PRE-APPROVED CONTRACTS FOR INTERNET COMMERCE

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I. INTRODUCTION

One of the prominent themes of current contract law scholarship that has particular significance for electronic commerce is the concern that sellers will be able to exploit buyers, especially consumer buyers, by inserting into standard-form contracts terms that systematically favor the former.[1] Consumers who deal with clickwrap, shrinkwrap, or browsewrap contracts[2] are likely to ignore terms provided only on or within

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1. *See, e.g.*, Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429, 432–33 (2002) (noting businesses' ability to take advantage of consumers in standard-form contracts).

2. *See* ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1449 (7th Cir. 1996) (describing "shrinkwrap" licenses as contracts which become operative when the "customer tears the

product containers, online at the time the goods are ordered, or in containers that arrive with the goods subsequent to the time when the goods are ordered. Failure to read terms may be predicated on rational judgments about low defect rates or the low likelihood of either finding oppressive, enforceable terms or being able to negotiate around them. These tendencies to disregard terms, however, may be exacerbated by cognitive errors, other forms of bounded rationality, or informational lapses that cause even reading buyers to misperceive the risks attending the goods they purchase or to apply improper discount rates to the risks they bear and thus to miscalculate the effects of unfavorable terms.

In the view of some, these buyers' failure to read terms or to act rationally or knowledgably with respect to them will induce sellers to insert oppressive terms and fail to reduce prices to reflect the subsequent risk allocation.[3] Buyers will then be surprised to learn that they bear risks to which they did not explicitly assent, of which they were not aware, and to which they allegedly would not have agreed.

I have previously expressed some doubt about the plausibility of these claims, at least with respect to a wide variety of salient contractual clauses and in a large variety of markets.[4]

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wrapping from the [retail software] package"); Hillman & Rachlinski, *supra* note 1, at 464 (explaining that the terms of "browsewrap contracts" are only visible if the consumer clicks on hyperlinks on websites, but "clickwrap contracts" require the consumer to agree to the terms by clicking on a series of statements).

3. *See, e.g.*, Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1407 (2004) (commenting that the tendency of credit card holders to undervalue penalty clauses allows "profit-maximizing issuers" to set higher penalties); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1205–06 (2003) (suggesting that sellers "have an incentive to make attributes buyers do not consider . . . favorable to themselves"); *see also* Hillman & Rachlinski, *supra* note 1, at 436–40 (discussing how "businesses standardize their risks and reduce bargaining costs by offering one set of terms to all consumers"); Robert A. Hillman, *On-line Consumer Standard-Form Contracting Practices: A Survey and Discussion of Legal Implications* 17 (Cornell Law Sch. Legal Studies Research Paper Series, Research Paper No. 05-012, 2005), *available at* http://ssrn.com/abstract=686817 ("[J]ust as e-commerce offers consumers new tools, it arms businesses with novel and relatively inexpensive methods of manipulating consumers."); Ronald J. Mann, *"Contracting" for Credit*, 104 MICH. L. REV. (forthcoming 2006) (manuscript at 7–8, on file with author) (explaining why consumers fail to properly appreciate the implications of contract terms).

4. *See generally* Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WIS. L. REV. 679. Many of these arguments emerge from the literature indicating the ability of impersonal markets to generate terms that buyers prefer, even where individual buyers cannot bargain. *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, 1390–91 (1983) (arguing that when dealing with consumers who are ignorant of market opportunities, firms respond by adding proconsumer provisions, but at anticompetitive prices); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the*

This is true both because sellers have incentives to avoid exploitation and because buyers have more capacity to avoid it than the conventional story suggests. On the seller side, sellers who attempt to capture the marginal buyer, who face reputational constraints, or who cannot distinguish readers from nonreaders, will face competitive pressures inconsistent with efforts to exploit nonreaders. Such sellers will be more likely to price terms that allocate risks to buyers and to enforce ostensibly oppressive terms only in the face of serious buyer misbehavior. Indeed, the primary role of such clauses may be to provide sellers with discretion to treat buyers who appear to be acting in good faith differently from those who appear to be acting opportunistically.[5]

On the buyer side, there are reasons to believe that ignorance is less pervasive than feared. Under relatively weak assumptions about competition, sellers have incentives to make certain favorable terms salient to consumers, including comparisons between terms available from different competitors. Consumers who have negative experiences with a seller in one context have incentives to publicize their experiences, inducing sellers to avoid adverse reputational gossip. The ubiquity of websites (for example, eBay's "Feedback Forum," eopinions.com, and tripadvisor.com) that permit consumers to post evaluations of products and services they have received significantly reduces the search costs for other consumers who desire to compare quality before making similar purchases. Consumers who suffer losses in one context may also translate what they have learned to other contexts. For instance, a buyer who is dissatisfied with one product and could not obtain redress as a consequence of an insufficient warranty may be more attentive to warranty terms when purchasing other goods, even though the latter are unrelated to the unsatisfactory goods.

Basis of Imperfect Information: A Legal and Economic Analysis, 127 U. PA. L. REV. 630, 637–38 (1979) [hereinafter Schwartz & Wilde, *Intervening*] (explaining that even though not all consumers do research before making purchases, competition among the firms for the informed consumers can "generate optimal prices and terms for all consumers"). Ronald Mann's recent manuscript on credit card contracts also reveals significant agnosticism as to whether certain controversial clauses, such as arbitration clauses, actually injure consumers or reflect implicit market demand. *See* Mann, *supra* note 3 (manuscript at 19–21) (noting the possibility that "the cost savings of arbitration are sufficiently valuable that inclusion of the clauses is efficient").

5. *See* Gillette, *supra* note 4, at 704–12; *cf.* Schwartz & Wilde, *Intervening*, *supra* note 4, at 662–66 (describing the business strategy of consumer discrimination, which involves providing various levels of quality and service depending on the type of consumer).

Nevertheless, even when these palliatives are taken into account, there remains significant space within which seller exploitation is theoretically plausible. Buyers may ignore terms that are not salient, that pose minimal risks, or about which they have insufficient information, and it is plausible that sellers could systematically capture quasi-rents with respect to those terms.[6] Where potential losses to any given consumer are small, the likelihood of either reputational or legal redress may be so remote that sellers essentially face little downside risk from efforts to exploit.[7]

Instances of systematic exploitative behavior are difficult to document or to assess.[8] The little empirical evidence that exists suggests less obvious seller misbehavior than theory might predict. Florencia Marotta-Wurgler's recent study of software license agreements found some evidence that sellers who do not make their contracts available prior to purchase actually offer terms that are no more pro-seller than those of sellers that make their terms available prior to purchase.[9] Indeed, her study reveals that those firms that disclose all terms to consumers and force them to "agree" prior to completing the purchase offer significantly more pro-seller terms than sellers that use rolling contracts.[10] Moreover, those firms that invited purchasers to identify themselves as business or consumer purchasers, and thus have the capacity to offer different terms to each group, did not provide more pro-seller terms to consumers.[11] More mature firms have fewer pro-seller terms,[12] however, perhaps suggesting that such firms have reputational stakes that are not shared by

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6. *See, e.g.*, Bar-Gill, *supra* note 3, at 1433–34 (2004) (suggesting that consumers' tendency to underestimate the probability of a breach of contract results in further exploitation by sellers).

7. An example from the credit card context may illustrate this phenomenon. Some credit card companies impose surcharges on currency conversion when cardholders make international transactions in nondollar currencies. These fees can be difficult to decipher because they are not necessarily individually disclosed when transactions are reported to consumers. Nevertheless, for the vacation traveler, the amounts at stake are likely insufficient to warrant additional investigation by the consumer. Even in this context, however, some fee-free credit cards are apparently available, so the cardholder for whom such fees are salient can find alternatives. *See* Christopher Elliott, *A Fee Even the Card Issuers Cannot Explain*, N.Y. TIMES, June 14, 2005, at C8.

8. *See* Hillman & Rachlinski, *supra* note 1, at 441 (indicating the various problems courts encounter when considering fairness issues in contracts).

9. *See* Florencia Marotta-Wurgler, *Are "Pay Now, Terms Later" Contracts Worse for Buyers? Evidence from Software License Agreements* 24 (N.Y. Univ. Law & Econ. Research Paper Series, Working Paper No. 05-10, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=799282.

10. *Id.*

11. *Id.*

12. *Id.* at 22–23.

newer firms. If these initial findings are robust throughout various industries, the scope of any problem may be greater in theory than in practice.

Moreover, the oppressiveness of any particular clause is often subject to interpretation. For instance, whether arbitration clauses or forum selection clauses, which are the target of many of the concerns about consumer exploitation, disfavor buyers as a class depends significantly on whether the reduced litigation costs that one would anticipate from such terms are passed on to nonlitigating buyers.[13] Buyers who would not arbitrate or litigate defects that caused minimal harms may prefer an *ex ante* price reduction to the possibility of an *ex post* recovery to be shared with a class action attorney.[14] The price reduction will be certain and may result in a savings that is larger than any anticipated individual award.[15] Similarly, boilerplate incantations that the terms of a clickware contract are "subject to change without notice" may be exploitative or not, depending on whether the risks are priced and perhaps on the propriety of the supplementary terms that are ultimately inserted. Terms against "reverse engineering" initially sound as if they overly restrict the rights of a buyer and arguably frustrate efforts to make socially beneficial advances that rely on existing products.[16] But these same restrictions may ultimately protect initial investors from being exploited by those who free ride on their efforts. Terms providing that any use, reproduction, or distribution of purchased software constitutes the buyer's acceptance of the applicable open source license agreement raise similar ambiguities. They might constitute onerous obligations that buyers must suffer, or they may induce the creation of public goods that are reflected in the

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13. *See* Gillette, *supra* note 4, at 698–99 (discussing the increase of arbitration clauses in consumer contracts and the subsequent decrease in product prices to reflect these restrictions).

14. *Id.* at 699.

15. Assume, for instance, that a seller anticipates that litigation awards will amount to $100,000 in damages and that there will be 100,000 purchasers in the class. Assuming that a class action attorney received 30% of the award, each class member would receive an award of seventy cents. Assume further that the seller could reduce damages to zero if all purchasers agreed to a binding clause not to litigate. A rational purchaser would be willing to sign such a clause for a price reduction of more than seventy cents and a rational seller would offer up to a one dollar price reduction to obtain consent to such a clause.

