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## Toward a New Model of Consumer Protection: The Problem of Inflated Transaction Costs

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# TOWARD A NEW MODEL OF CONSUMER PROTECTION: THE PROBLEM OF INFLATED TRANSACTION COSTS

JEFF SOVERN\*

## ABSTRACT

*Contrary to the predictions of conventional economic theory, firms often benefit by increasing consumer transaction costs. Firms do so by, for example, obscuring contract terms in a variety of ways, such as providing them after the contract is agreed to, enclosing them with other more interesting information, using small print, and omitting important terms such as arbitration fees from the written contract. Firms also benefit by taking advantage of predictable consumer behaviors, such as the tendency of consumers not to seek rebates, to overload when provided with too much information, and to ignore dull information when overshadowed by vivid information. Using behavioral law and economics, this Article provides examples of practices that inflate consumer transaction costs, explains why firms benefit from such practices, and describes the conditions giving rise to such practices. This Article also explains why inflated consumer transaction costs are objectionable and explores the law's response to the problem. Finally, the Article argues that lawmakers should adopt a norm barring the unnecessary inflation of consumer transaction costs and describes tests that lawmakers can employ to implement such a norm.*

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## TABLE OF CONTENTS

INTRODUCTION .....	1637
I. EXAMPLES OF INFLATED CONSUMER TRANSACTION COSTS .	1644
A. <i>Definition</i> .....	1644
1. <i>Transaction Costs as Roadblocks</i> .....	1645
2. <i>Brower v. Gateway 2000, Inc.</i> .....	1646
3. <i>Interlocking Ways To Inflate Transaction Costs</i> .....	1652
4. <i>Externalities and Internalities</i> .....	1652
5. <i>Internalities and Rebates</i> .....	1656
6. <i>Small Print (and the Internet's Equivalent) as a Transaction Cost</i> .....	1657
7. <i>Use of Transaction Costs To Conceal Changes in Contract Terms</i> .....	1660
II. CONDITIONS FOR INFLATION OF CONSUMER TRANSACTION COSTS .....	1661
A. <i>Lack of Competition To Reduce Transaction Costs in the Marketplace</i> .....	1663
B. <i>Why the Market Fails To Create Competition for Reduced Transaction Costs</i> .....	1667
C. <i>Other Limits to Schwartz and Wilde's Theory</i> .....	1669
D. <i>More on Internalities</i> .....	1675
E. <i>Other Reasons Why Firms Might Not Compete To Reduce Transaction Costs</i> .....	1680
III. WHY INFLATING CONSUMER TRANSACTION COSTS IS OBJECTIONABLE .....	1683
IV. CONSUMER PROTECTION LAW AND INCREASED CONSUMER TRANSACTION COSTS .....	1687
A. <i>Legislation and Regulation</i> .....	1688
B. <i>Case Law</i> .....	1691
V. ADOPTING A NORM CONCERNING INFLATED TRANSACTION COSTS .....	1699
A. <i>Tests of When To Outlaw Practices That Inflate Transaction Costs</i> .....	1701
B. <i>Implementing the Norm</i> .....	1705
CONCLUSION .....	1708

## INTRODUCTION

This Article contends that another norm should be added to the pantheon of consumer protection: merchants should not increase consumer transaction costs without good cause. While many existing consumer protection rules can be explained by this norm, the law's failure to adopt such a policy explicitly has damaged consumers. This principle should be embraced and used to formulate consumer protection rules. After supporting these claims, this Article offers guidance for implementing such a norm.

At first glance, such a norm may seem unnecessary. In many contexts, contracting parties have no incentive to increase transaction costs unnecessarily.<sup>1</sup> They obviously do not gain by inflating their own transaction costs for no purpose. They often will not benefit by unnecessarily increasing the transaction costs of those entering into contracts with them either. Conventional economic wisdom suggests that if people unnecessarily increase the costs incurred by their contracting parties, those parties are likely to find it cheaper to do business with a competitor.<sup>2</sup> The practice may also generate ill will.

Consumer transactions, however, do not always follow this general rule, if indeed it is a general rule. In many circumstances, businesses benefit by increasing consumer transaction costs to the detriment of consumers. Indeed, some practices are profitable largely because they inflate consumer transaction costs. Accordingly, firms increase consumer transaction costs because doing so enriches them. Although these practices reduce the surplus from exchange, firms find that acceptable because they maximize their individual gains from the transaction.<sup>3</sup>

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1. See Harold Demsetz, *The Cost of Transacting*, 82 Q.J. ECON. 33, 34 (1968) ("[E]xchange will tend to be conducted in ways that economize on the cost of transacting.").

2. See *infra* notes 94-95 and accompanying text.

3. The phrase "surplus from exchange" refers to the value created by the contract. See Robert Cooter & Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 CAL. L. REV. 1432, 1462 (1985). Firms may increase their own gains from a transaction, but if they reduce the consumer's gain from the transaction by more than the firm gains, the total gains from the transaction are reduced.

An example that will be used throughout this Article is mail-in rebates. Mail-in rebates increase the costs consumers must incur to obtain the reduced price; instead of simply paying less for the item from the beginning, as would be true with a sale item, consumers must fill out a form, gather proofs of purchase, and send them to the manufacturer.<sup>4</sup> The result is that only a handful of consumers obtain rebates; estimates range from a low of less than three percent,<sup>5</sup> to five to ten percent,<sup>6</sup> to forty to fifty percent.<sup>7</sup> Some

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4. See Peter K. Tat, *Rebate Usage: A Motivational Perspective*, 11 PSYCHOL. & MARKETING 15, 17 (1994).

The rebate redemption process is complicated and time consuming. The redeemer has to collect the rebate certificate, complete the form, mail the form to the fulfillment center with the qualifiers, i.e., the proofs of purchase and sales receipts, before the expiration date. Having performed these tasks, the redeemer has to wait for four to six weeks to receive the rebate check. In some instances, the terms of the rebate are so inconvenient and difficult that the whole process becomes a very frustrating experience for the redeemers.

*Id.*

5. See David Jacobson, *What Good Are Rebates? Everybody Likes Them, But Nobody Mails Them In*, BUFF. NEWS (N.Y.), June 23, 1993, at 1 ("On average, only 2.5 percent of the rebates available at the store are ever sent in. A mere 0.5 percent of the rebates made available via print advertising get mailed off.... [O]nly 2.4 percent of clip-out coupons and 27.4 percent of on-package coupons get used ...."); Christine Winter, *Tardy Rebates Anger Buyers; Complaints Lead to State Inquiry and At Least One Class-Action Lawsuit*, SUN-SENTINEL (Fort Lauderdale, Fla.), Apr. 16, 2000, at 1A (quoting Holly Anderson, spokeswoman for the National Consumers League, as saying, "We believe that only 2 to 3 percent of all those who buy successfully fill out those rebates and get their money back.").

6. See Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420, 1450 (1999); William M. Bulkeley, *Rebates' Secret Appeal to Manufacturers: Few Consumers Actually Redeem Them*, WALL ST. J., Feb. 10, 1998, at B1 (quoting Wes Bray, a partner in Market Growth Resources Inc., a consulting firm, as saying, "Not many consumers redeem [rebate coupons]—5% to 10% maximum"); Ryan Malkin, *Cash In on Rebates*, SMARTMONEY, Sept. 2003, at 63 (reporting that "90 percent of consumers don't send in the rebate—or do it incorrectly"); Stuart Silverstein, *As Rebates Spread, Some Consumers Fume*, L.A. TIMES, Dec. 13, 1998, at C1 ("In the supermarket and drugstore industries ... redemption rates—the percentage of customers who receive rebates—average below 10%").

7. See Howard Millman, *Customers Tire of Excuses for Rebates That Never Arrive*, N.Y. TIMES, Apr. 17, 2003, at G9 (reporting that approximately sixty percent of purchasers never get the rebates on the goods they bought); see also Renee DeGross, *The Spate of Rebates; More Sellers of Products Use Them To Entice Customers—Some of Whom End Up Unhappy*, ATLANTA J.-CONST., Dec. 18, 2003, at 1C ("Various surveys conclude that a little less than half of consumers who buy goods with rebate offers actually try to redeem them. About 20 percent wind up in disputes, according to the Aberdeen Group, a Boston-based market research firm."); *Forget Coupons and Rebates—Just Lower the Prices*, TIMES-PICAYUNE (New Orleans, La.), Apr. 30, 1993, at E5 ("Companies offering rebates know that most consumers don't mail in their forms."); Lorrie Grant, *Rebates Motivate Consumer Choices*, USA TODAY, Mar. 1, 2004,

purchasers never send the rebate form in, while others mail the form to the manufacturer but are denied the rebate because they did not comply with the stated requirements, by, for example, omitting the product's serial number.<sup>8</sup>

When consumers fail to obtain rebates, manufacturers retain the funds involved, making rebates particularly valuable to manufacturers, especially when compared to coupons or sales. Manufacturers apparently employ rebates chiefly because they increase sales by creating an illusion of a lower price, while the transaction costs generated by rebate offers permit manufacturers effectively to charge the unrebated price to most consumers.<sup>9</sup>

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at 6B ("Two people out of five never bother to apply for the rebate," says analyst Peter Kastner of information technology market analysis firm Aberdeen Group."); Louis J. Haugh, *Refunds: An Old Standby Stands Out*, ADVERTISING AGE, May 3, 1982, at M-26 (referring to a Nielsen study that said that forty-seven percent of consumers do not follow through on redemption offers); Silverstein, *supra* note 6 (reporting that in computer and consumer electronics industries "redemption rates commonly run from 15% to as high as 80%.").

8. See Edward J. Finn, *The Great Rebate Caper*, 131 SALES & MARKETING MGMT., Oct. 10, 1983, at 43 (noting that one consumer was denied a rebate because the consumer failed to submit an original, dated sales receipt with the store name clearly shown); Millman, *supra* note 7.

9. Daniel Seligman, *The Rebate Debate*, FORTUNE, Dec. 12, 1994, at 255 ("[C]ompanies want people to be initially attracted by the lower price but repelled by the bother of collecting—so that many of them end up not asking for the rebate."); Silverstein, *supra* note 6 ("Why not just make life simple for consumers and provide the discounts at the cash register? Because for most retailers and manufacturers, that would defeat the purpose of rebating."); Winter, *supra* note 5 (quoting Michael Erbschloe, vice president of research for Computer Economics, a marketing research firm, as saying, "Why not just do the rebates at the store? Because everybody would collect then, that's why. If they were sincere about cutting the price, they would all rebate at the cash register."); see also Bulkeley, *supra* note 6 (quoting Charles Weil, president of Young America Inc., which mails rebate checks, as saying, "the whole point behind rebates is to entice purchases and hope [consumers] don't remember to submit" claims (alteration in original)); DeGross, *supra* note 7 ("Manufacturers hope some consumers will forget about claiming the rebate check, to the benefit of the maker," said Kurt Barnard, president of Retail Forecasting, which tracks shopping trends and consumer spending."); Grant, *supra* note 7 ("Consumers treat rebates as a discount at the time of purchase, but their post-purchase behavior is that they don't redeem them," says Dhruv Grewal, professor of marketing at Babson College ...."); Jacobson, *supra* note 5 ("[E]ven though people don't send in for rebates, they like the idea of them.... [According to Kerry Smith Sr., publisher and editor of Promo Magazine, manufacturers use rebates because consumers do not] take [sellers] up on the incentive [and thus consumers pay] full retail for [products]. But [consumers] respond[] to a price-reduction offer."); Millman, *supra* note 7 ("Manufacturers have the better of two worlds when they use rebates," said Z. John Zhang, an associate professor of marketing at the University of Pennsylvania. "Rebates motivate consumers to buy at full price, and many consumers never send in their rebates for redemption."); Silverstein, *supra* note 6 ("[T]he rebate phenomenon relies on simple consumer

Commentators claim that some manufacturers, in an effort to make rebates even more profitable, impose time-consuming requirements as a part of rebate applications largely to discourage consumers from submitting them.<sup>10</sup> For example, one manufacturer required consumers to mail in the end panel from a box, a dated cash register receipt, and a form on which the consumer had to write five words of four or more letters that can be formed by using the letters from the phrase "full prescription strength."<sup>11</sup> Similarly, when one seller offered a computer system for \$300 after rebates, consumers had to submit four different rebate forms to four different firms, each with a different set of rules.<sup>12</sup> As the head of one company offering rebates explained, "We're not trying to make it easy."<sup>13</sup> Companies that administer rebate programs are reported to "frequently tout their ability to run rebate promotions with a large face value but a low redemption rate."<sup>14</sup>

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psychology. Manufacturers and retailers know that if an advertisement touts a powerful computer as costing less than \$1,000—after rebate—it draws customers to the store. They also know that many of those same consumers will forget to mail in their rebate forms or give up when the requirements prove to be too much of a burden."); cf. *id.* ("[A] number of manufacturers, *though hardly the majority*, apparently want to enjoy the advantages of rebates without paying for them promptly, if at all." (emphasis added)).

10. See Peter Tat, William Cunningham & Emin Babakus, *Consumer Perception of Rebates*, J. ADVERTISING RES. Aug.-Sept. 1988, at 45, 46 ("[C]ertain rebate offers seem to be designed to discourage consumer participation."); Tat, *supra* note 4, at 17 ("The rebate redemption process is complicated and time consuming."); Carole Fleck, *The Long Rebate Wait: Clip the Bar Code, Circle the Receipt, Cross Your Fingers*, AARP BULL., Apr. 2004, at 21, available at [http://www.aarp.org/bulletin/yourmoney/Articles/a2004-04-22-long\\_rebate.html](http://www.aarp.org/bulletin/yourmoney/Articles/a2004-04-22-long_rebate.html) ("[S]ome [companies] deliberately make it difficult to redeem rebates by imposing complex qualifying terms and conditions."); Grant, *supra* note 7 ("The system is generally set up to make applying for the money as difficult as possible."); Millman, *supra* note 7. But see Silverstein, *supra* note 6 ("Industry officials contend that few, if any, manufacturers impose requirements simply to dissuade consumers from seeking rebates. All the same, they concede that many manufacturers don't want to make the process so easy that everyone gets rebates."); *The Rebate That Isn't*, CONSUMER REP., Jan. 1986, at 67 ("One inspired variation is to make the terms of the rebate so inconvenient that only masochists would bother.").

11. See Jacobson, *supra* note 5.

12. See *Doin' the Rebate Rumba: Are the Deals Worth the Dance?*, CONSUMER REP., Nov. 1999, at 62 [hereinafter *Rebate Rumba*].

13. Toni Mack, *Rebate Madness*, FORBES, Feb. 13, 1984, at 76. The article explains that the use of rebates "can stimulate sales at no extra cost," and quotes another officer of the same company as saying that "[p]eople promise, 'I'm gonna take that rebate form and send in for my \$5.' But most of them don't." *Id.* at 79.

14. Millman, *supra* note 7 (quoting Z. John Zhang, associate professor of marketing at the University of Pennsylvania).

Some sellers have gone even further. One manufacturer required consumers to send in the price code from the product's carton, even though the carton did not have a price code.<sup>15</sup> Another manufacturer instructed consumers to hold a bottle under boiling water for five minutes to remove the neck label so it could be submitted to the manufacturer.<sup>16</sup> Still another seller limited the rebate in fine print to those who had purchased the item on one of two days in July and required applications to be postmarked by the end of July.<sup>17</sup> *Consumer Reports* warns readers, "[h]iding important details is all part of the rebate game."<sup>18</sup>

Given the profitability of rebates, their swelling popularity is hardly surprising.<sup>19</sup> Estimates of the total number of rebates offered in 2003 (excluding car sales) are as high as six billion dollars<sup>20</sup> with one chain alone reportedly having offered rebates on 217 different

15. *The Rebate That Isn't*, *supra* note 10. The article also describes other ways manufacturers made obtaining rebates difficult:

[A manufacturer] offered a ... rebate with the purchase of 12 quarts of motor oil. To collect, you had to send in a dated sales receipt for the 12 cans plus the emblems from 7 cans—and you had to do it within 30 days of purchase. Stripping the emblem from the cardboard can require care: Cut too deep and the oil would leak out.... [Another manufacturer] had a sticker that promised a \$1 refund, with "details on the back of the sticker." You had to open the box before you could read the back of the sticker, which explained that you had to buy two boxes.

*Id.*

16. Finn, *supra* note 8; *see also* Jacobson, *supra* note 5 (describing a rebate offer in which a liqueur bottle had to be soaked in warm water so that the label could be removed and mailed in). The rebate process for a computer printer was similarly difficult:

The form says that to get the check, you attach the sales receipt, which "must include the ... serial number and purchase date." Alas, our sales receipt from Dell did not include the serial number.... [W]e placed seriatim calls to Dell and Hewlett-Packard customer service people and were told at both ends that the existing sales receipt would doubtless be okay so long as we knew the serial number (which has to be written in on the form itself). The chap at Hewlett-Packard said that what really mattered was making sure the serial number was shown on the bar code label, which is glued to the cardboard box the printer comes in. You are expected to remove this label surgically with something like a razor blade and send it in along with the sales receipt and rebate form.

Seligman, *supra* note 9.

17. *See Rebate Rumba*, *supra* note 12.

18. *Id.*

19. *See Malkin*, *supra* note 6 ("Manufacturer rebate offerings have increased 167 percent from 2000.").

20. DeGross, *supra* note 7 (claiming that \$6 billion in 2003 represents an increase from \$3.3 billion in 1999).



products.<sup>21</sup> In some sectors of the economy, rebates are ubiquitous.<sup>22</sup> But the practice of offering rebates that manufacturers know will not be redeemed because of transaction costs is arguably fraudulent. Rebates also share a quality with the widely banned practice of bait and switch<sup>23</sup>: consumers are baited by the rebate and effectively switched to a different transaction. Though in some cases that is because of the consumer's own behavior, manufacturers understand that many consumers act in such a fashion; indeed, manufacturers depend on it. Manufacturers do have an alternative that eliminates consumer transaction costs: they could replace the rebate with a lower price. In short, manufacturers find rebates attractive precisely because they generate consumer transaction costs.

One way to address rebates is to see them as a particular species of fraud and deal with them through existing common law deceit claims and deceptive trade practices legislation.<sup>24</sup> Certainly some rebate practices violate these rules, and perhaps all do. Another way to respond to the rebate problem is to adopt legislation outlawing or regulating rebates.<sup>25</sup> This might force manufacturers to offer their products at a lower price to all consumers or perhaps to sell at the actual price without misleading consumers into erroneously thinking they will obtain a rebate. In either case, many consumers would benefit.<sup>26</sup> By and large, consumer protection law has responded to individual examples of firms increasing consumer

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21. Bulkeley, *supra* note 6.

22. See Millman, *supra* note 7.

In 2002, 75 percent of the ads placed by retailers and software makers for products like word processing and spreadsheet programs contained offers of rebates, according to Roger Lancot, an analyst with the Beyen Corporation, a market research firm based in Niagara Falls, N.Y. For highly competitive hardware components like hand-held organizers, ads offering rebates tripled last year.

*Id.*

23. See, e.g., MICH. COMP. LAWS ANN. § 445.356(6)(4) (West 2002); N.Y. GEN. BUS. LAW. § 396 (Consol. 1999); VA. CODE ANN. § 18.2-217(a) (2004).

24. See generally Dee Pridgen, CONSUMER PROTECTION AND THE LAW 13-544 (2003) (discussing common law misrepresentation, state unfair and deceptive practices acts, and private action to enforce these laws).

25. See, e.g., S.B. 1154, 2003-2004 Sess. (Cal. 2004) (vetoed Sept. 29, 2004) (law would have regulated rebates).

26. Not all consumers would benefit, however. Consumers who obtain the rebate would lose their savings, though they would recapture the time devoted to securing the rebate. See DeGross, *supra* note 7 ("Experts say rebates can work for careful consumers ....").

transaction costs in just such an ad hoc fashion: by barring the objectionable practices or attempting to subsume them under existing norms. Although helpful, such an approach leaves intact the ability of merchants to increase consumer transaction costs in other ways. This Article contends that in addition to adopting or adapting rules to respond to specific acts, consumer protection law should embrace a general norm that unnecessarily increasing consumer transaction costs is itself objectionable and the idea that such a norm should serve as a basis for both legislation and case law.<sup>27</sup>

While some practices that inflate transaction costs are also deceptive, such as rebates, many are not. The current debate regarding the relative merits of the opt-in and opt-out approaches to personal privacy provides an illustration.<sup>28</sup> Many companies profit not only from selling goods to consumers but also from selling

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27. In some circumstances, consumers may also benefit from the imposition of transaction costs on other parties. The debate on penalty defaults sparked by the writing of Ian Ayres and Robert Gertner provides an example. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989). Suppose a default rule is favorable to a seller. If the seller knows the default rule, the seller has no incentive to disclose the rule to the consumer, because then the consumer might seek to contract around the rule, to the detriment of the seller. Ayres and Gertner suggest as a solution the creation of penalty defaults—default rules that put the burden of contracting around the default rule on the party who is more likely to be informed about the consequences of not specifying the rule: “By setting the default rule in favor of the uninformed party, the courts induce the informed party to reveal information, and, consequently, the efficient contract results.” *Id.* at 99; see also *id.* at 103-04 (“When relatively informed parties strategically withhold information, courts, to promote information revelation, should choose a default that the informed party does not want.”). In other words, the Ayres-Gertner solution imposes on the seller the transaction costs incurred in contracting around the default rule. Professor Robert Scott calls default rules adopted for such reasons “information-forcing” defaults. Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 609-11 (1990); see also Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 390-91 (1993). Though seemingly paradoxical, both parties, in theory, will sometimes benefit from higher transaction costs. This is in line with Robert Cooter’s insight that lowering transaction costs delays settlements and makes noncooperation more likely, both of which may harm the parties. See Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 23 (1982).

28. Compare Jeff Sovern, *Opting In, Opting Out, or No Options at All: The Fight for Control of Personal Information*, 74 WASH. L. REV. 1033, 1118 (1999) (arguing for an opt-in system), with Timothy J. Muris, *The Federal Trade Commission and the Future Development of U.S. Consumer Protection Policy* 41-50 (George Mason Univ. Law & Econ. Research Paper Series, Paper No. 04-19, 2004), available at [http://ssrn.com/abstract\\_id=545182](http://ssrn.com/abstract_id=545182) (former FTC Chairman Muris arguing against an opt-in system).

to other businesses the names and addresses of consumers who have purchased particular goods. Consequently, firms may be reluctant to trim the names of consumers from their lists; in general, the fewer names, the less valuable the list. The law, however, requires some businesses to notify consumers of their right to opt out of the trade in their personal information. Businesses in this situation often maximize the costs consumers incur in opting out. For example, at least one company requires those who opt out to write the company, even though the company permits consumers to express their wishes by telephone on matters on which the company wishes to hear from them. Nor does the company provide a form that the consumer could fill out and return to the company.<sup>29</sup> In short, many practices that inflate consumer transaction costs cannot be addressed by existing prohibitions against fraud and so another basis must be found for attacking them. A ban on unnecessary increases in consumer transaction costs offers a tool for addressing problematic practices.

Part I of this Article offers other examples of situations in which merchants benefit by inflating consumer transaction costs. Part II describes the conditions giving rise to these situations. Part III explains why inflating consumer transaction costs is objectionable. Part IV explores how consumer protection law has responded to some specific instances of merchants increasing consumer transaction costs. Part V provides guidelines for the operation of a general norm that merchants may not unnecessarily increase consumer transaction costs.

