

# THE COST OF CONSENT: OPTIMAL STANDARDIZATION IN THE LAW OF CONTRACT

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## ABSTRACT

*This Article argues that informed consent to contract terms is not a good to be maximized, but an information cost that courts should minimize. As a result, courts ought to minimize the cost sum of information costs and contractual surprise. The Article applies information-cost theory to show that information-forcing rules are often inefficient at both the micro- and macroeconomic levels. Such rules also impose greater costs on third parties than the benefits they create for the contracting parties. When one consumer creates an idiosyncratic deal, the information-savings benefits of standardization are reduced for all other potential consumers. The Article demonstrates that in some cases courts are already abandoning a rigid view of contractual consent when consent is too costly; but that under other doctrines, courts insist on an inefficient level of informed contractual consent.*

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“DAD! Too. Much. Information!”  
—Author’s daughter, age 6.

## INTRODUCTION

In contract theory, consent is indispensable and standardization disfavored.<sup>1</sup> In practice, consent is costly, and standardization is the solution. This Article attempts to realign contract law with the broader discourse on standardization. It argues that contractual consent is an information cost and proposes that standardization is the way to reduce that cost.

Traditional theories of contract treat consent as an indispensable expression of will, of autonomy, or as a vital element of an ongoing relationship. Economic theories of contract, especially those in the Coasean tradition, have treated consent as incidental to negotiation over contract defaults. The Coasean bargain requires that a contracting party be able to gain its counterparty’s contractual consent with minimal transaction costs.<sup>2</sup> As a result, economists have not strongly focused on consent as a transaction cost, and almost none have focused on it as an information cost.<sup>3</sup>

Traditional contract theories malign standardized contracts for increasing information costs.<sup>4</sup> The usual argument is that standardized contracts hide or backload terms, confuse consumers, and raise the costs of information.<sup>5</sup> But

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<sup>1</sup> See Peter H. Schuck, *Rethinking Informed Consent*, 103 YALE L.J. 899, 900 (1994) (“Consent is the master concept that defines the law of contracts in the United States. . . . [It] expresses the primacy of individualistic values in our culture. To say that one cannot be bound by a promise that one did not voluntarily and knowingly make is to say that the individual should be the author of her own undertakings . . .”). For an in-depth discussion of the role of consent in contracting, see Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1179–80 (1983).

<sup>2</sup> See David M. Driesen & Shubha Ghosh, *The Functions of Transaction Costs: Rethinking Transaction Cost Minimization in a World of Friction*, 47 ARIZ. L. REV. 61, 68 (2005) (“Coase claimed that absent transaction costs, parties could simply bargain around an inefficient decision made by a court . . .”).

<sup>3</sup> See, e.g., Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713, 715–16 (1997) (“[W]e present a theoretical, institutional, and empirical analysis of two independent, but conceptually related, forces that influence the balance of standardization, customization, and innovation in contracts: learning externalities and network externalities.”).

<sup>4</sup> See Amy J. Schmitz, *Embracing Unconscionability’s Safety Net Function*, 58 ALA. L. REV. 73, 105–06 (2006) (“Courts, therefore, may apply unconscionability as a substitute for market correction prevented by sellers’ monopoly power and purchasers’ high information costs. In this way, unconscionability provides courts with means for checking whether contracts are truly products of contractual liberty.”).

<sup>5</sup> Standardization has two meanings, rarely distinguished. The first refers to a drafter repeatedly offering the same contractual terms to all potential counterparties. For example, a widget manufacturer might offer the

everywhere else that standardization is studied (for example, standardization in industrial manufacture, computer programming, or medical consent), standardization lowers the cost of information.<sup>6</sup> Thus, the anti-standardization doctrines of adhesion and unconscionability seem adrift in an age of mechanized production and electronic contracting.

A simple example shows why the leading views of consent and standardization are incomplete. Suppose you buy a cup of coffee. You have not consented to the fine print on the coffee cup in any way that is worth mentioning. You know roughly what is in the contract; it is, after all, standardized. There is no need to read it. Indeed, it would be an economic tragedy if you did read the fine print. The time cost of doing so might well exceed the benefit to you of purchasing the coffee. The cost of obtaining your consent could kill the deal.

This Article contradicts the received wisdom of contract theory. I focus on the cost of consent, rather than its presence or absence. This redefines the question of consent. The relevant question, I posit, is not whether the customer has purchased enough information to have meaningfully consented to the contract. Rather, the important question is how much information is efficient for the consumer to purchase. I also propose that standardization reduces, rather than increases, the information costs of consent. As a result, I propose that courts should minimize the cost sum of contractual consent and surprise, just as they minimize the cost sum of precautions and accidents in torts. Finally, I propose that courts reconsider the use of information-forcing rules in the mass-market context.

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same contract to everyone. The second refers to standardization across drafters. For example, every widget manufacturer may come to offer the same or similar terms. Both are important for consumers who seek to reduce information costs. A consumer suffers lower information costs if the cup of Starbucks coffee she buys today is subject to the same terms and conditions as the cup of Starbucks coffee she bought yesterday. This saves the consumer time because she does not have to relearn the terms of each deal. But consumers also benefit if the standardized contract they receive from Starbucks is substantially the same as the deal they get from Daily Grind.

<sup>6</sup> See Joseph M. Perillo, *Neutral Standardizing of Contracts*, 28 PACE L. REV. 179, 180–84 (2008) (discussing the literature of standardization outside of contract); see also Mark A. Hall, *A Theory of Economic Informed Consent*, 31 GA. L. REV. 511, 512 (1997) (discussing the “fundamental incompatibility of conventional informed consent theory and modern economic reality”); Schuck, *supra* note 1, at 903–05 (discussing the costs of informed consent in healthcare); Avery Wiener Katz, *Is Electronic Contracting Different? Contract Law in the Information Age 1* (2005) (unpublished manuscript), <http://www.columbia.edu/~ak472/papers/Electronic%20Contracting.pdf> (arguing that standardization and search in electronic contexts can reduce information costs).

This leads to a counterintuitive payoff. If standardized deals lower information costs, customized deals may raise them. I argue that customized deals that economic theory has long considered efficient instead increase information costs for third parties and thus can be suboptimal across the run of mass-market contracts. This may explain why firms will not negotiate with consumers for idiosyncratic but otherwise efficient contract terms. (Imagine negotiating over the counter at Best Buy, even for terms for which you are willing to pay more than the cost to Best Buy. Best Buy is unlikely to agree, even though the terms are efficient between the parties.<sup>7</sup>)

A caveat: these insights apply best to mass-market, high-volume, low-value transactions, in which the slight increase in transaction costs engendered by information-forcing rules actually threatens a percentage of the potential transactions. Nobody wants to dicker terms over a purchase of a cup of coffee; everyone wants to negotiate over terms in a home-purchase agreement. In individuated, customized contracts, the parties themselves clearly believe that the cost in time and money of dickering terms is lower than the potential damage caused by deviation from one or both parties' expectations. Thus, I confine my discussion to the mass-market context.

This Article proceeds as follows: Part I discusses the traditional literature of contractual consent, the economic literature of Coasean bargains and incomplete contracts, and the literature of information costs. Part II illustrates the economic cost of requiring consumers to buy too much information. It argues that contractual consent is a transaction cost to be minimized, not a good to be maximized. Part III shows that even when information exchange is efficient for two contracting parties, their creation of an idiosyncratic agreement may increase information costs for third parties. Part IV addresses and ultimately rejects concerns that contract standardization may stifle innovation in contract terms. Part V closes with final observations and recommendations.

## I. LITERATURE

Contract theory is an old field, and it is useful to examine what has gone before. Liberal theory has enshrined consent at the center of the contract

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<sup>7</sup> Of course, the clerk at the counter lacks authority to make such a deal. Issues of agency and apparent authority aside, the issue of authority merely begs the question as to why Best Buy would structure its practices that way, if it meant turning down mutually beneficial contract terms.

process and encourages courts to maximize consent by maximizing information exchange.<sup>8</sup> Economic theory has largely ignored issues of consent, focusing instead on the Coasean bargain.<sup>9</sup> To the limited extent that economists have focused on consent costs, they too have encouraged courts to maximize information exchange.<sup>10</sup> This Article asserts that consent is costly and that information exchange should be minimized in certain cases.

The first section below discusses liberal theories of contractual consent. The second section discusses economic views of consent and the development of information-forcing rules. The third section discusses the literature of information costs, a literature that has not yet been applied to contract law. Throughout this Part, I identify the gaps that my analysis fills in the current literature, as well as points of departure between prior literature and the current analysis.

### A. *Liberal Contract Theory*

Traditional theories of contract rely on informed consent as a linchpin of contract, whether as an expression of a contracting party's individual autonomy or as a building block in a reciprocal relationship that is the foundation of the business relationship between two parties.<sup>11</sup> Traditional theory asserts that without meaningful informed consent, there is no contract.<sup>12</sup> These theories express the liberal principle that a person may not be contractually bound except by her consent.<sup>13</sup> As such, the basic approach of

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<sup>8</sup> See Schuck, *supra* note 1, at 900.

<sup>9</sup> See, e.g., Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1285 (1980) ("The parties can always bargain out from the rule, for instance by a limited damages agreement. Thus, when transactions costs are zero, the particular damage rule selected for reciprocal promises is irrelevant. Although the existence of transactions costs renders bargaining over damage rules costly in practice, the feedback adjustment of the return promise markedly reduces the potentially inefficient effects of legal rules."); see also *infra* notes 25–42.

<sup>10</sup> See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 97 (1989) ("Because the non-enforcement default potentially penalizes both parties, it encourages both of them to include a quantity term.").

<sup>11</sup> See IAN R. MACNEIL, *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS* 71 (1980) (setting out a theory of contract, termed "relational," which describes contract as a subsection of the broader ongoing relationship of the parties); see also Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269, 270 (1986) ("Properly understood, contract law is that part of a system of entitlements that identifies those circumstances in which entitlements are validly transferred from person to person by their consent.").

<sup>12</sup> See Barnett, *supra* note 11, at 270 ("Consent is the moral component that distinguishes valid from invalid transfers of alienable rights.").

<sup>13</sup> See Margaret Jane Radin, *Boilerplate Today: The Rise of Modularity and the Waning of Consent*, in *BOILERPLATE: THE FOUNDATION OF MARKET CONTRACTS* 189, 196 (Omri Ben-Shahar ed., 2007) [hereinafter

liberal theories to contractual consent could be paraphrased as “the more the merrier.”<sup>14</sup>

The modern discussion about consent in standardized contracts seeks to return to a traditional, robust sense of contractual consent.<sup>15</sup> The focus of this debate is on ensuring that consumers have meaningfully consented to the terms of an agreement.<sup>16</sup> Theorists discuss and decry the application of End User License Agreements, Terms of Use, and Terms of Service to consumers who have not knowledgeably consented to the terms of a contract in any way.<sup>17</sup> For example, a consumer might be held to have consented to collection of private information about that customer merely by virtue of having browsed a website.<sup>18</sup> The Terms of Use of the website, available if one were to search hard enough, bind the consumer to part with her personal data both at that website and wherever else she might travel on the web. Similarly, clicking “I Accept” upon downloading software, entering a website, or turning on a

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Radin, *Boilerplate Today*] (“The traditional picture of contract is the time-honored meeting of the minds. The traditional picture imagines two autonomous wills coming together to express their autonomy by binding themselves reciprocally to a bargain of exchange.”).

<sup>14</sup> I use “liberal” here in the philosophical, not the political, sense. Liberal contract theory holds that no person may be bound by law except by her informed consent, leading to the twin fictions of the social contract and of consent to mass-market contracts. See Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553, 575 (1933) (“According to the classical view, the law of contract gives expression to and protects the will of the parties, for the will is something inherently worthy of respect.”); see also Michael I. Krauss, *Tort Law and Private Ordering*, 35 ST. LOUIS U. L.J. 623, 625 n.9 (1991) (“The ‘Autonomy of the Will’ theory, fundamental to the elaboration of classical liberal theories of contract, holds that humans are characterized by their sovereign capacity to self-determine their future through free choice. Although all choice is influenced by people and by circumstances (uninfluenced action is the result of instinct, not choice), the Autonomy of the Will theory refuses to equate influence to duress.” (citing THOMAS HOBBS, *LEVIATHAN* ch. XIV (M. Oakeshott ed., Basil Blackwell 1946) (1651))).

<sup>15</sup> See Margaret Jane Radin, *Humans, Computers, and Binding Commitment*, 75 IND. L.J. 1125, 1153 (2000) (“If the world of online contract turns out to be more standardized—or more obviously standardized—than the world of offline contract, the world of online contract will be troubling from the point of view that holds consent requisite for binding obligation to arise.”).

<sup>16</sup> See *id.* at 1160 (“Although customization is technologically possible on the Web as never before, nevertheless machine-made contract and the global scope of electronic commerce may result in more standardization and even less room for old-fashioned bargaining. What will happen to the liberal ideal of requiring consent before parting with one’s entitlements?”).

<sup>17</sup> See Margaret Jane Radin, *Online Standardization and the Integration of Text and Machine*, 70 FORDHAM L. REV. 1125, 1135 (2002) (“Almost every website contains a little link at the bottom of the home page labeled ‘terms’ or something similar. If you click on these terms, you will most often see a full-blown purported adhesion contract containing much fine print, in which the user exculpates the firm for its own negligence, agrees to binding arbitration or litigation on its home turf under its home jurisdiction’s law, agrees to limit damages to the price of the product, waives all warranties express and implied, and so on.”).

<sup>18</sup> See Radin, *Boilerplate Today*, *supra* note 13, at 196 (“Consent is fictional on Web sites whose terms of service state that just by browsing the site . . . one has agreed to whatever the terms say, now or as they may be changed in the future.”).

computer is deemed sufficient consent to enforce broad-reaching contracts.<sup>19</sup> Contract theorists see these cases as a deviation from norms of contract law rather than as its desirable next step.<sup>20</sup>

The theory advanced in this Article departs sharply from the traditional approach to contractual consent. Instead of advocating information-forcing rules to make sure that consumers are informed, this Article seeks to demonstrate that informed consent is expensive, that standardization is the best way to keep information costs low, and that consumers rationally prefer standardized deals to idiosyncratic ones.

For high-volume, low-value transactions, each trade generates very little social wealth. Let us return to the example of purchasing a cup of coffee. Perhaps that exchange creates twenty-five cents worth of social wealth. Now, imagine the time cost involved in reading even a short contract. Even if we set opportunity costs equally low by assuming the consumer is paid the federal minimum wage (which works out to nearly ten cents per minute), the value of the transaction will vanish if contract doctrine compels the consumer to spend three minutes perusing fine print. In this case, it would cost more to become informed as to the terms of the agreement than the amount of wealth generated by the trade itself. Thus, there is an affirmative value in *not* reading a contract.<sup>21</sup> Standardization is the best way to constrain the range of consumer choice and reduce information costs. This Article therefore departs from the received wisdom on both the advisability of information-forcing rules in the mass-market context and the rules that disfavor consumer contract standardization.

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<sup>19</sup> See *id.* (“Consent is fictional when almost all of us click onscreen boxes affirming that we have read and understood things we have not read and would not understand if we did.”).

<sup>20</sup> See Radin, *supra* note 15, at 1161 (“[T]he only ameliorative avenue I can see is for policymakers to take on the task of deciding which terms it is important to draw buyers’ attention to in order to preserve their autonomy, and which kinds of terms must be simply excluded on autonomy grounds.”).

<sup>21</sup> Although he did so in a critique of the economic approach to law, Ian Macneil succinctly stated the problem:

[T]he limited extent to which it is possible for people to consent to all the terms of a transaction, even a relatively simple and very discrete one, soon forces the development of legal fictions expanding the scope of “consent” far beyond anything remotely close to what the parties ever had in mind.

Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 883–84 (1978).

### B. Boilerplate and Coasean Bargains

The economic analysis of boilerplate discusses the benefits of contract standardization for contract drafters. It argues quite effectively that network effects cause contract drafters to reuse contract language (in the form of boilerplate) to save themselves drafting costs, economize on learning costs, reuse “safe” language that has been vetted by courts, and signal to prospective counterparties that the contract drafter does not seek an unfair advantage through the drafting process.<sup>22</sup>

This boilerplate literature focuses primarily on why a drafter would reuse contract language.<sup>23</sup> The literature leaves for future development, however, the question of why a mass-market consumer would prefer a standard deal to an individuated one. The usual account—that standardization creates drafting-cost savings that drafters will then pass on to the consumer—seems incongruous with contracting experience. Drafters pass cost savings along only in competitive markets. Unless there is a reason not to do so, companies will quite rationally pocket the savings. Yet even in fields where competition is suppressed (for example, in car component manufacturing in which there are few buyers and high barriers to entry), with correspondingly low incentives to pass drafting-cost savings on to buyers, buyers still prefer standard deals.<sup>24</sup>

Economic literature has not explained why consumers regularly prefer a standardized agreement to an individuated one, even when the standard agreement is more expensive. Where economic theory falls short, common sense does not. Imagine choosing between a high-priced, brand-name computer and a lower cost, customized computer. Many of us would select the high-priced standardized deal. This Article therefore seeks to fill this gap between theory and practice by focusing on the direct informational benefits of contract standardization to the consumer.

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<sup>22</sup> See Kahan & Klausner, *supra* note 3, at 718 (“One set of benefits, which we call ‘learning benefits,’ arises when a firm adopts a contract term that has been commonly used in the past, regardless of whether other firms will continue using it in the future. A second set of benefits, which we call ‘network benefits,’ arises when a firm adopts a term that will be part of the firm’s contract at the same time that it is part of many other firms’ contracts, regardless of whether it has been commonly used in the past.”).

<sup>23</sup> *Id.* at 719–20 (“Potential ‘learning benefits’ of both commonly used explicit terms and default terms include: (a) drafting efficiency; (b) reduced uncertainty over the meaning and validity of a term due to prior judicial rulings; and (c) familiarity with a term among lawyers, other professionals, and the investment community.”).

