Why Parties Enter Into Unfair Deals: The resentment factor

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by Justin Malbon

Unfair deals are prevalent, which does not serve the interests of the harmed party to a deal nor society more generally. The law tends to focus on providing the harmed party the means for gaining compensation for unfair deals, which distracts attention away from investigating the reasons and motivations for the stronger party offering and entering into unfair deals in the first place. This article seeks to address this deficiency by proposing a theory – here coined “deal theory” – to explain “dealar” behaviors and motivations. The theory builds on insights offered by relational contract theory, the ultimatum bargaining game and behavioural economics; as well as making its own theoretical claims.

It is here claimed that the dealor makes 3Rs cost calculations – regulation, reputation and resentment costs – before deciding whether or not to offer an unfair deal. A dealor might seek to mitigate these costs by deploying cheat and bully strategies. The legislative and regulatory challenge is to harness the 3Rs costs to provide disincentives for unfair deals. This article pays particular attention to the resentment cost because its potential effectiveness in constraining unfair behaviour has generally been underestimated.

It is claimed in this article that a heightened understanding of the strong party’s incentives and motivations for offering and performing unfair deals by using the insights offered by deal theory can help improve the legal, administrative, economic and other measures that can promote the interests of the harmed party and society more generally.

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1 The author is a Professor at the Law School, Monash University. He particularly thanks for their comments on a draft of this article, Prof FJ Garcia, Boston College of Law; Prof Matthew Palmer, Visiting Fellow, Clare College, Cambridge UK; and his colleagues Dr Dale Smith and Dr Patrick Emerton. Any errors are the author’s.
Part I Introduction

We are well aware that some deals are inherently unfair. A contract, for instance, might contain unfair terms or be performed in a way that leads to unfair outcomes. In regulating unfair contracts attention tends to focus on protecting the weak party from the consequences of the contracts. Litigants, as an example, have an array of causes of action available to them that offer remedies for the consequences of unfair deals, including actions in deceit, duress, and unconscionability.

The focus on the consequences for the weak party of unfair deals tends to draw our attention away from considering the reasons why a strong party offers an unfair deal in the first place. Although there is considerable value in taking a morals based approach to the law, doing so tends to draw our attention to the harm done to the “victim” and away from providing adequate attention to the motivations and incentives for the strong party to insist on unfair terms in the first place. A heightened understanding of the strong party’s incentives and motivations for offering and performing unfair deals can help improve the legal, administrative, economic and other measures that could be taken to promote the interests of the weak party.

To advance our understanding of why a strong party might impose unfair terms on a weak party – via a contract, or an international treaty, or by some other means – this article makes a number of postulations about the cost-benefit calculations made by the strong party before she proposes an unfair deal. The postulations are collected under a general theory, which is here coined as “deal theory”. Deal theory, as described here, is a work in progress. This article is the first of a proposed series in which the author seeks to map out the terrain of the theory. To assist the endeavor, the author invites the reader’s comments, insights, corrections and criticisms regarding the theory as espoused in this article.

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The reasons why unfair deals are worthy of attention is because they have a negative impact on the interests of one or both the parties, and are economically and socially sub-optimal. Just as fair contracts, for instance, can be said to be optimal in that they maximize the joint welfare of the parties to the contract and maximize social welfare more generally, unfair contracts can be said to be sub-optimal and lead to the inefficient allocation of resources. In the international sphere, unfair treaties can provoke the resentment of the weaker party, leading it to perform its treaty obligations grudgingly, if at all. At worst, unfair treaties can promote national resentment, social unrest and poverty in the weak country, and international instability. It makes sense therefore for policy-makers, legislators, regulators and diplomats to promote laws and practices that promote fair deals between parties. Attaining the correct policy settings requires in part a more sophisticated understanding of the incentives and motivations for a strong party to propose and perform unfair deals – which is what deal theory seeks to provide a means for doing.

The account given in this article of deal theory will necessarily be incomplete, in part because this is an evolving project. Part II of the article does, however, sketch the theory in outline. For ease of terminology, contracts, international treaties and various other arrangements between parties are referred to as “deals”. This term is used because it is broader than the technically defined term “contract”, “treaty” or other inter-party arrangement. “Deal” refers, for instance, to pre-contractual offers as well as to contracts themselves and other less formal arrangements between parties. The party offering the deal is referred to as the “dealor”, which in the context of this article, is the initiator of the deal offer, and will often (although not necessarily) be the strong party. The other party to the deal is referred to as the “dealee”, which in relation to unfair deals is generally (although not necessarily) the weak party.

Deal theory, as postulated here, claims that prior to offering a deal, a dealor will make an often crude cost-benefit calculation about the gains to be made from offering an unfair deal as compared to a fair deal. If the dealor calculates that the financial and other returns of an unfair deal will exceed those that could be expected under a fair deal – at least in the immediate term – she will be inclined to offer an unfair deal; and *vice versa*. She might not be so inclined towards an unfair deal if she calculates that any short or
medium term gains will be eroded or obliterated in the medium to longer term by the latent costs of an unfair deal. These latent (and actual) costs on the dealor of an unfair deal are postulated in this article to be “3Rs costs”; namely the regulation, reputation and resentment costs to the dealor of offering and entering into an unfair deal. The 3Rs costs are elaborated upon in Part II.C.

In considering whether to offer an unfair deal, a dealor might make a further calculation. If she calculates that an unfair deal could lead to 3Rs costs, the dealor might decide to employ a cheat or bully strategy to mitigate those costs. Under the cheat strategy the dealor calculates that the dealee, and indeed any regulator, will be unaware of the inherent unfairness of the deal, or at least will discover the unfairness when it too late to be able to inflict 3Rs costs upon the dealor. An alternative that might be available in some circumstances is a bully strategy. Here the dealor believes that offering and engaging in an unfair deal might, for example, provoke the dealee’s resentment (a 3Rs cost), and could give the dealor a bad reputation (another 3Rs cost), but the dealor calculates that this will not inflict any damage upon her because the dealee has no choice but to enter into the deal. This might arise, for instance, where the dealor is a monopolist. These strategies are briefly discussed in Part II.E.

One of the 3Rs costs is the cost to the dealor of the dealee’s resentment. If the dealee believes that she is being treated unfairly under the deal, she will resent it and seek some kind of retribution. The resentful response can be visceral. Indeed, the depth of emotion it can provoke is evident in our vernacular: if a person inflicts an unfair deal on us we say we have been conned, shafted, screwed, played for a sucker, and so on. Imagine, then, the additional armory available to the legislature or a regulator if it could harness the collective resentment of dealees to a particular type of unfair deal to gain retribution against unfair dealors. This would add to mechanisms for responding to unfair deals beyond the traditional legal measures such as awards for damages, fines, injunctions and other standard legal and regulatory responses to unfair behavior. This is not to propose over-exuberant dealee vigilantism; rather the proposal is for consideration to be given to broader strategies for reducing the incidence of unfair deals. That is to say, a more sophisticated understanding of the 3Rs costs and the cheat and bully strategies that can be used to mitigate these costs can help improve legislative and regulatory
responses for promoting an environment for fair dealing. These propositions are briefly elaborated upon in Parts III and IV.

In some cases the 3Rs costs overlap so that, for instance, a dealee’s resentment may lead her to inflict reputation damage on the dealor – which is to say that there can be an overlapping of, and an iteration between, resentment and reputation costs. In other cases a regulator upon discovering that the dealor has breached a law requiring the dealor, in effect, to behave fairly, might require the dealor to publish an admission of wrongdoing and a public apology. This would overlap regulation and reputation costs.

This article pays particular attention to the resentment cost, in part because of the potential significance of its impact on dealees. The resentment cost is discussed at Part II.C. The discussion relies heavily upon the insights offered by the ultimatum bargaining game, which was first developed by Guth, Schmittberger, and Schwarze. The game challenges the assumptions of rational choice theory, upon which much of neo-economic theory is based. Under rational choice, if I were offered a deal that would leave me, say, a $1 better off than if I did not enter the deal, then I would accept the deal, all other things being equal. The ultimatum bargaining game shows that if I am offered such a deal, but that it would leave the dealor considerably better off than me, I might well reject the deal even if I leave myself worse off than if I had accepted the deal. It appears that under some conditions a party will refuse to accept a deal if she believes that the other party will make undue (unfair) gains from the deal.

The observations of the ultimatum bargaining game also suggest that a dealor will often be aware (consciously or otherwise) of the potential risks they face in provoking a dealee’s resentment by proposing a deal the dealee will perceive as unfair. Game experiments reveal that dealors tend to make proposals close to an equal split of the proceeds of the deal. Experiments also reveal that dealees are prepared to accept proposals that fall some distance short of an equal split. So, for example, under experimental conditions in which a dealor is required to make an offer to the dealee of a

share of the stake, dealors tend to offer somewhere between 50%-40%. Dealees, on the other hand, tend to reject the offer when the share of the stake drops below 20%-30%.5

The insight offered in this article is that the game’s experimental results imply that dealee’s have an unfairness tolerance. That is, assuming a 50%-50% split is the optimum point of fairness, and that dealees tend to reject offers below an average 25% share in the stake, the average unfairness tolerance is the proportion between 50% and 25%; which is a 25% unfairness tolerance. The point at which the dealee will reject is described here as the dealee’s tipping point, or line of resentment.

The difficulty a dealor faces is accurately assessing where the dealee’s line of resentment lies. At what point, for instance, will the dealee assess that the deal on offer is exploitative, and will reject? Worse still, what if the dealee accepts the deal, but feels exploited and takes revenge by inflicting ongoing reputation and resentment costs on the dealor? The dealee might enter a deal originally thinking it is fair, and later discovering it is not. Or she may feel that she will do herself more harm than good by refusing the deal, but nevertheless seek to punish the dealor for taking unfair advantage of the dealee’s weak bargaining position. The dealee will often punish covertly, so as not to raise the ire of the dealor. She may well fear a tit for tat response if the dealor discovers that the dealee is inflicting 3Rs costs.