## I. EXAMPLES OF INFLATED CONSUMER TRANSACTION COSTS

### A. Definition

The phrase "transaction costs" has been variously defined, often depending on the context.<sup>30</sup> For purposes of this Article, "transaction

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29. See Sovern, *supra* note 28, at 1085-87.

30. For example, transaction costs have a particular meaning in the context of Coase's theorem, though that has not prevented economists from debating that meaning. For lists of some approaches to transaction costs in that context, see Cooter, *supra* note 27, at 16; Pierre Schlag, *The Problem of Transaction Costs*, 62 S. CAL. L. REV. 1661, 1675 (1989); Cento G. Veljanovski, *The Coase Theorems and the Economic Theory of Markets and Law*, 35 KYKLOS

costs" is defined very broadly to include funds a buyer spends on a purchase but does not provide directly to the seller and the time a buyer devotes to making a purchase that does not directly benefit the seller. For example, the definition includes the costs and time devoted to making the purchase decision and the time needed to read small print. Also included are certain costs incurred after the purchase, such as the time spent filling out a rebate form, efforts to communicate wishes to firms, and litigation to resolve disputes arising out of the purchase.<sup>31</sup>

### 1. *Transaction Costs as Roadblocks*

Merchants increase consumer transaction costs in several circumstances. One is the situation exemplified by rebates, in which the consumer's performance is complete once the consumer has paid for the item; all that remains is for the merchant to perform in some way. If the merchant can throw roadblocks in the way of the consumer seeking performance, the merchant can avoid performing and so obtain a windfall.<sup>32</sup> A variant of this situation is the case in which sellers make it difficult for consumers to communicate

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53, 68 (1982). See also Douglas W. Allen, *What Are Transaction Costs?*, 14 RES. L. & ECON. 1 (1991) (discussing definitions); Steven N.S. Cheung, *The Transaction Costs Paradigm: 1998 Presidential Address Western Economic Association*, 36 ECON. INQUIRY 514, 515 (1998) ("Transaction costs' must be defined to be all the costs which do not exist in a Robinson Crusoe economy."); Richard O. Zerbe Jr. & Howard E. McCurdy, *The Failure of Market Failure*, 18 J. POLY ANALYSIS & MGMT. 558, 562 (1999) (stating that transaction costs are "the resources necessary to transfer, establish, and maintain property rights"); David Driesen & Shubha Ghosh, *The Functions of Transaction Costs: Rethinking Transaction Cost Minimization in a World of Friction* 31 (Mar. 17, 2004) (unpublished manuscript, available at <http://ssrn.com/abstract=386060>) (defining transaction costs as "the costs of dealing with people").

31. Cf. James D. Hess, *A Comparison of Alternative Approaches to Economic Organization*, 146 J. INSTITUTIONAL & THEORETICAL ECON. 72, 74 (1990) (including legal costs of disputes in the definition of transaction costs); Alan Randall, *Market Solutions to Externality Problems: Theory and Practice*, 54 AM. J. AGRIC. ECON. 175, 176 n.2 (1972) (including the cost of enforcing decisions in the definition of transaction costs).

32. The practice is like an externality for the buyer in that the practice imposes on a party a nonmonetary effect not taken into account by that party in the contracting process. Cf. Zerbe & McCurdy, *supra* note 30, at 561 (offering examples of and providing the classic definition of externality).

requests the firm does not wish to receive.<sup>33</sup> The privacy opt out described above is an example.<sup>34</sup>

Some examples of inflated consumer transaction costs are fairly prosaic and not worthy of lawmakers' attention. For example, grocery stores place staples such as milk, bread, and eggs at opposite ends of the store to force consumers to walk past more items in the store, and thereby increase the chance that the consumer will make additional purchases.<sup>35</sup> By increasing the cost to consumers of shopping, the store increases its sales.<sup>36</sup>

## 2. *Brower v. Gateway 2000, Inc.*

*Brower v. Gateway 2000, Inc.*,<sup>37</sup> which addressed whether a dispute between a consumer and a seller of computers through mail or telephone orders had to be resolved through arbitration,<sup>38</sup> illustrates at least six ways firms can use increased consumer transaction costs to enhance their own position. First, rather than providing consumers with a copy of its standard term contract before the goods arrived, perhaps by appending the terms to its purchase order,<sup>39</sup> Gateway tucked the contract in with the

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33. For an example, a series of articles and letters in *The New York Times* about how companies respond to overbilling discussed whether companies deliberately overbill with the expectation that many consumers will not complain, thus permitting the company to keep the amount of the overcharge. Consumers wrote in to the *Times* about the difficulties they encountered in getting their complaints remedied. In some cases, the overcharges recurred monthly, but the company insisted that consumers call each month to request an adjustment. This is surely an example of the company inflating consumer transaction costs for the company's benefit. More than 1200 consumers wrote to the *Times* in the first four days about the problem, suggesting that it may be widespread. See *A New Charge Called 'Oops': Readers Recount Misadventures*, N.Y. TIMES, Dec. 11, 2003, at G8; *Getting Bilked? Some Think So*, N.Y. TIMES, Dec. 4, 2003, at G9; David Pogue, *Checking Your Bill for a New Charge Called 'Oops'*, N.Y. TIMES, Dec. 4, 2003, at G1; David Pogue, *In Running Down Rogue Charges, Persistence Is Crucial*, N.Y. TIMES, Dec. 4, 2003, at G9.

34. See *supra* notes 28-29 and accompanying text.

35. Hanson & Kysar, *supra* note 6, at 1447.

36. *Cf. id.* ("[M]ost produce aisles are designed as mazes to encourage meandering among the many fruits and vegetables on display ....").

37. 246 A.D.2d 246, 676 N.Y.S.2d 569 (1998).

38. *Id.* at 248, 676 N.Y.S.2d at 570.

39. Gateway sends customers a written purchase confirmation before shipping the computer. Jean R. Sternlight, *Gateway Widens Doorway to Imposing Unfair Binding Arbitration on Consumers*, FLA. B.J., Nov. 1997, at 8, 9.

computer.<sup>40</sup> The contract provided that consumers who retained the computer for more than thirty days after delivery had agreed to Gateway's terms.<sup>41</sup> The company's delayed disclosure of the contract made it more difficult than necessary for consumers to discover Gateway's terms. That delay increased the cost to consumers of comparison shopping for terms, which, in turn, made it easier for Gateway to avoid competing by offering more favorable terms.<sup>42</sup>

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40. *Brower*, 246 A.D.2d at 248, 676 N.Y.S.2d at 570. Neither Gateway's advertisement nor its website mentioned an arbitration term, the term at issue in the case. Sternlight, *supra* note 39, at 8.

41. *Brower*, 246 A.D.2d at 248, 676 N.Y.S.2d at 570. This practice of providing consumers with contract terms after the product is sold and delivered is not unique to Gateway.

The marketing practice of holding back terms in Internet transactions is most in evidence in the software industry, where disclosure is often delayed until after credit card payment. In a survey of the 100 largest U.S. personal computer software companies, the author and her research assistant found that 87.5% of those that engaged in Web transactions ... did not make pre-transaction disclosure of their terms ....

Jean Braucher, *Delayed Disclosure in Consumer E-Commerce as an Unfair and Deceptive Practice*, 46 WAYNE L. REV. 1805, 1806-07 (2000). The full terms of insurance policies are also often provided to consumers only after the consumer has purchased the insurance. Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J.L. & ECON. 461, 484 n.50 (1974); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 540 (1971).

Manufacturers typically insert consumer warranties inside a product's box. Goldberg, *supra*, at 484 n.50; Slawson, *supra*, at 541. This practice seems slightly less troublesome because of the Magnuson-Moss Warranty Act's provisions and its implementing regulations requiring sellers to make copies of warranties available before purchase, *see* 15 U.S.C. § 2302(b)(1) (2000); 16 C.F.R. § 702.3 (2005), though whether many consumers know they have a right to inspect warranties before making a purchase is unclear. Moreover, whether sellers are living up to their obligations under the statute is also unclear. *Cf.* Sternlight, *supra* note 39, at 12 n.12 (reporting that "persistent attempts to procure a copy of the arbitration provision from Gateway sales and customer service representatives did not prove productive").

42. *See* Braucher, *supra* note 41, at 1810.

[D]elayed disclosure ... inhibits shopping, making it an anti-competitive practice .... To find the best deal, a customer would have to engage in repetitive purchases, undoing one at a time and then searching for a better one, not knowing if the deal just reversed is the best available. To use economic terminology, delayed disclosure increases transaction costs dramatically.... Furthermore, delayed disclosure often goes hand in hand with merchant decisions not to compete. If merchants decide not to compete concerning certain terms ... they have every incentive to hold back that information until after payment so as not to drive away customers.

*Id.* The point may be only slightly overstated. Consumers who want to know the terms under which merchants will sell could probably learn those terms by asking the merchant. The Magnuson-Moss Warranty Act obliges merchants to supply warranty terms upon request, *see* 15 U.S.C. § 2302(b)(1) (2000); *see also* 16 C.F.R. § 702.3 (2005), and probably most, if asked,

The second way Gateway increased consumer transaction costs to its advantage was by requiring consumers unhappy with the terms of sale to repack the computer and return it. Gateway thus significantly increased the costs faced by consumers in objecting to the contract terms.<sup>43</sup>

Third, any consumers who did wade through the three-page, sixteen-paragraph contract learned from the tenth paragraph that disputes arising out of the agreement were to be submitted to arbitration.<sup>44</sup> Critics have pointed out that consumers are unlikely to appreciate the full significance of terms providing for binding arbitration;<sup>45</sup> indeed, even for them to try may be irrational, given

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will furnish other terms simply as a matter of good customer relations. Undoubtedly, however, few consumers will think to ask. Moreover, when firms do not make the terms of their contracts readily available, fewer consumers will learn those terms.

43. See Sternlight, *supra* note 39, at 12 (claiming this was a "dramatic and expensive step of returning the brand new computer"); see also *Step-Saver Data Sys., Inc. v. Wyse Tech.*, 939 F.2d 91, 102 (3d Cir. 1991) (rejecting the claim in a similar case that terms enclosed with the goods bound the purchaser and that if the purchaser did not agree to the terms, the purchaser had to return the goods within a set period, while acknowledging that "the [seller] may be relying on the purchaser's investment in time and energy in reaching this point in the transaction to prevent the purchaser from returning the item").

44. *Brower*, 246 A.D.2d at 248, 252-53, 676 N.Y.S.2d at 570, 573. Gateway is hardly unusual in including arbitration clauses in its agreements. See, e.g., Joan Lowy, *Consumers Are Losing the Right to Sue Without Knowing It*, SCRIPPS HOWARD NEWS SERV., May 2, 2000 (noting that one bank "sent a dense notice in small type to its 40 million credit card customers informing them that they were giving up their right to go to court in favor of arbitration unless customers responded in writing within the next three weeks").

45. See David S. Schwartz, *Enforcing Small Print To Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33, 56-57.

[Pre-dispute arbitration clauses] are, in substance, immaterial to the core of the transaction, which would typically center around price .... They thus receive little attention from the adherent. Even if the adherent bothers to read and understand the arbitration clause, she is extremely unlikely to be able to assess the value of a judicial forum for future disputes with the drafting party. Unlike the drafting party, who has had such disputes before, and has probably experienced both arbitration and litigation, the adherent is unlikely to have had any such experience and is also unlikely to undertake the time and expense to research the implications of an arbitration clause or obtain legal advice. In her ignorant position, the adherent is most likely to undervalue the right to a judicial forum.

*Id.* (footnote omitted); see also *Broemmer v. Abortion Servs. of Phoenix, Ltd.*, 840 P.2d 1013, 1017 (Ariz. 1992) (holding an arbitration agreement unenforceable when consumer was not told that she was giving up the right to jury trial and the agreement was not explained to her; consumer was not sure what arbitration meant); Braucher, *supra* note 41, at 1814; Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 676 (1996). Thus, consumers are unlikely to understand

the cost of learning enough to evaluate all the terms in a standard form contract<sup>46</sup> and the low likelihood that a consumer would end up in a dispute that required arbitration.<sup>47</sup> Some consumer attorneys refuse to take on a contingent-fee basis arbitration cases that they otherwise would have if the cases could have been heard in court. Hence, consumers unable to finance litigation cannot obtain redress because the cost of asserting their rights—a transaction cost—is too high.<sup>48</sup>

Fourth, the arbitration clause provided that the arbitration was to be governed by the rules of the International Chamber of Commerce (ICC).<sup>49</sup> The ICC rules required payment of an advance fee of \$4000 before claims of less than \$50,000 would be heard; of

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that discovery is often limited in arbitration and that because class actions are unusual in arbitration, an agreement to arbitrate is likely to make litigation uneconomical. Braucher, *supra* note 41, at 1855-56; Sternlight, *supra*, at 683. See generally Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. MIAMI L. REV. 1263, 1270 (1993) ("[Consumers] generally lack the legal background to understand the subordinate clauses.").

46. See Michael I. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583, 600 (1990) ("It is, therefore, rational for even a conscientious consumer to pay little, if any, attention to subordinate contract terms."); cf. Edward A. Purcell, Jr., *Geography as a Litigation Weapon: Consumers, Forum-Selection Clauses, and the Rehnquist Court*, 40 UCLA L. REV. 423, 486-87 (1992) ("[I]t would be irrational for consumers to absorb the costs of identifying and evaluating such technical contractual provisions [as forum selection clauses].").

47. See Lee Goldman, *My Way and the Highway: The Law and Economics of Choice of Forum Clauses in Consumer Form Contracts*, 86 NW. U. L. REV. 700, 717 (1992) ("The costs of obtaining and understanding information about contract terms are especially daunting when the form terms involve risks that are unlikely to occur."); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1226 (1983) ("[M]any of the terms [in standard form contracts] concern risks that in any individual transaction are unlikely to eventuate. It is notoriously difficult for most people, who lack legal advice and broad experience concerning the particular transaction type, to appraise these sorts of contingencies.").

48. Caroline E. Mayer, *Hidden in Fine Print: 'You Can't Sue Us,'* WASH. POST, May 22, 1999, at A1. Some evidence suggests that arbitration clauses in consumer contracts reduce the number of claims consumers file. See ERIK MOLLER, ELIZABETH S. ROLPH & PATRICIA EBENER, *PRIVATE DISPUTE RESOLUTION IN THE BANKING INDUSTRY* 22-23 (1993) (reporting the results of a study by the RAND Institute for Civil Justice that found that "new arbitrable litigation decreased markedly after the introduction of" arbitration requirements). Thus, arbitration clauses themselves seem to pose an impediment to consumers seeking to resolve a disagreement, suggesting that they effectively function as a transaction cost, perhaps for the reasons stated in the text.

49. *Brower*, 246 A.D.2d at 248, 676 N.Y.S.2d at 570.



that fee, \$2000 was nonrefundable even if the consumer prevailed.<sup>50</sup> In addition, the ICC rules provided that the loser of the arbitration must compensate the victor for legal fees,<sup>51</sup> thus making it possible for consumers to incur additional expenses if they invoked arbitration. The cost of successful arbitration (\$2000 nonrefundable filing fee, plus any other costs incurred in pressing the claim) may well exceed the computer's value. The cost of unsuccessful arbitration (\$4000 filing fee, plus Gateway's legal expenses, plus any other costs) surely would. Gateway effectively increased the cost of dispute resolution to the point where it made little sense even for consumers whose claims were clearly meritorious to assert them.<sup>52</sup>

Fifth, even consumers who grasped what arbitration entailed would not have learned from the contract the cost of filing for arbitration because that cost was not stated.<sup>53</sup> Thus, a consumer who noticed the arbitration clause and wanted to know the cost of filing for arbitration would have had to research the cost of asserting her rights. Even assuming that consumers knew how to research the filing fee question, it seems unlikely that any consumer would, especially given that psychological studies suggest that consumers understate the risk of nonperformance by the sellers.<sup>54</sup> In other words, any consumers who realized that they were agreeing to a contract did not know exactly what they were agreeing to, thus giving Gateway the opportunity to insert whatever terms it wanted in the contract.

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50. *Id.* at 249-50, 676 N.Y.S.2d at 571.

51. *Id.*

52. *Cf.* Sternlight, *supra* note 45, at 683 (suggesting that filing fees are used to increase consumer transaction costs; the author reports that, "As one lawyer noted, at least when one goes to court the judge is free."); Lowy, *supra* note 44 ("Arbitration fees can be prohibitive, especially for consumers with small claims. A 'filing fee' of \$100 or more is common, as are hourly arbiter fees that can run into the thousands of dollars."). *But see* Christopher R. Drahozal, "Unfair" Arbitration Clauses, 2001 U. ILL. L. REV. 695, 698 (arguing that pre-dispute arbitration clauses benefit consumers).

53. The arbitration provision established that International Chamber of Commerce rules would govern any proceedings, but it did not relate the content of those rules. *Brower*, 246 A.D.2d at 248, 676 N.Y.S.2d at 570.

54. *See* Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1179 (2003). *But cf.* Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633, 705-06 (2001) (arguing that contracting parties may overestimate the risk of future breach if they recently experienced a breach of contract).

Sixth, the contract provided that arbitration was to take place in Chicago, Illinois, thus adding travel costs to the cost consumers faced in asserting their rights.<sup>55</sup> For many consumers, the cost of travel alone, much less the filing fee, might be enough to make them forego arbitration.<sup>56</sup>

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55. *Brower*, 246 A.D.2d at 248, 676 N.Y.S.2d at 570; see also Sternlight, *supra* note 45, at 682 (noting that companies increase consumer transaction costs by obliging consumers to bring actions in distant forums). Edward Purcell has observed that

[f]orum-selection clauses are tactical devices that enable companies to cast heavy burdens and costs on consumers while conserving their own resources and guaranteeing themselves an unrelenting leverage against their adversaries.... In economic terms, forum-selection clauses may be understood as a rational method whereby companies multiply the transaction costs that litigation imposes on those with claims against them in order to force such claimants to discount or abandon their claims, thereby enabling the companies to externalize a higher percentage of their overall costs of operation.

Purcell, *supra* note 46, at 455. He further explained the cost of litigating in a distant jurisdiction as follows:

The deterrent effects of geography are numerous and weighty. The threshold task of merely retaining counsel in a distant location ... is profoundly daunting to ordinary people.... Once litigation begins, the process quickly piles on additional burdens. One is the obvious need to travel and communicate over long distances .... [T]hese burdens will be especially heavy if the plaintiff's claim arises from events in his home state and many or all of his witnesses reside there.... [P]sychologically the claimant feels more cut off, more vulnerable, and even more anxious than he otherwise would. That burden is magnified by the fact that the attorneys representing his corporate adversary feel relatively comfortable and secure litigating in their home court.... [T]hey will tend to drive a harder bargain, [and] hold off settling for a longer period in the hope of obtaining increasingly more favorable terms ....

*Id.* at 446-49 (footnotes omitted). This apparently is not a new strategy for merchants. See Craig Karpel, *Ghetto Fraud on the Installment Plan* (pt. 2), N.Y. MAG., June 2, 1969, at 41 ("[M]erchants and finance companies often sue, not in the county where they reside or in the county where the defendant resides, but in some other county which is likely to be inconvenient for ghetto consumers to get to."). Perhaps because of the litigation spawned by its contracting practices, Gateway now makes the standard terms of its contracts available on its website. See GATEWAY, INC., GATEWAY STANDARD TERMS OF SALE (2005), <http://content.gateway.com/www.gateway.com/about/legal/warranties/8510858.pdf>. The contract still provides for mandatory arbitration, but Gateway promises to reimburse consumers who prevail in the arbitration for their filing fees. *Id.* at para. 6. The consumer may choose to conduct the arbitration online, on the phone, by submission of documents, or in person at any reasonable location near the consumer's residence. *Id.* The arbitration term also explains in bold print that the consumer, by agreeing to the provision, is waiving the right to proceed in court or to bring a class action. *Id.*

56. Cf. Purcell, *supra* note 46, at 486 ("The primary result of [a Court enforcing forum-selection clauses] will most likely be to eliminate suits ... and to deny forums ....").

### 3. *Interlocking Ways To Inflate Transaction Costs*

In sum, Gateway increased both the cost of backing out of the transaction and resolving any disputes so much that many consumers would have been better off swallowing their losses and moving on, rather than attempting to proceed against Gateway. *Brower* also demonstrates another one of the remarkable things about the phenomenon of inflated consumer transaction costs: the way the methods interlock to inflate the cost of avoiding still another method. For example, Gateway's practice of obscuring the terms of the contract made it more difficult for consumers to discover that they had to return the computer within a limited time period or else be bound by those terms. It also made it less likely that consumers would realize that the terms of the contract might be unattractive, thereby reducing their motivation to return the computer. Similarly, the requirement that consumers unhappy with the terms of the contract go to the effort of repacking and returning the computer rather than just withdrawing from the contract before the computer was sent increases the likelihood that even a consumer who learned of the binding arbitration in time to object to it would not bother to rescind the deal. In turn, the expense of resolving disputes through costly binding arbitration in a distant forum prevents consumers from complaining about Gateway's contracting practices, including the practices described above. The net effect of these practices is to insulate much of Gateway's contract from market competition, which means that Gateway is free to behave monopolistically in crafting certain terms for its contract.

### 4. *Externalities and Internalities*

*Brower* also illustrates two different types of transaction cost increases. In the first type, the merchant's conduct imposes an externality upon the consumer, a cost that the consumer either overlooked or underestimated in entering into the contract. The delayed disclosure of the terms, which increases the consumer's costs in comparing terms offered by rival computer dealers, is an example.

The second type of transaction cost increase depends on what have been dubbed "internalities,"<sup>57</sup> that is, systematic consumer behaviors that function as if consumers are imposing externalities upon themselves. These internalities have been analogized to transaction costs and explain why "bounded rationality" often seems more bounded than rational.<sup>58</sup> Ordinarily, it seems unfair to lay responsibility for consumer failures at the feet of merchants. But when companies are aware of these tendencies and take advantage of them in structuring their dealings with consumers, it appears appropriate to view the merchants' behavior as a deliberate attempt to inflate consumer transaction costs.

For example, by putting consumers in a position where they had to return the computer if they were dissatisfied, rather than simply notifying consumers of the contract terms in advance, Gateway took advantage of two related internalities. The first is what psychologists call the status quo effect, the preference to stay with the status quo even when it is randomly determined,<sup>59</sup> and the second is the endowment effect, the tendency of consumers to want to retain possessions they have had even for a short time.<sup>60</sup> As Jon

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57. Colin Camerer, Samuel Issacharoff, George Lowenstein, Ted O'Donoghue & Matthew Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1221 & n.30 (2003); R. J. Herrnstein, George F. Loewenstein, Drazen Prelec & William Vaughan, Jr., *Utility Maximization and Melioration: Internalities in Individual Choice*, 6 J. BEHAV. DECISION MAKING 149, 150 (1993).