<sup>24</sup> *Id.*

Economic analyses to date have not focused on the costs of contractual consent.<sup>25</sup> In Coasean bargaining, parties attempt to bargain around contractual default rules.<sup>26</sup> The purpose of Coasean contract experiments is to show that it does not matter who benefits from an initial allocation of a right.<sup>27</sup> If Party *A* is initially given a resource, Party *B* may pay *A* for the right to use it if *B* can put it to a better use.<sup>28</sup> Regardless of who initially has a right, other parties may bribe the initial owner if they have more efficient uses for the owned resource. Coasean experiments in contract bargains seek to show that initial allocations of rights do not matter if the parties are able to contract around those allocations in a cost-free manner.

The Coase Theorem recognizes that transaction costs may cause an otherwise efficient bargain to fail.<sup>29</sup> The cost of reaching a bargain might be enough that an otherwise mutually beneficial trade will not take place. So the Theorem assumes that parties will reach efficient outcomes regardless of legal rules only when transaction costs are zero.<sup>30</sup> To mimic this, Coasean experiments minimize transaction costs.<sup>31</sup> The cost of informing a contractual counterparty of the terms, in order to secure her consent, is a transaction cost. One assumption of Coasean contract literature is, therefore, that the cost of securing the other party's consent to modify the contractual default is zero.<sup>32</sup>

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<sup>25</sup> *Id.* at 715–16 (“[W]e present a theoretical, institutional, and empirical analysis of two independent, but conceptually related, forces that influence the balance of standardization, customization, and innovation in contracts: learning externalities and network externalities.”).

<sup>26</sup> See Stewart Schwab, *A Coasean Experiment on Contract Presumptions*, 17 J. LEGAL STUD. 237, 242 (1988) (“[T]he Coase Theorem asserts that a change in contract presumption affects neither the efficiency of contracts nor the distribution of wealth between the parties.”).

<sup>27</sup> *Id.* (“Probably the most common formulation of the Coase Theorem asserts that, absent transaction costs, interacting parties will reach an efficient outcome even if the law awards initial legal entitlements to less valued uses.”).

<sup>28</sup> *Id.* at 238 (“The Coase Theorem predicts that, absent transaction costs, the entitlement holder will use the entitlement only if he is the efficient user. If not, the Coase Theorem predicts, he will make himself better off by trading the entitlement (for a price) to someone who values it more highly.”).

<sup>29</sup> See R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960) (“These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost.”).

<sup>30</sup> See *id.* (“The argument has proceeded up to this point on the assumption . . . that there were no costs involved in carrying out market transactions.”).

<sup>31</sup> See *id.* at 16 (“It is clear that an alternative form of economic organization which could achieve the same result at less cost than would be incurred by using the market would enable the value of production to be raised.”).

<sup>32</sup> See Donald H. Regan, *The Problem of Social Cost Revisited*, 15 J.L. & ECON. 427, 427 (1972) (“The proposition is: That in a world of perfect competition, perfect information, and zero transaction costs, the allocation of resources in the economy will be efficient . . .”).

The Coasean experiments to date have treated contractual consent as costless to obtain.<sup>33</sup>

For example, suppose participants play a game in which they assume the roles of Employer and Employee.<sup>34</sup> In the game, Employer and Employee attempt to bargain over a clause determining the conditions under which Employee can be fired.<sup>35</sup> In one theoretical state, the law allocates the employment right to Employee, in the form of a “for-cause” termination rule. In the other theoretical state, the law allocates the employment right to Employer, under an “at-will” employment rule. The question that the Coasean experimenter seeks to answer is whether the parties will bargain around the default rule (that is, bargain for “for-cause” termination in an “at-will” state, or for “at-will” employment in a “for-cause” state) if it is efficient to do so.

If consent is otherwise costless to obtain, the parties will reach an efficient contract whether the state law presumption favors at-will employment or for-cause termination.<sup>36</sup> If consent is costly to obtain, inefficient outcomes will occur. Because the focus of the experiment is whether the parties will bargain around defaults, the structure of the game makes consent functionally costless. There is a sunk cost effect. By the time the experiment begins, the participants have already incurred the cost of bargaining. For example, students at Stanford took part in the experiment above as part of class participation.<sup>37</sup> Students had to attend the class anyway and had to spend time bargaining regardless of the outcome. Their time was already wasted. These costs were sunk costs and did not deter them from bargaining.<sup>38</sup> In fact, beyond initial sessions, experiment participants were often penalized for not reaching an

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<sup>33</sup> See *supra* note 30.

<sup>34</sup> See Schwab, *supra* note 26, at 240 (“A nonunionized, competitive labor market nicely illustrates a contract presumption’s theoretical inability to influence the distribution of wealth.”).

<sup>35</sup> See *id.* at 246 (discussing experimental design).

<sup>36</sup> See *id.* at 254 (“In sum, the data are consistent with the reformulated Coasean hypothesis that the legal rule does not affect whether the parties reach an efficient result.”).

<sup>37</sup> See *id.* at 246 (“As part of my regular law school labor law classes and David Lipsky’s industrial and labor relations (ILR) classes on collective bargaining theory, 222 students were paired and asked to bargain over a collective bargaining contract. . . . Students were given a regularly scheduled class period for their initial bargaining session, and about half the students completed negotiations and signed their contract in this period.”).

<sup>38</sup> See RICHARD A. POSNER, *The Nature of Economic Reasoning*, in *ECONOMIC ANALYSIS OF LAW* 7–8 (4th ed. 1992) (“‘Sunk’ (incurred) costs do not affect decisions on price and quantity. . . . This discussion of sunk costs should help explain the emphasis that economists place on the ex ante (before the fact) rather than ex post (after the fact) perspective. Rational people base their decisions on their expectations of the future rather than on their regrets about the past. They treat bygones as bygones.”).

agreement.<sup>39</sup> Thus, the “null alternative”—in which the costs of bargaining were greater than the gains of bargaining—was off the table. The very form of the Coasean experiment selects against those whose time is more valuable than the per-hour opportunity cost of the experiment.

Study participants in experiments are therefore willing to spend time dickering terms that many of us would not be willing to spend. From the Coasean bargain perspective, this is good. The participants will act as though contracting were costless. This is a simple way of simulating the zero-transaction-cost assumption of the Coase Theorem. But for the purposes of this Article, those experiments avoid the most important part of contracting: the costs of reaching a deal.

For “real world” contracting parties, the time spent reading or dickering contract terms is a marginal cost, not a sunk cost.<sup>40</sup> Real world contracting parties are not being paid to dicker terms to contract agreements. Nor have they already suffered the cost of time such that they might as well read the contract. If I do not read the contract, I save time. Or conversely, if I must spend a lot of time learning the fine details of an agreement, I may decide not to make the deal at all. That is precisely the point of departure between this Article and its predecessors. This Article treats consent as costly to obtain and asks whether a consumer will enter a transaction at all, given the information costs of doing so.<sup>41</sup>

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<sup>39</sup> See Schwab, *supra* note 26, at 247 (“[E]ach side would lose ten points for every hour the contract signing was delayed . . .”).

<sup>40</sup> See Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697, 700 (1975) (“Marginal cost is the increment to total cost that results from producing an additional increment of output. It is a function solely of variable costs, because fixed costs, by definition, are costs unaffected by changes in output.”).

<sup>41</sup> Notably, a pre-Coasean contract theorist, Karl Llewellyn, came closest to articulating a cost theory of consent. See KARL N. LLEWELLYN, *THE COMMON LAW TRADITION: DECIDING APPEALS* 370–71 (1960). His approach was to differentiate between specific consent to dickered terms, and “blanket assent” to reasonable additional terms. Llewellyn’s approach generates many of the same benefits of the cost theory set forth in this Article—notably, the common-sense intuition that consumers do not (and probably should not) read mass-market contracts. This Article recognizes an intellectual debt to Llewellyn’s formulation. However, there are serious differences in the approaches. First, Llewellyn did not provide any theory of consent as a cost. Rather, he merely recognized that informed consent to all of the terms of a mass-market contract was an implausible standard and that courts ought not to use that standard to determine whether a consumer consented. More importantly, Llewellyn did not compare the cost of any given consent (whether “dickered” or “blanket”) with the damage from any surprise caused by deviation from the consumer’s expectations. The approach suggested by this Article does not differentiate between “dickered” or “default” terms but uses a single, unitary standard: where the cost of informed consent to a given term exceeds the damage caused by surprise (weighted of course by the chance of the surprise actually occurring), courts ought to let sleeping dogs lie, rather than “fix” the contract by using information-forcing doctrines.

I do not mean to suggest that the Coasean literature is unaware of the importance of transaction costs.<sup>42</sup> To the contrary, influential economic literature focuses on how legal rules might encourage parties to minimize transaction costs by exchanging closely held information.<sup>43</sup> This literature advocates the use of information-forcing rules to encourage contracting parties to reveal information that only one party knows.<sup>44</sup> These theorists argue that information-forcing rules bring the deal closer to the Coasean ideal of perfect information.<sup>45</sup> Under this view, encouraging parties to reveal secret information has a positive secondary effect on the cost of contractual consent because the party with the lower cost in obtaining the information is encouraged to reveal it, thus lowering the costs of informed consent.<sup>46</sup>

A primary example is the academic discussion about incomplete contracts.<sup>47</sup> Incomplete-contract theory discusses the role of default rules and mandatory rules in encouraging efficient contracting behavior.<sup>48</sup> The literature focuses on what to do when parties do not address an issue in a contract, leaving the decision to default contract law.<sup>49</sup> The question then becomes whether courts should reduce costs by picking default rules that the parties would have chosen had they negotiated or whether courts should adopt a suboptimal default rule, termed a “penalty default,” to encourage the parties to bargain around the default.<sup>50</sup> Such a penalty default rule encourages (or

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<sup>42</sup> Indeed, the absence of transaction costs is central to the Coasean approach. See Schwab, *supra* note 26, at 238 (“The Coase Theorem predicts that, absent transaction costs, the entitlement holder will use the entitlement only if he is the efficient user.”).

<sup>43</sup> See generally Ayres & Gertner, *supra* note 10.

<sup>44</sup> *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.”).

<sup>45</sup> *Id.* at 103 (“But the high-damage millers may intentionally choose to withhold information that would make their contracts more efficient. . . . To counteract this strategic behavior, courts should choose defaults that are different from what the parties would have wanted.”).

<sup>46</sup> *Id.* at 99 (arguing that “social welfare may be enhanced by forcing parties to reveal information to a subsidized judicial system”).

<sup>47</sup> See generally *id.* at 87 (arguing for contract default rules that penalize parties who conceal private information); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 *YALE L.J.* 615, 616 (1990) (describing strategic incentives to profit from closely held information).

<sup>48</sup> See Ayres & Gertner, *supra* note 10, at 87 (“The legal rules of contracts and corporations can be divided into two distinct classes. The larger class consists of ‘default’ rules that parties can contract around by prior agreement, while the smaller, but important, class consists of ‘immutable’ rules that parties cannot change by contractual agreement.”).

<sup>49</sup> See *id.* at 91 (“This Article provides a theory of how courts and legislatures should set default rules. We suggest that efficient defaults would take a variety of forms that at times would diverge from the ‘what the parties would have contracted for’ principle.”).

<sup>50</sup> See *id.* at 93 (“This Article provides a general theory of when efficiency-minded courts or legislatures should set penalty defaults and how they should choose between tailored and untailored default rules.”).

forces) parties to disclose closely held information in order to bargain on an issue.<sup>51</sup>

This Article departs from the incomplete-contract literature at two points. Penalty default rules and other information-forcing rules maximize information exchange. This Article argues that information exchange is costly and that the cost sum of information exchange and surprise should be minimized. Information-exchange theorists tend to suggest permissive information-forcing rules that cause parties to exchange information only when it is efficient to do so.<sup>52</sup> But, as discussed below, the penalty default approach ignores information costs by encouraging consumers to attempt to create idiosyncratic, customized deals.<sup>53</sup> For example, if you absolutely must have a Beanie Baby by Christmas, information-forcing rules encourage you to tell the shipper this so that the shipper may charge you a higher premium.<sup>54</sup> This higher premium covers the shipper's liability in the event that the Beanie Baby does not arrive until after the holiday season and your nephew is bitterly disappointed.<sup>55</sup> Yet such negotiation does not occur in the mass-market context, even when it is efficient on a deal-by-deal basis. This Article explains why this is so. Such deals may be efficient for the drafter and consumer but may raise information costs for all other users of standardized contracts.<sup>56</sup>

Under the influence of incomplete-contract theory, courts have adopted rules requiring greater and greater disclosure from drafters.<sup>57</sup> The irony is that the greater the amount of disclosure, the more rational it is for consumers not to read any of it. Learning about the contract terms simply takes too much

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<sup>51</sup> See *id.* at 92 (“Penalty defaults are designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer. In contrast to the received wisdom, penalty defaults are purposefully set at what the parties would not want—in order to encourage the parties to reveal information to each other or to third parties (especially the courts).”).

<sup>52</sup> See *id.* at 97 (“Penalty defaults, by definition, give at least one party to the contract an incentive to contract around the default. From an efficiency perspective, penalty default rules can be justified as a way to encourage the production of information.”).

<sup>53</sup> See *id.* (“Because the non-enforcement default potentially penalizes both parties, it encourages both of them to include a quantity term.”).

<sup>54</sup> See *id.* at 102 (“Nonetheless, so long as transaction costs are not prohibitive, a miller with high consequential damages will gain from revealing this information and contracting for greater insurance from the carrier because the carrier is the least-cost avoider.”).

<sup>55</sup> See *id.* at 101–02 (“Informing the carrier creates value because if the carrier foresees the loss, he will be able to prevent it more efficiently. At the same time, however, revealing the information to the carrier will undoubtedly increase the price of shipping.”).

<sup>56</sup> See *infra* Part III.A.

<sup>57</sup> See Ayres & Gertner, *supra* note 10, at 97 (“Because the non-enforcement default potentially penalizes both parties, it encourages both of them to include a quantity term.”).

time compared to the benefit received. Information-cost theory therefore may do a better job than incomplete-contract theory of explaining and predicting consumer contracting behavior.

### C. *Information Costs in Property*

This Article applies information-cost theory to understand standardization in contract law. Thomas Merrill and Henry Smith first applied a model of information costs to analyze standardization in property law.<sup>58</sup> It is therefore useful to briefly describe how information-cost models have been used in the property context and to discuss why information-cost theory has not yet been applied to the contract context. In this section, I discuss the history of information-cost theory, its application to property law, why it has not yet been applied to contract law, and why I think it ought to be so applied.

Property is a system of mandatory rules, not modifiable by the agreement of the parties.<sup>59</sup> The goal of property law is to keep transaction costs low.<sup>60</sup> If transaction costs are low, high-value resources will flow to high-value users.<sup>61</sup> Property law keeps transaction costs low by limiting the number of forms that property can take.<sup>62</sup> Information-cost theory therefore asserts that there is a reason to keep the number of property forms low. This is the *numerus clausus* principle—Latin for “the number [of forms] is closed.”<sup>63</sup> New forms of property can only be created by the slow grinding of the machinery of the common law (or legislatures) and not by private agreement.<sup>64</sup>

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<sup>58</sup> See generally Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000) [hereinafter Merrill & Smith, *Numerus Clausus*]; Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773 (2001).

<sup>59</sup> Merrill & Smith, *Numerus Clausus*, *supra* note 58, at 1.

<sup>60</sup> Driesen & Ghosh, *supra* note 2, at 68 (“The goal of reducing or eliminating transaction costs has strongly influenced both scholarship and public policy.”).

<sup>61</sup> See Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules—A Comment*, 11 J.L. & ECON. 67, 68 (1968) (“If people are rational, bargains are costless, and there are no legal impediments to bargains, transactions will *ex hypothesi* occur to the point where bargains can no longer improve the situation; to the point, in short, of optimal resource allocation.”).

<sup>62</sup> See Merrill & Smith, *Numerus Clausus*, *supra* note 58, at 8 (“The existence of unusual property rights increases the cost of processing information about all property rights. . . . Standardization of property rights reduces these . . . costs.”).

<sup>63</sup> *Id.* at 4.

<sup>64</sup> See *id.* at 69 (“By insisting that courts respect the status quo in terms of the menu of property rights, the *numerus clausus* also channels legal change in property rights to the legislature. This institutional-choice dimension, we have argued, reinforces the information-cost minimization features of the doctrine, because legislated changes communicate information about the legal dimensions of property more effectively than judicially mandated changes.”).

Consider the fee simple absolute, the leasehold estate, or the other limited forms property can take. These limitations on forms lower information costs by constraining choice. When there are only a few forms of property to choose from, it becomes cheaper to choose.<sup>65</sup>

This phenomenon is part of everyday life. For example, the process of ordering at a restaurant is greatly facilitated if there is only one entrée on the menu.<sup>66</sup> (Of course, there is a tradeoff: frustration costs rise if some customers do not want the chicken pot pie.) The standardization of the menu reduces information costs. After going to the restaurant once, one does not even need a menu to order.

Standardization in property forms reduces information costs not only for a given person entering into a transaction, but for all third parties considering such a transaction.<sup>67</sup> On the other hand, idiosyncratic arrangements in property would, if enforced by courts, raise information costs. Suppose that Party *A* wants to use Party *B*'s bicycle on Monday mornings. *A* and *B* decide to create a new property right—a “Monday-morning use right”—which *B* will sell to *A*.<sup>68</sup> This is an efficient deal for both *B* and *A*. *B* wants the money more than the bicycle on Monday mornings, and *A* wants a bicycle on Monday mornings without having to store it on her back porch.<sup>69</sup>

How could such a deal be inefficient? Consider the problem such an arrangement poses for third parties. If the law countenances Monday-morning use rights, then anyone who wants to buy the bicycle from *B* will have to inquire whether the bicycle is encumbered with such a right.<sup>70</sup> The problem gets even worse. Anyone else who wishes to buy a bicycle will suffer information costs, in the form of the question: “Is the bicycle that I want to buy

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<sup>65</sup> See *id.* at 33 (“When it comes to the basic legal dimensions of property, limiting the number of forms thus makes the determination of their nature less costly.”).