To avoid crossing the resentment line, the dealor will tend to act conservatively and make an offer that is well short of the line. This explains why the experimental results show that dealors tend to make offers close to the equal split, despite the fact that other experimental data reveals that dealees will often accept offers as low as a 35%-25% share. The better the dealor understands the character and values of the dealee, however, the better able the dealor becomes in offering a deal that approaches the tipping point, or line of resentment. If the dealor discovers that the dealee has a high unfairness tolerance, she will be inclined to make an offer that unduly benefits the dealor, relative to theoretical optimum point of fairness. Where an equal split is feasible, this is the theoretical optimum point of fairness. If the dealee is well informed about the deal and

has reasonable alternatives to the deal on offer, she will likely have a low unfairness
tolerance. Either way, the more the dealor is able to accurately calculate where the
deele’s line of resentment lies, the more value the dealor can extract from the deal
without risking 3Rs costs. This explains why in large one-off or relational deals the
deele will spend a considerable amount of time and effort into getting to know the deelee
before making firm proposals to the deelee.

Deal theory makes a number of postulations – or hypotheses – as to why parties
enter into “unfair” deals. This begs the question as to what precisely is meant by the term
“unfair” in this context. This question is examined in Part III.

This article adopts two broad approaches to elucidating upon deal theory. First, it
posits that dealors make 3Rs costs calculations, and that they also weigh up whether they
can adopt a cheat or bully strategy to mitigate the 3Rs costs. If after making those
calculations the dealor assesses that she will make greater gains from an unfair deal, she
will proceed on that basis. Conversely, if she assesses that she will make greater gains
from a fair deal, she will proceed on that basis. These are general theoretical postulates,
which is to say that it is not claimed that all dealors proceed in this way, merely that in
many, if not most, instances this occurs. Some dealors may find that offering an unfair
deal is morally repugnant, no matter how much he gained by an unfair deal even after
allowing for the 3Rs costs. However, for analytical purposes we assume that parties act
self-interestedly rather than altruistically. The basis for this assumption is outlined in
Part III.

The second proposition is article is that dealors can miscalculate their own best
interests. That is, they may discount the 3Rs costs by unduly preferencing the short-term
gains of an unfair deal over any longer term potential losses. This has parallels to
hyperbolic discounting by consumers. Another countervailing effect is the agency effect. 
These miscalculations are outlined in Part V.

The third aspect of this article is essentially normative. Here it is argued that if the
legislative or regulatory objective is to promote the deals, then the insights gained from
deal theory can be harnessed to obtain that objective.
Leading on from the examination of unfairness is the claim made in this article that legal systems, in essence, define unacceptable (that is to say, unfair) conduct, and provide a means of retribution or compensation for the unfair conduct. Much the same process occurs inside the minds of each of us. We will, for our own purposes, define certain conduct impacting upon as unacceptable and unfair. We will often seek our own means of retribution – often covertly – to make redress for the unfairness. In this way a mini-legal system is operating inside our head – one that identifies the behavior of others that is unfair and seeks some kind of retribution or compensation for that behavior. So here we have two systems; the legal system (which is described in this article as the “macro-system”) and our personal systems of fairness (described as the “micro-system”). The postulation made in Parts III.B and IV is that the macro-system works most effectively if it operates in reasonable harmony with our collective micro-systems of justice. That is to say; generally speaking, the more the macro-system harmonizes with our collective micro-systems, the more optimal becomes the macro-system’s performance and effectiveness in enforcing its standards. In other words, the more the macro-system reflects the deeper assessments of fairness by our collective micro-systems, the more effective the macro-system becomes in enforcing its own laws and rules. A further, and related, claim made in this article is that the two systems do not operate independently of each other. The macro-system informs the understandings of fairness of our collective micro-systems, and vice versa.

Resentment can therefore play a role in two contexts: first, in moderating the behavior of the dealor in relation to a specific deal; and second, as a force to be harnessed by the legislature or a regulator to moderate the behavior of dealors more generally.

This article, then, attempts some counterbalance to the essentially moral based focus on the interests of the weak party by directing attention to the incentives for and calculations by the strong party in offering unfair deals. Deal theory, as expounded here, incorporates insights offered by relational contract theory, behavioral economics, and as mentioned, the ultimatum bargaining game, as well as offering insights of its own.

In offering a grand theory (and hopefully not a grandiose theory) in this article, I, the proponent, run the constant danger of mixing descriptive accounts with normative
claims. That is to say, a postulate about party behavior attempts a best fit explanation or theory as to what a party is doing, and why. At times a postulation can double as a proposal about what the party ought to be doing – which invariably introduces (an often unspoken) moral dimension to what is supposedly a (quasi)-scientific endeavor. The ‘is’ and the ‘ought’ can have a magnetic attraction to each other so strong that it can be hard to tear them apart. That is to say, a descriptive account of what is can be colored by a proponent’s view of what ought to be. A forensic examination of the account given in this article is bound to reveal a smudging of the is and the ought. I have pondered whether at every opportunity I should clearly signal whether a descriptive or normative claim is about to be made. On further reflection I believe that doing so is somewhat futile. The reason is this: although the account given in this article attempts to side-step questions of morality (that is, an essentially normative account), no account of law and justice can, or indeed should, be free of such questions. Normative concerns about the morality of the law should at least be standing there somewhere in the low-lit background. Descriptive accounts of law are necessarily (and should necessarily) be framed within some kind of normative dimension – whether explicitly considered or not. A rigorously “scientific” and apparently value-free (descriptive) analysis, on the other hand, is in constant danger of arriving at reasonings that can be truly horrific if used to comprehend and direct real world practice. That is, to analyze and theorize upon the law in a rigorously value-free way runs the risk of inviting or justifying legal systems that lead to perverse outcomes. Nevertheless, I will attempt where appropriate to signal whether a descriptive and normative claim is about to be made.

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6 The standard example of this is a strict value-free positivist account of the law. There are unlikely to be many proponents of this hard core form of positivism. Nevertheless, it comprehends that the unique characteristic of the law is its capacity to enforce obedience to its edicts. The validity of its edicts is determined solely by asking whether the legislature followed the proper form in enacting laws (ie a majority of legislators voted for the edict). Thus, all edicts (ie laws) that are created using the proper form are necessarily valid, regardless of the fact, for example, that the laws might be arbitrary and might inflict great harm without any apparent justification upon a minority of the citizenship.
Part II      Deal Theory in Outline

II.A  Introduction

Parties who negotiate and settle fair deals maximize their own joint welfare whilst enhancing overall social welfare, yet parties often enter into unfair deals. Why is this? The reasons can vary from deal to deal, with a wide range of factors influencing party behavior. Various psychological, cultural and behavioral factors may come into play, many of which are peculiar to the parties and their specific circumstances. The particularity of many of the factors leading to unfair deals leaves the observer unable to gain useful insights into why parties more generally are inclined to enter unfair deals, and what we should do to avoid unfair deals in the future. Human behavior and motivations are enormously complex rendering attempts at analyzing and predicting party behavior incredibly fraught.

One way of responding to this is to make more generalized and somewhat abstract theoretical claims about party behavior. Generalized claims can sometimes be accurate than more specific claims. By way of analogy, the generalized claim (or prediction) that average winter temperatures will be lower than average summer temperatures is highly accurate, at least in temperate and polar zones. Despite being a generalized prediction, it is extremely useful. Fashion houses can design and prepare clothing for the next season, sports are played in seasons in which they can be more comfortably played, medicines are manufactured in anticipation of seasonal diseases and holidays are had in the most appropriate season.

Highly specific predictions (for example that next February 21 will be a clear sunny day with a 42 degree temperature) might offer us even more utility, but cannot yet be achieved if the relevant day is some months away. No doubt the capacity to make highly specific long term weather predictions would also be extremely useful, but this is not to deny the accuracy and utility of generalized predictions and claims. Generalized theories are also useful in that they offer a means for laying bare hidden assumptions and potential

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7 See A Schwartz and RE Scott “Contract Theory and the Limits of Contract Law” (2003-04) 113 Yale Law Journal 541, p. 543 who propose that as far as contracts between firms are concerned, “contract law should facilitate the efforts of contracting parties to maximize the joint gains (the ‘contractual surplus’) from transactions”. They claim that contract law should do nothing else.
limitations in existing ways of doing things. For the purposes of analysis then, the
claims made in this article will necessarily be generalized and simplified.

II.B The Assumptions

As a starting point, it will be assumed that dealors generally act self-interestedly rather
than altruistically. This is not to suggest that a dealor’s self-interested behavior is
necessarily antithetical to the self-interests of both parties. Nor does it necessarily
involve unfair or unethical behavior or outcomes. Being self-interested is not necessarily
synonymous with being unduly selfish, as we will see in the discussion in Part III dealing
with fairness.

If we assume for the moment that self-interest is a fundamental driver, it allows us
to ignore some of the confusing ‘noise’ of psychological, cultural, behavioral and other
drivers that are specific to a particular dealor and dealee, and a particular deal. Some
people will not offer apparently self-interested deals because they are motivated by
altruism, generosity or cultural mores. For purposes of analysis, the wider the range of
drivers or motivations behind a dealor’s deal offer that are taken into consideration, the
more complex the analysis becomes and the less able it is to make useful (generalized)
claims about deals. That is, if we allow ourselves to be submerged in a sea of detail and
specificity we will be drowned by complexity. There would be little chance of gaining
insight into party behavior beyond that which led to a single transaction.

