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## The Moral Hazard of Contract Drafting

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# THE MORAL HAZARD OF CONTRACT DRAFTING

ERIC A. ZACKS \*

## ABSTRACT

*This Article identifies and examines the principal-agent problem as it arises in the context of contract preparation. The economic agency relationship, as it may be understood to exist for contract drafting, provides a superior framework for understanding and reforming the inability of the non-drafting party (the principal) to control the drafting party (the agent). As an economic agent, the drafting party faces a moral hazard when preparing the contract because of the differing interests of the parties as well as the information and control asymmetries that exists. For example, the use of standard form contracts in consumer transactions is an example of the drafting party being motivated and able to act in the drafting party's favor without detection or resistance by the non-drafting party. To date, contract law reforms typically have focused on the non-drafting party's ability to monitor and attempted to alleviate information and control asymmetries, with suboptimal results. Economic theory, however, not only helps explain these failures but also suggests superior reforms. Reforms should be focused on realigning the interests of the two parties instead of remedying the problems that emanate from such misalignment. More specifically, reforms should incentivize drafting parties to devote resources to determining how to make effective disclosure of contract terms and penalize drafting parties when they do not.*

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## I. INTRODUCTION

This Article argues that contract reforms for standard form contracts, while implicitly recognizing the moral hazard faced by contract drafting parties, have improperly focused on improving the ability of non-drafting parties to monitor drafting parties to improve

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their contracts and not on changing the fundamental incentives of drafting parties to prepare one-sided contracts that are difficult to comprehend. Scholars recognize that “repeat players” may prepare standard form contracts in a particularly advantageous manner because they know that the non-drafting party (the principal) typically will not read or otherwise be able to detect or counteract such behavior.<sup>1</sup> Similarly, scholars suggest that standard form contracts may be designed in part to take advantage of particular cognitive biases and judgment heuristics of the non-drafting party.<sup>2</sup>

Unfortunately, most contract law reforms for standard form contracts have focused on alleviating the symptoms of the problematic relationship between parties to a standard form contract instead of the cause. In particular, reforms focus on improving the ability of the non-drafting party or courts to detect and control opportunistic contract drafting behavior. For example, mandated disclosure and the unconscionability doctrine are systematic reforms that attempt to alleviate the pre-formation information and control asymmetries that exist between the drafting party and non-drafting party. Mandated disclosure of particular terms (in particular language or formats) theoretically improves the ability of non-drafting parties to understand the terms of the contracts they are signing (and to refuse to sign when such terms are undesirable), while unconscionability enables non-drafting parties and courts to detect and punish drafting parties that take unfair advantage of the bargaining process.

These reforms have failed in part because they do not fundamentally change the misalignment of interests between the drafting party and the non-drafting party, specifically the desire of the drafting party to obtain the most advantageous terms through a strategically designed contract. These reforms also fail because they are based on a faulty assumption that the non-drafting party or the other monitors, such as legislatures or adjudicators, are capable of determining what constitutes effective disclosure without cooperation from the

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1. This is typically presented as a problem in terms of an information asymmetry or the cost to the consumer of acquiring the information. *See, e.g.*, Michael I. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583, 598 (1990) (“Some sellers attempt to increase this cost [of acquiring information] through the use of fine print or obscure placement. Even without these additional obstacles, the sheer number of terms to be analyzed in the typical form contract imposes too great a burden for the consumer.”) (footnote omitted).

2. Instead of being strictly based on information gaps or information costs, the problems of standard form contracts may be based upon the imperfect rationality of individuals. *See, e.g.*, OREN BAR-GILL, *SEDUCTION BY CONTRACT* 21 (2012) (“The behavioral-economics theory of contract design is an imperfect-rationality theory, not an imperfect-information theory.”); Trond Petersen, *Recent Developments in: The Economics of Organization: The Principal-Agent Relationship*, 36 ACTA SOCIOLOGICA 277, 289 (1993) (suggesting that the “agency framework [in the mathematical literature] would be strengthened by taking the notion of bounded rationality seriously”).

drafting party. Importantly, although these reforms are directed at improving the contract formation process through specific *ex ante* requirements (mandated disclosure) or general bargaining parameters (unconscionability), these requirements or defenses typically are invoked only after consent to the contract purportedly was given and a presumption of enforceability exists. Accordingly, the drafting party enjoys all the benefits of obtaining the non-drafting party's dubious consent, while the non-drafting party faces the burden of rebutting the presumed enforceability of such consent. Such reforms consequently fail to change the interests or behavior of the drafting parties in the standard form contract context.

This Article suggests that the task of contract preparation should be analyzed in terms of economic agency. Economic agency provides a more complete and nuanced understanding of the contract drafting relationship because it does not focus solely on the limitations on the non-drafting party or others to monitor the drafting party that permit the drafting party to draft one-sided contracts. Instead, it also identifies the reason that such limitations matter, namely the different interests of the parties. Rather than focusing on and trying to remedy the vulnerability of the drafting parties, economic agency suggests that by realigning the interests of the parties, the asymmetries of information and control can be rendered more benign.

Viewed in terms of economic agency, the drafting party can be understood to be the economic agent of the non-drafting party with respect to the task of preparing the contract. This relationship necessarily suffers from the principal-agent problem, meaning that dichotomies of interests, information, and control exist between the parties. These dichotomies may encourage and permit the drafting party to obtain a more advantageous contract in certain contexts, such as the use of standard form contracts in consumer transactions. The existing critiques of problematic legal consent to contract thus can be understood as attacking the issues that stem from the economic agency relationship between the parties concerning the form and content of the written contract. Without the ability to observe and control the agent preparing the contract, the principal that signs the contract may have little ability to control the contents of the contract. Contract law scholars have implicitly understood this.

As an example, credit card agreements have been criticized for insufficient disclosure of important terms, such as late fees or default interest rates, which (in part) prompted the passage of a federal act to address such deficiencies.<sup>3</sup> These agreements may exist as they do

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3. See BAR-GILL, *supra* note 2, at 81 (noting that "there is evidence that the high level of complexity was a deliberate design feature of the credit card contract"); Eric A. Zacks, *Unstacking the Deck? Contract Manipulation and Credit Card Accountability*, 78 U. CIN. L. REV. 1471, 1478 (2010) ("Current weaknesses in the disclosures contained in or

because the credit card companies are able to prepare contracts with such favorable terms and the principal (the consumer) is unable to detect such characteristics or, more significantly, able to respond rationally to such characteristics.<sup>4</sup> Consumers may not be able to understand credit card agreements' disclosure of late fees or other fees because of the complexity of such arrangements, and even if they do, they may inaccurately assess whether they will ever incur such fees.<sup>5</sup> Scholars' criticisms of such agreements now may be better understood in terms of the moral hazard that exists when one party is able to prepare the contract on behalf of the other without oversight or resistance by the other.

Similarly, scholars have criticized certain standard form contracts that secure legal consent using such questionable techniques as "rolling contracts" and other types of relatively passive acceptance by the consumer.<sup>6</sup> Such "legal consent" has been attacked as not being significant because the consumer has limited options to act to counteract such a contract.<sup>7</sup> For example, if the consumer reads the contract

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accompanying credit card agreements also suggest that Issuers prepare such agreements in their favor in an attempt to maximize profits.").

4. As an example, Bar-Gill suggests that consumers' perceptions of price can be manipulated. BAR-GILL, *supra* note 2, at 15 ("[C]ontract design is used to minimize the *perceived* total price by amplifying the effect of product-use mistakes.").

5. BAR-GILL, *supra* note 2, at 53 ("Complexity plays into the imperfect rationality of cardholders. . . . Increased complexity may be attractive to issuers, as it allows them to hide the true cost of the credit card in a multidimensional pricing maze.").

6. See, e.g., NANCY S. KIM, WRAP CONTRACTS 53-69 (2013) (addressing, in detail, the problematic issues arising from the use of "wrap contracts"). "Rolling contracts" are contracts where additional contractual terms and conditions are delivered with or after product delivery (but after basic agreement regarding the transaction). Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WIS. L. REV. 679, 681 (2004) (describing how rolling contracts "essentially permit parties to reach agreement over basic terms, such as price and quantity, but leave until a later time, . . . the presentation of additional terms that the buyer can accept, often by simply using the good, or reject, by returning it").

7. If the party is not in a position to understand and counter the terms, then any apparent assent to the contract is meaningfully weakened. Accordingly, the "standard analysis in SFC [standard form contract] cases is that because the recipient of terms cannot be reasonably expected to negotiate, review, or fully comprehend [standard form contracts] that are drafted by more sophisticated and self-interested sellers, the effectiveness of alleged contract terms becomes a matter for judicial scrutiny." Gillette, *supra* note 6, at 680-81. Moreover, the delivery method may intentionally impair the non-drafting party's ability to respond to such terms. See Roger C. Bern, "Terms Later" Contracting: *Bad Economics, Bad Morals, and a Bad Idea for a Uniform Law*, *Judge Easterbrook Notwithstanding*, 12 J.L. & POL'Y 641, 735-41 (2004) (describing how purposely delivering standard terms after the product has been sold and delivered "increase[s] the likelihood that the vendor will be able to obtain both its terms and a price greater than what the buyer may have been willing to pay had the terms been disclosed up front"); cf. Randy E. Barnett, *Consenting to Form Contracts*, 71 FORDHAM L. REV. 627, 635 (2002) ("When one clicks 'I agree' to the terms on the box [of a license agreement on a web site], does one usually know what one is doing? Absolutely. There is no doubt whatsoever that one is objectively manifesting one's assent to the terms in the box, whether or not one has read them. The same observation applies to signatures on form contracts.").

delivered with the purchased goods (a “rolling contract”) and decides that the agreement as prepared is unacceptable, it may be very expensive to return the purchased merchandise, or there may be decision-making biases that will inhibit such a return (such as the endowment effect associated with possession of the product).<sup>8</sup> The limited or expensive options available to the consumer or the tendency of a consumer to accept passively a written contract, however, now can be understood as limitations on the ability of a principal to control an agent’s actions even when detected. The drafting party (the economic agent), consequently, is incentivized to enhance and exploit these limitations to the drafting party’s personal benefit by preparing a particular type of contract (with favorable terms) and delivery system intended to induce assent.