<sup>66</sup> *Id.*

<sup>67</sup> See *id.* (“Limiting the number of basic property forms allows a market participant or a potential violator to limit his or her inquiry to whether the interest does or does not have the features of the forms on the menu. Fancies not on the closed list need not be considered because they will not be enforced.”).

<sup>68</sup> See *id.* at 27 (“But suppose *A* wants to create a ‘time-share’ in the watch, which would allow *B* to use the watch on Mondays but only on Mondays (with *A* retaining for now the rights to the watch on all other days).”).

<sup>69</sup> See *id.* (“As a matter of contract law, *A* and *B* are perfectly free to enter into such an idiosyncratic agreement. But *A* and *B* are not permitted by the law of personal property to create a *property right* in the use of the watch on Mondays only and to transfer this property right from *A* to *B*.”).

<sup>70</sup> See *id.* (“But consider what will happen now when any of the *other* ninety-nine watch owners try to sell their watches. Given the awareness that someone has created a Monday-only right, anyone else buying a watch must now also investigate whether any particular watch does not include Monday rights.”).

burdened with an idiosyncratic Monday-morning use right?"<sup>71</sup> If courts allow any form of customized property (perhaps by adding Tuesday-evening use rights to the mix), the value of having standardized property forms rapidly decreases.<sup>72</sup>

The cost of the idiosyncratic deal is not borne by the original parties to the deal, both of whom know that the bike is subject to a Monday-morning use right. The cost is borne by every third party that enters the market for a bicycle. The increased information cost is a straightforward externality. But if property law limits property forms—to the fee simple, for example—then third-party prospective purchasers know what sticks in the bundle come along with a purchase without needing to conduct an expensive inquiry.<sup>73</sup>

Until now, contract law has been excluded from information-cost analysis. Contract law has traditionally been seen as the antithesis of property.<sup>74</sup> The flexibility of the contractual form often results in high information costs and low frustration costs.<sup>75</sup> The low frustration costs occur because customized contracts can be used to craft any deal that the parties desire.<sup>76</sup> The high information costs happen because a high level of customization does not permit parties to any given individualized contract to know anything about the terms of any other contract. Information-cost theorists have thus far defined contract law through individuated, customized, negotiated agreements, rather than standardized deals.<sup>77</sup> Consider employment contracts. My employer and I can negotiate for any salary we agree upon. Thus, our frustration costs are

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<sup>71</sup> See *id.* at 32 (“Those considering whether to purchase property rights in [given objects] will have more to investigate: They will have to assure themselves that they are getting all the days of the week that they want. Furthermore, they will have to worry about dimensions of division and elaboration that perhaps no one has yet thought of, making the acquisition of any [object] more uncertain as well as riskier.”).

<sup>72</sup> See *id.* at 26–27 (“The need for standardization in property law stems from an externality involving measurement costs: Parties who create new property rights will not take into account the full magnitude of the measurement costs they impose on strangers to the title.”).

<sup>73</sup> See *id.* Suppose that property forms were not standardized. Title searches would take more time and become more expensive because every prior idiosyncrasy must be excluded by the searching party.

<sup>74</sup> See *id.* at 3 (“[P]arties to a contract are free to be as whimsical or fanciful as they like . . . . [T]he law will enforce as property only those interests that conform to a limited number of standard forms.”).

<sup>75</sup> See *id.* at 55 (“[C]ontract rights themselves can be tailored just as a house can be custom-built, but the way of owning it is highly simplified to reduce information costs to third parties.”).

<sup>76</sup> See *id.*

<sup>77</sup> See *id.* at 3 (“A central difference between contract and property concerns the freedom to ‘customize’ legally enforceable interests. The law of contract recognizes no inherent limitations on the nature or the duration of the interests that can be the subject of a legally binding contract . . . . Generally speaking, the law will enforce as property only those interests that conform to a limited number of standard forms.”).

low. But I cannot determine the salaries of my colleagues based on my own salary term. Thus, my information costs are high.

By contrast, the hallmark of property systems is high standardization, resulting in low information costs and high frustration costs.<sup>78</sup> The cost of a highly standardized property system is that parties will not be able to achieve the deals they want, resulting in frustration.<sup>79</sup> For example, until state legislatures adopted the condominium form of property, courts refused to accept that innovation.<sup>80</sup> This frustrated buyers and sellers.

The rationale usually offered for strongly separating contract from property law is that property law binds the world.<sup>81</sup> Contract law does not, due to the constraints of privity.<sup>82</sup> Idiosyncratic forms of property raise information costs for transactions in property because property law binds third parties.<sup>83</sup> A putative Monday-morning use right complicates transactions for everyone because everyone is bound by property rules.<sup>84</sup> If a purchaser buys a bicycle that was previously encumbered by a Monday-morning right, she is bound by that right.

Property theorists note that property rights are in rem—actionable against the object owned—rather than in personam—against another person.<sup>85</sup> Because property rights are in rem, they bind successors in interest.<sup>86</sup> Customized property rights therefore create a potential minefield for subsequent purchasers.<sup>87</sup> Property theorists distinguish between contract and

<sup>78</sup> See *id.* at 38–42 (discussing the interaction between frustration costs and property rights).

<sup>79</sup> See *id.* (discussing the economically optimal standardization of property forms as a function of frustration costs and information costs).

<sup>80</sup> See *id.* at 15–16 (“In theory, it might be possible to create a condominium by clever combination of preexisting property forms. But in practice, condominiums did not emerge until the 1960s, when virtually all states adopted statutes expressly authorizing the creation of condominiums. Thus, the story of the emergence of the condominium is also broadly consistent with the *numerus clausus* in that this new form of property was the product of legislative change, rather than private contract or judicial innovation.”).

<sup>81</sup> See Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. 373, 374 (2002) (“Property rights differ from contract rights by being ‘good against all the world.’”).

<sup>82</sup> *Id.*

<sup>83</sup> See Merrill & Smith, *Numerus Clausus*, *supra* note 58, at 32 (“[B]ecause property rights are in rem, all those who might violate property rights, accidentally or not, must know what they are supposed to respect. An indefinite set of types of rights will raise the cost of preventing violations through investigation of rights.”).

<sup>84</sup> See *id.*

<sup>85</sup> See Hansmann & Kraakman, *supra* note 81, at 409 (“Under their view, the distinguishing feature of a property right is that it is an in rem right . . .”).

<sup>86</sup> See *id.* at 409–10.

<sup>87</sup> *Id.*

property on this ground.<sup>88</sup> Once a right has been separated out from the property bundle of sticks, how are subsequent parties to know?<sup>89</sup> The fact that property rights run against successors in interest divides property law from contract law in current theory.<sup>90</sup>

Unlike property rights, contracts are limited by privity.<sup>91</sup> Under the traditional approach, it would be fine for *A* and *B* to *contract* for *B* to use *A*'s bicycle on Monday mornings, because contract rights run only between *A* and *B*. The contract right will not be enforceable against any subsequent purchaser of the bicycle.<sup>92</sup> The bicycle will be free to pass unencumbered in the stream of commerce regardless of the contractual agreement between *A* and *B*.

But what if one wanted to draft contracts that lowered information costs at the expense of some frustration? This is not hard to imagine. Such contracts would be one-size-fits-all. They would constrain choice and would disfavor individualized negotiation in favor of a single contract form. Of course, such contracts exist as our everyday standardized mass-market contracts.

This Article departs from the literature by arguing that standardized contracts are like property in that the value of standardized contracts is that they lower information costs. Standardization creates benefits and customized contract terms create costs for third parties to contracts, regardless of privity. The idiosyncratic terms in one contract can raise information costs for all other contracting parties.

An example may help demonstrate how this happens. The standard term in a sales contract is that merchants do not disclaim damages for personal injury.<sup>93</sup> Now suppose two parties create an idiosyncratic waiver of personal

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<sup>88</sup> *Id.* at 378 (“[T]he attribute that distinguishes a property right from a contract right is that a property right is enforceable, not just against the original grantor of the right, but also against other persons to whom . . . rights in the asset . . . are . . . transferred.”).

<sup>89</sup> *Id.* at 398 (“Accommodating verification rules comes at a price. Permitting two or more strangers to establish and maintain, with ease, complicated and highly individualized relationships concerning use of a common asset is costly.”).

<sup>90</sup> *Id.* at 379.

<sup>91</sup> *Id.*

<sup>92</sup> See Merrill & Smith, *Numerus Clausus*, *supra* note 58, at 27 (“But suppose *A* wants to create a ‘time-share’ in the watch, which would allow *B* to use the watch on Mondays but only on Mondays (with *A* retaining for now the rights to the watch on all other days). As a matter of contract law, *A* and *B* are perfectly free to enter into such an idiosyncratic agreement.”).

<sup>93</sup> See U.C.C. § 2-719(3) (2002) (“Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable . . .”).

harm resulting from a negligently constructed microwave. Assume the courts enforce this waiver. If such an idiosyncratic waiver were permitted, all subsequent transacting parties who wanted the “standard” deal would suffer increased costs because they would have to ensure that the idiosyncratic term was not part of their proposed agreement. This effect jumps the privity barrier.<sup>94</sup> It does not depend on the original agreement binding anyone else. Rather, information costs for everyone who wants a microwave will rise if the idiosyncratic contract term appears in any agreement.

Property theory fails to convincingly exclude contract law from information-cost analysis. Standardized contracts reduce information costs just like standardized property forms do.<sup>95</sup> Likewise, idiosyncratic contracts raise information costs just like idiosyncratic property forms do.<sup>96</sup> This does not depend on whether the rights created by the contract “run with” the product or not.

Suppose that you purchase a bicycle. If you wanted a bicycle that was unencumbered by Monday-morning use rights, you would incur search costs to determine whether the bicycle you were about to purchase was subject to any such rights. But that problem can be caused by either an idiosyncratic property right or by an idiosyncratic contract right. The problem is that customized deals raise information costs for all parties who desire to rely on a standardized transaction. If all bicycle sales contracts have standardized terms, then you can buy a bicycle without studying the contract. But if courts begin to enforce idiosyncratic and customized terms, you must incur search costs to ensure that you get what you want.

Rather than exclude contract law from information-cost analysis, I propose that information costs lie at the center of the distinction between dickered and standardized contracts. The work of applying information-cost theory to contract has only barely begun. I am aware of only two articles that apply a “property model” of information costs to contract law.<sup>97</sup> In a prior article, I

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<sup>94</sup> It is worth noting that the “hard property” account relies on a strong view of privity of contract not supported in the contract literature of the latter half of the twentieth century. The property account only works if privity prevents the costs of idiosyncratic agreements from spilling over in contracts cases, while the in rem effect of property causes spillover in property cases. I do not think the strong version of privity assumed by the property theorists still exists. *See, e.g.,* *Ultramares Corp. v. Touche*, 174 N.E. 441, 445 (1931) (Cardozo, J.) (“[T]he assault upon the citadel of privity is proceeding in these days apace.”).

<sup>95</sup> *See infra* Part III.

<sup>96</sup> *See infra* Part III.

<sup>97</sup> *See* Joshua A.T. Fairfield, *The Search Interest in Contract*, 92 IOWA L. REV. 1237 (2007); Henry E. Smith, *Modularity in Contracts: Boilerplate and Information Flow*, 104 MICH. L. REV. 1175 (2006).

called for the use of a property model of contract to understand why consumers search for the deals they want, rather than negotiating for them.<sup>98</sup> In another article, Henry Smith provided a property-based account of standardized contract terms.<sup>99</sup> Smith viewed boilerplate as a middle ground between the “corner solutions” of property and contract—property being the bailiwick of strong standardization, and contract the bailiwick of strong customization.<sup>100</sup> Smith then discussed how contract boilerplate can use “modularity,” or the intentional limitation of interaction between different terms in a contract, to increase information flow and decrease transaction costs.<sup>101</sup> This is indeed an important insight: I have elsewhere written that modularity is an important method of lowering the costs of searching for the right contractual deal, as part of a process of search optimization.<sup>102</sup>

I share with Smith the intuition that property information-cost theory can be profitably extended to contract analysis. But there the two analyses diverge. This Article treats information costs as central to contract theory, rather than as a middle ground between property and contract. Unlike Smith, I do not place contract at one pole, and property at the other pole.<sup>103</sup> Rather, both contract and property law reduce information costs at the expense of some frustration when they are standardized; and benefit from flexibility at the expense of higher information costs when they are individualized.<sup>104</sup>

In sum, this Article fills several longstanding gaps in the literature. Both traditional and economic contract theory encourage courts to maximize consent through use of information-forcing rules. I challenge this presumption below by showing that consent is costly, and encourage courts to minimize the cost sum of contractual consent and consumer surprise.<sup>105</sup> Moreover, traditional contract literature has generally mulcted standardized contracts for raising information costs. I argue instead that standardization reduces information

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<sup>98</sup> Fairfield, *supra* note 97, at 1290.

<sup>99</sup> Smith, *supra* note 97, at 1179.

<sup>100</sup> *See id.* at 1176 (arguing that boilerplate language in contracts is in the middle of the spectrum running from contract rights to property rights).

<sup>101</sup> *See id.* at 1176–77 (explaining how boilerplate takes advantage of modularity and the resulting benefits).

<sup>102</sup> *See* Fairfield, *supra* note 97, at 1278–81 (describing search optimization and how it makes searching faster).

<sup>103</sup> *See* Smith, *supra* note 97, at 1222 (“And boilerplate is interesting and revealing because it is perched somewhere between the poles of contract and property.”).

<sup>104</sup> *See infra* Part III.

<sup>105</sup> *See infra* Part III.

costs.<sup>106</sup> Finally, where information-cost theorists have limited the application of information-cost theory to property law, I argue that information-cost theory is central to contract law, and indeed that standardized contracts cannot be understood without analyzing information costs.

## II. THE COST OF CONSENT

This Part discusses the economic effect of forcing consumers to buy too much information. Courts often view their role in contract cases as that of maximizing information exchange.<sup>107</sup> I suggest here that courts instead ought to minimize the cost sum of information and surprise. In tort law, economic theory has long advocated minimizing the sum of precautions and accidents.<sup>108</sup> I draw from tort theory to argue that courts should similarly minimize the cost sum of disclosures and surprise in contracts. First, I show the cost of disclosures. Second, I propose to reduce that cost by minimizing the cost sum of disclosures and surprise. The subsequent sections discuss how courts can achieve this minimization by encouraging standardization in mass-market contracts.

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<sup>106</sup> See *infra* Part III.

<sup>107</sup> See *Gatton v. T-Mobile USA, Inc.*, 61 Cal. Rptr. 3d 344, 363 (Cal. Ct. App. 2007) (“[T]he contract readily comported with the ‘unfair surprise element’ of procedural unconscionability, i.e., supposedly agreed-upon terms that are hidden in a prolix printed form and never brought to the attention of the weaker party.”); *Parish v. Jumpking, Inc.*, 719 N.W.2d 540, 545 (Iowa 2006) (“Under the Restatement, a product ‘is defective because of inadequate instructions or warnings when the foreseeable risks of harm posed by the product could have been reduced or avoided by the provision of reasonable instructions or warnings . . . .’” (citing RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2(c) (1998))); *C & J Fertilizer, Inc. v. Allied Mut. Ins. Co.*, 227 N.W.2d 169, 176 (Iowa 1975) (demonstrating that a term is likely unconscionable “if the adhering party never had an opportunity to read the term, or if it is illegible or otherwise hidden from view” (citing RESTATEMENT (SECOND) OF CONTRACTS § 237 cmt. f (Tentative Draft Nos. 1–7, 1973))); *Germantown Mfg. Co. v. Rawlinson*, 491 A.2d 138, 146 (Pa. Super. Ct. 1985) (“An unexpected clause often appears in the boilerplate of a printed form and, if read at all, is often not understood. By signing such a form, a party is bound only to those terms which such party would reasonably expect such a printed form to contain.”); *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145, 151 (Exch. Div.) (“Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.”); see also *Schmitz*, *supra* note 4, at 103 (“This article invites courts to resist these formalist trends and . . . require parties to disclose material facts during pre-contractual negotiations . . . . Similarly, risk disclosure may be proper in other one-sided relationships . . . .”).

<sup>108</sup> See *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947) (Hand, J.) (“[T]he owner’s duty, as in other similar situations, to provide against resulting injuries is a function of three variables: (1) The probability that she will break away; (2) the gravity of the resulting injury, if she does; (3) the burden of adequate precautions.”).

### A. *Limits and Definitions*

As I present this approach, I acknowledge its limits. Liberal contract theory may tell us that consent based on full disclosure is so important to us as human beings that we must have it, regardless of cost.<sup>109</sup> Nothing I say here contradicts that. Society may value contractual consent for other reasons—to bind citizens together as a community or strengthen individuals' sense of autonomy.<sup>110</sup> If the goal of our society is indeed to foster expressions of free will or the development of rich relationships through the legal system, then perhaps robust contractual consent is something for which we are willing to pay a lot.<sup>111</sup> Subsidizing consent is no odder than subsidizing farms. But we should do so with eyes open to the costs that such a choice incurs. A theory of the cost of consent is useful, even necessary, to those who believe consent is indispensable, because at the very least the cost of a thing is a good demonstration of its value.<sup>112</sup>

For purposes of this discussion, I take liberal contract theory at face value. I define consent as informed agreement.<sup>113</sup> Consent requires information, because a party cannot, under liberal theory, consent to a term of which she is unaware.<sup>114</sup> Thus, the cost of consent I speak of here is the cost of conveying enough information to a mass-market contracting party to ensure that she is aware of and understands the terms. This is how both liberal and economic theory encourage information exchange: if the information is communicated, the counterparty is bound.<sup>115</sup> Legal enforceability is the reward given for securing consent by communicating information.<sup>116</sup>

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<sup>109</sup> See Hall, *supra* note 6, at 572 (“The relativist version . . . is that the more patient understanding and participation the better, regardless of the costs to other values entailed in achieving greater autonomy. The absolutist position is even stronger: no valid consent is obtained unless understanding is perfect.”).