16. *See* Bowers v. Baystate Techs., Inc., 320 F.3d 1317, 1325 (Fed. Cir. 2003) (stating that a proscription "'on all copying whatsoever would stifle the free flow of ideas without serving any legitimate interest of the copyright holder'" (quoting Atari Games Corp. v. Nintendo of Am., Inc., 975 F.2d 832, 843 (Fed. Cir. 1992))).

buyer's ability to obtain the license at a price lower than what would be available under alternative contractual regimes.[17]

Notwithstanding my doubts about the scope of the problem, I assume for purposes of this Essay that market correctives are insufficient to constrain sellers' tendencies to exploit buyers. I make that assumption for purposes of a thought experiment about the form of legal intervention that would then be appropriate. As market discipline breaks down, the case for some form of legal intervention becomes stronger.[18] But what form should that intervention take? The natural instinct of reformers to inject courts into the fray bears its own risks of inconsistency and limited institutional competence to weigh the competing interests of buyers as a class, disappointed buyers as litigants, and sellers.[19] Reliance on judicial redress for cases of true exploitation may also be of limited use because the amounts at issue in any case may be too insubstantial to warrant the litigation costs, so courts may never have an opportunity to review the offensive term.[20] Where litigation has occurred, courts have responded with mixed results. The rolling contracts and "boxtop" cases famously consider sellers' ability to propose additional enforceable terms at the time of delivery. These decisions implicitly either reject[21] or endorse[22] a view that market correctives will be sufficient to prevent exploitation of buyers who disregard terms presented at the moment of receiving desired goods. Arbitration clauses that appear on confirmation forms, on

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17. *See, e.g.*, Ariz. Cartridge Remanufacturers Ass'n v. Lexmark Int'l, Inc., 421 F.3d 981, 983 (9th Cir. 2005) (describing Lexmark's program which "gives purchasers an upfront discount in exchange for their agreement to . . . a form of post-sale restriction on reuse"); J.T. Westermeier, *Open Source Software*, *in* PLI'S TENTH ANNUAL INSTITUTE FOR INTELLECTUAL PROPERTY LAW 425, 427–40 (2004) (explaining the philosophy behind open source and arguing that open source software promotes increased reliability and quality).

18. *See* HUGH COLLINS, REGULATING CONTRACTS 279–86 (1999) ("Although we cannot determine clear tests for when market failures are sufficiently serious to justify regulation, it is plain that such regulation can contribute to the reduction of imperfections in markets that provoke unfair contracts.").

19. *See* Hillman & Rachlinski, *supra* note 1, at 440–41 (noting the difficulty courts have balancing the interests of consumers and businesses).

20. *See* COLLINS, *supra* note 18, at 284 (suggesting that "the consumer is much more likely to put up with the deception and merely use the non-legal sanction of selecting another brand next time" because of the "costs of . . . legal action").

21. *See* Specht v. Netscape Commc'ns Corp., 306 F.3d 17, 25 (2d Cir. 2002) (invalidating the arbitration clause in the contract because the lack of notice and unambiguous assent undermine the integrity and credibility of electronic bargaining).

22. *See* ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1453 (7th Cir. 1996) ("Competition among vendors . . . is how consumers are protected in a market economy."); *see also* Hill v. Gateway 2000, Inc., 105 F.3d 1147, 1150 (7th Cir. 1997) ("Consumers browsing the aisles of a store can look at the box, and if they are unwilling to deal with the prospect of additional terms can leave the box alone . . . .").

sellers' websites, or in browsewrap or shrinkwrap similarly have received a wide array of judicial reactions,[23] and efforts to invalidate such clauses are likely to increase after a recent decision by the California Supreme Court declared unconscionable at least some waivers of class action arbitration in credit card agreements.[24] A Washington appellate court recently invalidated a forum selection clause establishing jurisdiction in Virginia for all claims against America Online, Inc.,[25] thereby agreeing with a California appellate court[26] and disagreeing with a Maryland federal court on the same issue.[27]

The resulting uncertainty of such claims does not appear to be in danger of being resolved any time soon. The changing technology that makes these contracts possible suggests that contract terms, which are inherently part of what the buyer is purchasing, will similarly shift as technologies will affect both plausible and optimal risk allocations.[28] Of course, one could subject each questionable term to judicial consideration under the opaque standards of "unconscionability" or similar substantive and procedural safeguards. Ideally, such an evolutionary process would ultimately generate fairly precise

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23. *See, e.g.*, Westendorf v. Gateway 2000, Inc., No. 16913, 2000 Del. Ch. LEXIS 54, at *2–3 (Del. Ch. Mar. 16, 2000) (upholding an arbitration clause found in documents delivered with the product); Stenzel v. Dell, Inc., 2005 ME 37, ¶ 1, 870 A.2d 133, 137 (rejecting appellant's arguments that an arbitration clause was illusory and unconscionable); *In re* RealNetworks, Inc., No. 00 C 1366, 2000 WL 631341, at *5–7 (N.D. Ill. May 11, 2000) (rejecting argument that an arbitration clause is unconscionable and therefore unenforceable). For cases invalidating arbitration clauses, see, for example, *Specht*, 306 F.3d at 20 ("[P]laintiffs' bare act of downloading the software did not unambiguously manifest assent to the arbitration provision contained in the license terms."); Comb v. PayPal, Inc., 218 F. Supp. 2d 1165, 1177 (N.D. Cal. 2002) (holding that the arbitration clause is substantively unconscionable); Defontes v. Dell Computers Corp., No. PC 03-2636, 2004 WL 253560, at *7 (R.I. Super. Ct. Jan. 29, 2004) (holding insufficient notice bars enforcement of arbitration clause).

24. *See* Discover Bank v. Superior Court, 113 P.3d 1100, 1110 (Cal. 2005) (holding that certain situations allow class action consumers to circumvent arbitration agreements).

25. Dix v. ICT Group, Inc., 106 P.3d 841, 843–45 (Wash. Ct. App. 2005).

26. *See* Am. Online, Inc. v. Superior Court, 108 Cal. Rptr. 2d 699, 701–02 (Ct. App. 2001) (holding the America Online forum selection clause invalid).

27. Koch v. Am. Online, Inc., 139 F. Supp. 2d 690, 695–96 (D. Md. 2000) (validating the forum selection clause). Florida courts are divided on the issue. *Compare* Am. Online, Inc. v. Pasieka, 870 So. 2d 170, 170, 172 (Fla. Dist. Ct. App. 2004) (finding that "the purpose and effectiveness of the [Florida Deceptive and Unfair Trade Practices Act] would be seriously undermined if the claims . . . were required to be brought in Virginia"), *with* Am. Online, Inc. v. Booker, 781 So. 2d 423, 424–25 (Fla. Dist. Ct. App. 2001) (declaring the forum selection clause both valid and enforceable).

28. *See* Hillman & Rachlinski, *supra* note 1, at 476 (implying a tendency for technological change to affect standard contract terms as well as efficient risk allocations).

rules about the conditions under which particular clauses were appropriate. But, given the limited resources available to courts to reverse engineer the contracting process,[29] there is little reason to believe that judicial decisions will reflect a coherent analysis of the conditions that distinguish exploitation from efficient risk allocation.[30] Courts are not likely to provide an appropriate forum, for instance, in which to determine whether a good bundled with an arbitration term is less expensive than a good bundled with a litigation term, or whether any price differential is explained by the seller's lower litigation risk.[31] Moreover, the limits of judicial investigatory authority are likely to have systemic effects. Confronted with a clause that in isolation appears to be one-sided and unable to decipher how that clause fits into the contract as a whole, judicial processes are likely to focus on the injuries suffered by a particular consumer and identify apparent unfairness with exploitation.[32]

In this Essay, while I assume that consumer exploitation is a sufficient problem to warrant some form of legal redress, the difficulties raised by judicial investigation lead me to consider an alternative forum. Primarily, I consider Arthur Leff's suggestion, which was proposed thirty-five years ago, to introduce a regulatory role into the process of contracting for mass-market goods.[33] While Leff appeared to be speaking largely of statutory regulation enforced and expanded by common-law courts,[34] others have implied that the appropriate forum for intervention may be administrative.[35] Leff's insight was motivated by a perception

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29. *See* Gillette, *supra* note 4, at 712–15 (acknowledging that courts may not have the tools necessary to identify whether contract terms reflect buyer interests).

30. *See* COLLINS, *supra* note 18, at 272 (indicating the susceptibility of judicial decisions to criticism for failing to sufficiently inquire into the efficiency considerations of a particular contract).

31. *See* K. N. Llewellyn, Book Review, 52 HARV. L. REV. 700, 704 (1939) (expressing concern about judicial capacity to consider the propriety of clauses in standard-form contracts).

32. Professor Collins, certainly no foe of regulating contracts, refers to the likelihood that "courts may succumb to the illusion of unfairness." COLLINS, *supra* note 18, at 273.

33. *See generally* Arthur Allen Leff, *Contract as Thing*, 19 AM. U. L. REV. 131 (1970) (asserting that the government should intervene to control the quality of contracts).

34. *See id.* at 149–52 (arguing that contracts should be seen as things or a "'part of' the goods being sold," which brings in additional regulation by statute and common law).

35. *See, e.g.*, LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 217 & n.146 (2002) (discussing the possibility of an agency that regulates the writing of standard-form contracts); Larry Bates, *Administrative Regulation of Terms in Form Contracts: A Comparative Analysis of Consumer Protection*, 16 EMORY INT'L L. REV. 1, 9 (2002) ("A control system that provides for administrative regulation of form contracts is the most effective means by which to protect consumers against unfair terms in form contracts."). *But see* James R. Maxeiner, *Standard-Terms Contracting in the Global Electronic Age: European Alternatives*, 28 YALE J. INT'L L. 109, 157 (2003) (discussing

that mass-market contracts were the functional equivalent of mass-produced products.[36] Regulation of products may be warranted where their defects are easily known to expert regulators but not to occasional buyers. In that context, expert regulators can cure informational asymmetries either by mandating disclosure or by dictating product design in ways that presumably replicate the bargain that would be struck by an informed consumer. If consumer contracts suffer from similar asymmetries and sellers can similarly exploit uninformed consumers through inefficient risk allocations, why not impose a similar solution through regulation of contract terms?

Leff was not writing as a fanatical advocate of regulation.[37] He recognized that regulation poses its own risks, including the risk that regulation could reduce choices for low-income consumers by excluding from the market affordable low-quality goods that some might prefer to unaffordable high-quality goods.[38] But Leff was writing during a period that preceded much of the analysis of agency responses to vested interests and of the practical consequences of immunizing regulated entities that comply with administratively promulgated standards. Our current understanding of the administrative system may further inform any debate about whether standard-form contracts in consumer transactions should be promulgated by a centralized agency that purports to represent all parties.[39] The suggestion I entertain, therefore, is a bit less radical than delegating to administrative agencies the role of drafting consumer contracts. My more moderate task is to consider a procedure by which sellers (or buyers for that matter) could propose contracts to an administrative agency that would presumably be positioned to evaluate the propriety of the contracts' terms. I assume that the agency would be modeled on (or folded into) an agency such as the Federal Trade Commission or the Consumer Product Safety Commission. That is, I assume a federal entity with a staff, comprising both lawyers and economists, that can make

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Germany's decision to implement "institutional action" instead of adopting an "administrative oversight" program to approve new standard contract terms). Ronald Mann suggests administrative invalidation of certain terms in credit card contracts combined with promulgation of standardized forms, either by the credit card industry or administratively. *See* Mann, *supra* note 3 (manuscript at 16–28) (exploring possible methods of regulating credit card agreements and explaining how standardized terms would improve consumer understanding of such agreements).

36. Leff, *supra* note 33, at 148 (noting the similarity between mass-produced products and mass-produced contracts).

37. *See id.* at 156 (recognizing the potential downside of regulatory control).

38. *Id.* at 155–56.

