uncomplaining consumers, then the price of the lower quality good or service may be low enough so that the sophisticated consumers are better off with the lower quality good (plus complaint-based compensation when things go wrong), than they would be with the higher-quality, higher-price good. When these conditions hold, the complaint-based benefits strategy not only allows the firm to retain and add sophisticated, influential customers, but effectively gives those customers a price subsidy that is paid for by less-well-informed, or simply more acquiescent, consumers.[96]

By this same token, however, the complaint-based benefits strategy creates an opportunity for new firms to enter and offer the good or service on a simple one-part contract that offers no discretionary benefits but charges a lower price.[97] Since by hypothesis low-value consumers do not demand discretionary benefits, the simple, low-price contract will give them the same good or service as they receive under the two-part contract, but at a lower price. Hence, such a contract will attract the business of all the low-value consumers. The entry into the market of low-price, "no-frills" providers will destroy the cross-subsidy offered by the two-part contract, and with such entry, that market may segment into low-price, no-frills providers and high-price, quality providers. In such a segmented equilibrium, there will no longer be any reason to use bargaining around the standard form, no frills terms to screen out high-value consumers.

[96] To see this, suppose that it costs the firm an amount c to provide the basic good or service, but an extra amount f to provide frills demanded by a high-value type, and let the probability of a low-value consumer be q, while the probability of high-value-consumer type is then $(1 - q)$. Under a strategy of granting frills only when the consumer reveals herself to be a high-value type, the firm's expected costs, which will equal price, p, under competition, are given by $qc + (1 - q)(c + f) = c + (1 - q)f = p$. Hence the price p both above the cost c of servicing low-value consumers and below the cost $(c + f)$ of servicing high-value consumers.

[97] That is, using the notation set out above, *supra* note 96, a competitive contract of this form sets $p = c$.

In some markets precisely such a phenomenon seems to have occurred. Higher-cost, higher-price "legacy" airlines such as American Airlines and Delta have for some time used optional first-class upgrades and other tools to identify and compensate valuable customers. The Travel Insider reports that "airlines have become very much more sophisticated in how they handle their first class seats" by using information technology to identify valuable customers: "with the great deal of information now on [gate] agents' computer screens about each individual passenger, the fare they paid, and their frequent flier status, [airlines now] have set procedures for who gets upgraded first and who gets upgraded last . . . ."[98] Before information was available to gate agents, they "truly could close their eyes and choose passengers, seemingly at random" for upgrades.[99] Now, however, agents "are expected to follow set procedures if/when upgrading for free."[100] "Because of these extra procedures and extra information," continues the article, "it is much harder for people to get themselves pushed up the upgrade eligibility list *unless they have a valid entitlement to enhanced status*."[101]

Such a strategy of discretionary benefits may please high-value frequent airline travelers, but it provides no benefits to low-value passengers. Following the lead of Southwest Airlines, during the 1990s a number of low-price, no-frills carriers entered the market and targeted precisely such low-value passengers. Such carriers offer no discretionary benefits such as upgrades, but they do offer very low prices. Predictably, they have attracted a large number of customers and have placed enormous pressure on the pricing strategies of legacy carriers.

As this example shows, market structure imposes quite definite limits on the ability of firms to use the two-part standard-form contracting strategy as a way of screening for high-value customers. Unless there are barriers to entry, or consumers have very high switching costs, the discretionary-benefits strategy will be undermined by the entry of no-frills, low-price providers.[102] This analysis thus generates the sharp empirical implication that

[98] *Free Fist Class Upgrade—Fantasy or Fact?*, TRAVEL INSIDER, Feb. 19, 2005, http://www.thetravelinsider.info/2003/0228.htm.

[99] *Id.*

[100] *Id.*

[101] *Id.* (emphasis added). The article continues, "Almost without exception, if an airline is going to give away empty first class seats, they will start off with their 'best' frequent fliers and/or the people that paid the highest fares." *Id.* Observe that just as providers have an interest in lowering the transaction costs of discretionary forgiveness, so too do they have an interest in finding algorithms and rules of thumb that effectively and cheaply discriminate among customers in granting discretionary benefits. As the legacy carriers' practices illustrate, as computational speed and capacity have increased, the algorithms available to firms for such ex-post screening use increasingly detailed and accurate customer-specific information. As a consequence, firms can rely on information about customer value that they have directly collected and need rely less on customer complaints as a signal of customer type.

[102] Discretionary benefits are in this important sense quite different than the case of shrouded costs considered by Gabaix and Laibson. *See* Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. (forthcoming Aug. 2006), *available at* http://econ-www.mit.edu/faculty/download_pdf.php?id=527.

the two-part standard-form contracting practice should exhibit long-term survival only in industries that are relatively noncompetitive.

This does not, however, imply that it is only in such relatively noncompetitive industries that we will observe such a contracting strategy. Even if undermined from below, as it were, by the entry of no-frills providers, the discretionary-benefits strategy may have been a valuable, albeit temporary, instrument for firms. The strategy allows firms to identify and attract high-value, sophisticated consumers. Hence even if firms using such a strategy eventually lose their low-value consumers to low-price, no-frills entrants, the discretionary benefits strategy may well have accelerated growth in firm size and sales for a number of years, thus increasing the firm's stock market value. The two-part strategy will also have given firms lots of information about high-value consumers, information that firms can use in devising new price and nonprice strategies designed to keep the business and maximize revenues from such high-value consumers.

