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## Standard Form Contracts

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## STANDARD FORM CONTRACTS

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**Abstract.** The literature on standard form contracts has increased dramatically in recent years, as lawyers and economists have debated their desirability in both business and consumer settings. The development of novel forms of contracting, such as telephonic and Internet-based contracting, as well as the application of interdisciplinary approaches to legal issues have raised questions concerning the meaning of assent to terms that are presented with little practical opportunity for negotiation. Many of the arguments for or against the enforcement of standard form contracts rely on assumptions concerning the extent to which some buyers can serve as surrogates for others and the presence or absence in standard forms of terms that reflect what would emerge in a competitive environment. Recently, some empirical literature has appeared on these questions as well. Finally, some commentators have suggested additional administrative regulation of contracts to reduce exploitation of those presented with unalterable standard forms. This review of the literature, prepared for the forthcoming *Encyclopedia of Law and Economics* (2d edition), discusses the current state of the theoretical and empirical literature on these issues.

Standard form contracts, sometimes referred to as “boilerplate” or adhesion contracts, constitute a category of contracts that are presented to a party for acceptance or rejection without substantial additional negotiation. A standard form contract may be drafted by the party who presents it or by a third party, such as a trade association. Early commentary on standard form contracts assumed that the absence of bargaining indicated the superior market position of the drafter, usually the seller of goods or provider of services. As a result, these contracts were thought to have a poor fit with conceptions of volitional consent that underlie the neoclassical basis for enforcement of contracts. Kessler (1943), Slawson (1971), and, to a lesser degree, Rakoff (1983), exemplify this position. In economic terms, this literature contends that standard form contracts tend systematically to be identified with the presence of market failures. Courts also concluded that standard form contracts implied superior bargaining power and the imposition of terms on the adhering party. In *Henningsen* (1960), for instance, the court noted

an absence of competition for warranties and inferred an inequality of bargaining power from the fact that (1) a substantially similar limited warranty was found in virtually all automobile contracts, and (2) the warranty was presented to the consumer as a condition to purchasing the automobile.

### **Benefits of Standard Form Contracts**

Subsequent literature identified more socially useful roles for standard form contracts, analogous to the benefits that arise from standardization in product markets. First, standard form contracts reduce transactions costs. In the strongest form of this claim, the drafter provides terms consistent with those to which the parties ultimately would have bargained. If, for instance, the standard form allocates risks to the parties best positioned to avoid or insure against them, then presumably the terms reflect the positions most parties in similar positions would have preferred and the absence of bargaining does not imply a lack of consent. This might be the situation, for instance, where a standard form contract evolves from repeated interactions between sophisticated market actors.

Second, standard form contracts generate benefits associated with network externalities. As developed in the legal literature, standardization of contracts confers learning effects as courts and parties agree on meanings of potentially vague terms, while competition among suppliers of contract terms generate contracts that reflect optimal terms. Kahan and Klausner (1997); Klausner (1995); Chakravarty and MacLeod (2004). Repeat players may prefer standard forms that reduce uncertainty about the meaning of contract terms.

Third, standard forms facilitate control of agency costs in mass market transactions (Rakoff 1983, 1223). If agents are authorized to negotiate terms, principals will have to monitor agents to ensure that contract modifications do not adversely affect the pricing models under the

original contract. Agents may attempt to raise their productivity by offering terms that shift to their principals risks that the original terms allocated to the other party. Should those risks materialize, the principal rather than the agent will be required to bear the related costs. The agent has little incentive, and potentially insufficient information to price the reallocated risks accurately. As a result, any reallocation of risks that the agent negotiates may fail to reflect the additional expected losses that the principal bears. Standard form contracts reduce agency costs by negating the authority of agents to agree to any changes to the original terms of the contract. Assuming that the initial allocation reflects a “fair” price for the risks that the other party agrees to bear, the resulting reduction in agency costs should result in contractual terms that are agreeable to both parties.

### **Market Failure Explanations – Transactions Costs, Externalities, and Monopoly**

These rationales for standard form contracts implicitly assume that standard forms arise in well-operating markets, so that their terms approximate those to which the parties would have agreed had costly bargaining occurred. Critics of standard form contracts question the existence of these conditions and instead identify characteristics that would allow standard forms to endure notwithstanding the inclusion of inefficient terms. The fact that a term is common throughout an industry cannot of itself be evidence of its efficiency. The pervasive use of a term throughout an industry is consistent with either of two diametrically opposed phenomena. It may represent perfect competition so that each firm in the industry takes terms dictated by the market. Or it may be evidence that firms within the industry have oligopoly power and thus have the capacity to impose onerous terms on counterparties. One cannot assume that standard terms reflect an equilibrium solution that has evolved to minimize transactions costs, even when the contract is between repeat players. Indeed, while transactions costs may explain the evolution of efficient

terms, they may also explain how inefficient terms could survive in standard form contracts. A drafter could introduce a term the inefficiency of which is too minor to induce the other party (who will inefficiently bear the expected loss) to incur the costs necessary to bargain for an alternative term.