For the purposes of deal theory it is also assumed that the self-interested dealor will
make calculations about whether to offer a fair or an unfair deal. A dealor, it is posited,
calculates before proposing a deal the potential benefits and costs of offering a fair as
opposed to an unfair deal. The calculation might be made in a split-second or may be
measured and quantified in the dealor’s mind over time. That is to say, the calculations
might be consciously weighed and measured, or take place in the dark recesses of the
sub-conscious mind. It might be a considered calculation, or barely considered at all.
For our purposes it is assumed the calculation is made nonetheless. It is assumed, then,

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Academy of Science USA, 99(Suppl. 3), 7257-7262. p.7267.
that a rather crude cost-benefit analysis is made in which the dealor assesses that if the potential gains to the dealor in offering an unfair deal outweigh the potential costs, an unfair deal should be proposed. Thus, if the benefits of an unfair deal compared with a fair deal outweigh the costs of an unfair deal, a rational (although not necessarily “ethical”) dealor will pursue the unfair deal. The regulatory challenge, as will be discussed later, is to introduce factors that will weigh the cost-benefit analysis in favor of a fair deal.

The term “unfair” is loaded, and suggests assessments of morality and ethics. That is, it might be said a deal is unfair because it is “immoral” or “unethical”. Moral and ethical concerns lie at the heart of a healthy system of law and justice. Deal theory does not suggest any displacement of these concerns. It seeks instead to complement and enhance these concerns, paradoxically enough, by suspending our attention to those moral and ethical concerns. This is because they direct our attention almost solely towards the harm done to the weak party and to the remedy that should be provided to her, and distract adequate attention from the reasons and motivations for the strong party to engage in the unfair conduct in the first place.

An additional problem with morality and ethics is their relative vagueness and contestability, which invite interminable debates about whether it can truly be said the deal is unfair, and whose moral compass we should use to navigate our way to drawing conclusions on the question. This article by-passes these questions for the moment, not because they lack significance or centrality, but because the article attempts to reduce indeterminacy by removing as much complexity, or “noise”, from our considerations as reasonably possible to enable more generalized claims to be made.

II.C The 3Rs Costs
This article posits that the self-interested dealor faces a number of potential costs in offering an unfair deal. These potential costs, which beset all deals, are described as the 3Rs costs; regulation, reputation and resentment costs. These are potential and actual costs to the dealor of offering and undertaking an unfair deal; more specifically these are the regulation, reputation and resentment costs of an unfair deal. A dealor will decide
(however fleetingly or carefully considered) to offer a fair deal or an unfair deal to a dealee. In making that decision, she will consciously or unconsciously consider three potential costs of offering an unfair deal, which now will be considered in turn.

**Regulation costs**

Regulation costs are the costs of being successfully sued by the dealee, or being pursued by regulatory authorities, and the risk of laws and regulations being made more stringent in the future in response to unfair deal behavior. ‘Regulation’ in this context broadly includes the law of contract and any other laws and regulations that regulate the deal between the dealor and dealee. The regulatory cost of an unfair deal include, for example, any loss sustained from being sued for breach of contract, or from any other civil law action taken by the dealee; or action taken by a regulator in relation to the deal (for example, for breaching competition laws or regulations), and the costs of future stricter regulatory oversight.

Regulation costs are often the least concerning of the 3Rs costs for the dealor. Krawiec claims, for instance, that a growing body of evidence indicates that internal compliance structures do not deter prohibited conduct within firms and may largely serve as window-dressing to provide market legitimacy and reduced legal liability. She concludes, rather pessimistically, that present regulatory structures do not sufficiently deter corporate misconduct and simply lead to a proliferation of costly, and arguably ineffective, internal compliance processes.9 Parker and Nielsen are not quite so pessimistic.10 Their study of 999 large Australian firms suggests that although business

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implementation of competition law requirements are partial, symbolic and half-hearted, regulatory enforcement action does improve compliance system implementation.\textsuperscript{11}

Although regulation costs might not be considered particularly significant, there are exceptional cases where the regulation costs in fact turn out to be extremely high, at least in the medium to long term. The collapse of Enron led to the jailing of its CEO and Federal indictments against its executives for devising complex financial schemes to defraud the company. Gross regulatory breaches leading to sharp regulatory responses were not confined to Enron around the time of its collapse:

The SEC in June 2002 charged WorldCom with massive accounting fraud [the company had wrongly listed over $3 billion of its 2001 expenses and $797 million of its first quarter 2002 expenses as capital expenses]. In January 2002, Global Crossing filed for Chapter 11 bankruptcy protection, listing assets of 22.4 billion and debts totalling 12.4 billion dollars, the fourth largest bankruptcy in US history. The company was accused of employing misleading transactions and accounting methods, which gave the appearance that the company was generating hundreds of millions of dollars in sales and cash revenues that did not actually exist. At Adelphia Communications, the former CEO John Rigas, two of his sons, and two other former executives were charged with conspiracy, securities fraud and wire fraud and with looting the company of hundreds of millions of dollars. At Tyco, tens of millions of dollars in fraudulent bonuses were uncovered, and $13.5 million dollars in unauthorised loans to key Tyco managers. This was an unprecedented display of accounting fraud, regulatory failure, executive excess and avoidable bankruptcy, with resulting widespread disastrous losses incurred by employees, pension funds and investors.\textsuperscript{12}

This corporate behavior led the US Congress in July 2002 to enact the Sarbanes-Oxley Act, which imposed a considerable amount more regulatory requirements and oversight, the ultimate effectiveness of which is debatable.\textsuperscript{13}


\textsuperscript{12} T Clarke “Cycles of Crisis and Regulation: the enduring agency and stewardship problems of corporate governance” (2004) 12 Corporate Governance 153 at 158.

These collapses involved the extensive use of unfair deals. Enron, for example, manipulated the Californian energy market to illegally extract profits exceeding $500 million during 2000 and 2001. Extensive use was made of cheat and bully strategies, the apparent success of which only emboldened key players into promoting and entering into larger and nastier unfair deals. A Staff Report of the US Federal Energy Regulatory Commission concluded that Enron had proprietary knowledge of market conditions through its online trading system that was unavailable to other market participants. This enabled it to engage in “wash trading”, an illegal stock trading practice where an investor simultaneously buys and sells through different brokers. This gave other players the false impression of market liquidity, causing artificial volatility allowing Enron to take advantage and gain massive profits at the expense of other traders and ultimately the consumers of energy in California. What can be seen here is that the key players within the offending corporations miscalculated 3Rs costs, more specifically the regulatory costs, and miscalculated the longer term success of their cheat and bully strategies.

Generally, however, firms are unlikely to be too concerned about unhappy customers suing them for breach of contract or for other alleged breaches because the proportionate cost of litigation to a consumer relative to their income and assets is likely to be considerably higher than it is for a firm, particularly a large firm. There is, therefore, a financial disincentive facing consumers seeking to enforce their legal rights. These

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15 See K Metaxoglou & A Smith, “Efficiency of the California Electricity Reserves Market” (2007) 22 Journal of Applied Econometrics 1127 at 1130, where they say:

Among those who took advantage of systematically higher DA [day ahead] prices were Enron traders, by means of their now infamous ‘Get Shorty’ strategy. Violating market rules and acting as pure speculators, they sold DA at a high price expecting to buy back HA [hour ahead] for a low price, thus gaining the difference. According to taped discussions available from the web site of the Snohomish Public Utility District, Enron traders were so allured by this ‘sweet margin’ in their buybacks that they did not hesitate to engage into illegitimate business practices, having learned well how to game the market rules. Under the directions of their chief executives, Enron traders repeatedly submitted false information regarding the physical availability of reserve resources that they did not have.

16 Relying on this bias can backfire, as it did spectacularly so in the McLibel case of McDonald’s Corporation & McDonald’s Restaurants Ltd. v Helen Steel & David Morris [1997] EWHC QB 336 in which McDonalds sued the defendants for libel, presumably thinking this would intimidate the defendants so they would not hand out anti-McDonald’s literature. The company won a pyrrhic victory as a result of the court ordering the defendants to pay damages of £40,000. The case was considered a public relations
effects might be mitigated to some extent if a regulator has standing to sue on the consumer’s behalf, or if there is an industry run independent disputes settlements scheme which is of no financial cost to the consumer.

**Reputation costs**

Driving an unfair bargain can also lead to the second 3Rs cost – namely, reputation cost. The dealer may, for example, gain a reputation for being ruthless, underhanded or having a propensity to unduly gain benefits for herself at the expense of the dealee. This might cause the dealee, and other potential dealees to avoid entering into deals with the dealer in the future, or to exercise excessive caution when dealing with the dealer during the course of the deal or in bargaining for future deals.

There is a considerable amount of literature regarding the costs of a firm attaining a bad reputation, and conversely the financial and other benefits of having a good reputation.17

From a dealee’s perspective, a dealer’s reputation turns on questions of how much the dealee can trust the dealer and how careful they need to be in dealing with the dealer, and how much confidence she can have in any representations the dealer makes about the deal. If the dealee is in a weak bargaining position relative to the dealer, she is highly dependent on the dealer doing the right thing and not unfairly exploiting her strong position. A dealee in a weak position invariably is also at an informational disadvantage to the dealer. Again, the dealee is reliant on the dealer not unfairly exploiting this advantage. One factor that can moderate dealer behavior is fear of the potential reputation damage that can be caused by an unfair deal. It can be posited that dealees, sensing their weaker position, are likely to attach considerable (and possibly exaggerated) significance to any reputation news they receive about a potential dealee. Any good news

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(ie that the dealee can be trusted and will treat the dealee fairly) will be read by the dealee as highly encouraging and comforting. Bad news will cause financial damage related to the number of potential customers who hear about and believe the bad news.