58. See Rachlinski, *supra* note 54, at 1225.

59. Raymond S. Hartman, Michael J. Duane & Chi-Keung Woo, *Consumer Rationality and the Status Quo*, 106 Q.J. ECON. 141, 143-44 (1991); Eric J. Johnson, John Hershey, Jacqueline Meszaros & Howard Kunreuther, *Framing, Probability Distortions, and Insurance Decisions*, in CHOICES, VALUES, AND FRAMES 224, 235-37 (Daniel Kahneman & Amos Tversky eds., 2000); Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193, 197 (1991) ("[I]ndividuals have a strong tendency to remain at the status quo ...."); William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7, 8 (1988) ("[D]ecision makers exhibit a significant status quo bias."). Changes in Pennsylvania and New Jersey insurance laws illustrate the preference. Johnson et al., *supra*, at 238. Both states passed laws permitting motorists to retain a right to sue in exchange for higher insurance rates. *Id.* Pennsylvania motorists started with the right to sue at the higher rate, a right approximately seventy-five percent opted to keep. *Id.* New Jersey drivers started with a restricted right to sue at a lower rate, and only about twenty percent selected the greater right to sue. *Id.* Thus, for the vast majority of drivers, the initial allocation of rights determined the choice. *Id.* For other situations in which the default choice influenced the final choice, see Sovern, *supra* note 28, at 1092.

60. A series of experiments reported by Jack Knetsch illustrate the endowment effect.

D. Hanson and Douglas A. Kysar have written, "[by] simply getting the product into the hands of the consumer, its value to that consumer may be enhanced."<sup>61</sup> Psychologists have also demonstrated that consumers tend to underestimate the impact of these effects on their valuations, so that consumers tend to value something more when they possess it than they anticipated. For example, a consumer who actually possessed the computer would be more reluctant to part with it than a consumer who merely contemplated having one.<sup>62</sup> Consequently, a consumer who might not have ordered a computer if she saw Gateway's terms in advance might choose to retain it if she did not receive the terms until she had the computer.<sup>63</sup>

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Jack L. Knetsch, *The Endowment Effect and Evidence of Nonreversible Indifference Curves*, in CHOICES, VALUES, AND FRAMES, *supra* note 59, at 171. In one experiment, subjects were given a coffee mug and invited to trade it for a candy bar; eighty-nine percent preferred the mug. *Id.* at 172-73. Another group of subjects were provided with a candy bar and invited to exchange it for a mug; ninety percent of that group preferred the candy bar. *Id.* In other words, the subjects preferred ownership of an object they had possessed even fleetingly over something they did not yet have. *See also* Kahneman et al., *supra* note 59, at 194-97 (detailing additional experiments); Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1342 (1990) (referring to this phenomenon as an "instant endowment effect"). The same trait, carried over to a computer in the consumer's possession, may lead consumers to retain the computer even though, had they known the terms before the purchase, they might not have bought it.

61. Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 734 (1999). Richard Thaler has made a similar observation:

Consider the case of a two week trial period with a money back guarantee. At the first decision point the consumer thinks he can lose at most the transactions costs of taking the good home and back. If the transactions costs are less than the value of the utilization of the good for two weeks, then the maximizing consumer pays for the good and takes it home. The second decision point comes two weeks later. If the consumer has fully adapted to the purchase, he views the cost of keeping the good as an opportunity cost. Once this happens the sale is more likely.

Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 46 (1980).

62. *See* George Loewenstein & Daniel Adler, *A Bias in the Prediction of Tastes*, in CHOICES, VALUES, AND FRAMES, *supra* note 59, at 726-34; *see also* Samuelson & Zeckhauser, *supra* note 59, at 9 ("[Status quo] bias is considerably more subtle. In the debriefing discussions following the experiments, subjects expressed surprise at the existence of the bias. Most ... seemed unaware (and slightly skeptical) that they personally would fall prey to this bias.").

63. *See* Roger C. Bern, "Terms Later" Contracting: *Bad Economics, Bad Morals, and a Bad*

When Gateway took advantage of these effects, or of the likelihood that consumers would not read the terms of the contract because of their excitement in receiving their computer, or of the probability that consumers would not appreciate the significance of the arbitration clause in the absence of an explanation, Gateway arranged its transaction so as to inflate consumer transaction costs. Substantial evidence suggests that businesses are aware of consumer behaviors and psychology. Indeed, manufacturers spend billions of dollars every year studying just that.<sup>64</sup> Sellers clearly use consumer internalities to manipulate consumers and increase sales,<sup>65</sup> just as Gateway did and those who offer rebates do.

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*Idea for a Uniform Law, Judge Easterbrook Notwithstanding*, 12 J.L. & POL'Y 641, 725 (2004).

Once the purchaser has the computer in hand, even if he knows of the objectionable terms in time to resist them, he is most unlikely to do so. The downside of parting with "his computer" (including the hassle of getting it back into the box and shipping it back), along with the need to begin a search for its replacement, loom much larger than the possible upside of averting potential remedial limitations he may face if by chance the thing does not function properly. "Foregone gains are less painful than perceived losses."

*Id.* (quoting Kahneman et al., *supra* note 59, at 203). Jon Hanson and Douglas Kysar have similarly acknowledged that

manufacturers might use money-back guarantees, test drives, thirty-day no-risk trial periods, free samples, and other marketing ploys, all of which are designed to create in the consumer a sense of ownership. Because of the endowment effect, the sense of ownership by itself might lead the consumer to experience an increased valuation of the product.

Hanson & Kysar, *supra* note 61, at 734 (footnote omitted). Similar observations have also been made in the business management literature by Gerald E. Smith and Thomas T. Nagle:

[I]t is often better to decouple product acquisition and payment by first endowing buyers with the product. If buyers can be persuaded to take the product home, they will adjust their reference point to include the newly acquired asset. They will then be reluctant to return the product when payment is due, since this will require that they incur a loss.

Gerald E. Smith & Thomas T. Nagle, *Frames of Reference and Buyers' Perceptions of Price and Value*, 38 CAL. MGMT. REV. 98, 101 (1995).

64. Hanson & Kysar, *supra* note 6, at 1429-37 (citing studies performed by marketing professionals).

65. *Id.* at 1432-33, 1439-67 (giving many examples of sellers using consumer behavior and psychology to manipulate consumers).

### 5. Internalities and Rebates

Though internalities will be discussed more fully below,<sup>66</sup> a brief discussion about how rebates also take advantage of consumer internalities may be helpful at this point. Prospect theory has established that consumers are more sensitive to losses than gains.<sup>67</sup> When a consumer makes a purchase, the price looks like a loss, and so the consumer experiences the rebate as a "reduction in pain," which makes the rebate attractive. By the time the consumer contemplates the work required to obtain the rebate, however, the rebate seems less like a reduction of a loss and more like a gain, thereby making the rebate appear less important.<sup>68</sup> The result is that sellers have manipulated consumers into buying to secure a rebate the consumers never seek.

Psychological experiments with rebates confirm that rebates are ripe for manipulation. In one experiment, researchers asked subjects whether they would pay a premium of \$1000 for comprehensive and collision car insurance that included a deductible of \$600.<sup>69</sup> Another group was asked whether they would pay \$1600 for the same coverage, except that the policy provided for payment of a \$600 rebate at the end of the year if the driver had not made any claims; if the driver asserted claims, the rebate would be reduced by the amount of the claims up to \$600.<sup>70</sup> The first offer is economically preferable because it does not require the insured to make a \$600 interest-free loan to the insurer.<sup>71</sup> Nevertheless, more than two-

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66. See *infra* notes 141, 143-48 and accompanying text.

67. See generally Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979). Edward J. McCaffery has contributed the following observation:

For example, people will not use credit cards if a merchant advertises a 3 percent penalty for using them, but they will do so if the same merchant advertises a 3 percent bonus for using cash: Being penalized appears worse than forsaking a bonus, although the two outcomes are economically equivalent. Similarly, people consistently attach more disutility to losing a sum of money or a valuable possession than they do to failing to gain the same sum or good.

Edward J. McCaffery, *Cognitive Theory and Tax*, in *BEHAVIORAL LAW AND ECONOMICS* 398, 401 (Cass R. Sunstein ed., 2000).

68. See Seligman, *supra* note 9.

69. Johnson et al., *supra* note 59, at 232-34.

70. *Id.*

71. *Id.*

thirds of the respondents said yes to the second offer, while fewer than half agreed to the first offer, a statistically significant difference.<sup>72</sup> Thus, the rebate clouded the decision-making process in such a way as to lead to a less beneficial result.

A second rebate experiment makes the point even more clearly. Subjects were offered disability policies that would pay two-thirds of their salary.<sup>73</sup> One policy had a monthly cost of \$90 and provided a rebate of \$1200 to insureds who did not make a claim within five years; the other policy cost only \$70 per month but did not provide for a rebate.<sup>74</sup> Under the first policy, insureds would make sixty payments of \$90 totaling \$5400.<sup>75</sup> Subtracting the \$1200 rebate yields a net payment of \$4200.<sup>76</sup> An insured who chose the second policy would make total payments of \$4200 as well (sixty payments of \$70).<sup>77</sup> But an insured who chose the second policy would not risk losing \$1200 if she made a claim, and in addition, she would have the use of the money earlier, making the second policy a better choice.<sup>78</sup> Nevertheless, more respondents preferred the rebate policy.<sup>79</sup> The promise of a rebate thus appears to leave consumers muddled. This is itself a transaction cost.

#### *6. Small Print (and the Internet's Equivalent) as a Transaction Cost*

Gateway's attempt to conceal the terms of its contracts by increasing consumer transaction costs is hardly unique. Probably the best-known example is the practice of some firms of placing unfavorable terms in small print, or perhaps in the middle of a sea of fine print, to reduce the likelihood that consumers will read the

72. *Id.*

73. *Id.* at 234-35.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* A consumer might prefer having money at an earlier time for at least two reasons. First, the consumer could invest the money, so that at the end of the insurance policy term she would have even more money available. Second, because of inflation, the purchasing power of a dollar at the outset of the policy term is likely to be greater than its purchasing power at the term's end.

79. *Id.*



terms and so decline to enter into the contract.<sup>80</sup> The use of fine print is so universally accepted that consumers do not seem to hold it against firms, and so businesses rarely lose goodwill by using it.

Though the Internet has facilitated many communications, it has not ended the use of fine print to conceal unfavorable terms.<sup>81</sup> For

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80. See Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429, 432-33, 446 (2002) ("Businesses ... know[] that consumers reliably, predictably, and completely fail to read the terms employed in standard-form contracts.... Businesses also can create boilerplate that is difficult to read by using small print, a light font, and all-capital lettering and by burying important terms in the middle of the form."); Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1389 (1983) ("[C]onsumers may not understand the legal relationships that their purchase contracts create because they do not read the language in those contracts. Firms have an incentive to exploit this ignorance by using 'hidden' terms that will disadvantage consumers if circumstances cause these terms to be invoked."); see also Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215, 273 (1990) ("[T]erms are often written in fine print to economize on paper and handling, and expressed obscurely or in legal or technical jargon, which raises the cost of becoming acquainted with them even further."); Meyerson, *supra* note 45, at 1270 ("[B]usinesses do not want consumers to read [contracts] prior to signing."); W. David Slawson, *The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms*, 46 U. PITT. L. REV. 21, 27 (1984) ("[B]usinesses know full well that their forms will not generally be read, let alone understood."). Small print does not necessarily mean form contracts, as forms need not be in small print that is difficult or uninviting to read. For example, the "Federal Box" mandated by the regulations implementing the Truth in Lending Act is undeniably a form, but is not intended to be unreadable; in fact, the converse is true. See 12 C.F.R. § 226.17 (2005) (indicating that disclosures must be made "clearly and conspicuously").

81. See Braucher, *supra* note 41, at 1807.

Effectiveness of disclosure on the Web is also a big problem. Those businesses that do post their terms online often use this medium to make standard forms harder to find, longer, and less readable. To reach terms on a Web site, a consumer usually has to click on a button, uninvitingly labeled "legal" or "terms and conditions" and obscurely placed, for example, at the very bottom of a long Web page. Assuming the consumer clicks, the terms are often presented in multi-page scroll-down formats with unreadable paragraphs of block letters and incomprehensible legalese.

*Id.*; see also *Pollstar v. Gigmania Ltd.*, 170 F. Supp. 2d 974, 980-82 (E.D. Cal. 2000) (denying a motion to dismiss a breach of contract claim when the defendant claimed it had not consented to a license agreement because "[n]otice of the license agreement [was] provided by small gray text on a gray background" on the plaintiff's website and despite acknowledging that "many visitors to the site may not be aware of the license agreement"); Margot Saunders, *A Case Study of the Challenge of Designing Effective Electronic Consumer Credit Disclosures: The Interim Rule for the Truth in Lending Act*, 7 N.C. BANKING INST. 39, 43-44 (2003) (describing a scenario involving e-commerce that could occur under the Federal Reserve Board's Interim Rule on Regulation Z in which a consumer does not get a paper copy of her right to rescind the transaction and an electronic copy is effectively unavailable to her because she lacks a computer or URL for the website informing her of her right to rescind, thus

example, few consumers are likely to understand that when they agree to the terms and conditions on the website known as GoHip—which offers free videos, among other services—their web browser home page will become the GoHip web page, advertisements for GoHip will be added to their email, and advertisements for GoHip will appear on their monitor at various times.<sup>82</sup> Similarly, consumers who click on the “I agree” box on an end user license agreement may allow a company to put spyware on their computer—software which may permit distant companies to monitor computer use and permit popup ads to appear on a consumer’s computer screen. In the words of Professor John Soma, “There is no full disclosure of what’s in these programs. If there is, it’s in the 37th footnote in the back of a long and boring legal document no one will read.... That is not meaningful disclosure.”<sup>83</sup>

When PC Pitstop, a marketer of anti-spyware services, surveyed 7260 computer users with Gator or GAIN (Gator Advertising Information Network) applications installed on their computers, it found that 74.2% did not recall installing Gator or a GAIN application; 14.9% had not read the license agreement; 8.5% had read the license agreement for no more than five minutes; and fewer than 3% had spent more than five minutes reading the license agreement, a

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increasing transaction costs for consumers who wish to rescind). Kaustuv M. Das offered the following example:

[V]isitors to NBC.com’s website may not notice the hyperlink labeled “Privacy & TOS” among the list of hyperlinks at the bottom of the webpage.... [E]ven if a visitor to the site were able to figure out that TOS referred to “terms of service,” they may be misled by the fact that clicking on the hyperlink brings up a page entitled “NBC Online Privacy Policy.” It is only upon scrolling down a number of screens that a visitor would find a statement specifying that: “USE OF THIS SITE SIGNIFIES YOUR AGREEMENT TO THE TERMS OF USE AND PRIVACY POLICY.” Upon scrolling down further to the fifteenth numbered paragraph, labeled “Miscellaneous,” a visitor would find that he or she had consented to exclusive jurisdiction in the courts of New York, New York, U.S.A.

Kaustuv M. Das, Note, *Forum-Selection Clauses in Consumer Clickwrap and Browsewrap Agreements and the “Reasonably Communicated” Test*, 77 WASH. L. REV. 481, 499 (2002) (footnotes omitted).

82. Dave Peyton, *Proceed Cautiously When Downloading from GoHip*, CHI. TRIB., Oct. 23, 2000, at 7.

83. Michael Bologna, Special Report, *Cybersecurity, Spyware’s Harms, Benefits, Cures Debated as Legislation Emerges*, FTC Workshop Nears, 3 PRIVACY & SEC. L. REP. 407, 409 (2004).

document that PC Pitstop estimated would take the average reader at least twenty minutes to read.<sup>84</sup> That many consumers would knowingly agree to the placement of spyware on their computers seems unlikely, but by increasing consumer transaction costs, companies are able to create the illusion of consumer agreement.

Websites also offer a special advantage to businesses that desire to make the terms of their contracts less obvious: because firms can measure "hits" on particular pages, they can determine which formats generate the fewest hits, and then use those formats to obscure terms that the firm would rather consumers not see.<sup>85</sup> Though consumers shopping on Websites can take as long as they like to review contract terms and may do so in the privacy of their own home,<sup>86</sup> unlimited time offers no advantage to those who simply overlook obscure terms.

### *7. Use of Transaction Costs To Conceal Changes in Contract Terms*

In addition to using transaction costs to conceal contract terms at the beginning of contractual relationships, merchants also employ transaction costs that cause consumers to overlook changes in the terms of ongoing contractual arrangements. Companies that send periodic bills to consumers, such as credit card issuers, utilities, and cable television providers, sometimes include with the bills documents known as "bill-stuffers" to, for example, change contract terms materially<sup>87</sup> or notify consumers of their privacy

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84. PC Pitstop, *Survey Says: Gator Users Didn't Know*, <http://www.pcpitstop.com/gator/Survey.asp> (last visited Mar. 14, 2006).

85. Hillman & Rachlinski, *supra* note 80, at 479, 483 ("If a website configuration deters consumers from reading standard terms that consumers reasonably would find unpalatable, then such a configuration might increase sales.").

86. *Id.* at 492.

87. See *Ting v. AT&T*, 182 F. Supp. 2d 902, 912 (N.D. Cal. 2002), *aff'd in part, rev'd in part*, 319 F.3d 1126 (9th Cir. 2003), *cert. denied*, 540 U.S. 811 (2003) ("[A] reasonable class member would not have expected the billing statement to contain a new contract, and therefore might well have discarded the [consumer services agreement] as a stuffer."); *Badie v. Bank of America*, 79 Cal. Rptr. 2d 273, 276-77 (Cal. Ct. App. 1998) (discussing which bill-stuffer provided that disputes were to be settled by binding arbitration); John J. A. Burke, *Contract as Commodity: A Nonfiction Approach*, 24 SETON HALL LEGIS. J. 285, 322 (2000) ("[T]he credit card industry frequently sends a written notice of change in contract terms along with the monthly statement."); Mayer, *supra* note 48 (reporting that American Express

rights.<sup>88</sup> Sometimes the bill-stuffer, often in the form of a colorless, uninteresting-looking document that may be mistaken for junk mail,<sup>89</sup> accompanies other items likely to be of greater interest to consumers, such as a statement of how much is owed, forthcoming features on pay-per-view, and the like. These more interesting papers obscure the bill-stuffer. By making it more difficult for the consumer to learn the terms of the transaction, the company increases the likelihood that the consumer will approve the changes or perhaps unknowingly act in a way that signifies approval.

The above examples all have certain common characteristics. This Article now turns to the conditions under which firms can and will inflate consumer transaction costs.

## II. CONDITIONS FOR INFLATION OF CONSUMER TRANSACTION COSTS

Six conditions must be present before a rational firm will deliberately inflate consumer transaction costs. First, and most obviously, the firm must benefit from the consumer's refraining from certain conduct, such as sending in a rebate form, requesting privacy, backing out of a contract, or seeking to resolve a dispute.

Second, the firm must be able to increase consumer transaction costs by, for example, requiring the consumer to fill out a difficult form or by burying terms in fine print.

Third, the conduct must be something consumers will forego if the transaction costs can be made high enough. Rational consumers will engage in a transaction until the costs of doing so exceed the transaction's benefits. Accordingly, if a business can inflate consumer transaction costs to the point that the costs exceed the benefits from engaging in the transaction, a rational consumer will abandon the transaction. In some circumstances, significant transaction costs do not deter consumers. For example, the process

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included a mandatory arbitration provision in a bill-stuffer described as "routine, even innocuous—the typical fine print that's usually stuffed in the same envelope with the monthly bill and often thrown away").

88. See Sovern, *supra* note 28, at 1085.

89. Sternlight, *supra* note 45, at 691 ("Arbitration clauses are often buried in seemingly insignificant places, camouflaged as insignificant junk mail ...."); Robert Alexander Schwartz, Note, *Can Arbitration Do More for Consumers? The TILA Class Action Reconsidered*, 78 N.Y.U. L. REV. 809, 830-31 (2003).

of purchasing a home and obtaining a mortgage can be time consuming and expensive, yet many consumers undertake that process because the benefits of home ownership are so great. This implies that the consumer's benefits from engaging in the transaction the business wishes to discourage must not be so significant that the consumer is willing to incur substantial transaction costs to obtain those benefits. Obtaining a modest rebate or protecting personal privacy fits that description for many consumers.

Fourth, merchants should not inflate consumer transaction costs if doing so reduces total profits (including profits generated from future sales) more than the gains from the practice itself.<sup>90</sup> For example, merchants who depend on repeat sales to the same consumers are unlikely to do things that anger consumers enough to drive them away. Even businesses that do not depend on repeat sales may be restrained from misbehavior by the prospect of a poor reputation costing them sales.<sup>91</sup> This reality undoubtedly deters many firms from inflating consumer transaction costs in certain ways, but many practices nevertheless do not generate consumer ire. Thus, few consumers seem to blame the manufacturer for the consumer's own failure to send in the rebate form. Hence, the manufacturer obtains the added revenue without losing future sales. Similarly, as noted above, consumers accept small print as a way of doing business and are unlikely to hold it against firms.<sup>92</sup> Gateway's practice of requiring the consumer to pay for arbitration in a distant forum as a way of increasing the cost of resolving disputes also probably does not cost it sales to that consumer because any consumer angry enough at Gateway to consider arbitration is unlikely to buy from Gateway again anyway.<sup>93</sup>

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90. Cf. Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1240 (2003) ("As long as the long-term costs exceed the short-term benefits, sellers will not, in fact, find it to be in their self-interest to offer inefficient terms.").

91. Cf. Hillman & Rachlinski, *supra* note 80, at 442 ("Businesses must worry that if they consistently include and enforce terms that exploit consumers [in their contracts], they will develop an unsavory reputation, just as if they offered shoddy goods or services."); Muris, *supra* note 28, at 12 ("Market factors, such as a business's concerns about repeat business and reputation, can ... overcome some of the incentives a seller might otherwise have to dishonor its agreements.").

92. See *supra* note 80 and accompanying text.

93. Conceivably, the consumer might tell friends about Gateway's practice and so cost

Fifth, the consumer must either overlook or underestimate the cost at the time the consumer enters into the transaction. This condition is related to the sixth condition: namely, that the market must have failed to create competition from a seller who would provide the good or service without inflated transaction costs. In theory, when a company perceives that other firms inflate consumer transaction costs, the company should compete on the basis that it does not do so.<sup>94</sup> Consumers who care about artificially increased transaction costs should respond by patronizing companies that do not impose inflated transaction costs, just as they would avoid any company that overcharges. Indeed, increasing transaction costs is one form of overcharging.<sup>95</sup>

#### *A. Lack of Competition To Reduce Transaction Costs in the Marketplace*

The short response to this theoretical consideration is that in the consumer product market producers at least sometimes do not

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Gateway business through word of mouth, but Gateway likely made a judgment that the loss of sales through word of mouth about its practice would be less costly than using other mechanisms for resolving disputes would be. In any event, additional damage to Gateway's reputation from consumers troubled by the arbitration clause is likely to be no greater than the damage from consumers who are unhappy enough with their computers to seek arbitration. Cf. R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of an Informed Minority To Correct for Imperfect Information*, 47 HASTINGS L.J. 635, 663 (1996) ("[C]onsumers do not often get 'burnt,' and thus a manufacturer will not lose much repeat or referral business the few times it does occur."); Korobkin, *supra* note 90, at 1240 ("The costs of this small number of defections, however, [are] likely to be outweighed by the benefits gained from use of the inefficient term in contracts with the far larger number of buyers for whom the term never becomes salient.").

94. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 116 (Aspen Publishers 6th ed. 2003) (1973) ("If one seller offers unattractive terms, a competing seller, wanting sales for himself, will offer more attractive terms."); Korobkin, *supra* note 90, at 1208 ("Economic analysis suggests that in a perfectly functioning market with complete information contracts between buyers and sellers will contain only efficient terms ...."); Sternlight, *supra* note 45, at 687 ("[F]ree marketeers argue that if the terms of consumer contracts were in fact unduly and inefficiently biased toward the supplier, then other suppliers, in order to benefit themselves, would step in and offer a contractual provision that treated the consumer more generously.").

