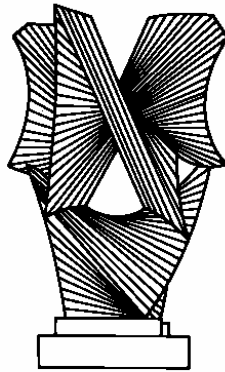


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## The Unconventional Uses of Transaction Costs

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# THE UNCONVENTIONAL USES OF TRANSACTION COSTS

*David Gilo and Ariel Porat\**

*Boilerplate: Foundations of Market Contract*

(Cambridge University Press, O. Ben Shahr ed.) (forthcoming 2007)

## **Introduction**

Standard-form contracts offered to consumers contain numerous terms and clauses, most of which are ancillary to the main terms of the transaction. We call these ancillary terms “boilerplate provisions.” Since most consumers do not read boilerplate provisions, or find them hard to understand, courts are suspicious of harsh boilerplate provisions and sometimes strike them down. Many law-and-economics scholars agree that striking down harsh clauses included in boilerplate language is justified when there is asymmetry of information between the supplier and consumers with respect to the harsh clause, which precludes consumers from fully understanding the effects of the clause on their legal rights. In such cases, there is a risk that the supplier will extract payment from the consumer without the latter being aware of the fact the payment does not reflect the reduction of value due to the harsh clause.

In this Chapter we argue that boilerplate provisions and standard-form contracts with the transaction costs that they generate are used—or could be used—by suppliers for purposes other than for extracting payments from consumers through harsh clauses. Some of these uses are efficient and some are inefficient. What all these uses have in common is that their virtue to the supplier lies in the transaction costs imposed upon consumers, from which the supplier expects to gain. However, in contrast to the familiar use of boilerplate provisions as creating asymmetry of information between the supplier and consumers, we discuss cases in which the asymmetry of information is not necessarily between the supplier and consumers, but rather between different kinds of consumers or between consumers and nonconsumers. We also discuss cases in which the supplier could gain from the

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transaction costs imposed on consumers even absent any kind of information asymmetries.

We identify four main categories of cases, characterized by the different goals suppliers might try to achieve by imposing transaction costs on consumers. *In the first category of cases* the supplier uses boilerplate provisions and other contractual terms for segmentation of consumers. By creating transaction costs that some consumers are willing to bear while others are not, suppliers could screen out unwanted consumers, discriminate in prices by conferring benefits only on consumers who incur the transaction costs, hide benefits conferred upon one group of consumers from the eyes of another group, and receive information about consumers' preferences. *In the second category of cases* the supplier uses boilerplate provisions for stabilization of cartels, obstruction of competition among suppliers and as an anticompetitive signaling device. Suppliers achieve these goals by using boilerplate language to make their contracts complex and by hiding beneficial terms in boilerplate provisions, making them available only to consumers who are ready to incur transaction costs. *In the third category of cases* the supplier imposes transaction costs in order to create a facade of a contract that is different than its true nature, thereby escaping legal or public scrutiny. *In the fourth and last category of cases*, the supplier uses standard-form contracts to create self-inflicted transaction costs that credibly signal that the contract, or some of its terms, are not negotiable. This credible signal is conveyed to consumers as well to competitors, for different purposes.

The various uses of boilerplate language and standard-form contracts to generate transaction costs raise the question of whether these uses are desirable from a social perspective. We discuss some policy implications and demonstrate how certain doctrines and principles of antitrust law, consumer law, contracts, and torts could be applied to cope with the harsh effects of beneficial boilerplate terms that we identify.

## **I. Segmentation of Consumers**

### **A. Screening Consumers Out**

At times, the supplier is not interested in transacting with all consumers but only with certain segments that are more profitable. She could screen out unwanted consumers by inflicting high transaction costs upon them, thereby making the transaction prohibitively costly for them. For example, an Israeli landlord who offers apartments for rent and wants to exclude ethnic Arabs, can draft all contracts in

Hebrew, thus raising transaction costs for non-Hebrew speakers and deterring Arabs from transacting with him. Or, a supplier who wishes to attract repeat or large buyers (for whom it is cost-effective to incur set-up costs and to reach sale volume targets) can raise transaction costs for all consumers by complicating the boilerplate language or the contracting stage as a whole. Only consumers who expect high enough gains or who could economize on the transaction costs would incur them, and typically those would be the repeat or large consumers. For various reasons, that we elaborate upon elsewhere, suppliers are expected sometimes to prefer using transaction costs to using a subscription fee, even though transaction costs constitute a net loss to both sides of the contract, while a subscription fee raises the supplier's revenue.<sup>1</sup>

In other cases, the supplier is concerned about "risky" consumers, who would not fulfill their part of the deal, or otherwise burden the supplier. Ideally, the supplier could charge them higher prices, or collect damages from them when they fail to perform their part of the contract. Practically, when it is hard to directly observe consumer types, requiring consumers to pass the test of high transaction costs could often be a better choice. For example, short-term employment contracts and rental contracts require applicants to fill out long forms that differ from each other for each and every workplace or lease.<sup>2</sup>

Note that using transaction costs and standard-form contracts to screen out unwanted consumers could be sustainable even when the supplier faces intense competition from other suppliers. First, in some cases, as in the example of using contracts in Hebrew to exclude Arabs, many consumers the supplier wishes to retain do not bear considerable transaction costs, and therefore competing suppliers could not steal such consumers on account of such transaction costs. Second, even in cases in which consumers the supplier wishes to retain do bear some transaction costs, they can potentially enjoy the fact that other consumers are excluded. Accordingly, they may well prefer the supplier to competitors who do not screen out unwanted consumers via transaction costs.