Network effects of standard form contracts may similarly generate spillover costs as benefits. Klausner (1995) argued that promulgation and widespread acceptance of terms could generate lock-in effects and dilute incentives for contractual innovation. Goetz and Scott (1985) and Davis (2006) examine how the objectives of the drafter of widely adopted standard form contracts affect the extent to which terms align with socially optimal contract terms. Inertia within the organization, production costs, the objective functions of agents within the promulgating organization, and the capacity to attract users of standard forms will necessarily affect the quality of the contract terms that pervade a network. The solution to that potential problem, however, may lie more with state-supplied or subsidized alternative contract terms than with the regulation of privately supplied terms.

Much of the more recent literature, therefore, has been dedicated to an exploration of whether the conditions of well-operating markets can be assumed to be satisfied. Katz (1998) argued that there was little evidence to support most market failure explanations for standard form contracts. He contended that actors with significant market power would be unlikely to utilize their position to dictate terms in standard form contracts. Monopolists would depress quantity rather than quality in order to maximize profits, and oligopolists still tend to compete over prices even when other contract terms are standardized. While Katz recognized that standard form contracts could increase barriers to entry by setting high quality standards, and that standard forms would deny some inframarginal buyers the ability to obtain the products or

preferences they desired, he doubted whether government regulation of contract terms could improve the situation. Kornhauser (1976) offered an explanation of why firms that had oligopoly power might coordinate on terms rather than only on price. He suggested that sellers in such markets could use standard forms to implement agreements not to compete on certain dimensions, such as warranty coverage, that could facilitate price coordination that maximized profits.

### **Market Failure Explanations – Asymmetric Information and Disincentives to Read**

Katz identified the presence of asymmetric information as the leading justification for regulation of contract terms. Legal defenses to enforcement of contract terms, such as unconscionability, are consistent with this argument, insofar as application of the defenses typically depend on the drafters' possession of information that adherents to the contract lack. The concern about asymmetric information is also consistent with the assertion that standard form contracts are most problematic in consumer markets for mass-marketed goods, where sellers, as repeat players, have opportunities to construct self-serving contract terms the value of which occasional buyers cannot evaluate. For instance, sellers could include a warranty disclaimer or an arbitration clause in a standard form contract without reducing the price of goods by an amount that reflects the fair value of the warranty or reduced costs related to arbitration because the consumer has insufficient information about product failure rates or the costs of dispute resolution.

Indeed, consumer buyers may fail to read terms at all, given an assumed low likelihood of product failure, an inability to negotiate about disfavored terms, and high costs of becoming informed about expected risks. The high costs related to reading suggest that few consumers will actually read standard contract terms, an assumption confirmed by surveys concerning online

contracts. (Hillman & Rachlinski, 2002). Although failure to read may be rational, sellers could exploit buyer inattention to insert terms without risk that buyers will object. Sellers may subsequently assert that failure to read does not dilute the enforceability of the contract, as long as the buyer had an opportunity to examine the contract terms prior to conclusion of the contract. Buyers may accept the application of the term, notwithstanding the possibility of legal defenses to its enforcement. Stolle and Slain (1998) offer experimental evidence that exculpatory clauses that are inserted into contracts deter the propensity of buyers to seek relief for defects.

Failure to read may present a particular characteristic of contract terms that are presented to the consumer simultaneously with delivery of the goods, notwithstanding that negotiations over some terms, such as price, occurred previously. Courts have disagreed about the enforceability of subsequently presented terms in these situations, often referred to as “rolling contracts.” *Hill* (1997) upheld the validity of terms presented at the time of delivery of consumer goods, while *Step-Saver Data Systems Inc.* (1991) concluded that a box-top license presented at the time of purchase did not become part of the parties’ agreement where prior conduct was sufficient to conclude a contract.

Schwartz and Wilde (1979 and 1983) questioned the assumption that failure to read necessarily precludes the development of standard form contracts with terms that reflected efficient terms or consumer preferences. They observed that consumers vary in their propensity to search for and analyze terms. Where competitive sellers cannot tell *ex ante* whether they are dealing with an informed or an uninformed buyer, and assuming a minimal number of reading buyers, they will offer all buyers terms that would be offered to reading consumers in order to capture the marginal buyer. As a result, consumers who read terms protect inframarginal nonreaders from potentially overreaching sellers. The survey evidence noted above, however,

indicates that it is not clear whether the condition of a minimal number of reading buyers necessary to reach that result can be satisfied. Schwartz and Wilde (1983) contended that if consumers as a group anticipate failure rates that are either unbiased or pessimistic, then sellers will respond with contract terms that are consistent with consumer beliefs. Only if consumers routinely understate failure rates will sellers be able to exploit consumer ignorance. Schwartz and Wilde believed that consumers would not systematically be too optimistic, so the conditions of seller overreaching would be rare. They did, however, suggest that the state could promote competition among drafters of by subsidizing the production of price lists and important contract terms that firms offer.

