Cooter, Robert, and Thomas Ulen (2008), *Law & Economics*, Pearson International, Boston, MA, pp. on standard form contracts (302-304).



***1. Fill in a Form: Contracts of Adhesion*** Most written contracts use standard forms. Some terms in a standard-form contract are fixed; others may be variable. For example, the legal staff of an automobile manufacturer may provide its salespersons with form contracts that stipulate the warranty (fixed terms) and leave the price open for negotiation (variable term). Some standard forms do not allow the parties to vary *any* terms. In an extreme situation, one party makes a take-it-or-leave-it offer, meaning that the other party must sign the standard form or not make a contract.

Many fixed terms in standard-form contracts are uniform throughout an industry. For example, many automobile manufacturers promise to repair certain problems with their new cars within the first 5 years or 50,000 miles of the car's life. When terms are uniform, sellers do not compete over them. Narrowing the scope of competition can reduce its intensity.

To see why, consider cartels. The members of a cartel agree to keep prices up, which profits the members as a group. Each individual member, however, profits even more by undercutting the cartel's price and luring buyers away from other members. To prevent such "cheating," the cartel must punish members who undercut the cartel's price. Uniform, fixed terms in contracts prevent sellers from offering special concessions to buyers. Consequently, the cartel can focus on determining whether all members charge the cartel's price. Monitoring "cheating" in the cartel is much easier when all sellers use the same contract with fixed terms.

In an influential article, Friedrich Kessler called take-it-or-leave-it agreements "contracts of adhesion." (Friedrich Kessler, *Contracts of Adhesion: Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943).) This term suggests that standard-form contracts indicate the existence of a monopoly, which deprives buyers of bargaining power. Consequently, courts sometimes use "contract of adhesion" as a term of opprobrium to undermine the enforceability of a contract.

This court practice can be justified when sellers use standard-form contracts to reduce competition. However, this court practice is unjustified when sellers use standard-form contracts to increase the efficiency of exchange. Standard-form contracts narrow the scope of bargaining, which can promote efficiency in two ways. First, standard-form contracts can promote price competition by reducing product differentiation. To see why, consider an analogy. Toothpaste comes in different sizes, shapes, colors, textures, tastes, and smells. Manufacturers tinker with these differences in an attempt to attract customers by differentiating their product. Product differentiation complicates price comparisons. Price competition would be more intense if all toothpaste were the same. Similarly, uniformity reduces differences among contracts and intensifies the competition over price.

Second, standard-form contracts reduce transaction costs. The parties can bargain over variable terms, such as the price, and the parties cannot bargain over fixed terms. Instead of bargaining, buyers choose among standardized contracts with different price and non-price terms. Seller may build an actual contract by plugging "modules" of language into a universal form. Thus, standard forms reduce the number of terms requiring drafting, bargaining, and agreement.

One of the standard assumptions of a perfectly competitive market is that transaction costs are zero. Standard-form contracts can move a market closer to the perfectly competitive ideal by reducing transaction costs. The availability of

substitutes in perfectly competitive markets prevents anyone from bargaining over price. Similarly, the availability of substitutes in perfectly competitive markets prevents anyone from bargaining over contracts. In general, substitutes turn everyone into "takers" of the price. The fact that many firms use the same standard form may indicate a high level of competition among them. Take-it-or-leave-it contracts can indicate perfect competition rather than monopoly.

Because standard-form contracts can increase competition and efficiency in exchange, the phrase "contract of adhesion" should not be applied to standard-form contracts. Rather, the phrase should be reserved for monopoly contracts. The relevant question is whether a market is competitive or monopolistic. The fact that a contract was made on a standard form does not establish a presumption in either direction.

What should courts do with the terms in monopoly contracts? In monopoly contracts, the price is too high. Courts, however, usually do not think that adjusting the prices in a contract is their job. Courts are more willing to adjust the nonprice terms. Should they?

To answer this question, we first ask whether the nonprice terms of monopoly contracts are efficient or inefficient. The abstract answer given by economic theory is simple. The nonprice terms of a contract typically create incentives that affect the size of the surplus from exchange, and efficient nonprice terms maximize the surplus from exchange. In contrast, the price terms typically distribute the surplus between the parties. Sometimes the monopolist can use its power to extract the entire surplus from each exchange. A monopolist with this power will maximize its profits by maximizing the surplus from each exchange. In brief, a monopolist who can extract all of the surplus from each exchange by controlling the price will choose efficient nonprice terms.

In contrast, a monopolist who cannot extract all of the surplus from exchange by controlling the price may adopt inefficient nonprice terms in order to increase its control over the price terms. (These propositions can be restated in familiar jargon for economists.)[45] For example, a monopoly supplier of software may increase its power to over-price by contracts that prohibit resale.

Besides monopoly, another defect in markets can cause inefficient standardization of contracts. Lawyers often use the term "contract of adhesion" when a seller takes advantage of a buyer's ignorance. Thus contracts often stipulate a process for resolving future disputes that favor sellers, such as compulsory arbitration before a board organized by the association of sellers. The buyer often fails to read the contract with sufficient care to be aware of such terms, or the buyer is aware

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[45] In economic jargon, a perfectly discriminating monopolist sets efficient nonprice terms in its contract. Otherwise a monopolist may use inefficient nonprice terms to increase price discrimination. To illustrate the latter, assume that buyers who are willing to pay a lot for a product also prefer a strong warranty, whereas buyers who are willing to pay a little prefer a weak warranty. Recognizing this fact, the monopolist might offer two contracts: a high-price-strong-warranty contract and a low-price-weak-warranty contract. The difference in warranties helps to separate the two consumer groups so the monopolist can charge them different prices. Without the two nonprice terms, the monopolist cannot tell the two groups apart.

but does not appreciate the term's significance. When such a contract results in a legal dispute, the buyer's lawyer will argue that the court should void the contract because the standardized form prevented the buyer from bargaining. (Remember that according to the bargain theory of contract, which many judges accept in some form, "no bargain" implies "no contract.") This argument, however, misleads. If buyers are informed and markets are competitive, the standardized terms in form contracts will be efficient, not biased against buyers, without any bargaining. The real problem with this kind of contract is the buyer's ignorance, not the absence of bargaining.

**QUESTION 7.39:** Explain how uniformity can reduce price competition by strengthening cartels or increase price competition by reducing product differentiation.

**QUESTION 7.40:** Competition drives prices down to costs, whereas monopolies price above cost. California banks have paid large damages for allegedly charging fees greater than the cost of certain services that they provide. Suppose a car manufacturer charges an additional $450 for an automatic transmission in a new car. What inefficiencies would result if the consumer could sue the manufacturer and make the company prove that $450 is not disproportionately above the actual cost of the automatic transmission?

**QUESTION 7.41:** Monopoly distorts contracts by making prices too high. Why would a monopolist ever want to distort the nonprice term by, say, limiting liability for harm caused by defective products?

**QUESTION 7.42:** Assume that two kinds of buyers purchase contracts from a monopolist who promises to deliver goods in the future. One kind of buyer values the good more highly than the other. The monopolist would like to charge a higher price to the buyers who value the good more highly, but he cannot identify who they are. To overcome this problem, he offers two different contracts. One contract charges a high price and offers to pay high damages in the event that the seller fails to deliver the goods. The other contract charges a low price and offers to pay low damages in the event that the seller fails to deliver the goods. Explain why the two kinds of buyers might prefer different contracts. Explain why the monopolist might gain from offering two kinds of contracts. (In economic jargon, the "menu" of contracts "separates" the "pool" of buyers and permits "price discrimination.")