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<sup>1</sup> See Gilo and Porat, MLR Article, at note 15 and accompanying text.

<sup>2</sup> See e.g., Educational Housing Services, <http://www.studenthousing.org/> (last visited Dec. 2, 2005). See also job search sites on the Internet, Monster, <http://www.monster.com> (last visited Jan. 8, 2006), and Career Builder, <http://www.careerbuilder.com> (last visited Jan. 8, 2006).

## **B. Price Discrimination**

A supplier of uniform goods and services may find it beneficial to discriminate in prices in order to extract more surplus from consumers. But price discrimination could be prohibited by law, or hard to implement because it requires information about consumers' willingness to pay. Suppliers would therefore try to use approximations for consumers' willingness to pay. They do so in many familiar ways. Airlines charge consumers higher prices for short stays, knowing that most short-journey travelers are businesspeople who are willing to pay higher prices. Or, many vendors distribute free coupons, entitling their holders to discounts, knowing that most of those who spend time collecting coupons have a lower willingness to pay.

Boilerplate provisions can serve a similar sorting function, facilitating price discrimination. For example, a seller of a relatively cheap product might offer in a boilerplate provision a special discount if consumers fill out a certain form and mail it back to the supplier. Only consumers who bear the transaction costs will get the special discount, and those are typically the ones whose willingness to pay is lower, and would not have bought the product at the posted price absent the beneficial term. Had the beneficial term been more salient, many other consumers would have also received the discount too, and the supplier's overall profits would have diminished.

Of course, this proxy of consumers' willingness to pay is an imperfect one. In particular, some consumers who do not incur the transaction costs would not be willing to pay the posted price absent the discount. Conversely, some consumers who incur the transaction costs would buy the product even absent the discount but nevertheless incur them because they gain more than others from doing so or are more sophisticated and well-informed consumers.

A common example is hiding a best-price-guarantee in the boilerplate. Another example is the case of selling goods with an option to return and receive a refund if later the consumer changes his mind for any reason. A similar practice is common in subscription sales. For example, Internet service providers often have a boilerplate provision granting customers an option to cancel within a certain period of time and get their money back.<sup>3</sup> Many customers are not aware of this option, hidden in the fine

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<sup>3</sup> See, for example, the boilerplate terms of sale of Speakeasy, offering broadband Internet services: "Speakeasy offers a 25-day Trial Period on all ADSL services . . . . If you feel that you must cancel within 25 calendar days of your Activation Date you may do so without being subject to a Disconnection Fee." Speakeasy, Terms of Service (Sept. 28, 2005), <http://www.speakeasy.net/tos/> (last visited Dec. 1, 2005).

print, and do not execute it. But it is those who are more hesitant about signing up that would tend to incur the transaction costs and explore the boilerplate. They will be the ones disproportionately utilizing the benefit.

Conferring benefits only upon those who know how to appreciate them is the mirror image of the familiar use of harsh boilerplate terms set by the supplier in order to extract surplus from consumers, without them being aware of it. There, the supplier incorporates a boilerplate term hoping that most consumers will not be able to estimate their negative effect. In the beneficial-terms case, however, those who do not appreciate the beneficial terms and therefore do not receive them cannot argue that their expectations were frustrated: they got exactly what they expected to get. This is in contrast to the familiar use of harsh boilerplate terms, where the main concern is that the consumer expected a different contract than the one she actually got.

Conferring benefits through boilerplate to consumers who are less willing to pay can be preferable to offering them a direct discount because it avoids reputational sanctions or retaliation by frustrated consumers who have not enjoyed the benefits offered to other consumers. For example, this technique can be used to draw new customers by offering them better deals than those granted to old consumers. Instead of explicitly limiting the applicability of beneficial terms to new consumers and offending old faithful consumers, the supplier could hide the beneficial term in boilerplate, and exercise it selectively only to a subset of consumers.

Another strategy that could lead to price discrimination is to raise transaction costs by complicating the contract offered to consumers, without using beneficial terms at all. Cellular phone contracts are a good example. Consumers face a menu of packages, each different with regard to rate per minute, monthly fee, night rate, and so forth, in a way that it is difficult for a consumer to calculate which package is better. Those who would incur the transaction costs and get the better deals are probably those who use their cellular phones more and therefore have more to gain from thoroughly exploring all of the available options. They could also be the more sophisticated consumers, who can easily understand the differences among the various options and choose the one most suitable to their needs. Here, the supplier is using complicated boilerplate in order to offer better deals to high-volume or sophisticated users, who would often be more sensitive to the price they are required to pay.

