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Shute: The Math is Off

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INTRODUCTION

This year marks the twentieth anniversary of the Court’s decision in Carnival Cruises v. Shute.\(^1\) Reversing the common law rule that forum selection clauses in “form contracts”\(^2\) are presumptively unenforceable, the Court reasoned that such clauses should be enforced because consumers “benefit in the form of reduced [prices] reflecting the savings that the [firm] enjoys by limiting the fora in which it may be sued.”\(^3\) The Court’s calculation was off, however, because it failed to account for the latent costs of such clauses. The time has come to get the math (and, perhaps, the law) right.

To begin, it is useful to understand the relationship between insurance and contracts. Consumer insurance agreements are, of course, one type of contract. And contracts, strangely enough, are also a form of insurance. Judge Richard Posner, for example, notes that contracts allocate risk and writes that “contracts also shift risks, and thus provide a form of insurance.”\(^4\) Of course, mere risk shifting isn’t insurance — insurance also requires risk spreading. Many people pay the insurer relatively small amounts of money so that the insurer has a pool of money to cover the costs for those few who suffer loss.\(^5\) A relatively low probability risk for the individual is converted into a certain cost for the group. And because most individuals are risk averse, social welfare is increased. Yet the idea of contracts as insurance is useful as a point of departure.

\(^2\) This Essay uses the term “form contract” instead of “adhesion contract” because of the pejorative connotation sometimes given to adhesion contracts, although for present purposes the two are synonymous. See BLACK’S LAW DICTIONARY 318-19 (7th ed. 1999) (defining “adhesion contract” in part as a “standard-form contract prepared by one party, to be signed by another party in a weaker position, usu. a consumer, who has little choice about the terms”).
\(^3\) Shute, 499 U.S. at 594 (“[I]t stands to reason that passengers who purchase tickets containing a forum clause like that at issue in this case benefit in the form of reduced fares reflecting the savings that the cruise line enjoys by limiting the fora in which it may be sued.”).
\(^5\) TOM BAKER, INSURANCE LAW AND POLICY 2 (2nd ed. 2008).
The typical consumer contract — the form contract — often contains standard clauses that function not as insurance, but as reverse insurance. Instead of spreading costs across the group, the clauses concentrate them on the few who suffer loss. To illustrate, the risk to an individual consumer that a particular product will give rise to a cause of action approaches zero percent. But for the firm, the risk that at least one defective product will give rise to a cause of action approaches 100 percent. Litigation, of course, involves risks and costs. Forum-selection clauses shift some of this risk and cost from the firm to the consumer. And choice-of-law clauses shift some of the risk and cost of adverse judgments. By transferring risks and costs, a product’s price may be reduced. Indeed, this price mechanism was the analytical foundation of Shute and is, so far as it goes, accurate.6

Yet this overlooks two significant costs. First, as noted above, although all consumers may enjoy a reduced purchase price, it is at the expense of the unfortunate few who face concentrated risks and costs after the purchase has been completed and after the improbable has occurred. Second, the reduced purchase price has a hidden cost for all — when a firm is aware that its exposure in tort has been reduced, it less likely to take safety precautions at the margin. Thus, risks and costs are not only concentrated, but magnified.7

While a number of different types of contract clauses may create this type of “reverse insurance,”8 forum-selection clauses and choice-of-law clauses (collectively “procedural clauses”9) do so pervasively.

The Court’s two leading decisions on the enforceability of procedural clauses, Shute and The Bremen v. Zapata Off- Shore10 illustrate the risk and cost

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7 This insight was first pointed out by Professor Michelle Boardman, to whom this Essay owes a great debt.
8 For example, arbitration clauses. However, this Essay’s admittedly modest proposal does not seek to remedy all problems with form contracts. Just two — forum-selection clauses and choice-of-law clauses.
concentration in practice. A relatively recent development in the law, Shute was the first (and only) Court case to hold such clauses enforceable in form contracts.\textsuperscript{11} Decided in 1991, the Court enforced “a nonnegotiated forum-selection clause in a form ticket contract.”\textsuperscript{12} As a result, the Shutes bore the costs and risks of litigating in Carnival’s home-state court, about thirty-five hundred miles away. Moreover, their rights were governed by Carnival’s chosen law as well.

To understand just how significant the choice of law can be, one need only look to The Bremen, which involved a contact containing a forum-selection clause selecting “the London Court of Justice.”\textsuperscript{13} The contract also contained an exculpatory clause waiving liability for damages “in any case.”\textsuperscript{14} The exculpatory clause was unenforceable in courts in the United States, but “prima facie valid and enforceable”\textsuperscript{15} in London. Thus, enforcing the forum-selection clause decided the case. While The Bremen involved two sophisticated international corporations negotiating contract terms clause-by-clause with “strong evidence that the forum clause was a vital part of the agreement,”\textsuperscript{16} the Court in Shute thought this a distinction without a difference.\textsuperscript{17} Taken together, Shute and The Bremen mean the costs of litigating in a far-away forum and the risk of outcome-determinative choice-of-law may be concentrated through procedural clauses.