In some instances a whole marketplace may gain a bad reputation. Akerlof noted some time ago in a famous paper on the market for ‘lemons’ (the colloquial term for cars that suffer from numerous mechanical and other failings) the problems of a marketplace where there is little trust in the quality of the products on offer. He questioned why second hand cars (in the 1960s) sold for considerably less than new cars, even when the second hand car was relatively new and unused. He speculated that the reason was because potential buyers realized they were at an informational disadvantage to the seller. The seller had the opportunity of using the car for a sufficient period to become aware of whether or not it was a lemon. Because of this potential buyers become suspicious of a car’s quality and will therefore only be prepared to pay a relatively low price. Thus, the risk of purchasing a lemon is factored into the price of second hand cars. Because buyers are only prepared to pay low prices, this drives out the quality products (because the market price is so low quality products would sell at a loss), which in turn only confirms the market’s reputation for low quality, which can further drive down prices leading to the potential collapse of the market.

More recently there have been a number of studies into the problems of the online marketplace where buyers might be dealing with one-off sellers. The sellers are strangers with neither a good or bad reputation, which itself can lead to a lemons market in which the risk of bad deal is factored into the price thereby driving out quality and downgrading the marketplace as a whole.

One way of overcoming a lemons problem is to establish some kind of reputation system. With deal relationships between individuals, the dealee might meet a stranger about whom she knows very little. Here she is likely to be very cautious in her dealings.

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with the stranger. If there are a series of interactions between the parties, their history of
past interactions informs the dealee about the dealer’s trustworthiness.\textsuperscript{20} The past
dealings raise expectations and assumptions by the parties about their future dealings, and
the likely opportunities for future reciprocity or retaliation if one of the parties
misbehaves. Axelrod described these expectations as the “shadow of the future”.\textsuperscript{21}

A first dealing with a stranger presents a situation where the parties have no
history of past dealings, and therefore no basis for anticipation of future dealings. Here
there is a lack of a shadow of the future for constraining present behavior. We can see
from Akerlof’s insights that this serves neither the interests of the dealee or a fair dealer.
The dealee’s information disadvantage may well prompt her to only be prepared to pay a
relatively low price for the goods or services on offer because of the perceived risk of
buying a lemon. It is therefore in the interests of both parties to establish a reputation
system. Resnick et al, propose that an effective reputation system requires at least three
properties:

- Long-lived entities that inspire an expectation of future interaction;
- Capture and distribution of feedback about current interactions (such information
  must be visible in the future); and
- Use of feedback to guide trust decisions.\textsuperscript{22}

There are a number of studies that confirm that considerable value can be gained for a
seller who develops a good reputation, and is trusted by the marketplace.\textsuperscript{23} To put it
categorically, there can be considerable value attained by having a good reputation, and a
considerable loss of value if a seller has a bad reputation. It is therefore often in the
interests of dealors to develop and maintain a good reputation. That is to say, a bad
reputation can be very costly.

\begin{footnotes}
\item P Resnick, R Zeckhauser, E Friedman, and K Kuwabara “Reputation Systems” (2000) 43
  Communications of the ACM 45 at 46.
\item P Resnick, R Zeckhauser, E Friedman, and K Kuwabara “Reputation Systems” (2000) 43
  Communications of the ACM 45 at 47.
\item PW Roberts & GR Dowling “Corporate Reputation And Sustained Superior Financial Performance”
\end{footnotes}
**Resentment costs**

We turn now to the focus of this article: resentment costs.

There is a burgeoning field of research dealing with resentment. Experimental evidence suggests that parties do not always undertake contract negotiations and performance in a narrowly self-interested way. Instead, parties often act according to their sense of reciprocal fairness. This behavior is contrary to predictions of rational choice theory.\(^{24}\)

Attention was drawn to reciprocal fairness by the ultimatum bargaining game, which was first developed in 1982 by three German economists, Guth, Schmittberger, and Schwarze\(^ {25}\). The game at its simplest involves two parties; A and B. A is offered a sum of money, say $100, on the condition that A makes one offer to B for a share in the stake. B has one opportunity to either accept or reject the offer. B is aware of all these factors. If B accepts, the stake is shared as agreed, if B rejects both parties receive nothing.

Rational choice theory predicts that on the whole parties will choose the alternative that is likely to give them the greatest satisfaction. On that basis we would expect that B will accept any share of the stake offered by A as she will be better off than before she accepted the offer. Rejecting any offer by A would leave B in a worse position than if she had accepted, no matter how small A’s offer. We would expect, for example, that if A offered B a $1 share, she would accept because she would be $1 better off. Repeated experiments using the ultimatum bargaining game, however, demonstrate that B is likely to reject a $1 offer (when the stake is $100), so that both A and B will receive nothing. The evidence shows not only that responders reject small offers, it also shows that proposers, perhaps anticipating rejection, usually offer substantially more than the smallest possible amounts.\(^ {26}\)


In the first ultimatum game, undertaken by Guth et al, proposers made average offers of 36.7% of the stake, while one offer of 30% was rejected. The results of subsequent ultimatum game experiments are variable, but on average the minimum amount that responders will accept is between 20%-30% of the total stake. That is, responders prefer no deal to one they consider to be unfair, despite the fact they would be better off by accepting the unfair deal. Proposers, perhaps anticipating the possibility of rejection of low offers, tend to offer between 40%-50% of the stake. Taking the position of the proposer, it would appear she is either acting altruistically or she is calculating that her self-interest is best served by not inviting a rejection by the responder. Recall that under the rules of the game the proposer has only one shot at making an offer, and rejection by the responder will leave her (as well as the responder) with nothing.

As a note of caution, when observing a deal we need to be careful about our assessments of how the parties perceive unfairness in relation to a particular deal they are negotiating or performing. For instance, the parties may perceive a deal to be fair (or at least, not unfair) even if, say, the price of the goods or services is substantially higher or lower than the going market price (which can be said to be the optimum fairness point). The parties may depart from the market price (if there is one) to make allowances for the fact that one party is bearing a greater risk burden than the other under the deal. The price might be lower than the market price to promote a long-term business relationship as part of a strategy to increase market share or to induce the other party to move from an existing supplier. Here we can say that the optimum point of fairness for the parties has shifted from the normal (market) optimum point.

If allowance is not made for any shift from the normal market position in the optimum point of fairness for the parties to a particular deal, it can mislead an observer

When combining the results of a number of research studies, the overall outcome shows that roughly 60-80% of offers fall within the interval 0.4, 0.51, while 3% are below 0.2.
into believing the deal is unfair. As Schwartz and Scott observe, deal terms that superficially appear to be one-sided are often mistakenly believed to be the product of unequal bargaining power.\textsuperscript{30} However, as they explain, an apparently one-sided deal is very unlikely to be unfair if during bargaining both parties have a next best option, are both patient negotiators (ie one party is not under pressure to conclude the deal whilst the other is, because of financing or other pressures) and are sophisticated. These elements may well not be in play for unfair contracts.\textsuperscript{31}

The results of ultimatum game suggest, somewhat paradoxically, that the selfish thing to do is to act altruistically. That is, if we act too greedily we will be punished by the other party, and consequently end up worse off. Although this suggests that generally people act altruistically, it also seems that our behavior is more complex than that. Trivers suggests that although parties gain mutual benefit through reciprocal altruism, there is a constant temptation to receive more than one provides through subtle cheating.\textsuperscript{32} Research also shows that “that people use impression management strategies to appear fair, often by dividing outcomes equally, especially when they expect recipients to be aware of the division”.\textsuperscript{33} Thus, the concern for fairness does not preclude other factors such as greed from affecting behavior.\textsuperscript{34} Some analysts posit that there is a contest between two extreme positions; between ‘fairmen’ who divide everything equally and ‘gamesmen’ who behave selfishly and rationally like proper economic agents.\textsuperscript{35} In Thaler’s view, most people are not well described by either extreme view:

Rather, most people prefer more money to less, like to be treated fairly, and like to treat others fairly. To the extent that these objectives are contradictory, subjects make trade-offs. Behavior also appears to depend greatly on context and other subtle features of the environment.\textsuperscript{36}

The experimental outcomes leave us with a bewildering array of evidence. Some evidence suggests people are concerned about fairness, other evidence indicates that most

\begin{itemize}
\item RL Trivers “The Evolution of Reciprocal Altruism” (1971) 46 Quarterly Review of Biology 35 at 37
\end{itemize}
are selfish, and yet other evidence indicates that we usually seek to deal cooperatively.\textsuperscript{37} Various commentators have attempted to explain the reasons for such apparently contradictory results. One explanation is simply that “this is a heterogeneous world where some people exhibit reciprocal fairness and others are selfish”.\textsuperscript{38} Just as humans are inclined to act fairly, they are also inherently ready to act unjustly and unfairly, or do wrong if they can get away with it.\textsuperscript{39} Apparently, this behavior has roots in our biological evolution. Evolutionary psychologists hypothesize that humans have evolved “mental algorithms for identifying and punishing defectors”.\textsuperscript{40} Humans apparently adapted to identify cheaters and to be identified as a non-sucker, that is, someone who is not easily exploited. As a result, there is a tendency to act spitefully when treated unfairly.\textsuperscript{41} Fehr and Schmidt claim there is an important interaction between a population’s distribution of preferences and its strategic environment.\textsuperscript{42} They conclude that:

\begin{quote}
\ldots there are environments in which the behavior of a minority of purely selfish people forces the majority of fair-minded people to behave in a completely selfish manner, too.\ldots. Likewise, in a simultaneous public good game with punishment, even a small minority of selfish players can trigger the unraveling of cooperation. Yet, we have also shown that a minority of fair-minded players can force a big majority of selfish players to cooperate fully in the public good game with punishment.\textsuperscript{43}
\end{quote}

A significant factor influencing the behavior of parties in all these environments is their perceptions of whether an outcome of a particular deal is fair. Perceptions appear to be based upon a ‘reference point’ or ‘reference transaction’ from which assessments of fairness are made. If the parties believe that neither is more entitled to the stake than the other, the reference point is typically an even split, assuming an even split is identifiable

by the parties.\textsuperscript{44} If both parties believe one is more entitled than the other, the reference point shifts more in favor of that party.\textsuperscript{45} Evaluations of entitlement in a given situation are “the product of complicated social comparison processes”.\textsuperscript{46}

The equal split is usually not feasible because most transactions do not involve dividing up the pie; rather they involve exchanging one item (money) for a particular good or service. Many transactions are more complex still. The ultimatum bargaining game, as we have seen, is played out in simplified environment in which the only fairness consideration is the proportion of the split of the money on offer. Evidence suggests that fairness concerns may be less pronounced in settings where splitting equally is impossible.\textsuperscript{47} In reality, there are few contexts in which this is the case because the quid pro quo is not simply a split of funds, but the exchange of money for goods or services, as well as other more complex exchanges.