Yet another boilerplate-based strategy to achieve price discrimination is to induce the consumer to rely and depend on the supplier for on going assistance.

Dependency often results in the purchase of more services and products. For example, suppliers of computer accessories and programs can distribute manuals that are inaccessible to unsophisticated users.<sup>4</sup> If the unsophisticated (or inexperienced) consumers are less sensitive to the price or less aware of the additional price they would have to pay for the supplier's assistance, the supplier could extract payments from these consumers that she would not have been able to extract but for the transaction costs she artificially created. At the same time, the supplier manages to retain sophisticated consumers with a lower willingness to pay.

Could these forms of price discrimination—through benefits, complexity, and dependency generated in the boilerplate terms—survive competitive pressures? The more artificial and cumbersome are the transaction costs readers need to incur, competing suppliers would tend to reduce the level of these transaction costs in order to steal readers from one another. If the market is competitive enough and there are enough readers, such competitive pressures could reduce the transaction costs imposed on all consumers to zero so that discrimination between readers and nonreaders is dissipated. However, when there are only a few suppliers in the market, discrimination via boilerplate could still be sustained through collusion between suppliers or when some suppliers enjoy market power. Such market power could stem, for example, from product differentiation<sup>5</sup> or from capacity constraints.<sup>6</sup>

### **C. Hiding Benefits Granted to Selected Consumers**

Sometimes there are privileged consumers who are entitled to benefits beyond what most consumers expect. The supplier would often like to understate these benefits, by placing them in boilerplate language, in order to avoid frustrating the consumers who do not receive them.

An illustrative example is benefits granted by airlines to Frequent Fliers. In the forms that establish the relationships between the airlines and the passengers, the privileges for frequent flyers are understated. However, the airlines directly mail frequent flyers all the relevant details concerning the privileges they are entitled to.

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<sup>4</sup>The "Help" devices of Microsoft Office programs are too complicated for some users, who would prefer to pay for support or to learn about operation of the programs in special courses.

<sup>5</sup>With product differentiation, readers that prefer the supplier's brand to competing brands will be willing to incur some transaction costs and stick with the supplier's brand. See generally Jean Tirole, *The Theory of Industrial Organization* 280 (1988).

#### **D. Collecting Information about Consumers Preferences**

Suppliers would often like consumers to reveal not only their willingness to pay, as discussed in previous sections of this chapter, but other preferences as well. This information helps suppliers market their products and services to new consumers and to update strategies vis-à-vis their existing consumers. Occasionally, boilerplate language and the imposition of transaction costs could help extract this information from consumers. For example, a cellular phone provider could offer additional services for free but make them available through a process that requires consumers to read and learn instructions placed in boilerplate language, or to fill out long and time-consuming forms. Had the cellular phone company not conditioned the availability of the various services upon incurring the transaction costs, most consumers would order these services and the cellular phone company would know very little about their true preferences. Using the transaction costs strategy could occasionally be more effective than charging consumers for the services they order, since the latter strategy could be more costly to administer, more deterring for many consumers, or raise consumers' suspicion with regard to the supplier's motives.

### **II. Prevention of Competition and Cartel Stabilization**

Explicit collusion between competitors is prohibited by antitrust law. But firms often try to sustain higher-than-competitive prices even absent explicit coordination, through what is known as tacit collusion. Tacit collusion is possible when firms independently find it unprofitable to deviate from a collusive price.. A growing body of the antitrust literature is devoted to identifying practices that facilitate the sustainability of tacit collusion.<sup>7</sup>

#### **A. Making It Difficult to Compare among Rivals**

The complexity of boilerplate is a method that can help firms promote anticompetitive goals, in at least three ways.

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<sup>6</sup>In the case of capacity constraints, suppliers cannot reduce transaction costs imposed upon readers to zero, since then they would not have the capacity to serve all readers that would flow to them.. See generally *id.* at 215–16.

<sup>7</sup> See, e.g., David Gilo, *The Anticompetitive Effect of Passive Investment*, 99 *Mich. L. Rev.* 1, 17-18 (2000); David Gilo, Yossi Moshe & Yossi Spiegel, *Partial Cross Ownership and Tacit Collusion*, 37 *RAND J. ECON.* 81 (2006); Jonathan B. Baker, *Vertical Restraints with Horizontal Consequences: Competitive Effects of “Most-Favored-Customer” Clauses*, 64 *Antitrust L.J.* 517 (1996).