This is not to say that all clauses in form contracts have this concentrating effect. Professor David Gilo and Dean Ariel Porat, for example, have identified a number of “beneficial boilerplate provisions.”\textsuperscript{18} Some function as insurance —

\textsuperscript{11} For a thoroughgoing historical analysis of forum-selection clauses, see Marcus, supra note 9, at 988-1015.
\textsuperscript{13} The Bremen v. Zapata Off-Shore, 407 U.S. 1, 2 (1972).
\textsuperscript{14} Id. at 2 n.2.
\textsuperscript{15} Id. at 8 n.8.
\textsuperscript{16} Id. at 14.
\textsuperscript{17} Carnival Cruises v. Shute, 499 U.S. 585, 593 (1991) (“[T]he Court of Appeals’ analysis seems to us to have distorted somewhat this Court’s holding in The Bremen. . . . [W]e do not adopt the Court of Appeals’ determination that a nonnegotiated forum-selection clause in a form ticket contract is never enforceable simply because it is not the subject of bargaining.”).
like standard warranties and exchange provisions. Because form contracts can act as both insurance and reverse insurance, a more nuanced analysis is needed.

This Essay provides that analysis, focusing on one category of form contract provisions, procedural clauses. The thesis is that these procedural clauses create a negative externality sufficient to counsel a change in the law back to the pre-Shute rule under which procedural clauses in form contracts were presumptively unenforceable. This Essay proposes requiring the parties to internalize the cost of the externality by eliminating the enforceability of procedural clauses in form contracts. In sum, this Essay contributes two insights: (1) procedural clauses in form contracts aren’t merely a fundamental fairness concern, they are an externality; and (2) changing the baseline of enforceability fixes this externality.

Starting from the standard law and economics position that assumes efficiency is the purpose of contract law, this Essay accepts this first principle —, the function of contracts is the efficient allocation of resources. And, as a general matter, freedom of contract is the most efficient method of allocating resources. However, as applied to form contracts first principles are more complicated.19 And more interesting.

Part I challenges the standard law and economics position as applied to procedural clauses in form contracts, identifying the bounded rationality, rational ignorance, and predictable irrationality20 of consumers which contribute to the externality. Building upon the work of Professor Todd Rakoff,21 this part further considers the firms’ incentives, some healthy, some perverse, regarding procedural clauses in form contracts. To be clear, the problem is not that the contract is being offered on a take-it-or leave-it basis. Professor Rakoff has persuasively explained how standardized terms promote transactional efficiency from the firm’s perspective.22 Nor is the problem a mere failure to read. As explained below, notice isn’t sufficient to repair the externality. Part II considers

19 See infra Part I.C.
22 See Rakoff, supra note 21.
some repairs which would be sufficient, concluding that the most efficient solution is a legislative fix implementing a market-oriented solution. This Essay proposes forcing the contracting parties to internalize the costs of the externality by changing the baseline of post-

Shute enforceability of procedural clauses back to their traditional unenforceability. The Essay concludes with some brief thoughts about who will pay under the proposal and whether it matters. The ultimate conclusion is not that the proposal redistributes wealth, but rather that it is net efficient, internalizing the social costs into the contract price.

I. THE PROBLEM

An externality, according to Professor Ronald Coase, may be “defined as the effect of one person’s decision on someone who is not a party to that decision.”\(^\text{23}\) Judge Posner elaborates that an externality is a cost which a party “will not take into account in making its decision; the cost is external to its decisionmaking.”\(^\text{24}\)

Procedural clauses in form contracts create an externality for several reasons. First, as discussed above, they shift the risks and costs of litigation. Indeed, procedural clauses do more than shift risks, they magnify them. To illustrate:

[T]he seller can expect a given number of problems to arise and may subsidize the costs of travel in those cases through marginally higher prices on all goods. The effect is the same as for the investor who has enough investments to diversify his or her portfolio. Risk is reduced. By contrast, consumers may engage in only one such transaction and therefore face a significant “undiversified” risk.\(^\text{25}\)

Of course, the “undiversified risk” includes more than travel costs. It involves the risk of litigating in the firm’s chosen forum, as in \textit{Shute}, where the firm enjoys the advantages of being a repeat player.\(^\text{26}\) It involves the risk of an outcome-

\(^\text{24}\) \textsc{Posner}, supra note 4, at 71.
\(^\text{26}\) \textsc{See} \textsc{Ian Ayres and Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules}, 99 \textsc{Yale L.J.} 87, 98 (1989).
determinative choice-of-law, as in *The Bremen*. And it involves inefficient incentives — the firm’s incentives to rent-seek for and the forum’s incentives to protect domestic firms (e.g., statutory caps on recoverable damages for certain types of torts\(^{27}\)). By increasing overall risks and costs and incentivizing inefficient rules of law, procedural clauses decrease overall social welfare.\(^{28}\)

Second, the clauses concentrate costs away from the lower cost-avoider. As a general matter, the firm is usually better able to prevent the type of harms that give rise to the litigation (e.g., the widget blowing up). But the firm will only take safety measures at the margin when the expected cost of taking safety measure is less than the expected cost of *not* taking the safety measure.\(^{29}\) Because procedural clauses reduce the firm’s expected costs (both the cost of litigation and the cost of adverse judgments), it reduces the firm’s incentives to produce safer products. This is not to suggest, of course, that all safety measures are efficient.\(^{30}\) Rather, it merely suggests that procedural clauses shift the “expected cost” equilibrium point, marginally reducing the firm’s incentive to take a safety measure. But as will be demonstrated below, because consumers do not “price” the latent cost of procedural clauses, this equilibrium point is inefficient.\(^{31}\)

Third, the clauses concentrate costs away from the cheaper information-gatherer. Professor Anthony Kronman notes that a “court concerned with economic efficiency should impose the risk on the better information-gatherer. Thus, an efficiency-minded court reduces the transaction costs of the contracting process itself.”\(^{32}\) Professors Ian Ayers and Robert Gertner observe: “If one side is

\(^{27}\) *See*, e.g., Va. Code § 8.01-581.15 (limiting awards in medical malpractice cases).


