On the Optimal Regulation of Unread Contracts

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ABSTRACT

Most contracts in which we engage in the marketplace, we do not care to read. Consequently, a classic question arising in the law of contracts is whether, and to what extent, the content of such agreements ought to be subject to special scrutiny of courts, regulators or legislatures. This paper, accordingly, develops an economic theory of the optimal regulation of unread contracts.

Under a prevalent view, when contract drafters are repeat players, there is little need for regulatory intervention, as the drafters' concern for their reputation serves a disciplinary function, which guarantees the efficiency of the drafted terms. Alternatively it is often maintained that a small percentage of informed consumers can guarantee efficiency.

Our paper revisits these insights and finds them flawed in three main respects. First, the mere assumption of repeat play does not, in and of itself, guarantee the sustainability of reputation. The socially desirable equilibrium, in which reputation disciplines sellers, is but one of many possible equilibria to which the market might converge and nothing guarantees that the optimal equilibrium would be selected. Second, even if the desirable equilibrium is sustained, it is expected to guarantee the efficiency of only some contractual provisions, not all. In particular, a reputation-minded drafter will tend to include efficient terms only to the extent that they pertain to high-probability contingencies, but not if they pertain to low-probability events. Finally, the influential conviction of contract law theorists that an informed minority of consumers is sufficient to guarantee the efficiency of contract terms is shown to be inapplicable when the majority's lack of information emanates from their failure to read.

We identify a regulatory framework that functions as a corrective measure to the above-mentioned failures. The suggested framework both serves to eliminate inefficient equilibria; and guarantees the efficiency of those aspects of the contract that reputation fails to remedy, i.e. provisions governing low probability contingencies. Although the principles of legal doctrine are not framed in the language of the proposed theory, we argue that it incorporates much of the same principles. Hence, the theory is not merely prescriptive, but also, to some extent, explanatory.

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I. INTRODUCTION

Legal theorists have long realized that most contracts entered into in the marketplace are unread by consumers prior to their formation. Contractual offers are made in a standard form and written in legal jargon, unintelligible to most consumers. Furthermore, even if contracts were read and deciphered, there would generally be no room for bargaining over their terms. Typically, the person with whom consumers deal is merely an agent of the seller, unauthorized to approve of any requests for modification. Reading is thus often a sterile exercise, consuming a costly effort but producing little benefit.

As is widely acknowledged, this contractual reality undermines one of the most fundamental notions of the institution of contract - that of volitional assent. Under most prominent theories of contract law, a contract ought to be deemed enforceable only if it encapsulates the mutual will of both contracting parties. If, however, consumers are known to be systematically ignorant of the terms of the agreement, then the most basic question of contract resurfaces: whether and on what basis should they be deemed bound by its terms? Does the drafter hold unrestricted power to enforce self-serving provisions upon ignorant consumers? And if not, how should the limits be drawn?

In view of these questions, scholars have traditionally suggested that courts ought to scrutinize the fairness of contractual provisions, making sure that consumers' interests are not compromised. This view, to be sure, still enjoys prominence in the United States

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1 Moreover, reading is a relationship-specific investment, exposing the reader to ex-post appropriation, or "hold-up". In equilibrium, therefore, it is often irrational to read. See Avery Katz, Your Terms or Mine? The Duty to Read the Fine Print in Contracts, 21 RAND J. ECON. 518(1990).
and elsewhere.\textsuperscript{3} Many economically-oriented scholars, however, disapprove of this prescription. While acknowledging the factual premise that most contracts are unread, the economic literature has advanced the notion that the free-market is endowed with self-correcting mechanisms that guarantee the efficiency of contracts.\textsuperscript{4} More particularly, it suggests that the seller, as a repeat player, is concerned with her long-run reputation, which can only be established and maintained if the contracts she drafts are efficient. As the seller expects the content of a one-sided contract to be ultimately revealed, drafting such a contract would run against her own self-interest in the long-run. The concern for losing one's reputation serves therefore as a powerful disciplinary force. In equilibrium contracts are optimal even if consumers do not read them. As there is thus no market failure to fix, it is best to refrain from any regulatory intervention. To the extent that economic analysis supports consumer protection policies, it is typically grounded in behavioral arguments – arguments based on challenging the traditional economic assumptions of rationality.\textsuperscript{5}

In this paper we revisit the theoretical foundations underlying this claim. Its aim is to establish that the mechanism of reputation does not, in fact, render legal intervention superfluous. To the contrary, the mechanism of reputation crucially depends on the threat of legally enforceable, pro-consumer intervention. We highlight, in particular, two distinct market failures that legal regulation could be used to address. First, in a setting where both sellers and buyers are repeat players and are costlessly informed about the


history of the game, there will generally be a host of equilibria to which the market might converge, of which typically only one is efficient. Alternative equilibria include ones in which sellers offer inefficient contracts consistently, or alternate between efficient and inefficient offers in different periods. Legal regulation, in turn, could serve a corrective function by altering the strategic environment in which buyers and sellers interact. By changing the rules of the game, it could be used to eliminate inefficient equilibria, thereby leaving the efficient one as the unique prediction of the game. We argue below that legal regulation in fact fulfills such a function.

The second potential failure emanates from the fact that individual buyers are often not costlessly informed about the game's history. A non-reading buyer, who enters into the game at a period other than the first, acquires information about the game’s history only by consulting with buyers who have participated in previous rounds. But when information is disseminated in that way, it is not likely to flow perfectly. In particular it is likely to be costly, often prohibitively so, to acquire information about provisions pertaining to low-probability contingencies (e.g., the availability of warranties which apply only in the rare case of a defect). Most consulted parties will never become aware of the content of such provisions, as they themselves have not read the contract, and the relevant (low probability) event has not occurred in their particular case. Consequently, the pool of potential transmitters of such information will be small, and hence reputation will perform poorly as a vehicle for market correction. This failure produces at least a prima facie justification for legal regulation to step in and control the content of provisions pertaining to low-probability events. Somewhat counter-intuitively, this implies that the lower the probability of defects is, (i.e., the overall "better" the product is), the greater the need to intervene on behalf of consumers. Defects affecting 50% of the products are less likely to justify intervention relative to defects affecting 5% of the products.

The form of legal intervention that we identify as desirable is found to match, at least in its core principles, the contours of existing legal regulation. The theory developed here is thus not only normative, but also explanatory. Whereas the rhetoric of existing laws draws primarily on notions of fairness, this paper establishes that current legal
doctrine could be reinterpreted as designed to promote efficiency, by correcting the above-mentioned market failures.

As regulatory schemes go, the one considered here is not cost-free. If applied, it would require sellers to invest in conspicuous disclosure, it may increase the costs of litigation, and, to the extent that it is applied imperfectly, it may generate costs resulting from judicial error. Consequently, its benefits must be measured against its associated costs. The balance between benefits and costs is an empirical matter lying beyond the ambit of this paper. Our aim therefore is not to argue conclusively that legal regulation ought to be introduced, but rather to identify a regulatory scheme that may help cure market failures characterizing consumer markets, and to establish the resemblance between the proposed scheme and the principles of existing legal doctrine.