95. Cf. Hillman & Rachlinski, *supra* note 80, at 441 ("Consumers concerned about the possibility of exploitation can try to avoid terms they consider exploitative and refuse to transact with businesses that have reputations for offering and enforcing manipulative contract terms.").

compete on the basis that they offer lower transaction costs. Two examples make the point. The first is the quotation of interest rates prior to enactment of the Truth in Lending Act.<sup>96</sup> Different lenders quoted interest rates on consumer loans in different ways. Some used the dollar add-on method; some used the discount basis; others stated a monthly rate as applied to a defined balance; and still others combined different methods.<sup>97</sup> Consumers could not compare rates calculated by one method to rates determined by another method without going through complex calculations, which were beyond the skills of most consumers.<sup>98</sup> As a result, consumers attempting to shop for the lowest rates found it difficult to do so. In theory, in a competitive lending market, the lenders offering the lowest rates should have found a way to communicate that to consumers, perhaps by quoting rates in all of the various ways lenders used, so that consumers could compare their rates to those of other lenders.

If the lenders charging the lowest rates had found an effective way to let consumers know that they were the cheapest, the Truth in Lending Act might never have come into existence, or might have been enacted in a different form.<sup>99</sup> But for whatever reason, the

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96. Consumer Credit Protection Act §§ 101-114, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601-13); see also 12 C.F.R. pt. 226 (2005) (implementing certain provisions of the Truth in Lending Act).

97. NAT'L COMM'N ON CONSUMER FIN., CONSUMER CREDIT IN THE UNITED STATES 169-70 (1972); see also Jonathan M. Landers & Cathleen Chandler, *The Truth in Lending Act and Variable-Rate Mortgages and Balloon Notes*, 1976 AM. B. FOUND. RES. J. 35, 65 ("[C]onsumers' knowledge of the cost of credit [was] woefully inadequate ...."). But see Homer Kripke, *Gesture and Reality in Consumer Credit Reform*, 44 N.Y.U. L. REV. 1, 4 (1969) ("[T]he middle class buyer has already learned where credit is cheapest."); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 681 (1979) ("[C]onsumers apparently knew that finance companies charged higher rates than banks ....").

98. See OEO LEGAL SERV. TRAINING PROGRAM, MEMORANDUM (Apr. 1972), reprinted in JOHN A. SPANOGLE, RALPH J. ROHNER, DEE PRIDGEN & PAUL B. RASOR, CONSUMER LAW: CASES AND MATERIALS 108, 108-10 (2d ed. 1991) (demonstrating that a loan of \$100 for one year payable in twelve monthly installments at 8% calculated by various methods would yield 8% APR under the actuarial method, 14.45% APR under the add-on method, and 15.68% APR under the discount method).

99. The Truth in Lending Act addressed the problem of comparison shopping in a number of ways. Requiring lenders to quote rates calculated by the same method was one way. See 15 U.S.C. §§ 1606, 1632 (2000). One of the purposes of the Truth in Lending Act is "to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit." 15

market did not supply the information consumers needed to compare loan prices.<sup>100</sup> It took regulation to do that. If the market did not reduce transaction costs in quoting the price of credit, which can amount to thousands of dollars over the life of a loan, it can be expected that other arenas will exist in which merchants do not compete on the ground that they offer lower transaction costs.

A second example is more recent. In 1999, Congress passed the Gramm-Leach-Bliley Act, requiring each consumer financial institution to notify its customers of its privacy practices and allow consumers to opt out of the sale of their personal information in certain circumstances.<sup>101</sup> Polls had consistently demonstrated that many consumers were concerned about the trade in their personal information long before Congress acted.<sup>102</sup> Yet banks for the most part did not compete on the basis of privacy though it appears that at least some banks sold information about their customers.<sup>103</sup>

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U.S.C. § 1601(a) (2000).

100. Cf. Landers & Chandler, *supra* note 97, at 64 ("Congress thought that consumers ought to have certain basic information regarding consumer credit transactions .... Consumers ought to have the information simply because rational consumers would want it, and most consumers lack the bargaining power to get it from creditors without statutory mandate or the ability to compute it themselves.").

101. Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12 U.S.C. and 15 U.S.C.). The relevant provisions are codified at 15 U.S.C. §§ 6801-6827 (2000).

102. For discussion and summaries of a number of polls on consumer privacy, see Mike Hatch, *The Privatization of Big Brother: Protecting Sensitive Personal Information from Commercial Interests in the 21st Century*, 27 WM. MITCHELL L. REV. 1457, 1477-81 (2001); Sovern, *supra* note 28, at 1056-64; see also Lawrence A. Young, *The Landscape of Privacy*, 55 CONSUMER FIN. L.Q. REP. 4, 4 (2001) ("[C]onsumers were becoming alarmed that banks use and sell financial information that many Americans consider private."); Jedediah Purdy, *An Intimate Invasion*, USA WEEKEND, July 2, 2000, at 7 (reporting that seventy-nine percent of survey respondents believed that their financial records could be accessed by too many people).

103. Some banks were sued by regulators for failing to protect the privacy of their customers. For example, Minnesota's attorney general sued U.S. Bancorp in January 1999 while the New York State attorney general sued the bank then known as Chase Manhattan Bank. Both cases were settled. See Elizabeth K. Brill, *Privacy and Financial Institutions: Current Developments Concerning the Gramm-Leach-Bliley Act of 1999*, 21 ANN. REV. BANKING L. 167, 176 (2002); David W. Roderer, *Tentative Steps Toward Financial Privacy*, 4 N.C. BANKING INST. 209, 210-11 (2000). For a copy of the settlement order in the U.S. Bancorp case, see Edmund Mierzewski, *Privacy Materials*, in CONSUMER FINANCIAL SERVICES LITIGATION 2001 at 893, 951-61 (Practicing Law Inst. ed., 2001). Even after enactment of Gramm-Leach-Bliley, banks continue to provide customer information to third parties. An America's Community Bankers survey found "[a]pproximately one of every two institutions



Few, if any, banks that publicized their privacy policies or offered consumers the opportunity to bar the sale of their personal information can be found.<sup>104</sup> Consumers who wished to protect the privacy of their banking transactions had to investigate their banks' practices and draft their own requests for privacy. To be sure, the privacy protections afforded by the Gramm-Leach-Bliley Act are flawed in that they have not eliminated all the transaction costs imposed by financial institutions on those who would protect their privacy,<sup>105</sup> but the statute does represent a significant attempt to

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with assets greater than \$1 billion shares information with non-affiliated third parties." *ACB Privacy Compliance Survey*, WASH. PERSPECTIVE, Dec. 3, 2001, supp. at 1.

104. Cf. Julie L. Williams, Chief Counsel, Office of the Comptroller of the Currency, Address at the Financial Institutions Insurance Association Regulatory and Compliance Conference (June 22, 1999), available at <http://www.occ.treas.gov/ftp/release/99-59a.txt> ("[I]ndividuals may not realize—and have no way of forcing disclosure of—just how their personal information is being handled [by financial institutions]."). Similarly, Minnesota Attorney General Mike Hatch has commented that

[w]ith little notice to their customers, many financial institutions and telemarketers have routinely entered into marketing agreements with one another over the past few years. These marketing agreements allow the telemarketer to have access to bank customer information, such as names, phone numbers, Social Security numbers, account balances, and credit limits.... [T]he marketing agreements have become a standard industry practice among the country's largest financial institutions.

Hatch, *supra* note 102, at 1491. See also Henry Gilgoff, *Private Matters: More Banks Now Selling Personal Consumer Data*, *NEWSDAY*, July 25, 1999, at F7 (quoting Comptroller of the Currency John Hawke, Jr., saying that "[t]here's mounting evidence of an increase in banking practices that are at least seamy, if not downright unfair and deceptive," and "the deals are widespread among the country's biggest banks").

105. See *Oversight Hearing on Financial Privacy and the Gramm-Leach-Bliley Financial Services Modernization Act Before the S. Comm. on Banking, Housing & Urban Affairs*, 107th Cong. (2002) (statement of Mike Hatch, Att'y Gen. of the State of Minnesota).

The opt-out notices flooding consumers' mailboxes ... have not meant much for the typical consumer. The notices are dense and impenetrable. Even the most educated and persistent of consumers would have a hard time deciphering statements such as "we may disclose [information to] ... carefully selected business partners (e.g., so they can alert you to valuable products and services)" to mean the financial institution will allow telemarketers to charge your credit card account without obtaining a signature or account number from you.

*Id.*; see also *id.* (statement of Edmund Mierzwinski, Consumer Program Director, U.S. Public Interest Research Group), available at <http://www.privacyrights.org/A2/uspig-rlb0902.htm> (stating that privacy notices "have been widely panned by a variety of experts for their inscrutable, dense language" and "[c]onsumers have not been adequately informed or given effective choice"); John Schwartz, *Privacy Policy Notices Are Called Too Common and Too Confusing*, *N.Y. TIMES*, May 7, 2001, at A1. One advocate concluded that

[c]onsumers will have difficulty reading and understanding the privacy notices

remove barriers to privacy, a step that banks did not seem inclined to take absent legislation.

In both these examples, Congress acted to solve a problem the market ignored. Given that our legislative system is famously one of checks and balances in which the passage of statutes is difficult and requires a sustained commitment, it seems likely that these examples involve issues of considerable consumer concern. Yet financial institutions did not respond to that concern by competing over transaction costs. The lesson is that, for whatever reason, businesses at least sometimes do not behave as market-based predictions assume they will.

### *B. Why the Market Fails To Create Competition for Reduced Transaction Costs*

Why does the market break down in this way, so as to permit businesses to inflate consumer transaction costs?<sup>106</sup> Though it may be impossible to be certain of the reasons, it is possible to identify potential explanations for the phenomenon. In different contexts, several factors may converge.

First, some of the relevant businesses have a monopoly. Utilities and cable television companies, for example, usually do. Second,

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they receive from their banks. The notices were supposed to [be] written in a "clear and conspicuous" style so they would be "reasonably understandable." Instead, the notices I reviewed were poorly written with too many long sentences and too many uncommon words. Several notices will be illegible for some consumers, because of basic layout and design problems. They include too many words per line and not enough spacing between lines.

Mark Hochhauser, *Lost in the Fine Print: Readability of Financial Privacy Notices* (July 2001), <http://www.privacyrights.org/ar/GLB-Reading.htm>.

106. Cf. Zerbe & McCurdy, *supra* note 30, at 561 ("Market failures are thought to occur when the market fails to produce public goods, or inadvertently produces externalities, or gives rise to natural monopolies, or disenfranchises parties through information asymmetries, or creates undesirable income distributions."). Market failures can also be classified by what causes them:

Market failures take one of two forms. Some are external to the consumer, or "outside the head," leading to an inability of the market to provide sufficient options. Other failures are internal to the consumer, or "inside the head," in the sense that they make the consumer unable to effectively choose among the available options.

Neil W. Averitt & Robert H. Lande, *Consumer Sovereignty: A Unified Theory of Antitrust and Consumer Protection Law*, 65 ANTITRUST L.J. 713, 723 (1997).

even competitive markets may act monopolistically as to some features. In 1979, Alan Schwartz and Louis L. Wilde wrote of markets that are monopolistic for terms.<sup>107</sup> They argued that in markets in which enough consumers search for a particular attribute, firms would compete for consumers by offering that attribute.<sup>108</sup> If firms could not distinguish between searchers for that attribute and nonsearchers, the firms would offer the same terms to nonsearchers.<sup>109</sup> To put it another way, if firms competed to attract searchers, nonsearchers would benefit as well.<sup>110</sup> Schwartz and Wilde concluded that in markets in which firms compete for searchers rigorously enough to generate optimal prices and terms for all consumers, no regulatory intervention would be needed.<sup>111</sup> But there are limits to the utility of this device to protect consumers. With rebates, for example, consumers self-select, so that consumers who are not drawn by the rebate offer provide no protection to those who are. Many of the situations in which firms inflate transaction costs also involve self-selecting consumers. Thus, if some Gateway customers return their computers within thirty days, that does nothing for other customers who retain theirs. Similarly, those who write letters to protect their privacy typically protect only their own rights, not the rights of others.

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107. Schwartz & Wilde, *supra* note 97.

108. *Id.* at 638.

109. *Id.*

110. For still another version, see Cruz & Hinck, *supra* note 93, at 646 ("[T]he cost of losing the marginal consumers will outweigh the benefits of gouging the infra-marginal consumers.").

111. Schwartz & Wilde, *supra* note 97, at 638-39. Others have expounded on this conclusion with regard to contract terms:

[I]t is conceivable that if only 10 per cent of the buyers of a particular class of goods or services studied all terms scrupulously before contracting and were influenced in their choice of contractual offerings by their evaluation of the so-called fine print clauses, this might create effective competitive pressures on each supplier in the relevant market to adjust the terms of all his contracts so as to minimize the risk of losing the potential business.

M.J. Trebilcock & D.N. Dewees, *Judicial Control of Standard Form Contracts*, in *THE ECONOMIC APPROACH TO LAW* 93, 105 (Paul Burrows & Cento G. Veljanovski eds., 1981).

### *C. Other Limits to Schwartz and Wilde's Theory*

Scholars have responded to Schwartz and Wilde's arguments by observing that in some, perhaps most, markets firms can discriminate among buyers<sup>112</sup> or renegotiate terms for aggressive customers.<sup>113</sup> The theory will also fail to help consumers if searchers seek terms that do not benefit other consumers.<sup>114</sup> Even with respect to products that have some attributes that nearly all consumers care about, such as price, consumers might not care about other attributes, such as terms in fine print, and so might not search for them, with the result that not enough searchers will exist to create a market in the particular terms.<sup>115</sup> Not only are these terms less

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112. For example, many manufacturers of consumer appliances now provide relatively short warranty periods. Retailers offer service contracts or extended warranties for an extra charge to consumers who want greater protection. Thus, retailers are able to discriminate between consumers who want long-term and short-term warranties, and so consumers who shop for long-term warranties no longer protect other consumers.

113. See Cruz & Hinck, *supra* note 93, at 674-75 (stating that consumers who make their displeasure known receive greater benefits from firms); Goldberg, *supra* note 41, at 485 (discussing the ease with which companies can renegotiate for aggressive customers but keep the information barrier high for others); Warren Mueller, *Residential Tenants and Their Leases: An Empirical Study*, 69 MICH. L. REV. 247, 264-68 (1970) (offering examples of customers who renegotiated lease terms); Slawson, *supra* note 80, at 43-44 (discussing three court decisions in which users of forms had changed terms only for parties to one transaction rather than changing forms generally); Sternlight, *supra* note 45, at 691 (discussing the possibility of firms renegotiating arbitration clauses for informed consumers). Scholars have also speculated that Internet retailers will offer different contract terms to consumers who read and object to standard terms. See Hillman & Rachlinski, *supra* note 80, at 472. Firms can even distinguish among complaining consumers after the transaction has occurred. See generally Jeff Sovern, *Good Will Adjustment Games: An Economic and Legal Analysis of Secret Warranty Regulation*, 60 MO. L. REV. 323 (1995). For a dramatic illustration of what can happen when sellers can distinguish between buyers, see Ian Ayres, *Further Evidence of Discrimination in New Car Negotiations and Estimates of Its Cause*, 94 MICH. L. REV. 109 (1995), which states that car dealers charge different prices based on the race and gender of purchasers.

114. Cruz & Hinck, *supra* note 93, at 671-72 ("[T]here is no reason to expect an informed minority to typify the demands of the other consumers.... [The minority could seek] a different warranty[,] ... a different forum selection clause, or even [that] the product ... be colored avocado green.").

115. Several commentators have observed that these searches are quite rare:

[T]here is no evidence that a small cadre of type-A consumers ferrets out the most beneficial subordinate contract terms, permitting the market to protect the vast majority of consumers.... It is hard ... to imagine a sufficient number of prospective consumers refusing to rent a car because the contract contains an unfair forum selection clause.

likely to be of interest to consumers, but the cost of learning about them and comparing them is also likely to be greater than would be true of, for example, a price term.<sup>116</sup> For example, few consumers are likely to understand the drawbacks of binding arbitration.<sup>117</sup> If too few consumers search for firms that do not require binding arbitration, then Schwartz and Wilde's searchers will not protect the nonsearchers.<sup>118</sup>

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Meyerson, *supra* note 45, at 1270-71.

[Schwartz and Wilde's] assumptions are unrealistic. Although it may be true that there are some markets at some times and places where sellers have generally changed their forms to please the relatively few informed and powerful buyers, Schwartz and Wilde offer no evidence to support their conclusion that such markets are typical.

Slawson, *supra* note 80, at 43. *See also* Cruz & Hinck, *supra* note 93, at 664 ("[T]he existence of any sizable informed minority is highly doubtful."); Sternlight, *supra* note 45, at 691 ("[With regard to arbitration] it seems likely that the 'knowledgeable minority' is an extremely small minority.... If the knowledgeable minority is sufficiently small, the supplier may well make enough money from taking advantage of the majority to more than justify losing the minority's business."); *cf. id.* at 688 ("[I]t seems generally true that while consumers may be well informed about certain key contractual terms, such as price or color or engine size, they generally know very little about the subordinate contract terms ....").

116. Goldberg, *supra* note 41, at 485. Michael I. Meyerson has elaborated on this point:

Subordinate terms will not be known because the cost of acquiring the necessary information exceeds the expected gain to the consumer from that information. The first cost of acquiring information concerning contract terms is the time the consumer must spend reading the document.... Some sellers attempt to increase this cost through the use of fine print or obscure placement.... The cost to the consumer is made all the more excessive by the high cost of understanding a term's legal significance. Again, some sellers try to increase this cost by hiding the term's meaning in obscure "legalese".... [C]ostly research is generally required to understand the legal effect of a particular term. Obviously, consumers will not be able to undertake such research for every form they sign.

Meyerson, *supra* note 46, at 597-98 (footnotes omitted). *See also* Cruz & Hinck, *supra* note 93, at 675-76 ("[I]t is seldom the case that there will be many consumers for whom the cost of becoming informed is less than the expected loss from the inefficient terms."); Goldman, *supra* note 47, at 719. Sometimes, as discussed above, firms use inflated transaction costs to make it more difficult to ascertain the features of such terms. *See supra* notes 45-56 and accompanying text.

117. *See supra* note 45 and accompanying text; *see also* Melvin Aron Eisenberg, *Text Anxiety*, 59 S. CAL. L. REV. 305, 309 (1986) ("The average consumer knows that he probably will be unable to fully understand the dense text of a form contract ...."); Hillman & Rachlinski, *supra* note 80, at 436 ("[T]he consumer would not understand much of the language of the boilerplate even if she took the time to read it.").

118. *Cf. Korobkin, supra* note 90, at 1240 ("The types of terms that generally appear in form contracts suggest that the negative reputational consequences of inefficient non-salient form terms are unlikely to discipline sellers to offer efficient terms.").

Similarly, scholars have suggested that consumers might justifiably assume that few consumers will bother to read the terms, and therefore sellers, knowing this, will draft terms that are unfavorable to consumers. Accordingly, consumers can skip the dreary task of reading the terms because they can already anticipate the worst.<sup>119</sup> Consumers may also forego reading contracts because they believe that other firms will not offer better terms,<sup>120</sup> a belief that may be correct.<sup>121</sup> Even if other firms do offer better terms, consumers will not search for those better terms if they do not anticipate that the terms will be better, especially given the cost of searching for and reading competitors' contracts.<sup>122</sup> In addition, as R. Ted Cruz and Jeffrey Hinck have written, "there is a very strong incentive for buyers to free ride on the information of others, and if everybody free rides, no informed minority will ever form."<sup>123</sup> In any event, it is quite clear that many consumers do not

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119. Cruz & Hinck, *supra* note 93, at 668; Katz, *supra* note 80, at 282-90.

120. See Goldman, *supra* note 47, at 718; Hillman & Rachlinski, *supra* note 80, at 436, 446-47.

121. Slawson, *supra* note 41, at 531. *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991), discussed *infra* notes 213-19 and accompanying text, is instructive. The case involved the enforceability of a forum selection clause in a cruise line passenger ticket. The International Committee of Passenger Lines, a trade association of sixteen passenger cruise lines operating eighty-one vessels, filed an amicus brief describing the use of such forum selection clauses as a "universal practice" in passenger ticket contracts; all sixteen members of the association used them. Brief of The Int'l Comm. of Passenger Lines as Amicus Curiae Supporting the Petition for Writ of Certiorari, *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991) (No. 89-1647), 1990 U.S. S. Ct. Briefs LEXIS 392.

122. Meyerson, *supra* note 46, at 599-600 (noting the high transaction costs of finding a seller offering the preferred term).

123. Cruz & Hinck, *supra* note 93, at 676.

read through boilerplate agreements<sup>124</sup> and that not doing so may be rational utility-maximizing behavior.<sup>125</sup>

Consequently, as to un-searched-for attributes, the market can still be monopolistic. In Schwartz and Wilde's view,

[a] market can be considered monopolistic for any term used by all or almost all firms if: (1) the market is not price competitive; and (2) the term at issue appears in arcane legal language and fine or otherwise inconspicuous print .... [Or, if] the market is

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124. See Mayer, *supra* note 48.

[R]egulators say ... many consumers agree to mandatory arbitration without knowing it. The clauses may be buried in a pile of documents a consumer is asked to sign quickly, such as during a real estate settlement; tacked onto the back of a sales receipt; or, in the case of some Internet retailers, placed at the bottom of a special World Wide Web page that specifies the terms and conditions of each sale.

*Id.*; see also Burke, *supra* note 87, at 299 ("Courts know that parties sign or manifest assent to standard form contracts that they have not read, understood or negotiated."); Meyerson, *supra* note 45, at 1269 ("It is no secret that consumers neither read nor understand standard form contracts."); *The Arbitration Trap: How Consumers Pay for 'Low Cost' Justice*, CONSUMER REP., Aug. 1999, at 64 ("Many consumers aren't aware their transaction includes an arbitration clause ...."). Other proof is anecdotal. Federal law required a bank to notify its customers of certain rights. The bank puckishly mailed to a hundred of its customers a pamphlet in which it offered to send ten dollars to anyone who replied by sending to the bank their name and address on a piece of paper with the word "regulation" written on it. No one did so. See ALAN SCHWARTZ & ROBERT E. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 1142 (2d ed. 1991); Jeff Sovern, Letter to the Editor, *Banks Are Too Sly on Risks of Debit Cards*, N.Y. TIMES, July 17, 1997, at A22.