39. *See, e.g.*, KAPLOW & SHAVELL, *supra* note 35, at 217 & n.146.

independent investigations, hold hearings, and obtain comments from interested parties prior to issuing final decisions to approve or disapprove a proffered contract. Contracts that were administratively approved would qualify for safe harbor treatment—clauses contained therein would not be assailable in court on the grounds of unconscionability or other forms of overreaching.[40]

The proposal for an approval process is not unique. The Israeli Standard Contracts Law of 1982 explicitly allows sellers to submit a standard-form contract for approval from a Standard Contract Tribunal.[41] Approval constitutes certification that the contract does not contain any terms that are unduly disadvantageous to consumer buyers.[42] The law also permits government actors to seek tribunal invalidation of allegedly oppressive terms that have been included in contracts,[43] though that procedure is of less concern for present purposes. Sellers whose contracts have been approved may so indicate on their contracts.[44] Hence, obtaining tribunal approval signals high contract quality.[45] Additionally, approved contracts are immune

40. On regulatory schemes that create safe harbors in order to avoid risks of liability, see Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349 (1993).

41. Standard Contracts Law, 5743–1982, 37 LSI 6 (1982) (Isr.); *see* Sinai Deutch, *Controlling Standard Contracts—The Israeli Version*, 30 MCGILL L.J. 458, 473, 475 (1985) (indicating the broad power of the Israeli Tribunal to approve or reject standard contract terms and noting that the original Israeli Standard Contracts Law of 1964 had been unsuccessful and was substantially amended in 1982); Shmuel I. Becher, Going Beyond the Traditional Approaches to Standard Form Contracts: The "Good Housekeeping Law" 11–12 (Mar. 2005) (unpublished manuscript, on file with author) (noting that Israeli law allows traders to get their contract terms pre-approved); *see also* Gerald M. Adler, Case, *Restrictive Covenants and the Standard Contracts Law*, 5 ISR. L. REV. 580 (1970) (considering the application of the Israeli Standard Contracts Law of 1964 to restrictive covenants); Kenneth Frederick Berg, *The Israeli Standard Contracts Law 1964: Judicial Controls of Standard Form Contracts*, 28 INT'L & COMP. L.Q. 560, 561 (1979) (describing the creative combination of judicial and administrative controls in the Israeli Standard Contracts Law of 1964); Comment, *Administrative Regulation of Adhesion Contracts in Israel*, 66 COLUM. L. REV. 1340, 1340 & n.4 (1966) (discussing how Israel enacted the 1964 statute to "cope with the burgeoning problem of standard form contracts"). This section of this Essay relies on accounts of the Israeli law in Shmuel I. Becher, *supra*, and Sinai Deutch, *supra*.

42. Becher, *supra* note 41, at 11 (stating that "the main purpose of the statute is to protect consumers from 'unduly disadvantageous' contract terms").

43. *Id.* at 12 (describing how "the Attorney-General, the Commissioner of Consumer Protection and other consumers' organizations [can] apply to the tribunal for annulment" of unfair terms).

44. *Id.*

45. *Id.* at 5 (noting its similarity to a "'Good Housekeeping Seal of Approval'"); *see also* Clayton P. Gillette, *Reputation and Intermediaries in Electronic Commerce*, 62 LA. L. REV. 1165, 1169 (2002) ("Even in transactions among strangers, reputational information theoretically can indicate the likelihood of satisfactory performance.").

from judicial invalidation for a period of up to five years, depending on the length of approval.[46] The decision to approve a contract, however, is judicially reviewable on request of either the attorney general or consumer groups.[47]

Apparently, few sellers take advantage of the Israeli approval option.[48] A predecessor law, enacted in 1964, generated only around sixty submissions.[49] The 1982 revisions were intended to increase incentives for submissions but apparently produced little success.[50] The reasons for the limited success, however, are not clear and may not be transferable to the United States.[51]

The European Union's Directive on Unfair Terms in Consumer Contracts ("Directive")[52] similarly bears some of the features of a pre-approval system. The Directive requires member states, as a matter of national law, to declare unenforceable any unfair terms used in a contract concluded between a consumer and a buyer or seller.[53] An "unfair term" under the Directive is one that "causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer."[54] While the Directive does not create a system to evaluate individual contracts prior to their use in consumer markets, it does contain an Annex that contains a "non-exhaustive list of the terms which may be regarded as unfair."[55] As a result, the Directive has the effect of denying in advance approval of any contract containing one or more of the

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46. Deutch, *supra* note 41, at 475.

47. *Id.* at 476.

48. Becher, *supra* note 41, at 13 & n.46 (describing the activity of the tribunal as "limited").

49. Deutch, *supra* note 41, at 474 (noting that this sparsely used law existed for eighteen years).

50. *See* Becher, *supra* note 41, app. B at 62 (stating that the new law did not meet expectations).

51. For instance, Becher suggests that more limited competition in Israel could conceivably reduce the role of reputation. *Id.* at 64. Because approval is largely a signal of high reputation, American companies might be expected to more readily take advantage of the opportunity to transmit such a signal.

52. *See* Council Directive 93/13, 1993 O.J. (L 95) 29 (EC), *available at* http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:31993L0013:EN:HTML (setting forth model regulations, laws, and provisions for the governing bodies of the European Union's member states to utilize in crafting laws pertinent to consumer contracts). The best analysis of the Directive and discussion of its applications in the European Union can be found in Maxeiner, *supra* note 35, at 131–41. Maxeiner reports that subsequent proposals to add more administrative mechanisms to the Directive, including a possible pre-approval system, were rejected as "extremely bureaucratic." *Id.* at 140.

53. *See* Council Directive 93/13, *supra* note 52, art. 6, § 1, at 31.

54. *Id.* art. 3, § 1, at 31.

55. *Id.*; *see id.* annex at 33 (listing seventeen unfair terms).

prohibited terms. By defining an unfair term as requiring the creation of a "significant imbalance," the Directive might be construed to mandate evaluation of the contract as a whole rather than analysis of a particular term in isolation. Nevertheless, as implemented, the Directive appears to invalidate the listed terms, regardless of the context in which they are employed. The United Kingdom, for instance, has implemented the European Union Directive through issuance of a series of regulations by the Office of Fair Trading (OFT).[56] The regulations provide that a consumer is not bound by an unfair nonprice term in a standard-form contract.[57] Both individual consumers and the OFT are empowered to enforce the regulations.[58] For current purposes, however, the most relevant aspect involves the delineation, in a schedule attached to the regulations, of terms that the OFT considers unfair.[59] As in the Directive, these terms essentially provide a nonexhaustive litany of predisapproved terms, and thus provide a limited pre-approval process. But, again, disapproval applies regardless of context and regardless of offsetting gains that consumers might receive from accepting the risks implicit in the rejected terms.

In theory, the pre-approval option appears attractive from the perspective of both buyers and sellers. For sellers, it provides legal certainty about the effects of their terms and reduces the risk of litigation, judicial inconsistency in the evaluation of contract terms, and the invalidation of contract terms without a commensurate reduction in the price of the underlying good. Sellers might, for instance, submit an entire contract to the agency and request a determination whether the document, on balance, and perhaps taking into account the suggested price of the good to be sold, can be administratively approved. Alternatively, a seller might submit a particular term that it fears would be judicially rejected under any circumstances, such as a clause that provides the seller unilateral authority to change interest rates or payment terms, and seek a determination of

56. *See* The Unfair Terms in Consumer Contracts Regulations, 1999, S.I. 2083 (U.K.), *available at* http://www.opsi.gov.uk/si/si1999/19992083.htm [hereinafter U.K. Unfair Terms].

57. *See id.* art. 6, ¶ 2 ("In so far as it is in plain intelligible language, the assessment of fairness of a term shall not relate . . . to the adequacy of the price . . . as against the goods or services supplied in exchange."); *id.* art. 8, ¶ 1 ("An unfair term in a contract concluded with a consumer by a seller or supplier shall not be binding on the consumer.").

58. OFFICE OF FAIR TRADING, UNFAIR STANDARD TERMS 4–5 (2005), *available at* http://www.oft.gov.uk/NR/rdonlyres/720A136C-9435-40C4-8549-7BDFCCF85B70/0/oft143.pdf.

59. U.K Unfair Terms, *supra* note 56, sched. 2.

whether the clause is permissible. One might anticipate that the agency's comparative advantage over courts lies in the ability to evaluate the overall propriety of the contract, perform econometric studies that reveal the pricing of risks, or survey consumer attitudes to determine their willingness to accept risks that the contract imposes on them. A review of agency websites reveals that the use of economic expertise to test the functioning of markets increasingly appears to form much of the bread and butter of agency activities in the field of consumer protection.[60]

From the buyer's perspective, administrative approval permits an objective third party to undertake a task that even a rational buyer would be unlikely to assume—finely tuned perusal of contract terms and evaluation of the relative risks associated with the good. Thus, administrative agencies might perform for the buyer the function of a faithful agent who can accurately represent the buyer's interests and reject terms that would not result from an informed bargaining process.

Nevertheless, I conclude that the administrative approval option is more problematic than this first glance indicates. Seller drafting of standard-form contracts is likely to generate terms that deviate from the ideal. But that does not mean administrative drafting or approval will induce contracts with optimal terms. It may instead mean that the resulting contract similarly deviates from the ideal, but does so in ways that differ from the results that occur when sellers draft contracts that are exposed only to *ex post* judicial review.

One might respond that such administrative deviation is appropriate because it at least provides opportunities for inputs from representatives of buyers who otherwise have no role in the drafting process. But that conclusion assumes both that buyer interests are not internalized by sellers and that the interests of all buyers are identical. If administrative approval serves the interests of injured buyers by invalidating a contractual term, but only by imposing on buyers, as a class, costs that they would not have been willing to pay had they known of the risk at the time of contracting, then it is by no means clear that administrative mandates to exclude the term serve the interests of buyers generally. This is true even if, *ex post*, injured buyers are happy to have the benefits of administrative intervention.

In the balance of this Essay I pursue these potential limitations of the pre-approval process. I suggest that the

60. See, for example, the studies performed by the Bureau of Economics within the Federal Trade Commission, which are available at http://ftc.gov/be/econrpt.htm.

political economy of administrative approval will likely affect the content of standard-form contracts and will do so in a manner that systematically skews contract terms away from what both informed buyers and sellers would negotiate. This does not necessarily mean that administrative approval will create "better" or "worse" contracts, whether the standard of evaluation is "efficiency," "fairness," or some other metric. It means only that administrative approval is not a panacea for any bargaining failures that result from the employment of standard-form contracts in mass markets. As a result, one cannot readily conclude that its limitations are less than those generated by unregulated markets.

Part II of this Essay begins, however, with some observations on the likelihood that the pre-approval process would be employed by sellers. Unless there can be some assurance that any such process would be more successful than the Israeli experience predicts, the risks that such a system presents may be irrelevant. Part III notes, however, that many of those risks apply with equal force to the more radical proposals that administrative agencies become more substantially involved in the drafting of consumer contracts.

II. A THEORY OF SAFE HARBORS

A. *Incentives for Creating Safe Harbors*

Administrative approval of contractual terms for one seller would presumably immunize all users of the terms from judicial evaluation and invalidation for use of the approved terms. Approval of terms, therefore, amounts to a safe harbor for all who sell goods of the same type as those offered by the seller that obtained the approval and who use the accepted terms. As a consequence, one would expect that once a seller obtains approval for a term, other sellers will employ identical or similar terms in order to receive the benefits of immunity.[61] Counterintuitively, this creation of a safe harbor may reduce use of the approval process, and perhaps explain some of its limited utilization to date.