\(^{29}\) Compare Learned Hand’s celebrated \(B < P \times L\) formula in *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947) (where \(B\) is the burden or cost of avoiding accidental loss, \(P\) is the probability of loss absent \(B\), and \(L\) is the expected magnitude or cost of such loss), with Posner, *supra* 44, 167-70.

\(^{30}\) *See* Posner, *supra* 44, 167-70.

\(^{31}\) *See infra* Part I.C.

repeatedly in the relevant contractual setting while the other side rarely is, it is a sensible presumption that the former is better informed than the latter." As the repeat player, the firm is the cheaper information-gatherer in at least two respects. It is the cheaper information-gatherer regarding the expected cost of injury from the product. Additionally, it is cheaper information-gatherer regarding the expected costs of litigation.

Fourth, the clauses concentrate costs away from the superior risk-bearer. The firm is better able to bear the costs — not because it is the deeper pocket (although it generally is), but because it is the repeat player who can spread the cost over multiple transactions. In effect, it is able to act as an insurer by converting a low probability risk into a certain cost. And, of course, the firm need not self-insure; because it is the repeat player, it is also in a better position to purchase market insurance.

Finally, the clauses concentrate costs away from the party who accounts for procedural clauses’ costs in the decision-making process. As discussed above, firms recognize that by transferring the risks and costs of litigation, a product’s price may be reduced. In contrast, because of consumers’ bounded rationality, rational ignorance, and predictable irrationality, consumers do not factor in the cost of procedural clauses in pricing products. Consequently, consumers demand an inefficiently inflated quantity. When coupled with the firm’s reduced incentives to produce safer products, the result is overconsumption of inferior products.

33 Ayres and Gertner, supra note 26, at 98.
34 Goldman, supra note 25, at 722-23.
35 See, e.g., Carnival Cruises v. Shute, 499 U.S. 585, 594 (1991) (“[I]t stands to reason that passengers who purchase tickets containing a forum clause like that at issue in this case benefit in the form of reduced fares reflecting the savings that the cruise line enjoys by limiting the fora in which it may be sued.”).
Recognizing the controversy that behavioral economics has provoked in some quarters, it is important to note that this Essay does not pursue what Judge Posner refers to as that “most common of criticisms of the economic analysis of law,” namely, “that it rests on the unrealistic assumption that people are rational maximizers of their self-interest.” Rather, this Essay uses the available empirical research to pursue what himself refers to as “[o]ne of the main purposes of law, from an economic standpoint,” namely, “the control of externalities.” To internalize the externality created by procedural clauses, however, a look inside the mind of the consumer is first necessary.

A. A First Look: Some Symptoms

Empirical research has consistently shown that we are rational — but only up to a point — we are boundedly rational. For example, in one study recently reviewed in the University of Chicago Law Review, subjects were asked to choose from among two or more alternative products based “on four, eight, or twelve attributes. Faced with only two alternatives of four attributes each, the subjects

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37 See, e.g., See Andrew Ferguson, Nudge Nudge Wink Wink, THE WEEKLY STANDARD, April 19, 2010, available at http://weeklystandard.com/articles/nudge-nudge-wink-wink. For those interested in further discussion of the issue, in April 2010 the Cato Institute is hosting an online forum where diverse scholars debate the topic. Titled “Slippery Slopes and the New Paternalism,” it can be found at http://www.cato-unbound.org/. As a preliminary matter, one counterargument against behavioral economics popularized by Glenn Beck, and made by Ferguson in the Weekly Standard, must be disposed of. See Ferguson, Nudge Nudge Wink Wink; Audio tape: Glenn Beck: The most dangerous Czar (September 9, 2009) (transcript available at http://www.glennbeck.com/content/articles/article/198/30255/). Criticizing the research methods, the data, or conclusions of behavioral economists may be useful—indeed, this is how science progresses—but criticizing “the idea of it,” as Ferguson does, is not particularly useful. Particularly, when the very “idea” criticized appears to be drawing conclusions from scientific research. It is quite accurate, as Ferguson contends, that “behavioralists say they’ve discovered that we do dumb things systematically . . . with a consistency that smart people can observe.” See Ferguson, Nudge Nudge Wink Wink. It is not true, as he goes on to argue, that they use “irrationality” as a synonym for “any opinion or style of behavior they disagree with on political grounds.” Id. How behavioral economists actually go about defining rationality, bounded rationality, and irrationality is one of the tasks of this Essay.


39 Posner, supra note 38, at 302.

40 See, e.g., Korobkin, supra note 36; Eisenberg, supra note 36.
consulted all of the available information before making a choice.”

Paradoxically, however, as the number of alternatives increased, the information consulted prior to choosing decreased. “With more alternatives, subjects consulted even less information.” In other words, our decision-making process is limited by more than external factors such as search and information costs, it is limited by our innate limitations, our bounded rationality. There is only so much we will consider before deciding. Summing up “[a] great body of theoretical and empirical work in cognitive psychology,” Professor Melvin Eisenberg observes “the substantive action that would maximize an actor’s utility may not even be considered by the actor, because actors set process limits on their search for and their deliberation on alternatives.”