<sup>110</sup> See Barnett, *supra* note 11, at 297–300 (arguing that voluntary consent is the centerpiece of a workable theory of individual entitlements).

<sup>111</sup> See MACNEIL, *supra* note 11, at 4 (“By contract I mean no more and no less than the relations among parties to the process of projecting exchange into the future. . . . This, or rather the relations between people when this occurs, is what I mean by contract.”).

<sup>112</sup> See RICHARD A. POSNER, *THE NATURE OF ECONOMIC REASONING* (1998), *reprinted in* LAW AND ECONOMICS ANTHOLOGY 4 (Kenneth G. Dau-Schmidt & Thomas S. Ulen eds., 2002) (“Cost to the economist is ‘opportunity cost’—the benefit forgone by employing a resource in a way that denies its use to someone else.”).

<sup>113</sup> See Schuck, *supra* note 1, at 900 (“To say that one cannot be bound by a promise that one did not voluntarily and knowingly make is to say that the individual should be the author of her own undertakings . . .”).

<sup>114</sup> *Id.*

<sup>115</sup> See Ayres & Gertner, *supra* note 10, at 127 (“We have shown that when one party to a contract knows more than another, the knowledgeable party may strategically decide not to contract around even an inefficient

I do not suggest that contract law ought to dispose of consent entirely. But it is worth unpacking the two major roles that consent plays within contracting practice.<sup>117</sup> The first role is consent to be bound.<sup>118</sup> The second role of consent is informed consent to the terms of an agreement.<sup>119</sup> I do not propose to eliminate the former. Consent to be bound by an agreement must still be surrounded by all the pomp and circumstance of contract law to inform parties that they are about to enter into binding legal relations.<sup>120</sup> Without a robust concept of consent to be bound, courts would not know to whom they should apply a given contract.<sup>121</sup> But that is quite different from the rules regarding knowledge of the terms of an agreement. The jurisprudence of information forcing and unconscionability has created an impenetrable thicket of law in which courts routinely tell corporations what terms ought to be included, in what type-set, and in what order.<sup>122</sup> Still, even when corporations do what they are told, the courts are often still unsatisfied, and again inform the corporation

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default. Because the process of contracting around a default can reveal information, the knowledgeable party may purposefully withhold information to get a larger piece of the smaller contractual pie. This possibility of strategic incompleteness leads us to embrace more diverse forms of default rules.”).

<sup>116</sup> *Id.*

<sup>117</sup> See Stephen E. Friedman, *Improving the Rolling Contract*, 56 AM. U. L. REV. 1, 2 (2006) (“The proposal, which I refer to as ‘Template Notice,’ is an intermediate form of disclosure that meets the pressing concerns of both buyers and sellers. It would not require sellers to provide the full text of all contract terms before or during purchase or order. It would, however, require sellers to do more than merely give notice that unspecified additional terms will be forthcoming.”).

<sup>118</sup> See *id.* at 3 (describing how an overall template would allow the transaction to proceed without cutting off further discussion of all the terms).

<sup>119</sup> See *id.* (suggesting that deferring the terms will make “assent . . . more meaningful”).

<sup>120</sup> See Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 800–02 (1941) (describing “cautionary” and “channeling” functions of legal formalities, which serve to inform parties that they are about to undertake binding legal relations).

<sup>121</sup> See Barnett, *supra* note 11, at 302 (“In contract law, this informational or ‘boundary defining’ requirement means that an assent to alienate rights must be *manifested* in some manner by one party to the other to serve as a criterion of enforcement. . . . Without such communication, parties to a transaction (and third parties) cannot accurately ascertain what constitutes rightful conduct and what constitutes a commitment on which they can rely.”).

<sup>122</sup> See Fairfield, *supra* note 97, at 1273 (“Courts often hold standardized contracts to a different standard because they deem that consumers have not consented to the deal.”); see also *Decker v. Nationwide Ins. Co.*, 1 Pa. D. & C.5th 147, 153 (Pa. Ct. Com. Pl. 2007) (involving an insurance coverage document with “headings in larger, bold-face type, with a bulleted, single-spaced list”); *Raper v. Oliver House, LLC*, 637 S.E.2d 551, 552 (N.C. Ct. App. 2006) (“[A]greement to arbitrate is prominently located on the last page of the contract in bold face type, directly above plaintiff’s signature.”); *Gillman v. Chase Manhattan Bank*, 534 N.E.2d 824, 829 (N.Y. 1988) (“[T]he location and the size of print may, in a proper case, be factors bearing on procedural unconscionability . . .”).

that a different term must be bolded in a different place.<sup>123</sup> These attempts to get information to consumers who reasonably do not want it are misplaced.

I define “contractual surprise” as the chance that a customer will be surprised by a strange contract term, or, conversely, unsurprised by a standard term.<sup>124</sup> Either the consumer is ignorant of something she should know, or is told something she already knows. If a buyer does not read the contract, there is a chance that the contract may contain a surprising non-standard term. Of course, if she does read the contract, she runs the risk of having wasted her time if the deal is the standard one.

One example of contractual surprise might be a prospective buyer of an airplane who is surprised to learn that features of the aircraft described in a product brochure are disclaimed in the contract for sale.<sup>125</sup> Or, software purchasers are often surprised at the disclaimer of functionality in the software license contract.<sup>126</sup> In high-value transactions, preventing contractual surprise may be worth the cost.<sup>127</sup> But if the term is standardized, and the customer already knows it, the benefit of forcing the exchange of the information is nil.

### *B. Transaction Costs and Consent*

In determining the optimal standardization of contracts, I treat informed consent as a transaction cost. Here, I ask whether the cost of obtaining a party’s consent to terms in a mass-market transaction is worth the trouble.

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<sup>123</sup> *Compare* Net Global Mktg., Inc. v. Dialtone, Inc., 217 F. App’x 598, 600–02 (9th Cir. 2007) (finding agreement unconscionable when the document was twelve pages long and contract term was not given its own clear heading), *with* Boghos v. Certain Underwriters at Lloyd’s of London, 115 P.3d 68, 74 (Cal. 2005) (finding arbitration clause enforceable when provision was the only text bolded).

<sup>124</sup> *See, e.g.,* A & M Produce Co. v. FMC Corp., 186 Cal. Rptr. 114, 122 (Cal. Ct. App. 1982) (“‘Surprise’ involves the extent to which the supposedly agreed-upon terms of the bargain are hidden in a prolix printed form drafted by the party seeking to enforce the disputed terms.”).

<sup>125</sup> *See* Betaco, Inc. v. Cessna Aircraft Co., 103 F.3d 1281, 1282–83 (7th Cir. 1996) (holding that the purchase agreement was fully integrated, and therefore, a contractual disclaimer effectively negated warranty statements made in aircraft product brochure).

<sup>126</sup> *See, e.g.,* M. Block & Sons, Inc. v. Int’l Bus. Machs. Corp., No. 04-C-340, 2004 WL 1557631, at \*8–\*9 (N.D. Ill. July 8, 2004) (holding that the disclaimer was conspicuous, and therefore, enforceable).

<sup>127</sup> *See* Fairfield, *supra* note 97, at 1260 (“Parties tend to negotiate capital purchases such as equipment or real estate development: no amount of search can create the precise deal that the buyer desires, so some degree of customization must occur.”).

In the familiar tort formulation, courts and theorists minimize the cost sum of precautions and accidents.<sup>128</sup> Precautions are good things. But the strength of economic analysis lies in telling us when there has been too much of a good thing. In torts, for example, economic analysis can tell us that a given precaution could both save lives and be too expensive.<sup>129</sup>

By analogy, courts should minimize costs when the sum of costs is the cost of informed consent to a given contractual term plus the cost created by surprise (for example, an accident caused by not reading some disclosure about a product). First, the burden of an additional contractual disclosure is the sum of reading and writing costs. It costs sellers to draft, print, and draw attention to terms, and it costs consumers to read those additional terms. When the cost of getting informed consent is greater than the benefit of preventing surprise, then courts ought not to use information-forcing rules to force informed consent.

In a nod to the famous tort formulation, courts should not use coercive information-forcing rules when the burden (*B*) of the additional disclosure outweighs the chance of the information being relevant (*P*) times the damage caused by letting the consumer live in ignorance (*L*), or when  $B > PL$ . In other words, when a contractual disclosure is more expensive in terms of time or money than letting a consumer be surprised by the content of the contract, courts should let the consumer be surprised. Further, note that *PL* is likely to be quite low if the term is standardized, because the consumer is likely aware of the term and thus is not surprised in any event.

An example may be helpful. Suppose a customer, with one dollar in her pocket, wishes to buy a cup of hot coffee from a fast-food chain. The cost of the coffee is fifty cents. However, suppose courts require the corporation to convey information to the consumer (on pain of liability) in the form of a

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<sup>128</sup> See *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947) (Hand, J.) (“Possibly it serves to bring this notion into relief to state it in algebraic terms: if the probability be called *P*; the injury, *L*; and the burden, *B*; liability depends upon whether *B* is less than *L* multiplied by *P*: i.e., whether  $B < PL$ .”).

<sup>129</sup> There is an argument that lives are infinitely valuable, and thus cost-benefit analyses are useless when lives are at stake. When risks are aggregated across millions of people, precautions appear to directly save a certain number of lives. And if lives are infinitely valuable, then any precaution must be efficient. But this does not appear to be so. A better way of discussing the question is to note that people take non-zero risks with their lives all the time, and express measurable willingness to pay to avoid some risks, while they appear willing to bear other risks. If lives were truly infinitely valuable, I would never drive a car again. If lives were not very valuable, I would drive a car with little protection. Because I drive a car with a high crash-test rating, the truth seems to be somewhere in between. I am willing to pay for enough precautions to avoid some risks, but not to eliminate all risk.

contractual disclosure written on the cup indicating that the coffee is “VERY HOT!!!” The disclosure incurs printing costs of an additional five cents per cup, which are borne by the consumer. This is not improbable, because an information-forcing requirement is likely to result in all coffee-sellers raising their costs, thus leaving little room for a customer to avoid the additional cost by going to a competitor.

There are three efficiency effects in this instance: first, the customer may not be able to purchase the fifty-cent danish that she prefers with her coffee because she has now spent too much on coffee. (This is illustrated in Figure 1 in the next section.) Second, she may decide not to buy the coffee because she is one of the few people for whom the fifty-cent coffee was the absolute maximum she would pay. (This is shown in Figure 2 in the next section.) And finally, there is a serious chance that she knew already that the coffee was likely to come piping hot, and thus *any* cost incurred in informing her of this fact is an absolute waste.

The next sections illustrate this approach, using an indifference curve and a supply–demand curve. The cost of informed consent in mass-market contracting not only affects individual decisions, but can be aggregated across all transactions in a given market. Thus, the following section seeks to demonstrate the cost of consent both to individual consumers and to total social welfare.

### C. *Illustrating the Cost of Consent*

There are two ways to show the costs of information-forcing rules to consumers. The first involves an indifference curve.<sup>130</sup> In this figure, we have a budget constraint, line A, representing the money that a consumer has to split between good G (on the X axis) and all other goods (on the Y axis). We also have an indifference curve, curve C, that represents the utility of different mixes of goods that the consumer might choose to buy.<sup>131</sup> The line is curved because people prefer a mix of goods. Most people prefer a glass of milk and a cookie to two glasses of milk or two cookies.<sup>132</sup> And it would take a lot of milk to make up for having no cookies at all.

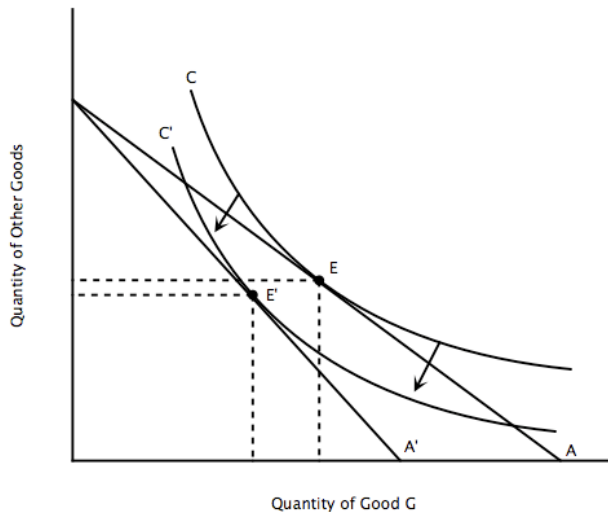
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<sup>130</sup> See *infra* fig.1.

<sup>131</sup> See WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS: PRINCIPLES AND POLICY* 97 (10th ed. 2006) (“Any two points on the same indifference curve . . . represent two combinations of the goods that the consumer likes equally well.”).

<sup>132</sup> See Adrian Vermeule, *The Cycles of Statutory Interpretation*, 68 U. CHI. L. REV. 149, 181 (2001) (“Most people prefer to have three cookies and one glass of milk than to have four cookies.”).

FIGURE 1



The consumer's preferred allocation is represented by point E, where the indifference curve is tangent to the budget constraint. All points on C have the same utility to the consumer, and all points to the left of C have less utility, so E is where the consumer's budget can buy her the most utility.

Suppose that a court employs an information-forcing rule to require a manufacturer to sell (and the consumer to buy) the communication of more information about good G than the consumer would desire. By forcing the consumer to spend more money on information about good G, a court will reduce the amount of good G that a customer can buy with her budget. This moves the budget constraint to line A': the new mixes of goods that the customer can afford. The indifference curve C' that is tangent to A' indicates E', the point of greatest utility on A'. E' is the point at which the consumer can afford the mix of good G (with court-required information) and other goods that maximize her utility. Although a consumer is indifferent to the mix of goods on any given curve, she is not indifferent between curves. The shift from budget constraint A to A' puts her in an inferior position, point E', which she is forced to adopt by a court's information-forcing rule.

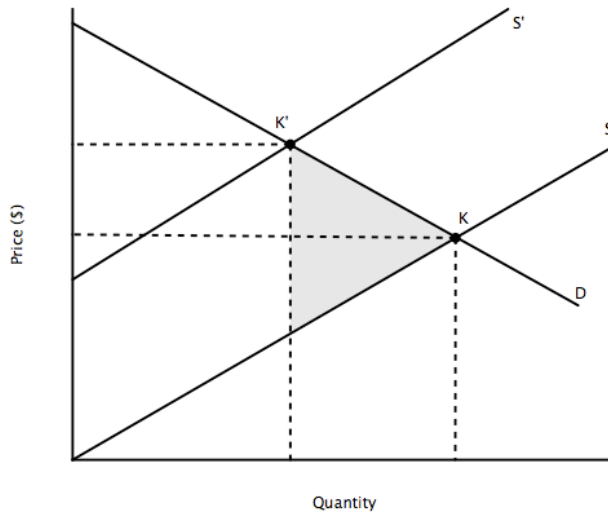
By forcing a consumer to buy more information associated with good G, courts would cause a consumer to substitute other goods for good G and would leave less wealth for her to buy other goods that she may want, decreasing her overall spending power. The first effect is called the substitution effect, which represents the fact that the consumer would have to increase her consumption of other goods and reduce her purchases of good G from Q1 to Q2 in order to remain indifferent to the change in price of good G. Of course, the consumer does not have enough money to do this (that is, the consumer's budget is A' rather than A\*, which is the budget she would need to reach E\*, the tangent point between her new budget slope and her old indifference curve), and so there is a second effect, called the income effect. The income effect demonstrates that as a result of the price increase of G, the consumer has less wealth to buy all goods, G included. The resulting decrease in good G purchases is shown by the distance from Q2 to Q3. The substitution effect and the income effect together reflect the amount by which the consumer will decrease her purchases of good G. And the shift from C to C' shows that the consumer is worse off across the board: any point on C' is worse than any point on C.

It is also possible to show the economic impact of information-forcing rules using a straightforward demand curve.<sup>133</sup> Here, the price of good G is on the Y axis, and the quantity of good G produced is on the X axis. Supply is mapped by an upward-sloping line, here line S, representing the cost to the supplier of producing the marginal good.

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<sup>133</sup> See *infra* fig.2.

FIGURE 2



The higher the price for a commodity, the greater the supply—thus the positive slope to the line. Demand is mapped as a downward-sloping line, here line D, representing the utility of consumers who purchase the goods. As long as consumer utility is higher than seller's cost of production, the seller will make the good and the buyer will buy it. The slope of the demand curve is negative because as price increases, the quantity demanded decreases. Correspondingly, as price decreases, the quantity demanded increases. The intersection of the supply and demand curves, point K, represents the price that will encourage the optimal production of goods in society.

Meddling with this balance can throw things off. Suppose that a court adopts an information-forcing rule that requires a supplier to sell, and consumers to buy, more information about the product or service in order to generate "informed consent," on pain of unenforceability. This raises the costs of the supplier, by tacking the cost of the information onto the price of good G. The supply curve shifts to the left, indicating the increase in the cost of production at all points. The new line, S', intersects with D at point K'.

Some people may be willing to pay the greater price, even though it leaves less room in their budgets for other goods they may have wanted to buy.<sup>134</sup> But some percentage of the population would not be willing to bear the extra cost. They will take that money and purchase other goods, which yield less utility to them than good G would have. Those lost trades of good G are deadweight loss, and are indicated by the shaded triangle.