1. *Facilitation of Collusion and Raising Prices.* If most firms in a market offer noncompetitive terms, and their contracts with consumers are complex, the profits one of them could make by offering more competitive terms are small, since many consumers would find it difficult to assess whether the complex terms offered by their current supplier are better than the competing offer. Stealing a substantial number of customers would require an extreme and salient benefit, which is less profitable. Note that unlike consumers, the firms themselves would not find it hard to assess whether their rival has deviated from a collusive equilibrium, since they are sophisticated and have a lot at stake. Hence, complexity facilitates ongoing (tacit or explicit) collusion between rivals.<sup>8</sup>

2. *Raising Prices even Absent Collusion.* Complexity of boilerplate also typically raises the prices that would prevail absent collusion. As is well known, in markets with only a few firms, even absent ongoing collusion, prices will often exceed marginal costs. Common reasons for this are product differentiation (i.e., consumers do not see the competing products as perfect substitutes) and capacity constraints (i.e., firms are not able to lower prices all the way down to marginal costs, due to their capacity constraints). Consumers' difficulties in fully understanding the value they get from a supplier, and their consequent difficulties in comparing suppliers can enable suppliers in such industries, even absent collusion, to raise prices even further above marginal costs. Indeed, various economic models find that elevated search costs, which consumers need to bear in order to compare between competing suppliers, have the effect of raising prices in oligopolies, even absent ongoing collusion.<sup>9</sup>

3. *Entry Deterrence.* Complexity of contracts can also serve as a barrier to entry of new firms into the market. A new entrant would find it hard to steal customers away from the incumbent firms, because their customers would find it hard to verify that the entrant is offering them a better deal.

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<sup>8</sup>Note that not all firms need to offer complex contracts in order for the anticompetitive effects of complexity to exist. As long as complexity is abundant enough, it would be useless for a rival offering a simple contract to try to steal customers from suppliers who offer complex contracts.

<sup>9</sup>See Simon P. Anderson & Régis Renault, *Pricing, Product Diversity, and Search Costs: A Bertrand-Chamberlin-Diamond Model*, 30 *RAND J. Econ.* 719 (1999) (showing that prices in oligopoly rise when search costs rise); Christopher R. Knittel, *Interstate Long Distance Rates: Search Costs, Switching Costs, and Market Power*, 12 *Rev. Indus. Org.* 519 (1997) (showing that search costs and switching costs have enabled long-distance carriers in the United States to raise prices after the dissolution of AT&T).

## **B. How Can Beneficial Boilerplate Terms Facilitate Collusion?**

Let us begin by showing that collusion over harsh boilerplate terms can be less sustainable than collusion with beneficial competitive boilerplate terms, in which competitive benefits are offered only to readers. With collusion over harsh boilerplate terms, suppliers can steal two kinds of consumers by deviating from collusion: readers of boilerplate terms, who are aware of the harsh terms, and nonreaders of the boilerplate terms, who find out about them only when the deviating supplier highlights it. Moreover, both groups of consumers might develop antagonism about their previous supplier who until then tried to abuse them via harsh boilerplate terms. This type of collusion is also vulnerable to a court striking down the harsh terms of one supplier, thereby forcing him to “deviate” from this type of collusion.

On the other hand, when suppliers collude over the salient part of their contract, and offer competitive benefits only to readers of the boilerplate terms, deviating from collusion (by offering competitive benefits not only to readers of the boilerplate provision, but to all customers) becomes less profitable. Such deviation has the potential of stealing only nonreaders of the boilerplate provision, since readers of the boilerplate provision already enjoy competitive terms.<sup>10</sup> Second, even the nonreaders of the boilerplate provision would not necessarily switch to the deviating supplier, since their original supplier could retain them by pointing out to them that the special discount was in their contract (in a boilerplate) all along. Third, firms often deviate from collusion in order to exclude their rivals from the market. But as we show elsewhere,<sup>11</sup> a supplier can use beneficial boilerplate terms to credibly signal to his rivals that he is too efficient to be successfully excluded.

Competitive beneficial boilerplate terms also make price cutting less profitable compared to a situation where suppliers collude on a uniform price without any boilerplate provisions. Suppliers’ short-term profits when deviating from collusion without any boilerplate provisions are larger than their profits when deviating from collusion with competitive beneficial boilerplate terms. Without boilerplate

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<sup>10</sup>In this sense, hiding benefits in boilerplate language is a stronger facilitator of collusion than price-matching policies, in which the supplier promises to match a rival’s price cut. With price matching, a price matcher’s rival can still make considerable profits from deviating from collusion, due to consumers’ hassle in going to the rival and then back to the price matcher in order to invoke the price match. See Morten Hviid & Greg Shaffer, Hassle Costs: The Achilles’ Heel of Price-Matching Guarantees, 8 *J. Econ. & Mgmt. Strategy* 489 (1999). In contrast, with hidden benefits in boilerplate language, the rival cannot steal readers, since they are already enjoying the competitive benefits.

<sup>11</sup>See Gilo and Porat, MLR Article, at 1013.

provisions, the deviating supplier can steal all types of consumers—readers and nonreaders of boilerplate provisions alike. On the other hand, when suppliers place competitive benefits in their boilerplate terms a deviating supplier can steal only nonreaders. Even nonreaders would remain with their current supplier if their current supplier immediately makes it apparent to them that they could have enjoyed the benefits hidden in their contract all along. Furthermore, as explained above, to the extent a supplier wishes to deviate from collusion in order to exclude its rival, it is less likely to do so when suppliers hide benefits in boilerplate provisions.