And when juxtaposed against attributes like physical appearance, product reputation, and, of course, price, procedural clauses are substantially less likely to be factored into purchasing decisions. Professor Rakoff labels this divide as the difference between “visible” and “invisible” attributes. For Professor Korobkin, they are “salient” versus “non-salient” attributes. Whatever the label, common experience confirms that we regularly take into account some things in making purchasing decisions, some things we do not.

A skeptical reader may wonder whether product reputation might implicitly account for the cost of oppressive procedural clauses. The short answer is that it can, but it generally does not, because firms would prefer to screen out litigious consumers: “because a change in a term’s status from non-salient to

41 Korobkin, supra note 36, at 1228 & n.91 (citing John W. Payne, Task Complexity and Contingent Processing in Decision Making: An Information Search and Protocol Analysis, 16 ORG. BEH. & HUMAN PERFORMANCE 366 (1976)).
42 Korobkin, supra note 36, at 1228 (citing Payne, supra note 42).
43 Eisenberg, supra note 36, at 811.
44 See id.
45 Rakoff, supra note 21, at 1250-52.
46 TK Footnote needed.
47 Consider your own experience. About how many form contracts have you entered into over the past two decades (the time since Shute was decided)? How many times did you first investigate whether the contract contained procedural clauses? And how many times did you factor the clauses into your evaluation of the product’s price? And would you, dear reader, consider yourself more or less likely than the average consumer to be aware of the existence of form contract provisions and their legal effect?
salient for a particular buyer could be viewed by sellers as a signal that the buyer is particularly difficult to please or quarrelsome, the seller might consider the loss of that buyer’s patronage in future transactions a benefit rather than a cost.”  

A related, albeit slightly more sophisticated, challenge to this Essay’s thesis that procedural clauses are inefficient is posed by the theory of “hypothetical market assent,” taken up next.

B. What Peter Parker Can Teach Us About Procedural Clauses in Form Contracts

According to the hypothetical market assent theory, although the majority of consumers have not read or shopped for boilerplate terms, “a quite small proportion of smart consumers who actually read and shopped for good standard-form contract clauses could put enough competitive pressure on firms so that they would adopt efficient standard-form terms.” In theory, these super-shoppers save us from otherwise inefficient behavior. Sadly, however, as applied to procedural clauses in form contracts, these superheroes transform like Peter Parker infected by an extraterrestrial symbiote in Spider-Man 3 into something darker and far more dangerous to firms: a litigiously-minded consumer.

In more formal law and economics terms, the hypothetical market assent theory does not function in the procedural clause context because of an adverse selection problem. The theory is predicated on a group of consumers considering the clauses salient, thus creating enough market pressure to create efficient procedural terms. But the type of consumer who is looking for a “high-quality” (i.e., more protective, less restrictive) procedural clause is the type of consumer the firm would prefer to screen — the litigious type. Professor Korobkin elaborates:

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48 Korobkin, supra note 36, at 1241.
50 Johnson, supra note 49, at 862-63.
51 SPIDER-MAN 3 (Columbia Pictures 2007).
Although circumstances will occur that cause a form term to become relevant regardless of the identity of the buyer, terms will become relevant more often for buyers inclined to search for product defects and problems, buyers with a low tolerance for such problems, buyers inclined toward invoking legal rights (including litigation) in case of conflict, and buyers inclined not to perform their obligations in the customary manner desired by the seller. If these buyers are both more likely than average to find form terms salient and less profitable on average to sellers — both reasonable assumptions — sellers will face an adverse selection problem.52

That is, the firm’s inclination to avoid lawsuits creates an incentive to screen out those customers predisposed to sue. Procedural clauses facilitate this screening in a net inefficient, mildly perverse way. Filtered out are the super-shoppers capable of creating the efficient hypothetical market assent. Who remains? The ordinary consumer, of course, but who is the ordinary consumer?

C. A Second Look: Bounded Rationality, Rational Ignorance, and Predictable Irrationality

Consumers are rational and self-interested, naturally, but in some very interesting ways. As noted above, we are boundedly rational.53 When making purchasing decisions we use heuristics, or mental shortcuts. And sometimes these shortcuts lead us astray.

The “availability heuristic,” for example, leads us astray when it comes to estimating risk, particularly low probability risk. Discussing the availability heuristic, Professors Richard Thaler and Cass Sunstein explain that people “assess the likelihood of risks by asking how readily examples come to mind.”54 “[V]ivid and easily imagined causes of death (for example, tornadoes) often receive inflated estimates of probability, and less-vivid causes (for example, asthma attacks) receive low estimates, even if they occur with a far greater frequency (here, a factor of twenty).”55 Procedural clauses in form contracts, of course, allocate risks with relatively low probabilities. And when “these possible

52 Korobkin, supra note 36, at 1238-39.
53 See supra Part I.A.
54 Richard Thaler & Cass Sunstein, Nudge 25 (Yale 2008).
55 Id.
but unlikely outcomes are not readily ‘available’ to buyers, they are likely to respond to the risk of these harms by treating them as if they do not exist at all.”\textsuperscript{56} Indeed, empirical research on the point is overwhelming: “One of the most robust findings of social science research on judgment and decisionmaking is that individuals are quite bad at taking into account probability estimates when making decisions.”\textsuperscript{57}

In this context, of course, the availability heuristic describes a similar phenomenon as Professor Rakoff’s discussion of “invisible” attributes and Professor Korobkin’s discussion of “non-salient” attributes — because of our bounded rationality, we discount (or fail to account for) the costs of procedural clauses in making purchasing decisions.