Schwartz and Wilde (1979) argued that competitive sellers will not exploit consumer inattention if it is costly for sellers to distinguish between reading and nonreading buyers. There may, however, be situations in which sellers can distinguish *ex ante* between reading and nonreading buyers at low cost. Gillette (2004) speculated that if business buyers are more likely to read than consumer buyers, then sellers may be able to separate buyers into different subgroups and offer each subgroup a different contract. Only the subgroup populated by readers would receive value-maximizing terms. A seller that sells computers, for instance, may offer value-maximizing warranty terms on computers that are likely to be used for business purposes, while exploiting informational advantages with respect to computers likely to be purchased for consumer purposes.

### **Discretionary Enforcement of Terms**

Gillette (2004) argued that the absence of explicit assent to standard contracts may be less problematic than neoclassical contract theory implies, because the drafter does not intend to deploy nominally oppressive terms in the absence of circumstances that would warrant their use

to constrain opportunistic buyers. In those circumstances, even ostensibly one-sided contract terms may provide efficient solutions to conditions that are not readily susceptible to bargaining, so that state invalidation of terms would reduce net efficiency. Ostensibly one-sided terms, for instance, might be inserted into contracts by sellers who could not determine *ex ante* whether adhering parties are likely to act in good faith, but might be able to make an *ex post* determination of bad faith conduct. Sellers would then exercise discretion to invoke a pro-seller term in the event that they faced a bad faith buyer, but waive the clause in dealings with a good-faith buyer. This argument had precedent in claims by Klein (1980) a grant of discretion to one party could efficiently constrain counterparties who are not easily disciplined by markets or whose opportunistic behavior cannot readily be detected or verified to third parties.

Bebchuck and Posner (2006) extended this claim. They predicted that parties who have a reputation for fair dealing could efficiently employ nominally one-sided contracts with counterparties, such as consumers, who do not have robust reputations, if the former assert contractual rights only in response to egregious behavior by a counterparty. Where, for instance, sellers' practices are known to buyers, buyers may accept a contract that omits a term that the buyer prefers, believing (correctly) that sellers will honor the nonexistent term in a state that the buyer believes will materialize. A buyer, for instance, may be willing to accept a short return-period term for a good if the buyer knows that the seller accepts goods for a longer period of time as long as the seller does not suspect buyer abuse. Johnston (2006) also suggested that ostensibly one-sided standard terms may not reflect actual practices of contract enforcement. He suggested that these terms serve as a basis for post-contract bargaining. He claimed, contrary to the argument that standard forms are intended to limit the discretion of agents, that standard form

contracts allow agents discretion to grant exceptions in order to maintain relationships with counterparties who can be identified as co-operative or value-enhancing in future dealings.

### **Behavioral Explanations for Standard Form Contracts**

Efficiency claims about standard form contracts have also been challenged under principles derived from behavioral economics that suggest adherents to proposed contracts will undervalue adverse events. Korobkin (2003) contended that adhering parties will typically price only a limited number of contract attributes. Assuming that virtually all adhering parties focus on the same attributes, drafters of standard forms will be able to introduce self-serving inefficient terms on less salient attributes. For instance, if, at the time a contract is concluded, buyers underestimate product or service failures and thus do not anticipate the need to resolve conflicts with sellers or providers, buyers may ignore the consequences of a standard clause that requires arbitration of disputes or that precludes the use of class actions for small-value contracts. As a result, sellers will be able to include arbitration clauses without a commensurate reduction in contract prices. Bar-Gill (2004) and Mann (2006) contended that contracts offered by credit card issuers are particularly susceptible to cognitive biases, because consumer cardholders will either ignore or underestimate possible subsequent events, such as post-default increases in interest rates, e.g., due to naïve hyperbolic discounting. This possibility may justify greater judicial supervision of contracts through doctrines such as unconscionability and greater use of mandatory terms, or, more conservatively, require more conspicuous disclosure of terms that might adversely affect cardholders and of the expected costs to consumers of these terms.

Gabaix and Laibson (2006) proposed that firms might hide, or shroud, information from their consumers by failing to disclose “add-on” costs that were required by initial investments. For instance, the purchase of a printer might entail subsequent purchase of printer ink cartridges

of a certain type, and myopic consumers might fail to anticipate some of the related costs. Although Gabaix and Laibson's analysis focused on sequential contracting behavior, where a contract of purchase at one period (the printer) required another contract of purchase as a subsequent time period (the replacement printer cartridge), the same phenomenon could exist within a single contract if consumers focus on a salient term and are myopic with respect to the probability that another term of the same contract might be relevant. For instance, consumers who underestimate the probability that they will default on credit card payments may fail to pay sufficient attention to a term that dramatically increases interest rates in the event of default. Gabaix and Laibson, however, also proposed that consumers could benefit from learning effects and therefore might not be subject systematically to biased contracts.