The remainder of the paper is divided into six parts. Part II surveys the literature and establishes that the dominant position in the economically-oriented theory is that there are free-market mechanisms that guarantee optimal quality of consumer contracts even in the absence of pro-consumer legal intervention. Part III demonstrates, however, that in the absence of legal intervention, the market may well converge to one of many inefficient equilibria, and shows how a legal rule protecting the "reasonable expectations" of consumers can, if properly understood, guarantee that the efficient equilibrium is ultimately selected. Part IV then develops the claim that a desirable equilibrium is not likely to guarantee the efficiency of terms pertaining to low-probability events. Consequently, courts should intervene to favor consumers where a low-probability state of the world is realized, provided that the pro-consumer outcome is efficient. Part VI relaxes the assumption that contracts are unread by all consumers, and allows for the possibility that there exists a minority of consumers who do become informed. Contrary to an influential argument, we find that an informed minority will not generally suffice to resolve the market failures that actual regulation is designed to correct. Finally, Part VII establishes that the two major efficiency-enhancing rules resulting from our analysis are in conformity with existing legal doctrine. The theory thus sheds new light on the interpretation of concepts such as unconscionability, reasonable expectations, merchantability, usage of trade etc.
II. DOES UNREAD IMPLY INVISIBLE?

Since the seminal article by Kessler, contract law theorists have been drawn to the view that "contracts of adhesion" raise a challenge for contract law and that unread contractual provisions should be examined with special scrutiny by the courts. It is uncontroversial that in most cases one of the parties is unlikely to have read the contract. Realizing that such contracts deviate radically from the foundational paradigm of contract law, namely that of individuals explicitly bargaining over the terms of a transaction, legal theorists have suggested that courts ought to examine the fairness of contractual provisions and interfere when the terms of contracts are unfair. Tod Rakoff, among the most eminent advocates of this view, differentiated between visible and invisible terms. Visible terms are those for which "a large proportion of adherents (although not necessarily all) may be expected to have shopped." The invisible terms, so Rakoff believes, are unknown to most or all buyers and hence should be presumptively unenforceable. In his view, enforcing such terms "trenches on the freedom of the adhering party."

Economic analysis, however, questions the distinction between visible and invisible terms. In an equilibrium based on Rakoff's assumptions there should presumably be no invisible terms; in the absence of reputational effects, all unread terms will be (rightly) assumed by consumers to be of the worst possible quality. The reason is as follows: If a term is unobserved by a consumer, then the seller cannot charge a price for constructing it in a pro-consumer fashion. Thus, by degrading quality to the lowest possible level, the seller unequivocally maximizes profits. As the consumer is aware of that inclination, she correctly predicts the seller’s choice. Accordingly, the price she pays is also commensurate to the value she attaches to a term of the lowest possible quality.

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6 Friedrich Kessler, Contracts of Adhesion – Some Thoughts about Freedom of Contract, 43 Col. L. Rev. 629 (1943)
8 Rakoff, supra note 2, at 1251.
9 Id.
10 Id., at 1237.
11 The argument above rests on the observation that the drafting party controls the content of contract terms, and hence content is a choice variable. A distinct argument made in the literature rests on the presumption
Hence, contrary to Rakoff’s conviction, consumers should not be subject to manipulation as they know the true nature of the contracts into which they enter. This conclusion, however, does not negate Rakoff’s primary normative claim that courts ought to adopt a pro-consumer approach.\textsuperscript{12} For, even if consumers are not exploited (as they are not ignorant of the contractual provisions), the content of these provisions remains suboptimal. Contracts simply fail to maximize welfare. Both buyers and sellers would prefer a different outcome – one in which contracts are more favorable to consumers and prices higher. Hence, a pro-consumer judicial intervention may be justified not on grounds of autonomy but on grounds of efficiency.

With that said, the notion that courts ought to intervene on behalf of consumers has been repeatedly challenged. Clearly, the result of intervention can only be as good as the courts’ capacity to identify optimal terms, or, at least, to set terms that are on average better than those that unregulated markets would otherwise bring about. Given the limitations of courts and, in particular, their potential lack of information and expertise, it is not surprising that theorists have searched for market solutions which would ultimately exempt the courts from the onerous task of determining what the optimal content of contracts is.\textsuperscript{13}

Two views have been advanced in that regard. Under one view, sellers would be deterred from behaving opportunistically due to concern for their reputation.\textsuperscript{14} The seller, that sellers carry different innate propensities to offer good quality. Under that presumption, an adverse selection argument leads to the same conclusion, namely that terms can never be invisible in equilibrium. The reasoning is a standard one: in the absence of information, a typical buyer would assume she is dealing with an average-quality seller and would pay no more than her reservation price for average-quality terms. Sellers of high-quality terms would then be unable to recover their costs and be driven out of the market. Once that occurs, average quality would plummet and, consequently, buyers would be willing to pay even less for such products. The process would continue until equilibrium is reached where only the worst possible quality is offered. As buyers would be aware of the character of the equilibrium, they would only be willing to pay a price reflecting their reservation values for the lowest possible quality. See Avery Katz, 

\begin{quote}
\end{quote}

\textsuperscript{12} Katz, Id., at 504.


so it is claimed, is a repeat player, seeking to maximize long-term profits. Thus, even if contractual terms are unread, their content is revealed to the market in time. As information is disseminated, firms that offer unfavorable contractual terms at high prices would be driven out of the market, as consumers would eventually refuse to buy from them. Under a second view, most famously associated with Schwartz & Wilde, the market consists of informed and uninformed buyers. To guarantee the provision of efficient terms it is sufficient that a certain percentage of consumers is informed.15 When the fraction of informed consumers meets a certain threshold, it induces the seller to behave as if all consumers are informed. Hence, either because producers are repeat players, concerned about their reputation, or because a sufficient number of consumers serve the function of disciplining producers, the free market naturally gravitates towards the optimal result, without need for pro-consumer intervention. Judicial intervention is thus redundant at best or destructive at worst, as it might erroneously mandate that the quality of contractual terms be raised above the optimal level.

The next three sections establish that these arguments favoring the market ultimately fail and that regulation of unread contracts is therefore necessary to guarantee efficiency.

III. LEGAL REGULATION AS A PREREQUISITE FOR REPUTATION

One of the most insightful observations of game theory has been that the mere repetition of a game may dramatically impact its ultimate result. When a game is played only once, equilibrium outcomes may be quite grim. That is the case, for instance, in the prisoner’s dilemma game, where the parties’ dominant strategies produce an equilibrium strictly inferior to some other potential outcome of the game. But if the same game is repeated

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over and over again, and the horizon of play is infinite or, at least uncertain, then the result may turn on its head, and the desirable outcome could be supported in equilibrium.

This famous insight is the one underlying the claim that concerns for reputation may generate efficiency when contracts are unread. The seller is assumed to be a repeat player, offering contracts periodically over a prolonged and generally unlimited duration. She bases her choice of action not solely upon the payoff it would generate in the immediate round of play, but also upon its impact on the choices of consumers in future rounds. The seller would refrain from exploiting consumers not due to the goodness of her heart, but rather because she understands that exploitation of consumers' ignorance cannot endure indefinitely.