This is not to say that such behavior is irrational. Indeed, from a certain perspective, consumers’ ignoring procedural clauses in making purchasing decisions is quite rational. Professor Randy Barnett observes that “the low probability of the term ever being invoked in some future lawsuit, combined with the relatively low stakes of many such contracts, makes it irrational for form-receiving parties to spend time reading, much less understanding, the terms in the forms they sign.”\textsuperscript{58} Professor Barnett notes an opposite presumption applies to the firms, who are “repeat players” that “can amortize the cost of obtaining knowledge of the background rules over a great many transactions.”\textsuperscript{59}

Put differently, transaction costs make consumers’ ignorance rational. Broadly defined, transaction costs include “search and information costs, bargaining and decision costs, [and] policing and enforcement costs.”\textsuperscript{60} It is well understood that procedural clauses in form contracts reduce a firm’s transaction

\textsuperscript{56} Korobkin, \textit{supra} note 36, at 1234.
\textsuperscript{57} \textit{Id.} at 1232.
\textsuperscript{60} \textit{COASE}, \textit{supra} note 23, at 6 (quoting Carl Dahlman, \textit{The Problem of Externality}, 22 J.L. & ECON. 148 (1979)).
costs. Yet this accounts for only one side of the ledger — it fails to account for consumers’ transaction costs. For consumers, it may be relatively inexpensive to obtain the basic information regarding the contract’s procedural clauses (i.e., the forum selection and choice-of-law clauses are often available on the firm’s website). But evaluating this information is not cheap. Professor Michael Meyerson, for example, points out that on an elemental level, “[w]ithout legal advice, consumers cannot understand how typical [procedural clause] contract terms shift risks away from the seller and onto the consumer.” Compounding consumers’ transaction costs, in the unlikely event that legal advice regarding the terms’ consequences was sought, it is not obvious that an attorney would be able to quantitatively evaluate (i.e., price) the procedural clauses.

In the even more unlikely event that consumers accurately priced a particular contract’s procedural clauses, shopping for a different contract with preferable procedural terms would also entail significant transaction costs. And advertising cannot be expected to reduce the costs of shopping because procedural clauses “deal with risks that a competitor would be foolish to emphasize. For example, it would be ludicrous for a seller to base an advertising campaign on the claim that ‘if you injure yourself on our cruise, you can sue us anywhere.’” Moreover, as a practical matter, “sellers will not want to divert their limited advertising budgets to publicizing factors that will play at most a minimal role in purchasing decisions.”

In sum, consumers are rationally ignorant of procedural clauses. And firms have incentives to keep consumers that way: not only do procedural clauses keep the firm’s transaction costs down, but their litigation exposure as

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61 See, e.g., Korobkin, supra note 36, at 1246 (“Form contracts exist, of course, because of the substantial transaction cost savings that they produce. A requirement that all contracts be individually negotiated would increase transaction costs so substantially that many common and productive transactions would be rendered economically unfeasible, potentially causing commerce to grind to a halt.” (footnote omitted)).
62 Meyerson, supra note 36, at 599.
63 Goldman, supra note 25, at 719.
64 Meyerson, supra note 36, at 602.
65 In all, procedural clauses in form contracts do a remarkably bad job of performing Fuller functions, particularly the cautionary function. See generally Lon Fuller, Consideration and Form, 41 COLUM. L. REV. 799 (1941).
well. This information asymmetry leads to inefficiencies — rationally ignorant, consumers will not demand efficient terms.\textsuperscript{66} Perversely, this a hidden cost for all — when a firm is aware that its litigation exposure has been reduced, it is less likely to take safety precautions at the margin. Because of rational ignorance, we are all left less safe (defective products, after all, may injure someone other than the purchaser). An externality is created.

Moreover, consumers are more than boundedly rational and rationally ignorant — we are predictably irrational too. Professor Dan Ariely, a behavioral economist at the Massachusetts Institute of Technology, explains that we are “predictably irrational . . . our irrationality happens the same way, again and again.”\textsuperscript{67} For example, we are predictably irrational when it comes to “emotion laden” tradeoffs: “comparing dissimilar attributes [which] require the decisionmaker to put an implicit price on attributes that [he or] she intuitively feels should not be commodified.”\textsuperscript{68} Among these attributes are the legal rights implicated by procedural clauses. Korobkin explains:

If buyers believe that personal safety or the right to seek redress of legal wrongs in a court of law are entitlements that should be inalienable and not subject to commodification, explicitly trading off these types of entitlements against a product’s price and physical features might create elevated stress levels. . . . Buyers are likely to respond to the stress caused by sellers’ attempts to force them to commodify personal safety or legal rights by employing non-compensatory decisionmaking strategies that allow them to avoid making such tradeoffs — by effectively ignoring these terms during the selection process and thus rendering them non-salient.\textsuperscript{69}

That is, when faced with putting a price on something which the consumer feels should not be commodified, the predictably irrational consumer often instead ignores the term.

\textsuperscript{66} Professor Korobkin, for example, observes: “Although market forces should ensure that sellers will offer efficient salient contract terms, non-salient attributes are subject to inefficiencies driven by the strategic behavior of sellers.” Korobkin, supra note 36, at 1231-32.

\textsuperscript{67} ARIELY, supra note 20, at xx.

\textsuperscript{68} Korobkin, supra note 36, at 1230 (citation omitted) (citing Mark Kelman, Consumption Theory, Production Theory, and Ideology in the Coase Theorem, 52 S. CAL. L. REV. 669, 692 (1979)).