To some extent, the drafting party and the non-drafting party have irreconcilable interests because the contract will dictate the terms of their future relationship, and to the extent that a term is favorable to one party, the other party is correspondingly disadvantaged. The interests to be realigned, instead, must be the interests with respect to detection and comprehension of the material terms of the contract. The drafting party would prefer that the non-drafting party be unable and unwilling to detect disadvantageous terms, while the non-drafting party would prefer to be able to detect such terms.

Accordingly, contract law reforms must utilize tools that incentivize the drafting party to make effective disclosure of disadvantageous terms. Importantly, these tools must not rely on ad hoc or stale determinations of what constitutes effective disclosure by legislatures, judges, or even the non-drafting parties themselves. As an example, the presumption of enforceability with respect to contract terms in standard form contracts could and should be reversed. Under such a regime, drafting parties would be forced to demonstrate that the disclosure in standard form contracts is effective. Shifting the burden to the drafting parties to deploy resources with respect to effective disclosure reduces the incentive for disclosing parties to obscure or confuse with respect to particular contract terms and aligns the parties’ interests. To that end, improper disclosure would put drafting parties at a competitive disadvantage instead of an advantage, as improperly drafted contracts would not be enforced. Limiting court review to whether drafting parties can demonstrate empirically that a contract made effective disclosure of its terms also reduces the possibility of legislative or adjudicative error.

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8. For example, the endowment effect may deter the party from returning the product if the contract terms are not delivered until after the product has already been delivered. Jeff Sovern, *Toward a New Model of Consumer Protection: The Problem of Inflated Transaction Costs*, 47 WM. & MARY L. REV. 1635, 1653-54 (2006).

This Article proceeds as follows: Part II provides an overview of the economic conception of the principal-agent problem and how it can be understood to exist when one contracting party is empowered to prepare the written contract. It then addresses implications of the principal-agent problem within the contract preparation context. Part III of this Article then explains how economic agency theory helps us understand which contracts are problematic as well as why particular contract law reforms have not achieved success. Part III also proposes a different set of reforms designed to address the differing interests of the parties instead of focusing on the asymmetries of information and control that can be exploited. By realigning the drafting party's desire to receive advantageous terms with the non-drafting party's interest in understanding disadvantageous terms, contract law reforms can promote effective disclosure. Part IV concludes that the model of the economic agency relationship as it exists in the contract preparation context, including the associated principal-agent problem, not only provides an important analytical tool for contract law scholars but also important solutions for addressing gaps in contract preparation and formation.

## II. ECONOMIC AGENCY AND CONTRACT LAW

For economic purposes, an agency relationship is created when one party (the "agent") is empowered to complete a task on behalf of another (the "principal").<sup>9</sup> Economic agency should be distinguished from the legal status of agency and the associated duties and liability arising from such status.<sup>10</sup> Generally, legal agency is only created if the agent has been empowered with enough discretion to modify the legal relations of the principal and if the principal has enough control

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9. GLENN BLACKMON, INCENTIVE REGULATION AND THE REGULATION OF INCENTIVES 7 (1994) (The principal-agent "relationship arises when one party, the *principal*, employs another party, the *agent*, to perform some task"); Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57, 58 (1989) ("[A]gency theory is directed at the ubiquitous agency relationship, in which one party (the principal) delegates work to another (the agent), who performs that work.").

10. Part of the distinction between the two types of agency is based on the assumption regarding whether a trust or fiduciary relationship exists. In legal agency relationships, one party is understood to be standing in some sort of fiduciary relationship, meaning one where the party has been empowered, presumably based on trust, to act on behalf of the other party. By contrast, "economic models of agency have tended to assume an absence of trust, focusing instead on moral hazard and adverse selection." Ramon Casadesus-Masanell, *Trust in Agency*, 13 J. ECON. & MGMT. STRATEGY 375, 375 (2004). Although there is obvious overlap between the two conceptions, the law of agency arose before the economic literature concerning principal-agency problems. See ERIC A. CHIAPPINELLI, CASES AND MATERIALS ON BUSINESS ENTITIES 89, 93 (2d ed. 2010). Given the lack of overlap in origins and assumptions, it is not surprising that the legal solutions to agency (legal or economic) problems have been different. Indeed, this Article is an attempt to reconcile ways in which economic understandings of agency may supplement the legal gaps that are based on only a fiduciary notion of agency.

over the time and manner in which the agent completes her task.<sup>11</sup> Thus, legal agents typically are economic agents, but economic agents are not necessarily legal agents.<sup>12</sup>

Importantly, the drafting party, if also a signatory and party to the contract, would *not* be considered a legal agent of the non-drafting party with respect to the task of preparing the contract. For example, the drafting party does not owe the fiduciary duties associated with being a legal agent, such as the duty to disclose all relevant information to the other party or to act in the best interests of the other contract party, to the contract party regarding the contract, its preparation, or its contents.<sup>13</sup> Instead, the burden and responsibility for the contents of the contract lie almost exclusively with the party executing the contract.<sup>14</sup> Indeed, contract law imposes a duty to read upon the party signing the contract, which is in accord with the idea that the drafting party is acting on her own behalf and not as a legal agent of the other party.<sup>15</sup> This Article is primarily concerned, however, with the economic (and not legal) conception of agency and how it informs the preparation of contracts.<sup>16</sup>

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11. Generally, the legal agent has to be empowered to act on behalf of the principal with respect to third parties. *See, e.g.*, Ramon Casadesus-Masanell & Daniel F. Spulber, *Trust and Incentives in Agency*, 15 S. CAL. INTERDISC. L.J. 45, 88 (2005) (“The definition of agency in economics departs considerably from the legal definition. . . . In economics, the agent often is a subordinate employee who performs a productive task for the principal. . . . Yet the legal definition of agency is clear—an agent is a representative sent by the principal to represent the interests of the principal in transactions with third parties.”).

12. Because legal agency requires specific types of powers to be granted to the agent and specific amounts of control to be retained by the principal, the economic conception of agency is necessarily broader than the legal concept. *See* Basile v. H & R Block, Inc., 761 A.2d 1115, 1120 (Pa. 2000) (“[A]gency [for legal purposes] results only if there is an agreement for the creation of a fiduciary relationship with control by the beneficiary.” (quoting Smalich v. Westfall, 269 A.2d 476, 480 (Pa. 1971))); CHIAPPINELLI, *supra* note 10, at 89 (comparing the legal conception of economic agency to the economic conception).

13. These obligations, if they exist at all, would be derived from common law concepts or statutory requirements (as opposed to a legal agency relationship). *See* CHIAPPINELLI, *supra* note 10, at 95 (“The [legal] agent is a fiduciary to the principal, which means that the agent has higher duties than the implied duties of good faith and fair dealing ordinarily found in a contractual setting.”).

14. Courts expect parties to have read and understood the contracts that they have signed and generally hold them liable under unread contract. Edith R. Warkentine, *Beyond Unconscionability: The Case for Using “Knowing Assent” as the Basis for Analyzing Unbargained-for Terms in Standard Form Contracts*, 31 SEATTLE U. L. REV. 469, 476 (2008) (“As a corollary to finding assent to contract formation, traditional contract doctrine imposes on the parties a ‘duty to read.’”).

15. The duty to read means “[a] party that signs an agreement is regarded as manifesting assent to it and may not later complain about not having read or understood it.” E. ALLAN FARNSWORTH, *CONTRACTS* § 4.26 (4th ed. 2004).

16. As such, any references to “agency” or “agents” in this Article should be understood (unless otherwise specified) as describing economic, not legal, agency relationships.



### A. An Overview of the Principal-Agent Problem

A much-discussed issue with the creation of any sort of agency relationship is the “principal-agent” problem.<sup>17</sup> The principal-agent problem stems from the differences between the motivations and interests of the parties and the accompanying asymmetries of information and control.<sup>18</sup> If the interests of the parties are different, and the agent has better information and more control over the agent’s performance, then the agent may face a “moral hazard” and be inclined to act in the agent’s best interest at the expense of the principal (without the principal being able to detect or counteract such behavior).<sup>19</sup> Each of these basic factors will be addressed briefly in turn.

As to the parties’ respective interests, the principal generally would prefer the agent to complete the task using the highest quality and efficiency at the minimum cost to the principal.<sup>20</sup> The agent, on

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17. BLACKMON, *supra* note 9, at 7 (noting that “[t]he principal-agent relationship gives rise to the principal-agent problem and to an entire literature of information economics”) (emphasis omitted).