IV. The Value of Discretion: Distributional Issues in the Regulationof Standard-Form Contracts and Their Renegotiation

An immediate implication of the preceding analysis is that the effect of laws or regulations mandating generous standard-form terms would be to replace a system in which firms extend a wide and trusting invitation and then enforce standard-form terms only against those whom its on-the-ground managers have found to have violated that trust, with one in which firms use only attorney-drafted standard-form terms to control their exposure to contractual risk. Such a move from individualized ex-post screening to crude ex-ante screening may well harm the very groups—such as generally poorer, economically disadvantaged racial minorities—that it was designed to help.

On the other hand, mandating that firms offer generous terms in the ex-ante standard-form contract, rather than allowing firms to exercise their discretion in determining when and whether to grant such terms ex post when problems arise, might well prevent the cross-subsidization of high-value, sophisticated consumers by low-value, less sophisticated consumers that is entailed by the discretionary strategy. That is, by mandating generous standard-form terms, the firm's cost, and hence the competitive price, would increase.

Such a price increase will almost surely be higher than the increase in value that any consumer type gets from the mandatory terms. The reason why this is so is crucial to understand, for it sharply distinguishes this analysis of mandatory standard-form terms from earlier law-and-economics work on the topic. When the law mandates generous standard-form terms, it is

There, unsophisticated consumers subsidize sophisticated consumers because they pay supra-competitive prices for add-on services that sophisticated consumers avoid, but there is no incentive for new firms to enter to steal the business of the unsophisticated consumers, because by assumption, the unsophisticated do not realize that they will demand and buy the add-on services.

possible that it is giving low-value, low-sophistication consumers terms that they value at more than their cost, but which they did not get under the discretionary strategy because they lack the sophistication, or simple willingness, to complain and bargain ex post. However, if this is true, then it would seem that firms would have been better off simply offering and advertising the generous standard-form package in the first place. When, however, the firm promises all customers these generous terms, it has lost the ability to screen for customer opportunism.[103] Such opportunism is costly. Hence when the firm sells a standard-form package with all the various benefits and forgiving adjustments that it would otherwise have made on a discretionary basis under the tough standard-form contract, nonopportunistic customers must pay for the costs of opportunism that the firm can no longer control. While low-value, low-sophistication customers might indeed value discretionary benefits at more than they cost the firm when they are not opportunistically claimed, such customers may well not value the benefits as highly as their cost to the firm when it can no longer control opportunistic claims. That is, in this model, the firm's costs are endogenous, and they are systematically higher when being nice is required, so that the firm cannot control opportunistic claiming, than when being nice is discretionary, so that it can control such opportunism.

This is to argue that it is very likely that low-value, low-sophistication customers will be priced out of the market if policies that were discretionary with the firm become part of the firm's standard-form obligations. It is true that when opportunism is not so serious as to price out the low-value, low-sophistication customers, mandating generous standard-form terms may eliminate the cross-subsidization of high-value, highly sophisticated customers by low-value, low-sophistication customers. All customers may end up getting the benefits that accrued only to the higher value customers under the discretionary strategy.

Such a happy outcome is, however, not likely. For one thing, since opportunism becomes a more severe problem under mandatory generous standard-form terms, the firm will have a very strong incentive to instruct employees to behave in a non-cooperative fashion when customers bring complaints by insisting upon very narrow and legalistic interpretations of the firm's superficially generous standard-form contractual obligations. Thus, whereas under the discretionary strategy high-value customers were met with an ex-post willingness to bargain, they will often encounter precisely the opposite, unreasonable insistence upon narrow interpretations of standard-form obligations, in the world of mandatory standard-form terms. This makes it much more likely that the high-value, high-sophistication types will drop out of the market for the firm's product or service and switch their business to a more expensive higher-quality provider, a provider whose prices are so high that low-value, low-sophistication customers are not part of the market. In such a case, mandating generous standard-form terms may induce a kind of adverse selection; as higher-value customers drop out, and

[103] This insight is the basis for the analysis in Bebchuck & Posner, *supra* note 85, at 87–28.

the ostensibly generous standard-form terms offered to remaining low-value, low-sophistication customers are in practice degraded further and further.

All of this analysis, moreover, presumes my conflation of high-value with high-sophistication. While it may be true that high-income, high-education customers are the ones who get the benefits of the discretionary-firm strategy, this is not necessarily the case.[104] It might well be that it is the middle-income customer who is most familiar with and adept at bargaining with the firm when something goes wrong with her or the firm's performance. High sophistication, this to say, may accompany middle or even low income. If this is so, then the tough standard form combined with discretionary forgiveness strategy may be one which especially benefits customers who are keen but not wealthy. Indeed, it is precisely such customers, rather than high-wealth customers, who are likely to be most attracted to the products or services of a firm with relatively low prices and meager standard-form promises but which will bargain when things go wrong. By the same token, it will be such smart but middle-income customers who will be most harmed by a legal rule mandating generous standard-form terms.

V. Standard-Form Terms and the Doctrinal Control of Firm Opportunism

A. *The Complexity of Opportunism*

It may quite aptly be objected that opportunism cuts both ways, that just as consumers and employees might opportunistically invoke generous standard-form contractual rights, so too might opportunistic firms harshly and unfairly enforce harsh standard-form clauses. While this is indeed possible, such behavior would alienate and drive away customers. And if word-of-mouth is indeed as important as many contemporary marketing experts increasingly believe, by unfairly driving away their current customers, such firms would do much to ensure that they do not get future customers.[105] Thus, while firm opportunism cannot be ruled out as a general theoretical matter, it seems likely to be a potentially profitable strategy only where the firm is selling a good or service that consumers buy only very infrequently and in small quantity, and where the firm makes its sales in widely diffuse locations that are not part of the same consumer word-of-mouth network.