\textsuperscript{69} Korobkin, supra note 36, at 1231-32.
Consequently, actual notice is not a viable solution to the externality. To illustrate: if before purchasing a ticket, assume each cruise line customer had to watch a video that explained the clauses in plain English, included calculations on the risk of injuries on a given cruise, the expected cost of litigating in the particular forum, the relevant laws, and likelihood of recovery in the forum. Would this be sufficient to eliminate the externality? Putting to one side the improbably of such an arrangement, recall the research discussed above. Paradoxically, research shows more information does not lead to more informed decisions. As the number of attributes involved in a decision increases, the information consulted prior to choosing decreases. Moreover, the information contained procedural clauses is precisely the type which consumers often act predictably irrational towards — ignoring it, even with actual notice — because it involves something which the consumer feels should not be commodified.

Which brings us back to the problem of procedural clauses’ inefficiencies. Of course, standard economic analysis assumes that as a general matter freedom of contract combined with market pressures will lead to efficient contract terms. As applied to form contracts, however, this assumption begins to break down. Consumers do not factor in the cost of procedural clauses in purchasing decisions. This leads to overconsumption, as “uninformed consumers will actually prefer an inefficient contract, with a lower stated price but higher actual cost.” This, in turn, creates social costs:

First, consumers may purchase inappropriately large quantities of consumer goods because they have not accurately internalized the product’s true costs (the “quantity effect”). . . . Second, sellers are encouraged to include subordinate clauses unfavorable to the consumer even when the seller would be in a better position to bear the risk addressed by the clause (the “quality effect”).

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70 Id. at 1228 (citing Payne, supra note 42).
71 Meyerson, supra note 36, at 605.
72 Goldman, supra note 25, at 718.
The resulting social cost is illustrated in the following figure:\textsuperscript{73}

While the precise cost of these inefficiencies is unclear, one of the contributions this Essay makes is that a precise calculation is unnecessary — the market will decide. It is to this proposed solution this Essay now turns.

II. SOLUTIONS

This Part considers various methods of addressing the externality, concluding that the most efficient solution is a legislative fix implementing a market-oriented solution. First, however, four alternatives are considered: (1) unconscionability; (2) reasonable expectations; (3) Piguovian tax; and (4) inaction.

A. The Orthodoxy: Classic Command & Control

One possible method of addressing the externality is through the unconscionability doctrine. Professor Korobkin advocates for this approach, proposing a “modified unconscionability doctrine,”\textsuperscript{74} with procedural unconscionability determined according to “salience” and substantive unconscionability determined according to “efficiency.” Candidly, he acknowledges that his expansive application of the unconscionability doctrine entails social costs of its own as it “clearly invites an intensely factual inquiry, thus making it difficult for courts to resolve disputes on motions for summary

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\textsuperscript{73} Adapted from N. GREGORY MANKIW, PRINCIPLES OF MICROECONOMICS 206 fig.2 (3d ed. 2004).

\textsuperscript{74} Korobkin, supra note 36, at 1290.
Professor Korobkin is prepared, however, to trade higher decision costs in exchange for lower error costs.

This Essay rejects Professor Korobkin’s proposal; it is not obvious that the proposal would actually result in lower error costs. As Professor Richard Epstein points out, one of the unconscionability doctrine’s principal problems is the degree of discretion it transfers to “courts to act as roving commissions to set aside those agreements whose substantive terms they find objectionable.” The large measure of discretionary authority Professor Korobkin’s proposal would vest in courts to redraft contracts would inevitably lead to unpredictability in application. Rather than the judicial *ex post* redrafting of contracts, a more certain, evenhanded method of internalizing the externality is needed.

A second method, the doctrine of reasonable expectations, holds more promise, though it too entails high decision costs, judicial discretion, and consequent unpredictability. The doctrine, first developed by Professor Robert Keeton in the insurance law context, provides that “objectively reasonable expectations” of consumers “regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.” Critics contend that courts applying the doctrine of reasonable expectations do not base their decision on consumers’ *ex ante* expectations, but rather on the courts’ *ex post* equitable judgments. Yet assuming, *arguendo*, that this criticism has some merit as applied to insurance contracts, it is nevertheless possible that the criticism does not apply with equal force to other types of form contracts. Insurance contracts are, of course, generally form contracts—rich in boilerplate and offered on a take-it-or-leave-it basis. Yet they are also a class unto themselves, involving technical provisions which are often far more complex than other types of form contracts. While consumers may not have objectively reasonable expectations about insurance contracts, they may have such expectations about other types of consumer defense.

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75 *Id.* at 1281.
78 TK Footnote needed.
contracts. Thus Professor Meyerson, for example, proposes placing “the focus on the reasonable expectations of the consumer”\(^\text{79}\) when evaluating the enforceability of form contract terms.

This Essay rejects Professor Meyerson’s proposal. Given the analysis set forth in Part I of this Essay, it seems unlikely that at the time of contracting consumers actually have any expectations regarding procedural clauses, objectively reasonable or otherwise. Of course, courts might ask what consumers would have expected had they thought about it, but this too seems to invite little more than \textit{ex post} redrafting. Again, a better \textit{ex ante} solution internalizing the costs of the externality is needed.