18. Eisenhardt, *supra* note 9, at 58 (describing the “agency problem that arises when (a) the desires or goals of the principal and agent conflict and (b) it is difficult or expensive for the principal to verify what the agent is actually doing”); Douglas E. Stevens & Alex Thevaranjan, *A Moral Solution to the Moral Hazard Problem*, 35 ACCT. ORGS. & SOC’Y 125, 125 (2010) (The principal-agent “model raises expectations about the occurrence of self-interested behavior and the usefulness of financial incentives in solving the moral hazard problem.”).

19. As used in this Article, the term “moral hazard” will be used to refer to the problem faced by an economic agent when the agent has the ability to act (undetected) in the agent’s personal interests to the detriment of the principal. See BERNARD SALANIÉ, *THE ECONOMICS OF CONTRACTS* 107 (2d ed. 2005) (“We speak of *moral hazard* when the Agent takes a decision (‘action’) that affects his utility and that of the Principal; the Principal only observes the ‘outcome,’ an imperfect signal of the action taken; [and] the action the Agent would choose spontaneously is not Pareto-optimal.”); Jörg Guido Hülsmann, *The Political Economy of Moral Hazard*, 1 CZECH J. POLITICKÁ EKONOMIE 35, 35 (2006) (citing Y. Kotowitz, *The Moral Hazard*, in *THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS* 549 (John Eatwell et al. eds., 1st ed. 1987)) (“Moral hazard is present in ‘actions of economic agents [...] to the detriment of others in situations where they do not bear the full consequences [...] of their actions.’”). Although used in this broader sense for the purpose of this Article, “moral hazard has never been a straightforward, purely logical or scientific concept.” Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 239 (1996). Baker traces the development of the term “moral hazard” from its uses in the insurance industry in the 1800s to the generalization of the concept to encompass all relationships that involve risk. Importantly, beginning with the exchanges between Kenneth Arrow (who applied the concept of moral hazard to the economics of the U.S. health care system) and Mark Pauly, there has been disagreement regarding whether morality is relevant at all to “moral hazard” or whether it is merely a question of incentives. *Id.* at 268. Without wanting to wade too far into the debate but still wanting to use the term as a shorthand to describe effectively the situation of an economic agent with superior information and control, this Article uses the term moral hazard (based on the differing interests and incentives of the agent in such a situation) without regard to whether actions taken by the agent might be or are in fact immoral.

20. Principals are inclined to try to extract as much benefit from the economic agent at the lowest cost, which may include ratcheting, which means attempting to add additional and uncontracted for tasks to the economic agent without additional compensation. See

the other hand, generally would like to complete the task using the minimum effort while extracting the maximum compensation from the principal or otherwise profiting from the task and any associated opportunities.<sup>21</sup>

This differential in interests is problematic based on disparities in the parties' relative information and control. First, the principal has less and probably worse information *ex ante* about whether the agent is capable of performing the task with the desired quality and in the desired time frame.<sup>22</sup> In addition, the agent likely will have superior information regarding, both during and after the performance period, whether the agent performed the task as and when desired.<sup>23</sup>

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CHIAPPINELLI, *supra* note 10, at 90 ("Measured strictly from the principal's economic best interest, principals have an incentive to ratchet because they get the desired task performed at a lower cost.").

21. The interests of the agent are just the mirror image of the desires of the principal. *See* Hülsmann, *supra* note 19, at 37 ("The agent, who is fully informed about his own activities, has an incentive to act in his own material interest against the material interests of his less informed principal."). There are other differences between the parties, of course. The profile of principals and agents may be different as well. Agents may be more risk-averse as the party with more to lose (by ending up with a suboptimal result associated with riskier choices) than the principal as the party with more to gain (by ending up with a result above the desired level associated with riskier choices). Other differences may arise because of the different profile of the agent prior to and after contract formation. *See* Stevens & Thevaranjan, *supra* note 18, at 125 ("In the most basic case, a risk-neutral principal offers a risk-free wage to a risk-averse agent to perform a productive effort, and the agent accepts the offer as long as the wage adequately compensates him for the effort. After accepting the offer, however, the agent prefers to shirk and provide less than the agreed-upon level of effort because he is assumed to be effort-averse and morally insensitive (*i.e.*, opportunistically self-interested).").

22. Because of this disparity in information, agents may be able to misrepresent their qualifications to the principals. This problem, known as adverse selection, can be costly to the principal even if the principal is in a position to detect poor performance once the agent has been engaged. *See* INÉS MACHO-STADLER & J. DAVID PÉREZ-CASTRILLO, AN INTRODUCTION TO THE ECONOMICS OF INFORMATION: INCENTIVES AND CONTRACTS 11 (Richard Watt trans., 2d ed. 2001) (noting that in "adverse selection" problems, "the principal can verify the agent's behaviour, but the optimal decision, or the cost of this decision, depends on the agent's type, that is, on certain characteristics of the production process of which the agent is the only informed party . . . [including] personal characteristics of the agent").

23. One of the reasons that agents are often employed is because the principal is unable or unwilling to become intimately involved with the task. *See* Bengt Hölmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 74 (1979) ("The source of this moral hazard or incentive problem is an asymmetry of information among individuals that results because individual actions cannot be observed and hence contracted upon."). The principal may be unwilling to invest the time necessary to monitor the agent while performing or the money necessary to determine whether the agent in fact did a good job. *See* BLACKMON, *supra* note 9, at 7 (describing the principal-agent problem in terms of the ability of the agent to "take some actions that further his interests at the expense of the principal's interests. . . . It is difficult (*i.e.*, expensive) to monitor or verify the behavior of the agent"). For example, it may be difficult to determine whether the performance of an individual employee (an economic agent) was good or bad with respect to a project with which many employees were involved. *See* Petersen, *supra* note 2, at 278 ("The principal-agent relationship is interesting when (a) there is some uncertainty in the way the agent's action gets transformed into the output, and (b) there is asymmetrical information, for example, the

As a result of the asymmetries of information, the agent also may have more control over whether the agent performs as and when desired by the principal.<sup>24</sup> The agent has been empowered to perform the task by the principal, presumably because the principal believed it was more expedient to have someone else perform the task; thus, it necessarily follows that the agent will have some level of independence from the principal to perform the task and, therefore, to have more information about the agent's performance.<sup>25</sup> The agent will therefore determine how and when the task is performed, including modifying the task's performance based on changing conditions.

As a result of these asymmetries of interests, information, and control, agents face a moral hazard and, accordingly, may be inclined and incentivized to act in a number of ways that are below the desired performance level.<sup>26</sup> First, agents may shirk by performing the task at a level below the quality desired by the principal (and expend less time and effort as a result, which is a benefit enjoyed solely by the agent).<sup>27</sup> The agent may be able to do so because the principal

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agent (e.g. a worker) observes her own action, but the principal (e.g. an employer) does not observe the action of the agent. The principal can then not be sure whether the agent acts in the principal's best interest.”).

24. Because the agent often is an expert, the principal is going to have to rely on the agent's judgment and determination of performance. See Casadesus-Masanell & Spulber, *supra* note 11, at 72 (“The agent is often a specialist on the task he has been hired to perform, having a comparative advantage if not an absolute advantage relative to the principal, giving the agent greater capacity to process information and determine the most desirable course of action.”).

25. As noted by Arrow, “by definition the agent has been selected for his specialized knowledge and therefore the principal can never hope completely to check the agent's performance. You cannot therefore easily take out insurance against the failure of the agent to perform well.” Kenneth J. Arrow, *The Economics of Moral Hazard: Further Comment*, 58 AM. ECON. REV. 537, 538 (1968). For example, the amount of information the employer has about the effort made by the employee is limited and difficult to verify. Pablo Arocena et al., *Why Are Firms Challenging Conventional Wisdom on Moral Hazard? Revisiting the Fair Wage-Effort Hypothesis*, 20 INDUS. & CORP. CHANGE 433, 434 (2010) (“In this situation, information asymmetries may give the employee incentives to behave inappropriately from the perspective of the employer . . .”).

26. In the absence of effective deterrence, the economics models of the agency relationship suggest that the agent will act opportunistically and in her own personal interests. Hülsmann, *supra* note 19, at 37 (“Whenever the principal cannot effectively monitor the activities of his agent, therefore, the latter has an incentive to increase his own (monetary and psychic) income at the expense of the former.”); Peter Wright et. al., *A Reexamination of Agency Theory Assumptions: Extensions and Extrapolations*, 30 J. SOCIO-ECON. 413, 415 (2001) (noting that “the expectation is that economic actors may disguise, mislead, distort, or cheat as they partner in an exchange”). This model is based on the idea that agents are motivated generally to maximize their personal gains. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (“If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.”).

27. Shirking is a somewhat unobvious way of acting in one's own personal interests because the agent is not necessarily receiving additional benefits from having “shirked.” See Eisenhardt, *supra* note 9, at 61 (arguing that the agent may simply not put forth the

cannot detect that the agent is doing so nor control (without the benefit of such information) the agent from doing otherwise.<sup>28</sup> For example, a painter may only paint a house with one coat of paint (instead of two, as may have been desired by the homeowner) if the painter believes that the homeowner will be unable to detect the quality difference between one or two coats of paint (or to monitor the painter while she paints).<sup>29</sup> This shirking saves the painter from having to spend the time painting the second coat or incur the cost of purchasing more paint for the second coat, while the painter presumably will still charge the principal for a “completed” task.