The process of obtaining approval is likely to prove costly to the party obtaining it. Approval involves monetary costs of submission and defense of the proposed contract. In addition, a seller faces some risk of reputational damage if a submission is

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61. *See* Becher, *supra* note 41, at 20–21.

rejected by the administrative agency.[62] Because approved contracts of necessity become publicly available after administrative endorsement (publicity of their approval, after all, is their purpose) 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. This phenomenon could explain the reported low use of the pre-approval process in a small country like Israel, where the limited number of firms in any industry could affect free riding.[63]

It might be possible to avoid free riding, however, if a trade organization submitted a contract on behalf of its members. Indeed, this might make significant sense for at least some industries. If, as predicted, members of the industry would migrate to similar contracts once one member obtained pre-approval, then costs to the industry as a whole could be reduced if a centralized intermediary—a trade association—performed that function on behalf of all members. The result would be greater use of the process itself without significantly altering the substantive provisions of contracts.

But it is not entirely clear that centralized submissions would be appropriate in all industries. Contractual clauses may also be a basis for competition within a trade. Credit card contracts, for instance, often vary in such terms as interest rate, annual fee, late fees, and over limit fees.[64] One would expect, therefore, that while a trade association might seek pre-approval for a particular term that would benefit all members, such as an arbitration clause, only individual firms would submit relatively complete contracts.[65] Free riding might be reduced in this

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62. *Cf.* Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 354 (1996) (noting that failed contract terms "may weigh more heavily in . . . reputational payoff than a contract term that succeeds"); Becher, *supra* note 41, at 30 (gaining pre-approval of contractual terms results in increased reputation and market power).

63. *See supra* notes 48–51 and accompanying text.

64. *See* DAVID S. EVANS & RICHARD SCHMALENSEE, PAYING WITH PLASTIC 217–21 (2d ed. 2005) ("Card issuers compete with each other—and identify profit opportunities—by tailoring their cards to meet the preferences and demands of different groups of consumers.").

65. In the credit card context, Ronald Mann suggests that the credit card networks could draft standardized terms for their members and implies that some "non-price terms" could be subject to variation by individual issuers. *See* Mann, *supra* note 3 (manuscript at 28).

situation, but only if sellers are willing to limit their competition to the nonstandardized terms.

The extent to which this reduction in free riding occurs should depend significantly on the motivation that leads sellers to seek the safe harbor of administrative approval. Sellers will be attracted to the prospect of pre-approval in either of two situations. First, sellers would be likely to use the safe harbor if failure to do so created a risk of significant liability or reduced the likelihood of a significant benefit. If, for instance, sellers were subject to punitive damages for employing unconscionable clauses in their contracts and could avoid a finding of unconscionability by employing a pre-approved contract, they would be more likely to obtain and utilize a pre-approval process that eliminated the likelihood of significant liability. Because punitive damages are typically not awarded in contracts cases,[66] however, the risk of not using the pre-approval process may be too insubstantial to warrant the costs of obtaining pre-approval. In short, the difference between using and avoiding the safe harbor may be insufficient to warrant incurring the costs related to the latter. Safe harbors make sense where the alternative, to continue the metaphor, is to risk foundering on the shoals of liability. If, however, the alternative is only potential invalidation of a clause in an occasional contract case, incurring the costs related to procuring a safe harbor seems less attractive.

Nevertheless, in the absence of a contractual waiver, certain legal principles could expose sellers to significant liability or to adverse publicity. For instance, a class action brought on behalf of multiple consumers who claim economic harm as a consequence of some defect in the product or the contract could both generate significant liability and cause the seller broad reputational harm. Sellers, therefore, might desire to draft clauses that waive any right that a consumer would otherwise have to bring a class action. Sellers cannot easily bargain individually for these clauses and thus might prefer to include them in a standard-form contract. But if these clauses are invalidated, the seller could suffer additional liability and reputational damage.[67] Thus, sellers might wish to ensure that contract clauses purporting to waive class actions or to select sympathetic governing law are not themselves subject to attack. To the extent that sellers are unable to bargain for class action waivers, they may find a pre-approval process more attractive.

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66. *See* JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 14.3 (5th ed. 2003).

67. *See, e.g.*, Discover Bank v. Superior Court, 113 P.3d 1100, 1109–10 (Cal. 2005).

The second scenario that might encourage use of pre-approval exists where the process confers a competitive advantage not otherwise available. Assume that the seller who receives approval is permitted to advertise that fact through some form of legend such as—"This contract has been certified as appropriate for consumers by the Federal Trade Commission." Although nonsubmitting sellers may be able to mimic the language of the approved contract, they might not be able to employ the quality signal implicit in the governmental imprimatur. Some sellers may be indifferent to the marketing advantages that flow from such a legend. They may desire only to obtain the immunity from judicial invalidation that flows from approval. Others, however, may desire both the immunity and the marketing advantage that attaches to a contract denominated as governmentally approved. If they cannot obtain that feature without individual submission, free riding becomes less of an issue.

B. Safe Harbors as Rules

Regardless of the initial incentives for obtaining a safe harbor, sellers will find approved language useful only where it takes the form of a relatively precise rule.[68] Contractual language, albeit administratively approved, that is sufficiently ambiguous to require subsequent interpretation will not provide the seller with the immunity from judicial intervention that warrants incurring the costs of seeking pre-approval in the first place. For instance, an administrative mandate that approves, without further specification, contracts that provide a "reasonable remedy" for the buyer would offer little solace to the seller; courts would still have to determine whether a remedy proposed for a particular case satisfied the administratively approved criterion.[69] Thus, safe harbors make sense under circumstances in which something closer to a rule, rather than a standard, is appropriate.

A rule, in turn, makes sense when the conditions under which it will be applied are sufficiently uniform that one would anticipate that its application tends to generate a normatively appropriate result in each case. For instance, if the purpose of the rule is to allocate a risk of loss efficiently, and if sellers of the

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68. *See* Swire, *supra* note 40, at 369–70.

69. *See id.* (discussing how typically the "form of a safe harbor allows a regulated entity" to have both a "general, usually vague, standard that restricts activity by the regulated entity" and a "more specific[] rule[,] . . . which provides the 'safe harbor' by specifying activity that will be deemed to meet the general standard").

good *X* are systematically in a better position to avoid losses than buyers of the good during the period between contract formation and the seller's performance, it makes sense to have a rule that imposes the risk of loss during this period on sellers. If, on the other hand, sellers of *X* may or may not be in a superior position to avoid losses during this period, depending on a variety of other circumstances, then a rule that places the risk of loss on sellers is less justifiable, at least by reference to an efficiency criterion.

Where the conditions for application of a rule make sense, promulgation of a standard, rather than a rule, will simply generate additional costs without creating any offsetting gains. A well-meaning decisionmaker who applies a standard to recurring conditions would have to evaluate the propriety of an actor's conduct in each case by looking at a variety of circumstances but would ostensibly come to the same conclusion in the large majority of cases. Use of the standard in such a case would have two adverse effects. It would increase decisionmaking effort by requiring evaluation of the multiple variables relevant to application of the standard, even though the appropriate result of that application will be identical from case to case. Second, error costs (defined as deviation from the socially optimal outcome for the particular case) would increase, as even a well-meaning decisionmaker would occasionally misapply the standard, finding cases of propriety where none existed, or cases of impropriety where the actor had acted reasonably.[70] The application of a rule in these cases would reduce those costs, though rules might also produce error in that they withdraw discretion that might generate a superior result in a few particular cases.[71]

Where the underlying circumstances are relatively uniform, therefore, a rule conditioned on those circumstances would economize on decisionmaking effort without generating an offsetting increase in error costs. In these cases it would be worth incurring the *ex ante* specification costs necessary to promulgate a rule rather than the *ex post* specification costs associated with a standard. Of course, there would be some occasions in which the rule dictates a response inappropriate under the circumstances. In those cases, a decisionmaker who was authorized to consider a more robust set of variables would reach a result that varied

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70. *See, e.g.*, Frederick Schauer, *Rules and the Rule of Law*, 14 HARV. J.L. & PUB. POL'Y 645, 685–88 (1991) (describing how using rules occasionally produces incorrect decisions).

71. *See id.* If the case warranted the exercise of discretion in a significant number of cases in order to achieve a socially optimal outcome, then the case is likely not appropriate for a rule at all. But even where a rule is appropriate, there may be a few cases where unusual circumstances warrant a deviation from its dictates.

from the one dictated by the rule.[72] But where the circumstances that affect proper decisionmaking are relatively constant, the economizing effects of a rule would presumably compensate for the occasionally more accurate results of highly individualized decisionmaking.

Standards, of course, are appropriate where just the opposite conditions dominate. If the circumstances that affect proper decisionmaking are highly variable with the situation, *ex post* evaluation of appropriate conduct is superior to *ex ante* efforts to specify behavior.[73] Any such *ex ante* efforts will necessarily either create significant error or cause efforts at *ex ante* lawmaking that will be so detailed as to consume excessive effort. Legislative efforts to dictate appropriate driving speeds for all road conditions would likely produce a long and unwieldy set of provisions, inferior to an admonition, enforced *ex post*, to drive "reasonably" under the circumstances.

Effective rules, moreover, require uniformity across more than space. Once rules are put into place, they may become difficult to alter or reverse, even if the underlying conditions that generated their initial promulgation have changed sufficiently to warrant a different rule.[74] A rule that made sense to constrain actors who faced little competition, for instance, may simply impose superfluous or harmful constraints if competition evolves.[75] A speed limit that seemed appropriate when gasoline was plentiful and inexpensive might be inappropriate during times when gasoline conservation is primary. Thus, standards may be preferable to rules, even where the latter would minimize decisionmaking costs and error costs at the time of formulation, if one anticipated significant change in the factors affecting a proper decision during the period when the rule is in force.

Initially, one might question whether the need for intertemporal uniformity is necessary to justify the application of a rule. After all, if conditions change over time, then it is entirely plausible that the decisionmaker could simply announce a new

72. *See* Edward A. Morse, *Reflections on the Rule of Law and "Clear Reflections of Income": What Constrains Discretion?*, 8 CORNELL J.L. & PUB. POL'Y 445, 454–63 (1999) (emphasizing the importance of flexibility in rulemaking in order to avoid unjust results).

73. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 562–63 (1992) (providing an example of this contrast from the hazardous waste disposal industry).

74. *See, e.g.*, Clayton P. Gillette, *Lock-In Effects in Law and Norms*, 78 B.U. L. REV. 813, 822 (1998) (explaining how common law can become stuck in outdated doctrine).

75. *Cf.* Samuel Noah Weinstein, *Bundles of Trouble: The Possibilities for a New Separate-Product Test in Technology Tying Cases*, 90 CAL. L. REV. 903, 915–17 (2002) (arguing for "governmental noninvolvement in technologically dynamic markets" where natural market forces tend to correct anticompetitive behavior).

rule that is appropriate to the new circumstances. This would certainly appear to be the case where the decisionmaker is a legislature or an administrative agency that has the jurisdiction to initiate rule changes without having a dispute brought before it.