This optimistic scenario generated by the strategic structure of the repeated game, however, also has an important limitation. What the theory establishes is that a desirable equilibrium may be reached in the repeated version of the game, even if it is not within reach in the single-round game. It does not establish, however, that the desirable equilibrium is the unique equilibrium of the repeated game. Quite to the contrary, the celebrated “folk theorems” pertaining to infinitely repeated games, suggest that repeated interaction generally produces an exceptionally large number of equilibria, most of which can hardly be considered optimal.16

One particularly important result is that if an objectionable outcome is an equilibrium of a single-round game, then its repetition will be an equilibrium of the repeated game as well. The intuition underlying this observation is straightforward: if a combination of strategies is a Nash equilibrium of the single-round game, then, by definition, each player’s action is a “best response” to the action taken by the other. It follows that if a player is known to take the same action in each round of the repeated game, it must be a best response for the other player to repeat the same action as well, over and over again. Hence, it is a general result that the repeated game does not rule out the undesirable outcomes produced by the single-round game. It merely allows for additional outcomes to be supported in equilibrium as well.

Indeed, the folk theorems teach us that there are many combinations of strategies that form sub-game perfect equilibria in repeated games. Many of them may be quite peculiar, such as strategies that fluctuate between periods of cooperation and defection in an erratic fashion. From a predictive point of view, this great multiplicity of equilibria reflects a weakness of the theory of repeated games: if many different strategy combinations are supported in equilibrium, the theory does little to predict the ultimate outcome of the game. In the absence of further information, there is little basis for assuming that, of all possibilities, the socially optimal equilibrium will necessarily be played. Rather, the range of possible equilibria suggests that something in the rules of the game must be altered if the socially optimal equilibrium is to become unique. If regulation of markets could be designed to accomplish that task, it might play a highly constructive role.

A. A Simple Model

Let us demonstrate the relevance of these observations to contract law. Suppose that a seller S offers a contract to a non-reading buyer B, on a take-it-or-leave-it basis. A contract \( c(q, p) \) is a pair of quality \( q \) and price \( p \). Quality here is defined broadly, so as to represent both a complete specification of product attributes, and a complete set of any additional obligations governing the terms of the transaction. Higher quality is beneficial to consumers but more costly for sellers to produce. Buyers directly observe the asking price, but not the quality level.

Let \( q \) denote a lower bound on quality, and let \( p \) denote the highest price the buyer would be willing to pay for a widget of quality \( q \). Further, let \( \hat{q} \) denote some quality level higher than \( q \) and let \( \hat{p} > p \) be the corresponding price the buyer would pay for a widget of such quality. The game is depicted in figure 1. (Payoffs are omitted, as they depend on the particular values of \( \hat{q} \) and \( \hat{p} \).)
Initially consider the case in which the game is played only once. It is easy to verify that the only plausible outcome of such a game is one in which the seller offers the contract \( c(q, p) \) and the buyer accepts. That is so, even though there will generally exist a contract \( c(\hat{q}, \hat{p}) \) dominating \( c(q, p) \). Unfortunately, a strategy that includes a price higher than \( p \) is not supported in equilibrium: as the buyer does not observe quality prior to sale, the seller’s incentive is to provide quality \( q \) regardless of the price the buyer is willing to pay. As the buyer acknowledges that incentive, he is willing to pay no more than \( p \).

But what if the game could be repeated infinitely? The good news is that a more efficient contract can now be provided in equilibrium. To see that, denote the optimal contract by \( c(q^*, p^*) \), where \( q^* > q \) and \( p^* > p \), and consider the following combination of strategies:

- The seller begins by offering \( c(q^*, p^*) \), and keeps offering the same contract as long as the buyer has accepted the offer in previous rounds. If the buyer...
ever rejects the offer, the seller reverts to offering $c(q, p)$ forever.

The buyer's strategy is to accept the offer at a price not exceeding $p^*$ in the first period, and to continue doing so provided that quality has not been lower than $q^*$. If quality in a particular period has been lower than $q^*$, the buyer thereafter accepts the offer only at $p$.

It is easy to verify that such “trigger” strategies support the efficient outcome as a sub-game perfect equilibrium, provided that the seller's discounting of the future is not very high. The problem, of course, is that this desirable equilibrium is far from being unique. To see that, consider, for instance, the strategy combination in which the seller offers $c(q, p)$ in every round and the buyer accepts only if the price is $p$, both regardless of the game’s history. That, too, is a sub-game perfect equilibrium. Or consider the following strategy pair:

- The seller alternates between $c(q^*, p^*)$ and $c(q, p)$ as long as the buyer accepts, and reverts to offering $c(q, p)$ forever if at some period the buyer rejects.

- The buyer is willing to buy at $p$ in even periods and at $p^*$ in uneven ones, as long as the quality in uneven periods has always been at least $q^*$. If quality in uneven periods has ever been lower, then the buyer accepts thereafter only if the price is $p$. 
That, too, is a sub-game perfect equilibrium. The list of equilibria of course goes on, encompassing many different combinations of strategies, each requiring different actions to be taken at different stages of the repeated game. It transpires that the challenge in this setting is not merely to demonstrate that the socially desirable outcome is supported in equilibrium; rather, it is to identify the means by which to dispose of inefficient equilibria. Only then could one consider the socially optimal equilibrium as a valid prediction of the game.

The analysis thus far has focused on a setting of an infinitely repeated game, as that is the context in which a reputation argument can be most meaningfully made. Note that if alternatively one assumes that the game is finite and the parties know exactly when it would end, then reputation for efficient offers would no longer be sustainable. As is well understood, a finite game does not allow for efficient contracting in equilibrium due to unraveling. Thus, if the game is indeed finite, the need for legal intervention is only reinforced.

B. The Legal Solution: Protecting “Reasonable Expectations”

Legal intervention could be instrumental in addressing this market failure, if it could be used to reconstruct the rules of the game so as to generate an efficient equilibrium that is unique. In the context of our model, the rule of "reasonable expectations" provides a solution to the problem, regardless of whether the game's horizon is infinite, uncertain or finite.

Plainly stated, the rule of reasonable expectations provides that sellers must either offer contracts that conform to a minimum standard (namely, that which meets

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17 In a finite game, the last period is in effect equivalent to a one-shot game, as the seller, by definition, can then not expect to reap any future profits by acting efficiently. Realizing this, a rational buyer would thus not be willing to pay more than $p$ at that stage. But given the buyer's low willingness to pay in the last period, the seller would have no reason to act efficiently in the second-to-last period. Therefore, in the second-to-last period the buyer would pay only $p$ as well. Reiterating this reasoning further produces the unraveling result, under which the unique sub-game perfect equilibrium is one in which a "low-quality, low-price" contract is offered throughout the repeated game.
consumers’ “reasonable expectations,”) or conspicuously disclose to consumers the ways in which their offers depart from that minimum, prior to the completion of the sale. If sellers fail to do either of those things, the law will come to the aid of the consumer.