Where the equal split is feasible, it stands as a strong reference point for the parties. For observers and the parties it serves as the optimum point of fairness. For most of us, equal splitting “plays an important role in our upbringing and, typically, our first bargaining experiences with siblings and friends are situations where sharing equally is quite common (often enforced by third parties like parents or teachers)”.\textsuperscript{48} In the absence of an equal split reference point, the behavior of the parties can change dramatically. As Guth and Huck noted:

Comparing the equality game with the inequality games we observed that behavior changed dramatically although the inequality games were generated by only slightly altering a single payoff vector. More precisely, proposers choose significantly more often unfair offers when the exactly equal split is not feasible and responders reject unfair offers less often when all offers imply a payoff

advantage for the proposer…. The general message of these results (which seem in line with a focal–point explanation) is that fairness concerns may be less pronounced in settings where splitting equally is impossible. In reality equal splits are quite often not feasible, e.g., because of different enforceable claims.49

In summary, parties generally attempt to be perceived by each other as acting fairly. If an optimum point of fairness (eg the equal split) is ascertainable and known to the parties, they will tend to propose and accept deals that have a closer alignment with the optimum fairness point, than if it is not ascertainable or known to the parties. If the dealee does not know the optimum fairness point, this offers a strong temptation to the dealor to act greedily.

II.D The Unfairness Tipping Point

Commentary on the ultimatum bargaining game outcomes has naturally focused on the fact that it suggests parties act according to their assessments of fairness. This tends to overlook another very interesting insight that the game provides, and that is the degree to which the responder is prepared to tolerate “unfairness”. If an equal split is feasible, the ultimatum bargaining game suggests that most responders will not reject until the offer falls below 20%-30% of the stake, and given that our socialization would suggest that an equal split is the optimum point of fairness it appears that responders have an unfairness tolerance of between 20%-30%.50 Proposers on the other hand tend to make offers closer to the equal split. This suggests that they are uncertain as to what the responder’s unfairness tolerance (or tipping point) is, so they play conservatively and hence make an offer closer to the equal split.

Negotiations are in reality often not undertaken on an accept or reject basis, nevertheless, there is evidence of dealees punishing dealors for perceived unfair deals in

real world circumstances.\(^5\) Even in the absence of circumstances in which more pronounced assessments can be made of fairness, sensitivity to unfair treatment subsists:

Behaviourally, humans are reciprocators – in most cases reflecting in their own behaviour their perceived treatment by others. If nonshareholders believe that management is not acting fairly toward them – that is, if management is withholding ‘too much’ of the corporate surplus for the shareholders – the other stakeholders will be resentful and will act out their resentment in some way….In our experiment, the creation of the agency-maximization duty resulted in a severe drop in the number of deals consummated….Even though the duty caused the proposers – our analogue to corporate managers – to act more ‘efficiently’, the resentment of the other players created an end result that was inefficient.\(^6\)

So, a resenter will be unduly harsh in punishing the dealor, even if, as we have seen, the punishment will also hurt the dealee. Empirical evidence suggests that customers have strong feelings about the fairness of a firm’s short-run pricing practices, which could explain why some firms hold their prices below prices they could gouge as a monopoly.\(^7\)

The term ‘resentment’ implies that the resentor is responding to more than mere non-fair behavior, but to perceived highly unfair behavior. In which case, the dealor’s behavior has to be perceived as sufficiently extreme to invoke an extreme response from the dealee.

The point at which the dealee will read the dealor’s behavior as being so unfair as to invoke sanctioning behavior by the dealee will depend very much on how the dealee assesses where the optimum fairness line is drawn, and how she will assess the point at which the dealor has gone too far and crossed her resentment line. As the dealee has the power to punish it is wise for the dealor to gain a sense of where lies the dealee’s line of

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\(^5\) See MM Pillutla and JK Murnighan “Being Fair or Appearing Fair: Strategic Behavior In Ultimatum Bargaining” (1995) 38 Academy of Management Journal 1408, pp.1409-10 where they say:
In ultimatum experiments, offers are absolutely final; both parties (who have no history and no expected future) receive nothing if an offer is rejected. The starkness of these interactions necessarily limits their generality, but they provide a basis for clear tests of theoretical predictions and for evaluating whether fairness can explain actions in competitive negotiations.


resentment. The better the dealor knows about the dealee’s character and world view the more accurate the dealor’s assessment of the dealee’s line of resentment, that is to say, the dealee’s tipping point.

Fehr and Schmidt believe that the resentful party’s capacity to punish is substantially limited in monopoly markets in which the dealees cannot punish the monopolist by destroying some of the surplus and enforcing a more equitable outcome. This suggests to them that fairness plays a smaller role in most markets for goods (which presumably are more likely to be beset by monopolists) than in labor markets. Thus:

… in addition to the rejection of low wage offers, workers have some discretion over their work effort. By varying their effort, they can exert a direct impact on the relative material payoff of the employer. Consumers, in contrast, have no similar option available. Therefore, a firm may be reluctant to offer a low wage to workers who are competing for a job if the employed worker has the opportunity to respond to a low wage with low effort.54

On the flip side, perceived fair behavior is generally rewarded, with the dealee performing her obligations beyond the required standards. Fair behavior can induce a virtuous cycle.55 There is an increasing body of evidence suggesting that when offered a trust contract,

…a substantial number of individuals will both pay higher prices and extend higher levels of effort than narrow self-interest would dictate. When offered the same choices plus the possibility of obtaining a monetary sanction if the promisor shirks, the average price offered by buyers and the average effort given by sellers was lower. Without coercive enforcement, reciprocal fairness generates high levels of performance. But once the interaction is backed by coercion, reciprocity declines and overall performance is reduced.56

It can be speculated that the unfairness tolerance will be higher or lower than, say, the 25% average that can be inferred from ultimatum bargaining game outcomes depending on market conditions and other factors that lead to greater or lesser degrees of dealee deference. In competitive markets the tolerance might be quite low because the buyer (dealee) has other purchasing options and because she feels affronted by offers that

are substantially above the going market price. In a competitive market the dealee believes she holds the cards and will take a high price offer, relative to the going market price, as an insult to her dominant position. In a monopoly market the situation is different, market power lies with the seller (dealor). Not only does the buyer have few if any other options she is resigned to the fact that she has little power other than to accept or reject the deal on offer. Being affronted by the deal on offer will serve little purpose. If we frame these two situations in terms of human hierarchy, where one player stands higher on the hierarchy ladder than the other, in the competitive market the buyer stands in a higher position than in the monopoly market. It can be speculated that the closer the parties are in hierarchy, the lesser the unfairness tolerance; and vise versa.

There is another possibility as well. Assuming we are hierarchical animals, it follows that a person lower on the hierarchy will yield to a greater or lesser degree to a person holding a higher position. Assume also that our social structures and interactions reward initiative. That is, human progress is to some degree driven by conscious and unconscious rewarding of the initiator. Admittedly, there are social situations where a countervailing effect applies – particularly in some large organizations like government bureaucracies where a person taking an initiative that is later perceived to have failed, this can lead to the initiator suffering loss of face or demotion. Putting that to one side, and assuming a general position where initiative is rewarded, then it is possible that a deal proposer enjoys a privileged position relative to the responder, and is thus accorded a degree of unfairness tolerance. As an example, if a potential employer makes the first move by offering a specified wage it can be speculated that the potential employee is more likely to accept than to haggle.

The suggestion here is that there is a relationship between the perceived power balance between the parties and the unfairness tolerance of the perceived weaker party. Further claims can be made on the basis of these assumptions. First, the power balance between the parties during the course of a deal relationship can change. Second, each party can perceive the power balance differently. Party A might believe that B is in the stronger position, whilst Party B believes that A is in the stronger position. Or, even if A thinks she is in a strong position, she might not believe her position to be quite as strong as B imagines it to be.
Taking both these propositions we can look at the “deal” relationship between electors and the members of the legislature they have elected. Electors will at first allow the majority legislators a greater unfairness tolerance than “normal” because the legislators took the initiative in proposing policies and running for election. If the legislators begin to enact laws the electors believe are unfair, allowances will at first be made, and resentment and reputation costs will be low. In the first months after election the electors also will be inclined to be deferential, in part because the legislators will be seen to hold the more powerful position as lawmakers. If the legislators continue to pass laws that the electors take to be unfair even after allowing for the unfairness tolerance, resentment and reputation costs will come into play. If damage is done to the legislators’ reputation, the electors may be decreasingly declined to act deferentially towards the legislators.

Democracies are designed so that resentment costs can be inflicted upon the legislators via the ballot box. In dictatorships, this option is not available to the people, placing pressure on the people to find other means for inflicting resentment costs. A dictator will also seek to suppress public option and the media so as to reduce reputation costs (and any related resentment costs caused by reputation damage). The other advantage of a democracy is that the tenure of the legislators is limited. As time moves closer to the election date, the power shifts from the legislators to the electors, who ultimately have the power to dismiss the legislators.