Still, to call a firm that rigidly enforces the harsh terms of its standard-form contracts opportunistic is to strain the meaning of the term. After all,

[104] This is similar to the point made by Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 Stan. L. Rev. 361, 377–80 (1991) (arguing that if poor consumers attach low value both to a product and to a generous term such as a warranty, then they may be made worse off when the law mandates such a term, because high-value consumers drive up the price of the good by a large amount when the warranty is mandated).

[105] *See* Bebchuck & Posner, *supra* note 85, at 829–30 (presuming that when firms are sensitive to their market reputations, the problem for contract design is in controlling consumer, not firm, opportunism).

such a firm is just doing what it has a contractual right to do and is in a sense a much more straightforward actor than the firm that awards discretionary forgiveness and discretionary benefits. Real firm opportunism would seem to consist not in being a literalist about form contract rights and obligations, but in creating a false appearance of pursuing a policy of forgiveness or complaint-based benefits by mimicking the behavior of a firm that really does implement these strategies. The truly opportunistic firm would take steps to appear to pursue a nice, forgiving strategy, while eventually reneging on those promises for various technical or legalistic reasons that are burdensome or impossible for most consumers, even quite sophisticated ones, to sort through. Indeed, a firm might be so successful in clouding and confusing the consumer as to its employment of such a strategy that even existing customers are not aware of what has happened: they may actually believe that the firm has a legitimate reason for failing to forgive or to respond to their complaints.

If opportunistic firms are indeed successful in mimicking forgiving firms, their presence may eventually lower the incentive for firms to be forgiving. This effect is somewhat complex. On the one hand, a legitimately good firm still pleases and retains its customers, who remain with it and inform other potential new customers. On the other hand, even a good firm sometimes fails to forgive (indeed, this is the way that consumer opportunism is disciplined), and opportunistic consumers may spread bad, false news about good firms, news that is in general credible when there are some opportunistic firms in the overall market mix.

B. *Doctrinal Implications*

The possibility of good and bad types on both sides of the firm-consumer divide raises an obvious question about the potential for laws and regulations to improve the performance of two-part standard-form contracts. My general answer to this question is that courts should support the standard-form, discretionary benefits/forgiveness market equilibrium. To get more precise prescriptions for judicial action (or inaction), the key thing to see about the market equilibrium is that in it, while all firms have very strong incentives to actually discipline customer opportunism, only those firms that are long-run players in the game and really seek to build lasting customer relationships have an incentive to actually confer discretionary benefits beyond what they have promised in their form contracts.

For firms that are opportunistic short-run players, the second stage is too costly. Such opportunistic firms will instead rely upon the standard-form terms themselves to extract consumer rents, setting up standard-form terms that are onerous and then refusing to renegotiate them at all, or fraudulently promising but then failing to forgive. Indeed, and most seriously for the viability of socially desirable market equilibrium in two-part contracts, if firms could renege on promises to be forgiving of customer breach or to extend benefits to rectify customer disappointment with their own performance failures without customers actually being able to determine whether the firm in fact has a valid legal reason for so doing, to in effect shroud their failures in complex legalese, then all firms would have an incentive to pursue such a highly opportunistic strategy. The market equilibrium posited above would then unbundle.

It is, unfortunately, far from clear that courts can do much to prevent such firm opportunism. One's first thought might well be that courts could reduce firm opportunism by holding firms to their agents' ex-post (that is, after the standard-form contract has been made) promises offering discretionary forgiveness or complaint-based benefits. Somewhat unconventionally, the crucial legal doctrines in implementing this role are not those—such as the unconscionability doctrine considered below—that get at whether the standard-form contract was itself in some sense fairly bargained for. They are instead doctrines governing the enforceability of relatively informal promises made apart from or in the process of renegotiating the standard-form contract. Candidate doctrines would include those determining the enforceability of an express warranty made outside a standard-form contract that by its terms excludes any such warranties and the enforceability of an oral modification of a standard-form contract that by its terms precludes any such oral modification.

It is possible that through such doctrines, courts could increase the cost to opportunistic firms of inducing consumers to make more payments by promising but failing to deliver discretionary benefits or forgiveness. But there are opportunistic consumers as well as firms.[106] After all, the whole point of the strategy of discretionary benefits/forgiveness is to screen for opportunistic consumer types. Such opportunistic consumers are the ones to whom the firm will not promise forgiveness or extra benefits. But they are precisely the ones who will file lawsuits claiming that such promises were made when they in fact were not. If courts are prone to making errors in determining whether such promises were made, and in particular have a high probability of a false positive (finding a promise was made when one was not), then they increase the incentive for such opportunistic, bad-faith lawsuits. Substantive legal rules strongly impact the likelihood of such errors. The legal fact-finder may well interpret evidence that the defendant firm has a general practice of giving its agents the discretion to forgive the breach of or go beyond promises contained in the standard-form contract as indicating that its agents did precisely that in this particular instance. Hence contract-law rules that presume that the terms of a present contract are affected by prior course of dealing or past performance tend to facilitate plaintiff opportunism and raise the risk that a defendant firm will be erroneously held liable for a forgiving promise that it never made. If sufficiently likely, such erroneous ex-post liability may increase the cost to the firm of

[106] The importance of two-sided opportunism and opportunistic, bad-faith lawsuits cannot be overestimated. For an analytical treatment of two-sided opportunism and a discussion of how the possibility of bad-faith, opportunistic lawsuits figures in neoclassical economic analysis of the proper scope of legal rules protecting against contractual opportunism, see Jason Scott Johnston, *Opting in and Opting out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291, 301–08 (1992).

pursuing two-part standard-form contracts by so much that firms no longer allow discretionary forgiveness/benefits, thus destroying what is in general a socially desirable market outcome.