An agent may also act directly against the interests of the principal by taking property or benefits that belonged (or should have belonged) to the principal for the agent’s own benefit.<sup>30</sup> The opportunity to secure these “private benefits” arises because, again, the principal cannot detect the agent is doing so, and the agent has the information and control to be able to identify the opportunity and seize upon it. In the house-painting example, the painter could take some of the paint paid for by the homeowner and use it for her own house (without paying for it). The painter also might be able to utilize other personal property of the homeowner for her own benefit (such as eating the homeowner’s food) while permitted on the homeowner’s premises.

The principal is not necessarily powerless to address the asymmetries of information and control described above. Principals often incur costs in order to address the principal-agent problem and reduce the risk that the agent will engage in shirking or other problematic, opportunistic behavior.<sup>31</sup> These agency costs can include ex ante costs

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agreed-upon effort—that is, the agent is shirking). Instead, shirking is acting opportunistically because the agent may be compensated as if the principal’s desired level of effort had been expended, even though it had not. Accordingly, in this sense, the agent is receiving additional financial rewards, at least relative to the actual output of effort. BLACKMON, *supra* note 9, at 7-8 (“It is tempting and easy to make judge the agent to be ‘bad’ in this situation . . . . Often the shorthand description of the agent’s behavior carries this negative connotation. The agent may ‘shirk,’ engage in ‘slack,’ or . . . engage in ‘abuse.’”).

28. Accordingly, there is a direct link between observability and opportunistic behavior. See SALANIÉ, *supra* note 19, at 119 (“Because the action is unobservable, the Principal cannot force the Agent to choose an action that is Pareto-optimal.”); BLACKMON, *supra* note 9, at 8 (noting that “the agent does not profit from his opportunity to shirk, slack, or abuse as long as the principal anticipates the agents opportunity to so behave”).

29. Agents could commit fraud as well when a principal has explicitly charged an agent with the details of the task and the agent ignores those details to the extent that the principal is unable to detect such malfeasance.

30. CHIAPPINELLI, *supra* note 10, at 91 (“The second moral hazard that principals face is the risk that the agent will use his or her discretion opportunistically to obtain *private benefits* for which the agent will bear only part (or even none) of the cost.”).

31. These costs can be incurred either by monitoring agents (or hiring others to monitor) or implementing financial incentives, both of which methods are designed to deter opportunistic behavior by the agent. Charles W. L. Hill & Thomas M. Jones, *Stakeholder-Agency Theory*, 29 J. MGMT. STUD. 131, 132 (“According to agency theory, the principal can limit divergence from his/her interests by establishing appropriate incentives for the agent,

incurred to screen potential agents for qualification as well as costs incurred during the time of or after performance to ascertain whether the agent performed as desired.<sup>32</sup> Contracts exist in part to detect and constrain opportunistic actions of one of the contractual promisors (an economic agent of the other with respect to a particular promised task).<sup>33</sup> Contracts are distinct from other creations of economic agency relationships because the contract provides a legally enforceable remedy to the promisee (the principal) if the promisor's obligations specified in the contract (i.e., the agent's tasks) are not

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and by incurring monitoring costs designed to limit opportunistic action by the agent.”). These costs are known as “agency costs” and represent an overall loss to the principal. *Id.* (“The sum of the principal’s monitoring expenditures, the agent’s bonding expenditures, and any remaining residual loss are defined as agency costs.”).

32. Accordingly, agents could be deterred either through detection and rejection of improperly qualified agents at the commencement of the relationship as well as additional monitoring of performance and outcome-based incentives. *See* Arocena et al., *supra* note 25, at 434 (noting that “the conventional solution to moral hazard is to align the incentives of all players through strict monitoring of the agent’s behavior and incentive packages linked to the fulfillment of the principal’s interests”). Some have suggested focusing on non-economic means to address the principal-agent problem. *See, e.g.*, Stevens & Thevaranjan, *supra* note 18, at 126 (“The possibility for morality or social norms to control self-interest was raised early on in the development of agency theory but the literature chose to emphasize economic incentive solutions to the moral hazard problem.”)(citing Joel S. Demski & Gerald A. Feltham, *Economic Incentives in Budgetary Control Systems*, 54 *ACCT. REV.* 336, 346-47 (1978))). Although not addressed in this Article, it seems doubtful that social norms can reform standard form contract drafting practices, and, in fact, the opposite may be true. *See, e.g.*, KIM, *supra* note 6, at 5 (“In the dynamic online and mobile computing environment the aggressive practices of businesses—accomplished in large part through wrap contracts— threaten to reshape societal norms and values . . . .”); MARGARET JANE RADIN, *BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW* 15-16 (2013) (suggesting that the use of boilerplate results in the “normative degradation” of the legal system as well as the elimination of democratically provided rights); *see also* Arrow, *supra* note 25, at 538 (suggesting that “[o]ne of the characteristics of a successful economic system is that the relations of trust and confidence between principal and agent are sufficiently strong so that the agent will not cheat even though it may be ‘rational economic behavior’ to do so.”). The absence of trust in certain contract situations, such as transactions between many mass sellers and consumers (who are typically strangers), suggests that stronger means must be used to detect drafting parties who are acting opportunistically. *See infra* Part IV for a discussion of reforms suggested by economic agency for this area.

33. Contracts attempt to address these issues in part by providing binding financial incentives for the agent not to act opportunistically after being engaged to act on the principal’s behalf. *See* Casadesus-Masanell & Spulber, *supra* note 11, at 90 (“Economic analysis of the agency model seeks to characterize the terms of an optimal agency contract. Because of moral hazard, the principal must rely on performance based rewards such as bonuses and commissions to induce the agent to work.”). Designing a contract that provides the “appropriate” financial incentives is not simple, particularly since the inputs (effort) or outputs (performance) may be difficult to measure. For example, as for the relationship between a money manager (an agent) and an investor (a principal), “[t]he investor’s problem then is how to design an optimal compensation contract in light of the moral hazard and adverse selection problems that arise from the fact that the manager’s quality and effort as well as the complexity of the available investment opportunities are the manager’s private information.” Alex GersHKov & Motty Perry, *Dynamic Contracts with Moral Hazard and Adverse Selection*, 79 *REV. ECON. STUD.* 268, 268 (2012) (noting that contracts may not be utilized in common business practices because they are expensive to draft and enforce).

fulfilled.<sup>34</sup> As a result, the contract can provide the principal with the ability to alleviate the information and control disparities that ordinarily exist.<sup>35</sup> The contract can be seen as an attempt, however imperfect, to address the information and control asymmetries between two parties based on known or contemplated differences in personal interests.<sup>36</sup>

Thus, there is an existing body of literature that recognizes the significance of the post-formation contract principal-agent problem and the moral hazards faced by promisors after they have agreed contractually to perform. There is also a separate body of literature that recognizes that contract preparers may design contracts in order to take advantage of the other parties' imperfect or incomplete rationality, particularly in the consumer contract context.<sup>37</sup> The literature to date, however, has not recognized explicitly that the foundation of these critiques is the principal-agent problem as it may exist in the context of contract preparation. In other words, addressing the principal-agent problem between promising parties by entering into a contract (to alleviate information and control asymmetries that exist after the contract is signed) creates a new agency problem: the principal-agent problem (and the accompanying moral hazard) associated with the diverging interests, information, and control that exist for the task of drafting the contract.

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34. The ability of contracts, no matter how detailed, to provide protection against opportunistic behavior is contested in the literature. See, e.g., Stefan Wuyts & Inge Geyskens, *The Formation of Buyer-Supplier Relationships: Detailed Contract Drafting and Close Partner Selection*, 69 J. MKTG. 103, 103 (2005) ("Theoretically, some researchers argue that detailed contract drafting offers a way to protect against the partner's opportunism through the threat of legal enforcement, whereas others argue that detailed contracts are seldom used in practice because they are costly to draft and enforce." (citing Paul L. Joskow, *Contract Duration and Relationship-Specific Investments: Empirical Evidence from Coal Markets*, 77 AM. ECON. REV. 168, 169 (1987); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 64-66 (1963))).

35. Hülsmann, *supra* note 19, at 39 (noting that "principals acting on a free market . . . are also free to design contracting relationships in ways that minimize: a) the danger of moral hazard arising in the first place and b) the danger of moral hazard, once there, affecting them negatively"); Wuyts & Geyskens, *supra* note 34, at 106 ("Thus, through clearly articulated clauses, contracts narrow the domain around which parties can be opportunistic. For example . . . [a] precise statement of how each party is to perform decreases the likelihood that the partner will hide important performance-related information, such as information about capacity constraints. On the other hand, failing to specify all elements of the exchange contractually increases incentives for short-term cheating.").

36. It is understood that agency costs cannot completely eliminate opportunistic behavior of agents. See Wright et al., *supra* note 26, at 425 ("In spite of contracting, monitoring, and bonding efforts, however, there will still remain 'some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal.'" (quoting Jensen & Meckling, *supra* note 26, at 308)).

37. These are often standard form contracts. See, e.g., BAR-GILL, *supra* note 2, at 6-43; Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1216-44 (2003).