Finally, the collusive profits when hiding benefits in boilerplate provisions are expected to be larger. Without benefits hidden in the boilerplate, many readers end up not purchasing the product, whereas they would have purchased it with the hidden benefits. It is true that without hidden benefits, readers who do purchase the product pay more. Suppliers, however, always have the option of not hiding benefits in their boilerplate. Hence, if they do so in a particular case, it must be that the former effect outweighs the latter effect and that it is more profitable to suppliers to hide benefits in the boilerplate than not to do so.<sup>12</sup> Accordingly, even if a single firm in an industry adopts beneficial boilerplate terms, collusion could be facilitated. Beneficial boilerplate terms adopted by a single supplier make his rivals less eager to cut prices because their profits from deviating from collusion diminish. It also makes this supplier less eager to cut prices, because his collusive profits become larger.

[o1]Beneficial boilerplate terms could also be a device that incumbent firms use to deter entry of new rivals. When a potential entrant observes these terms, he receives a credible signal as to how far incumbent firms could go with respect to all consumers in order to fight the entrant if he decides to enter. Absent such beneficial boilerplate terms, if the entrant is imperfectly informed about incumbents' costs and capabilities, the entrant may place a positive probability on the possibility that incumbents are less efficient or capable than he is. The odds that the entrant would indeed take his chances and enter are then greater. Once he is in the market, it becomes harder for incumbents to drive the entrant out, as his costs of entry will have already been sunk. Thus, beneficial boilerplate acts as a signal to potential entrants of the incumbent's propensity to fight back, and it is a less costly signal than offering

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<sup>12</sup> Alternatively, it might be that suppliers prefer hiding benefits in the boilerplate because collusion over a uniform price would break down. In such a case too, obviously, it must be that hiding benefits in the boilerplate facilitates collusion, since under uniform pricing there would be no collusion.

better deals to all customers. With beneficial boilerplate, the benefits that the incumbent has to offer his customers in order to keep them are “dormant”—they need only be exercised if entry occurs.

### **III. Creating False Appearances**

When courts assess a harsh clause in a standard-form contract, they consider the fairness of the contract in its entirety, and not only the particular clause.<sup>13</sup> Accordingly, a supplier who wishes to minimize the chances that a certain term would be struck down would try to offset it with beneficial terms, which would help convince the court that the contract in its entirety is fair. This strategy could prove useful not only vis a vis courts, but also vis a vis the press, consumer organizations, or competitors who try to criticize the supplier for harsh clauses in its standard-form contract.

Such offsetting beneficial terms, however, are costly to the supplier. It would prefer to keep the oppressive terms intact and not have to bear the full cost of the offsetting beneficial terms. The supplier could achieve this by placing the beneficial terms in boilerplate language, so that only those who read and fully understand them would actually enjoy them. The supplier can influence the number of customers that actually enjoy the beneficial terms by controlling the complexity of their apprehension and “hiding” them deeper in boilerplate language.

Moreover, at times a supplier who grants some parties certain special benefits might be interested in hiding these benefits from third parties. For example, a university who has a standard contract with faculty who are inventors does not want faculty members who do not have a chance of being inventors, and the public at large, to observe the extreme benefits granted to the inventors. To achieve this goal the university could use language which is full of jargon and which is obscure and difficult to understand.

### **IV. A Credible Signal for Not Negotiating**

In many cases a supplier would like to signal his customers or his competitors that certain terms in the contract are not negotiable. Standard form terms are a way for

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<sup>13</sup>See Hugh Collins, *Regulating Contracts* 260–66 (1999) (explaining that unfairness cannot be detected by analyzing specific terms as seemingly unfair because these terms are usually concessions granted in exchange for other advantages).

a supplier to impose transaction costs upon himself in the event that the contract is negotiated, thereby credibly committing not to negotiate his contracts. Non-negotiability of contracts could serve various purposes. We focus here on three purposes that have received less attention.

### **A. Signaling Improved Incentives**

Non-negotiability of contractual terms could signal that the supplier's improved incentives, brought about by maintaining these terms in all or most of the supplier's contracts, remain intact.<sup>14</sup> For example, a car manufacturer may want to signal consumers the car's quality by offering a long term warranty. But in order for the warranty to credibly signal the car's quality, the customer has to know that the warranty applies to all or most customers and cannot be waived easily. After getting the signal and recognizing the car's high quality, any given customer may try to waive the warranty in exchange for a refund. But if many customers do so, the supplier's improved incentives would no longer exist. Accordingly, the supplier needs to credibly commit not to negotiate the warranty.