This argument recommends that if courts are to get into the business of enforcing promises of discretionary forgiveness/benefits that are made after and go beyond standard-form obligations, then they should do so only if there is very strong evidence that the promise was in fact made. As I read the central cases, while some courts have followed this recommendation, others have been, if anything, too cautious in enforcing such promises. My analysis suggests that with sufficient evidentiary safeguards, oral misrepresentations by a firm's agent that deviate from standard-form contract terms are a form of opportunistic exploitation that should be deemed fraudulent and hence should constitute grounds for rescinding a contract. State high courts, however, appear to be split on the issue of whether general standard-form merger clauses[107] and/or language that disclaims reliance on oral representations bar actions for fraud claiming that oral representations by the firm's agents in fact induced such reliance.[108] On my analysis, provided that the proof standard is sufficiently high, standard-form disclaimers and merger clauses should not bar proof that such oral representations were indeed made. Such an approach is precisely what courts have taken in dealing with a closely related issue, the enforceability of oral agreements modifying written standard-form contracts that by their terms prohibit oral modification.[109] Here the courts have held that while detrimental reliance or partial performance may make enforceable an oral promise modifying obligations in a standard-form contract that precludes such modification unless in writing, such reliance or performance must be "unequivocally referable" to the oral modifying promise and must not be "compatible" with the original agreement.[110]

[107] Calling the situation on this particular issue a "split" may be going too far, as even the strongest judicial statement in favor of holding that a merger clause bars evidence of fraud, UAW-GM Human Res. Ctr. v. KSL Recreation Corp., 579 N.W.2d 411 (Mich. Ct. App. 1998), has already been subject to the limiting interpretation that it is inapplicable to frauds that allegedly nullify assent to an entire contract, as opposed to assent to a particular term. *See* Star Ins. Co. v. United Commercial Ins. Agency, 392 F. Supp. 2d 927, 928-29 (E.D. Mich. 2005).

[108] *Compare* Van Der Stok v. Van Voorhees, 866 A.2d 972, 975–76 (N.H. 2005), *and* Snyder v. Lovercheck, 992 P.2d 1079, 1084–85 (Wyo. 1999), *with* Danann Realty Corp. v. Harris, 157 N.E.2d 597, 599 (N.Y. 1959).

[109] It is tautologically true that oral promises modifying a standard-form contract are made after oral promises or representations that are made before the individual has actually entered into the contract. It is true that the evidence I discuss above pertains almost entirely to post-contractual renegotiation by such agents. However, on my analysis, what is crucial is that firms screen customers by giving their agents the discretion to be more generous than the standard-form and that there is indeed evidence that this discretion is exercised. To the extent that the cases on, in particular, oral express warranties expanding upon the limiting language of a standard-form show that agents are making promises before the contract is even entered into, the cases themselves provide even more evidence of the kind of bargaining I discuss, including evidence suggesting that the bargaining to vary the terms of the standard-form may often occur much earlier, at the contract formation stage.

[110] *See* Towers Charter & Marine Corp. v. Cadillac Ins. Co., 894 F.2d 516, 522 (2d Cir. 1990) (citing Rose v. Spa Realty Assocs., 366 N.E.2d 1279, 1283 (N.Y. 1977)); *see also* Wis. Knife Works v. Nat'l Metal Crafters, 781 F.2d 1280 (7th Cir. 1986) (interpreting oral promises modifying

Courts have dealt with consumer-sales contracts falling under the Uniform Commercial Code in a somewhat more liberal way. On the one hand, under section 2–316(1) of the Uniform Commercial Code,[111] standard-form terms attempting the "negation or limitation" of express oral warranties are "inoperative" to the extent that they conflict with the express warranty.[112] While this might seem to make it too easy for a consumer buyer to falsely claim that a firm's agent made an express warranty expanding on standard-form promises, comment 2 to this same section, dismisses this worry with the explanation that "[t]he seller is protected under this Article against false allegations of oral warranties by its provisions on parol and extrinsic evidence and against unauthorized representations by the customary 'lack of authority' clauses."[113] Neither of these points is convincing. A standard-form clause stating that an agent lacks actual authority can and sometimes should be overcome by showing a pattern or practice of agent representations and promises that establishes apparent agent authority. The Code's parol evidence rule is, moreover, very liberal in allowing for the admission of evidence of "course of dealing or usage of trade" to "explain" or "supplement" standard-form terms.[114] Especially given the language of section 2–313 that a buyer need not show any "particular reliance" for oral express affirmations of fact "made by the seller about the goods during a bargain" to become part of the parties' contract,[115] the courts have generally admitted parol evidence of such affirmations and have ruled that they override the warranty exclusion clause of a standard form.[116]