This Article argues that economic agency literature is instructive with respect to the situation of contract drafting once the drafting party is understood or interpreted as the economic agent of the non-drafting party with respect to preparing the contract.<sup>38</sup> The next Section discusses the principal-agent problem as it exists for contract preparation and its manifestations in terms of information asymmetry, control imbalances, and unfair or unexpected results, which may help explain why contracts are prepared as they are.

### *B. The Differing Interests of the Contract Parties*

As with any agency relationship, the interests of the principal (the non-drafting party) and the agent (the drafting party) are different, as they are each seeking to maximize the benefits realized from the relationship.<sup>39</sup> The agent in this instance, however, also happens to be the party that directly benefits from a particular formulation of the parties' legal rights and obligations in the written contract. Thus, the agent has an interest in a written contract that provides the most flexibility for the agent, less exposure to potential liability for the agent, less flexibility for the other party, and a greater exposure to potential liability for the other party.<sup>40</sup> As discussed in the introduction to Part II, contract law assumes that these differing interests represent a legitimate basis for maximizing gains. It does so by not imposing a duty upon the drafting party to draft in good faith or to act as a legal agent with respect to the non-drafting party.

For "repeat players," these differing interests may be more important since the same contract will potentially be used for many transactions. Accordingly, if the drafting party is a repeat player (such as a corporate entity that routinely does business with similarly situated customers), the drafting party also would prefer to have a contract that has a standard set of terms and conditions which are well understood by the drafting party and provide consistent legal results, even if that involves the engagement and expense of profes-

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38. Whether the drafting party is, under strict economic theory, an economic agent of the non-drafting party is not addressed in this Article. This Article instead focuses on whether the economic agency literature helps illuminate certain problems that arise from strategic contract drafting and suggests alternative reforms.

39. As discussed in Part I *supra*, each party is different, will have different interests, and will be motivated to act in her own interests. See BLACKMON, *supra* note 9, at 7 ("The interests of the principal and the agent are different; each seeks to maximize his own reward, however measured."). Accordingly, when one assents to a contract, her choice might be understood as manifesting an accurate determination that the terms of that contract fulfill those interests. See Gillette, *supra* note 6, at 714-15. This Part will discuss why that premise is untrue for particular contracts.

40. See Korobkin, *supra* note 37, at 1216-44 (arguing that drafting parties are incentivized, including by the market, to draft standard form terms that favor the drafting parties).

sionals.<sup>41</sup> It also would be cheaper for the drafting party to utilize the same contract so that it does not have to negotiate and draft a new contract from scratch with respect to similar transactions.<sup>42</sup>

For the party that does not prepare the contract, her interests with respect to the contract are almost diametrically opposed to those of the drafting party. The principal (the party that does not prepare the contract) would be interested in less flexibility for the agent, greater exposure to potential liability for the agent, more flexibility for the principal, and less exposure to potential liability for the principal. If the principal (the non-drafting party) is not a repeat player, the principal also may prefer a contract that is specifically tailored to the principal's personal situation rather than a written contract that purports to govern the typical transaction.<sup>43</sup>

More significantly, the party that did not prepare the contract may prefer not to have any written contract, particularly if the party believes that she would be better protected in the absence of a written contract. For example, an individual consumer may prefer to purchase an apple without a contract, believing that food safety regulations, sales statutes, criminal statutes, or civil tort remedies will adequately protect her interests if the apple proves to be unsafe. The

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41. Using the same contract may alleviate uncertainty for both courts and other contracting parties regarding particular terms. See Clayton P. Gillette, *Standard Form Contracts*, in 6 CONTRACT LAW AND ECONOMICS 115-16 (Gerrit De Geest ed., 2d ed. 2011) (“[S]tandardization of contracts confers learning effects as courts and parties agree on meanings of potentially vague terms. . . . Repeat players may prefer standard forms that reduce uncertainty about the meaning of contract terms.”). For individual sellers, it makes sense to incur the expense of drafting a one-sided contract if the contract will be used with many customers, even if the individual value of any one contract is minimal. See Meyerson, *supra* note 1, at 599 (“The aggregate value to the business of the potential profit from each individual transaction justifies the expense [of paying for legal advice regarding the contract].”). This obviously is not as true for consumers engaged in a rare and perhaps relatively inexpensive transaction.

42. This also may “facilitate control of agency costs in mass market transactions.” Gillette, *supra* note 41, at 116. The agency literature in this area typically is concerned about the agency relationships *within* the firm preparing the contract itself. “If agents [of the drafting party such as a salesperson] are authorized to negotiate terms, principals will have to monitor agents to ensure that contract modifications do not adversely affect the pricing models under the original contract.” *Id.* By preventing internal agents from legally modifying the forms, firms are able to prevent their agents from performing suboptimally. See Barnett, *supra* note 7, at 631 (“[H]ow does the firm constrain the ability of agents to serve their *own* interests . . . ? Simple: we bind both agents and third parties to the (unwaivable) terms in a form contract.”). In a somewhat ironic manner, permitting firms to prevent their agents from acting opportunistically allows firms to act opportunistically relative to the non-drafting parties.

43. This point is debatable. Individuals may be comforted utilizing a standard contract because it indicates to them that they are acting in accordance with typical social practice. See, e.g., G. Richard Shell, *Fair Play, Consent and Securities Arbitration: A Comment on Speidel*, 62 BROOK. L. REV. 1365, 1368 (1996) (“[I]n terms of negotiation theory, customers sign arbitration clauses because firms leverage two important sources of bargaining power: the authoritative legality of the printed form and what psychologists call ‘social proof.’”).



presence of a written contract may signal to the individual consumer that the drafting party desires to limit the individual consumer's existing (default) legal rights.<sup>44</sup>

The party that did not prepare the contract may also be entering into a transaction of convenience, meaning that the party's interests with respect to the contract are only to receive the benefit of the transaction. The principal, then, may authorize or ratify the preparation of the contract in order to receive the benefits of the transaction as quickly as possible without regard to the legal consequences of the written document (perceiving them to be a "necessary evil" to receive the benefit of the transaction).<sup>45</sup> For example, a computer user may enter into a software license with a "click" of a button on the computer (without negotiation) in order to receive the benefits of the transaction as soon as possible. If the risks associated with the transaction are perceived by the other party to be minimal, then the interests of the other party may lie elsewhere, such as consummating the transaction as quickly as possible.

### C. *The Drafting Party's Discretion*

Significantly, the agent (the drafting party) also can take actions that benefit her at the expense of the principal. In this instance, the drafting party is preparing the document that, if signed unmodified, specifies and will govern both parties' legal obligations. As the preparer of the contract, the drafting party will have the ability to control the exact language used in the contract, including how the language defines and describes the various promises. The preparer can decide which promises and other legally binding terms should be included as part of the agreement and describe them as desired by the

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44. This may be somewhat similar to the way in which consumers view product liability disclaimers. See Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420, 1565 (1999) (noting consumer perceptions of product warnings as the "handiwork of overly cautious manufacturer attorneys" that do not need to be read).

45. This effect arises from both the rarity of the transactions themselves as well as the lack of contract utility as perceived by the consumer. See Warkentine, *supra* note 14, at 515 (noting that "[t]he adhering parties encounter such forms [standard form contracts] in isolated transactions and are more interested in the commodity or service they are purchasing than the form they are being asked to sign"). Moreover, even if inclined to read the contract, consumers are unwilling to engage in unproductive uses of their time, such as where the contract is not written in an understandable manner. See Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429, 446 (2002) ("Reading and understanding boilerplate terms is difficult and time consuming for consumers. Consumers recognize that they are unlikely to understand the lengthy and complicated legal jargon in the boilerplate. To make matters worse, consumers commonly encounter standard forms when they are in a hurry.") (footnote omitted).

preparer. The drafting party also will be able to control the presentation features of the contract such as its organization, font size, length, and formatting.

As an economic agent, the drafting party is incentivized to prepare the contract in such a way as to maximize her interests. It is a little unusual in terms of agency because we typically think about agents “shirking” their responsibilities, while in this instance the agent will be actively seeking to undermine her responsibilities completely.<sup>46</sup> That is, the agent will prepare the contract, but the agent is incentivized to do so as to maximize the agent’s future gains under the contract.<sup>47</sup>

In this context, it makes more sense to understand contract preparation as providing an opportunity for the drafting party to receive private benefits. The agent (the drafting party) may be placed in a position to act in her own best interest to the detriment of the other party, in this instance by including particular terms or conditions and otherwise preparing the contract in the agent’s favor as opposed to the other party’s. One could easily imagine the number of one-sided provisions that could be included, such as altering the basic “deal” terms of the promises, varying the standard of performance, limiting contractual remedies of the non-drafting party by narrowing the definition of damages or limiting the time period for claims of breach, or correspondingly enlarging the contractual remedies of the drafting party.

The agent may also be inclined to prepare the contract to induce the principal to enter into the transaction, even if the transaction (as described and governed by the contract) is not as attractive as it appears. For example, drafting parties may frame the contractual terms in order to exploit particular cognitive biases of the non-drafting parties.<sup>48</sup> Similarly, drafting parties can deter detection of their actions by increasing the transaction costs for the non-drafting party involved with reviewing and negotiating the agreement, including by using legalistic language, drafting lengthy agreements, or delaying

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46. See Wright et al., *supra* note 26, at 413 (discussing the typical economic exchange with a third party, wherein a party’s agent (dealing with the third party) can act in a manner that is inconsistent with the principal’s best interests).