One way to do so is to commit contractually not to negotiate. This would usually not be an effective commitment device, however, because customers would find it hard to monitor the supplier's relations with all its other customers. An alternative commitment device, is to use boilerplate provisions or standard-form contracts to make negotiation over the warranty particularly difficult and complicated. For example, the boilerplate provisions could provide that the warranty cannot be waived without prior approval by the CEO or the board, or without following a cumbersome process. If customers know that all contracts contain this boilerplate, they would worry less about waivers.

Alternatively, actual contacts with buyers could be made by the supplier's agents, and these agents could have no discretion to negotiate the contract. Typically, such a supplier will operate with standard-form contracts, the terms of which are rigid and not negotiable. Blocking negotiation by the supplier's agents could be achieved either by an explicit rule forbidding negotiation or by filling the boilerplate language with professional or legal jargon and employing agents that are not capable, or lack sufficient information or skills, to understand or negotiate the standard terms.

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<sup>14</sup>See Baird, *supra* note, at 2724 ("Unsophisticated consumers are often better off in a market in which no one can bargain for special terms than in a market where everyone can.").

State laws often enable suppliers to submit their standard contracts to a certain agency or to the state's attorney general for approval.<sup>15</sup> Such submission of a supplier's standard contracts enhances their rigidity and negotiation-proofness. This is because any subsequent change of the contract's terms would require resubmission to the state agency for new approval in order to enjoy the legal defenses inherent in such approval. Also, a very convincing way for a supplier to signal consumers that negotiating the contract is impossible is by making the transaction through the Internet, where, obviously, no live agent conducts any type of negotiation.<sup>16</sup>

### **B. Signaling Commercial Buyers about Uniformity of Terms**

Another case in which a supplier would want to impose upon himself and his customers costs of negotiating terms is when the supplier wishes to signal to its customers that prices, or other terms, are uniform for all customers. If a buyer were to suspect that the supplier is granting special benefits to other buyers he might hesitate to enter the contract or insist on better terms<sup>17</sup> One way the supplier can promise not to grant discriminatory benefits is to commit contractually not to discriminate. However, such a commitment is difficult to enforce, and complicated monitoring mechanisms would have to be constructed. Such mechanisms could also be relatively easily circumvented by the supplier, by offering subtle or disguised benefits.

A possibly more credible way for the supplier to commit not to discriminate is by developing uniform contracts and boilerplate provisions that are difficult for the supplier to negotiate.<sup>18</sup> For example, a boilerplate that says:

“NO LICENSOR, DISTRIBUTOR, DEALER, RETAILER,  
RESELLER, SALES PERSON, OR EMPLOYEE IS AUTHORIZED  
TO MODIFY THIS AGREEMENT OR TO MAKE ANY

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<sup>15</sup>See, e.g., Plain Language Contract Act, Minn. Stat. Ann. §§ 325G.29–.36 (West 2004 & Supp. 2006). Section 325G.35, entitled “Review by the attorney general” states: “Any seller, creditor or lessor may submit a consumer contract to the attorney general for review as to whether the contract complies with the requirements of section 325G.31 . . . . Any consumer contract certified pursuant to subdivision 1 is deemed to comply with section 325G.31 . . . .”

<sup>16</sup>See Hillman & Rachlinski, *supra* note, at 468 (“[E]-consumers cannot negotiate because web pages and installation software do not allow for interaction with a live agent.”).

<sup>17</sup>See David Gilo, Retail Competition Percolating Through to Suppliers and the Use of Vertical Integration, Tying, and Vertical Restraints To Stop It, 20 *Yale J. on Reg.* 23, 25–75 (2003), and the literature cited there, *id.* at note 9.

<sup>18</sup>Indeed, McAfee and Schwartz claim that franchisors use uniform and rigid contracts with franchisees in order to better commit not to negotiate them. However, they discuss uniformity alone, rather than mechanisms that raise the costs of negotiation. McAfee & Schwartz, *supra* note, at 213.

REPRESENTATION OR PROMISE THAT IS DIFFERENT FROM,  
OR IN ADDITION TO, THE TERMS OF THIS AGREEMENT”

helps the seller credibly commit not to negotiate.<sup>19</sup>

### **C. Signaling Competitors about Uniformity of Terms**

Firms often like to commit to being less aggressive and less eager to cut prices in order to induce rivals to compete less aggressively as well. They can do so by making their terms of sale rigid and costly to change. When changing terms of sale vis a vis particular buyers involves high transaction costs, a supplier who wants to offer more competitive terms than his rivals would have to change his standard form contract with regard to all buyers. But such a competitive move would be less profitable to the supplier, since it is more detectable to his rivals and they would respond more quickly.<sup>20</sup> This could improve the prospects of tacit collusion in the supplier’s industry in the first place.

## **V. The Legal Implications of Hiding Benefits in the Boilerplate**

Identifying the various uses of boilerplate language and artificial transaction costs imposed on buyers raises the question of whether these uses are desirable from a social point of view. If the answer is negative, a second question arises: should the law intervene and if so, by what means? The analysis in Sections I-IV reveals that there are two specific practices that may raise legal concerns that have been ignored by the current literature and by courts. The first is the practice of artificially complicating the transaction in ways that benefit suppliers at the expense of buyers, and the second is the practice of hiding benefits in the boilerplate. In what follows, we shall focus on the policy implications of the latter.