125. See Randy E. Barnett, *Consenting to Form Contracts*, 71 *FORDHAM L. REV.* 627, 631 (2002); Hillman & Rachlinski, *supra* note 80, at 436; Katz, *supra* note 80, at 273; see also Trebilcock & Dewees, *supra* note 111, at 115 ("[M]any consumers probably rely in part on the constraints (real or illusory) imposed by other consumers at the margin (i.e., they let the market shop for them). In addition, reading complicated forms in detail denies the principal virtue of standard form contracts—reduced transaction costs."); Eisenberg, *supra* note 117, at 305 ("[C]onsumers who are faced with ... form contracts ... refus[e] to read, and ... it is reasonable for them to do so."); Goldman, *supra* note 47, at 717 ("[P]urchasers would be acting irrationally if they incurred the costs required to fully comprehend all contract terms."); Rakoff, *supra* note 47, at 1226 ("[T]he near-universal failure of adherents to read and understand the documents they sign cannot be dismissed as mere laziness."); Schwartz & Wilde, *supra* note 80, at 1460 ("Whether a consumer reads a particular contract may depend on whether the consumer perceives the expected gain from reading to exceed the cost."); Sternlight, *supra* note 45, at 689 (arguing that reading the fine print would sometimes not be enough because a consumer would need legal advice to assist her in understanding its significance). As discussed *infra* note 179 and accompanying text, the law has responded to the practice by requiring certain information to appear conspicuously. Consumers may thus assume that any information of genuine value will not be in small print, and so reading the fine print is a waste of time.

price competitive ... a monopolistic outcome for any term should be presumed to occur if a substantial portion ... of the comparison shoppers are not term conscious.<sup>126</sup>

As Victor Goldberg has written, "[u]nless the firm intentionally makes the particular term an important selling point—as is sometimes the case with the length or inclusiveness of the warranty—few, if any, customers will perceive the existence of variations in terms."<sup>127</sup>

When consumers are not aware of or do not appreciate the ramifications of a term or practice, the firm has license to use that term or practice to inflate consumer transaction costs.<sup>128</sup> W. David Slawson has explained, "[a]n unfair form will not deter sales because the seller can easily arrange his sales so that few if any buyers will read his forms, whatever their terms, and he risks nothing because the law will treat his forms as contracts anyway."<sup>129</sup> If the market cannot function, firms can behave monopolistically.<sup>130</sup>

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126. Schwartz & Wilde, *supra* note 97, at 661 (footnotes omitted); *see also id.* at 660 ("Evaluating terms is more costly than evaluating prices ...."). Mandatory arbitration clauses may be an example of a term that is universally used, or nearly so, in some markets. *See* Mayer, *supra* note 48 (discussing credit card companies' use of arbitration). Some have argued that even consumers who do not read the fine print can nevertheless exercise control over firms' behavior through their expectations. If the product and firm do not meet consumer expectations, regardless of what the contract provides, consumers can punish firms by withholding business and urging other consumers to shop elsewhere. If enough consumers react this way, firms may have to fulfill consumer expectations even though they have no contractual obligation to do so. *See* Trebilcock & Dewees, *supra* note 111, at 105. Although this phenomenon happens often enough in the automobile market to have earned a name—good will adjustments—and to be regulated in some states, *see generally* Sovern, *supra* note 113, it probably does not happen often enough in most markets to offset the losses to consumers caused by inflation of transaction costs.

127. Goldberg, *supra* note 41, at 485.

128. *Cf.* Purcell, *supra* note 46, at 494 ("The fact that specific provisions happen to appear in the contracts, after all, is the result of nothing necessarily other than consumer ignorance and the common interests of the companies."); Sternlight, *supra* note 45, at 688-89 ("If the consumer is not aware of the existence or significance of [a] clause, the supplier is free to impose a term that benefits the supplier but significantly harms the consumer.").

129. Slawson, *supra* note 41, at 531; *see also* Meyerson, *supra* note 46, at 595 ("[I]nefficient transactions occur because consumers do not read form contracts, or do not understand the terms, and are thus unaware of their contents. Moreover, the businesses that draft these contracts do so knowing that they will not be read by the typical consumer.").

130. *See* Rakoff, *supra* note 47, at 1231 ("Because customers generally neither are expected to nor do read, understand, or shop the form terms, market behavior gives no clue to their preferences.").



This circumstance is thus a variation of George A. Akerlof's famous lemons model.<sup>131</sup> Firms compete to offer terms and features that consumers pay attention to while having their way with terms that consumers either do not pay attention to or do not understand. Victor Goldberg gives the example of a competitive insurance industry without any governmental intervention:

Firms in the industry compete by lowering their price and then compensate for this by decreasing the coverage (*in as hidden a way as possible*) with other firms being forced to cut also in order to remain competitive. A sort of "Gresham's Law" of bad policies driving out good would ensue.<sup>132</sup>

The italicized phrase of course brings to mind the deliberate inflation of transaction costs.

Once a firm has the power to behave monopolistically in some respects, it can use inflated transaction costs to avoid the very competition that might make it harder to inflate still other costs, as alluded to above.<sup>133</sup> For example, when firms delay the disclosure of their terms, as in *Brower*, they increase the cost to consumers of finding out those terms, thus rendering their markets less competitive. The practice of delaying disclosure of terms may explain the failure of many software sellers to give warranties.<sup>134</sup> By making it harder for consumers to discover the absence of a warranty, sellers avoid the need to compete to offer one. Though the reasoning may sound circular—firms inflate transaction costs so they can disrupt the functioning of markets, and they use the resulting impaired markets to inflate transaction costs—it is not. The process starts with a defect in the market, perhaps consumer ignorance, as in the case of the rebates, and builds from there.

Arguably, if consumers do not pay attention to or abandon efforts to protect their interests merely because doing so would require reading small print or writing a letter, the particular interests must

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131. See generally George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 48 (1970).

132. Goldberg, *supra* note 41, at 486 (emphasis added). Other forces might ameliorate the problem, such as advertising or private producers of information, though "there is no reason to believe that the market will negate the standard form contract problem." *Id.*

133. See *supra* note 128 and accompanying text.

134. Braucher, *supra* note 41, at 1813.

not matter much to them, and therefore are not worth attending to.<sup>135</sup> But that argument is flawed. It fails to take into account how consumers actually behave and the internalities alluded to above.<sup>136</sup> E. Scott Maynes has written about how “consumers [often] cannot find the time to manage effectively consumption that has grown more complex and dynamic.”<sup>137</sup> That is because many consumers subordinate their interests as consumers to their interests in their jobs<sup>138</sup> and because consumers must spread their attention “thinly across thousands of transactions and the management of hundreds of possessions.”<sup>139</sup>

#### *D. More on Internalities*

Consumers respond predictably to certain stimuli, and companies can take advantage of this behavior. Some internalities have already been discussed,<sup>140</sup> but others exist. For example, the famous tendency of people to procrastinate probably leads many consumers to put off seeking rebates until finally they abandon the effort altogether.<sup>141</sup> Firms aware of this when choosing between a rebate

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135. Cf. Note, *Efficiency and a Rule of “Free Contract”: A Critique of Two Models of Law and Economics*, 97 HARV. L. REV. 978, 993 (1984) (“The consumer who, by reason or obliviousness, fails to search for the discount price is less likely to merit our solicitude ....”).

136. See *supra* notes 116-24 and accompanying text.

137. E. Scott Maynes, *Consumer Problems in Market Economies*, in *ENCYCLOPEDIA OF THE CONSUMER MOVEMENT* 158, 163 (Stephen Brobeck ed., 1997).

138. *Id.* at 158.

139. *Id.* at 158-59; see also Howard Latin, “Good” Warnings, Bad Products, and Cognitive Limitations, 41 UCLA L. REV. 1193, 1216 (1994) (“Once it is recognized that decisionmaking capacities are limited and that people have many competing demands made on their time and attention, the failure of consumers to read some product warnings becomes foreseeable and inevitable.”).

140. See *supra* notes 57-89, 116-24 and accompanying text.

141. Cf. Camerer et al., *supra* note 57, at 1225 (suggesting that one source for “status quo bias” is “procrastination—the tendency to repeatedly delay taking beneficial actions based on a mistaken belief that one will take them in the future”); Ted O’Donoghue & Mathew Rabin, *Doing It Now or Later*, 89 AM. ECON. REV. 103, 103 (1999) (explaining that people have present-biased preferences); Brian Bergman, *Guilt-Free Goofing Off*, *MACLEAN’S*, July 28, 2003, at 38 (reporting that sixty percent of survey respondents describe themselves as modest procrastinators and ninety-five percent of respondents say they procrastinate at least occasionally, and quoting Professor Piers Steel as saying that “[p]rocrastination is our normal state of being”); Barbara Yost, *Don’t Delay To Read Why We Procrastinate*, *SEATTLE TIMES*, May 2, 2004, at M2 (reporting that psychologist William Knaus estimates that “20% of the population are inveterate procrastinators”).

offer and a lower price may choose the rebate precisely to take account of this behavior.

Similarly, whether or not it is rational for consumers to forego reading fine print,<sup>142</sup> it appears that a number of consumer characteristics operate to reduce the desire of consumers to read fine print. One characteristic is the tendency of consumers to focus on what social scientists label "vivid" information, that is, more interesting and exciting information, rather than dull information.<sup>143</sup> Bills identifying what a consumer owes and circulars such as pay-per-view listings with colorful photographs are more likely to draw consumer attention than are bill-stuffers printed in legalistic language.<sup>144</sup>

Another reason consumers may not bother to read terms is that many contract clauses address problems that may arise in connection with contract performance, problems that afflict relatively few consumers. A considerable body of evidence suggests that consumers tend to be optimistic<sup>145</sup> and so may not expect to be

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142. See *supra* notes 116-24 and accompanying text.

143. See RICHARD NISBETT & LEE ROSS, HUMAN INFERENCE: STRATEGIES AND SHORTCOMINGS OF SOCIAL JUDGMENT 45 (1980) (explaining that people process and remember vivid information more than pallid information); Jonathan Shedler & Melvin Manis, *Can the Availability Heuristic Explain Vividness Effects?* 51 J. PERSONALITY & SOC. PSYCHOL. 26, 35 (1986) (finding that vividness is correlated with recollection of facts); Marie G. Wilson, Gregory B. Northcroft & Margaret A. Neale, *Information Competition and Vividness Effects in On-Line Judgments*, 44 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 132, 137-38 (1989) (finding that jurors were more likely to use vivid information in making their decisions).

144. Researchers have also found that many consumers give more attention to pictures than text. See NISBETT & ROSS, *supra* note 143, at 51 (listing studies); Robert E. Gehring, Michael P. Toglia & Gregory K. Kimble, *Recognition Memory for Words and Pictures at Short and Long Retention Intervals*, 4 MEMORY & COGNITION 256, 256, 260 (1976) (finding that recollection is better for pictures); Roger N. Shepard, *Recognition Memory for Words, Sentences, and Pictures*, 6 J. VERBAL LEARNING & VERBAL BEHAV. 156, 158-60 (1967) (finding that color in pictures aids in recollection).

145. See David A. Armor & Shelley E. Taylor, *When Predictions Fail: The Dilemma of Unrealistic Optimism*, in HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 334, 334 (Thomas Gilovich et al. eds., 2002) ("One of the most robust findings in the psychology of prediction is that people's predictions tend to be optimistically biased."); Melvin Aron Eisenberg, *The Emergence of Dynamic Contract Law*, 88 CAL. L. REV. 1743, 1782 (2000) (stating that contracting parties tend to be "unrealistically optimistic"); Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1659 (1998) ("[P]eople are often unrealistically optimistic about the probability that bad things will happen to them. A vast number of studies support this conclusion."); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806,

affected by such terms. For example, consumers may not pay attention to terms governing disputes because they may not anticipate a dispute.<sup>146</sup> Similarly, consumers may not trouble themselves about default terms<sup>147</sup> because psychological studies suggest that consumers underestimate the likelihood that they will default.<sup>148</sup>

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806, 818-19 (1980); see also Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, in *HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT*, *supra*, at 230, 248 ("Although overconfidence is not universal, it is prevalent, often massive, and difficult to eliminate ...."); Hillman & Rachlinski, *supra* note 80, at 454 ("People intending to purchase a product likely will overstate their own ability to assess the reputation and good faith of the person or company with whom they are interacting."); Dan N. Stone, *Overconfidence in Initial Self-Efficacy Judgments: Effects on Decision Processes and Performance*, 59 *ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES* 452, 453-54, 468 (1994) (citing studies that demonstrate consumer optimism). For examples of optimistic behavior, see Cass R. Sunstein, *Hazardous Heuristics*, 70 *U. CHI. L. REV.* 751, 772-74 (2003) (reviewing THOMAS GILOVICH ET AL., *HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT* (2002)) ("With respect to most of the risks of life, people appear to be unrealistically optimistic."). For a warning against oversimplifying reports of research on topics such as consumer optimism and against generalizing too widely from such research, see Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics' Equal Incompetence*, 91 *GEO. L.J.* 67, 125 (2002); see also Gregory Mitchell, *Taking Behavioralism Too Seriously? The Unwarranted Pessimism of the New Behavioral Analysis of Law*, 43 *WM. & MARY L. REV.* 1907, 1911-12 (2002) (arguing that legal writers often misinterpret behavioral research). That warning seems less apropos here because the available studies offer significant support for the notion that people will be overly optimistic about the likelihood that they will breach contracts. See, e.g., Eisenberg, *supra*, at 1783-86 (giving examples of consumers underestimating risk). On the other hand, some evidence suggests that in some cases, people exaggerate the probability of risks. See Korobkin, *supra* note 90, at 1232-33 (stating that people exaggerate risks that are familiar and easy to imagine).

146. See Braucher, *supra* note 41, at 1813-14 ("Shopping is often much less common when it comes to contingent terms such as warranties, remedies, dispute forum, or other terms that only matter if something goes wrong with a purchase and that are therefore secondary concerns to consumers. Use of legalese adds to the problem ....").

147. See Jean Braucher, *Defining Unfairness: Empathy and Economic Analysis at the Federal Trade Commission*, 68 *B.U. L. REV.* 349, 363 (1988) ("Debtors in general do not expect to default and avoid thinking about this risk.").

148. Eisenberg, *supra* note 145, at 1784 ("The availability heuristic may lead a contracting party to give undue weight to his present intention to perform, which is vivid and concrete, as compared with the abstract possibility that future circumstances may compel him to breach."); Larry T. Garvin, *Adequate Assurance of Performance: Of Risk, Duress, and Cognition*, 69 *U. COLO. L. REV.* 71, 149 (1998) ("Experiment has shown that we are an optimistic lot, consistently underestimating risks and overestimating advantages."); Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 *CORNELL L. REV.* 717, 723-24 (2000) ("[P]eople generally have an inflated view of their own capabilities and therefore downplay risks they believe they can

Excessively optimistic consumers may make poor decisions. Schwartz and Wilde have suggested that "[m]arkets may correct poorly for consumer optimism."<sup>149</sup> In the context of warranties, they explained the consequences of consumer optimism: "If ... optimism causes ... consumers not to demand [warranties], warranties will probably not appear. Firms lack an incentive to offer broader warranties than consumers demand because warranties are costly ...."<sup>150</sup> Thus, firms may choose not to compete on the basis that they will absorb a risk because they can expect that consumers will assume that the risky event will not in fact occur. Consequently, firms have nothing to lose by inserting terms that impose risks on consumers.<sup>151</sup> The result, again, is a by-product of market failure.

Consumers also suffer from information overload, the tendency to disregard relevant information when too much is provided.<sup>152</sup> Too

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control."); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091-93 (2000); Rachlinski, *supra* note 54, at 1179. Russell Korobkin has suggested that the explanation for this phenomenon lies in the availability heuristic under which consumers take into account risks that they know of or can readily imagine but disregard risks with which they are less familiar. Korobkin, *supra* note 90, at 1232-33. He explains:

[I]f a low-probability risk comes to pass: if the seller's product does not function; if the buyer does not pay on time; if the parties become embroiled in a dispute that leads to litigation .... If these possible but unlikely outcomes are not readily "available" to buyers, they are likely to respond to the risk of these harms by treating them as if they do not exist at all.

*Id.* at 1233.

149. Schwartz & Wilde, *supra* note 80, at 1429. Schwartz and Wilde concluded—based on information available at the time they wrote—that no reason existed to assume that consumers will be systematically optimistic, *id.* at 1435-36, but later studies have called this conclusion into question, see *supra* notes 145-48 and accompanying text.

150. Schwartz & Wilde, *supra* note 80, at 1429.

151. Firms face a different situation from consumers. As Edward A. Purcell, Jr., has explained:

Because the companies deal with millions of consumers they have the economic incentives to gain whatever information seems useful, and they know that over the aggregate of their consumer sales they will derive substantial benefits from various advantageous and arcane contractual provisions that they incorporate, even though such provisions will become useful in only a small percentage of their total transactions.

Purcell, *supra* note 46, at 487.

152. See, e.g., John C. Bergstrom & John R. Stoll, *An Analysis of Information Overload with Implications for Survey Design Research*, 12 LEISURE SCI. 265, 278 (1990) (finding that the quantity and complexity of information can obscure decision making); Kevin Lane Keller & Richard Staelin, *Effects of Quality and Quantity of Information on Decision Effectiveness*, 14 J. CONSUMER RES. 200, 211-12 (1987); Naresh K. Malhotra, *Information Load and Consumer*

much information appears to cause many consumers to adopt strategies to reduce the amount of information to a more manageable amount when making decisions.<sup>153</sup> Consequently, many consumers undoubtedly "manage away" the small print.<sup>154</sup>

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*Decision Making*, 8 J. CONSUMER RES. 419, 427-28 (1982) (listing studies). Early studies included Jacob Jacoby, Donald E. Speller & Carol A. Kohn, *Brand Choice Behavior as a Function of Information Load: Replication and Extension*, 1 J. CONSUMER RES. 33, 40-41 (1974) (finding that consumers made poorer decisions with more information); Jacob Jacoby, Donald E. Speller & Carol Kohn Berning, *Brand Choice Behavior as a Function of Information Load*, 11 J. MARKETING RES. 63, 67 (1974) (same). For criticism of the early Jacoby studies, see, for example, Naresh K. Malhotra, *Reflections of the Information Overload Paradigm in Consumer Decision Making*, 10 J. CONSUMER RES. 436, 436-37 (1984) (suggesting that information overload does occur, but that the early Jacoby studies did not demonstrate it); J. Edward Russo, *More Information Is Better: A Reevaluation of Jacoby, Speller and Kohn*, 1 J. CONSUMER RES. 68, 71-72 (1974) (claiming that Jacoby used the incorrect measure of information); John O. Summers, *Less Information Is Better?*, 11 J. MARKETING RES. 467, 467 (1974) (criticizing Jacoby's methods); William L. Wilkie, *Analysis of Effects of Information Load*, 11 J. MARKETING RES. 462, 465-66 (1974) (criticizing Jacoby for combining brands and items in defining information). For Jacoby's replies, see Jacob Jacoby, Donald E. Speller & Carol A.K. Berning, *Constructive Criticism and Programmatic Research: Reply to Russo*, 2 J. CONSUMER RES. 154 (1975); Jacob Jacoby, *Information Load and Decision Quality: Some Contested Issues*, 14 J. MARKETING RES. 569 (1977) (agreeing and disagreeing with critics of his research). For studies rebutting the information overload effect, see Naresh K. Malhotra, Arun K. Jain & Stephen W. Lagakos, *The Information Overload Controversy: An Alternative Viewpoint*, 46 J. MARKETING 27, 34-36 (1982) (finding that consumers made better choices with more information); Thomas E. Muller, *Buyer Response to Variations in Product Information Load*, 69 J. APPLIED PSYCHOL. 300, 304 (1984) (finding that consumers used the extra information given them); Debra L. Scammon, *"Information Load" and Consumers*, 4 J. CONSUMER RES. 148, 148-49, 153-54 (1977) (finding that length of exposure was more important than amount of information). For criticism of these last studies, see Jacob Jacoby, *Perspectives on Information Overload*, 10 J. CONSUMER RES. 432, 432-34 (1984) (suggesting that the studies cited *supra* do not really disprove information overload). For criticism of the Keller & Staelin study cited *supra*, see Robert J. Meyer & Eric J. Johnson, *Information Overload and the Nonrobustness of Linear Models: A Comment on Keller & Staelin*, 15 J. CONSUMER RES. 498 (1989). Keller and Staelin's response appears in Kevin Lane Keller & Richard Staelin, *Assessing Biases in Measuring Decision Effectiveness and Information Overload*, 15 J. CONSUMER RES. 504 (1989). For law review discussions of information overload, see David M. Grether, Alan Schwartz & Louis L. Wilde, *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277 (1986) (suggesting that information overload does not exist). But see Eisenberg, *supra* note 117 (arguing that refusing to read dense contracts is reasonable); Robert E. Scott, *Error and Rationality in Individual Decisionmaking: An Essay on the Relationship Between Cognitive Illusions and the Management of Choices*, 59 S. CAL. L. REV. 329, 329-31, 361-62 (1986) (expanding on the Grether analysis).

153. See Korobkin, *supra* note 90, at 1226-29.

154. See Hillman & Rachlinski, *supra* note 80, at 450-52 ("Some scholars have argued that this tendency to simplify decisionmaking means that people essentially cannot evaluate the many situations covered by the terms in standard-form contracts.").

*E. Other Reasons Why Firms Might Not Compete To Reduce Transaction Costs*

Another reason competitive markets do not supply reduced transaction costs is that some businesses may choose not to compete in a particular way for fear that their advertising would not be effective, would be costly, or might obscure other messages they would rather convey.<sup>155</sup> In theory, firms should advertise terms that are more favorable to consumers if the profits from increased sales generated by those terms exceed the cost of the advertising together with the lost profits from eschewing terms that are less favorable to consumers.<sup>156</sup> But this equation seldom leads to the advertising and adoption of terms that consumers would prefer.<sup>157</sup> To understand why, imagine a business that competes on the ground that it does not insist on binding arbitration in a distant forum. What seller would want to call attention to the fact that it ends up in disputes with its customers?<sup>158</sup> Even if such advertising increased the seller's market share, it would probably reduce sales of the generic product,

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155. See Korobkin, *supra* note 90, at 1242-43.

[S]uch marketing efforts will be costly, so sellers will have to balance the benefits of exploiting their competitive advantage against the cost of making the market responsive to it.... [I]n a complex world in which products have many attributes, it seems likely that a seller could fail to make certain attributes salient no matter how many resources it expends on advertising ....

*Id.*

156. Cruz & Hinck, *supra* note 93, at 658-59.

157. *Id.* at 660 ("Most contract terms likely provide less benefit to consumers than the cost of providing them plus the cost of advertising them."). But see Goldman, *supra* note 47, at 716 ("If a seller includes unwanted terms in its contracts, a business offering the preferred higher price/easier terms option should inform consumers that although the competitor's price is lower, the real value that the competitor offers is less.").

158. See Sternlight, *supra* note 45, at 692.

[R]ealistically, no seller is likely to call attention to possible problems with its own product by telling consumers that "if it explodes you can sue us in court, not just through an arbitration." In other words, by publicizing the risks relevant to the arbitration clause the seller might well cause sales as a whole to plummet.