47. For example, drafting parties will attempt to insert additional economic bonuses for the drafting parties or penalties to the other party under the contract that may not have been negotiated or contemplated by both parties. See Korobkin, *supra* note 37, at 1206 (suggesting that drafting parties will be incentivized to prepare one-sided standard form contracts).

48. For example, drafting parties will be incentivized to draft contracts that impair the non-drafting parties’ ability to assess the price of a product or service. See BAR-GILL, *supra* note 2, at 23 (“Sophisticated sellers facing imperfectly rational consumers will seek to reduce the perceived total price of their products without reducing the actual total price that consumers pay. When consumers are myopic or optimistic, this wedge between perceived and actual prices can be achieved by back-loading costs onto long-term price dimensions.”).

delivery of contractual terms.<sup>49</sup> Such self-interested actions can diminish the value that might otherwise have been realized by having one party prepare the contract.<sup>50</sup>

#### *D. The Non-Drafting Party's Ability to Monitor and Control*

The differing interests of the parties and the ability of the agent to act in her own interest with respect to preparing the contract may only be problematic if the principal is unable to detect the agent's self-interested behavior. For example, if the non-drafting party is able to read and understand the contract and its legal implications, then the non-drafting party may be able to detect whether the drafting party did in fact prepare the written document in her favor. Nevertheless, in many instances, it may be difficult and expensive to monitor or verify the behavior of the agent (the drafting party).<sup>51</sup>

For example, the contract may be written in legalistic language, making it difficult for the principal to understand what the written contract actually means.<sup>52</sup> In addition, many parties entering into a contract may be unaware of the legal implications of particular language (even if the terms are understandable).<sup>53</sup> In certain instances,

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49. The intentional use of such tactics, particularly where non-drafting consumers are not in a position to counteract them, has been criticized. See Sovern, *supra* note 8, at 1660-61.

50. This diminishment in value is, again, something endemic to the principal-agent problem and again suggests the relevance of such literature to the contract-drafting scenario. See BLACKMON, *supra* note 9, at 7 ("Thus the principal-agent relationship has two sides: There are benefits to be reaped from the comparative advantage of the agent, yet there are also losses to be incurred from unobserved, self-interested actions of the agent.").

51. As discussed in Part II *supra*, monitoring may be difficult because of the information and expertise gap between the parties. In addition, monitoring may be expensive, particularly if expense is measured relative to the value of the transaction to the non-drafting party. See, e.g., Samuel Issacharoff & Erin F. Delaney, *Credit Card Accountability*, 73 U. CHI. L. REV. 157, 166-67 (2006) ("The democratization of markets and the repeat nature of the seller's transactions give rise to the prospect of the incremental extra charge, the marginal defect in goods, the sleight of hand of the bait-and-switch, all of which are not worth the transactional headaches for the consumer to challenge.").

52. This is particularly true when the non-drafting party is not an attorney or likely to be represented by an attorney. See, e.g., Russell Korobkin, *The Borat Problem in Negotiation: Fraud, Assent, and the Behavioral Law and Economics of Standard Form Contracts*, 101 CALIF. L. REV. 51, 78 (2013) ("[S]ince standard form contracts are usually drafted by lawyers, the language is often inaccessible to laypeople."); BAR-GILL, *supra* note 2, at 29 (arguing that learning from expert advice for particular transactions has its limits because, inter alia, "consumers do not seek advice before each and every purchase or use decision" and such advice may not be available in each situation).

53. See Meyerson, *supra* note 1, at 596 ("While information can never be perfect, it is particularly inappropriate to make an assumption of perfect consumer knowledge. Even though consumers may know many of the characteristics of frequently purchased products, they will remain ignorant of the characteristics of contract terms which typical experience does not reveal.").

the non-drafting party may also not have the time (or be inclined to spend the time) to read a lengthy contract to determine and consider the legal implications of each provision.<sup>54</sup>

Similarly, the differing interests of the parties and the agent's discretion may be more problematic if the principal is not situated to be able to counteract or address the agent's behavior.<sup>55</sup> For example, even if one was able and had the time to read the contract and thereby encounter contractual provisions that might be problematic, that individual still may be unable to figure out how to modify the words used in the contract.<sup>56</sup> A non-drafting party may also be unable to control the drafting party's behavior where the contract is offered on a "take-it-or-leave-it" basis or under similar circumstances that make modification of the contract difficult.<sup>57</sup> For example, consumers often interact with corporate employees that do not, or do not appear to, have the authority to modify the consumer contract.<sup>58</sup> It also may be difficult or expensive to "shop" for better contractual terms in such situations.<sup>59</sup>

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54. The difficulty in comprehending the language is compounded when the value of the transaction is low. As suggested by Eisenberg, "[w]here form contracts involve a low dollar value of performance, the cost of thorough search and deliberation on preprinted terms, let alone the cost of legal advice about the meaning and effect of the terms, will usually be prohibitive in relation to the benefits." Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 243 (1995).

55. Accordingly, "[e]ven if the principal can tell what the agent did, he may be unable to tell what the agent should have done to serve the principal's interests." BLACKMON, *supra* note 9, at 7. In terms of contract drafting, the inability of the non-drafting party to understand and counteract one-sided drafts undercuts the meaningfulness of assent to such contracts. Bar-Gill argues that this is because "[t]he freedom of contract paradigm is based on the presumption that contracting parties correctly anticipate their future actions and thus the future consequences of the contract they have signed." Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1415 (2004).

56. Moreover, it may not be cost-effective for the non-drafting party to solicit expert advice. See Meyerson, *supra* note 1, at 598-99 ("A consumer will only purchase the services of an attorney if the expected loss from not understanding the contract exceeds the cost of legal advice. For most consumer purchases other than a house, the cost of legal advice will far exceed the expected value of the gain to be derived.").

57. This is the case for many contracts of adhesion. See Robert Prentice, *Contract-Based Defenses in Securities Fraud Litigation: A Behavioral Analysis*, 2003 U. ILL. L. REV. 337, 361-62 (2003) ("Consumers and investors not only think that adhesion contracts are generally nonnegotiable, they are correct (practically speaking) in so thinking.") (footnote omitted).

58. See Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1225 (1983) ("Customers know well enough that they cannot alter any individual firm's standard document. . . . If they do not [understand the take-it-or-leave-it nature of the agreement], and if they attempt to bargain the form terms, the salesman will explain his lack of authority to vary the form.").

59. In some instances, a different seller offering better terms might be difficult to locate. See Meyerson, *supra* note 1, at 599 ("Whatever benefit might be derived by the consumer who accurately understands a contract term must be further discounted by the high transaction costs of altering the term or finding a seller with a preferred term.").

As discussed in Part II, individuals may not be able to assess risks accurately, which will diminish their inclination, and therefore their ability, to monitor and control the agent's actions.<sup>60</sup> For example, if one does not perceive accurately the risk of the drafting party preparing a one-sided contract, then the non-drafting party may not be in a position to address the principal-agent problem.<sup>61</sup> Similarly, even if the other party perceives accurately the risk that the drafting party will prepare a one-sided contract, the other party may not accurately perceive the risks associated with such a one-sided contract.<sup>62</sup> Put another way, the non-drafting party may believe that it is unlikely that she will be forced to incur any liability arising from a one-sided contract, even if the non-drafting party has actually read the contract and is aware of possible negative outcomes. For example, a credit card holder may comprehend that a credit card agreement is likely to be one-sided in favor of the credit card issuer and may even be aware that contingent fees may be assessed, but the credit card holder also might underestimate the likelihood of such contingencies actually occurring.<sup>63</sup>

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60. See Bar-Gill, *supra* note 55, at 1373 (“The [consumer] contract itself, commonly designed by the seller, will be shaped around consumers’ systematic deviations from perfect rationality.”); Bern, *supra* note 7, at 721-22 (“The combined effect of [bounded rationality and cognitive defects] is to produce a setting in which consumers are very vulnerable to being overreached by sellers and sellers are tempted to act opportunistically.”).

61. For example, on a basic level, the mere fact that consumers do not read or understand certain types of contracts can lead to strategic contract drafting by sellers. See Meyerson, *supra* note 1, at 595 (“[I]nefficient transactions occur because consumers do not read form contracts, or do not understand the terms, and are thus unaware of their contents. Moreover, the businesses that draft these contracts do so knowing that they will not be read by the typical consumer.”) (footnote omitted). Moreover, even when reading contracts, consumers may be inclined to underestimate the risk that the contract is one-sided. See Hillman & Rachlinski, *supra* note 45, at 451 (“[S]everal features of the business-to-consumer standard-form contract suggest that consumers are more apt to worry too little about contractual risks.”); Warkentine, *supra* note 14, at 515 (noting that consumers “may shop for the price of the goods or the color of the car, but they will almost never think about the form contract they are required to sign”).

62. Some non-drafting parties may be overly optimistic about risks of negative contractual outcomes, even though such parties understand the risks as created by the contract. Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1179 (2003) (“[I]f individuals are overconfident about their own ability to perform the terms of the contract, they would tend to underestimate the likelihood that they will be unable to perform. They might then be too willing to enter into clauses that expand their own liability for nonperformance.”) (footnote omitted). This is particularly true with respect to risky terms that do not concern performance and do not have a high degree of risk. See Eisenberg, *supra* note 54, at 241 (noting how “bounded rationality, optimistic disposition, systematic underestimation of risks, and undue weight on the present as compared with the future” are relevant to particular types of contractual provisions).