As shown by these admittedly simple graphs, information-forcing rules run the risk of requiring consumers to purchase more information than they desire. Courts often do this when they require additional disclosures in contracts, or hold a contract unenforceable for failure to adequately disclose terms. This causes consumers to suboptimally allocate their own resources, and it causes some proportion of gainful trades to fall through. The reader might protest that these increases in cost are not very much, because the cost of including an additional contract term is not very great. Yet in mass-market contracts, the surplus to be divided between buyer and seller may be very small. The additional cost may therefore matter in enough cases to decrease overall social welfare significantly.<sup>135</sup>

### III. THE BENEFITS OF STANDARDIZATION

The prior Part demonstrated that where the cost of mandatory information transfer outweighs its benefit, parties rationally do not—and should not—read contracts in order to consent to terms. But some information-forcing rules are permissive, not mandatory.<sup>136</sup> Such rules encourage parties to reveal idiosyncratic information about themselves when it is efficient for the contracting parties to do so.<sup>137</sup> This Part argues that even permissive information-forcing rules may be inefficient overall, where the information costs that customized deals impose on third parties outweigh the benefits of the

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<sup>134</sup> See *supra* fig.1.

<sup>135</sup> For an examination of the cost of useless labels in commercial products, see *Parish v. Jumpking, Inc.*, 719 N.W.2d 540, 545–46 (Iowa 2006) (describing a myriad of separate warning labels on a trampoline).

<sup>136</sup> See Ayres & Gertner, *supra* note 10, at 103 (“The uninformed party, the carrier, may attempt to learn the expected damages of the informed parties, the millers, by offering a menu of insurance contracts. The millers might then be induced to self-select the insurance contract that is optimal for their expected damages.” (discussing *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145, 151 (Exch. Div.))).

<sup>137</sup> See *Hadley*, 156 Eng. Rep. at 151 (“Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.”).

contracting parties. I further argue that consumers, who search for deals, prefer standardized deals because standardization reduces consumer information costs.<sup>138</sup>

I then apply these insights to several problems in contract law. Courts often speak as though their role is to enable a broad range of contractual choice and encourage informed consent by eliminating standard contracts.<sup>139</sup> I demonstrate that courts instead often act *sub silentio* to reduce options, limit individualized negotiation, and thus reduce information costs. I further demonstrate that courts use supposedly anti-standardization doctrines like unconscionability and adhesion instead to standardize agreements within a given industry. Courts standardize contracts by eliminating contractual outliers: those contracts which deviate sufficiently from the norm such that they raise information costs for all parties.

### A. *Contract Information Externalities*

This section analyzes the effect of information-forcing regimes on third parties. The first subsection explains how customization increases information costs to third parties. The second subsection demonstrates how standardization can lower information costs to third parties.

#### 1. *Customization Increases Information Costs to Third Parties*

The benefits of standardization (and the concurrent costs of idiosyncratic agreements reached by informed, negotiated consent) affect not only the parties who negotiate the agreement, but every other party who wishes to enter into a transaction of similar kind.<sup>140</sup> Recall the example of the exploding microwave.<sup>141</sup> If the consumer does not desire to purchase insurance against a microwave explosion, then it is efficient, as between consumer and seller, for

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<sup>138</sup> See Fairfield, *supra* note 97, at 1256 (“The franchise system creates information economies for potential diners, not just production benefits for the franchisee. The same economies exist in contract: Parties often prefer the standard deal to an idiosyncratic one.”).

<sup>139</sup> See *Ticknor v. Choice Hotels Int’l, Inc.*, 265 F.3d 931, 939–45 (9th Cir. 2001) (finding standardized arbitration provision unenforceable because it lacked mutuality, and contained terms favoring franchisor over franchisee); *Comb v. Paypal, Inc.*, 218 F. Supp. 2d 1165, 1172–77 (N.D. Cal. 2002) (finding standardized contract compelling arbitration unenforceable as unconscionable because of specific content of terms governing mutuality, venue, costs of arbitration, etc.).

<sup>140</sup> For the value of these standard practices to industries, see Avery Katz, *Taking Private Ordering Seriously*, 144 U. PA. L. REV. 1745, 1746 (1996) (evaluating whether rules established by industries are efficient, and arguing that private ordering means more than mere absence of state regulation).

<sup>141</sup> See *supra* text accompanying note 93.

the parties to disclaim liability for personal injury in the event of negligent manufacture. But the cost of the idiosyncratic damages waiver falls on third parties, who now must inspect their contracts for the customized term.

The lens of information costs can help explain why courts interpret terms consistently with standard trade or industry understandings of terms, while often rejecting the idiosyncratic interpretations advanced by the parties before the court. Case illustrations may help cement the point. *L & A Contracting Co. v. Southern Concrete Services, Inc.* considered the impact that an idiosyncratic definition of “default” would have on the broader industry of surety providers.<sup>142</sup> The court determined that the definition of “default” proffered by L & A was impractical because it departed from the industry meaning of the term.<sup>143</sup> The court noted: “A definition of a contract term that leads to impractical or commercially absurd results is unreasonable. . . . Sureties deprived of a clear rule for notices of default would be reluctant to enter into otherwise profitable contracts.”<sup>144</sup> The terms of the individual contract before the court mattered less than the impact of the term across the construction and surety industries.

Given that parties are usually free to define their own contract terms, the result in *L & A Contracting Co.* is startling. Under traditional contract theory, that case is either an outlier or wrongly decided.<sup>145</sup> But the lens of information-cost theory permits us to see why the court rejected the contractual definition of default in favor of the industry definition. The cost to other members of the industry of no longer knowing what “default” meant would have been greater than the benefit of the customized default term to the parties in the case. The court prevented the costs to the industry of the private agreement by rejecting the idiosyncratic contract term.

Courts do not always reject idiosyncratic definitions. Often they will instead use interpretive rules that exert a gravitational pull on contract terms. Thus, a “definition . . . must be determined in light of reasonable industry custom and usage . . . even though words in their ordinary or legal meaning are unambiguous.”<sup>146</sup> Judge Learned Hand’s formulation is similarly striking: “I

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<sup>142</sup> 17 F.3d 106, 110–11 (5th Cir. 1994).

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> See *Caulkins Indiantown Citrus Co. v. Nevins Fruit Co.*, 831 So.2d 727, 735 (Fla. Dist. Ct. App. 2002) (“[W]here a contract is clear and unambiguous, the express contract terms may not be varied by resort to extrinsic evidence, including that related to the UCC obligation of good faith or custom and usage.”).

<sup>146</sup> *Stender v. Twin City Foods, Inc.*, 510 P.2d 221, 225 (Wash. 1973).

cannot see why judges should not hold men to understandings which are the tacit presupposition on which they deal.”<sup>147</sup> These cases are traditionally understood as purely interpretive. Under the conventional view, industry custom is supposed to supplement, not supplant, contractual terms.<sup>148</sup> But courts do more than merely resolve ambiguity by reference to custom and practice. They actively interpret terms in ways that remove idiosyncrasies that might raise contracting costs across the industry.<sup>149</sup> This gravitational pull exerts a constant pressure on contract terms to conform to the standard understanding, and reduces the industry-wide impact of customized deals.

Consider the case of *Arc & Gas Welder Associates, Inc. v. Green Fuel Economizer Co.*<sup>150</sup> The subcontractor, Green, hired Arc to provide steel plates, polished to a “No. 4 finish.”<sup>151</sup> The general contract called for a polish with no pits, cracks, or crevices.<sup>152</sup> Green maintained that the “No. 4 finish” contemplated in its contract with Arc required such smoothness as well.<sup>153</sup> The court rejected that argument, finding that standard industry practice for polishing “means a smoothness which does not exceed 42 micro-inches, resulting in a surface without pits,” ignoring the cracks and crevices requirement from the contract.<sup>154</sup> In justifying its argument, the court noted that “the parties used terms which had a definite meaning in the industry and may not now be heard to say that they did not use the terms as the industry understood them.”<sup>155</sup> Industry players are not allowed to offer their own idiosyncratic definition of terms the industry relied upon for clarity. Instead, the court pulls such outliers toward the industry standard, because such idiosyncratic interpretations would increase costs for all other industry contracts.

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<sup>147</sup> *Kunglig Jarnvagsstyrelsen v. Dexter & Carpenter, Inc.*, 299 F. 991, 994 (S.D.N.Y. 1924) (Hand, J.).

<sup>148</sup> *See Caulkins*, 831 So.2d at 733 (“Generally, where the language of a contract is ambiguous, parol evidence is admissible to explain or clarify the intention of the parties.”).

<sup>149</sup> *See L & A Contracting Co.*, 17 F.3d at 111 (“Sureties deprived of a clear rule for notices of default would be reluctant to enter into otherwise profitable contracts.”).

<sup>150</sup> 285 F.2d 863 (4th Cir. 1960).

<sup>151</sup> *Id.* at 864.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.* at 866.

<sup>154</sup> *Id.* at 867.

<sup>155</sup> *Id.* at 868.

## 2. *Standardization Lowers Information Costs for Third Parties*

The traditional view is that standardized agreements hide terms and raise information costs.<sup>156</sup> But viewed through the lens of information-cost theory, it is clear that standardized agreements reduce information costs for parties who are searching for the set of contract terms that they desire. Suppose peanut butter manufacturers made only one type of peanut butter. If a customer desires to purchase peanut butter, the process is quick and easy: there is only one kind to buy. The customer will admittedly suffer frustration costs if she prefers extra chunky peanut butter. But her frustration costs may be less than the benefit of having a streamlined purchasing process. Suppose instead that the purchasing consumer now faces a store shelf stocked with peanut butter that is chunky, extra chunky, reduced fat creamy, reduced fat super chunky, natural creamy, crunchy, cinnamon-raisin, white chocolate, smooth, creamy, honey-roasted, organic, unsalted, soy, mixed with jelly, “The Heat is On” spiced, or in a squeeze bottle. Frustration costs will be low because the consumer can purchase precisely what she wants. But this comes at a cost; verifying the correct type of peanut butter takes extra time in the aisle. The consumer cannot grab and go.

The peanut butter example relies on the features of a product to make a point about standardization. It is only one step from peanut butter to contract terms. Imagine a consumer who, instead of choosing a standard warranty, must choose from many different individuated options. The cost of informed choice rises for each additional permutation presented.

### *B. Direct Benefits of Standardization to Consumers*

This explains why consumers desire standard deals. Consumers search for deals that contain the mix of contract terms and product features that they desire.<sup>157</sup> They spend more time as third parties searching for a contract than they do negotiating terms within a contract.<sup>158</sup> That is: if Party *A* (a consumer) enters into an idiosyncratic contract with Party *B* (a supplier), Party *C* (another

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<sup>156</sup> See *A & M Produce Co. v. FMC Corp.*, 186 Cal. Rptr. 114, 122 (Cal. Ct. App. 1982) (“‘Surprise’ involves the extent to which the supposedly agreed-upon terms of the bargain are hidden in a prolix printed form drafted by the party seeking to enforce the disputed terms.”).

<sup>157</sup> See *Fairfield*, *supra* note 97, at 1240 (“[I]nquiring buyers might go to a website to compare prices, guarantees, and warranty terms already on offer.”).

<sup>158</sup> See *id.* (“The primary cost of contracting is not in negotiating the fine details of the contract with the store; the cost of contracting is finding a store that sells the desired product coupled with the desired contract.”).

consumer) suffers higher information costs. Consumers therefore rationally respond to information costs. They care more about information externalities that raise the costs of searching than they do about dickering terms within an agreement. Traditional theory analyzes consumers as though they had already entered a contract.<sup>159</sup> But consumers do most of their work in the pre-contractual moment; they search for deals they desire rather than negotiate for them.<sup>160</sup> Consumers prefer standardized deals because they reduce the costs of search in the pre-contractual moment.

The traditional explanation for why consumers prefer standardized contracts, that drafting cost-savings result in lower prices, seems incomplete. It is unclear that companies will pass the savings along rather than pocketing the profits. Imagine a competitive market at equilibrium: the point at which no company can unilaterally depart downward in price and make money.<sup>161</sup> Now suppose Company A develops a new standardized contract. Company A could try to steal customers from competitors by using the saved drafting costs to depart downward in price. But standardized contract language gives no competitive advantage because it is not proprietary.<sup>162</sup> Other companies would copy the standardized language, and could depart downward as well. In fact, other companies would save even more, because they did not incur the original drafting costs or the costs of fireproofing the boilerplate in litigation.<sup>163</sup> The result would be reduced profits for all sellers. Thus, it is more likely that corporations will therefore simply pocket drafting cost savings.

The drafter-centered view of standardization ignores a significant portion of the benefits that standardization creates within modern commercial

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<sup>159</sup> See *Isler v. Tex. Oil & Gas Corp.*, 749 F.2d 22, 23 (10th Cir. 1984) (“The very notion of contract is the consensual formation of relationships with bargained-for duties.”).

<sup>160</sup> See *Fairfield*, *supra* note 97, at 1240 (“[P]rospective purchasers search for counterparties that offer the set of contract terms they desire.”).

<sup>161</sup> See DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 21 (1994) (“[N]o player could do better by choosing a different strategy given the strategy the other chooses. The strategy of each player must be a best response to the strategies of the other.”).

<sup>162</sup> Although he did so in his proposal for pre-approved contract terms, Clayton Gillette summarized the problem with non-proprietary contract terms:

Because approved contracts of necessity become publicly available after administrative endorsement . . . and can be mimicked by competing sellers who did not contribute to the process of obtaining approval, sellers may refrain from submitting proposals in order to free ride off the efforts of competitors without incurring any of the commensurate costs or downside risks.

Clayton P. Gillette, *Pre-Approved Contracts for Internet Commerce*, 42 HOUS. L. REV. 975, 989 (2005).

<sup>163</sup> *Id.*

markets.<sup>164</sup> While producers may benefit from standardization by reducing production costs and benefiting from economies of scale, products benefit from economies of demand as well. Most basically, the more people use the standard, the more the standard becomes useful.<sup>165</sup>

Imagine a manufacturer of electric cords. It is true that standardization does lower the manufacturing costs to the factory owner. Using the same base template over and over again is the foundation of the Industrial Revolution. But there is another reason that the manufacturer of electrical cords finds such a ready market for identical cords. Consumers benefit from standardization that goes beyond the cost-savings analysis realized by the manufacturer through economies of scale and repetition. Standardization benefits consumers because consumers do not need to inquire upon purchasing an item with an electric cord whether that cord will fit the sockets in the consumer's wall. The customer may purchase a cord more swiftly and with less inquiry, and be more certain of a positive result. These reduced information costs benefit the consumer directly because the consumer spends less time shopping for the "right" electrical cord. This is a direct savings to the consumer.

The same concept applies to contracts. Consumers save time (and thus money) when they accept "the standard deal," rather than learn the particulars of a specifically negotiated contract.<sup>166</sup> This Article argues that contracts benefit from economies of demand in the same manner that products benefit from economies of demand. The terms of a contract become more valuable—and desirable—the more people know, understand, and use them because the more people use standard terms, the less expensive contracting becomes for

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<sup>164</sup> See Fairfield, *supra* note 97, at 1256 ("For example, travelers on the interstate highway system may well choose to go to a franchise restaurant not only because the restaurants routinely benefit from economies of scale that allow them to pass along lower costs to the consumer but also because the travelers know what to expect.").

<sup>165</sup> See Merrill & Smith, *Numerus Clausus*, *supra* note 58, at 33 n.127 (stating that standardization in manufacturing has the twin benefits of facilitating economies of scale and of reducing transaction costs by, *inter alia*, reducing the need for monitoring (citing Charles P. Kindleberger, *Standards as Public, Collective and Private Goods*, 36 *KYKLOS* 377, 378, 384 (1983))); William M. Sage, *Regulating Through Information: Disclosure Laws and American Health Care*, 99 *COLUM. L. REV.* 1701, 1741–42 (1999) (stating that standardization carries with it many benefits, including the reduction of "data collection and processing costs").

<sup>166</sup> See Fairfield, *supra* note 97, at 1274 ("Yet at least *some* theory of contract ought to be incensed when consumers are required to read contracts. The cost of doing so is considerable, especially as a proportion of the expected gain to be realized out of the trade. Let us say a consumer values his time at ten dollars per hour. If a contractual relationship takes an hour to fully comprehend, a consumer faced with even a pro-standardization regime will prefer not to undertake the trade if he is required to read the contract.").

everyone.<sup>167</sup> The converse is also true—the more customization that parties use in their contracts, the more expensive contracting becomes for everyone else.

### C. Courts and Standardization

Given the above analysis, contract law ought to minimize information costs to third parties. Courts can reduce information costs to consumers by enforcing standardized agreements.<sup>168</sup> To do so, however, courts must evolve beyond traditional contract theory. Current theory holds that a court's function is to enable choice and facilitate individualized information transfer.<sup>169</sup> This section argues that courts can and should abandon the rhetoric of negotiated agreement and instead constrain individualized negotiations to preserve a uniform standard and reduce information costs. Legal theory also seems to mulct standardized contracts for lack of consent under the doctrines of adhesion and unconscionability.<sup>170</sup> This section demonstrates that courts do not use anti-standardization doctrines to limit standardized contracts. Instead, courts (not without irony) often use anti-standardization doctrines to eliminate contractual outliers and promote standardization.<sup>171</sup>

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<sup>167</sup> See *infra* Part IV.A; see also Fairfield, *supra* note 97, at 1255 (“As before, if the meeting of the minds between two parties as to idiosyncratic contract terms (or idiosyncratic interpretations of a previously settled and standardized term) is given effect, the broader contracting community suffers higher search costs.”).

<sup>168</sup> See *C & J Fertilizer, Inc. v. Allied Mut. Ins. Co.*, 227 N.W.2d 169, 177 (Iowa 1975) (“[T]he burglary ‘definition’ which crept into this policy comports neither with the concept a layman might have of that crime, nor with a legal interpretation.”).