Legal rules, however, are vulnerable to forces that favor the status quo.[76] These forces may emerge from either relatively malign or benign sources, but their stultifying effect is the same. The promulgation of a rule creates a set of entitlements that beneficiaries will desire to maintain.[77] Thus, they will resist changes that could alter their favored position. More benignly, an existing rule may encourage investments that increase switching costs, thereby offsetting the benefits that would be created by a rule better suited to changed conditions. For instance, any rule will involve some ambiguity, and the existing rule may already have been subjected to interpretations that clarify its meaning and allow uniform practices to develop.[78] As behavioral patterns under the existing rule become entrenched and conventional, it is in no one's interest to comply with an alternative strategy, even though the latter would have been selected had no rule existed. Here we are in the realm of "lock-in"[79]—in a world of network externalities of the type that legal principles inherently entail.[80]

There are, of course, mechanisms for breaking out of lock-in, even where network externalities are significant. We have, for instance, migrated from MS-DOS as an operating system, even though file sharing among multiple computers occurs with a frequency that one might think could frustrate such evolution.[81]

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76. Of course, markets are similarly vulnerable to inertia. *See* Gillette, *supra* note 74, at 816–22 (comparing regulated and unregulated markets achieving equilibrium). Ultimately, it would be interesting to investigate the relative flexibility of markets and legal rules.

77. *See* Adam J. Hirsch, *Evolutionary Theories of Common Law Efficiency: Reasons for (Cognitive) Skepticism*, 32 FLA. ST. U. L. REV. 425, 430 (2005) (suggesting that those "who benefit from an existing rule may be led . . . to overinvest in defending the status quo").

78. *See* Gillette, *supra* note 74, at 819 (explaining how ambiguities in contract terms may be resolved by consistent court interpretation of terms).

79. *See id.* at 813 (characterizing institutions as "locked-in" when they "become too routinized or excessively limit the realm of possible choice" and consequently become "unable to adapt to changes in the underlying conditions they seek to organize or accommodate").

80. *See id.* at 817 (analogizing the potential for lock-in in legal principles with problematic resistance to change in technological markets); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 729, 734–35 (1997) (explaining how externalities can result in suboptimal contract terms); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 772–75, 837–38 (1995).

81. See Gillette, *supra* note 74, at 819, for additional examples.

My claim, therefore, is not that lock-in is inevitable. Rather, my claim is that the possibility of inefficient lock-in should make us wary of employing a rule where the conditions on which it is based are susceptible to change across time.

C. Approved Contracts and the Theory of Safe Harbors

Assuming that administrative pre-approval of contracts could create a safe harbor, to what extent are the contract terms that are likely to be submitted consistent with the conditions for rules that I have discussed above? Will contract terms be applied under circumstances that are sufficiently precise to induce sellers to submit contracts for pre-approval? And if they are, are the conditions of administrative approval or disapproval sufficiently flexible to avoid lock-in effects when the conditions of contracting change?

I have suggested that safe harbors make sense when they take the form of relatively precise rules. By this metric, the terms that have become controversial in standard-form contracts suggest a mixed response. Some of these clauses are quite precise. Think, for instance, of a forum selection clause that requires claims against the seller to be brought in a particular jurisdiction. On its face, such a clause leaves little room for interpretation. In addition, because the forum selected is likely to be a jurisdiction where the seller is located or that has law with which the seller is familiar and that the seller finds hospitable to its interests, there is a low likelihood that the seller would want to alter the selected jurisdiction frequently. Thus, one might conclude that sellers would enjoy sufficient benefits from obtaining pre-approval of a forum selection clause to justify incurring the related costs.

Whether that is the case, however, may depend on the variance in potential damages among customers who enter into the contract. For instance, the Washington court that invalidated the America Online standard clause selecting Virginia as the forum for all disputes relied in part on the fact that damages suffered by individuals would tend to be less than $250.[82] As a result, the court suggested that requiring travel to Virginia would effectively eliminate the right of Washington residents to bring claims.[83] If the great majority of buyers faced the same incentive structure to litigate, a global administrative decision

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82. Dix v. ICT Group, 106 P.3d 841, 844 (Wash. Ct. App. 2005).

83. *See id.* at 844–45 (noting that the low level of damages and the unavailability of class action suits in Virginia effectively deters consumers from litigating).

about the validity of such a clause may be appropriate. One could imagine, however, cases in which buyers vary widely in the damages they face, and thus have very different incentives to engage in distant litigation. For instance, an online seller of computers could use the same clause when selling to firms, sole proprietors, and consumers. A flat rule concerning the validity of a forum selection clause in that context would be more suspect, because it would be less clear that all buyers would, if informed and able to bargain, have the same reaction to the proposed term. Of course, even if an agency were faced with a set of buyers who were similarly situated with respect to the potential adverse effects of the proposed clause, the agency would not necessarily approve the proposal. Instead, the agency would presumably want to investigate whether any ostensibly pro-seller effects were offset either by pro-buyer terms elsewhere in the contract or by a pricing scheme that reflected the risks taken by buyers. That, after all, is the alleged comparative advantage offered by administrative intervention.

Even if the term were considered acceptable to buyers, the presence of a very precise clause could raise other issues that are susceptible to litigation. Lack of uniformity in application could diminish the desirability of seeking pre-approval for the initial clause because it would not have the immunizing effect that sellers desire. Assume, for instance, that a contract contains a choice-of-law clause that specifies which law should be used to resolve disputes, but the named state does not permit class actions in the type of case that the consumer desires to bring against the seller. Assume further that the disputes that the product at issue is likely to generate involve damages that are insufficient to warrant individual litigation, but that are substantial enough in the aggregate to justify class action litigation. In such a situation, the law of some states might require invalidation of the clause as one that offends the public policy of the state by effectively denying redress to an injured party.[84] If litigation were brought in such a state, its courts might refuse to apply the law selected by the parties. It is by no means clear that the federal agency's validation of the choice of law clause means that a foreign court would be required to apply all aspects of the selected jurisdiction's law. The agency's approval might imply that the agency found choice-of-law clauses acceptable but was not passing judgment on the propriety of

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84. That, in essence, was the basis for the court's holding in *Discover Bank v. Superior Court*, 113 P.3d 1100, 1110 (Cal. 2005), that waiver of class arbitration may be unconscionable under certain circumstances.

every aspect of the selected law. If so, a buyer might still challenge such a clause where it allegedly required a court to apply law that offends the public policy of the forum state. The resulting uncertainty about that outcome could be sufficient to reduce the benefits of obtaining pre-approval.

Other controversial terms appear even less susceptible to the conditions of safe harbors. For instance, consider the debate over rolling contracts. While much of the debate about "pay now, terms later" focuses on the minutiae of contract formation,[85] the underlying issue reflects different conceptions of the salience of terms presented at different times of the transaction. But those conceptions rely heavily on context. The implications of a presentation of post-delivery terms may vary significantly depending on whether the buyer is a consumer opening a gift on Christmas morning or a vendor of a multi-user system purchasing standard software.[86] A rule that either approves or disapproves the incorporation of postdelivery terms into contracts on a wholesale basis ignores that context. On the other hand, a "rule" that attempts to specify the factors that might render such a term acceptable or unacceptably onerous ultimately degrades the utility of the "rule" because subsequent litigation will be necessary to determine how the factors cut in a particular case.

The threat of lock-in where intertemporal uniformity does not exist presents a more complex issue. Initially, it might appear that approval of contracts in electronic commerce would pose a significant threat of unfortunate lock-in. The developing nature of the area suggests that useful forms of contracting continue to evolve,[87] so the possibility that changes in technology could lead to novel contracting patterns seems relatively high.

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85. *See, e.g.*, Klocek v. Gateway, Inc., 104 F. Supp. 2d 1332, 1336–41 (D. Kan. 2000) (analyzing a mandatory arbitration clause according to basic contract rules such as offer and acceptance). *See generally* James J. White, *Autistic Contracts*, 45 WAYNE L. REV. 1693, 1710–13 (2000) (applying traditional contract principles to software licenses); Batya Goodman, Note, *Honey, I Shrink-Wrapped the Consumer: The Shrink-Wrap Agreement as an Adhesion Contract*, 21 CARDOZO L. REV. 319 (1999) (proposing that adhesion contract principles should apply to the shrinkwrap agreements commonly found in off-the-shelf software, which "allow computer software publishers to impose standard terms and conditions . . . on a purely 'take-it-or-leave-it' basis").

86. *See* Step-Saver Data Sys., Inc. v. Wyse Tech., 939 F.2d 91, 100 (3d Cir. 1991) (distinguishing the facts of this box-top license dispute from a similar dispute in *Bethlehem Steel Corp. v. Litton Industries, Inc.*, 488 A.2d 581 (Pa. 1985), because *Bethlehem Steel* involved "'gaping holes in a multi-million dollar contract that no one but the parties themselves could fill'").

87. *See, e.g.*, Melissa Robertson, *Is Assent Still a Prerequisite for Contract Formation in Today's E-conomy?*, 78 WASH. L. REV. 265, 268–75 (2003) ("Contract law has evolved over the years to accommodate modern business practices.").

Thus, one might realistically be concerned about the capacity of contracting parties to adjust governmentally approved terms even though doing so was warranted by new conditions. Any well-accepted contractual form will tend to generate some degree of lock-in because widespread use permits the development of settled meanings and norms within the community of contracting parties.[88] Once the contractual term is employed, it will generate the benefits associated with widespread contracts—boilerplate—generally. Courts will interpret the meaning of the clause, potentially reducing ambiguity about its meaning (as opposed to its enforceability). Parties to contracts will develop a set of practices around the clause, and those practices may become widely known as consistent with the clause. Those who fail to use the term will be seen as outliers and will send implicit signals of uncertain meaning, including the plausible signal that they are too idiosyncratic to be desirable trading partners.[89] Once a seller has received approval to use a particular clause, thus immunizing the seller from invalidation, there will be significant incentives to incorporate the clause in similar contracts given that any alternative remains open to judicial challenge. For instance, even if there is disagreement within the community of programmers about the propriety of a clause prohibiting "reverse engineering,"[90] programmers may have a common understanding of the prohibition's scope. Sellers who might find an alternative scope of the restriction— perhaps even a narrower one—more attractive may fail to employ it simply because doing so could raise costly issues of interpretation that use of the existing form makes unnecessary.

Market mechanisms are, of course, susceptible to similar pressures. Nevertheless, contract terms that evolve through a series of market transactions may be less apt to suffer these effects because it is more difficult for a single term to attain the salience necessary for potential contracting parties to coordinate. The approval process generates salience because the approved contract would be readily available to potential users, while the government's imprimatur would provide both legitimacy and a signal that the contract was one that was appropriate for use. Thus, we should anticipate that parties would coordinate by using the approved form or term. But once that coordination

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88. *See supra* notes 79–80 and accompanying text (discussing lock-in).

89. *See* Gillette, *supra* note 45, at 1167 (commenting on the importance of reputation in determining desirability as a trading partner).