63. BAR-GILL, *supra* note 2, at 53-54 (noting that consumers underestimate the likelihood that the contingency of a future cost will materialize—for example, an optimistic credit cardholder might underestimate the probability of making a late payment, leading her to underestimate the importance of the late fee).

### *E. Agency Costs and Contract Preparation*

In the contract preparation context, the non-drafting party may take steps to address the principal-agent problem. In other words, in order to ensure that the agent does not use her superior information and control to perform (or fail to perform) the agreed-upon task of preparing the contract as desired, the principal may incur monitoring and other agency costs.

First, the non-drafting party could reduce the information asymmetry by monitoring the preparation of the contract by reading it and negotiating it. Reading, though, can be costly in terms of time.<sup>64</sup> The non-preparer also could reduce the information and control gap by hiring other parties to act on her behalf.<sup>65</sup> In the contract preparation context, one may hire an attorney to make sure that the contract is prepared in accordance with expectations, which often can be costly.<sup>66</sup> As a preliminary matter, a party could engage in transactions only with those parties that have good reputations with respect to their contracts by screening potential applicants or hiring an outside party to screen them.<sup>67</sup>

Outside parties also could act on the principal's behalf without the principal's consent or knowledge.<sup>68</sup> For example, statutes may protect non-drafting parties by prohibiting particular provisions or requiring particular contract presentation or disclosure. Similarly, judges can determine *ex post* whether a drafting party took unfair advantage of

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64. This cost is often compounded where the parties have a relationship or have already discussed particular deal elements. *See* Korobkin, *supra* note 52, at 77 (“[A]t least when the drafting party has already described salient elements of a proposed deal, reading is not a low-cost way to avoid the risk of opportunist exploitation of nondrafting parties.”).

65. *See* Rachlinski, *supra* note 62, at 1168 (“Individuals often learn to restructure problems so as to avoid, or at least reduce, the difficulties that the limitations of human cognition would otherwise impose. . . . Furthermore, individuals can delegate decisionmaking to privately employed experts with better judgment.”).

66. The cost should be measured based on the relative value of the transaction. Korobkin, *supra* note 52, at 78 (“When this is the case [that laypersons cannot understand a standard form contract’s terms], the task of ‘reading’ the standard form contract actually requires paying a lawyer to review it, a process that is costly even if the contract itself is not long.”). In addition, engaging another party (an economic agent) gives rise to a separate principal-agent problem. The non-drafting party will now be forced to assess whether the expert is effectively performing and may be unable to do so, and the expert may be inclined not to perform as effectively as might be desired by the non-drafting party (based on the asymmetry of information and control). *See* Rachlinski, *supra* note 62, at 1219 (“[E]mploying expert decisionmakers is costly. Experts can charge dearly for their time, and as with organizational settings, agency problems emerge.”).

67. *See* Rachlinski, *supra* note 62, at 1216 (“As an alternative to organizational choice, people can delegate their decisions to others. Many professionals offer more than just knowledge—they offer a better decisionmaking perspective.”).

68. *See* Gillette, *supra* note 6, at 689 (suggesting that other parties, such as courts or regulators, could act on behalf of buyers with respect to particular contracts).

the non-drafting party with respect to the preparation of the contract. As with any other monitoring techniques, however, there is an associated cost.<sup>69</sup>

### III. CONTRACT LAW REFORMS: WHAT DOES ECONOMIC AGENCY TELL US?

#### A. *Identifying Problematic Contracts*

Understanding the contract preparation process as being based on an agency relationship enhances our understanding of various contract formation problems. The principal-agent problem initially helps us identify which types of contracts may be problematic. Issues with respect to contract formation arise when the principal (the non-drafting party) does not have sufficient control or information regarding the agent's (the drafting party) actions with respect to the preparation of the contract.

The existing critiques of problematic legal consent to contract, then, can be understood as attacking the issues that stem from the economic agency relationship between the parties concerning the form and content of the written contract. Without the ability to observe and control the agent preparing the contract, the principal that signs the contract may have little ability to control the contents of the contract.

In the standard view of a negotiated or "dickered" contract, each party will read and negotiate the terms of the contract. It may seem a little inaccurate, then, to describe one of the parties as being an "agent" in this situation. After all, each party is "active" with respect to the final appearance of the contract, whether by negotiating the contract or making actual modifications to the initial draft. This activity, though, proves the point of the economic agency analysis outlined in this Article. Each party "needed" to be active or else face the risks associated with the principal-agent problems involved if only one party prepares the contract.

The fact that a contract may have been "dickered" suggests that the principal (the non-drafting party) was in a position to detect and counteract any negative results from the agent's opportunistic behavior such as any unfavorable contractual provisions. If the principal can respond to the agent's completion of the written contract by reviewing the contract, identifying problematic provisions, and negotiating

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69. Gillette discusses the agency costs that arise when courts or regulators attempt to represent customers, which can significantly affect the effectiveness of such agents. *Id.*

alternatives, then the principal will have incurred the necessary agency costs to avoid any unfortunate results arising from the opportunistic behavior of the agent (the drafting party).

A “dickered” contract may also suggest that the principal was in a position to, or did in fact, screen potential agents. If the principal had leverage enough to negotiate contractual provisions, then presumably the principal also could have considered other potential contractual partners or screened the opposing party. If the principal did not believe that she had the leverage to negotiate such terms, then such negotiation may not have taken place.

Such active or sophisticated parties also may have incurred other agency costs to address the principal-agent problem in contract preparation. The principal (the party not preparing the contract) may have hired an attorney or other advisor to assist with the negotiation and revision of the contract.<sup>70</sup> The attorney will provide the principal with information regarding the task performed by the drafting party (as agent). For example, an attorney will be able to explain what various terms within the contract mean as well as advise, if the attorney is experienced, as to whether the contract contains any unusual or off-market terms. This “monitoring” is an additional cost to the principal, but it is incurred based on the principal’s awareness that the agent (the drafting party) otherwise will be able to prepare a one-sided contract.

In addition, an attorney will permit the principal to counteract any acts taken by the drafting party to prepare a one-sided contract. First, the attorney may be able to negotiate better terms on the principal’s behalf. The attorney may also be utilized to revise the initial contract and use her expertise (that the non-drafting party does not possess) to do so. As an agent, of course, the attorney perhaps also faces the same conflict of interest as the opposing contracting party when preparing the contract. The attorney, for example, may desire to utilize a lower level of care when preparing the contract than otherwise might be desired by the principal (if the attorney is being compensated based upon completion of the task as opposed to an hourly basis). In this instance, however, the agent of contract preparation (the attorney) is not involved with as severe a principal-agent problem as the initial agent of contract preparation (the opposing contracting party). The attorney is not only bound by ethical rules concerning attorney conduct, but the attorney also faces malpractice lawsuits if the contract is not prepared in the principal’s best inter-

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70. Presumably, the non-drafting party would need to perceive accurately that a contract might be one-sided and recognize that she is unable to address the associated problems with such a contract. See Rachlinski, *supra* note 62, at 1219 (“Often, even if people employ a suboptimal strategy and cannot adapt, they can recognize their own limitations and hire others to help them make decisions.”).



ests. More directly, the attorney does not directly benefit from a contract that is not prepared in the principal's best interests, while the opposing contracting party does. Thus, the attorney likely will be a better agent (than the drafting party) for the principal with respect to preparing the contract.<sup>71</sup>

The economic analysis of the agency relationship surrounding contract preparation thus can help inform legal analysis of the consent to the written contract. Whether a contract is negotiated can be an important indication of whether the principal-agent problem has manifested itself unchecked. If unchecked, legal consent to the written contract may be more highly questionable. Where sophisticated principals have incurred (or are able to incur) agency costs and have attempted to (or are able to) monitor the preparation of the contract, the agents' opportunistic behavior may be constrained.<sup>72</sup> On the other hand, where these agency costs are not or cannot be incurred regularly, there perhaps is more concern that the agent will be able to utilize her superior information and control to prepare a one-sided contract. Of course, existing contract law scholarship has recognized these issues without resort to economic theory. As will be seen, however,

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71. Rachlinski suggests that attorneys are well situated to help a client overcome certain cognitive biases. He cites how financial planners help alleviate overconfidence problems when clients select their own investments and suggests that "[a]ttorneys also can restructure problems for their clients in ways that avoid common cognitive pitfalls." Rachlinski, *supra* note 62, at 1216. Being "situated somewhat outside of the decision making environment, [attorneys] can see multiple frames and other perspectives more easily than clients." *Id.* at 1216-17.

72. Issacharoff & Delaney argue:

Focusing on ex post mechanisms—such as knowledge gained through repeat play or the availability of agents to counteract imperfect spot judgments—highlights a shortcoming in the behavioral literature. . . . "Over time, individuals will seek out others who have better knowledge than themselves to make critical decisions, at least as long as they have some recourse against fraud and other forms of misappropriation."