This rule, to be sure, has often been condemned as being a meaningless abstraction delegating excessive discretion to judges and allowing them, in effect, to interfere arbitrarily in the freedom of contract. Moreover, it has been argued that consumers’ expectations are themselves determined by whatever standard courts choose, and hence the rule hardly clarifies the criteria upon which the standard ought to be based.\textsuperscript{18}

Yet, properly interpreted, the reasonable expectations rule could be given an intelligible meaning, under which it could be justified as serving as a “game changer”, which desirably reconstructs the space of equilibrium strategies. We propose, in particular, the following dynamic interpretation of the reasonable expectations rule: A contractual term offered in period $n$ will be said to satisfy the reasonable expectations of consumers if it is at least as favorable to consumers as that offered in period $n-1$. If the seller wishes to offer a less favorable term in period $n$ relative to period $n-1$, she would be allowed to do so only if she announces that intention conspicuously prior to the completion of the sale.

The concept of reasonable expectations, thus interpreted, enables a seller to commit to maintain efficient contract terms. As explained in more detail below, by enforcing that commitment, inefficient contractual offers become losing prospects for sellers. As sellers are thus induced to offer efficient contracts, inefficient equilibria are eliminated. The details of this result are presented next.

\textbf{Proposition:}

Suppose that the seller is prepared to offer the contract $c(q^*, p)$ in the first period, as a form of investment. Then, under the rule of reasonable expectations, the

unique equilibrium of the repeated game is one in which the optimal quality $q^*$ is offered in all rounds of play, and the buyer always accepts the offer.

**Proof:**

Suppose that in some period $n$ the seller offers a contract of quality $q^*$. It follows that, in period $n+1$, absent a conspicuous announcement that quality has been degraded, it is optimal for the buyer to accept a contractual offer at any price not exceeding $p^*$. But as $q^*$ is the quality level maximizing overall gains from trade, the seller maximizes profits by offering $c(q^*, p^*)$ in $n+1$, rather than announcing an intention to degrade quality. Thus, if $q^*$ is offered in period $n$, it is also offered in period $n+1$.

To guarantee the optimality of contracting throughout the repeated game, it is therefore sufficient that the seller offer a contract of quality $q^*$ in the first round. Let us therefore focus attention on the seller’s offer in period 1. As there is no history of play, and thus reasonable expectations have not yet been formed, the buyer would not necessarily accept an offer at any price exceeding $p$. Thus, to guarantee maximal profits from round 2 and onwards, the seller may have to offer quality $q^*$ at the low price of $p$ in the initial period. Thus, if the seller undertakes such an investment, contracting will be optimal in all rounds of play.

The uniqueness of the optimality result rests on the assumption that the seller is prepared to offer efficient quality at a low price for a single period, in order to establish expectations for efficient quality throughout the game. As the game repeats itself through an uncertain horizon, doing so will generally be an attractive strategy for the seller. If he fails to offer $q^*$ in the first period, his profits in all future periods will be less than maximal. The tradeoff is thus between a short-term cost confined to a single period, and a prospect of future gains multiplied by the number of repetitions. In the typical scenario, one assumes that the short-term cost will be strictly outbalanced by the potential for
future profits. As long as that is the case, the socially optimal equilibrium will remain unique.19

A significant advantage of the proposed rule is that it relieves the courts of the burdensome task of identifying the optimal contract directly, or inquiring into the efficiency of particular terms. Under this rule, the sellers themselves are those who set the standard at the earlier stage of the game. The judicial role is simply to enforce a commitment to produce products of at least the quality provided in the previous round, as long as the seller has not made the change conspicuous. Thus, the operational costs of legal intervention, as well as the potential cost of judicial error, are significantly lower than conventionally assumed.

Finally, it should be noted that simultaneous reductions in quality and price should still require conspicuous disclosure under the rule. The reason is a practical one: as the gravity of the quality reduction is unobserved by the buyer directly, disclosure is required for the buyer to ascertain the relative scale of the two modifications. If it were otherwise, then consumer reliance on historic contract terms as an indication for those offered at the present, would cease to be reliable.

C. Possible Objections

a. The Cost of Conspicuous Modifications

The protection of consumers’ "reasonable expectations" functions as a commitment device, enabling both sellers and consumers to enforce cooperation, while overcoming the sellers' short-run temptation to deviate. But commitment, valuable as it may be, also comes at a cost. In reality, sellers sometimes seek to change the terms of the contract not

19 This typical result would not hold if one of the three following conditions applies:

(1) The seller’s discounting of future income is exceedingly high, such that the present loss is not counterbalanced even by the discounted value of gains in all periods to come; or

(2) The social value of $c(q^*, p^*)$ is very close to the social value of $c(q, p)$, and hence the seller’s added cost at the present is not compensated by sufficiently significant gains in the future; or

(3) The seller holds an incorrect belief that the buyer will accept the contract in period 1 even if the price exceeds $p$. Under that scenario, the seller’s offer may be rejected, and, consequently, gains from trade across time would not be maximized.
in order to exploit non-reading consumers, but rather for other, perfectly benign reasons. Thus, for instance, changes in input prices or in consumers' preferences may alter the character of the efficient contract. When that is the case, they can beneficially free themselves from the grip of legal commitment only if the changed terms are communicated to consumers in a conspicuous fashion.

Of course, making terms conspicuous is itself a costly endeavor. The rule of reasonable expectations generates costs in terms of the limits it imposes on the flexibility of efficient contract modification. In particular, if input prices fluctuate very frequently, or if such changes generate merely a minor diminution of quality when they occur, then the costs of regulation may indeed outweigh its associated benefits.

To contain the cost, the following adjustments in the regulatory framework may be considered. First, it may be desirable to allow sellers a certain leeway in adjusting quality downwards without penalty in appropriate circumstances. Doctrinally, this could be achieved by interpreting the concept of reasonable expectations as applying not to a discrete quality level, but rather to some narrowly-defined range of quality levels, such that if diminution in quality is so minor as to render the cost of conspicuous communication inefficient, the court would not intervene.

Second, when changes in contract terms are more dramatic, and would therefore require a heavy cost of disclosure, a seller may alternatively opt for a different strategy to reduce cost, namely by changing the product's trademark. By launching a new line of products, or marketing the same product under a new name, a seller alerts consumers of a potential change in the product features. By doing so, the seller, in effect, reverses the game back to its initial period, relieving itself of any commitment with respect to the terms offered in the past. This strategy allows the seller to cheaply begin again with a clean slate, while allowing consumers to establish a new set of expectations.

Of course, changing a trademark will generally involve a cost for the seller as it would have to forego any value arising from the product's pre-existing reputation. It is important to observe, however, that from an ex ante perspective, this should be counted as a social benefit, rather than a social cost. Reputation is socially valuable only to the extent that it conveys credible information about product attributes. If sellers were allowed to utilize previously-established expectations to sell products not conforming to
these expectations, reputation would substantially lose credibility, to the detriment of both contracting parties.

So far we focused on the cost that conspicuous disclosure imposes on sellers. Yet, disclosure also levies a cost on consumers. Arguably, consumer contracts often remain unread in the first place, precisely because consumers wish to avoid the cost of becoming informed. The standard-form contract overloads them with information, making it prohibitively costly to evaluate and digest it. How could the regulation of information disclosure solve a problem which ultimately stems from consumers' inability to absorb information?