A wise or canny dealor will be aware that despite holding a dominant position in the relationship, and having some scope within the unfairness tolerance, she will be aware that if she crosses the dealee’s line of resentment the power balance may shift away from her. She will therefore be careful not to traverse that line.

The unfairness tolerance of the weaker party is not merely explained by hierarchical deference and initiator reward, the weaker party is also acting in her own self interest. There is often a cost to the weaker party of punishing the stronger – as she will often also be punishing herself. Take an example of an employee who believes she is being unfairly underpaid and is considering punishing her employer by failing to undertake some of her assigned tasks. Doing this exposes her to the risk of being discovered and the employer
firing her. The employee will therefore weigh up the degree to which she is resentful with the risks and likely extent of retaliation by the employer.

The dealee’s resentment, however, can be costly to the dealer. As an example, an employer who pays her employee a wage well below the market rate may suffer an employee who punishes her by shirking. The employee may undertake her tasks poorly and become unreliable in the performance of her duties. Similarly, a resentful party to a non-employment contract may well fail to perform their obligations to the standards they would if they were not resentful. The problem the dealer faces is that it is usually difficult to detect whether shirking is actually taking place and the extent of potential losses that are being suffered as a result. Because of the risk of retaliation, dealees rarely announce their unwillingness to perform their promised obligations, instead they “typically affirm solidarity, protest helplessness in the fact of intractable problems, or act in subtle ways that are difficult to evaluate”.

On the basis of insights offered by the ultimatum bargaining game, it can be posited that in the real world a dealer who is sensitive to the risks of being perceived to be unfair and consequently being punished by the dealee will, if possible, attempt to assess the dealee’s tipping point. The less knowledge the dealer has about the dealee’s tipping point, the more conservatively the dealer is required to act to avoid resentment. The more knowledge the dealer has, the closer she can push the deal towards the tipping point. Putting matters more positively, pre-deal negotiations may in part involve the parties getting to know each other better so that they can reach an agreement that both perceive to be fair so that they will be both committed to the full performance of the deals. That is, they may both search out how the other is feeling about the proposed deal to ensure there is no resentment.

II.E  Cheat and Bully Strategies

A dealer might decide to mitigate 3Rs costs by using a cheat or bully strategy, it is here posited. In using a cheat strategy, the dealer assesses she can mitigate 3Rs costs because (she calculates) the dealee and the regulator are unlikely to discover the deal is unfair, or if they discover it to be unfair it will be too late for them to inflict 3Rs costs. Using a bully strategy, the dealer calculates that even if the dealee is aware the deal is unfair, the dealee has nowhere else to go. The dealer calculates that the dealee will decide that the unfair deal is better than no deal at all, and that any potential 3Rs costs will not hurt. Bully deals might be an available strategy where the dealer is a monopolist.

Taking a marketplace perspective, markets can be described as clean or dirty; and international treaty negotiations can be described as taking place in clean or dirty international settings. A clean marketplace, for instance, is one in which unfair contracts are the exception rather than the rule. Here there is healthy competition, the 3Rs costs play an important role in disciplining dealer behavior and the environment for cheat and bully strategies do not exist. In a dirty marketplace unfair deals are commonplace. Any disciplinary effect the 3Rs costs might have are mitigated by the widespread use of cheat and bully strategies. Dealors are able to make effective use of cheat strategies, for example, by charging prices in excess of those they could charge in a clean market. In a dirty marketplace, a vast array of tactics is available for cheat strategies. They include obscuring the visibility of price competitors by heavily using advertising and promotional campaigns to draw attention away from the price competitors. Other tactics involve competing with complex pricing systems that render product and price comparison difficult if not impossible. Cheat terms can appear in consumer contracts, which might include hidden fees, excessive penalty clauses, hidden kick-back arrangements with third parties, and so on. Cheat strategies can include neutralizing potential reputation costs by again using feel-good advertising campaigns and public relations exercises to enhance the dealer’s reputation undeservedly. A bully strategy might involve collusion with potential competitors to avoid competing on price or service and product quality.

In the marketplace, perceptions of unfairness play a central role. In a dirty marketplace the unfair dealer engages in a course of conduct through its standard contracts and other mechanisms to hide the unfair characteristics of the deal from the
dealee, or simply disregards what the dealee might think about the fairness or otherwise of the deal.

**Part III  What is an Unfair Deal?**

**III.A  Introduction**

Recall that a central purpose of our analysis is to understand why parties enter into unfair deals. This begs the question as to what is meant by an unfair deal. Arriving at an answer to this apparently simple question is not easy. To begin with the term has a somewhat chameleon-like quality. At times it refers to a particular dealee’s perception of unfairness – and indeed, it also refers to the dealor’s perception of what the dealee perceives is unfair. At other times the term “unfair” has a public meaning – either in the form of the general public perception of unfairness, or in the form of definitions of fairness concepts which are crystallized in laws. In some contexts unfairness is not consciously framed in a moral context or discussion - for example, where an innate or visceral response arises from a dealee’s perception that she has been being screwed by a deal. In other contexts, notions of unfairness are a consciously moral concern. Although these different formulations of unfairness appear to be discrete, in reality the various formulations of unfairness bleed into each other. Our innate sense of unfairness, for example, is doubtless informed by moral concerns, whether we are conscious of this or not. And articulated moral concerns about fairness maybe simply narrow self-interest in the guise of higher principle.

Remember, unfairness can be viewed from the perspective of an individual dealee, or from society’s perspective. The social perspective may take shape as a generalized conception of unfairness (discoverable, perhaps, by public opinion surveys), or it might be fairness as crystallized by the law. In any event the two general perspectives are not mutually exclusive of each other.

Unfairness can also be viewed internally – from a party’s particular perspective, which is to say from a subjective perspective – or externally, from the perspective of an outside observer. When we speak of a cheat strategy to mitigate 3Rs costs regarding an unfair deal, we cannot be speaking of unfairness as perceived by the dealee, because the dealor is deliberately hiding information from the dealee that might provoke her
resentment about the deal. So here, unfairness needs to be assessed by an observer external to the deal to assess whether it is unfair. This will require placing a notional dealee in the position of the actual dealee. The notional dealee is taken to be fully informed about the nature and consequences of the deal (that is, the notional dealor is placed in the uncheat position). If the observer determines that the notional dealee would perceive the deal to be unfair, then it can be said to be unfair. Putting it another way, the deal can be said to be unfair if no rational dealee in the uncheat position would accept the deal, assuming other reasonable alternatives were available to the dealee.

The term “unfairness” is also troublesome because although on the surface it suggests a relatively stable meaning, in reality it rests upon a highly unstable substratum. To begin with a dealee, a dealor, an observer, and the law may each hold very different assessments of the fairness of a particular deal. The term can infer a highly subjective assessment by the parties; as mentioned above, a dealee’s response to a perceived unfair deal can be visceral if she thinks she has been exploited. “Unfairness” is a term that also infers that it is not confined to subjective considerations, and that objective criteria can also apply. In both the subjective and objective states moral considerations can be applied. But “morality”, like “unfairness” has an unstable meaning. It suggests both purely subjective assessments of morality – that might have little or no bearing on socially defined morality (if there is such a thing); and a more “objective” or socially or externally defined meaning. The term suggests that it is determined by generally accepted conceptions of appropriate social and by personal values.

We will side step a morals based inquiry for a moment to attempt to avoid indeterminate (and possibly interminable) debates. There is no suggestion here that these questions are not central to considerations about unfairness. Nor is it suggested that questions of morality can or should be considered as being in some way independent of questions about unfairness. Rather, morality is seen to be important, but mysterious. We need therefore to suspend questions of morality for a moment for analytical purposes, and not because it is a side issue. Rather it is the reverse; morality so dominates the unfairness discourse that it obscures from view other operatives upon our sense of fairness and our behavioral responses to perceived unfairness.
III.B What is Unfair?

For the purposes of analysis, a distinction is made between fairness, non-fairness and unfairness. Our personal sense of fairness (and unfairness) is informed by a limitless range of sources, including our upbringing, friends, associates, parents and school; and by stories, TV shows, the law, and so on. We each tolerate in our daily lives all kinds of slights and minor injustices, and no doubt are daily authors of the same. We can perhaps describe these tolerated breaches of fairness as acts of ‘non-fairness’; acts that we consider not to be fair, but not intolerably so. Acts by others that we consider to be intolerable and deserving of some kind of retribution are to our mind unfair. Unfairness is to our minds categorical, and invites a visceral response – the desire to punish the offender in some way.

We each have ways of privately defining unfair conduct and seeking to punish the offending behavior. What might become immediately obvious to the reader is that the process by which we each privately categorize the deeds that are intolerably unfair and deserve punishment is a microscopic playing out of the essential features of our legal and regulatory system (our justice system). We each carry within our heads a micro-system of justice, which defines and seeks to punish unfair behavior. The micro-system to some degree or other is informed by and interacts with the macro-system of justice. Deal theory is interested in that interaction.

The interaction between the macro and micro systems could be described as an interaction between the public sphere and the private, although that distinction is not altogether helpful. When we can speak about the micro-system in a personal or a collective sense. In the collective sense we are not speaking of my private micro-system, or yours, but all our micro systems collectively. In this sense the micro-systems as a collective are not within the private sphere – they in some sense are a shadow form of the macro-system, but without its institutions and express rules. It is useful, then, for analysis to distinguish between an individual micro-system and the collective sum of our micro-systems. If we speak of a micro-system in an individual sense, we are talking about the micro-systems of the parties to a particular deal.
It can be said that if a macro-system reflects to a considerable extent the values and worldview of the collective micro-systems of a society, this indicates that there exists in that society an effective legal system (in terms of society’s capacity to enforce unfairness prohibitions and remedies). It also suggests that the society is democratic (in the sense of giving legal effect to the general desire and values of the members of that society). We can describe this as a responsive macro-system. Such a system would not (and in making a normative claim, should not) to some degree or another merely reflect the values and worldview of the collected micro-systems; it would (and should) influence them as well. In other words there would be an iterative communication between the two systems.\(^{59}\)

Perhaps this describes precisely how our political system works, although we cannot be sure. Buried in these descriptions is a normative claim. I am imagining that in a modern democratic society our collective micro-systems are inherently ‘fair’ and ‘just’. I do not imagine that we collectively would desire to use the sheer weight of majority sentiment to inflict ‘unfair’ outcomes on a minority; but I must admit to that possibility. And given that the micro-systems are influenced by the values, perspectives and rules of the macro-system, it is also possible that a harsh and mean-spirited macro-system could well induce the collective micro-systems to harmonize with its nasty worldview.