<sup>169</sup> See *supra* note 139 (discussing the prevailing theory that customers prefer standardization because it reduces consumer information costs).

<sup>170</sup> See Randy E. Barnett, *Consenting to Form Contracts*, 71 *FORDHAM L. REV.* 627, 627 (2002) (“Yet contract theorists are nothing if not suspicious of such contracts, having long ago dubbed them pejoratively ‘contracts of adhesion.’ Indeed, I would wager that a plurality of contracts teachers would favor a judicial refusal to enforce form contracts altogether . . .”).

<sup>171</sup> See, e.g., *Sw. Pet Prods., Inc. v. Koch Indus., Inc.*, 107 F. Supp. 2d 1108, 1113–14 (D. Ariz. 2000) (holding that “substantive unconscionability focuses on the *terms* of the contract . . . [and] it appears that the terms were standard in the industry”); *Bennett v. Behring Corp.*, 466 F. Supp. 689, 697 (S.D. Fla. 1979) (explaining that “the Court must compare *the price actually being paid by the complaining party, to the price being paid by other similarly situated consumers in a similar transaction*”); *Reznor v. J. Artist Mgmt., Inc.*, 365 F. Supp. 2d 565, 577 (S.D.N.Y. 2005) (relying on the fact that “no . . . evidence that the objected-to provisions in the . . . agreement were unusual for the industry”); *Cal. Grocers Ass’n v. Bank of Am.*, 27 Cal. Rptr. 2d 396, 402 (Cal. Ct. App. 1994) (“Bank of America’s \$3 DIR fee is actually at the *low end* of prices charged . . . by other financial institutions, many of which charge between \$4 and \$10.”); *Carboni v. Arrospide*, 2 Cal. Rptr. 845, 849 (Cal. Ct. App. 1991) (“We have little trouble concluding that an interest rate of 200 percent . . . is substantively unconscionable . . . . [T]he interest rate . . . was approximately ten times the rate then prevailing in the credit market for similar loans.”); *Fotomat Corp. of Fla. v. Chanda*, 464 So.2d 626, 630 (Fla. App. Dist. 1985) (noting that “the limitation of liability provision was standard in the industry” and that “[t]his is clearly a commercially reasonable consideration”); *Retail Credit Corp. v. Shorterage*, No.

### 1. *The Numerus Clausus in Contract*

Contract law has not been traditionally understood as offering a limited number of contractual forms. The traditional understanding of the role of courts in contract cases is that they should facilitate negotiated choice.<sup>172</sup> Freedom of contract is as close to a universal positive principle as is accepted in contract law.<sup>173</sup> Instead, this Article proposes that courts should and sometimes do constrain choice and limit the range of contractual language in the mass-market context rather than enable idiosyncratic deals that raise information costs. Doctrines that constrain negotiated choice and limit the range of contractual terms should govern mass-market, high-volume, low-value cases, while doctrines enabling individual preferences and idiosyncratic understandings should govern low-volume, high-value, dickered cases. To some extent courts have already adopted this division, although haphazardly and *sub silentio*. This Article first explores those instances in which courts already constrain choice and language to keep contracts standardized. In response to these situations, this Article then proposes some changes courts could make to further encourage standardization and limit information costs in the mass-market context.

#### a. *The Statute of Frauds and Parol Evidence*

Commercial law constrains the range of contractual choice and standardizes agreements by requiring contracts to be in writing.<sup>174</sup> Once there is a writing, courts limit evidence of negotiations between the parties that occurred prior to or contemporaneous with the writing.<sup>175</sup> Under the parol evidence rule, courts therefore discard evidence of actual negotiations between

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69465, 1996 WL 199831, at \*1 (Ohio Ct. App. Apr. 25, 1996) (“[I]n determining . . . substantive unconscionability, this court must consider the interest rates which have been held to be ‘commercially reasonable.’” (citing *Collins v. Click Camera & Video, Inc.*, 621 N.E.2d 1294, 1299 (Ohio Ct. App. 1993) (noting that “courts examining whether a particular limitations clause is substantively unconscionable have considered . . . the standard in the industry”)); *M.A. Mortenson Co. v. Timberline Software Corp.*, 970 P.2d 803, 812 (Wash. Ct. App. 1999) (“Such clauses are standard in the software industry . . . . Indeed, they are useful in making software affordable.”); U.C.C. § 2-302 cmt. 1 (2002) (“The basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract.”).

<sup>172</sup> See *supra* Part II.A.

<sup>173</sup> See *supra* Part II.A.

<sup>174</sup> U.C.C. § 2-201(1) (2002) (“[A] contract for the sale of goods for the price of \$500 or more is not enforceable by way of action or defense unless there is some writing . . .”).

<sup>175</sup> § 2-202 (“[A] final expression of their agreement . . . may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement . . .”).

the parties.<sup>176</sup> Courts may, however, consider usage of trade to explain contract terms.<sup>177</sup> The effect of the parol evidence rule is that courts substitute the general community's understanding of the standard meanings of terms in place of any negotiated meaning not incorporated into the writing.<sup>178</sup>

Indeed, the parol evidence rule only excludes evidence of negotiations over idiosyncratic terms. Suppose Party *A* and Party *B* negotiate a contract: *A* and *B* may choose the standard shipping term, FOB Seller's place of business; or a different term—FOB Buyer's place of business.<sup>179</sup> If *A* and *B* desire the standard term but fail to include it in the contract, the term can come in under the trade-use exception.<sup>180</sup> However, if *A* and *B* negotiated for an idiosyncratic shipping rule but forgot to include that term in the contract, all evidence of those negotiated preferences would be excluded by the court as impermissible extrinsic evidence, because the idiosyncratic term would fall outside the scope of standard trade use or course of dealing.<sup>181</sup> The parol evidence rule is therefore best understood as a rule that reduces the information costs associated with contracting.

Information-cost theory helps explain why courts purport to enforce the negotiated preferences of the parties, yet exclude all evidence of such negotiations under the parol evidence rule. The parol evidence rule is not a rule about good evidence. If courts wanted good evidence, they would not exclude probative evidence of the actual intent of the parties in reaching an agreement. The actual effect of the rule is to exclude evidence of a negotiating process that would be highly likely to provide useful information about idiosyncratic terms that the parties desired.<sup>182</sup>

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<sup>176</sup> See *St. Johns N. F. Shipping Corp. v. S. A. Companhia Geral Commercial do Rio de Janeiro*, 263 U.S. 119, 120 (1923) (summarizing petitioner's argument and discussing, in a positive way, earlier cases where "testimony was offered to modify the custom by an oral contract, and [two state supreme courts] refused to admit such evidence on the ground of the parol evidence rule").

<sup>177</sup> § 2-202 (stating that contract terms "may be explained or supplemented . . . by course of performance, course of dealing, or usage of trade").

<sup>178</sup> See *Porto Rico Sugar Co. v. Lorenzo*, 222 U.S. 481, 482 (1912) (finding that parol evidence of the local grinding season based on industry practice properly was admitted to determine the time of performance, which was not specified in a contract to grind sugarcane).

<sup>179</sup> §§ 2-308, 2-319, 2-509.

<sup>180</sup> See § 2-202 (discussing the significance of "a course of dealing" or "usage of trade" to the parol evidence rule).

<sup>181</sup> See *id.* (discussing the concept of "merger" in final contract drafting).

<sup>182</sup> See *Hotchkiss v. Nat'l City Bank of N.Y.*, 200 F. 287, 293 (S.D.N.Y. 1924) ("A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent.").

*b. Trade Use and Industry Custom and Practice*

Trade use and industry standards shape judicial interpretation of contract terms.<sup>183</sup> Courts adopt industry standards as default rules.<sup>184</sup> When determining if a product is too expensive, courts compare the price to the standard market rate.<sup>185</sup> When measuring whether a contract term is unconscionable, courts look to standard practice.<sup>186</sup> When construing the meaning of terms, courts look to how the term is defined within the industry.<sup>187</sup>

The concept of “industry” itself is important for standardization. In contract law, each industry provides its own legal box within which it may control and establish standards.<sup>188</sup> This permits courts to tailor standard terms for that industry without worrying that those terms will be applied in other contexts. The effect of the legal concept of an industry is thus to limit spillover. Standardized contracts must be isolated on an industry-by-industry basis. If courts were to apply standardized terms from the shoe-selling industry to a law professor’s employment contract, there would likely be confusion. Within each box, courts create a gravitational pull toward a standardized contract.

*c. Standard Default Terms*

Courts also standardize contracts by filling contract gaps with default terms that operate in the absence of contractual language by the parties. These rules are often drawn from the Uniform Commercial Code (U.C.C.), which derives many of its default terms from industry standards.<sup>189</sup> Prevailing economic theory classifies default rules according to two categories: majoritarian defaults and penalty defaults. A majoritarian default is an optimal default contract term

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<sup>183</sup> See Elizabeth Warren, *Trade Usage and Parties in the Trade: An Economic Rationale for an Inflexible Rule*, 42 U. PITT. L. REV. 515 (1981) (“In commercial litigation, courts most frequently interpret contract terms according to the usage of the trade. That is, courts will give the disputed term the meaning it carries in similar business settings.”).

<sup>184</sup> See *infra* Part III.C.1.c–d.

<sup>185</sup> See *infra* Part III.C.1.c–d.

<sup>186</sup> See *infra* Part III.C.1.c–d.

<sup>187</sup> See Warren, *supra* note 183, at 518 (“Uniformly charging all parties in a trade with knowledge of a trade usage benefits everyone established in the trade by reducing their transactions costs.”).

<sup>188</sup> See *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993) (“We conclude that ‘ordinary business terms’ refers to the *range* of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope . . .”).

<sup>189</sup> See U.C.C. §§ 1-201(3), 1-205 (2002) (defining “agreement” to include course of dealing, usage of trade or course of performance and defining “usage of trade,” respectively).

chosen by the court on behalf of the parties, based on the theory that the parties would have wanted that term if they had negotiated over the provision.<sup>190</sup> A penalty default is a suboptimal default contract term imposed by courts to encourage the parties to bargain around the default.<sup>191</sup> Notably, neither theory explains why most contracting parties choose to use standard agreements that must in some respect be suboptimal between them, but still refrain from bargaining around them.

This Article proposes to construct default rules differently. A useful default rule is neither that which the majority of parties would have used if they had bargained, nor a rule designed to be suboptimal and force information exchange. A good default rule instead reinforces industry standards in order to reduce the information costs of other industry parties.<sup>192</sup> This may closely resemble a majoritarian default. But there remains a critical difference between a majoritarian default and an industry standard: a standard is the rule chosen (or not chosen) by most parties *given* transaction costs. The standard is a creature of transaction costs insofar as the goal of a standard is to minimize such costs. By comparison, a majoritarian default is the one parties would have selected *absent* transaction costs.<sup>193</sup> Or, in common-sense terms: a court might wisely enforce standardized rules that reduce information costs, but that do not reflect the choice that most parties would make if they were able to bargain costlessly.

Information-cost theory explains how default rules can be suboptimal between any given set of contracting parties, yet optimal for the industry as a whole. Contracting parties prospectively search for contracts they may want to enter, rather than retrospectively seeking to fine tune a deal they have already entered.<sup>194</sup> The information cost of simple, commonly held terms is low.<sup>195</sup>

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<sup>190</sup> See Ayres & Gertner, *supra* note 10, at 93 (“Scholars who attribute contractual incompleteness to transaction costs are naturally drawn toward choosing defaults that the majority of contracting parties ‘would have wanted’ because these majoritarian defaults seem to minimize the costs of contracting.”).

<sup>191</sup> See *id.* at 91 (“Penalty defaults are designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer.”).

<sup>192</sup> See *id.* (“An ‘untailored default,’ true to its etymology, provides the parties to all contracts with a single, off-the-rack standard that in some sense represents what the majority of contracting parties would want.”); see also Warren, *supra* note 183, at 518 (“In the long run, widespread application of the standard benefits trade newcomers as well by causing those established in the trade to deal with them on the same terms as others in the trade.”).

<sup>193</sup> See Ayres & Gertner, *supra* note 10, at 93.

<sup>194</sup> See POSNER, *supra* note 112, at 5 (“Rational people base their decisions on their expectations of the future rather than on their regrets about the past.”); see also Fairfield, *supra* note 97, at 1240 (“The primary

The information cost of individuated deals is high.<sup>196</sup> Industry parties who repeatedly contract may want to use standard language and leave industry standards intact even though there might be some benefit to deviating from the industry norm and employing uniquely negotiated terms.

Supplying default terms reduces the degree to which a contract can vary from the standard.<sup>197</sup> For example, if a contract deviates in its price term from the norm, its warranty provisions may still be standardized. If a contract deviates from the norm by offering an idiosyncratic disclaimer of liability, it may still be standardized in terms of price. Default rules offer a gravitational pull toward the norm.

*d. The Battle of the Forms*

The knockout rule's infamous gloss on U.C.C. section 2-207 is also best understood as a doctrine designed to restrict individuated negotiation in order to protect the informational benefits of standardized terms. The common understanding of the knockout rule is that if parties' terms differ, they are knocked out, and the U.C.C. default is applied.<sup>198</sup> However, courts will often look to industry standards before applying the U.C.C. default to determine whether there is a more tailored term for the particular industry.<sup>199</sup> For example, courts apply section 2-207 to insert specific industry standards on warranty periods, indemnification terms, time for payment due, or arbitration clauses.<sup>200</sup> In these cases, party preferences are therefore replaced with

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cost of contracting is not in negotiating the fine details of the contract with the store; the cost of contracting is finding a store that sells the desired product coupled with the desired contract.”).

<sup>195</sup> See *C & J Fertilizer, Inc. v. Allied Mut. Ins. Co.*, 227 N.W.2d 169, 177 (Iowa 1975) (“[T]he burglary ‘definition’ which crept into this policy comports neither with the concept a layman might have of that crime, nor with a legal interpretation.”).

<sup>196</sup> See *id.* at 176 (demonstrating that a term is likely unconscionable “if the adhering party never had an opportunity to read the term, or if it is illegible or otherwise hidden from view”).

<sup>197</sup> See Radin, *Boilerplate Today*, *supra* note 13, at 190 (“Standardization serves customization and vice versa. Uniformity at one level facilitates customization at another. Uniform terms serve as building blocks in a customized document. But those uniform terms themselves may be composed of building-block clauses arranged in a customized way.”).

<sup>198</sup> See, e.g., *Daitom, Inc. v. Pennwalt Corp.*, 741 F.2d 1569, 1579 (10th Cir. 1984) (applying the knockout rule such that the “ultimate contract . . . includes those non-conflicting terms and any other terms supplied by the U.C.C., including terms incorporated by course of performance (§ 2-208), course of dealing (§ 1-205), usage of trade (§ 1-205), and other ‘gap fillers’ or ‘off-the-rack’ terms”).

<sup>199</sup> *Id.*

<sup>200</sup> See *Dresser Indus., Inc., Waukesha Engine Div. v. Gradall Co.*, 965 F.2d 1442, 1452 (7th Cir. 1992) (stating that “the district court acted appropriately in allowing the jury to consider the parties’ course of performance, course of dealing, and usage in the trade” because plaintiff’s warranty provision reflected common business practice); *Vulcan Auto. Equip., Ltd. v. Global Marine Engine & Parts, Inc.*, 240 F. Supp. 2d

industry standards. This can best be understood as enforcing the standard deal in the industry at the expense of individuated preferences: a protection of the information costs inherent in the standard deal.

Note that consent is not a factor in these considerations: the parties have not, and should not, read each others' purchase orders or order confirmations. Although the battle of the forms is most commonly a business-to-business issue, it falls under the categorization of high-volume, non-negotiated transactions. Businesses ordering supplies should not scrutinize order forms with any more frequency than other purchasers of goods.

*e. Limited Corporate Forms*

Another example of the *numerus clausus* in contract law comes from corporate law. A business may only take one of a constrained set of legal forms. Corporations, limited liability partnerships, and other legally defined business associations present a standardized face to the public, declaring the extent of limited liability protection.<sup>201</sup>

Again, information-cost theory can be used to explain why the law recognizes only the particular forms. A primary function of corporate forms is to standardize the relationship between the corporation and the public (in terms of limited liability) and the relationship between shareholders and management.<sup>202</sup> The standardization of management–shareholder relationships is necessary to sell chunks of that relationship (in the form of stock) on consumer stock markets.<sup>203</sup> If we accept that efficient stock trading best serves

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156, 165–66 (D.R.I. 2003) (“The Official Comment to subsection (1) explains that a reasonable time depends upon the circumstances surrounding the contractual relationship. This Court, therefore, finds that a reasonable time for payment in this case is sixty days.”); Titanium Metals Corp. v. Elkem Mgmt., Inc., 191 F.R.D. 468, 470 (W.D. Pa. 1998) (allowing evidence that indemnification is non-standard in smelting industry, the court held “that usage of trade, if proven, is a valid gap-filler under UCC § 2-207(3)”; Flender Corp. v. Tippins Int’l, Inc., 830 A.2d 1279, 1286 (Pa. Super. Ct. 2003) (knocking out the arbitration clause as contrary to industry practice (citing *Daitom*, 741 F.2d at 1579)).

<sup>201</sup> See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 390 (2000) (listing the various corporate forms).

<sup>202</sup> See Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767, 770 (1989) (“[S]tate corporation statutes . . . enforce corporate contracts, reduce the costs of private contracting by creating standard corporate forms that the parties can opt into, and provide central notice to potential creditors that the firm has adopted limited liability.”).