There is an obvious flaw in this objection. It is one thing to bring to the attention of consumers innumerable contractual provisions that are heavily detailed and complex; it is quite another to bring to their attention a limited number of provisions pertaining only to those aspects of the contract which have been recently modified (e.g., quantity has decreased; warranty has been withdrawn, the contract shall be governed by the laws of Antarctica, etc.). The latter task is significantly less burdensome than the former.\(^{20}\)

b. Heterogeneous Tastes

A second possible objection to the suggested rule might posit that consumers in reality have heterogeneous tastes with respect to contract terms. What is a "good" for one buyer might be a "bad" for another. And for both goods and bads, the preferences of different buyers vary in their intensity. As different terms will thus be efficient for different contracting pairs, a regulatory scheme that enforces a unitary standard of the type proposed here could never accommodate the individual preferences of everyone.

While the argument is correct, it should be observed that it illuminates a failure emanating from the non-readership of contracts, rather than from the proposed form of regulation. When contracts are unread, individual tailoring of terms cannot be achieved, even without regulation. As the parties, by definition, fail to communicate their preferences, the terms of the transaction cannot be adjusted to those preferences. Regulation therefore does not create uniformity; it rather treats uniformity as a given, and

\(^{20}\) We concede however that sometimes internalization of even a single term may be costly. See, e.g., Korobkin, *supra* note 5 at 1234.
produces an environment in which the most efficient of uniform contracts is offered in equilibrium.

Of course, the picture becomes more complex if some consumers do read the contract. Under that assumption, a regulation-free world would allow sellers to offer a menu of contracts, from which reading consumers could choose their most favored version. The version actually chosen by reading consumers would achieve a closer fit between the terms of contracting and the parties' individual preferences, compared to the unitary standard imposed by regulation. It follows that the ultimate choice of legal policy must be driven, in substantial part, by the tradeoff between the benefits regulation confers to non-readers, and the potential cost it imposes on readers. The assessment of that tradeoff, in turn, ought to be informed by the empirical assessment of the relative proportion of readers within the overall consumer pool.

c. What is a Minimum Standard?

The rule of reasonable expectations provides that sellers must either offer contracts that conform to a minimum standard (namely, a standard that meets consumers’ “reasonable expectations,”) or conspicuously disclose to consumers the ways in which their offers depart from that minimum, prior to the completion of the sale. This proposal assumes therefore that one can easily identify which changes are unfavorable, for it is only those changes that give rise to a duty of disclosure. Yet, some changes are hard to classify. For instance, it might be difficult to determine whether a particular choice of law or whether an arbitration clause meets consumers’ preferences or not.

We have no conclusive answer to this question. Our proposed rule of reasonable expectations applies to the cases in which a modification clearly and unambiguously reduces the quality of the contract for consumers. This case is sufficiently frequent to make our proposal practically significant. It would be worthwhile to examine the circumstances under which our model could be extended to modifications which are more difficult to classify.
IV. THE REGULATION OF TERMS PERTAINING TO LOW PROBABILITY EVENTS

The legal requirement to satisfy consumers’ reasonable expectations serves to draw the parties to a desirable long-run equilibrium, in which reputation for efficient behavior is sustainable. Assuming that present buyers know the history of the game, the legal protection of reasonable expectations allows them to validly infer that the contract offered in the past will also be offered in the future, unless an adverse change is conspicuously announced. In reality, however, knowledge of the game’s history is not perfect. Some segments of information flow smoothly, while others are more difficult to transmit. An optimal legal regulation of unread contracts must take these imperfections into account, by affording differential treatment to different types of terms, depending on the extent to which their content is likely to be passed on to prospective consumers.

The extent to which information is transmitted depends on the number of existing consumers who hold the relevant knowledge. The larger the group of knowledgeable consumers, the more probable it becomes that information would be transmitted to others. Their number, in turn, is primarily a function of two variables: One is the overall size of the consumer pool (the larger the better); and the second is the nature of the term in question. Some aspects of the product, such as the day-to-day performance of the good, naturally become known to most consumers and are therefore likely to be conveyed rather effectively. There are other aspects of the contract, however, to which most consumers typically remain forever oblivious. Thus, for example, a “force majeure” provision, or a warranty disclaimer, may become operational only very rarely. For those provisions, reputation is likely to function poorly. A potential consumer seeking to learn the value of the contract is less likely to encounter a fellow consumer who holds the pertinent knowledge. Hence in such cases there seems to be a prima facie justification for legal regulation to step in and fix the market failure.

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1. Model

The following simple model formalizes the arguments made above. A potential buyer is offered a standard-form contract on a take-it-or-leave-it basis. Some terms of that contract become explicit in the transaction process. Thus, for example, if the contract is for the sale of a car, then the buyer knows, say, the car’s color and its price. Other terms remain implicit: they are written in the contract, but remain unknown to a non-reading buyer.

Implicit terms are further divided into two sets. One set includes aspects of the contract that become operational in all states of the world. Thus, for example, a restaurant patron may order a meal without knowing exactly what it would taste like; the taste, however, would ultimately be revealed. The second set, by contrast, consists of terms that become operational only in some states of the world, and not in others. A warranty, for instance, is of ultimate relevance only if the product is found defective; an arbitration clause becomes operational only if there is a legal dispute; a limitation imposed on oral modification would make a difference only upon a decision to engage in renegotiations. And the list of course goes on.

We consider a very simple contract, consisting of one term, which becomes operational only in some states of the world. For concreteness, let us suppose that the term specifies whether a particular defect is covered by a warranty. For convenience, and in order to focus on the legal regulation of the warranty provision, we assume that the probability of the defect is known to both the buyer and the seller, and thus the only question of interest is whether a warranty applies.

We use the following notation:

\[ N \] – number of persons who have acquired the widget in the previous period.

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22 Such terms are directly regulated under existing law. See section VI, infra.

23 Assuming alternatively that there is uncertainty with respect to both the probability of the defect and the content of the warranty provision would not change the qualitative results. Under such an assumption, buyers would inquire during the consultations both about the probability of the defect and about its coverage under the warranty. While this may affect the amount invested in search, it would have no effect on the result we establish here, namely that legal regulation may be justified when the objective probability of the defect is low.
Consider initially the case in which the potential buyer cannot consult fellow consumers prior to making his choice. As information about the history of the game can then not be obtained, the setting effectively turns into a series of isolated, one-shot games. Although sellers are still bound by the terms offered in a previous round, they have no incentive to set those terms efficiently, as prospective buyers’ willingness to pay cannot depend on the availability of a warranty. Buyers, in turn, realize this. They therefore set \( \theta \) at zero, and are willing to pay no more than \( v(0) \), the value of the contract to them given that a warranty is not included.

Let us now turn to the case in which potential buyers may consult with existing ones. Consultations are assumed to take place in the shadow of the reasonable expectation principle. Thus, in the absence of conspicuous announcements to the contrary, potential buyers can validly assume that the terms of historic transactions are the ones offered at the present. The problem they face thus reduces to that of adverse selection: while the attributes of the contract can be assumed to be fixed across time, the buyers’ problem is to discover what these attributes are.
It is assumed that the consulted consumers respond candidly, as they gain nothing by misleading the potential buyer. A consulted consumer, however, will not always know whether a warranty is provided, since she too had not read the contract before buying.

There could be two cases in which she would be able to respond informatively:

(a) Her own widget was found defective, and so ex post it became worthwhile for her to inquire whether the defect was covered by a warranty; and

(b) She obtained the information during a consultation she had initiated prior to acquiring her own widget.