Professor Arthur Pigou offers a third alternative—imposing a tax equal to the marginal social cost.\(^\text{80}\) Yet given the difficulty of calculating the third-party costs, it is unlikely that the government could accurately assess an appropriate level of taxation. Even if such calculation were possible (an assumption famously challenged in \textit{The Problem of Social Cost}\(^\text{81}\)), it is far from clear that such a solution would be desirable. Professors Maxwell Stearns and Todd Zywicki explain: “The government, even if theoretically capable of operating as a Pigouvian central planner, is unlikely to actually do so in practice.”\(^\text{82}\) Put simply, the choice isn’t between an imperfect market and perfect government regulation (or, of course, between a perfect market and a corrupt, incompetent legislature). Public choice theory’s insight is that neither is perfect.\(^\text{83}\)

This Essay has already shown how the market, as currently organized, is not internalizing the cost of procedural clauses in form contracts. The judiciary’s \textit{ex post} approach also appears ill-suited to the task. And the legislature too seems ill-equipped to calculate the cost \textit{ex ante}. Which brings us to the fourth option, doing nothing about the externality.

\(^{79}\) Meyerson, \textit{supra} note 36, at 611.


\(^{82}\) \textit{Stearns \& Zywicki, supra} note 80, at 45.

\(^{83}\) \textit{Id.}
Doing nothing makes sense if the expected costs of the intervention exceed the benefits. Professor Coase observes: “Whether there is a presumption, when we observe an ‘externality,’ that governmental intervention is desirable, depends on the cost conditions in the economy concerned. We can imagine cost conditions in which this would be correct and also those in which it is not.” Ultimately, this is an empirical question. A closer look at the expected costs and benefits of this Essay’s proposal are taken up in the next section.

B. An Unorthodox Proposal: A Market-Oriented Solution

This Essay proposes that state legislatures adopt a per se rule changing the baseline from enforceability to unenforceability of procedural clauses in form contracts. While this proposal is admittedly a command and control solution, at least in part, in that it is government imposed, it is actually predominantly market-oriented in that it seeks neither taxation nor direct regulation of the productive activity. Instead, the proposal enables the market participants to recognize the actual cost of their transactions and begin to bargain over who should pay. Admittedly, this proposal is unorthodox. But the substantive law it proposes is not unprecedented (indeed, refusing to enforce procedural clauses in form contracts was the dominant approach until Shute was decided twenty years ago).

As a threshold matter, as a matter of law neither Shute nor The Bremen bar such a proposal. Both cases were decided under the federal common law of admiralty, not under a federal general common law (which, as every first year law student knows, was famously rejected in Erie v. Tompkins). Thus, are free to craft their own approaches to the enforceability of procedural clauses in form contracts.

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84 COASE, supra note 23, at 26.
86 Shute, 499 U.S. at 590 (1991) (“We begin by noting the boundaries of our inquiry. First, this is a case in admiralty, and federal law governs the enforceability of the forum-selection clause we scrutinize.”); The Bremen, 407 U.S. at 10 (noting case came before the Court sitting in admiralty).
87 304 U.S. 64 (1938) (“Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. And whether the law of the State shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern. There is no federal general common law.” Id. at 78.)
contracts. Indeed, both Louisiana\textsuperscript{88} and Wisconsin\textsuperscript{89} have adopted consumer protection statutes making some types of procedural clauses unenforceable. The Louisiana statute, for example, states:

The following terms of a writing executed by a consumer are invalid with respect to consumer transactions or modifications thereof: (1) that the law of another state will apply; (2) that the consumer consents to the jurisdiction of another state; or (3) any term that fixes venue.\textsuperscript{90}

This paper’s insight is that by making a procedural term salient by including cost within price, market pressures will force the parties to internalize the cost of the externality. Of course, intervening in the marketplace will also entail costs.

1. Three Counterarguments

Admittedly, this proposal will come at the cost of potential efficiencies. By selecting certain fora, for example, forum-selection clauses could encourage certain courts to develop subject matter expertise on particular issues. One response to this argument, derived from public choice theory, is that while these courts may develop a more coherent body of law, they are also more likely to be captured by special interests because a firm is more likely to successfully rent seek if it can concentrate its attentions on a single state’s policymakers, rather than diffusing its lobbying efforts nationwide. A second response is that, in fact, the judicial system already has tools for making interstate or multiparty dispute resolution more efficient, including \textit{forum non conveniens} and transfer pursuant to 28 U.S.C. § 1404(a). Other firm-centered efficiencies (e.g., the ability to use the same counsel with jurisdictional expertise) are subject to similar replies.

Another potential criticism is that this proposal is inconsistent with the freedom of contract. Yet, up until about twenty years ago, procedural clauses in form contracts were unenforceable.\textsuperscript{91} While the historical practice may also be criticized as inconsistent with freedom of contract, it undercuts the notion that the present proposal is a wholesale departure from traditional contract


\textsuperscript{89} Wis. Stat. § 421.201 (2005), \textit{cited in} Goldman, \textit{supra} note 25, at 740 n.192.


\textsuperscript{91} See Marcus, \textit{supra} note 9, at 988-1015.
principles. Rather, the harder question regarding the freedom of contract critique centers on consent. Professor Barnett, for example, argues that “[r]efusing to enforce all of these terms would violate the [parties’] freedom to contract,”\textsuperscript{92} although he admits that consumers “are not realistically manifesting their assent to radically unexpected terms. Enforcing such an unread term would violate the parties’ freedom from contract.”\textsuperscript{93} While the ubiquity of procedural clauses makes it unlikely that they are “radically unexpected” as Professor Barnett uses the term,\textsuperscript{94} the harder question is what consumers actually think that they are assenting to when they breeze past the boilerplate. Because the answer is not obvious, the answer to freedom of contract issue is not either. Thus, this Essay does not go as far as Professor Rakoff, who contends that the freedom of contract argument is “incongruous”\textsuperscript{95} and “unsupportable”\textsuperscript{96} as applied to form contracts. The proposal is in tension with an ideal conception of the freedom of contract, as are form contracts themselves.