We will assume for a moment that the collective micro-systems are essentially egalitarian. From this it follows that a deal can be said to be unfair without having regard to the social or economic status of the parties. So a deal could be said to be unfair regardless of whether the dealee is rich or poor, or from the upper class or the lower class. This starting assumption needs to be relaxed somewhat to accommodate the proposition put in this article that unfairness tolerances can vary as a result of the perceived or actual power relationship between the parties. A poor person believing she is in a weak bargaining position may tolerate a greater degree of non-fairness before she resents the deal. Thus, for analytical purposes at least, the optimum point of fairness in a deal is determined from an egalitarian perspective. From these propositions, the normative

\(^{59}\) In a dictatorship, in which the macro-system is unresponsive, the macro-system would be used to influence or force the collective micro-systems to conform to its views of fairness. The macro-system would, to a substantially reduced degree, be influenced by the perceptions of fairness of the collective micro-systems.
claim can be made that a society that seeks to be egalitarian will/should seek to narrow the unfairness tolerances of deals that take place within that society.

There is another more pragmatic aspect to the ideal of harmonizing the macro and micro-systems. Two of the 3Rs costs, namely reputation and resentment, can inflict serious damage upon a dealer if the audience for the reputation claims is sufficiently large and the resentment response is sufficiently severe. If a regulator were to harmonize with the collective micro-systems in such a way as to enlist the aid of our micro-systems to trigger a retaliatory response against an unfair dealer, then this may well prove more effective in moderating future dealer behavior than by merely relying on the standard tools for enforcement such as using penalties or entitling parties to sue for compensation. Some regulators do in fact enlist two of the 3Rs, namely the reputation and resentment costs to moderate dealer behavior. As an example, the regulator who requires a dealer who has breached the law by misrepresenting the virtues of a product to publish a public apology and correct the claims made about the product. Here the regulator is effectively inviting each of our micro-systems to treat the dealer warily or boycott the dealer.

III.C Macro and Micro Perceptions of Fairness as a Moderator of Selfish and Selfless Behavior

Yet another function of the relationship (ideally) between the macro and micro systems is to regulate or moderate the moments, and degrees to which, we act or should act either selfishly or selflessly. As a society we benefit from each of our members acting at times either selfishly and selflessly (that is to say, cooperatively). A society that is overly selfish, it can be supposed, becomes mean-spirited, corrupt and brutal. A society that is overly selfless, on the other hand, can be claimed to be one that loiters aimlessly; becalmed upon a windless sea. It lacks direction, vitality and, ironically, cohesion. A selfless society (or group) will however tend to act in a highly cooperative way when it is seriously threatened or suffering privations. Here a high degree of cooperation is required for survival.

Organized selfishness (a process that includes the marketplace), on the other hand, requires a level of cohesiveness amongst self-interested players to function even in good times. That is, “beneficial” selfishness usually requires a degree of organization (and
paradoxically, cooperation) that may be lacking in a totally selfless society. An overly selfless society operates well below its economic potential, leaving its members more financially impoverished than needs be. In an overly selfish society, on the other hand, the selfish prevail and the selfless are effectively enslaved, to the detriment of the society as a whole.

Ideally, therefore a society needs its members to act to appropriate degrees both selfishly and selflessly. Arguably, a switching or moderating system is needed to ensure the proper interplay of these general behaviors. The claim here is that our micro and macro characterizations of “unfairness” play a critical role in the operation of that moderating system. The point at which unfairness arises may well mark the point at which selfish behavior becomes destructive, or at least counterproductive. So, an ideal society relies upon the effective operation of an unfairness moderator – which, when it works well, helps maintain equilibrium between overall selfish and selfless behaviors. We can see here how central our internalization of a sense of fairness is in ensuring that we personally are not taken undue advantage of by the selfish behavior of others, and to ensuring the overall functioning of a well functioning society.

The social benefit that can be gained by selfish behavior was identified some time ago by Adam Smith. His famous insight is that a society of members pursing their self-interest magically (as though there was an invisible hand guiding society) leads to the overall benefit of society. As he said, it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. The insight Smith offered is, of course, highly generalized as this magical process does not always work; markets are manipulated, some members of society are excluded from the marketplace or enter on seriously disadvantaged terms, and so on.

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60 See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations, the Glasgow Edition of the Works and Correspondence of Adam Smith*, 6th ed (Dublin: Wogan, Gilbert and Hodges, 1801) at p 15. A fuller context for the quote is as follows:

“But man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and shew them that it is for their own advantage to do for him what he requires of them...It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk of them of our own necessities but of their advantages”.
John Rawls also offers insights into how selfish behavior can notionally be attuned to deliver social benefit. He proposes that it is possible to imagine the design of a fair society by placing imagined players in the ‘original position’. Here the players stand behind a veil of ignorance where they design a set of rules for governing an imagined future society. After designing the rules the players enter the society. However, when designing the rules they are unaware of which position they will enter and what status they will hold in the new society. It is therefore in their self-interest to design the rules as fairly and non-discriminatory as possible. The Rawlsian game operates rather like the rule at a birthday party which requires that the child who divides up the cake will take the last remaining portion. In this way self-interest is harnessed so as to attain the general good. It is therefore in the best interests (the selfish interests) of those in the original position to design a society as fair and equal as possible because when they enter the world they have designed they may well end up in the least advantageous position.

Rawls’ (moral) pre-supposition is that society should be egalitarian – which is to say, self-consciously co-operative. What is interesting is the apparently paradoxical operation of the original position, which harnesses self-interest in the original position to attain an egalitarian society. And in other ways, Smith’s invisible hand paradoxically utilizes individual self-interest to enhance the economic and social benefits for society more generally.

Returning to the meaning of unfairness, Rawls’ perspective on how we come to specify what are fair terms and cooperation is interesting. He asks:

Are they specified by an authority distinct from the persons cooperating, say, by God’s law? Or are these terms recognized by everyone as fair by reference to a moral order of values, say, by rational intuition, or by reference to what some have viewed as ‘natural law’? Or are they settled by agreement reached by free and equal citizens engaged in cooperation, and made in view of what they regard as their reciprocal advantage, or good?  

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Rawls responds by saying the best answer is the last; that is where there is an agreement between citizens themselves reached under conditions that will set rules that are fair for all – these conditions exist in the “original position” posited by Rawls.62

There is in the accounts by Smith and Rawls a distinct air of artificiality. In Adam Smith’s marketplace the participants are well informed, are of equal means and have equal access to the marketplace. In Rawls’ original position the imagined players are free, equal, moral (at a basic level, at least) and rational. Under deal theory, by contrast, the players are hierarchical, constrained by bounded rationality and their “morality” is largely confined to questions about whether they intuitively consider the deal to be unfair or not. The players in deal theory, for the purposes of analysis, are artificial, but nevertheless are closer in nature to real world players than many other theories permit. Another difference is that under the Rawlsian and Smithsonian systems the outcomes are ultimately fair, whereas under deal theory the possibility of an unfair deal is ever present.

III.D Analyzing Unfairness

Unfairness, for present purposes, can be analyzed from the perspective of a particular deal. It can also be seen from a marketplace, or other sub-societal or societal, perspective. A more particularized analysis might pay particular regard to the micro-systems of the parties to a particular deal. A more contextualized analysis, on the other hand, will attempt to assess the unfairness boundaries as set within the collective minds of the players in the marketplace more generally. Under either form of analysis, unfairness is established by the parties to a deal or the players in the marketplace, rather than solely by systems or institutions external to the parties themselves. That is, unfairness is not primarily established by the operation of the law, regulations or externally devised moral or ethical standards. For the purposes of analysis, the micro-system fairness boundaries may well be influenced by external standards, laws and regulations, but are not imposed by them – as we will see in the discussion about folklaw, in the next section.

Superficially, it might be claimed that macro-system fairness standards are more discoverable than micro-system standards because macro-system standards can be found in written laws and regulations and the like, whereas micro-system standards exist within our heads. This claim, however, over-assumes the tangibility of the external standards; that is, their discoverability merely as words on pages or on computer screens. There is endless debate, for example, about the objective meaning of the words in statutes and constitutions. The claim about the more discoverable nature of the macro-system also underestimates the capacity of parties to a deal to be able to make relatively accurate estimates of each other’s fairness standards (assuming each has a reasonable knowledge about the other, and there are not distorting factors at play, such as agency problems and hyperbolic discounting. It also underestimates our capacity to interrogate the ways in which our micro-systems define unfairness. We can make generalized assessments and speculations about the workings of our micro-systems of justice; use our intuition to estimate the general standards of fairness held by the majority of players in a marketplace; or divine these standards by using qualitative or quantitative research methodologies. We can also use the ultimatum bargaining game, as we have seen in the discussion above, and also apply behavioral studies, and other forms of social science methodologies to gain insights into the operation of micro-systems.