Note that in both cases, the original person reporting whether a warranty is provided is one whose widget was found defective. It follows that the probability of obtaining a definitive response rises with the probability of a defect. Hence, $\pi'(q) > 0$.

For consultations to be advantageous, we assume that potential buyers would wish to buy the widget if and only if a warranty is provided. Hence, $v(0) < p < v(1)$. At the pre-consultation stage, we can accordingly cast potential buyers into two groups: one for which $v(\theta) \geq p$, and one for which $v(\theta) < p$. For the first group, consultations serve as a means to reduce the probability of a false positive: If it were not possible to consult previous buyers, the potential buyer would go ahead and purchase the widget, perhaps to his own detriment. The value of consultations for members of the first group is therefore that they may alert the potential buyer that the contract is not as appealing as it initially appeared. For the second group, accordingly, consultations serve to reduce the risk of a false negative. In the absence of new information, the potential buyer would refrain from the purchase, and thus possibly miss an opportunity to capture a positive benefit. The information provided by previous buyers is thus potentially beneficial, to the extent that it may convey the valuable information that the deal is in fact worth pursuing. A potential buyer chooses among previous buyers in an order that reflects cost-effectiveness. Thus,
for example, if some previous buyers are closer socially or geographically then the cost of approaching them might be lower.\textsuperscript{24}

For a buyer belonging to the first group, the benefit of the marginal consultation is given by the probability that the current widget owner knows whether a warranty is provided and that a warranty is indeed not provided, multiplied by the cost of an erroneous choice of accepting the contractual offer. Hence, a buyer in the first group will engage in the marginal consultation if and only if:

$$
\pi(q)(1 - \theta)[p - v(0)] \geq t(k)
$$

Similarly, for a buyer belonging to the second group, a marginal consultation would occur if and only if:

$$
\pi(q)\theta[v(1) - p] \geq t(k).
$$

Consultations might be conducted as long as former consultations have not yielded a definitive result. But of course, even absent a definitive result, consultations do not proceed forever. As the cheapest sources of information are exhausted first, the marginal cost of consultations rises. At a certain point, the prohibitive marginal cost drives the buyer to act in accordance with his original disposition.

How will a change in the probability of a defect $\pi$ affect this process? Clearly, the higher $q$ is, fewer consultations are needed, on average, before encountering a buyer who can provide the desired information. In such cases the mechanism of reputation works relatively well, as the expected cost of determining the contract's content is low. On the flip side, the lower the value of $q$, the less informative consultations become. The potential buyer may have to approach numerous people before finally stumbling upon one who can actually provide a helpful report concerning the availability of a warranty. Buyers’ reservation values would thus be less correlated with the quality of the

\textsuperscript{24} It is assumed, however, that the order in which the consulted persons are approached has no systematic effect on their responses (i.e., the sampling of consulted buyers remains random).
contractual offer. As sellers would not be able to charge a price for terms advantageous to consumers, such terms would not be provided regardless of whether they are efficient.

An additional lesson derived from the model is that the desirability of regulation is negatively correlated with the cost of consultations. That cost, in turn, may decline as the technology of human interaction progresses. Thus, for example, on-line communities and consumer reports allow for information to travel more cheaply than ever before. The more developed this mechanism becomes for exchanging information, the less attractive legal regulation becomes. The impact of such developments on the optimal form of legal regulation, however, should not be over-stated. First, even with easy access to products reviews published on-line, it may often still be costly and time-consuming to recover information about a term pertaining to a low-probability event. Second, websites collecting views of fellow surfers may not be entirely reliable: since sharing of one's experiences in a detailed report is costly, one expects there to be a disproportionate representation of commentators with particularly strong views. Furthermore, the greater the reliance of consumers on such information, the greater is the incentive of sellers to implant favorable views about their own products, and for competitors to implant unfavorable ones – both undermining the credibility of the reported information.\(^{25}\)

Given these important imperfections in the flow of information, legal scrutiny may therefore still be warranted, to the extent that it is directed at terms pertaining to low-probability events.

V. THE INFORMED-MINORITY ARGUMENT

The analysis thus far has proceeded on the assumption that contracts remain unread. With that notwithstanding, it is not entirely inconceivable that a minority of consumers, perhaps a small one, does read at least some contracts some of the time. In a highly influential paper, professors Alan Schwartz and Louis Wilde have advanced the

argument that a minority of informed consumers might, under some conditions, serve important corrective functions in competitive markets with imperfect information. The model they consider is one in which consumers are uninformed with respect to the price charged by different sellers. Consumers can learn the price charged simply by paying a visit to each of the various sellers. Doing so, however, generally involves a cost. In equilibrium, therefore, only some consumers in fact find it desirable to become informed. Schwartz & Wilde argue that to cure the perils of consumers' ignorance, one must merely make sure that a fraction of informed consumers surpasses a modest threshold value.

To establish the claim suppose the contrary, namely that, in the presence of an informed minority, the equilibrium price exceeded the competitive level. It would then follow that by lowering the price somewhat, a single seller could capture the business of all informed consumers, while retaining her existing share in the business of uninformed ones. True, by lowering the price, she would extract a smaller profit per each individual sale. However, as the volume of sales would then increase, her overall profit would rise, provided that the fraction of informed consumers is sufficiently large and the price cut sufficiently small. It follows that, contrary to the original premise, in the presence of such an informed minority, a supra-competitive price cannot be sustained in equilibrium. Consumers who shop therefore drive prices down for the benefit of all consumers, until prices ultimately reach the competitive level.

The Schwartz & Wilde model concerns asymmetric information regarding price. As they explicitly acknowledge, it does not necessarily carry over to cases involving

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27 Schwartz and Wilde devote a separate paper to analyzing the effect of imperfect information on the content of non-price terms. However, they explicitly restrict their analysis to cases in which imperfect information is not the result of failure to read the contract, but rather the consequence of risk misperceptions or unawareness of alternative market opportunities. Alan Schwartz & Louis Wilde, Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests, 69 VA. L. Rev. 1387, 1389 (1983).
ignorance of non-price terms, due to consumers’ failure to read the terms of the offer. In what follows, we show affirmatively that the model cannot be extended to such cases.

To establish this let us suppose first that consumers are uninformed with respect to quality or the provision of warranties due to their failure to read. The pertinent setting is captured in the game whose extensive form is depicted in figure 1 above. Initially consider the case in which an informed minority does not exist. As explained in section III, this game produces a single equilibrium outcome in which the commodity is sold at sub-optimal quality and a low price. Now suppose that an informed minority does read the contract and thus becomes informed. Could a single seller deviate from the abovementioned equilibrium and profit? The answer is "probably not," unless the fraction of informed consumers is very large. To cater to the wishes of the informed fraction, the seller would have to change the bundle he offers from "low price and sub-optimal quality" to a bundle of "high price and optimal quality." If he does that, however, he risks losing the patronage of the entire uninformed majority, which is not likely to pay a high price for a product whose quality it cannot verify.