*Id.*; see also Goldman, *supra* note 47, at 719 (explaining that firms do not want to call attention to negative potential outcomes); Korobkin, *supra* note 90, at 1242 ("[A] firm with an in-house legal department that gives it a cost advantage in litigating rather than arbitrating disputes with its customers is not likely to launch an advertising campaign bragging that 'you can sue us in court at any time without limitations.'"); Meyerson, *supra* note 46, at 602 ("Since consumers are, at best, only dimly aware of [contract clauses allocating risks to them], sellers will not want to call attention to the risks for fear of creating a disincentive for any purchase at all.").

including that seller's sales.<sup>159</sup> Nor is a seller likely to undertake the considerable burden of educating consumers on the drawbacks of binding arbitration. Such a seller might also fear that it would not recoup the benefits of its advertising campaign because those benefits would also flow to free riders.<sup>160</sup> A business would probably do better to add a binding arbitration term to its own contracts and compete on the basis of a more readily understandable term, like price.<sup>161</sup> The result, as Todd D. Rakoff has written, "is that over time more and more risks are shifted to the [consumer]."<sup>162</sup>

For another example, suppose company A offers its product at price  $P$ , with rebate  $R$ . The average net retail price for A's product will be between  $P$  and  $P-R$  because many consumers will not seek the rebate. Suppose a competitor,  $B$ , also wishes to offer its product at an average price between price  $P$  and  $P-R$ , but rather than using a rebate scheme,  $B$  simply wants to sell its product at a standard price.  $B$  could run an advertisement that says something like "You know you won't redeem the rebate coupon, so you won't get the benefit of the rebate. Buy our product and you won't have to pay the higher price you'll end up paying for A's product or deal with the rebate coupon." Such an advertisement might end up doing more for A than B among consumers who erroneously believe they will respond to a rebate offer; in addition, some of the benefits might again flow to free riders. The advertisement might also distract from

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159. Cf. Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: A Response to Market Manipulation*, 6 ROGER WILLIAMS U. L. REV. 259, 336-37 (2000) (arguing that marketing products by increasing consumer perceptions of the product's riskiness is likely to produce such effects).

160. Cruz & Hinck, *supra* note 93, at 659; Goldman, *supra* note 47, at 719.

161. Cf. Goldman, *supra* note 47, at 719 (explaining that firms do not want to waste their advertising budget by focusing on insignificant terms); Hillman & Rachlinski, *supra* note 80, at 452 ("This narrow cognitive focus that people bring to complex decisions creates a temptation for businesses to offer enticing prices and terms concerning the negotiable portions of the form and to make up for any concessions by drafting one-sided boilerplate terms."); Korobkin, *supra* note 90, at 1206 ("[M]arket competition actually will force sellers to provide low-quality non-salient attributes in order to save costs that will be passed along to buyers in the form of lower prices."); Meyerson, *supra* note 46, at 602 ("[S]ellers will not want to divert their limited advertising budgets to publicizing factors that will play at most a minimal role in purchasing decisions."); Sternlight, *supra* note 45, at 692 ("[S]ellers may be reluctant to expend a significant portion of their advertising budget on subordinate terms when they could likely achieve greater inroads by focusing on terms more likely to influence consumer choice.").

162. Rakoff, *supra* note 47, at 1227.



other messages *B* would prefer to convey. Consequently, *B* might choose to compete on a different basis. And, indeed, such advertising is unheard of.<sup>163</sup>

Still another reason why markets break down in this context is that some companies may be subject to a form of inertia and would rather not change their practices just to compete on a basis that may not increase sales. This is especially likely because a firm that chooses to compete on the basis of lowering transaction costs must forego the income generated by inflated transaction costs—and so competition on this basis is not costless. Put another way, firms may increase their sales to consumers by not inflating consumer transaction costs, but doing so may reduce their profits by decreasing other revenue. Thus, firms competing on the basis of reduced transaction costs are taking a risk that the increase in business will not offset the loss of profits. For example, imagine a firm that sells products to consumers and sells to others information about the consumers who buy their products. A business that chooses to compete on the basis that it makes it easy for consumers to opt out of the sale of their personal information runs the risk of not attracting enough customers to offset the losses from the sale of consumer information. Firms may not be willing to take that chance.

In sum, notwithstanding conventional economic theory, in many instances markets fail to produce competition to reduce consumer transaction costs. Though this phenomenon is due in part to consumer internalities, firms seem willing to take advantage of and profit from these internalities and so should not be excused from responsibility on that basis.

The reader should be cautioned that this list of conditions in which firms inflate consumer transaction costs may not be complete. It is at best a preliminary attempt to explore a complicated phenomenon.

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163. Cf. Goldman, *supra* note 47, at 718 (“[C]ompetitors generally are reluctant to engage in negative comparative advertising. Emphasizing a competitor’s harsh contract terms risks the possibility of negative counter-advertising, the sole effect of which may be reduced sales industry-wide.”).

### III. WHY INFLATING CONSUMER TRANSACTION COSTS IS OBJECTIONABLE

Explaining why inflated transaction costs are objectionable almost seems unnecessary. Transaction costs have been referred to as “the root of all evil,”<sup>164</sup> the cause of “monopolistic inefficiencies,”<sup>165</sup> “dead weight losses that reduce efficiency,”<sup>166</sup> and the source of all externalities.<sup>167</sup> Leading scholars have suggested that legal rules should be fashioned to minimize transactions costs.<sup>168</sup> The importance of transaction costs cannot be underestimated: they have been described as central to the study of economics<sup>169</sup> and held responsible both for the existence of firms<sup>170</sup> and how the

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164. Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 142 (1979). *But see* Driesen & Ghosh, *supra* note 30, at 3 (arguing that transaction costs are sometimes necessary but acknowledging that “some transactions costs might prove wasteful and deserve elimination”).

165. Harold Demsetz, *Why Regulate Utilities?*, 11 J.L. & ECON. 55, 61 (1968) (discussing negotiation costs).

166. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 26-27 (2002).

167. *See* Steven G. Medema & Richard O. Zerbe, Jr., *Educating Alice: Lessons from the Coase Theorem*, in 19 RESEARCH IN LAW AND ECONOMICS 69, 73 (Richard O. Zerbe Jr. & William Kovacic eds., 2000); Zerbe & McCurdy, *supra* note 30, at 562 (“[E]xternalities come into being because the transaction costs of resolving them are too high. In this sense, every story about externalities is also a story about transaction costs.”); *see also* Fred S. McChesney, *What’d I Say?: Coase, Demsetz and the Unending Externality Debate* 3-4 (Nw. Univ. Sch. of Law, Law & Econ. Research Paper Series, Research Paper No. 04-01), available at <http://papers.ssrn.com/abstract=491182> (“Low transaction costs allow internalization of social costs, and so reduce the incidence of externalities; as those costs rise, so does the extent of externalities.... In the limit, if there were no transaction costs, there seemingly would be no social costs.”). *But see* Harold Demsetz, *Ownership and the Externality Problem*, in PROPERTY RIGHTS: COOPERATION, CONFLICT, AND LAW 282, 284 (Terry L. Anderson & Fred S. McChesney eds., 2003) (arguing that, even in a world of zero transaction costs, externalities would still exist).

168. POSNER, *supra* note 94, at 427-28; R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 19 (1960); Cooter, *supra* note 27, at 14 (“[T]he structure of law should be chosen so that transaction costs are minimized, because this will conserve resources used up by the bargaining process and also promote efficient outcomes in the bargaining itself.”); *see also* AVINASH K. DIXIT, THE MAKING OF ECONOMIC POLICY: A TRANSACTION-COST PERSPECTIVE 61 (1996) (“There is clear potential benefit from economizing on transaction costs.”); Medema & Zerbe, *supra* note 167, at 83 (discussing transaction costs involved in cattle trespass in California); Veljanovski, *supra* note 30, at 67-68; Mark Wohar, *Alternative Versions of the Coase Theorem and the Definition of Transaction Costs*, 27 Q.J. BUS. & ECON. 3, 13 (1988) (summarizing different definitions of the economic goal of the law in the literature).

169. Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 233 (1979).

170. Ronald H. Coase argued in his famous article *The Nature of the Firm*, 4 ECONOMICA

organizational arrangements that govern trade in a market economy are established.<sup>171</sup> Nevertheless, offering some reasons why inflated transaction costs are troublesome seems desirable. In a nutshell, inflated transaction costs are objectionable because they typically waste resources or generate inefficiencies in the sense of misallocating resources or both.

Rebates illustrate both problems. Consumers who intend to seek the rebate but never bother, or fail in the attempt because they do not comply with arcane requirements, experience a distortion of their demand function.<sup>172</sup> Figure 1 displays the familiar model of supply and demand in which firms face a downward-sloping demand curve D'D: as prices decline, quantity demanded increases. The supply curve S'S slopes upward because as prices increase, sellers are willing to supply more goods. In the absence of rebates, the equilibrium price is determined by the intersection of the demand curve D'D with the supply curve S'S, which results in the selling of  $Q_0$  goods at price  $P_0$ . The consumer surplus—the benefit the consumer receives from the purchase—for a consumer purchasing at the equilibrium price is represented in Figure 1 by triangle HBE. When a seller offers a rebate, however, consumers who intend to seek the rebate believe that the price has been reduced to  $P_1$ ; consequently, consumers are now willing to purchase quantity  $Q_1$  of the goods because they expect to receive the larger consumer surplus depicted by triangle ABC. But when consumers fail to obtain the rebate, consumers still receive only the lesser surplus represented by triangle HBE. Indeed, even that surplus is eroded (in a way not depicted in Figure 1) because it comes at unnecessary expense: consumers have purchased  $Q_1$  of the goods rather than the lesser quantity  $Q_0$  at which they could have had the same surplus. Presumably the erosion, however, is partly offset by the ownership of additional units of the good. The rebate thus deceives consumers into inefficiently purchasing more goods than they would want if

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386 (1937), that firms are established because of transaction costs. In the absence of transaction costs, the market would be the most efficient way to buy and sell services, and so there would be no need for people to affiliate with firms. *Id.* at 390. The presence of transaction costs, however, sufficiently increases the cost of buying goods and services in markets such that it is cheaper to form firms. *Id.* at 390-93.

171. Paul L. Joskow, *Transaction Cost Economics, Antitrust Rules, and Remedies*, 18 J.L. ECON. & ORG. 95, 96 (2002).

172. See Figure 1.

they better understood the transaction costs incurred in obtaining rebates.

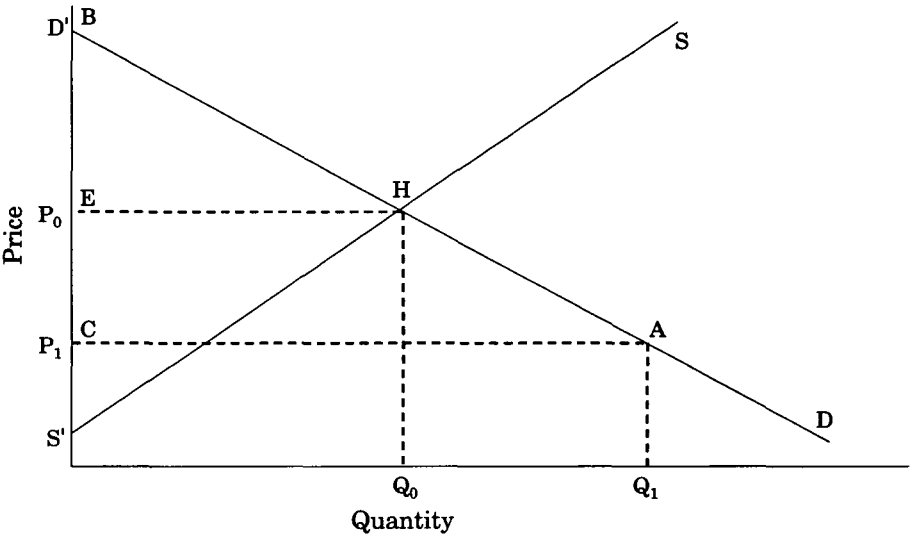


Figure 1

Even consumers who obtain the rebate incur transaction costs that do not benefit society because they must comply with the requirements for the rebate. If the seller simply offered the product at a reduced price, consumers would not have had to fulfill any requirements to obtain the reduced price. Accordingly, the rebate comes at a dearer price than necessary. Many of these costs, such as the requirement that the consumer make up words from the phrase “prescription strength” or boil labels in order to remove them, do not benefit the manufacturer offering the rebate, and so these costs are a deadweight loss to society.<sup>173</sup>

This deadweight loss to society comes up repeatedly when consumers are willing to incur the transaction costs necessary to protect their interests. Consumers also incur these costs when they, for example, write letters to protect their privacy or return a

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173. Only consumers who purchase the item never intending to seek the rebate—that is, consumers who are willing to pay the higher price—suffer no losses because of the rebate offer.

computer because of objectionable contract terms that were not disclosed prior to shipment. Firms may not mind this because their revenue from the transaction remains the same as if they had not inflated the consumer's transaction costs. But the surplus from the exchange is reduced because consumers are diverted from other activities.

Other methods of increasing consumer transaction costs also generate these results. Several examples discussed above, such as burying information in fine print, obscuring changes in contract terms by enclosing them in a bill-stuffer, or sending contract terms with the computer, result in consumers not having the information they need to make informed decisions. As a result, consumers again may act inconsistently with their preferences, producing an inefficient equilibrium.

The practice is also problematic in a similar form of inflated transaction costs noted above—the one exemplified by privacy opt outs in which firms increase consumer transaction costs by making it more difficult for consumers to communicate their preferences. When businesses make it more expensive for consumers to express their wishes but do not commensurately reduce their own costs, the companies make it less likely that consumers will register their desires, and the net benefits generated by the transaction are not increased. Again, the company has increased its share of the total economic surplus, but at the expense of reducing the overall size of that surplus.

Though transaction costs are generally to be minimized, they are particularly troublesome in consumer transactions. Because the stakes in consumer transactions normally are small, transaction costs have a disproportionate capacity to deter consumers from protecting their interests. Put another way, transaction costs are likely to eat up much of the surplus from exchange in consumer transactions given that that surplus is so small. Litigation provides one clear example.<sup>174</sup> Because the cost of litigation often exceeds the value of consumer claims, many suits cannot be justified on economic grounds.<sup>175</sup>

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174. Recall that this Article defines transaction costs broadly enough to include litigation costs. See *supra* notes 30-31 and accompanying text.

175. See Alon Klement, *Threats To Sue and Cost Divisibility Under Asymmetric Information*, 23 INT'L REV. L. & ECON. 261, 261 (2003) ("[M]ost claimants choose not to pursue

The Article has now demonstrated that firms inflate consumer transaction costs and that such a practice is socially undesirable. The Article will now explore how society has responded to this phenomenon.

#### IV. CONSUMER PROTECTION LAW AND INCREASED CONSUMER TRANSACTION COSTS

Though the law has not responded uniformly when firms increase consumer transaction costs, legislatures and administrative agencies, in particular, have often attempted to ban practices that inflate consumer transaction costs on an ad hoc basis. From these actions an underlying principle can be distilled that will not surprise anyone: the law should restrain businesses from inflating consumer transaction costs unnecessarily.<sup>176</sup> That principle, however, is seldom articulated in that way, and the failure to make it an explicit norm has limited the power of courts to root their decisions in such a rationale. Accordingly, courts have looked to other norms on which to rest their rulings. These norms have sometimes led courts to bar or regulate practices that inflate consumer transaction costs, but not always. All in all, while it is possible to infer that society seeks to bar inflated consumer transaction costs, it is also clear that any such norm has not always been recognized in that form.

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their grievance in court, fearing the prospect of high litigation costs."); Jeff Sovern, *Toward a Theory of Warranties in Sales of New Homes: Housing the Implied Warranty Advocates, Law and Economics Mavens, and Consumer Psychologists Under One Roof*, 1993 WIS. L. REV. 13, 85; David M. Trubeck, Austin Sarat, William L.F. Felstiner, Herbert M. Kritzer & Joel B. Grossman, *The Costs of Ordinary Litigation*, 31 UCLA L. REV. 72, 120 (1983) ("Our data do suggest that the smaller the case, the less likely it is that litigation will 'pay.'"); Jonathan L. Kempner, Note, *The Home Owners Warranty Program: An Initial Analysis*, 28 STAN. L. REV. 357, 369 (1976) ("[M]any claims are too small to be worth litigating."); Note, *Minnesota Statutory Warranties on New Homes—An Examination and Proposal*, 64 MINN. L. REV. 413, 417 n.19 (1980) (discussing the cost of litigating residential implied warranties); Muris, *supra* note 28, at 12 ("[R]esort to courts for enforcement of consumer transactions is often economically infeasible.").

176. Cf. Charles H. Breeden & Peter G. Toumanoff, *Transactions Costs and Economic Institutions*, in *THE POLITICAL ECONOMY OF FREEDOM: ESSAYS IN HONOR OF F.A. HAYEK* 161, 161, 168 (Kurt R. Leube & Albert H. Zlabinger eds., 1985) ("Much government activity can be viewed as attempts to cope with the existence of transactions costs.").

*A. Legislation and Regulation*

Legislatures have taken a number of steps to prevent the inflation of consumer transaction costs. Many of these steps make it easier for consumers to receive and understand information. For example, the Truth in Lending Act standardized the quotation of interest rates, finance charges, and other information so that consumers can readily compare the price of credit and determine which lender offers the best terms.<sup>177</sup> Similarly, some states require consumer contracts to be written in plain English so that consumers can more easily understand them.<sup>178</sup> Still other laws require certain terms to be conspicuous so that consumers are more likely to become aware of them.<sup>179</sup>

The Gramm-Leach-Bliley Act<sup>180</sup> and its implementing regulations combine several of these ideas. The Act itself mandates that disclosures to consumers be clear and conspicuous.<sup>181</sup> The regulations define that phrase as requiring that the notice be reasonably understandable and designed to call attention to the nature and significance of the information.<sup>182</sup> Those phrases are explained by examples. Thus, the regulations state that something is designed to call attention to the nature and significance of the information if it uses a plain-language heading, a typeface and type size that are easy to read, wide margins and ample line spacing, and boldface or

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177. See 15 U.S.C. § 1605 (2000) (finance charges); *id.* § 1606 (interest rate); *id.* § 1637 (disclosures for open-end credit); *id.* § 1638 (disclosures for closed-end credit). As discussed *supra* notes 96-97 and accompanying text, the ways in which interest rates were quoted before enactment of this legislation made comparison difficult, if not impossible.

178. See, e.g., CONN. GEN. STAT. ANN. § 42-152 (West 2000) (stating that consumer contracts "shall be written in plain language"); N.Y. GEN. OBLIG. LAW § 5-702 (Consol. Supp. 2005) (stating that consumer contracts must be written "in a clear and coherent manner using words with common and every day meanings"); 73 PA. CONS. STAT. ANN. § 2205 (West Supp. 2005) (stating that consumer contracts "shall be ... easy to read and understand").

179. See, e.g., 15 U.S.C. § 2303 (2000) (stating that consumer product warranties must be labeled conspicuously); N.Y. PERS. PROP. LAW § 335.1 (Consol. Supp. 2005) (stating that liability of an automobile lessee for the total loss of a vehicle must be conspicuously disclosed); U.C.C. § 2-316(2) (2004) (stating that any disclaimer of the implied warranty of merchantability must be conspicuous).

180. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12 U.S.C. and 15 U.S.C. (2000)).

181. See 15 U.S.C. § 6802(b)(1)(A) (2000); 16 C.F.R. § 313.3(b) (2005).

182. 16 C.F.R. § 313.3(b)(1) (2005).

italics for key words.<sup>183</sup> Writings qualify as reasonably understandable if written in short explanatory sentences and everyday words, among other things.<sup>184</sup> The regulations thus seem designed to minimize transaction costs so that consumers can make appropriate choices.<sup>185</sup>

Some rules reduce transaction costs by facilitating communications between consumers and firms. For example, the Fair Credit Reporting Act<sup>186</sup> requires credit reporting agencies to make toll-free numbers available to consumers for certain purposes.<sup>187</sup> Similarly, under the regulations implementing Gramm-Leach-Bliley, financial institutions must make it easy for consumers to opt out of the disclosure of their personal information, by, for example, providing a form for the consumer to return, a toll-free number, or an e-mail address for receipt of instructions.<sup>188</sup> The regulations expressly provide that financial institutions may not require consumers to draft their own letters to opt out.<sup>189</sup>

As demonstrated by its regulations implementing the Gramm-Leach-Bliley Act, the Federal Trade Commission (FTC) has often taken steps to reduce consumer transaction costs. Two more examples illustrate this point: first, through a trade regulation rule, the FTC requires gasoline stations to post octane ratings of gasoline, thus making it easier for consumers to determine which type of gas to buy;<sup>190</sup> second, another FTC trade regulation rule obliges

183. *Id.* § 313.3(b)(2)(ii).

184. *Id.* § 313.3(b)(2)(i).

185. Unfortunately, this attempt appears not to have been entirely successful. *See supra* note 104. If Congress wanted to give consumers the information they need to make an informed choice, Congress should have given financial institutions an incentive to provide consumers with that information by using an opt-in system. Sovern, *supra* note 28, at 1101-03.

186. Fair Credit Reporting Act of 1970, Pub. L. No. 91-508, 84 Stat. 1128 (codified at 15 U.S.C. §§ 1681-1681x (2000)).

187. Credit reporting agencies that furnish consumer reports in connection with credit transactions that the consumer does not initiate must maintain a toll-free number for consumers to call if they want their information excluded from the lists the agencies provide to others. 15 U.S.C. § 1681b(e)(5) (2000). This comes up most frequently with "pre-screening," that is, the practice of credit card issuers purchasing from credit bureaus lists of consumers who meet certain criteria. The credit card issuer then invites the consumers on the list to obtain the issuer's credit card.

188. 16 C.F.R. § 313.7(a)(2)(ii) (2005).

189. *Id.* § 313.7(a)(2)(iii)(A).

190. *Id.* § 306.10.



sellers of insulation to inform consumers in a clear and conspicuous way of a measure of the effectiveness of the insulation, known as R-value,<sup>191</sup> and to provide them with fact sheets explaining R-values,<sup>192</sup> again facilitating the consumer decision-making process.<sup>193</sup> Other administrative agencies have also acted to reduce consumer transaction costs. The Federal Reserve Board, in promulgating regulations to implement the Truth in Lending Act<sup>194</sup> and the Consumer Leasing Act,<sup>195</sup> has attempted to make it easier for consumers to make borrowing decisions.

Transaction costs in many other arenas have also drawn the attention of rulemakers. For a very different example from the ones already mentioned, procedural reforms have reduced the cost of asserting claims by, for example, providing for cheaper alternative forums, such as small claims courts.<sup>196</sup> Similarly, class actions spread the cost of asserting consumer claims over many claimants<sup>197</sup>

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191. *Id.* §§ 460.4-5, 460.10, 460.12.

192. *Id.* §§ 460.13-14.

193. The FTC explained when it adopted the R-value rule that

[m]arket imperfections that impede the process of providing such material information in the regular flow of commerce discourage consumer consideration of salient product features, diminish comparison shopping, and create unwarranted competitive parity or advantage for inferior products. Thus, a market that functions in this way not only harms consumers but also lessens fair and open competition.

Statement of Basis and Purpose, 44 Fed. Reg. 50,218, 50,223 (Aug. 27, 1979).

194. The Truth in Lending Act was passed as Title I of the Consumer Credit Protection Act, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601-1667 (2000)); 12 C.F.R. §§ 226.1-36 (2005).

195. Consumer Leasing Act of 1976, Pub. L. No. 94-240, 90 Stat. 257 (codified at 15 U.S.C. §§ 1667-1667f (2000)); 12 C.F.R. §§ 213.1-9 (2005).

196. *See, e.g.,* Licitra v. Gateway, Inc., 189 Misc.2d 721, 727, 734 N.Y.S.2d 389, 394 (Civ. Ct. 2001) ("Small Claims Court has been established to provide a quick and low-cost forum for the resolution of disputes.").

197. *See* Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 809 (1985) ("Class actions ... permit the plaintiffs to pool claims which would be uneconomical to litigate individually."). A more recent Supreme Court case has expanded on this principle:

The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights. A class action solves this problem by aggregating the relatively paltry potential recoveries into something worth someone's (usually an attorney's) labor.

*Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 617 (1997) (quoting *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (7th Cir. 1997)).

while the Fair Debt Collection Practices Act<sup>198</sup> limits the venue of collection actions brought by debt collectors to the district in which the consumer resides or signed the contract in question.<sup>199</sup>

### B. Case Law

Some court decisions seemingly have adopted implicitly the norm that companies should not excessively increase consumer transaction costs, while other cases have not. These decisions collectively suggest that courts are struggling with this subject. That may be so because courts typically base their decisions on interpretations of legislation or established common law principles, and the ad hoc approach taken by legislatures to inflated consumer transaction costs leaves the courts without a specifically stated norm that firms may not unnecessarily increase consumer transaction costs.

*Brower v. Gateway 2000, Inc.*<sup>200</sup> illustrates courts' uncertain treatment of this proposition. The court upheld the practice of delivering the contract terms to the consumer inside the computer box,<sup>201</sup> the requirement that consumers unhappy with the contract terms return the computer,<sup>202</sup> and the term mandating that any arbitration take place in Chicago.<sup>203</sup> On the other hand, because of the cost of applying to the ICC, the court invalidated as unconscionable the requirement that the rules of the ICC govern the arbitration.<sup>204</sup> The court described that cost as "unreasonable" and commented that it "surely serves to deter the individual consumer from invoking the process."<sup>205</sup> The court thus accepted the idea that

198. Fair Debt Collection Practices Act, Pub. L. No. 95-109, 91 Stat. 874 (1977) (codified at 15 U.S.C. §§ 1692-1692o (2000)).

199. 15 U.S.C. § 1692i (2000).

200. 246 A.D.2d 246, 676 N.Y.S.2d 569 (N.Y. 1998). For a summary of the facts in *Brower*, see *supra* notes 37-56 and accompanying text.

201. *Brower*, 246 A.D.2d at 250-51, 676 N.Y.S.2d at 572.

202. *Id.* at 252-53, 676 N.Y.S.2d at 573.

203. *Id.* at 253, 676 N.Y.S.2d at 574.

204. *Id.*

205. *Id.* The court added that, "barred from resorting to the courts by the arbitration clause in the first instance, the designation of a financially prohibitive forum effectively bars consumers from this forum as well; consumers are thus left with no forum at all in which to resolve a dispute." *Id.* Gateway had since amended its contract documents to permit arbitration by the American Arbitration Association (AAA). *Id.* Plaintiffs claimed that the

consumer transaction costs should not be excessive in some circumstances, while rejecting it in others, though not in those words.

To the extent that *Brower* upheld Gateway's practices, it relied on Judge Easterbrook's controversial decision in *Hill v. Gateway 2000, Inc.*<sup>206</sup> These Gateway cases and decisions like them<sup>207</sup> that

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AAA fees were also excessive, and thus the possibility of arbitration by AAA did not cure the unconscionability of Gateway's contract. *Id.* The court found the record insufficiently developed to rule on that claim. *Id.* at 253-56, 676 N.Y.S.2d at 574-75. Accordingly, the court remanded the case. *Id.* at 255-56, 676 N.Y.S.2d at 575. For other cases invalidating arbitration agreements on unconscionability grounds because of the cost of arbitration in light of the amount of the plaintiffs' claim, see *Shankle v. B-G Maint. Mgmt. of Colo., Inc.*, 163 F.3d 1230, 1234-35 (10th Cir. 1999); *Comb v. PayPal, Inc.*, 218 F. Supp. 2d 1165, 1176 (N.D. Cal. 2002); *Ting v. AT&T*, 182 F. Supp. 2d 902, 934-35 (N.D. Cal. 2002), *aff'd in part*, 319 F.3d 1126 (9th Cir.), *cert. denied*, 540 U.S. 811 (2003); *Leonard v. Terminix Int'l Co.*, 854 So. 2d 529, 535-38 (Ala. 2002); and *Mendez v. Palm Harbor Homes, Inc.*, 45 P.3d 594, 605 (Wash. Ct. App. 2002).

206. 105 F.3d 1147, 1149 (7th Cir. 1997).

207. See *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447, 1451 (7th Cir. 1996) (upholding as part of the contract a licensing agreement placed inside a software program's packaging); *Lozano v. AT&T Wireless*, 216 F. Supp. 2d 1071, 1073 & n.1 (C.D. Cal. 2002) (noting that customer had received a brochure stating that service is subject to the terms and conditions in a "Welcome Guide" and then holding that the "Welcome Guide" applied to the contract between the buyer and seller, stating "that providing customers with terms and conditions after an initial transaction is acceptable, and that such terms and conditions are enforceable, including arbitration clauses"); *I.Lan Sys., Inc. v. Netscout Serv. Level Corp.*, 183 F. Supp. 2d 328 (D. Mass. 2002) (holding that a clickwrap license governs over a purchase order); *Bischoff v. DirecTV, Inc.*, 180 F. Supp. 2d 1097, 1103-06 (C.D. Cal. 2002) (finding an arbitration term enforceable although supplied to a customer after service was activated); *Westendorf v. Gateway 2000, Inc.*, 41 U.C.C. Rep. Serv. 2d (CBC) 1110 (Del. Ch. 2000) (holding that Gateway's terms and conditions inside a computer box bind a consumer if the consumer fails to return the computer within thirty days); *Rinaldi v. Iomega Corp.*, 41 U.C.C. Rep. Serv. 2d (CBC) 1143 (Del. Super. Ct. 1999) (finding that a disclaimer of implied warranty of merchantability placed inside a Zip drive's packaging was conspicuous and part of the contract); *1-A Equip. Co. v. Icode, Inc.*, No. 1460, 2003 WL 549913 (Mass. App. Div. Feb. 21, 2003) (holding that a forum selection clause in an end user license and service agreement was part of the contract); *Levy v. Gateway 2000, Inc.*, 33 U.C.C. Rep. Serv. 2d (CBC) 1060 (N.Y. Sup. Ct. 1997) (upholding Gateway's arbitration clause); *M.A. Mortenson Co. v. Timberline Software Corp.*, 998 P.2d 305, 313 (Wash. 2000) (following the holding in *ProCD*). The Uniform Computer Information Transactions Act (UCITA), published by the National Commissioners on Uniform State Laws, also embraces these decisions. This acceptance can be seen in the following provisions: Section 113(c) provides that "[i]f a record or term is available for review only after a person becomes obligated to pay or begins its performance, the person has an opportunity to review only if it has a right to a return if it rejects the record." UNIF. COMPUTER INFO. TRANSACTIONS ACT § 113(c), 7(II) U.L.A. 59 (Supp. 2005). Section 112(a) states that

[a] person manifests assent to a record or term if the person, acting with

uphold late disclosure of terms have been severely criticized<sup>208</sup> and some courts have rejected them.<sup>209</sup> Much of the discussion of the issues necessarily has focused on the U.C.C., and especially section 2-207, the well-known battle-of-the-forms provision. That section, for all its virtues, seems not to be motivated by a desire to reduce consumer transaction costs but by other unrelated concerns.<sup>210</sup> A

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knowledge of, or after having an opportunity to review the record or term or a copy of it ... intentionally engages in conduct or makes statements with reason to know that the other party or its electronic agent may infer from the conduct or statement that the person assents to the record or term.

*Id.* § 112(a), 7(II) U.L.A. 55 (Supp. 2005). Section 208(2) is clearer:

The terms of a record may be adopted after beginning performance or use if the parties had reason to know that their agreement would be represented in whole or part by a later record to be agreed on and there would not be an opportunity to review the record or a copy of it before performance or use begins.

*Id.* § 208(2), 7(II) U.L.A. 80 (Supp. 2005). Comment three to section 208 explains:

Subsection (b) reflects the reality of layered contracting. While some contracts are formed and their terms defined at a single point in time, many transactions involve a rolling or layered process. The commercial expectation is that terms will follow or be developed after performance begins. This Act rejects cases that narrowly treat contracting as a single event despite ordinary practice. It adopts a rule in cases that recognize that contracts are often formed over time.

*Id.* § 208 cmt. 3, 7(II) U.L.A. 80 (Supp. 2005) (citing *ProCD* and *Mortensen*); see also UNIF. COMPUTER INFO. TRANSACTIONS ACT § 209 cmt. 5, 7(II) U.L.A. 82 (Supp. 2005). See generally Bern, *supra* note 63, at 772-79 (describing the history of UCITA and examining some of its provisions). Though the 2003 amendments to Article 2 of the U.C.C. purport to take no position on whether courts should adopt the reasoning of these cases, see U.C.C. § 2-207 cmt. 5 (amended 2003), 1 U.L.A. 397-99 (2004), at least one observer believes that the amendments undermine the statutory support for contrary decisions and appear to legitimize the *ProCD* line of cases, see Bern, *supra* note 63, at 783-94.

208. See, e.g., Bern, *supra* note 63, at 779-83; Braucher, *supra* note 41, at 1806-09; Thomas J. McCarthy, Patricia A. Tauchert, John D. Wladis, & Mark E. Roszkowski, *Sales*, 53 BUS. LAW. 1461, 1465-66 (1998); Sternlight, *supra* note 39; Batya Goodman, Note, *Honey, I Shrink-Wrapped the Consumer: The Shrink-Wrap Agreement as an Adhesion Contract*, 21 CARDOZO L. REV. 319, 344-52 (1999). But see Barnett, *supra* note 125, at 627; Darren C. Baker, Note, *ProCD v. Zeidenberg: Commercial Reality, Flexibility in Contract Formation, and Notions of Manifested Assent in the Arena of Shrinkwrap Licenses*, 92 NW. U. L. REV. 379, 379-82 (1997) (arguing that the *ProCD* court reached the correct result).

209. *Step-Saver Data Sys., Inc. v. Wyse Tech.*, 939 F.2d 91, 97-106 (3d Cir. 1991); *Klocek v. Gateway, Inc.* 104 F. Supp. 2d 1332, 1337-41 (D. Kan. 2000); *U.S. Surgical Corp. v. Orris, Inc.*, 5 F. Supp. 2d 1201, 1205-06 (D. Kan. 1998); *Ariz. Retail Sys., Inc. v. Software Link, Inc.* 831 F. Supp. 759, 766 (D. Ariz. 1993); *Licitra v. Gateway*, 189 Misc. 2d 721, 723-730, 734 N.Y.S.2d 389, 391-96 (Civ. Ct. 2001).

210. This unrelated motivation is suggested by the first official comment to the section, which describes two "typical situations" the section is intended to address. U.C.C. § 2-207 cmt. 1, 1 U.L.A. 208-09 (2004). In the first situation, both parties are said to send each other formal memoranda. *Id.* Consumers do not normally use formal memoranda in making purchases. The

norm that firms should not inflate consumer transaction costs would have led to a different outcome in the Gateway cases, or at least to a different rationale by the courts.<sup>211</sup> The courts would instead have focused more on how and whether delayed disclosure increases consumer transaction costs and impairs the functioning of the market.<sup>212</sup>

Forum selection clauses present a scenario in which courts have chosen regulation rather than an absolute ban on or outright approval of inflated transaction costs. For example, in *Carnival Cruise Lines, Inc. v. Shute*,<sup>213</sup> the Supreme Court reversed a court of appeals decision that refused to enforce a forum selection clause in a cruise line ticket.<sup>214</sup> The Court explained that such clauses are subject to scrutiny for fundamental fairness and evaluated the clause for reasonableness, finding that it passed those tests.<sup>215</sup> The plaintiffs, who appear to have been residents of Washington state, boarded in California for a cruise to Mexico and then back to California; the forum selection clause provided that disputes would be resolved in Florida, where the cruise line was based.<sup>216</sup> Whatever fundamental fairness and reasonableness mean, they apparently do not bar enforcement of a forum selection clause in

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comment gives an example of the second typical situation, in which the parties are said to send a printed purchase order and acceptance or acknowledgment form; the paragraph also refers to the buyer's form. *Id.* Consumers do not customarily use their own forms when buying goods. Section 2-207 thus seems designed to govern business-to-business transactions, rather than consumer transactions.

211. *Cf. Braucher, supra* note 41, at 1810 (noting that delayed disclosure of contract terms increases transaction costs).

212. *See supra* notes 40-42 and accompanying text.

213. 499 U.S. 585 (1991). The decision was criticized forcefully by Professors Mullenix and Purcell. *See Linda S. Mullenix, Another Easy Case, Some More Bad Law: Carnival Cruise Lines and Contractual Personal Jurisdiction*, 27 TEX. INT'L L.J. 323 (1992); Purcell, *supra* note 46, at 486-87.

214. *Carnival Cruise Lines*, 499 U.S. at 597.

215. *Id.* at 590-95. *Carnival Cruise Lines* in fact has much in common with the contracts in *Brower*. Not only do the contracts at issue in both cases include forum selection clauses (the *Brower* contract provided for arbitration rather than a judicial forum), but the clause at issue in *Carnival Cruise Lines* appears not to have been available until after the consumer purchased the ticket, according to Justice Stevens's dissent. *Id.* at 597 (Stevens, J., dissenting). Justice Stevens also reported that if a consumer, having read the ticket, decided to back out of the cruise, the contract excused the cruise line from refunding the consumer's money. *Id.*

216. *Id.* at 587-88.

such circumstances.<sup>217</sup> In many cases, of course, a requirement that consumer plaintiffs must incur the transaction cost of traveling across the country to assert their claims will itself be enough to dispose of the case.<sup>218</sup> Greater concern for the costs imposed by the forum selection clause might have produced a different approach.<sup>219</sup>

Such a different approach is evident in *Spiegel, Inc. v. Federal Trade Commission*.<sup>220</sup> Spiegel sold goods to consumers throughout the country via its catalog.<sup>221</sup> When consumers defaulted on their obligations, Spiegel sued them in Chicago, where it was based.<sup>222</sup> When consumers objected to the forum, either by traveling to Chicago to complain or by retaining local counsel, Spiegel voluntarily dismissed the action, but that did not help consumers who could not afford to travel or hire Chicago attorneys.<sup>223</sup> The FTC, observing that the cost of travel alone might exceed the amount in controversy, found that Spiegel had engaged in unfair practices in violation of the Federal Trade Commission Act.<sup>224</sup> The Seventh Circuit enforced the Commission's order.<sup>225</sup>

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217. One commentator has suggested that after *Carnival Cruise Lines*, if a business designates its home state as the forum, the consumer will not be able to defeat the forum selection clause. Goldman, *supra* note 47, at 711.

218. *Id.* at 712 ("[T]he expenses of transporting witnesses, hiring local counsel, and attending trial may make pursuit of legitimate consumer claims impractical or undesirable.").

219. *Carnival Cruise Lines*, 499 U.S. at 595. The Court did note:

[T]here is no indication that [the cruise line] set Florida as the forum in which disputes were to be resolved as a means of discouraging cruise passengers from pursuing legitimate claims. Any suggestion of such a bad-faith motive is belied by two facts: [the cruise line] has its principal place of business in Florida, and many of its cruises depart from and return to Florida ports. Similarly, there is no evidence that [the cruise line] obtained [the consumers'] accession to the forum clause by fraud or overreaching.

*Id.* By putting the burden on the consumer to demonstrate such a bad-faith motive, at least in cases in which the firm has its headquarters in the chosen state, the Court places a heavy burden on consumers. Consumers will have an especially difficult time carrying this burden, given the small stakes at issue in the typical consumer case, which will often make efforts to conduct discovery on such an issue uneconomic.

220. 540 F.2d 287 (7th Cir. 1976).

221. *Id.* at 290.

222. *Id.*

223. *Id.* at 290-91.

224. *Id.* at 291; see also 15 U.S.C. § 45 (2000).

225. *Spiegel*, 540 F.2d at 296-97 (enforcing Commission's order with modifications not relevant to this Article). For similar results, see *Comb v. PayPal, Inc.*, 218 F. Supp. 2d 1165, 1176-77 (N.D. Cal. 2002); *Sun Trust Bank v. Sun Int'l Hotels Ltd.*, 184 F. Supp. 2d 1246, 1261-62 (S.D. Fl. 2001); *In re J.C. Penney Co.*, 109 F.T.C. 54, 55-57 (1987) (reprinting consent

*Carnival Cruise Lines* and *Spiegel* are distinguishable in many ways. One case involves a forum-selection clause; the other does not.<sup>226</sup> In one, the plaintiff chose the forum; in the other, the defendant did. An administrative agency entitled to considerable deference had already ruled in and was defending its decision in *Spiegel* while private plaintiffs brought suit in *Carnival Cruise Lines*. Nevertheless, the different results owe at least as much to a different approach to forum selection clauses as they do to any of these facts. The Supreme Court was less concerned with inflating consumer transaction costs than was the FTC. If the Supreme Court had been able to employ the law of unfairness, as it would if reviewing an FTC unfairness decision, for example, it might have decided differently.

This distinction points out the central difference between courts and administrative agencies in this area. Administrative agencies may find it easier than courts to reduce consumer transaction costs at present because they may have recourse to a norm that permits them to take consumer transaction costs into account. Thus, the FTC's power to outlaw unfair practices allows the FTC to act in a way that courts generally cannot.

This is not to say that no relevant rules exist for courts to employ, just that the rules are not aimed directly at the problem of

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decree in which a company agreed not to bring collections cases against consumers in distant forums); *In re Marathon Oil Co.*, 92 F.T.C. 422, 424 (1978) (same); *In re S.S. Kresge Co.*, 90 F.T.C. 222, 224 (1977) (same); *In re Montgomery Ward & Co.* 84 F.T.C. 1337, 1339-40 (1974) (same); *In re West Coast Credit Corp.*, 84 F.T.C. 1328, 1330-31 (1974) (same); Schubach v. Household Fin. Corp., 376 N.E.2d 140, 140-42 (Mass. 1978); Williams v. Am. Online, Inc., 43 U.C.C. Rep. Serv. 2d (CBC) 1101, 1105-06 (Mass. Super. Ct. 2001); Celebrezze v. United Research, Inc., 482 N.E.2d 1260, 1262 (Ohio Ct. App. 1984) (holding that a bookseller's practice of suing in a forum distant from consumers' home was unfair and unconscionable); Santiago v. S.S. Kresge Co., 2 Ohio Op. 2d 54 (Court of Common Pleas of Cuyahoga Cnty. 1976) (holding that the practice of suing in a forum distant from consumers' home was unconscionable and violated Ohio UDAP statute); Paragon Homes, Inc. v. Carter, 56 Misc. 2d 463, 464-65, 288 N.Y.S.2d 817, 818-19 (Sup. Ct. 1968), *aff'd*, 30 A.D.2d 1052, 295 N.Y.S.2d 606 (App. Div. 1968). On the other hand, many courts uphold forum selection clauses against challenge. See, e.g., Caspi v. Microsoft Network, L.L.C., 732 A.2d 528, 529 (N.J. Super. Ct. App. Div. 1999) (enforcing an online forum selection clause in a class action suit).

226. Forum selection clauses are not necessarily dispositive. See *Thompson v. Handa-Lopez, Inc.*, 998 F. Supp. 739, 741, 746 (W.D. Tex. 1998) (holding that an "inconspicuous" clause that a reasonable person would not have noticed and that was "buried" within the contract on the defendant's website and that provided for binding arbitration in California did not deprive Texas courts of jurisdiction over the dispute).

inflated consumer transaction costs. The UCC's prohibition on unconscionable contracts and terms offers some aid; indeed, it was used in *Brower* to invalidate the term requiring application of the rules of the ICC.<sup>227</sup> Similarly, some states have enacted "little FTC" acts that prohibit unfair practices.<sup>228</sup>

Another rule that courts have used to stop companies from unnecessarily inflating transaction costs is the general requirement that contracting parties act in good faith, as exemplified in U.C.C. section 1-203.<sup>229</sup> For example, in *Badie v. Bank of*

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227. See *supra* Part I.A.2. The Code's prohibition on unconscionable contracts and terms appears in U.C.C. § 2-302, 1A U.L.A. 344 (2004). For other examples of the use of the unconscionability doctrine against agreements that inflated transaction costs, though not necessarily in those terms, see *Ting v. AT&T*, 182 F. Supp. 2d 902, 929-30 (N.D. Cal. 2002), *aff'd in part*, 319 F.3d 1126 (9th Cir.), *cert. denied*, 540 U.S. 811 (2003) (finding that when AT&T conceded that its (adhesion) contract would be read in its entirety by thirty percent of customers and that ten percent would not read it at all, and that the company did not take steps to increase the likelihood that customers would read the agreement, the agreement was procedurally unconscionable); *John Deere Leasing Co. v. Blubaugh*, 636 F. Supp. 1569, 1571, 1574 (D. Kan. 1986) (holding a contract term unconscionable because the term was in difficult-to-read fine print on the back of a form and the wording was "unreasonably complex ... as if the scrivener intended to conceal the thrust of the agreement in the convoluted language and fine print"); *Broemmer v. Abortion Servs. of Phoenix, Ltd.*, 840 P.2d 1013, 1018 (Ariz. 1992) (holding that an arbitration agreement was unenforceable because the consumer was not told that she was giving up her right to a jury trial and the agreement did not explain that to her, and stating that "[c]ontracts of adhesion will not be enforced unless they are conscionable and within the reasonable expectations of the parties"); *Villa Milano Homeowners Assoc. v. IL Davorge*, 102 Cal. Rptr. 2d 1, 7-8 (Ct. App. 2000) (finding unconscionable an arbitration clause found on pages 67-68 of a 70-page agreement that was probably accompanied by "thick stack" of other documents); *East Ford, Inc. v. Taylor*, 826 So. 2d 709, 715-17 (Miss. 2002) (finding unconscionable an arbitration clause printed in type a fraction of the typesize of other terms); *cf. McCarthy Well Co. v. St. Peter Creamery, Inc.* 410 N.W.2d 312, 316 (Minn. 1987) (declaring a contract term in tiny print unenforceable because it was unreadable, but declining to reach unconscionability issue).

228. For examples of courts using such statutes to prohibit practices that inflate consumer transaction costs, see *supra* note 225. For a description of every state's "little FTC" act, which indicates which states bar unfair practices, see JONATHAN SHELDON & CAROLYN L. CARTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES 759-75 (4th ed. 1997).