Turning to consumer-credit transactions, the Uniform Commercial Code's liberal attitude toward course of performance evidence has led some courts to be too ready to find that a pattern of forgiving conduct has overridden standard-form terms. This is dramatically illustrated by the split of authority on the issue of whether a consumer creditor who has accepted late payments as a matter of course may still insist upon the validity of a stan-

written contracts which by their terms prohibit oral modifications as enforceable under U.C.C. § 2-209 as waivers when there is proof of reliance). It is perhaps worth noting that standard economic theory of contract renegotiation cannot explain why courts would ever enforce a modification when the contract itself prohibited modifications. However, just as I have constructed an adverse selection – based explanation for enforcing such modifications, so too has Patrick W. Schmitz, *Should Contractual Clauses that Forbid Renegotiation Always be Enforced?*, 21 J. LAW, ECON. & ORG. 315 (2005) shown that certain kinds of contractual moral hazards can also justify enforcing such modifications.

[111] U.C.C. § 2-316(a) (1998).

[112] As comment 1 to U.C.C. § 2–316 explains, "[t]his section is designed principally to deal with those frequent clauses in sales contracts which seek to exclude 'all warranties, express or implied.' It seeks to protect a buyer from unexpected and unbargained language of disclaimer by denying effect to such language when inconsistent with language of express warranty . . . ." U.C.C. § 2–316 cmt. 1 (1998).

[113] U.C.C. § 2–316 cmt. 2 (1998).

[114] U.C.C. § 2–202(a) (1998).

[115] U.C.C. § 2–313 cmt. 5 (1998).

[116] *See* Richard F. Broude, *The Consumer and the Parol Evidence Rule: Section 2–202 of the Uniform Commercial Code*, 1970 DUKE L.J. 881, 917; *see also* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 12–4 (4th ed. 1995).

dard-form clause stating that such a pattern of behavior does not waive its rights to insist upon timely payment (an antiwaiver clause).[117] One general approach holds that if the creditor has in fact induced the consumer borrower to rely upon the ability to make late payments, then the creditor is estopped from reasserting its standard-form rights unless it first notifies the borrower. An alternative view holds that on basic Code principles of assent, a secured creditor's course of conduct may effectively change the meaning of the contract so that regardless of reliance, by accepting late payment, a creditor has waived its own standard-form antiwaiver provision. In such case, the creditor can reinstate its right to insist upon timely payment only if it gives the borrower reasonable notice that it is reverting back to the original, standard-form policy (and then only if the borrower has not materially changed its position in reliance on the waiver).

On my theory, both of these approaches to creditor waiver of a standard-form no-waiver clause fail to recognize the informational, screening function of creditor forgiveness. Creditors allow late payments as a kind of experiment even though they are not obligated to do so by their standard-form agreement. What creditors are trying to discover is borrower type: is this a "good" borrower, one with a temporary problem only and whose business we want to keep as a customer, or is this a "bad" borrower, one who really cannot make the agreed-upon payments and who is not worth keeping as a customer. When the creditor discovers a bad type, it will revert to the standard-form right to timely payment, which when not forthcoming will then allow it to declare the borrower in default and exercise its various standard-form default rights. On the margin, the risk that courts will find that tolerating late payments has entailed a loss of standard-form contractual rights makes forgiveness a riskier strategy for creditors. If the risk is significant enough so that creditors find forgiveness too costly, then they will respond by making the basic credit terms—interest rate, repayment period, and the like—tougher, thereby excluding from the market precisely those good faith, but ex-ante risky consumer borrowers that the courts are undoubtedly anxious to help, not hurt.

VI. Standard-Form Contracts Opting Out of Civil Liability as Determinants of the Viability of the Discretionary Benefits Equilibrium

As I mentioned at the outset of the previous section, the kind of standard-form terms that I analyzed in that section, mainly governing the firm and customer's respective performance obligations, are not those that have been the center of contemporary litigation and controversy. The most controversial standard-form terms are those that govern the resolution of breakdowns in the parties' relationship, breakdowns that reflect a failure of private cooperative resolution. Examples include clauses selecting the

[117] The discussion here is drawn from the opinion in *Tillquist v. Ford Motor Credit Co.*, 714 F. Supp. 607, 611-12 (D. Conn. 1989).

forum, or law, in which litigation will take place,[118] and, even more controversially, contract clauses mandating the arbitration of disputes.[119] Such clauses are increasingly common not only in consumer contracts, but also in individual employment contracts. The Supreme Court has endorsed the use of such clauses in both contexts, even where the underlying consumer or employee complaint invokes a right created by federal statute. At the same time, the Court has made clear that the ultimate enforceability of such clauses remains a matter of state law, so that state judges are free to strike them down as substantively or procedurally unconscionable.