Recall that this negative effect on the business of the uninformed majority is not applicable when the informational problem concerns price. In the case of price, satisfying the wishes of the informed fraction requires a reduction in price, which allows a deviating seller to retain his entire existing clientele, in addition to the new patronage provided by the informed group. When the informational problem concerns other contract terms, however, the individual seller must raise price, and consequently risk losing all of his existing uninformed patronage. To make that worthwhile, the informed fraction must be sufficiently sizeable so as to compensate her for that loss of business. The problem is thus not resolved by a mere minority of informed consumers.

The practical bite of the informed minority argument is further weakened by the fact that the cost of becoming informed about all non-price terms is higher than the cost of conducting an inquiry about price alone. Moreover, empirical studies suggest that virtually no one reads most standard-form contracts, not even a small minority. Finally,
as shown by Oren Gazal-Ayal, the theoretical foundation of the informed minority argument is undermined when the seller is a monopoly.\textsuperscript{30}

\textbf{VI. THE EFFICIENCY OF LEGAL DOCTRINE}

The analysis developed above suggests that a desirable regulation would be guided by two primary principles: one is the imposition of a duty to conspicuously disclose deviations from existing standards; and the other is a substantive scrutiny of terms that are inherently suspect, due to the rarity of their materialization. This section establishes that these two principles also serve as a good explanatory theory of existing law.\textsuperscript{31}

The doctrine governing the treatment of unread contracts is highly fragmented and, at times, controversial. It would be impossible to describe here all doctrinal intricacies governing unread contracts and even worse, highly tedious to try and do so. Our purpose is therefore more modest than this: it is to argue that the desirable doctrinal principles (as described in previous sections) are aligned with the core principles underlying actual doctrine. We do not argue that there is full convergence of the two – merely that the main contours of existing doctrine are compatible with our proposal. We first establish that prominent doctrinal norms support the reasonable expectations rule (as we define it) and later provide some doctrinal support for the claim that courts more readily intervene in terms pertaining to low-probability contingencies.

\textsuperscript{30} Gazal-Ayal, \textit{supra} note 21.

\textsuperscript{31} See, e.g., E. \textsc{Allan} \textsc{Farnsworth}, \textsc{Contracts}, §4.29 (2d. ed. 1990) ("Statutes deal with [unconscionable] terms in two principal ways. Some attempt to control the terms directly, by limiting the parties' freedom to determine them in a way unfavorable to the consumer. Others leave the parties free to determine the terms but attempt to give the consumer an informed choice as to whether to make the contract, by requiring that the terms be clearly disclosed in advance.")
A. The Rule of Reasonable Expectations and Existing Legal Doctrine

Courts' power to regulate the content of unread contracts is vested in a number of doctrinal sources. Most famously, the Restatement (Second) of Contracts, as well as the Uniform Commercial Code, provide that courts may refuse to enforce terms they view as unconscionable. Although the domain of the doctrine's application extends substantially beyond boilerplate, courts have been particularly receptive to unconscionability arguments when the offer has been made in standard form.

The concept of unconscionability is notoriously vague. In clarifying the U.C.C. provision, one finds two types of arguments. At times courts and commentators focus on the state of mind of the person who raises the grievance. At other times, the terminology focuses on established trade practices and past dealings. Terms such as “unfair surprise”, “reasonable communication” and “reasonable expectations” are indications to a concern for the state of mind of the vulnerable party. At the same time the use of terms such as "custom," "usage of the trade" and "course of dealings" indicates a concern for trade practices. The two are of course closely related as “a course of dealing may make it obvious that a party is not surprised by a particular provision of the contract,” and, consequently, a contract not departing from the standard course of dealing would not be deemed unconscionable.

In any event, it is clear that courts use the conventions of the market as a standard and often as a decisive factor in determining whether intervention is justified. The court does not examine the adequacy of contractual provisions against its own moral convictions, but rather compares them to the conventions established in the market in the past. As stated by Corbin, the doctrine applies when terms are "so extreme as to appear unconscionable according to the mores and business practices of the time and place."

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32 RESTATEMENT (SECOND) OF CONTRACTS, § 208.
34 See the official comment to U.C.C. §2-302. See also Murray, who argues that: “[t]here are so many unconscionability cases involving printed forms that some courts mistakenly list the printed form as a prerequisite to a finding of unconscionability. See JOHN MURRAY, MURRAY ON CONTRACTS §97 (2001).
35 See U.C.C., §2-314(3); LARY LAWRENCE, LAWRENCE'S ANDERSON ON THE UNIFORM COMMERCIAL CODE, 3d ed. 166 (2009)
36 Lawrence, Id.
Similarly, the official commentary to the U.C.C. provides that "[t]he basic test [for the presence of unconscionability] is whether, in light of the general commercial background and the commercial needs of the particular trade or case, the term or contract involved is excessively one-sided."38 The market standard, in turn, is not a static concept. Its ability to reflect the consumers' expectations, so as to prevent the unconscionable result, stems from the assumption that a rational inference can be made from past practices to present ones.

Section 2-314 of the U.C.C. similarly provides that in contracts for the sale of goods, there is an implied warranty that the good is "merchantable," i.e., that it is "fit for the ordinary purposes for which goods of that description are used"39 and in the case of fungible goods, that it is of "fair average quality within the description."40 To disclaim that warranty, the language of the disclaimer must be "in a record" and must be "conspicuous."41 Hence, "merchantability" too is a fundamentally relative concept, referring to a pre-existing market standard. And "merchantability" too assumes a market operating over time. In a static world, in which the scope of the seller's obligation cannot depend on the content of contracts offered in the past, it is almost meaningless to speak of an "ordinary" purpose for which goods are used. Indeed the doctrine itself provides specifically that if a good has just been launched, and has no "history," then the implied warranty doctrine does not apply.42 This is precisely what follows from the interpretation we propose, as in that case expectations based on past behavior have not yet been established, and thus could not be frustrated.43

Finally, section 211(3) of the Restatement (Second) of Contracts provides that "[w]here the [seller] has reason to believe that the [buyer] would not [manifest assent to the writing] if he knew that the writing contained a particular term, the term is not part of the agreement."44 The comment to this rule accordingly explains that "[a]lthough

38 U.C.C. §2-302 cmt.
39 U.C.C. §2-314 (c).
40 U.C.C. §2-314 (b).
41 U.C.C. §2-316(2).
42 Lawrence, supra note 35, at 314.
43 Of course, at the same time, one would expect a controversy to develop as to whether a newly-marketed product establishes an entirely new market, or merely constitutes a variant on products, grouped together within an existing market. In the theoretical part of the paper we assume, along with legal doctrine, that it is possible to define the relevant market to which expectations attach.
44 RESTATEMENT (SECOND) OF CONTRACTS, §211 (cmt. (f)).
customers typically adhere to standardized agreements and are bound by them without even appearing to know the standard terms in detail, they are not bound to unknown terms which are beyond the range of reasonable expectation.”

Hence, under that provision as well, a non-reading buyer is not bound by a contractual term if it lies outside the domain of her reasonable expectations, which are, in turn, formed on the basis of a market standard developed over time. Importantly, terms that fail to meet the reasonable expectations of consumers under this provision, do not give rise to mere discretionary powers to void them; instead these terms are automatically annulled and do not form a part of the agreement. That, in turn, suggests that courts are not assigned with the task of identifying whether a particular term is efficient or fair; rather, they are asked to compare the contract terms to the point of reference established by the market standard, and declare the term as void on the finding of a discrepancy. This conclusion is consistent with the theory developed above, namely that once inefficient equilibria are successfully eliminated, no further intervention is required to incentivize sellers to offer optimal terms.