90. *See generally* Pamela Samuelson & Suzanne Scotchmer, *The Law and Economics of Reverse Engineering*, 111 YALE L.J. 1575 (2002).

occurs, it is difficult to generate enthusiasm for moving to an alternative that does not enjoy the same benefits as the existing form.

This effect is likely to increase with the benefits of the status quo. To the extent those benefits include immunity from subsequent judicial invalidation, alternatives should be highly disfavored. Use of any alternative creates a risk of costly litigation that could lead to the kinds of mixed decisions seen in the cases of arbitration clauses,[91] forum selection clauses,[92] and rolling contracts clauses,[93] and at worst, from the seller's perspective, to invalidation of clauses that were either priced or accompanied by pro-buyer terms without adjustment of other contractual obligations. The result is that sellers will fail to utilize more efficient terms that are not found in the approved contract.

Assume for the moment, for instance, that the process of rolling contracts really does reflect an appropriate business pattern in an age of electronic commerce, especially when the contract terms could otherwise only be presented in a manner that discourages contracting (for example, through telephonic recitation) and further, that the goods are returnable for a significant period after delivery.[94] It is not unreasonable to consider whether such a contracting practice would have developed if a previously approved method of selling the same goods had existed and use of that method precluded the litigation costs entailed by the more efficient practice. The approved contract, in effect, becomes the information booth in Grand

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91. *Compare* Specht v. Netscape Commc'ns Corp., 306 F.3d 17, 20 (2d Cir. 2002) (refusing to enforce an arbitration clause included in terms listed "below the download button" on the defendant's webpage because "a reasonably prudent Internet user . . . would not have known or learned of the existence of the license terms before" downloading), *with* Hill v. Gateway 2000, Inc., 105 F.3d 1147, 1148–49 (7th Cir. 1997) (enforcing an arbitration agreement included inside a computer shipment because the plaintiffs had an opportunity to read the clause and return the computer), *and* Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569, 575 (App. Div. 1998) (holding that a clause requiring arbitration of claims was enforceable, yet a forum selection clause requiring such arbitration to occur before the International Chamber of Commerce was not enforceable).

92. *Compare* Koch v. Am. Online, Inc., 139 F. Supp. 2d 690, 695 (D. Md. 2000) (noting that a "forum selection clause is mandatory and should, therefore, be enforced unless unreasonable"), *with* Am. Online Inc. v. Superior Court, 108 Cal. Rptr. 2d 699, 702 (Ct. App. 2001) (refusing to enforce a forum selection clause as contrary to California law).

93. *Compare* ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1449–50 (7th Cir. 1996) (holding an enclosed license agreement enforceable where a vendor included notice of the license on the box), *with Specht*, 306 F.3d at 20 (refusing to enforce an arbitration agreement because the terms were not readily available before downloading software).

94. *See* Gillette, *supra* note 4, at 687–88 (contrasting Internet rolling contracts with telephone sales).

Central Station that serves as the quintessential, if apocryphal, coordination point.[95]

Nevertheless, I am reluctant to place too much weight on the risk of contractual lock-in as a consequence of administrative approval because switching costs from one pre-approved term to another may also be low under such a regime. The fact that one contract has been approved does not preclude other sellers from submitting alternative forms. If those forms are also approved, then the same immunity benefits and governmental imprimatur attach to them as to the earlier-approved forms. Thus, if the subsequent form provides more efficient risk allocations, other sellers could adopt it without fear of incurring liability. The agency's signal of quality control could reduce the claims of idiosyncrasy or stubbornness and thus dilute any incentives to stick with an existing contractual form simply because it represented the current industry standard. The switch is, of course, not costless. The proposer of the new form will incur the direct costs related to the submission and will bear some risk, including reputational risk, if the proposed form is not approved. Potential users will still incur some learning costs related to the scope and meaning of the new form and will lose the experiential benefits related to the existing form. But if the primary motive for submitting or using a proposed form is to avoid the legal uncertainty that exists under the current system, a subsequently approved contract offers the same benefits as the originally approved contract.

III. INSTITUTIONAL ISSUES: COMPETENCE AND CAPTURE

A. The Capacity to Calculate

I have assumed to this point that a pre-approval process could take advantage of administrative expertise both to correct informational failures in markets and to improve on the institutional inability of courts to discern tradeoffs within contracts and evaluate fair pricing. Under these circumstances, I have suggested that the limitations on safe harbor rules pose a significant, but not necessarily fatal obstacle to the implementation of a pre-approval process.[96] In this Part, I

95. *See* THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 55–56 & n.1 (1980). The legal literature refers to the coordination point in Schelling's experiment as the clock in Grand Central Station. He reports the finding as the information booth, which does have a clock in the center. *Id.* at 55 n.1.

96. *See supra* Part II.B (discussing the limitations on safe harbor provisions).

consider more seriously the assumption that is crucial to the desirability of any administrative process—the capacity of agencies, through a rulemaking process, to deconstruct a contract submitted for approval and evaluate the contract's overall fairness.

The possibility that an administrative process is more amenable than a litigation process to considering a contract as a whole poses at least a theoretical advantage. Contracts constitute bundles of entitlements and risk allocations, so that the propriety of any one clause will necessarily depend on tradeoffs among the various clauses and the price that one party pays to allocate a risk to the other party.[97] Presumably, both parties will benefit from placing risks on the party best positioned to avoid a risk or to insure against it. But the effect of that rationale is to give any clause considered in isolation the appearance of being one-sided. For instance, a clause that disclaims consequential damages may initially appear to be a pro-seller term. However, once one considers that consequential damages vary dramatically with the user of the good or service,[98] it becomes more plausible to believe that buyers are systematically better able to control the consequences of nonconforming performance than sellers. If that is the case, then neither buyers (who would have to pay more than the expected value of self-help for the seller to bear the risk of consequential damages) nor sellers (who could sell goods at lower prices if buyers accepted the risk of consequential damages) would tend to prefer that the latter bear the consequential damages risk. Thus, the disclaimer of such damages favors sellers no more than it favors buyers as a class, even if the particular buyer who suffers damage may wish *ex post* that he or she had not agreed to the clause.

The success of a pre-approval process, therefore, depends on the institutional capacity of the agency to consider the proposed contract as a whole as well as the effect of a particular clause within it. Indeed, the assumption that an approval process can avoid lock-in depends on the ability of the agency to make such evaluations, since the acceptability of subsequent forms requires a willingness to consider the consequences of small changes from previously approved contracts. Sellers presumably would be willing to participate in such a process if, but only if, they believed that the agency could determine that ostensibly pro-

97. *See* Bates, *supra* note 35, at 4–5 (discussing the effects of risk allocation in costs borne by the seller and consumer).

98. *See generally* JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 14.5(a) (4th ed. 1998) (describing the origin of the consequential damages rule).

seller clauses will be approved, as long as the contract as a whole reflects a bargain that does not exploit buyers.

At best, however, administrative ability to execute this task is dubious. Collins provides a nice description of the process that agencies would have to undertake:

> By conducting a detailed enquiry into the economic justifications for all the terms of the contracts, the regulatory agency or court will engage in a practice similar to that conducted by institutional economists, who are concerned with such matters as transaction costs, efficiency considerations in contract design, and governance structures. The regulator will also have to assess sociologically how the non-legal sanctions sustain the contractual practices and be sensitive to the way in which contractual terms permit the parties to dispense with the need to rely upon judicial sanctions for breach of contract. As well as the risk of making crass mistakes in conducting such an unfamiliar enquiry, adjudicators may weaken the integrity of legal doctrine by adopting a type of hybrid discourse, part legal and part socio-economic.[99]

Thus, it is not enough that agencies have staffs that can perform econometric studies that measure the price effects of different contractual clauses, though that task itself is daunting. In addition, the agency must have the inclination to evaluate the findings of the expert staff and incorporate those findings into decisions that ultimately generate political implications. These limitations reveal the difficulty of incorporating multiple factors that would be relevant to the kind of comprehensive analysis that pre-approval assumes will prevail in regulatory analysis. The difficulty becomes more patent if one contemplates what is required in a particular case in order to determine both the effects and political propriety of contractual terms. Consider, for instance, the classic example of a contractual term of uncertain efficiency and significant consumer effects: the cross-collateral clause in the controversial case *Williams v. Walker-Thomas Furniture Co.*[100] Wholly apart from the issue of whether the clause was expressed in comprehensible language,[101] one could

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99. COLLINS, *supra* note 18, at 272 (footnote omitted).

100. Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965).

101. The clause at issue, of dubious readability to the average consumer, recited that

> the amount of each periodical installment payment to be made by [purchaser] to the Company under this present lease shall be inclusive of and not in addition to the amount of each installment payment to be made by [purchaser] under such prior leases, bills or accounts; *and all payments now and hereafter made by* [*purchaser*] *shall be credited pro rata on all outstanding leases, bills and*

rehearse all the standard law school classroom arguments about whether even an intelligible clause to the same effect would be justified (for example, it reduces delinquencies by subjecting all goods purchased on credit to repossession; it reduces credit costs to the poor generally; it makes goods available to the poor) or exploitative (for example, it exploits buyers' inability to bargain and imposes a term to which informed buyers would not agree; it deprives buyers of goods for which they have paid an amount equal to the full purchase price).[102] Administrative efforts to resolve these conflicting concerns definitively or to confirm the empirical claims that underlie them are unlikely to be much more successful than the efforts of law professors to navigate and resolve them over the past four decades.[103] Agency expertise might provide a better avenue for resolving these disputes than generalist courts.[104] But the low baseline with which courts begin suggests that the improvement that agencies provide will not necessarily entail a satisfactory resolution of the difficult issues that contract terms imply.

Agencies could minimize the difficulty by responding with less highly tailored inquiries that do not look at the entire contract but rather focus on terms in isolation and disapprove individual terms that appear unduly burdensome. That categorical approach characterizes many administrative reactions to contract clauses that are considered potentially exploitative, such as the FTC's flat prohibition on holder-in-due-course clauses in consumer credit contracts[105] or the mandated reversibility of contracts made during door-to-door sales.[106] The validity of these clauses does not depend on the surrounding circumstances in which they are deployed.[107] A flat rule of that

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> *accounts* due the Company by [purchaser] at the time each such payment is made.

Id. at 447 (alterations in original) (internal quotation marks omitted).

102. *Compare id.* at 449 (noting that "when a party of little bargaining power . . . signs a commercially unreasonable contract . . . it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms"), *with id.* at 450 (Danaher, J., dissenting) (asserting that the appellant in the case at hand "seems to have known precisely where she stood").

103. A very thorough analysis of the basic economic arguments can be found in COLLINS, *supra* note 18, at 274–79. For the complex sociological arguments of *Williams*, see generally Muriel Morisey Spence, *Teaching* Williams v. Walker-Thomas Furniture Co., 3 TEMP. POL. & CIV. RTS. L. REV. 89 (1994).

104. *See* Bates, *supra* note 35, at 97 (noting that administrative agencies can "efficiently and effectively implement enforcement proceedings").

105. 16 C.F.R. § 433.2 (2005); Am. Fin. Servs. Ass'n v. FTC, 767 F.2d 957, 980 (D.C. Cir. 1985).

106. 16 C.F.R. § 429.1.