Applying the classical exploitation theory of standard-form contracts to the new wave of employment-dispute arbitration contracts, academic commentators have for the most part urged such judicial invalidation of mandatory arbitration clauses in employment and consumer contracts. In critiquing the Court's decision in *Gilmer v. Interstate/Johnson Lane Corp.*,[120] my colleague Clyde Summers has recently provided an eloquent and succinct statement of this position:

> The *Gilmer* arbitration clause had three basic characteristics that are common to all employment contracts which seek to substitute private arbitration processes for public judicial processes. *First*, the arbitration provisions were not negotiated by the parties; they were constructed by the employer, or its lawyers, with an eye toward protecting and furthering the interests of the employer and were presented in a standard-form contract which the employee had to accept without change if he wanted to work. *Second*, the employee is frequently not made aware of an arbitration provision buried in the fine print or in an employee handbook. In *Gilmer*, the provision was not even in the employment contract, but in the exchange's registration application that the employee was required to sign before being hired. Even when the provision is visible, the employee may not understand its impact or the rights that he is waiving. *Third*, the employee has no practical choice but to agree to the employer's prescribed terms if he wants to obtain or retain the job. The choice is between agreeing and being unemployed, for other potential employers may have equivalent contract clauses. In *Gilmer*, refusal to sign would have effectively barred Mr. Gilmer from working in the securities industry. The increasing commonness of these provisions in other industries significantly affects job opportunities. These employer-designed arbitration structures are properly described by the Court as "mandatory arbitration." They are more descriptively characterized as "take-it-or-leave-it" contracts.[121]

On my theory of standard-form contracting, such general hostility toward mandatory arbitration clauses is ill-founded and inimical to the kinds

[118] *See, e.g.*, Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 593-94 (1991).

[119] *See, e.g.*, Green Tree Fin. Corp. v. Bazzle, 539 U.S. 444, 448 (2003); Green Tree Fin. Corp.–Ala. v. Randolph, 531 U.S. 79, 82-83 (2000); Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 23 (1991).

[120] 500 U.S. 20 (1991).

[121] Clyde W. Summers, *Mandatory Arbitration: Privatizing Public Rights, Compelling the Unwilling To Arbitrate*, 6 U. Pa. J. Lab. & Emp. L. 685, 686-88 (2004) (footnotes omitted).

of cooperative consumer-firm and employee-employer relationships that are presumably everyone's desired objective. The case for judicial enforcement of standard-form arbitration clauses does not deny that there are opportunistic employers and consumer-goods manufacturers who will attempt to write complicated and technical arbitration clauses that effectively take away the employee or consumer's right to press her dispute. But when courts have seen such clauses—that either foist all the costs of arbitration on the employee or consumer, or give the employer or firm discretion to choose arbitrators who are biased in its favor—they have almost uniformly struck down the clauses as substantively unconscionable.[122]

Such a judicial approach is perfectly consistent with my earlier analysis of the proper judicial attitude toward the enforcement of firm promises to add to standard-form promises.

The problem with the exploitation theory of mandatory arbitration clauses is that it focuses on these egregious, worst-case clauses—which courts will not enforce and which are surely a short-lived opportunistic exception—without advancing any explanation as to the general economic function served by reasonable mandatory arbitration clauses. Here, I develop such a theory, one that shows why legal enforcement of arbitration of disputes that arise at the end of a consumer-firm or employee-employer relationship is crucial to the ability of firms and consumers and employers and employees to pursue the kind of tailored forgiveness and complaint-based benefits strategies that govern the performance of their ongoing and continuing relationships. On my analysis, the question is what sort of dispute-resolution regime best encourages cooperative resolution of performance problems in ongoing relationships, resolution that occurs in the shadow of the firm's standard-form contract. The answer begins with a stylized description of what it is that mandatory arbitration clauses get the parties out of, the present day civil liability system.

A. *The Pathologies of Contemporary American Civil Liability*

The first problem with civil liability from the point of view of encouraging firms to cooperatively resolve problems with customers and employees is not really a problem with the contemporary American civil liability system, but one that is inherent in any formal public legal system: its publicness. A public record of legal proceedings and a tradition of written, publicly available judicial opinions designed to create precedent for the future differs dramatically from private arbitration, where the default is that

[122] *See, e.g.*, Hooters of Am., Inc. v. Phillips, 39 F. Supp. 2d 582, 614 (D.S.C. 1998) (holding arbitration clause unconscionable where employer had total control over arbitrators); Knepp v. Credit Acceptance Corp., 229 B.R. 821, 837-38 (Bankr. N.D. Ala. 1999) (finding unconscionable an arbitration clause in which debtor would be required to pay the costs of arbitration); Graham v. Scissor-Tail, Inc., 623 P.2d 165 (Cal. 1981) (holding arbitration clause substantively unconscionable where nonunion members forced to arbitrate before union arbitration panel); Abramson v. Juniper Networks, 9 Cal. Rptr. 3d 422, 658-60 (Ct. App. 2004) (holding that an express provision requiring an employee to pay half the costs of arbitration was unconscionable).

decisions do not generate publicly available written opinions and there is no publicly available record of the proceedings.

The next thing to recognize about the American civil liability system is peculiar to the contemporary American system. This is that for product manufacturers and employers, that system is increasingly one that imposes precisely the kind of broad mandatory standard-form terms that I earlier concluded were unlikely to be in the interest of consumers and firms.[123] While some of these terms impose substantive limitations—product manufacturers cannot, for example, contractually exclude liability for personal injury caused by defective products[124]—the most important standard-form terms imposed by civil liability systems are those governing, or, more accurately, not governing, the determination of damages. Under both state common law and federal statutes that protect consumers and employees, firms are liable not only for compensatory but also punitive damages for violations of a wide variety of mandatory standard-form terms (such as strict products liability and workplace discrimination). Somewhat tautologically, because firms cannot contract out of various mandatory substantive obligations imposed by state and federal consumer- and employee-protection legislation, when they contract for arbitration rather than civil liability as a means of resolving endgame disputes, it is the civil liability system of awarding damages that they are contracting out of.