B. Scrutiny of Low-Probability Contingencies and Existing Legal Doctrine

Our second proposed principle, namely the strict scrutiny of low-probability contingencies, is also reflected in existing legal doctrine. In describing the doctrine, Melvin Eisenberg maintains that most preprinted terms that pose a challenge to contract law scholars are ones that “relate to the future and concern low-probability risks.” Moreover, the low probability of contingencies is sometimes regarded as a distinctive characteristic of form contracts and is regarded as the very reason for why these contracts are subjected to special scrutiny. The behavioral literature has also pointed out the relevance of low-probability contingencies to the desirability of regulation.

45 A similar rule is found in Article 2.1.20(1) of the UNIDROIT Principles, entitled “Surprising terms:” ”No term contained in standard terms which is of such a character that the other party could not reasonably have expected it, is effective unless it has been expressly accepted by that party.”
46 Eisenberg, supra note 5 at 240.
48 See Eisenberg, supra note 5, at 240-1 (“most preprinted terms are nonperformance terms that relate to the future and concern low-probability risks. Accordingly, the cognitive problems […] including bounded
Indeed, the terms typically voided by courts are not those whose content becomes known to consumers with high probability. Most obviously, courts do not regulate price, and do not prohibit the sale of low quality products as such. The regulatory scheme permits a menu of qualities to be offered, so as to allow consumers to choose their most favored combination of quality and price. Thus, low quality per se is not a sufficient condition for legal intervention.\(^49\) In fact, courts have been reluctant to intervene even in terms governing low-probability contingencies. When they do intervene, however, it is typically when contract terms are obscure, and when their content is not likely to be transmitted to the market effectively, due to the low likelihood ex ante that they would ever become operational. Warranty disclaimers;\(^50\) liability caps;\(^51\) excessive liquidated damages;\(^52\) arbitration clauses;\(^53\) forum-selection clauses;\(^54\) limitations on oral

\(^{49}\) Accordingly, a finding of unconscionability cannot be based on low quality alone, but rather requires a "gross disparity of the values exchanged." See U.C.C. §2-302 (cmt. (c)). For a recent affirmation of this principle, see IFC Credit Corp. v. United Business and Industrial Credit Union, 512 F.3d 989, 992-93 (7th Cir. 2008) (Easterbrook, J.): ("The judiciary does not monitor the content of the products, demanding that a telecom switch provide 50 circuits even though the seller promised (and delivered) 40 circuits. It does not matter that the seller's offer was non-negotiable...As long as the price is negotiable and the customer may shop elsewhere, consumer protection comes from competition rather than judicial intervention.")

\(^{50}\) Warranty terms are heavily regulated. While the exclusion of warranties is not prohibited per se, disclaimers are subject to strict disclosure requirements, which typically require particular language and form. See U.C.C. §2-316(2); The Magnusson-Moss Warranty Act, 15 USC §2301-2312. Additional limitations on warranty waivers apply variably in different states.

\(^{51}\) Under U.C.C. §2-719(3), "Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but limitation of damages where the loss is commercial is not."

\(^{52}\) U.C.C., §2-718.


modification\textsuperscript{55} are the sort of provisions that typically fall under the scrutiny of courts. Regulation is therefore best understood as a means to fix the market failure associated with ineffective dissemination of information, rather than an attempt to substitute the market where the forces of reputation function well.

The conviction that provisions pertaining to low-probability events are inherently suspect is most evident in the context of insurance contracts.\textsuperscript{56} Insurance almost by definition pertains to unlikely or distant contingencies. If our proposed differentiation between low probability and high probability events is correct, the scrutiny of insurance contracts should be stricter. And indeed courts and commentators emphasize that insurance contracts are unique in that they are subject to harsher scrutiny by courts relative to other consumer contracts. In a famous decision, Judge Learned Hand asserted that "the canon contra proferentem [construction of the contract against the drafter] is more rigorously applied in insurance than in other contracts.\textsuperscript{57} The willingness of courts to intervene more rigorously in insurance contracts received a major boost after the publication of Robert Keeton's seminal article, \textit{Insurance law Rights at Variance with Policy Provisions}.\textsuperscript{58} In accounting for the special treatment of insurance contracts, the rarity of the contingency triggering the payment seems to insurance law theorists an important fact as "it appears as if insurance companies are paid to do nothing at all except wait for the happening of an unlikely event."\textsuperscript{59} Thus, to sum up, legal doctrine endorses the principle that the frequency with which a term becomes operational plays an important role in determining whether courts intervene or not.

\textsuperscript{55} U.C.C. §2-209(2) (requiring that provisions in consumer contracts barring oral modification be separately signed).
\textsuperscript{56} See, e.g., comment (c) to Section 211 of the Restatement (Second) of Contracts. Corbin, supra note 37, §29.9; Murray, supra note 34, §97.B. Curtis Berger & Vivian Berger, \textit{Academic Discipline: A Guide to Fair Process for the University Student}, 99 COLUM. L. REV. 289, 330 (1999).
VII. CONCLUSION

This paper explored the desirable form regulation should take when contracts are unread. It identified two primary purposes that regulation of such contracts serves. First, regulation induces the selection of an optimal dynamic equilibrium, in which efficient contracts are offered across time and inefficient equilibria are eliminated. Second, it sustains the mechanism of reputation where it would otherwise fail, namely when the low probabilities of relevant contingencies inhibit learning of the game's history, and, consequently, undermine the capacity of repeat interaction to induce efficient behavior by sellers.

Importantly, to enforce the selection of an efficient dynamic equilibrium, legal regulation need not rely on the courts' erudition in matters of efficiency, or on their ability to identify the most efficient terms. Courts need only examine whether the contract conforms to the market standard established in the past, and allow for a substantial deviation from that standard only if it was conspicuously disclosed to consumers in advance. Thus, the determination of whether "reasonable expectations" are met is not driven by intuition or speculation. Rather, it is governed to a large extent by rule-like norms whose implementation does not depend on judicial sentiments or on the availability of verifiable information concerning the efficiency of contractual terms.

Somewhat greater discretionary powers are necessary in order to achieve the second function of regulation, namely to guarantee the efficiency of provisions pertaining to low-probability contingencies. Even when sellers are committed to previously established standards, prospective consumers are not likely to become familiar with those standards, as the cost of learning them are prohibitive. Thus, absent regulation, the market is likely to fall into a mutually undesirable equilibrium, in which such terms are systematically set inefficiently. To overcome this problem, courts must directly inquire into the efficiency of those terms.

The prescriptions of the model developed here are generally consistent with existing doctrine. Under the prevailing doctrine, existing market standards are given legal force, irrespective of whether courts view them as efficient or fair. When the provision in question conforms to the standard, courts generally refrain from interference, unless they
pertain to low-probability contingencies and their inefficiency is evident. In contrast, terms pertaining to general quality and price are typically left untouched, as their content is (ultimately) revealed even to non-reading consumers. The observations made in this paper thus provide a justification and explication of existing doctrinal principles.