229. U.C.C. § 1-203, 1 U.L.A. 244 (2004) ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."). See generally Seth William Goren, *Looking for Law in All the Wrong Places: Problems in Applying the Implied Covenant of Good Faith Performance*, 37 U.S.F. L. REV. 257, 263-68 (2003) (noting the mainstream acceptance of good faith). Another possible norm that courts may find useful is RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (1981), which provides that "[w]here the [merchant] has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement." See generally Hillman & Rachlinski, *supra* note 80, at 458-59; Meyerson, *supra* note 45, at 1287-89; Slawson, *supra* note 80, at 60-63. In some cases, contracting parties have also found aid in the



*America*,<sup>230</sup> Bank of America had used a bill-stuffer to modify its agreements with its depositors and credit card customers to provide for resolution of disputes by alternative dispute resolution (ADR).<sup>231</sup> Bank of America took the position that it had a right to do so because its agreements contained provisions allowing for changes in terms.<sup>232</sup> Notwithstanding California's public policy in favor of ADR, the court held the attempted amendment ineffective.<sup>233</sup> In the *Badie* court's view, it was objectively unreasonable—and hence a breach of the duty to act in good faith and deal fairly—for a party to add “an entirely new term which has no bearing on any subject, issue, right, or obligation addressed in the original contract and which was not within the reasonable contemplation of the parties when the contract was entered into.”<sup>234</sup>

In sum, though legislatures and administrative agencies have often acted to reduce consumer transaction costs, courts have been less free to do so, probably because they often lack a norm they can use to justify such action. One option would be to create a rule motivated by such a norm, similar to the rules in the U.C.C. barring unconscionable terms and requiring contracting parties to act in good faith. Another option is to leave the creation of rules barring the increasing of consumer transaction costs to legislatures and administrative agencies, but to urge them to be more mindful of the problem of inflated transaction costs. A judgment as to which course

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reasonable expectations test; that rule, transplanted from insurance law, limits enforcement of contract terms to those a consumer might reasonably have expected to appear in a contract. See *Kloss v. Edward D. Jones & Co.*, 54 P.3d 1, 5-9 (Mont. 2002) (finding that an arbitration clause that waived trial by jury was not within party's reasonable expectations and therefore was not enforceable); see also *Philadelphia Indem. Ins. Co. v. Barerra*, 21 P.3d 395, 399-404 (Ariz. 2000) (holding inconspicuous insurance terms that were incomprehensible to an ordinary consumer in rental car contract inapplicable when effect of terms would be inconsistent with consumer's reasonable expectations). See generally *Burke*, *supra* note 87, at 300-03 (discussing reasonable expectation test); Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461 (1989).

230. 79 Cal. Rptr. 2d 273 (Ct. App. 1998).

231. *Id.* at 276-77.

232. *Id.* at 277-78.

233. *Id.* at 291.

234. *Id.* at 284. The court added that “[t]hat is particularly true where the new term deprives the other party of the right to a jury trial and the right to select a judicial forum for dispute resolution.” *Id.* The court also found, as a matter of contract interpretation, that the customers, by agreeing to the change in terms, did not intend to give the bank the power to deprive them of the use of the court system and of a jury trial. *Id.* at 290-91.

is best requires some consideration of what such a norm might look like, and so this Article now turns to that issue, among others.

## V. ADOPTING A NORM CONCERNING INFLATED TRANSACTION COSTS

Legislatures and courts have not expressly adopted a general rule that firms may not inflate consumer transaction costs, though as described in the preceding Part, in many instances in which firms have increased consumer transaction costs to their own advantage, lawmakers have intervened on an ad hoc basis. This Part offers some guidance in implementing such a norm.

A norm prohibiting the unnecessary inflation of consumer transaction costs would supplement, rather than supplant, bans on particular practices that increase transaction costs. That is to say, the goal of a general norm would be to assist lawmakers and law enforcers in attacking practices that have not yet generated the legislative attention and energy necessary to enact legislation targeted at the offensive practice. Rebates again serve as a useful example. Some action concerning rebates seems desirable to avoid the bait-and-switch type of deception they seem to generate. Assuming that rulemakers wish to regulate rebates, they would most likely choose one of two approaches: either they would ban rebates altogether, or as a less sweeping first step, rulemakers could regulate them, by, for example, requiring simplified rebate procedures.<sup>235</sup>

A legislature could simply enact either of these two approaches. A regulatory agency could promulgate rules adopting them also, provided it acted consistently with its authorizing legislation. Courts, however, would probably be reluctant to require particular rebate procedures, though they could ban rebates provided they found a norm or statute which could be read to authorize such an action. A ban on unnecessary inflation of consumer transaction costs would facilitate such regulation, but it would not make it unnecessary.

Any regulation designed to implement a norm barring excessive increases in consumer transaction costs would necessarily be

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235. One proposal to regulate rebates was recently vetoed by the governor of California. See S.B. 1154, 2003-2004 Sess. (Cal. 2004) (vetoed Sept. 29, 2004).

paternalistic.<sup>236</sup> Regulations dealing with different increases in transaction costs might take different forms, such as a disclosure requirement or an outright prohibition on certain practices, but certainly they would interfere to some extent with the power to contract. That interference seems justified, however, as an example of what has been called asymmetric paternalism: that is, paternalism that benefits those who are not capable of protecting themselves—perhaps because of bounded rationality—while imposing little or no harm on those who are fully rational and capable of protecting themselves.<sup>237</sup> When market failures interfere with reaching an efficient outcome, the only alternative to intervention is acceptance of the inefficient outcome, which seems undesirable.

Many practices that inflate consumer transaction costs have legitimate justifications.<sup>238</sup> Some may even benefit consumers by reducing business expenses, thus enabling firms to offer their products at lower prices, at least in competitive markets. For example, imagine the use of a forum selection clause in connection with an incident that generates a great deal of litigation, such as a mass tort. In such circumstances, a firm would benefit from having all the cases filed in the same forum. The reduced litigation costs might ultimately benefit consumers as well. The fact that forum selection clauses are undesirable in much consumer litigation, such as isolated incidents like that in *Carnival Cruise Lines*, does not mean that they are undesirable in all.

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236. Camerer et al., *supra* note 57, at 1211 ("Paternalism treads on consumer sovereignty by forcing, or preventing, choices for the individual's own good, much as when parents limit their child's freedom to skip school ....").

237. *See id.* at 1212.

238. Just because a practice that increases consumer transaction costs can be justified does not mean that firms should be able to engage in it. For example, lenders could justify quoting interest rates in many different ways before enactment of the Truth in Lending Act, *see supra* text accompanying note 97 but those justifications were not enough to impose transaction costs on consumers, and so Congress enacted the Truth in Lending Act to provide for a uniform method of calculating interest rates. Similarly, inserting contracts with their products rather than furnishing them to consumers in advance, and using uninteresting bill-stuffers rather than designing inserts that are more likely to draw consumer attention are both probably less expensive for firms, but obscuring disclosures in such a way remains problematic.

Similarly, form contracts serve a number of important purposes,<sup>239</sup> ironically including the reduction of transaction costs.<sup>240</sup> To be sure, fine print is troublesome, but even other means of communicating contract terms, such as agreements written in legible type and simple English, may inflate consumer transaction costs, and would probably not be read by most consumers. A norm that outlaws standard term contracts arguably goes too far.<sup>241</sup> Consequently, a norm that outlaws all business practices that increase consumer transaction costs would be excessive.

Some mechanism is needed to distinguish between practices that inflate consumer transaction costs unnecessarily and those that are acceptable. Ideally, the result would enable consumers to purchase the goods and services in question with terms and at prices that maximize consumer utility. Accordingly, this Article now turns to mechanisms for distinguishing between practices that unacceptably increase consumer transaction costs and those that are less objectionable.

#### *A. Tests of When To Outlaw Practices That Inflate Transaction Costs*

As a threshold matter, lawmakers should ask, in Russell Korobkin's words, whether the practice involves a term that "is salient to a significant number of buyers."<sup>242</sup> If it is, the functioning of the market should see that the term is efficient as long as firms

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239. Ratkoff, *supra* note 47, at 1222-23.

Form documents promote efficiency within a complex organizational structure.... Standard forms facilitate the diffusion to underlings of management's decisions regarding the risks the organization is prepared to bear .... [f]orm contracts serve[] as an automatic check on the consequences of the acts of wayward sales personnel. The pressure to produce may tempt salesmen to make bargains into which the organization is unwilling to enter; the use of standard form contracts to state the terms of the deal obviates much of the need for, and expense of, internal control and discipline in this regard.

*Id.*; see also Karl N. Llewellyn, Book Review, 52 HARV. L. REV. 700, 701 (1939) (reviewing D. PRAUSHITZ, *THE STANDARDIZATION OF COMMERCIAL CONTRACTS IN ENGLISH AND CONTINENTAL LAW* (1937)).

240. Cruz & Hinck, *supra* note 93, at 638.

241. For a discussion of the benefits of standard form contracts, see Hillman & Rachlinski, *supra* note 80, at 437-39. *But see* Meyerson, *supra* note 45, at 1299 ("As a general rule, consumers should only be bound by those contract terms that they know and comprehend.").

242. Korobkin, *supra* note 90, at 1207.

cannot distinguish between searchers for the term and those who do not bother, and no intervention will be necessary. If, however, it is not salient, several other inquiries can be used to determine if a practice should be outlawed.

The first of these tests asks whether the practice is valuable to firms solely or principally because it inflates consumer transaction costs. If the answer is yes, then the practice should be presumed to violate the norm. However, one apparent problem with such a test is that firms can nearly always offer some justification for increasing consumer transaction costs. For example, merchants might attempt to rationalize the use of rebates by arguing that they generate mailing lists of consumers who have purchased a particular product,<sup>243</sup> and that such mailing lists are valuable.<sup>244</sup> Nevertheless, courts and administrative agencies are experienced at distinguishing between legitimate justifications and pretexts, and so should usually be able to penetrate to the truth.

The next test would ask what would happen if consumers had perfect information and could bargain competitively.<sup>245</sup> If, for example, consumers understood that they were not likely to obtain rebates, they would not take rebate offers into account in deciding whether to buy products. Rulemakers might respond to that either by outlawing any practice that both inflated consumer transaction

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243. P.J. Huffstutter, *O.C. Tech Beat; Freeafterrebate.com Offers What Name Says for the Record*, L.A. TIMES (Orange County Edition), July 12, 1999, at C1 ("Rebates also can ... be used to gather information about customers."); Ellen James Martin, *100 Years of Cutting Along the Dotted Line; Cents-able: Since the First 5-Cents-Off a Glass of Coke Offer, Coupons Have Saved Americans \$4.8 Billion a Year*, BALT. SUN, Dec. 27, 1995, at 1E ("Companies that use refund coupons are now developing a huge data base of information on consumer preferences, says Tom Wright, president and chief executive of [coupon design firm] First Fulfillment."); Silverstein, *supra* note 6, at C4 ("[M]anufacturers rely on rebates to collect information on consumers.").

244. Sovern, *supra* note 28, at 1108-09 (discussing the value of mailing lists). For some of the other justifications for offering rebates, see Marvin A. Jolson, Joshua L. Wiener & Richard B. Rosecky, *Correlates of Rebate Proneness*, J. ADVERTISING RES., Feb.-Mar. 1987, at 33, 34.

245. Pierre Schlag, *An Appreciative Comment on Coase's The Problem of Social Cost: A View from the Left*, 1986 WIS. L. REV. 919, 927-28 (arguing that Coase's article "might be stretched ... to suggest ... [w]here the various options in designing legal rules will necessarily result in significant transaction costs, legal rules should be structured so as to ... [as one alternative] approximate the sort of welfare enhancing agreements that would be reached in the absence of transaction costs"); see also RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 62 (1981) ("[I]n many cases a court can make a reasonably accurate guess as to the allocation of resources that would maximize wealth.").

costs and would not be agreed to by perfectly informed consumers, or by taking steps to inform consumers so that they would have the necessary information to make an appropriate decision—though again, internalities can bedevil even informed consumers. For example, policymakers might require rebate offers to disclose that few consumers redeem similar rebates.

This test has significant limits. Ascertaining what competitive markets would do in the absence of such a market is difficult. If consumers and firms were to bargain competitively, it could be expected that compromises and tradeoffs would occur, but determining in the absence of such a market what those tradeoffs might be is impossible. Nevertheless, it is hard to believe that consumers possessing perfect information and bargaining in competitive markets would ever agree to many of the practices that firms impose on consumers to inflate transaction costs. Knowledgeable consumers would be unlikely to approve of obscured contract terms, fees for arbitration that exceed the value of the good giving rise to the arbitration, forum selection clauses that require all litigation to take place in a distant forum, or a requirement that consumers must create and mail their own forms when the firm to which they are writing maintains a staff to receive other information by telephone, especially when the firm could make a single form to be used by all consumers rather than leaving a multitude of consumers to draft their own forms.<sup>246</sup> Accordingly, though this test will not yield a clear answer in some cases, in many situations it will.

A similar test would ask how consumers would behave in the absence of inflated transaction costs and then would attempt to replicate that result.<sup>247</sup> For example, policymakers could ask whether consumers would permit the sale of information about their

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246. From an efficiency standpoint, putting the burden of creating a privacy form on firms rather than on consumers makes more sense. A firm that has the burden of inventing such a form can do so only once and, by sending it to customers, obviates the need for customers to draft their own form. If the firm does not do so, customers who desire privacy will have to invent their own form, thereby investing much more time in the aggregate than would the firm. When the Federal Trade Commission drafted regulations to implement the privacy provisions of the Gramm-Leach-Bliley Act, it required the firms to supply consumers with the form. 16 C.F.R. § 313.7 (2005).

247. Cf. Schlag, *supra* note 30, at 1661-63 (characterizing the Chicago school of law and economics' market-based approach as arguing that "[w]here transaction costs are high, [a party should] structure the legal regime to approximate the outcomes that the parties would have reached in a zero transaction cost world").

purchases if they did not incur costs in preventing that sale. Though this approach is useful in some contexts, it again suffers from the defect that it is sometimes difficult to predict how consumers would behave in the absence of transaction costs. In circumstances in which different consumers would behave differently—which appears to be true of privacy, according to polls showing that consumers' preferences appear to vary<sup>248</sup>—it provides an uncertain guide.

A related test would focus on whether the loss to consumers would exceed the benefits to the company when the company increases consumer transaction costs. Parties in competitive markets should not agree to terms that generate a net reduction in the benefits from the transaction. For example, imagine a transaction between a buyer and a seller in a competitive market. Now assume that the seller offers the buyer a term that inflates the buyer's transaction costs in some respect. A buyer with perfect information in a competitive market should agree to such a term only if the seller compensates the buyer for the loss to the buyer's welfare; if the seller fails to do so, but still insists on the term, a rational buyer would buy from the seller's competitor who did not increase the buyer's transaction costs. The seller will be willing to pay the buyer enough to compensate the buyer for the losses in welfare the buyer suffers from the increased transaction costs only if the value of the term to the seller is equal to or greater than the loss the buyer suffers from the term; otherwise, the seller would suffer a loss from the transaction.

Accordingly, in a competitive market with all parties having perfect information, the parties would not agree to increase a party's transaction costs unless the other party's benefits from the transaction are at least as valuable to that party as the loss in welfare suffered by the party whose costs are increased. As a result, one test of whether terms that increase consumer transaction costs pass muster is whether the benefit to the company is at least equal to the loss to consumers.

Once again, rebates offer a useful example. The benefit to the company from using a rebate instead of a sale is its savings in providing money to consumers. Consumers who do not obtain a rebate suffer a loss in money equal to the gain to the company. But

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248. See Sovern, *supra* note 28, at 1056-64.

that is not the only loss consumers experience from rebates. As noted above, consumers who purchase an item in the mistaken belief that they will obtain the rebate have suffered a distortion of their demand function; they have purchased an item they would not otherwise have bought.<sup>249</sup> Consumers who submit the required form lose the time needed to complete the form; as discussed above, some of that loss is a dead weight loss to society.<sup>250</sup> The result is that the benefit to the company is less than the loss to consumers.

Policymakers should approach the problem of inflated consumer transaction costs, then, by first asking whether the firm has increased the consumer's transaction costs. If the firm has, policymakers should next ask whether the practice involves a term that is salient to a significant number of consumers. If it is not, policymakers should then explore whether the practice runs afoul of any of the other criteria discussed above: whether the practice affords any significant benefit other than to increase consumer transaction costs, whether the practice is one that consumers would agree to in a competitive market, how consumers would behave in a world of zero transaction costs, and whether the loss to consumers outweighs the benefit to the firm. Not all of these factors will have a clear answer with respect to a particular practice; perhaps none will. They offer a guide, however, for deciding which practices should be outlawed, or at least regulated.

### *B. Implementing the Norm*

Society can employ a variety of ways to adopt such a norm. Legislatures can enact statutes. The FTC can promulgate trade regulation rules,<sup>251</sup> probably using its power to ban unfair practices, or it could proceed on a case-by-case basis, as in *Spiegel*.<sup>252</sup> Other

249. See *supra* note 172 and accompanying text.

250. *Id.*

251. See 15 U.S.C. § 57a(a)(1)(A) (2000).

252. As for the role of the FTC in connection with inflated transaction costs due to market failures:

Even though the legislative history of the FTC Act does not explicitly refer to the market failure concept, with the advantage of hindsight one might well conclude that Congress had something like it in mind. The FTC may have been established because of a congressional belief that such factors as false information, imperfect or incomplete information, transaction cost problems, or



administrative agencies also can act concerning matters within their jurisdiction.

Courts present a more difficult problem for three reasons. First, as noted above, courts are circumscribed by the usually expressed need to employ an existing statute or common law rule. Three such existing rules include "little FTC" acts in states that include unfairness language in their statutes, the power to invalidate unconscionable terms and contracts, and the duty contracting parties have to act in good faith. Those powers will go only so far, but in many instances they will be helpful. At a minimum, courts resolving disputes under these rules can use the tests described above to determine whether a particular practice should be struck down. Though these tests are vague, they surely are no more so than the tests for, say, unconscionability, with its requirement of substantive and sometimes procedural unconscionability. Indeed, one test of substantive unconscionability could be whether a term unduly inflates consumer transaction costs. In any event, legislatures could respond to the limits of these existing norms by creating a new norm for courts to enforce that would outlaw the undesirable inflation of consumer transaction costs.

Second, courts tend to be more limited than legislatures and administrative agencies in fashioning remedies.<sup>253</sup> Thus, while legislatures and administrative agencies occasionally resort to disclosure requirements,<sup>254</sup> courts rarely do. Courts seldom can do more than either permit a term to stand or strike it,<sup>255</sup> although conceivably, legislatures could empower courts to use other remedies, including reformation of contracts.

Third, courts are ill suited to make the determinations described above. For example, courts do not seem ideally organized to decide

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insufficient resources explain the failure of the free market to adequately protect consumer welfare.

Averitt & Lande, *supra* note 106, at 728 (footnotes omitted).

253. *Cf.* Schwartz & Wilde, *supra* note 97, at 678 ("[C]ourts cannot issue the remedies necessary to initiate movement of markets toward competitive equilibria.").

254. *See, e.g.*, Truth in Lending Act, 15 U.S.C. § 1601 (2000) (citing disclosures in credit transactions as a major purpose for passing the Truth in Lending Act); 16 C.F.R. § 444.3 (2005) (requiring notice to cosigner of obligations assumed by the cosigner).

255. *Cf.* Schwartz & Wilde, *supra* note 97, at 678-82 (concluding that courts should exercise only limited powers in responding to information problems and that those powers should be exercised cautiously).

if a practice is one that consumers would agree to in a competitive market, how consumers would behave in a world of zero transaction costs, or if a loss to consumers outweighs the benefits to the firm.<sup>256</sup> On the other hand, courts have been up to the task of making difficult determinations many times before.

Confining the use of the norm to legislatures and administrative agencies runs some risk, too. Regulatory provisions directed at consumer problems are often targeted at specific problems. For example, the Gramm-Leach-Bliley provisions address privacy in financial transactions but do not reach other privacy issues. Thus, while a bank may be restrained from reporting that a consumer used her credit card to purchase a book, the bookstore is free to disclose the same purchase. When legislatures enact more general rules, like the prohibition on unconscionable terms in the U.C.C., courts are able to use the norms thus established to address a broader array of problems, including problems that the legislature did not anticipate. For this reason alone, it is desirable to give courts the power to employ a norm against unreasonable increases in transaction costs so that, to the extent the ingenuity of merchants outraces that of legislatures, courts can redress the balance.

In addition, legislatures and agencies tend to produce rules only when a problem is widespread and ongoing. The energy needed to pass a statute or even promulgate a rule is too great to squander on rarely repeated problems. But courts are obliged to act if only one suitor commences an action. Thus, courts may find a practice unconscionable when a legislature or administrative agency would not summon the resources needed to respond to the practice. Accordingly, courts should be able to employ the norm, rather than limit its use to legislatures and administrative agencies.<sup>257</sup>

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256. Cf. Hillman & Rachlinski, *supra* note 80, at 441 ("Courts have difficulty distinguishing between terms that create a reasonable arrangement of risks and terms that constitute exploitation of consumers. They lack the incentives and experiences that allow businesses to identify and distinguish between sensible practices and opportunities to exploit consumers.") (footnote omitted); Korobkin, *supra* note 90, at 1253 ("[R]equiring courts to determine *de novo* whether particular terms are efficient or inefficient would strain the bounds of judicial competence ....").

257. Cf. Korobkin, *supra* note 90, at 1206 ("Courts can increase utility for buyers and sellers, as well as promote social efficiency, by enforcing efficient terms in form contracts and refusing to enforce inefficient terms.").

Moreover, when courts invalidate a term, they furnish a variety of actors with an incentive to act. Firms that desire to have the benefits of the term must modify their practices by finding a way to add the term to new contracts without violating existing norms. Legislatures and administrative agencies may respond by creating disclosure rules that permit the term to be inserted in contracts provided that certain disclosures are made. The alternative of depriving the courts of the power to strike terms that unreasonably inflate consumer transaction costs seems less desirable than a regime in which courts may occasionally strike terms that would pass muster in a different form.

Ideally, legislatures will enact new statutes to make explicit that courts have the power to invalidate terms that unjustifiably increase consumer transaction costs. Such statutes could be written, like the unconscionability provision in the U.C.C., in general terms to give courts discretion to act when action is needed and to refrain from action when restraint is desirable. The statutes could provide that when a practice increases consumer transaction costs the merchant bears the burden of proving that the increase is justified. In determining whether the increase is warranted, courts could use the tests described above.

In sum, it seems best for legislatures and administrative agencies to use the norm as a guide in fashioning rules, and to permit courts to use it as well, preferably through enactment of new statutes but, failing that, through existing rules, such as the prohibitions on unconscionable contracts and terms, parties to contracts acting in bad faith, and unfair trade practices.

### CONCLUSION

This Article has demonstrated that firms inflate consumer transaction costs to generate greater profits. Firms do so, by, for example, obscuring contract terms in a variety of ways, such as providing them after the contract is agreed to; enclosing them with other, more interesting information; using small print; and omitting important terms from the written contract, such as arbitration fees. Firms also take advantage of predictable consumer behaviors, such as the tendency of consumers not to seek rebates, to overload when

provided with too much information, and to ignore dull information when overshadowed by vivid information.

When transaction costs are inflated unnecessarily, the total surplus from exchange is diminished even though one party's gains from the exchange may be enhanced. Legislatures and administrative agencies have often acted to restrain firms from increasing consumer transaction costs unnecessarily. Courts, however, lacking a clear norm to use to outlaw practices that increase transaction costs, have responded inconsistently to inflated transaction costs. Though courts have sometimes employed general rules, such as the prohibition on unconscionable terms and contracts, to bar increases in transaction costs, on other occasions they have declined opportunities to do so.

Lawmakers should embrace a norm prohibiting unnecessarily inflated transaction costs. When a firm has increased the consumer's transaction costs, policymakers should ask whether the practice involves a term that is salient to a significant number of consumers. If it is not, policymakers should then ask four questions: (1) Does the practice afford any significant benefit other than to increase consumer transaction costs? (2) Is the practice one that consumers would agree to in a competitive market? (3) How would consumers behave in a world of zero transaction costs? (4) Does the loss to consumers outweigh the benefit to the firm? The answers to these questions should determine whether the practice should be outlawed. Legislatures and administrative agencies should employ the norm in fashioning rules and courts should use the norm as a guide in implementing existing rules, including the prohibition on unconscionable terms and contracts.