What is the civil liability damage system? It is one that not randomly but systematically tends toward both undercompensation and overcompensation. It overcompensates in cases where there is a relatively large loss and undercompensates plaintiffs who have suffered relatively small losses. Cases involving very large losses are straightforward to understand. Although they may occur with low probability, when they do occur, the injured consumer or employee has an individually viable lawsuit that carries with it a highly uncertain probability of a mega-damage award in the hundreds of millions or billions of dollars that substantially overcompensates the plaintiff. As I shall explain momentarily, while rare, such cases have a disproportionate influence on firm/employer behavior. The more common products or employment case involves not catastrophic loss but a loss that is so small to each consumer or employee that no individual would find it rational to bring a lawsuit for damages. Modern civil procedure has solved that problem with class-action litigation, a device which permits the aggregation of lots of little claims into a large claim. Such aggregation, however, does nothing to change the incentives of an individual to bring a lawsuit. Such an individual still has little at stake and no reason to sue. Class actions work not by chang-

[123] For this important point, I am indebted to Stephen J. Ware, *Consumer Arbitration as Exceptional Consumer Law (With a Contractualist Reply to Carrington & Haagen)*, 29 McGeorge L. Rev. 195 (1998).

[124] *See* U.C.C. § 2–719(3) (1998) ("Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable"). The only way to avoid such liability contractually is to warn the consumer against product risks, but such warnings do not apply to the risks caused by defective products, and the warnings themselves may be found inadequate, which makes even a non-defective product defective (for failure to include an adequate warning).

ing the incentives of individual consumers, but by allowing plaintiff's attorneys to recover substantial compensation for pursuing the claims of a class of such harmed individuals. Because no individual consumer or employee has much at stake in such litigation, no individual has an incentive to actively monitor the attorneys who are ostensibly representing her interests. Without any real client to limit her discretion, the plaintiff's class-action attorney is subject only to the highly variable but generally exceedingly deferential oversight of the trial judge. Under this system, class-action attorneys are free to strike mutually beneficial settlement deals with the product manufacturer defendants. Under a typical deal of this sort, a product manufacturer whose product has actually caused, say, $100 million in harm to consumers will agree to settle for far less, say $50 million, a substantial fraction of which, such as $10 million, goes to the plaintiffs' attorneys. Consumers as a group end up with $40 million, far less than the $100 million that they would be entitled to in an ideal system.

A class-action system that generates such outcomes is subject to the obvious criticism that by grossly undercompensating individual class members, it has also grossly underdeterred product manufacturers or employers. Such criticism commits the mistake of comparing the real with the ideal. Relative to a world without the class-action device, the existing system at least generates some compensation and some deterrence. More importantly for present purposes, however, is to understand how there is a realistic alternative—private arbitration—and one that creates better incentives for firms to bargain to establish and maintain lasting, cooperative relationships with consumers and employees.

B. *Cooperative Relationships Are More Likely in the Shadow of Arbitration than under the Risk of Civil Liability*

Recall from my earlier analysis that it is the business value of the relationship—the value of an individual as a repeat buyer or as a trusted employee—that the strategy of tough standard-form terms coupled with tailored forgiveness and complaint-based benefits is designed to further. Such a strategy can breakdown entirely when the firm faces a risk of being sued in the civil liability system if the consumer or employee does not get all that she demands by way of forgiveness or additional benefits. There are several reasons for the breakdown. The first has to do with the inherent quality of publicly funded dispute resolution. If the firm's practice of sometimes paying benefits and sometimes not is litigated in court, the firm may be found to have established a new, standard practice of paying such benefits. It may also be taken to have admitted liability—benefits are paid, after all, when the firm admits that the customer or employee has a valid complaint. What was meant to have been discretionary will become a mandatory, liability triggering duty. Similarly, if the firm sometimes forgives employee malfeasance or consumer delays in payment, then not only does it encourage opportunistic behavior by employees and customers, but it may be held to have established a new standard-form promise to do so in all cases.

The other and in some ways even more problematic aspect of civil liability is the way that expectations about the magnitude of civil liability, rather than customer or employee value, can come to dominate and overwhelm the firm's thinking about customer and employee relationships. The large variation in civil-damage awards makes expected ex-post liability outcomes, rather than the perceived business value of cooperative resolution, a key determinant of what firms are willing to do. Firms have too great an incentive to resolve "cooperatively" complaints of questionable validity involving large customer or employee loss, and too weak an incentive to resolve much more clearly valid, but small customer and employee claims.[125]

Now consider the management of employee and customer relationships under arbitration. The first difference, and a profound one, is that because arbitration proceedings are not public, the firm does not have to worry that cooperative resolution of employee and customer complaints, or forgiveness of customer or employee contractual shortfalls, will establish a binding precedent that converts these discretionary acts into mandatory obligations applying to all employees and customers with legally similar situations.[126] Thus, under arbitration, the extension of benefits or forgiveness to deserving employees and customers does not mean that the firm has opened the door to opportunistic claiming.