### **A. Price Discrimination**

We argued that hidden benefits could be used to price discriminate between readers of the boilerplate and nonreaders. This practice raises objections from both a

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<sup>19</sup>This term is taken from the standard form contract of Novell, a software vendor. See [http://www.novell.com/licensing/eula/securelogin\\_35.pdf](http://www.novell.com/licensing/eula/securelogin_35.pdf). It shows how the supplier may also want to credibly commit toward *noncommercial* consumers that he will not discriminate among them.

<sup>20</sup>Unlike clauses like most-favored-nation, that also facilitate tacit collusion, but are difficult to implement and could draw antitrust scrutiny, the strategy of term-rigidity and difficulty of negotiation could more easily and credibly be implemented and does not currently draw antitrust attention.

social-welfare perspective and from the perspective of consumers who are adversely affected by the discrimination. We discuss these two perspectives separately.

*Social Welfare Perspective.* Recall that discrimination via beneficial boilerplate terms causes readers to pay less (or receive more) and causes non-readers to pay more (or receive less) than in the case with uniform pricing. Accordingly, in order to assess whether such discrimination is welfare-reducing the court needs to examine whether discrimination raised or reduced the total number of units sold by the supplier. But since various other factors affect the number of units sold, this would be practically impossible. Accordingly, we believe that intervention should hinge not merely on the discriminatory nature of beneficial boilerplate terms but rather on their other two uses: harming competition and creating the appearance of a fair contract.

*The Discriminated Consumer Perspective.* One possible claim a nonreader could invoke against the supplier is that the supplier failed to disclose to him that other consumers got a better deal than the one he got. In particular, the nonreader could claim that this undisclosed fact is a material part of the bargain, and since the supplier failed to disclose it, the consumer is entitled to rescind the contract or even sue for damages or enforce the beneficial terms in his favor.

There are numerous consumer protection statutes that impose duties of disclosure. However, most of these statutes oblige suppliers to disclose exclusionary clauses, limitations on explicit or implicit warranties, and many other terms that could constitute “a (bad) surprise” to a consumer who does not, or cannot, read boilerplate provisions carefully enough.<sup>21</sup> Such statutes are not relevant to our case, since we are dealing here with “good” surprises. Other statutes, prevailing in several states, impose a duty on suppliers to draft consumers’ contracts in plain language.<sup>22</sup> Such statutes could be of relevance here, as long as the transaction costs consumers need to incur in order to reveal the benefits in boilerplate provisions stem from difficulties in understanding the wording of the contract.

The common law also imposes upon a supplier a duty of disclosure in appropriate cases. In certain special cases, the consumer may have reasonable expectations—stemming from his special or long-term relationship with the supplier

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<sup>21</sup>For Instance, the Truth in Lending Act is aimed at increasing disclosure of credit costs to borrowers. Truth in Lending Act, 15 U.S.C. §§ 1601–07(c) (2000). Similarly, the Equal Credit Opportunity Act mandates that an applicant for credit is entitled to disclosures explaining the reasons why credit has been denied or revoked. Equal Credit Opportunity Act, 15 U.S.C. § 1691(a)–(f) (2000).

or from a promise or representation made by the supplier—that he would disclose any material fact of the bargain to the consumer.<sup>23</sup> In such special cases, regardless of the welfare analysis we conducted above, there could be grounds under contract law for the consumer to rescind the contract due to nondisclosure of the hidden benefits,<sup>24</sup> and even, in appropriate cases, to sue for damages or to enforce the beneficial terms on his behalf.<sup>25</sup>

## **B. Using Beneficial Boilerplate Terms to Harm Competition**

We argued in Section II that beneficial boilerplate terms, even if adopted by only one supplier, could harm competition by making tacit or explicit collusion more sustainable. Note that when the practice is banned, if collusion breaks down, nonreaders and readers of the boilerplate provisions alike enjoy competitive terms. This means that the collusion-facilitating characteristic of beneficial boilerplate terms is unambiguously harmful. Similar are the anticompetitive harms from beneficial boilerplate provisions that encourage anticompetitive accommodation by rivals or deter entry.

Accordingly, while the mere discriminatory characteristics of beneficial boilerplate terms do not justify intervention, when beneficial boilerplate terms are adopted by suppliers in an oligopolistic setting the case for legal intervention is strengthened. Naturally, the most appropriate legal tools to deal with such effects are the antitrust laws. We examine a host of possible antitrust tools elsewhere.<sup>26</sup> Within contract law doctrine, a possible approach would be to allow nonreaders of boilerplate language to attack the supplier for violating disclosure requirements. We noted above that such an approach would usually be unwarranted if the plaintiff's sole claim was

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<sup>22</sup>See, e.g., Plain Language Contract Act, Minn. Stat. Ann. §§ 325G.29–36 (2005) (enacted in 1981).