Part IV The Folk-law
The ways in which our individual and collective micro-systems interact with the macro-system – and more specifically the law – is interesting. As mentioned, in setting the

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63 See Part V, below.
64 Macaulay suggests the following approach by lawyers for aligning the law with the true intentions of parties to a contract:
Assuming that cost barriers permit, lawyers may be able to show judges what would be fair in a particular commercial context. The judges and the lawyers involved might never define ‘fair’ in a precise fashion that would satisfy a critic or offer answers to judges and lawyers in future cases. Nonetheless, all involved might accept that the results seemed to fall within an intuited zone of fairness. This process, however, might be very costly because it could require an exploration of the full commercial context. Of course, there is a risk that the judges might get it wrong, and cost barriers to proving the full context of a transaction would likely increase that risk. However, there is no reason to presume that the process always will be unduly costly or judges will always get it wrong.
optimum point of fairness and our unfairness tipping point for a deal, our micro-systems will have formed a (sometimes hazy) conception of fairness that is in part influenced by, but not determined by, our understanding of what the law says. This understanding is invariably informed by what we might each gather from TV shows, newspaper reports, stories told by our friends and so forth. All these sources, together will our own framing of values, cohere into what we imagine the law says. The law as we collectively and individually imagine what it says is in essence folkloric – or folklawic. Folklaw as we individually and collectively imagine it informs our micro-systemic formulation of unfairness.

The macro/micro systems interact in another way. As mentioned, each of our micro-systems has an impressive capacity to punish perceived unfair conduct. The offender’s (dealor’s) reputation can be trashed, and the hurt party can underperform her obligations or act in various ways to covertly sabotage the interests of the offender. Sometimes, however, this might not be enough, and the harmed party will seek to enlist the agency of the macro-system to gain appropriate retribution for the other party’s unfair behavior. We each imagine (or at least hope), it can be said, that we can call upon the aid of the macro-system if we are subjected to relatively serious acts of unfairness. We believe and hope that it has defined unfairness in approximately the same way we have, and that the macro system will parcel out punishments on our behalf and provide a means for us to demand compensation.65

The folk-law is hazy in outline and is carried in the minds of every citizen. It is the real law as imagined – and the imagined law is a mix of what each citizen thinks the law says and what she would like it to say. The imagined law may at times be harsher and at other times more forgiving than the real law. The folk-law also reflects (at a deep and unarticulated level) each citizen’s sense of fairness. Rawls would possibly equate folk-law with what he describes as a “public conception of justice”.66 As he sees it, a modern democratic society is based on the idea of citizens as free and equal persons, and the idea of a well ordered society. In his view, the public political culture of a democratic society

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65 Punishment here is not limited to punishment in the criminal law sense. It includes compensation or damages for breaches of agreements, and for torts.
and its conception of itself as a system of social cooperation are essential to its functioning. And an essential organizing idea of social cooperation is the idea of fair terms of cooperation, which in turn specify “an idea of reciprocity, or mutuality”.\textsuperscript{67} He adds that:

\begin{quote}
The idea of cooperation also includes the idea of each participant’s rational advantage, or good. The idea of rational advantage specifies what it is that those engaged in cooperation are seeking to advance from the standpoint of their own good.\textsuperscript{68}
\end{quote}

The folk-law is more egocentric than Rawls’ public conception of justice. Under Rawls’ system there is a shared public view of rational advantage or good. Folk-law, on the other hand, is in the mind of each person. Folk-law, however, is subject to many and varied influences, including by what it believes the real law claims to be unfair. It is the real law as we imagine it to be – that is, as we think it is and as we would like it to be.

In terms of a particular deal, if the dealee (and possibly the dealor) imagines that the law says that a particular behavior regarding the deal is impermissible (whether or not the law \textit{actually} states that) then this imagined standard assists with establishing an observable optimum point of fairness for the deal, as well as influencing the dealee’s perceptions of unfairness regarding the deal and her unfairness tipping point. This line will often be a hazy, contingent and shifting. But if the dealor crosses the line, she risks retribution by the dealee.

The ultimate aims of society should not necessarily be to engineer the folk-law and the real law into lock-step conformity; there can be a creative and dynamic engagement between the two. Each can moderate and inspire the other. If, however, there is constant disharmony and mis-communication between two systems, this would suggest an unproductive relationship, and possibly indicate the existence of a dysfunctional or autocratic society. The challenge for lawmakers and regulators is to gain relative synchronicity between the two systems.\textsuperscript{69} This is not simply a task of ensuring the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{69} The problems that arise if the macro-system does not align with the micro-system can be illustrated by the following commentary by McCauley regarding contract law:
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players fully understand and internalize the (legal and regulatory) rules of the game, but to also ensure the laws and regulations make sense to the parties and reflect their deeper sense of fair play. Likewise, the real law would need to reflect to some reasonable degree the aspirations of fairness and justice of the holders of the folk-law.

In an ideal case, the relationship between the two systems, including the agency role of the macro-system for our individual micro-system, does not amount to a social contract in which we trade our birthright freedoms with the state in return for the state protecting and defending us. Rather, it is a joint enterprise in which both the micro (individual and collective) and macro systems operate to constrain unfair behavior.

**Part V  Dealer Miscalculations of Her Own Self-Interest**

For completeness, we can turn briefly to the ways in which deal theory can provide insights into the ways in which the dealer can miscalculate her own self-interest by pursuing an unfair deal. As has been said, a dealer will either fleetingly, or in a more considered fashion, decide whether to propose a fair or unfair deal, and whether the 3Rs costs of an unfair deal could be mitigated by a cheat or bully strategy. We assume for the purposes of analysis that the parties to a deal will be acting self-interestedly and not altruistically. Dealers, it is suggested, are prone to making a number of miscalculations about their self-interest in relation to assessing 3Rs costs.

As mentioned, the more unfamiliar a dealer is about the dealee’s world-view and value-set, the greater her risks of miscalculating the dealee’s line of resentment. In addition, a dealer is prone to cognitive and behavioral effects that may lead to miscalculations. As an example, it would seem likely that she might be as equally liable to engage in the types of hyperbolic discounting assessments that consumers have been found to make when engaging in longer-term transactions, such as borrowing to buy a car.

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We might decide that there is a high cost in legitimacy if the legal system comes to symbolise that contract rests on manipulations of forms and courts reject the substance of the real deal of the parties. At the very least, if our courts allow those who draft written contracts to impose terms inconsistent with expectations and the implicit dimensions of contract, we can expect reformers to demand that the law police those bits of private legislation that masquerade as contracts so that they are fair.

or a house, or entering a pension scheme. It appears from a number of studies that humans have a tendency to place less weight on the future than on the present, so that we in effect discount future payoffs (this is the hyperbolic discounting effect).\textsuperscript{70} As an illustration, some people prefer one apple today than two apples tomorrow, but at the same time prefer two apples in one year plus one today to one apple in one year.\textsuperscript{71} On this basis can be extrapolated that a dealer in proposing an unfair deal is likely to preference the short-term benefits the deal will deliver and discount the longer-term 3Rs costs of so doing. This may well explain in part the behavior of the key Enron players. It is possible that they heavily discounted any likely future 3Rs costs, or simply assumed that the cheat and bully strategy they were using would be fully effective, forever.

In any event, the regulatory challenge is to work out ways of overcoming the effects of any hyperbolic discounting.

A dealer might also miscalculate because of agency effects. An ‘agent’ could be the dealer’s employee. Adverse agency effects might arise where the agent’s self-interest does not properly align with the dealer’s self-interest. The agent might aggressively pursue an unfair deal on the dealer’s behalf, realizing that the dealer will probably suffer 3Rs costs eventually. The agent might, despite this realization, pursue the deal because she will be rewarded by receiving staff bonuses for closing a deal, or will receive peer approval by her work colleagues, or will simply not care what impact an unfair deal will have on her employer (possibly because she resents the way she is treated by the employer and seeks to punish him).


\textsuperscript{71} See A Rubinstein, “Economics And Psychology? The Case of Hyperbolic Discounting” (2003) 44 International Economic Review 1207 who at p 1209 cites Thaler’s experiments reported in R Thaler “Some Empirical Evidence on Dynamic Inconsistency,” (1981) 8 Economic Letters 201. Rubinstein is dubious of claims that research data supports the hyperbolic discounting theory; he nevertheless offer a succinct description of the theory at 1209:

Ainslie and Haslam (1992) report that “a majority of subjects say they would prefer to have a prize of a $100 certified check available immediately over a $200 certified check that could not be cashed before 2 years; the same people do not prefer a $100 certified check that could be cashed in 6 years to a $200 certified check that could be cashed in 8 years.” Findings of this type have been replicated with choices involving a wide range of goods (e.g., real cash, hypothetical cash, food, and access to video games) and a wide range of subject populations. Most importantly, the results seem to be confirmed by our intuition.
Part VI Conclusion

This article offers a way of understanding the reasons why parties enter into unfair deals and proposes that the dealor calculates whether to offer it is in her interests to offer an unfair deal. This calculation involves the dealor making a 3Rs costs calculation. She also considers whether she can mitigate these costs with a cheat or bully strategy. Sometimes the dealor can miscalculate her own self-interest by unduly favoring short-term gains over longer-term losses. She might also miscalculate because of agency effects.

Unfair deals are not good for the dealee, or society more generally. Hence our individual and collective aversion to such deals, and our instinctive desire to moderate dealor behavior by punishing detected incidences of unfair conduct by inflicting 3Rs costs on the dealor. We have both a personal interest in reducing and eliminating the possibility that we will be the victims of an unfair deal, and a social interest in the establishment of formal (macro-system) mechanisms, enhanced by the power of informal (micro-system) mechanisms, for discouraging the incidence of unfair deals. Healthy macro and micro-systems have a mutual interest to rid society of unfair deals. Corrupt macro-systems may be less interested.

The challenge for legislators and regulators is to gain a more elaborated understanding of the motives and incentives for unfair deals, and to devise mechanisms to remove those incentives.