The second profound difference between civil liability and arbitration goes to the pattern of outcomes and damage awards. In terms of outcomes, the three sharpest differences between arbitration and civil litigation are: 1) that plaintiffs succeed at a much higher rate in arbitration than they do in civil cases that go to trial; 2) that while plaintiffs get about the same median award in both civil trial and arbitration, they get a higher mean award and much larger damages in big, catastrophic cases in civil trial than arbitration; and, 3) because of the overall cost savings, plaintiffs are able to find attorneys to represent them and hence pursue some smaller cases that they would not pursue in the civil liability system.[127]

The significance of these differences is that under arbitration, the loss suffered by a particular employee or customer will not be nearly as big a determinant of the firm's breakdown payment to the employee or customer as it would be under civil liability. The firm's incentive to accommodate and maintain an employee or customer relationship merely to stave off costly civil liability does not exist under arbitration. Because the required payment that the firm must make to an employee or customer when the relationship

[125] This is true notwithstanding the availability of the class action, since for small and medium sized claims, class actions will not be economically attractive to plaintiffs' attorneys unless there are a very large number of such claims that may be aggregated. It is true that in cases where the individual claim is small but there are a large number of claimants, the class action may be economically viable when individual arbitration is not.

[126] A similar point, but in a rather different context, is made by Bernstein, *supra* note 1, at 1743, 1776.

[127] Conclusions reached in a survey of empirical findings of arbitration versus civil litigation are presented in Lewis L. Maltby, *Employment Arbitration and Workplace Justice*, 38 U.S.F. L. REV. 105, 108–17 (2003).

ends tends to be relatively uniform under arbitration, that payment will have less influence on whether the firm acts to prevent the relationship from ending than it would under civil liability. When the value of the continuing relationship to the firm and employee/customer has little to do with the employee or customer's loss in a particular instance, both the firm and the employee/customer are better off when it is the potential future value of the relationship, rather than the damages in a particular case, that determines their joint behavior in promoting its continuation.

Appendix

Ex-post versus Ex-ante Screening of Opportunistic Borrowers

The claim in the main text was that if firms are not allowed to exercise their discretion to identify consumer borrowers ex post, renegotiating only with those that they find to have a legitimate reason for failing to pay on time and effectively screening out opportunistic borrowers, then firms will not be able to replicate such screening with different standard-form terms, such as the interest rate. This appendix demonstrates this assertion for a simple but fairly general model.

Assume that a one-period loan is made in the amount *L* at interest rate *r*, and that there are two types of consumer, a good type who will repay the full amount *L* unless she suffers misfortune, in which case she can repay nothing. The probability of misfortune is given by *q*. There is also a bad type of consumer who will always claim to have suffered benefit *B* from using the borrowed money. Assume that at repayment time, the firm's manager will have learned enough to perfectly distinguish a good from bad type of borrower, so that under a policy of discretionary forgiveness, the loan will be forgiven if and only if the manager determines that the borrower is a good type who has really suffered misfortune. Ex ante, when the loan is made, the firm only knows the probability *p* of a good type (and so also the probability *(1 – p)* of a bad type) of borrower. I begin with the simplest case, in which the borrower is able to keep its entire benefit *B* when it fails to repay the loan (the loan was entirely used up in consumption).

The first proposition is that for any given interest rate *r*, the firm is better off when it pursues discretionary forgiveness than when it does not. This follows immediately from comparing the firm's expected payoff when it pursues discretionary forgiveness, which is given by:

$$(1 - \mathrm{q})\mathrm{rL} - \mathrm{qL} = \mathrm{L}(\mathrm{r} - \mathrm{q}(1 + \mathrm{r})) \qquad (1)$$

while its expected payoff when it does not pursue discretionary forgiveness is given by:

$$\mathrm{p}[(1 - \mathrm{q})\ \mathrm{rL} - \mathrm{qL}] - (1 - \mathrm{p})\mathrm{L} \qquad (2)$$

Comparing (1) and (2), we see that the firm will always be better off when it investigates the truth of the borrower's ex-post claim because otherwise it will never be repaid by the bad-faith borrower.

By the same type of argument, the bad-faith borrower will always have a higher expected payoff, of simply B, when it is not investigated ex post, than when it is, in which case the bad borrower's expected payoff will be

$$(1 - q)(B - (1 + r)L) + qB = B - (1 - q)(1 + r)L(3),$$

which is equal to the expected payoff that the good borrower gets regardless of whether or not the firm pursues a policy of discretionary forgiveness.

To prove the claim in the text, observe first that under the discretionary forgiveness policy a mutually beneficial interest rate exists only if there exists an r such that both (1) and (3) are bigger than zero. For both (1) and (3) to be bigger than zero, it must be that both:

$$r > \frac{q}{1-q} \tag{4}$$

$$r < \frac{B}{(1-q)L} \tag{5}$$

These conditions just say that the higher the probability of nonpayment, the higher the interest rate must be for the loan to be profitable for the lender, while the borrower can pay a higher interest rate and still take the loan, the higher the ratio of its benefit to the loan amount and the higher its probability of not having to pay the loan back is. A necessary and sufficient condition of an r satisfying both (4) and (5) is that $qL < B$, the borrower's benefit must exceed the lender's expected loss due to nonpayment.

Were the firm to eschew the discretionary forgiveness policy, the interest rate that it would need to charge in order for the loan to be profitable would instead be given by:

$$r > \frac{1-p}{p(1-q)} + \frac{q}{1-q} \tag{6}$$

The right hand side in (4) is unambiguously less than the right hand side in (6). When the lender eschews the discretionary policy, it must toughen the standard-form term, the interest rate. Indeed, from (6) we can see that for a sufficiently low p, the probability of a good borrower type, there will not exist an interest rate such that the lender expects a positive payout. If the lender is not allowed to exercise discretionary forgiveness, but borrower opportunism is sufficiently likely, then it will not make the loan at all.