107. *See, e.g.*, *id.* (noting that the clause applies to "*any* door-to-door sale" conducted

sort, as I have suggested above, implies that the circumstances in which the regulated practice occurs do not vary significantly from case to case. Thus, if those circumstances tend systematically to involve exploitation of buyers, further investigation to make ad hoc determinations may be wasteful. For instance, the holder-in-due-course prohibition applies only when the consumer obtains credit from a party closely related to the seller, and that condition alone may suggest that the creditor is in a relatively favorable position to detect or deter any defalcations against which a holder in due course would want to be immune.[108] The uniformity of those characteristics across situations suggests that the rule will tend to generate the same result as a more detailed analysis in a significant majority of cases.

Other contract terms and practices, however, will be less susceptible to a categorical approach. The acceptability of rolling contracts, as I suggested above, may be contingent on matters such as context of presentation or availability of terms on a website prior to delivery.[109] The propriety of a forum selection clause may depend on whether the forum selected is convenient for all parties or appears to have been selected purely for strategic reasons.[110] Because the deployment of such clauses is likely to be sufficiently contingent on varying circumstances, a categorical rule will be inappropriate to approve or reject them.

Nevertheless, the European Union has adopted a categorical approach in its Directive.[111] Recall that the Directive defines an unenforceable, "unfair term" as one that "causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer."[112] While this definition, by referring to "significant imbalance," would appear to mandate evaluation of the contract as a whole, the Directive contains an annex that, as noted above,[113] lists terms, the inclusion of which require invalidation, regardless of the context in which they are employed. A French court relied on the list to invalidate thirty-one clauses in the standard terms used by the French subsidiary of America Online in its contracts with French

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by "*any* seller" (emphasis added)).

108. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 14-7, at 527 (5th ed. 2000) (describing the judicially created "close connection" doctrine).

109. *See supra* text accompanying notes 85–86.

110. *See, e.g.*, Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569, 574 (App. Div. 1998) (holding that a forum designation clause that is cost prohibitive and deters consumers from bringing suit is unenforceable).

111. *See generally* Council Directive 93/13, *supra* note 52.

112. *Id.* art. 3, § 1.

113. *See supra* note 55 and accompanying text.

subscribers without any nuanced analysis about the effects of the clauses in individual cases.[114]

The problem with such an approach is that it declines to engage in the very analysis for which administrative agencies presumably have a comparative advantage—the ability to review contract terms comprehensively and contextually in order to evaluate the net effects of the contract taken as a whole. Presumably, it is the greater ability to consider the contract as a whole, rather than to defend contract clauses in isolation, that would induce sellers to submit to a pre-approval process. Moreover, the ability of administrative agencies to avoid the risks of lock-in are likely to depend on how marginal changes affect the balance of contract terms as a whole rather than individually. Categorical approaches, therefore, are likely to have the effect of reducing submissions and of inducing only submissions that omit banned terms, a result that is likely to retard the very development of contractual clauses that could otherwise cause sellers to compete over terms.

B. Vulnerability to Capture

The institutional difficulty that threatens the utility of the administrative approval process, however, is not simply that agencies will be unable to perfectly perform the calculations needed to determine whether the balance struck by the agency is the correct one. After all, alternative means of striking the balance among clauses, including judicial intervention and market mechanisms, are similarly imperfect in allocating contractual risks. Rather, the final concern is that the pre-approval process itself will systematically generate results that deviate from the conclusions that would be reached by a publicly interested arbiter of fair contract clauses or that are preferred by the median consumer.[115]

This familiar capture story becomes somewhat complicated in the context of consumer regulation. Obviously, sellers who promulgate multiple contracts or the trade associations that represent them could be repeat players in front of agencies and

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114. David Naylor & Cyril Ritter, *B2C in Europe and Avoiding Contractual Liability: Why Businesses with European Operations Should Review Their Customer Contracts Now*, LEGAL UPDATES & NEWS (Morrison & Foerster LLP), Aug. 2004, http://www.mofo.com/news/updates/files/update1297.html (discussing the French case of *Union Fédérale des Consommateurs v. AOL France*).

115. M.A. UTTON, THE ECONOMICS OF REGULATING INDUSTRY 22 (1986) (describing the concern "that although regulatory agencies may start out as guardians of the public interest, they very soon succumb to the power and influence of the industry they are supposed to regulate and finish up protecting it rather than the public").

would have a significant stake in the outcome of agency resolutions. Thus we would expect, consistent with the conventional capture story, that sellers or producers would attempt to influence the decisionmaking process, skewing the decisions of agencies in a manner that was more sympathetic to the very pro-seller clauses that the agency was intended to scrutinize.

From this perspective, we would expect to see very little regulation that purports to favor consumers. But that prediction varies significantly from the landscape that dominates agencies that were presumably created to advance consumer protection. Those agencies—such as the Federal Trade Commission and the Consumer Product Safety Commission—appear to promulgate a significant amount of regulation that, on its face, favors buyers.[116] Indeed, these agencies appear to face as much criticism that they regulate too much as that they do not regulate enough.[117] How do we explain that phenomenon?

In the traditional capture story, one set of interests is able to dominate the regulatory process because it enjoys an organizational advantage over conflicting interests.[118] That advantage typically results from the fact that the favored group either enjoys concentrated benefits from regulation or risks bearing concentrated costs from regulation.[119] The benefits conferred or imposed on members of the group are sufficiently great to justify overcoming the costs that might otherwise preclude collective action.[120] Group members who would bear small, per capita costs or benefits or who face very high costs from attempts to organize are less likely to contribute to the debate and thus to obtain the regulations they prefer.[121] In

116. *See, e.g.*, *id.* at 58–59 (relating the Consumer Product Safety Commission's success in establishing the minimum width of baby cribs, which benefits consumers to the detriment of producers).

117. *See, e.g.*, W. Kip Viscusi & Ted Gayer, *Safety at Any Price?*, REGULATION, Fall 2002, at 54, 58–59 (pointing out that critics believe the U.S. Office of Management and Budget regulations are excessively stringent while arguing the regulations are not stringent enough).

118. Gary E. O'Connor, *Rendering to Caesar: A Response to Professor O'Reilly*, 53 ADMIN. L. REV. 343, 370 (2001) (explaining that "small groups (industry) are better able to organize than larger groups (the public/consumers)").

119. *Id.*

120. *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 21, 27 (1971) (showing one major concern in a member's decision to join a group is if the personal benefit exceeds the cost exacted by the collective).

121. JEAN-JACQUES LAFFONT & JEAN TIROLE, A THEORY OF INCENTIVES IN PROCUREMENT AND REGULATION 475 (1993) (explaining that "the smaller the group, the higher the per-capita stake, and therefore the [higher the] incentive of its members to affect the regulatory outcomes").

theory, this conventional story should cause underrepresentation of consumer interests. Consumers face high organizational costs due to geographical diffusion; they are unlikely to contribute significantly to their own welfare because they will enjoy small per capita benefits or suffer small per capita costs as a result of regulation, even where those effects are likely to be substantial in the aggregate.[122]

What makes consumer representation plausible in the regulatory context is the existence of organizational surrogates for individual consumers.[123] Just as businesses may be represented through trade associations, groups that purport to represent consumer interests may arise to reduce the organizational costs of proffering the positions of buyers in regulatory proceedings. Groups such as Public Citizen, Consumers Union, and the AARP have proven to be very effective proponents for their positions.[124] Thus, if both business and consumer interests will be represented, we might initially conclude that administrative decisionmaking constitutes a Madisonian ideal in which debate among different factions in a single forum ultimately generates a publicly interested result.[125] For instance, even if the agency is unable to produce its own econometric studies of the effects of an arbitration clause on consumer welfare, one would anticipate that both proponents and opponents of such a clause would marshal the arguments and evidence for presentation.[126] The result is that consumers would be represented in the pre-approval process to the extent that was

122. *Id.* (concluding that "dispersed consumers" with "a low per-capita stake" have little incentive to influence regulation).

123. Thomas L. Gais et al., *Interest Groups, Iron Triangles and Representative Institutions in American National Government*, 14 BRIT. J. POL. SCI. 161, 177 (1984) (showing the modern rise of "representatives of the public interest" and their increasing effectiveness in dealing with government regulation).

124. *See, e.g.*, AARP v. EEOC, 383 F. Supp. 2d 705, 706, 712 (E.D. Pa. 2005) (granting the AARP's request to enjoin the EEOC from allowing companies to reduce employment benefits once employees turn sixty-five); *see also Public Citizen: 30 Years*, PUB. CITIZEN, Anniversary Issue 2001, at 16, 19 (chronicling the many successes of Public Citizen over the years including helping to get the FDA to ban Red Dye #2 in 1976 and helping win passage of legislation mandating safer air bags).

125. *See* Ian Ayres & John Braithwaite, *Tripartism: Regulatory Capture and Empowerment*, 16 LAW & SOC. INQUIRY 435, 496 (1991) (theorizing that adding an empowered representative for consumer groups into the typical bipartite regulatory dynamic "might contribute to more decent, democratic, and efficient regulatory institutions"). *But see* Cary Coglianese, *Assessing the Advocacy of Negotiated Rulemaking: A Response to Philip Harter*, 9 N.Y.U. ENVTL. L.J. 386, 446 (2001) ("[T]here are good reasons to doubt that negotiated rulemaking will in fact lead to any systematic improvement at all in regulatory policy.").

126. *See generally* Symposium, *Mandatory Arbitration*, 67 LAW & CONTEMP. PROBS. 5 (2004) (debating mandatory arbitration clauses in consumer contracts).

unavailable when sellers draft contracts that accompany the goods they produce.

If there is a defect in this happy story, it emerges from the fact that the same obstacles to collective action that explain why some interest groups cannot successfully organize also explain the dynamics within groups that do organize.[127] Organized groups can be expected to serve their constituents' interests only if their officials are accountable to an informed constituency. If most members of an interest group invest little time in monitoring the performance of leaders, then the leaders of the group itself, or those few who do monitor, will be able to set an agenda that deviates from the preferences of the median group member. Such deviation may be minimal in a small group in which members can easily monitor each other or in which each has a relatively similar and intense interest in the outcome of group activity. It is highly plausible, for instance, that trade associations are more likely than consumer groups to set an agenda that is consistent with members' preferences.[128] Compared to consumers, members of trade associations will be smaller in number and individual members will have more homogeneous interests as well as more at stake in the outcome of regulatory debates. As a consequence, one would anticipate less free riding among trade association members, more monitoring of trade association activity, and thus more consistency between member preferences and association activity than in the consumer context.

This conclusion follows because consumer-oriented interest groups tend to rely on large numbers of members, each of whom pays a small amount of dues.[129] Membership often is motivated by the opportunity to receive by-products such as calendars, discounts, magazines, or political affiliation, rather than by a desire to participate in decisions or to monitor the position of the

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127. *See, e.g.*, Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595, 597–98 (1995) (studying the rulemaking processes of the American Law Institute (ALI) and National Conference of Commissioners on Uniform State Laws (NCCUSL) and concluding that the customary lack of scrutiny to processes producing the rules these institutions promulgate is naïve because the same forces that affect rules in regulated industries are similarly at play).