<sup>23</sup>See generally *United States ex rel. Bussen Quarries, Inc. v. Thomas*, 938 F.2d 831, 834 (8th Cir. 1991); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. First Nat'l Bank of Little Rock, Ark.*, 774 F.2d 909, 913 (8th Cir. 1985); *Restatement (Second) of Contracts* § 161 (1981); *Restatement (Second) of Torts* § 551 (1977).

<sup>24</sup>See *Restatement (Second) of Contracts* § 303(b) (1981); *Restatement of Restitution* § 8 cmt. e, § 28 (1937); Farnsworth, *supra* note, §§ 4.11, 4.15 (discussing the effects of nondisclosure and the remedies for misrepresentation).

<sup>25</sup>See *Restatement (Second) of Torts* § 551 (1977), Farnsworth, *supra* note, at § 4.15. When the beneficial boilerplate term involves warranties, a suit by a nonreader may be brought also for breach of an implied warranty. See Magnuson-Moss Warranty Act §§ 104, 108, 15 U.S.C. §§ 2304(e), 2308 (2000) (stating that the supplier cannot disclaim implied warranties, and if the supplier designates a written warranty as “full,” it must meet stated requirements, including an undertaking to provide a remedy without charge by repair, replacement, or refund); Farnsworth, *supra* note, at § 4.29.

<sup>26</sup>See Gilo and Porat, MLR Article, at 1025-29.

that he was the victim of price discrimination. In cases in which the practice facilitates cartels, raises prices, or deters entry, however, intervention through disclosure rules becomes warranted. Another contract law doctrine that could be invoked when boilerplate is shown to harm competition is to declare such contracts unenforceable for public policy considerations, as done with other types of anticompetitive agreements.<sup>27</sup>

To be sure, we are not advocating here a per se prohibition of beneficial boilerplate terms adopted by oligopolistic suppliers. Suppliers should be allowed to claim, in a particular case, that the practice involves welfare-enhancing attributes that outweigh the potential anticompetitive harm. The court would then face the nontrivial task of balancing between the probable anticompetitive threat and the welfare-enhancing benefits. Such balancing is extremely familiar to courts in antitrust cases involving conduct that is not illegal per se but still raises considerable anticompetitive concerns.

### **. Creating the Appearance of a Fair Contract**

We argued in Section III above that beneficial boilerplate terms raise policy concerns even absent an oligopolistic setting, when they are used by the supplier to create a false appearance of a fair contract, that is, when the benefits are not enjoyed by most consumers. Courts that review standard-form contracts should be aware of this. Therefore, when courts consider a standard-form contract, they should look not only at the appearance of the contract and at its theoretical potential to be fair, but rather at its fairness in fact, given the transaction costs imposed on consumers who may want to enjoy its beneficial terms.

### **Conclusion**

Unlike much of previous literature, this chapter did not focus on the asymmetric information between the supplier and consumers created by boilerplate language that includes harsh terms. We focused on other benefits the supplier can derive from the transaction costs that boilerplate language and standard-form contracts create. Because the costs of reading and understanding boilerplate are borne differently by different consumers, suppliers can set these costs to screen out

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<sup>27</sup>See *Restatement (Second) of Contracts* § 188.

unwanted consumers, price discriminate, stabilize cartels, elicit consumer preferences, and hide benefits granted to certain consumers. Boilerplate also serves to self-impose transaction costs by the supplier, in order to signal to buyers or to its competitors that negotiation of the contract would be very costly. Other uses of boilerplate create asymmetry of information between the supplier and its consumers, as in the classic discussions of standard forms, but they differ in that they do not extract surplus from uninformed consumers directly. Rather, they operate indirectly, as a cartel-facilitating tool, an anticompetitive signaling device, or a tool for creating the appearance of a fair contract.

Some of the uses of boilerplate language and transaction costs that we identify are desirable (such as signaling not to negotiate a warranty) and some are not (such as facilitating ethnic discrimination, artificially complicating the contract in order to harm competition, and creating a false appearance of a fair contract). Most of the uses, however, are in between these two polarities, and their desirability depends on the particular circumstances of the case (such as some cases of screening out small buyers, some cases of price discrimination, and some cases of collecting information about consumer preferences).

We identified two practices that especially raise policy concerns. The first is the practice of artificially complicating the transaction, and the second is the practice of hiding benefits in the boilerplate. These concerns are new to the legal scholarship and case law and should be addressed by courts in appropriate cases. Part V of the chapter approached the question of whether and when the use of beneficial boilerplate terms is desirable from a social perspective, and if not, we ask how the law should discourage them.

It is hard to verify whether suppliers are really trying to achieve most or all of the different goals discussed in this chapter. But even if suppliers are completely ignorant of these goals and uses, it is still important to be aware of the *consequences*, even if unintended, of using boilerplate language and artificially raising transaction costs. The aim of this Chapter was to illuminate these consequences.

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