<sup>203</sup> See Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 180 (1985) (“Each state’s corporate law provides a basic legal framework that governs the relations of investors with senior managers, directors, and controlling shareholders. Through the law of

all collective interests (shareholders, management, public, and corporate), then it makes sense for the terms of the relationship between management and shareholders to be standardized before being chopped up and sold as securities. Even if the entity does not offer stock, standardization of the corporate form standardizes the risks involved in buying the entity's debt, or in securitizing the entity's accounts or other rights to payment.<sup>204</sup>

## 2. *Standardization Through Anti-Standardization Doctrines*

The prior subsection demonstrated that numerous legal rules constrain the range of contractual choice and limit individuated negotiation. This subsection now advances that argument one step further to argue that courts use anti-standardization doctrines to standardize industry agreements.

Adhesion and unconscionability serve as the primary anti-standardization doctrines in contract law. Unconscionability has two parts: procedural and substantive.<sup>205</sup> Procedural unconscionability derives either from ostensible differences in bargaining power, or the hiding of surprising terms in prolix documents.<sup>206</sup> Substantive unfairness can reflect a range of concerns, from a price that is several standard deviations from the mean, to consequences of breach (such as cross-collateralization and repossession or foreclosure) that are widely disproportionate to the value of the contract.<sup>207</sup> A procedural flaw must result in substantive unfairness in order for the court to rewrite the document.<sup>208</sup> A contract of adhesion is one which “adheres” to a deal—a

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fiduciary duties, which proscribes theft and specifies standards of care and loyalty, corporate law serves as a standard form contract that substitutes for costly, fully contingent agency contracts.”).

<sup>204</sup> See Butler & Ribstein, *supra* note 202, at 770.

<sup>205</sup> See, e.g., *Discover Bank v. Super. Ct.*, 113 P.3d 1100, 1108 (Cal. 2005) (“To briefly recapitulate the principles of unconscionability, the doctrine has both a procedural and a substantive element, the former focusing on oppression or surprise due to unequal bargaining power, the latter on overly harsh or one-sided results.” (citation omitted)).

<sup>206</sup> See *Gatton v. T-Mobile USA, Inc.*, 61 Cal. Rptr. 3d 344, 363 (Cal. Ct. App. 2007) (“[T]he contract readily comported with the unfair surprise element of procedural unconscionability, i.e., supposedly agreed-upon terms that are hidden in a prolix printed form and never brought to the attention of the weaker party.” (citation omitted)).

<sup>207</sup> See, e.g., *Maxwell v. Fidelity Fin. Servs., Inc.*, 902 P.2d 51 (Ariz. 1995) (finding contract for sale of a solar water heater presented a question of unconscionability when the heater was never properly installed, the loans were collateralized by the purchaser's house, and the loans carried an interest rate of 19.5%).

<sup>208</sup> See *True Light Christian Ministries Church v. Clear Channel Outdoor, Inc.*, 809 N.E.2d 1198, 1201 (Ohio Ct. App. 2004) (“In order for a contract provision to be unconscionable, there must exist both ‘substantive’ and ‘procedural’ unconscionability. Substantive unconscionability exists when the contract terms are determined to be unfair and unreasonable.”).

standardized agreement that is a mandatory portion of a commercial transaction.<sup>209</sup>

Standardized documents are often termed “take it or leave it,” and consumers who sign such documents are held to have lacked sufficient bargaining power to consent to the agreement. Further, courts often find that standardized agreements are hard to read, and theorize that consumers should and will read simpler and clearer documents.<sup>210</sup> As a result, standardized contracts are often disfavored under unconscionability analysis. Some courts even view standardized contracts as per se procedurally unconscionable because the contract is not the result of a bargaining process.<sup>211</sup> This makes sense if negotiated consent is indispensable to the legal view of contract. Standardized contracts do not result in dickered bargains. But if one shifts the focus of contract law from securing maximum consent to securing efficient outcomes, the unconscionability attack on standardized contracts seems decreasingly useful.

Standardized documents are easier to read, to search for, and to search within than individually negotiated agreements.<sup>212</sup> Consumers can enter standardized contracts with confidence that they know what is in them, based on prior experience. There is a further problem with castigating standardized contracts as take-it-or-leave-it. Such documents offer a choice: the consumer may take her business elsewhere. Even if there is no competitor, the consumer may choose to refuse the deal entirely. Substantive unconscionability fares little better. Substantive unfairness is almost never determined in absolute

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<sup>209</sup> See *Comb v. Paypal, Inc.*, 218 F. Supp. 2d 1165, 1172 (N.D. Cal. 2002).

<sup>210</sup> See *Germantown Mfg. Co. v. Rawlinson*, 491 A.2d 138, 146 (Pa. Super. Ct. 1985) (“An unexpected clause often appears in the boilerplate of a printed form and, if read at all, is often not understood.”); *Gatton*, 61 Cal. Rptr. 3d at 363 (emphasizing that the terms were unconscionable because they were hidden).

<sup>211</sup> See *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1282 (9th Cir. 2006) (“When the weaker party is presented the clause and told to ‘take it or leave it’ without the opportunity for meaningful negotiation, oppression, and therefore procedural unconscionability, are present.” (citation omitted)); *Comb*, 218 F. Supp. 2d at 1172 (“A contract or clause is procedurally unconscionable if it is a contract of adhesion . . . . A contract of adhesion, in turn, is a standardized contract, which, imposed and drafted by the party of superior bargaining strength, delegates to the subscribing party only the opportunity to adhere to the contract or reject it.” (citation omitted)); *Martinez v. Master Prot. Corp.*, 12 Cal. Rptr. 3d 663, 668 (Cal. Ct. App. 2004) (“An arbitration agreement that is an essential part of a ‘take it or leave it’ employment condition, without more, is procedurally unconscionable.” (citation omitted)).

<sup>212</sup> See *Fairfield*, *supra* note 97, at 1283 (“Rather, third parties gain from lower search costs outside of litigation: The resulting unification of language makes it easier for parties to determine whether they can get what they want without engaging in costly negotiation.”).

terms. Rather, courts will look to the relative unfairness of the term against the backdrop of the industry.<sup>213</sup>

These persistent difficulties with unconscionability analysis can be resolved by resort to information theory. I posit that courts are often not using unconscionability analysis to target standard terms or standardized contracts. A contract that truly reflects the industry standard—and thus is the *most* standardized—is generally safe from unconscionability attack.<sup>214</sup> Rather, courts use the doctrines of adhesion and unconscionability to protect standard deals by striking outlier terms or deals. Courts do not strike prices or interest rates as unconscionable merely because the rate or price is high. A high rate or price that reflects the industry standard is not unconscionable.<sup>215</sup> For example, the Ninth Circuit determined that high interest rates are “not unusual for loans made to high-risk borrowers”;<sup>216</sup> and the Connecticut Supreme Court held that loans are not unconscionable where “the interest rates . . . charged [on the loans was not] beyond the ordinary charges then prevailing in the secondary loan market.”<sup>217</sup>

By comparison, courts strike prices and interest rates that are statistical outliers from the rate prevailing on similar purchases or loans.<sup>218</sup> The background common law rule is that courts will not inquire into the adequacy of consideration.<sup>219</sup> Yet, price unconscionability is a common and successful

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<sup>213</sup> See *infra* notes 214–18.

<sup>214</sup> See, e.g., *Reznor v. J. Artist Mgmt., Inc.*, 365 F. Supp. 2d 565, 577 (S.D.N.Y. 2005) (holding that there was “no . . . evidence that the objected-to provisions in the . . . agreement were unusual for the industry”); *Fotomat Corp. of Fla. v. Chanda*, 464 So.2d 626, 630 (Fla. Dist. Ct. App. 1985) (asserting that “the limitation of liability provision was standard in the industry . . . [and t]his is clearly a commercially reasonable consideration”); *M.A. Mortenson Co. v. Timberline Software Corp.*, 970 P.2d 803, 812 (Wash. Ct. App. 1999) (“Such clauses are standard in the software industry. Indeed, they are useful in making software affordable.”); cf. *Henningsen v. Bloomfield Motors*, 161 A.2d 69 (N.J. 1960) (holding that where all American car manufacturers used the same warranty terms, the customer could not shop around for better terms).

<sup>215</sup> See, e.g., *Retail Credit Corp. v. Shorterage*, No. 69465, 1996 WL 199831, at \*1–\*2 (Ohio Ct. App. Apr. 25, 1996) (“In determining . . . substantive unconscionability, this court must consider the interest rates which have been held to be ‘commercially reasonable.’”); *Cal. Grocers Ass’n v. Bank of Am.*, 27 Cal. Rptr. 2d 396, 402 (Cal. Ct. App. 1994) (“Bank of America’s \$3 DIR fee is actually at the *low end* of prices charged . . . by other financial institutions, many of which charge between \$4 and \$10.”).

<sup>216</sup> *Brown v. Investors Mortgage Co.*, 121 F.3d 472, 478 (9th Cir. 1997).

<sup>217</sup> *Cheshire Mortgage Serv., Inc. v. Montes*, 612 A.2d 1130, 1137–38 (Conn. 1992).

<sup>218</sup> See, e.g., *Carboni v. Arrospeide*, 2 Cal. Rptr. 845, 849 (Cal. Ct. App. 1991) (“We have little trouble concluding that an interest rate of 200 percent . . . is substantively unconscionable . . . . [T]he interest rate . . . was approximately ten times the rate then prevailing in the credit market for similar loans.”).

<sup>219</sup> For a comprehensive treatment of consideration and gross price disparity in unconscionability, see Frank P. Darr, *Unconscionability and Price Fairness*, 30 HOUS. L. REV. 1819, 1822 (1994) (“[T]he successful

claim.<sup>220</sup> Contracts selling overpriced goods are regularly struck as unconscionable.<sup>221</sup> In determining whether the good is overpriced, courts can only look at similar goods in the market. Thus, the measure of unconscionability is not absolute, but is determined by deviation from the industry standard.

Price unconscionability cases demonstrate the strength of information-cost analysis over informed consent analysis. If cases were determined based on informed consent, then grossly overpriced contracts would surely be enforced. “Of all the terms in a contract, the one most assuredly understood by the buyer is the price term.”<sup>222</sup> It is easier to understand why courts engage in price evaluation by looking at information costs. In many cases the price is packaged in such a way that makes it costly for consumers to decipher the true cost they will ultimately pay.<sup>223</sup> For example, it may be time-costly for consumers to determine the ultimate cost of a good over installment payments.

Even where prices are prominently displayed, significant deviation from the standard price still creates information costs for third parties. Recall that under information-cost theory, the actual parties to the contract are aware of idiosyncratic terms. A given contract term, including price, may be efficient as between two parties. But third parties will suffer costs created by an agreement that deviates from the standard. Even if any given price term is fully disclosed to the parties to that particular deal, price volatility across the run of deals causes third parties to incur search costs.

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price unconscionability cases run headlong into a bedrock contract ‘rule’ that the courts will not address the adequacy of consideration supporting an agreement.”).

<sup>220</sup> *Id.* at 1822–23.

<sup>221</sup> *Id.* at 1850–61 (citing *Murphy v. McNamara*, 416 A.2d 170, 173 (Conn. Super. Ct. 1979)) (rent to own contract that called for consumer to be charged \$1,268 for a television worth \$499); *Sho-Pro of Ind., Inc. v. Brown*, 585 N.E.2d 1357, 1361 (Ind. Ct. App. 1992) (windows sold for approximately four times their cost); *Howard v. Dialosa*, 574 A.2d 995, 997 (N.J. Super. Ct. 1990) (home worth \$150,000 sold for \$25,000); *Toker v. Westerman*, 274 A.2d 78, 79 (N.J. Dist. Ct. 1970) (\$400 freezer sold for \$1,230); *Vom Lehn v. Astor Art Galleries, Ltd.*, 380 N.Y.S.2d 532, 534, 538 (N.Y. Sup. Ct. 1976) (art sold for \$67,000 with a fair market value of only \$14,750); *Jones v. Star Credit Corp.*, 298 N.Y.S.2d 264, 265 (N.Y. Sup. Ct. 1969) (\$300 freezer sold for \$1,440)).

<sup>222</sup> *Id.* at 1822.

<sup>223</sup> Many lending companies offer loans over long periods of time so that each payment is low compared to the amount borrowed. For example, Cash Call, <http://www.cashcallmortgage.com/Pages/SiteRedirect.aspx> (last visited Feb. 17, 2009), offers a \$2,600 loan (minus a \$75 “loan fee”) for 42 payments of \$216.55, or \$9,095.10 in total. *See also Murphy*, 416 A.2d at 173 (discussing a \$499 television sold for \$1,268 and that the “agreement provided for weekly payments of \$16, and further provided that if the plaintiff paid that sum for seventy-eight successive one-week terms, she would become the owner of the television set”).

For example, courts accept that payday loan rates are higher, as an industry, than regular bank rates. However, if even one payday loan lender charges idiosyncratic prices far in excess of the current payday loan standard, then contracting prices for everyone in the industry will rise. Now every consumer must not only calculate her own interest rate, but must compare it to at least one other lender in order to be sure that her rate is standard. A loan shopper must now do research to ensure that she does not fall victim to the bad apple. One excessive rate in a barrel of competitive rates ruins the benefits of standardization for everyone. Because this extra search cost is now tacked onto every loan, the number of loans will fall and the industry as a whole will suffer.

If goods have a standard market price, consumers purchase without the need to inquire whether the vendor they are patronizing offers the best deal.<sup>224</sup> The deviation between the price of gasoline offered at your local gas station and the best price in town is likely to be small enough to make researching the question (or driving around to find out) unprofitable.<sup>225</sup> Of course, as the differences between gas prices rose during the recent price shock, the value of driving around looking for a better price rose. Thus, if price differences between vendors are high, parties incur information costs shopping for the best deal, rather than dealing with the most convenient vendor. Consequently, the law recognizes that standard prices are valuable. Indeed, the U.C.C. does not even require a price term to form an enforceable contract.<sup>226</sup> Parties routinely order without reference to price terms. Thus, the court will supply the industry's standard market price as a default price term.<sup>227</sup>

Courts also touch on the benefits of standardization in their discussions of contractual surprise. The traditional view is that parties cannot consent to terms of which they are unaware. A surprising term is unconscionable.<sup>228</sup> Yet courts limit this principle by reference to reasonable expectations.<sup>229</sup> A term

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<sup>224</sup> See Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1401–29 (1983) (showing that, just as with price diversity where consumers prefer one price, the variety of contract terms can affect consumer search costs).

<sup>225</sup> *Id.* at 1401 (“[P]rice diversity can exist when it is costly for consumers to inform themselves of the prices that different firms charge even though all consumers prefer the same price.”).

<sup>226</sup> U.C.C. §§ 2-201, 1-205 (2002).

<sup>227</sup> § 1-205.

<sup>228</sup> See *Germantown Mfg. Co. v. Rawlinson*, 491 A.2d 138, 146 (Pa. Super. Ct. 1985) (“The first concept of unconscionability which we shall examine may be classified under the rubric of ‘*unfair surprise*.’”).

<sup>229</sup> *Id.* (“If the form contains a material, risk-shifting clause which the signer would not reasonably expect to encounter in such a transaction, courts have held that the clause may be excised as it is unconscionable.”).

that one does not reasonably expect to find in the contract is unenforceable.<sup>230</sup> There is a further consideration, however. The reasonable expectations are defined by the industry standard, not by the contracting parties. As one court noted, “a merchant in a given industry will have, by definition, a difficult time establishing either subjective or objective ‘surprise’ regarding a proposed contract term that is standard in the industry.”<sup>231</sup>

In determining whether a contract term must be struck for unconscionable contractual surprise, courts ask whether the term is inside or outside of the norm for the industry.<sup>232</sup> If the term is outside the norm, the court finds the term unconscionable due to surprise.<sup>233</sup> If it is within the norm, the term is enforceable despite the “subjective or objective” surprise of the contracting parties.<sup>234</sup> Under traditional contract theory, this result is hard to explain. The parties’ intent ought to govern contract terms. However, under information-cost theory, this formulation of contractual surprise makes sense. A term that is surprising to the industry as a whole raises contracting costs to the industry as a whole. Courts will enforce an industry’s standard term even though it is surprising to a contracting party. The surprise of an industry weighs more heavily than the surprise of a single contracting party.

Nor is this analysis limited to the doctrines of unconscionability and contracts of adhesion. Courts applying consumer protection laws or determining unfair trade practices also enforce standardized agreements and attack outlier contract terms.<sup>235</sup> Standard deals are almost never deemed unfair. But courts find that terms which “substantially deviate from industry-wide practice” constitute unfair trade practices.<sup>236</sup> Indeed, the texts of state consumer protection statutes make this explicit.<sup>237</sup> Such statutes decline to set

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<sup>230</sup> *Id.*

<sup>231</sup> *Aceros Prefabricados v. TradeArbed, Inc.*, 282 F.3d 92, 101 (2d Cir. 2002).

<sup>232</sup> *Compare Germantown Mfg. Co.*, 491 A.2d at 146 (striking a non-standard clause), *with Aceros Prefabricados*, 282 F.3d at 101 (upholding a standard contract term).

<sup>233</sup> *See Germantown Mfg. Co.*, 491 A.2d at 146.

<sup>234</sup> *See Aceros Prefabricados*, 282 F.3d at 101.

<sup>235</sup> *See Weigel v. Ron Tonkin Chevrolet Co.*, 690 P.2d 488, 493 (Or. 1984) (“The civil action authorized by ORS 646.638 is designed to encourage private enforcement of the prescribed standards of trade and commerce . . .”).

<sup>236</sup> *See Frank Lopez, Using the Fair Housing Act to Combat Predatory Lending*, 6 GEO. J. ON POVERTY L. & POL’Y 73, 80 n.43 (1999) (“[L]oan fees which ‘substantially deviate from industry-wide practice’ may constitute an unfair or deceptive trade practice in violation of Massachusetts regulations” (citing *United Cos. Lending Corp. v. Sargeant*, 20 F. Supp. 2d 192, 209 (D. Mass. 1998))).