128. *See* OLSON, *supra* note 120, at 45, 55–56 (juxtaposing the collective action phenomena in large corporations where management is able to take action divergent from the owners' interest with that of corporations with a small number of stockholders where control is "not only *de jure*, but also *de facto*" because "whether a group will have the capacity to act . . . in its group interest . . . depends on whether the individual actions of any one or more members in a group are noticeable to any other individuals in the group").

129. *See, e.g.*, PUB. CITIZEN, Anniversary Issue 2001, at 3 (stating that funding for Public Citizen derives from its 150,000 individual members who pay membership dues of $20).

group in regulatory debates.[130] Indeed, given the diffuse benefits produced by consumer group activity and the low-value benefits that any individual consumer receives from consumer group activism, few members will have an incentive to invest the resources necessary to monitor closely the conduct of the group's leaders.[131] That is the case even though the benefits to consumers in the aggregate are significant.

Officials of these groups, however, have personal incentives to prefer activities that demonstrate political entrepreneurship, attract potential funding sponsors, and provide public exposure. Flat prohibitions on particular clauses, generated by testimony from those who have suffered the downside risk of those terms, are likely to be more salient with the group's audience than advocacy of the nuanced, subtle balancing that is inherent in optimal contract design. Officials may choose the former even if consumers as a group would be better served by the latter. Consider, for instance, the possibility that the benefits of an arbitration clause include a reduction in the price of the good to reflect savings enjoyed by the seller due to the absence of a threat of class action litigation and the significant attorneys' fees that such litigation may entail. As I suggested above, it is plausible that consumers as a group would prefer a reduced price to the right to institute litigation that few consumers would initiate, even if the good turned out to be defective.[132] Nevertheless, a consumer organization, confronted with reports of dissatisfied consumers, may find that opposition to arbitration clauses in all circumstances is more politically attractive, and more prone to generate publicity for the organization, than efforts to explain to consumers that they could receive economic benefits from waiving their right to litigate. Thus, it is by no means clear that the regulations supported by pro-buyer organizations and adopted by agencies that are the target of the efforts of such groups are in fact consistent with the preferences of buyers as a class.

These motivations are consistent with a particular resolution of the difficult distributive issue that arises when an ostensibly pro-seller term causes a loss to an identifiable buyer.

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130. *See* TERRY M. MOE, THE ORGANIZATION OF INTERESTS 28–29 (1980) (noting that one way to increase member contributions is through the use of "selective incentives," which are "private benefits").

131. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 328 (1976) (recognizing monitoring as an agency cost which will be incurred only if the benefit outweighs the costs).

132. *See supra* notes 14–15 and accompanying text.

As I suggested above with respect to *Williams*, the inclusion of a fairly priced clause that adversely affects defaulting buyers may confer benefits by reducing costs for nondefaulting buyers.[133] Thus, clauses that initially appear to be pro-seller may actually have a more neutral effect in that the class of buyers, or at least those who did not desire to subsidize defaulting buyers, would also prefer them. Indeed, even the buyer who, *ex post*, bears the costly risk of the clause may, *ex ante*, have preferred it. At least, that would be the case if the premium that the seller charged for bearing the greater default risk exceeds the buyer's expected cost of default.

With respect to some goods or some contract clauses, however, there may be valid distributive arguments for invalidating such clauses and requiring all buyers (or sellers who cannot pass on the related costs) to bear the risk of default. Perhaps it is desirable to avoid the imposition of the risk on identifiable buyers, or at least on some (consumer or low-income) buyers, and those reasons may even trump the argument that considers the interests of the class of buyers. We do, after all, often favor identifiable individuals over statistical individuals in formulating social policies.[134] This form of forced insurance may reflect a desire to be paternalistic or to protect individuals against cognitive error where those policies are deemed more appropriate than ensuring efficient risk allocation.

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133. Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 450 (D.C. Cir. 1965) (Danaher, J., dissenting) (suggesting the ostensibly pro-seller clause allowed buy-to-own merchants to reduce price as "their pricing policies will afford a degree of protection commensurate with the risk"). I am not claiming that the clause in that case had that effect; I am suggesting only the possibility that, under the appropriate market conditions (which arguably did not exist in *Williams*), we would anticipate that sellers would price the risk placed on buyers.

134. *See, e.g.*, GUIDO CALABRESI & PHILIP BOBBITT, TRAGIC CHOICES 31–50 (1978) (imagining, for example, the reaction of the public to statistical deaths from the failure to enact safety legislation as compared to the choice not to allocate funds to rescue trapped hostages); E.J. Mishan, *Evaluation of Life and Limb: A Theoretical Approach*, 79 J. POL. ECON. 687, 693–94 (1971) (realizing that activities that would kill specific individuals would never be a Pareto improvement because a person's life is priceless, whereas projects that only increase risk of death to a population in general allows rational calculation because of the anonymity and randomness of deaths that will occur). Thomas Schelling provides this poignant example of the concept:

> Let a six-year-old girl with brown hair need thousands of dollars for an operation that will prolong her life until Christmas, and the post office will be swamped with nickels and dimes to save her. But let it be reported that without a sales tax the hospital facilities of Massachusetts will deteriorate and cause a barely perceptible increase in preventable deaths—not many will drop a tear or reach for their checkbooks.

THOMAS C. SCHELLING, CHOICE AND CONSEQUENCE 115 (1984).

But my claim here is not that either the efficiency or the distributive argument is correct. Rather, my claim is that the organizational structure of nominally "proconsumer" interest groups and the incentives of their agenda-setters will tend towards support of a particular resolution of that issue, such as favoring invalidation of such clauses because their invocation creates salient events that leaders of the organization can utilize. That resolution may be inconsistent with the analytical advantages of agencies that might cause us to prefer administrative decisionmaking in the first instance. If interest group representation forecloses or skews the very debate that administrative agencies are enlisted to provide, we should perhaps be somewhat more reluctant to enlist them.

I am somewhat hesitant to reach this conclusion, however, because the same bias that proconsumer groups may exhibit towards identifiable over statistical harms may produce a more benign result. Sellers that submit contracts for pre-approval may favor clauses that systematically shift risks to identifiable defaulting buyers, especially where the risk at issue has low salience to most consumers. Under these conditions, market competition is less likely to correct misallocations that are costly to consumers because consumers will not compare sellers' terms on these issues. Sellers may propose such clauses because they reduce seller costs or because risk allocation at least provides sellers with an option to enforce the clause against individual buyers whom a seller perceives as misbehaving. Sellers who explicitly limit or disclaim warranties, for instance, may extend an expired warranty in the case of a buyer who clearly has suffered from a defective good; but that same seller may want to invoke the contractual clause against a buyer who appears to have misused the good. Self-help in this context allows sellers to avoid consumer misbehavior that is observable but not necessarily verifiable.[135] Buyers who do not misbehave and who expect to benefit from seller largesse even in the face of such a clause would presumably also prefer its inclusion in the contract because it would reduce the risk that they would have to subsidize misbehaving buyers. One may or may not believe that sellers internalize the interests of buyers in these issues. The point, however, is that in order to assert their claims, sellers will systematically seek to obtain agency approval of clauses by demonstrating that buyers as a class will benefit and that in so

135. For my discussion of the possibility that sellers would want to retain the right to make such distinctions and may employ stringent contract clauses for that reason, see Gillette, *supra* note 4, at 703–12.

doing sellers will necessarily elevate statistical buyers over identifiable ones.[136]

But if sellers have incentives to systematically encourage pre-approving agencies to favor statistical buyers over identifiable buyers, while probuyer groups systematically advocate solutions that favor identifiable individuals who bear the risks of such clauses, perhaps we obtain an ideal environment for publicly interested decisionmaking. If there are distributive or paternalistic reasons for favoring an *ex post* perspective, then perhaps proconsumer organizations that tend to favor that view—even if motivated by self-interest—would balance tendencies of pro-seller groups that might otherwise ignore that viewpoint by exclusively focusing on *ex ante* analysis. I am not contending that the emphasis on identifiable victims is superior to the emphasis on statistical victims; indeed, my bias would be in the opposite direction.[137] But that is a very different position from one that would omit consideration of the *ex post* perspective from the debate. If the latter is to be introduced within a pre-approval process, even if it is ultimately rejected, that will have to occur through consumer organizations.

IV. CONCLUSION

A pre-approval process is unlikely to prove a panacea to the issue of standard-form contracts for consumer goods. Sellers will not necessarily take advantage of the process, contracts with terms that disadvantage consumers may be approved, and contracts that, on balance, fairly allocate risks will likely be disapproved. It remains unclear, however, whether such a process provides marginal advantages over the current market approach combined with litigation to root out oppressive clauses. Initially, a pre-approval system promises to provide a higher level of certainty about the enforceability of clauses in consumer contracts.[138] But further investigation reveals a series of

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136. Alternatively, the same clause permits sellers to refuse redress to buyers who have actually received defective goods. If that is the primary use of the clause, then buyers as a class should oppose it. For current purposes, however, I am willing to assume that sellers prefer the disputed clause for benign reasons. The ultimate point is that, regardless of seller motivation, sellers that propose forms and buyer groups will have conflicting preferences about whether agency decisionmaking favors a statistical or identifiable approach.

137. *See* Clayton P. Gillette & James E. Krier, *Risk, Courts, and Agencies*, 138 U. PA. L. REV. 1027, 1071–75 (1990) (noting that experts base risk on fatality estimates, while lay individuals judge risk with a much richer model that includes many other factors).

138. *See, e.g.*, *supra* notes 52–55 and accompanying text (describing the European Union's Directive on Unfair Terms in Consumer Contracts and the accompanying list of

difficulties, ranging from the fit of such a process with theories of safe harbors to the capacity of agencies to promulgate rules that are untainted by the affected interests. Some of these difficulties are far from fatal. For instance, the capacity of the pre-approval system to accommodate multiple contracts for the same good reduces the risk of lock-in,[139] and the presence of consumer groups that have a bias for raising distributional over allocational issues may serve as a healthy counter to business groups that have the opposite bias.[140] But an optional system of the type I have discussed here will only be successful if pro-seller groups actually use it. The possibility of consumer group dominance in the administrative process, or the reduced likelihood that agencies would parse contract terms in a balanced way, also diminishes the likelihood that sellers would submit contracts for pre-approval.

Nevertheless, even as a thought experiment, consideration of a pre-approval process tells us something about the alternatives. The apparent biases of an administrative process for categorical approaches to contract terms or for *ex ante* decisionmaking also cause us to focus on the comparable biases in the other regulatory environments that might be used to reduce exploitation of consumers. Even if administrative processes favor *ex ante* decisionmaking, for instance, adjudication surely favors the *ex post*. If courts are incapable of reverse engineering multi-term contracts, markets are also imperfect in translating nonsalient terms into prices that reflect contractual risk allocations. The relevant, and I fear still unanswered, question is whether a pre-approval process will improve the desired match between contract terms found in the marketplace and those preferred by informed buyers.

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unenforceable clauses).

139. *See* discussion *supra* Part II.C (concluding no mutual exclusion limits risk of lock-in).

140. *See supra* notes 134–37 and accompanying text (discussing the countervailing effects of seller *ex ante* statistical and buyer *ex post* distributional concerns).