A third potential criticism is that, as a bright-line rule, the proposal will be over- and under-inclusive. First, it may be thought to be over-inclusive because in some cases the higher price will discourage customers who share a common domicile with the firm’s selected forum. This critique may have merit regarding concentrated post-purchase litigation costs for the individual, but it overlooks the hidden costs procedural clauses impose on society generally — i.e., the firm’s reduced incentive to take safety precautions at the margin. Second, the proposal may criticized as under-inclusive as well — other clauses in form contracts may create externalities overlooked by the proposal. This critique, it must be admitted, is accurate. But while accurate, it misses the public choice insight. There are no perfect solutions. The real question is whether the benefits exceed the costs. It is to the proposal’s anticipated benefits that this Essay now turns.

\textsuperscript{92} Barnett, \textit{supra} note 58, at 639.

\textsuperscript{93} \textit{Id}.

\textsuperscript{94} Professor Barnett illustrates what he means by radically unexpected with a hypothetical “your-favorite-pet” term. \textit{Id.} at 637. He explains: “If a term . . . specifies that in consequence of breach one must transfer custody of one’s beloved dog or cat, it could surely be contended by the promisor that ‘while I did agree to be bound by terms I did not read, I did not agree to that.’” \textit{Id.} (citation omitted).

\textsuperscript{95} Rakoff, \textit{supra} note 21, at 1236.

\textsuperscript{96} \textit{Id.}
2. Coase, Baselines, and Distributional Consequences

A legal baseline already exists; procedural provisions in form contracts are generally enforced. But this baseline does not account for the externality. Eliminating the enforceability of procedural clauses in form contracts moves the baseline to account for the externality. This Essay predicts that parties will contract around the revised baseline by modifying price, but in doing so the parties will be forced to internalize the costs. Specifically, because firms’ costs will increase, they will spread these costs over all contracts by incrementally raising their prices. And because firms will face increased risk of tort liability, they will also increase safety measures at the margin.

Although consumers do not want to pay higher prices, they would prefer higher prices and higher quality products to the inferior products carrying latent risks and costs hidden within procedural clauses. Admittedly, standard law and economics analysis assumes that the most reliable guide of what consumers actually prefer is what they choose, this assumption is less reliable when consumers are unaware what they are choosing. While this Essay deviates from standard law and economics analysis in some respects (e.g., consumers are rational and self interested, but also boundedly rational, rationally ignorant, and predictably irrational), this Essay does agree with one of the oft-quoted statements of standard law and economics — “there ain’t no such thing as a free lunch.” Discounts consumers get from procedural clauses are not free, and as a matter of policy, we should make consumers aware of their costs.

Meant, in part, to address information asymmetry, this Essay’s proposed solution is similar to penalty default rules proposed by Professors Ayers and Gertner.97 Similar to penalty defaults, the proposal is designed to create an incentive for the parties to exchange information — the cost of the clauses. And it lets the market determine what the cost is. The facial distinction between the proposal and a penalty default is that a penalty default can be contracted around, but the proposal cannot. This distinction is accurate, but largely academic. As things currently stand, procedural clauses could, in theory, be contracted around. As a practical matter, of course, they are not. The reason is transaction costs. One

97 Cf. Ayres & Gertner, supra note 33.
of the strengths of the proposal is that it reallocates the risks to the party that economic theory predicts would bear the cost, absent transaction costs.

Additionally, the proposal eliminates the cost concentration and restores the risk to the lower cost avoider. The result is net efficient, internalizing into the price of the form contract the types of social costs identified above: (1) the magnified risks and costs the reverse insurance function creates; (2) the firms’ decreased incentives to take safety precautions at the margin; and (3) the consumers’ bounded rationality, rational ignorance, and predictable irrationality which leads to overconsumption. The proposed solution moves the supply of consumer goods to the socially optimal level, and the societal gains exist no matter which market participants, consumers or firms, pay the eventual cost. This Essay concludes by considering which party will likely pay and whether it matters.

CONCLUSION

If there were no transaction costs associated with procedural clauses, then the elimination of their enforceability would just change the distribution—it would simply be a wealth transfer. Of course, the proposed solution entails transaction costs too. But it will force parties to internalize the externality created by form contracts. That is, it does more than effect distributional change — eliminating procedural provisions in form contracts changes participant behavior and eliminates the externality.

Nevertheless, disallowing procedural clauses in contracts will have distributional implications, depending on the relative elasticity of the market. Who will pay the price is an empirical question outside the scope of this Essay, ultimately relying “on the shape of the supply and demand curves.”

Normatively, paying a slightly higher premium for mandatory market insurance is not all bad, even if most of the costs are passed on to consumers. Increased costs would reduce consumer surplus, but would move the market toward a socially optimal outcome. Put simply, it will force market participants to

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98 See generally Coase, supra note 81.
recognize the actual cost of their transactions. Refusing to enforce procedural clauses reduces the current overconsumption of inferior, less safe products and moves the market towards a socially optimal level.