<sup>237</sup> *See, e.g., COLO. REV. STAT. ANN. § 6-1-1119(c)* (West 2006) (“[T]o support a finding of unconscionability, there must be evidence of some . . . absence of meaningful choice for one of the parties, together with contract terms that are, under standard industry practices, unreasonably favorable to the equity

their own metric for unfairness, but instead penalize contract terms that deviate from the industry standard.

Information-cost theory provides a new and better way to view these longstanding questions of contract law. Customized contracts impose information externalities on third parties. Standardized contracts reduce consumers' information costs. Courts that adopt rules encouraging information exchange therefore ought to consider the effect of such exchanges on third parties. An idiosyncratic deal may be efficient for two, but inefficient for the rest of the industry. Despite court rhetoric disfavoring standardized agreements, some courts protect standardized deals by using anti-standardization doctrines to strike outlier terms. The same principle applies to contract interpretation. Although courts claim to determine the meaning of the contract by reference to the parties' intent, courts *sub silentio* consider the impact of contract interpretation on the industry that relies on a standard deal, and often favor the industry interpretation over the idiosyncratic agreement of the parties.

#### IV. CHALLENGES: STANDARDIZATION AND INNOVATION

I have thus far argued that consent is costly, that standardization lowers those costs, and that courts should and do use contract doctrine to constrain the range of customization in mass-market contracts. There is a significant challenge, however, to this view. Would such constraints hinder innovation in contract law?

This Part argues that standardization fosters innovation. In the industrial context, standardization often permits innovation, by breaking problems down into manageable chunks.<sup>238</sup> I argue that standardization facilitates innovation in contract just as it does in the industrial context. Customization is not

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purchaser or associate.”); MONT. CODE ANN. § 30-14-2004(2)(b)(i) (2007) (requiring independent certification for debt managers to “ensure[] compliance with industry standards and best practices”); 66 PA. CONS. STAT. ANN. § 2203 (West 1999) (“In adopting the standards, the commission shall consider the absence of any applicable industry standards and practices or adopt standards in conformity with industry standards and practices . . .”).

<sup>238</sup> See Henry E. Smith, *Modularity in Contracts: Boilerplate and Information Flow*, in *BOILERPLATE: THE FOUNDATION OF MARKET CONTRACTS*, *supra* note 13, at 164 (“Modularity is beneficial in that it makes complexity manageable by allowing multiple people to work on a larger problem, often in very specialized ways, without incurring the costs of intense communication. Modularity also creates options in the sense that it allows a system to manage uncertainty; because each module can function and develop in relative isolation, these processes can occur without the need to resolve uncertainty elsewhere in the system.”).

synonymous with innovation, nor is standardization synonymous with stagnation.

### A. *Micro-Modularity*

When any system becomes complex, humans cannot work on the whole thing at once.<sup>239</sup> If each adjustment to any given part causes a cascade of other changes throughout the whole, the problem becomes impossible to work on. The problem must be broken down into parts, and the interaction between parts must be constrained.<sup>240</sup> Each part can then be worked on separately. Moreover, components must be standardized in how they interact with the whole, so that each can be removed and replaced with another.<sup>241</sup> Imagine the difficulty of working on a car engine that did not use standardized parts. You could not fix the engine without re-crafting the customized parts.

This process of limiting the interaction between part and whole, and of standardizing the components, is called modularization.<sup>242</sup> Components are called modules.<sup>243</sup> Modules can be removed and replaced without affecting the whole. When a system is modularized, a change to one part of the system does not spill over into other parts of a system.<sup>244</sup> From spark plugs to object-oriented programming, modularity spurs innovation.<sup>245</sup>

Standardization constrains the range of customization, in order to lower information costs. Here we see that these lower information costs also serve innovation, by making it possible to fix part of a problem without having to draft an entirely new and customized contract. It is true that switching a module will raise information costs, in the sense that one will have to inquire which module is being used in a given system. This is like a prospective

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<sup>239</sup> See *id.* at 165 (“[H]uman understanding of any system is enhanced by breaking it up . . . into modules.”).

<sup>240</sup> *Id.* at 164.

<sup>241</sup> *Id.* at 165 (“Forming a modular system involves partially closing off some parts of the system and allowing these encapsulated components to interconnect only in certain ways. This allows work to go on in parallel and facilitates certain kinds of innovation and evolution for a simple reason: Adjustment can happen within modules without causing major ripple effects.”).

<sup>242</sup> See *id.* at 164 (“Modularity is a device that deals with complexity by decomposing a complex system into pieces (modules), in which communications . . . are intense within the module but sparse and standardized across modules.”).

<sup>243</sup> *Id.*

<sup>244</sup> *Id.* at 165 (“Adjustment can happen within modules without causing major ripple effects.”).

<sup>245</sup> See Radin, *Boilerplate Today*, *supra* note 13, at 189 (“Modularity became important to physical architecture in the first part of the twentieth century and to the virtual architecture of computer science in the later twentieth century.”).

purchaser looking under the hood of a car to ensure that the engine used is indeed the one advertised. But the process of looking is much less costly if engines are standardized than if each one is custom-crafted. Looking under the hood and seeing a V8 engine tells you something. Looking under the hood at a custom-built engine tells you less.

Contracts have become increasingly modularized. Each section is set out under a separate heading. A severability clause limits the interaction of the part with the whole. If one section is removed, the rest of the contract still functions.<sup>246</sup> Modularity of contracts permits contract drafters to swap in components without redrafting the entire contract. That is doubtless a significant savings. But the rewards to consumers of component standardization are far greater. Consumers can search for the standardized contractual component they desire. By analogy, a search on eBay for “V8 engine” yields Jaguars, Fords, and Chevrolets, each containing the desired component. The standardization of contract components decreases the cost of searching for the desired deal.

### *B. Macro-Modularity*

Standardized terms within a contract are not the only method of reducing information costs in contract language. Entire contracts can be standardized. This section argues that constraint of contract language, standardization, and modularity plays significant roles in limiting information costs and fostering innovation across contracts as well.

In contract law, the concept of industry is a tool to standardize, and thus modularize, contracts.<sup>247</sup> For example, consider the rule that contracts from within the same industry are given similar construction.<sup>248</sup> A smelting contract is construed differently from a construction contract, even when the same words are used.<sup>249</sup> Courts draw from a given constrained context in construing

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<sup>246</sup> See Smith, *supra* note 238, at 169 (“With [a severability] term in place, the validity of each provision in the contract can be considered in isolation of other provisions. Here, as in many systems, modularity insulates the system as a whole from the failure of one part.”).

<sup>247</sup> See *Thomas & Betts Corp. v. Richards Mfg. Co.*, No. Civ. 01-4677, 2006 WL 902148, at \*15 (D.N.J. Apr. 4, 2006) (“[T]he relevant inquiry—whether or not the information at issue is commonly known in the industry—must be directed to the parties’ competitors.”).

<sup>248</sup> See, e.g., *Ragus v. City of Chi.*, 628 N.E.2d 999, 999–1002 (Ill. App. Ct. 1993).

<sup>249</sup> Compare *Titanium Metals Corp. v. Elkem Mgmt., Inc.*, 191 F.R.D. 468, 470 (W.D. Pa. 1998) (indicating that indemnification is non-standard in smelting industry), with *Metric Constr. Co. v. U.S.*, 1 Cl. Ct. 383, 399 (1983) (allowing evidence that industry standard for indemnification was 50% of anticipated profits).

a contract.<sup>250</sup> This prevents spillover from one context to another, and allows parties to craft standardized contracts, on a per-industry basis, that respond to the needs of that particular industry.<sup>251</sup> Within an industry, one contract's terms affect another because they feed into the pool of common language. When a court construes a contract, it construes all contracts in that industry, giving them a standardized meaning.<sup>252</sup>

When a new kind of contract is needed, it does not evolve through a line-by-line process of customization. Rather, new contracts can emerge as a block whole, a standardized contract for a new industry.<sup>253</sup> An example drawn from an emerging industry may help. Social networking sites and virtual worlds are governed by contract law.<sup>254</sup> Those contracts began as basic software licenses or website terms of use.<sup>255</sup> However, online communities faced social problems as well as software license issues.<sup>256</sup> Thus, the End User License Agreements needed to control social behavior (e.g., the behavior of one MySpace member toward another) rather than merely behavior that might affect the market for copyrighted material.<sup>257</sup> The preexisting software license terms did not solve these social problems.<sup>258</sup> Online community providers needed new contracts to deal with these new issues.<sup>259</sup>

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<sup>250</sup> See *Stender v. Twin City Foods, Inc.*, 510 P.2d 221, 225 (Wash. 1973) (noting that the "definition . . . must be determined in light of reasonable industry custom and usage . . . even though words in their ordinary or legal meaning are unambiguous").

<sup>251</sup> See *Thomas & Betts Corp.*, 2006 WL 902148, at \*15.

<sup>252</sup> See, e.g., *Ragus*, 628 N.E.2d at 999–1002 (construing terms of contract to comport with industry custom and practice).

<sup>253</sup> Note the similarities between End User License Agreements in virtual worlds. See Entropia, <https://account.entropiauniverse.com/pe/en/rich/107004.html> (last visited Feb. 17, 2009) (retaining all title and rights to all objects and virtual items and specifically denying any ownership by the user); Second Life, <http://secondlife.com/corporate/tos.php> (last visited Feb. 17, 2009) (owning all data stored on its servers); World of Warcraft, <http://www.worldofwarcraft.com/legal/eula.html> (last visited Feb. 17, 2009) (claiming ownership and rights to all characters, names, dialog, sounds, animations, and anything else within the world); cf. *Bragg v. Linden Research, Inc.*, 487 F. Supp. 2d 593, 606 (E.D. Pa. 2007) (finding procedural unconscionability in Second Life's Terms of Service arbitration agreement, because it was "the first and only virtual world to specifically grant its participants property rights in virtual land").

<sup>254</sup> See Joshua A.T. Fairfield, *Anti-Social Contracts: The Contractual Governance of Virtual Worlds*, 53 MCGILL L.J. 427 (2008) [hereinafter Fairfield, *Anti-Social Contracts*].

<sup>255</sup> *Id.*

<sup>256</sup> *Id.*

<sup>257</sup> See *id.* at 429.

<sup>258</sup> *Id.*

<sup>259</sup> *Id.*

These new contracts did not evolve line-by-line. Rather, the contracts emerged as a block.<sup>260</sup> Even though the novel terms of the contracts had not been tested by courts, the terms were standardized.<sup>261</sup> The terms across contracts were surprisingly similar for a new industry. Note that the traditional academic explanation for boilerplate—that it permits parties to benefit from a private conversation between drafter and court that results in court-approved terms—does not seem to explain this situation, in which the standardized contracts had not been tested in court.

Contract innovation does not seem to be constant and organic, but “sticky,” and “chunky.”<sup>262</sup> For a while, contracts don’t seem to change and are locked into court-approved language. Then a new industry needs a new contract. A new industry is a new box. Inside the box, industry-specific contracts can be developed without regard to spillover to other industries. Standardization within industries constrains customization. Industry contracts will be construed in light of industry custom and practice, even in the face of solid unwritten evidence of the parties’ actual intent.<sup>263</sup> But these constraints do not cause stagnation. In contract law, as elsewhere, micro-modularity and macro-modularity make innovation possible.<sup>264</sup>

Another way to explain the block emergence of new, standard terms is by reference to local and global optima. A standardized contract within an industry is a local optimum: it represents one good mix of information costs and features.<sup>265</sup> A global optimum (or a superior local optimum) is one that represents a better mix of costs, but is costly to achieve in the short term.<sup>266</sup> For example, a slightly better contract may be rejected because the information

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<sup>260</sup> See *supra* note 253 for examples of industry standardized contracts.

<sup>261</sup> See Fairfield, *Anti-Social Contracts*, *supra* note 254, at 438.

<sup>262</sup> See STAN J. LIEBOWITZ & STEPHEN E. MARGOLIS, *WINNERS, LOSERS & MICROSOFT* 9 (1999) (“A particular kind of network effect occurs as technology develops. As more firms or households use a technology, there is a greater pool of knowledge for users to draw upon. As we gain experience and confidence in a technology, the expected payoff to someone who adopts it may become greater. Once a few people have tried a technology, others know what can be expected.”).

<sup>263</sup> See *supra* Part IV.C.

<sup>264</sup> See *infra* Part V.

<sup>265</sup> See Andrew T. Guzman, *Choice of Law: New Foundations*, 90 *GEO. L.J.* 883, 899 (2002) (describing choice of law provisions and the difference between global and local optima, noting that “[i]f the costs and benefits of an activity are distributed unevenly across countries, national policies will diverge from the global optimum. The policy of an individual government may be either more or less permissive than the global optimum, depending on the distribution of these costs and benefits”).

<sup>266</sup> *Id.* (“In certain instances, for example, a globally optimal policy may cause a net loss in one or more countries when compared to the noncooperative, suboptimal outcome. In those cases, the losing countries will prefer the suboptimal outcome, frustrating efforts to achieve an efficient international regime.”).

costs created by a non-standard agreement are greater than the cost-savings generated by standardization. While standardization savings outweigh the benefits of novelty, the old contract remains the standard. However, when that balance tips, the contract will seem not to evolve, but to “snap” to a new position: one where the benefit of the novel contract term outweighs the gains of standardization.<sup>267</sup> Following the snap, information costs will again fall, as the new term becomes standard.

## V. PROPOSED CHANGES

The prior Parts have argued that consent is costly, that standardization reduces that cost, and that courts already have some tools to protect standard agreements by limiting idiosyncratic terms. This Part suggests several ways courts might change from current practice when dealing with mass-market contracts. The overarching principle is that courts should minimize the cost of informed consent by constraining contract language to standard terms, rather than ensuring informed consent by redrafting contracts. Further, courts should enforce standard terms because they lower the cost of information, rather than disfavor such terms based on some intuition that they raise information costs because consumers do not read them.

Courts should stop treating contractual consent as binary—as existing or not existing. Rather, they should ask how much consent the consumer has bought, and whether that is a reasonably efficient amount to buy. When courts use the doctrine of unconscionability to force buyers to buy more information than is efficient, they cause the usual economic harms. Similarly, the term “contract of adhesion” is empty of meaning, and its application should be reformed. A contract of adhesion is problematic under liberal contract theory because it is a “take it or leave it” bargain that vitiates the consumer’s ability to express free will through consent. But under information theory, a standardized agreement reduces the consumer’s information costs. Thus, to the extent courts wish to disfavor standardized agreements, they should distinguish not based on “adhesiveness.” Courts should instead distinguish

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<sup>267</sup> See Gaia Bernstein, *The Paradoxes of Technological Diffusion: Genetic Discrimination and Internet Privacy*, 39 CONN. L. REV. 241, 247 (2006) (“Interactive technologies are often characterized by a critical mass point quality (and related network effects) where the technology is of little use to the adopter unless a critical mass of people adopts it. Once the critical mass point is reached, diffusion accelerates, social norms become quickly entrenched and the technology is less likely to be abandoned.”).

between contracts that embody standard terms and documents that attempt to hide idiosyncratic terms.

Courts should stop using the fiction of the consumer who reads, and thus consents, to mass-market contracts. Forcing consumers to buy more information than they desire is not a useful goal. This rhetorical flourish is used by courts that feel the need to retain some vestige of contractual consent in the mass-market context. Reading a mass-market contract is an economic loss. It is almost never worth the time it takes. Courts should cease redrafting contracts that no one reads. Courts, not consumers, are the real readers of contracts. If the court does not understand the contract, then the contract is likely to be construed in a way that the drafter does not like. That is incentive enough for the drafter to get it right.

Courts should be very cautious about adopting information-forcing rules, even permissive ones, in the mass-market context. Information-forcing rules encourage the exchange of idiosyncratic information.<sup>268</sup> This may be efficient in individual deals, but is often inefficient across the range of deals.

Finally, courts should focus on standardized meanings rather than individuated meanings when they construe contracts. This is different from the usual divide between objective and subjective meanings of a term. When courts construe contract terms, they usually understand (although rarely state) that the beneficiaries of their labors are subsequent contracting parties. Thus, courts should not only construe terms based on objective evidence, but should further give weight to standard meanings of terms. This could even take the form of a presumption against customization in the mass-market context, which would be a complete departure from current court practice.

## CONCLUSION

This Article has attempted to shift the central question of contractual consent from “does informed consent exist?” to “how much informed consent is efficient for the buyer to buy and the seller to sell?” Along the way, the Article has attempted to demonstrate that the usual criticisms of standardized contracts are not persuasive, and that some of the information-forcing rules of recent literature might be a bad idea.

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<sup>268</sup> See *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145 (Exch. Div.).

The Article makes a limited argument. In mass-market contexts, the costs of informing consumers of the terms of contracts often outweigh the benefits of doing so, and therefore courts should critically reexamine the network of doctrines that force companies to make disclosures no consumer ever reads. In so doing, this analysis leaves intact traditional contract doctrine in the negotiation-centered setting, where information exchange is a critical part of the negotiation process.

But even this limited argument does much good for harmonizing contract law with practice. Consumers do not read mass-market contracts. Such contracts are routinely standardized and choice is constrained. Courts should understand why, rather than resist. Under preexisting contract theory, courts feel compelled to reform standardized contracts to reflect individual informed consent. Under information-cost theory, standard deals are efficient mechanisms that courts should protect.

Change may be slow in coming. Even where contract theorists have looked at the costs of securing contractual consent, they have endorsed information-forcing rules that encourage the exchange of idiosyncratic information. Yet even this supposedly efficient exchange does not match contracting practice. We do not reveal our secret vulnerabilities to sellers in order to get increased insurance, nor do we bargain prices down based on the revelation of secret strengths. One-size-fits-all contracts permit consumers to cheaply compare deals, and to enter into deals without inquiring as to what the components of the deal are. Knowing this, sellers do not offer standardized contracts because it permits them to reap cost savings. Sellers offer standardized deals because consumers demand them.