### **Empirical Examination of Claims about Standard Form Contracts**

More recent scholarship has empirically tested some of the theoretical claims about the presence and effects of one-sided clauses. Ben-Shahar and White (2004) examined long-term supply contracts in the automotive industry. They found that terms of standard form contracts used by different manufacturers varied within the industry, but consistently contained one-sided language that favored the drafter and extracted value from counterparties, notwithstanding the relational nature of the contracts and the sophisticated nature of the adhering party. The authors allow, however, for the possibility that the parties' practices vary from the obligations in the written terms.

Marotta-Wurgler assembled a database of end-user license agreements for software and analyzed terms to determine frequency, bias, and pricing. Marotta-Wurgler (2007a) concluded that licenses revealed a bias in favor of the software company that drafted the contract relative to contract law default terms. For instance, contract terms disclaimed warranties that would have

been implied at law. She also discovered that larger and younger firms offer more one-sided terms, but that, contrary to exploitation explanations, firms offered similar terms to both business buyers and consumers. Marotta-Wurgler (2008) found little evidence for the argument that firms in concentrated software markets or with high market shares impose one-sided terms on consumers relative to the terms offered by firms in less concentrated software markets or with low market shares. Marotta-Wurgler (2009) investigated software products sold online to determine whether terms presented after purchase are more pro-seller than terms available pre-purchase. She concluded that there was no evidence that terms presented in the later stages of rolling contracts were especially unfavorable to consumers.

### **Interpretation of Standard Form Contracts**

The possibility that a standard form contract reflects a market failure has also affected the manner in which courts interpret them. General principles of contract interpretation include construction of any ambiguity against the interests of the drafter. American Law Institute § 206 (1981). Application of this principle induces drafters to avoid ambiguity and thus reduce both uncertainty in contract terms and the costs (both litigation costs and error costs) related to third-party contract interpretation. In the case of standard form contracts, however, an additional justification for the principle includes reducing the scope of terms that reflect market failures. In addition, courts may interpret a standard form contract to effectuate the reasonable expectations of the average adherent. One consequence of that rule is to extend a restrictive reading of the contract even to sophisticated adherents who have greater than average knowledge of an ambiguity in the contract. American Law Institute § 211 (1981). In recognition of the failure of many parties to read standard form contracts, an additional principle provides that where the drafter has reason to believe that the party manifesting assent to the contract would not do so if

he or she knew that it contained a particular term, that term is not part of the agreement. This last principle arguably ensures that an element of assent informs even standard form contracts, but grants significant discretion to courts to determine the terms to which reasonable parties would agree.

### **Administrative Approval and Regulation of Standard Form Contracts**

Leff (1970) implied that the propriety of standard form contracts could best be resolved by assigning bureaucratic agencies the role of evaluating terms *ex ante*, as opposed to *ex post* judicial invalidation of terms deemed onerous. Leff analogized the terms in mass-market contracts to manufactured goods of sufficient complexity to exceed the comprehension of average consumers. Since a regulatory apparatus was employed to address information asymmetries in the latter context, Leff proposed similar solutions in the contractual setting. Sellers could submit potentially controversial terms and either approve them in a manner that would estop courts from subsequently invalidating them, or could signal to buyers which clauses were appropriate. Some countries have adopted similar procedures for pre-approval of contract terms. Deutch (1985) and Becher (2005) discuss the Israeli model. It is unclear, however, how frequently these administrative procedures are utilized by drafters of contracts.

Alternatively, agencies could prohibit terms that were deemed exploitative of informational advantages or of cognitive biases. For instance, regulations of the Federal Reserve Board prohibit credit card issuers from including in credit card contracts clauses that apply post-default penalty interest rates to prior purchases except in limited circumstances.

Agency analysis necessarily differs from judicial evaluation in that the former takes place through an *ex ante* analysis, while the latter takes place *ex post* with an identifiable adherent who claims an injury. Biases inherent in the different perspectives of regulation and litigation may

affect outcomes. Terms that might appear to be inappropriate *ex post* in an individual case might have been a good bargain *ex ante* for the class of buyers as a whole.

Pre-approval of contracts does implicate the incentives of regulators and private parties involved in the approval process. Agencies may be vulnerable to influence either by trade associations or consumer groups that promulgate or evaluate standard form contracts. As a consequence, it is unclear whether *ex ante* approval of terms will cause less deviation from optimal terms than either judicial regulation or reliance on extralegal constraints on seller opportunism, such as reputation.

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