Issacharoff & Delaney, *supra* note 51, at 168 (quoting Richard A. Epstein, *Second-Order Rationality*, in BEHAVIORAL PUBLIC FINANCE 355, 365 (Edward J. McCaffery & Joel Slemrod eds., 2006)). This may be true, but some empirical data has suggested that standard form contracts used in the automotive industry "consistently contained one-sided language that favored the drafter and extracted value from counterparties, notwithstanding the relational nature of the contracts and the sophisticated nature of the adhering party." Gillette, *supra* note 41, at 121. Perhaps even the sophisticated contracting party can fall victim to the other party's opportunistic contract preparation. See, e.g., Andrew Trotman, *Man Who Created Own Credit Card Sues Bank for Not Sticking to Terms*, THE TELEGRAPH (Aug. 8, 2013, 4:41 PM), <http://www.telegraph.co.uk/finance/personalfinance/borrowing/creditcards/10231556/Man-who-created-own-credit-card-sues-bank-for-not-sticking-to-terms.html> (describing how a credit card consumer altered the terms of a standard form agreement in his favor, which agreement was then signed by the bank as revised without detection).

economic theory helps illuminate the failure of current contract law doctrine to address problematic contract formation issues and suggests other solutions.

Typically, the “consent” issue in contract law is discussed in terms of whether a party to a contract assented to a contract in a legally sufficient manner, including by making a promise.<sup>73</sup> For example, many have noted the tendency of individuals to assent to standard form contracts without reading, negotiating, or understanding the contract.<sup>74</sup> Although these signatures certainly manifest an objective intent to be bound, scholars have been troubled (albeit to different degrees) by the lack of “meaningful” consent to such contracts.<sup>75</sup>

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73. The Restatement (Second) of Contracts defines a contract as “a promise . . . for the breach of which the law gives a remedy” and a promise as “a manifestation of intention to act or refrain from acting in a specified way, so made as to justify a promisee in understanding that a commitment has been made.” RESTATEMENT (SECOND) OF CONTRACTS §§ 1, 2 (1981). Braucher identified consent as a social construction. See Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697, 704 (1990). As contract delivery techniques have evolved, the debate about the proper construction of consent has followed. Accordingly, Gillette concluded:

Much of the contracts literature from the past three decades has been devoted to the identification of default rules that apply in the face of contractual silence and of decision rules that resolve conflict when one party attempts to bind the other party to terms on which no negotiation occurred.

Gillette, *supra* note 6, at 679.

74. Rakoff, *supra* note 58, at 1179 (noting that “the few empirical studies that have been done have agreed” that consumers are unlikely to read boilerplate or standard terms). This practice extends to electronic contracts as well. See Gillette, *supra* note 41, at 118 (“The high costs related to reading suggest that few consumers will actually read standard contract terms, an assumption confirmed by surveys concerning online contracts.”) (citation omitted). There are various reasons or justifications given for the low reading rate of consumer standard form contracts, including the relative expense of determining the meaning of particular terms, the take-or-leave-it basis of many consumer transactions, and the cognitive biases of consumers. See Eisenberg, *supra* note 54, at 243 (“[A] rational form taker will typically decide to remain ignorant of the preprinted terms.”); Hillman & Rachlinski, *supra* note 45, at 450 (“[C]onsumers also rely on decisionmaking strategies about contractual risks that keep them from reading the boilerplate.”); Meyerson, *supra* note 1, at 597-98 (“Subordinate [contract] terms will not be known because the cost of acquiring the necessary information exceeds the expected gain to the consumer from that information.”); Warkentine, *supra* note 14, at 469-70 (“People who sign standard form contracts rarely read them. . . . The party who has the greater bargaining power usually writes the standard form contract and often presents it for signature on a ‘take it or leave it’ basis.”).

75. See, e.g., KARL N. LLEWELLYN, *THE COMMON LAW TRADITION: DECIDING APPEALS* 370 (1960) (asserting that “specific” consent is not given to boilerplate or subordinate contractual clauses); RADIN, *supra* note 32, at 31 (“[T]o conclude our initial exploration of the normative degradation caused by boilerplate: Recipients cannot be said to have consented to, and thereby become subject to, purported contracts when they don’t know that they exist . . . .”); Jason Scott Johnston, *The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation Between Businesses and Consumers*, 104 MICH. L. REV. 857, 860-61 (2006) (“[J]udges and legal scholars viewed market-driven uniformity in standard-form contract terms with alarm, perceiving that even in reasonably competitive markets, consumers often had no choice of contract terms, so that a consumer’s apparent contractual assent to such terms was really ‘but a subjection more or less voluntary to terms dictated by the stronger party . . . .’” (quoting Friedrich Kessler,

Without reading, negotiating, or understanding these contracts, scholars are troubled that parties are relinquishing, or at least are being understood by judges as relinquishing, significant legal rights.<sup>76</sup>

As with all contracts but even more so with standard form contracts, the drafting party may be able to take actions that further her interests at the expense of the principal's interests. If one knows others do not read, then it is possible to prepare contracts that include terms that would not otherwise be agreed to or accepted.<sup>77</sup> Similarly,

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*Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 632 (1943)); Warkentine, *supra* note 14, at 479 (“Indeed, there appears to be a general consensus among scholars that a court should not treat the mere act of signing a standard form contract as assent to all of the individual terms of the contract.”). *But see* Barnett, *supra* note 7, at 636 (“[W]hen consenting in this manner [by clicking ‘I agree’ to an unread license agreement on a web site] one is running the risk of binding oneself to a promise one may regret later when learning its content. But the law does not, and should not, bar all assumptions of risk.”); Gillette, *supra* note 41, at 119 (explaining that “the absence of explicit assent to standard contracts may be less problematic than neoclassical contract theory implies, because the drafter does not intend to deploy nominally oppressive terms in the absence of circumstances that would warrant their use to constrain opportunistic buyers”). For thoughtful discussions of the varying scholarly approaches to the problem of consent to standard form contracts, see generally Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. MIAMI L. REV. 1263, 1269 (1993); Warkentine, *supra* note 14. This Article also addresses the failure of particular reforms designed to address standard form contracts based on understandings from economic agency *infra* Part III.B.

76. An initial argument against such contracts is that they are used to exploit the weaknesses of non-drafting parties to force them into undesired or unfavorable transactions. *See* Issacharoff & Delaney, *supra* note 51, at 166 (“[T]he democratization of markets and their transformation into mass markets strains this simple contractarian story [that market pressures will induce agents to act more in accordance with the interests of principals]. Increasingly, the relations between large sellers and multiple small buyers becomes a world of contracts of adhesion, with terms and conditions set by the seller with no realistic prospect of negotiation.”); Meyerson, *supra* note 1, at 594 (“One complaint frequently raised about standard form contracts, however, is that, because these contracts are not subject to negotiation, consumers generally will be worse off because of their use.”). The linchpin of this argument is the empirical reality that standard form contracts are not read, which permits drafting parties to compete to exploit the non-drafting parties. *See* Hillman & Rachlinski, *supra* note 45, at 454 (“This failure [by consumers to read standard terms] undermines market pressure to provide mutually beneficial terms. Despite their institutional limitations, courts therefore have reason to police the terms of standard-form contracts to protect consumers from exploitation.”). Such exploitation can include the modification or removal of default legal rights to which the non-drafting party is otherwise entitled, which suggests that the non-drafting party may need additional protection. *See* KIM, *supra* note 6, at 51 (noting how new forms of standard form contracts, such as clickwrap and browserwrap, permitted companies to “extract from consumers additional benefits that were unrelated to the transaction”); Shmuel I. Becher & Esther Unger-Aviram, *The Law of Standard Form Contracts: Misguided Intuitions and Suggestions for Reconstruction*, 8 DEPAUL BUS. & COM. L.J. 199, 201-02 (2010) (“The terms included in SFCs [standard form contracts] may at times seek to alter the legal rights that are usually granted to the consumer. Accordingly, academics call on courts and legislatures to intervene and provide consumers with adequate protection and relief.”) (footnote omitted).

77. Since standard form contracts are not read, it should be easy for drafting parties to prepare more one-sided contracts. *See* Gillette, *supra* note 41, at 118 (noting that, “[a]lthough [the] failure to read may be rational, sellers could exploit buyer inattention to insert terms without risk that buyers will object”). Given the repeat nature of many trans-

if drafting parties could exploit the known decision-making tendencies or other cognitive limitations of non-drafting parties,<sup>78</sup> drafting parties would “naturally” be inclined to do so.<sup>79</sup> For example, drafting parties often include the unilateral power to modify their consumer contracts.<sup>80</sup> In such instances, the drafting parties (as parties to the contract) are likely to modify the contract in such a manner to serve only the preparers’ interests, and the non-drafting party may have assented to the contract without reading the term or appreciating its significance.<sup>81</sup>

More problematically, not only may these contracts be heavily slanted in favor of the drafting party, but the drafting party may also

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actions for certain drafting parties, such drafting parties are also uniquely situated to be able to identify how and where one-sided terms would be most effective. *See* Hillman & Rachlinski, *supra* note 45, at 440 (“The ability of businesses to identify efficient allocation of risks also gives them the opportunity to exploit consumers by getting them to accept contract terms that inefficiently shift risks to consumers.”). As an empirical matter, it is understood that standard form contracts generally favor the drafting party. *See* Prentice, *supra* note 57, at 385 (“Provisions that make up the boilerplate of the form contracts will be almost universally pro-seller and anticonsumer/investor and, of course, seldom advertised.”); Warkentine, *supra* note 14, at 516 (“[I]t is common for terms in standard form contracts to favor the drafter.”).

78. *See* BAR-GILL, *supra* note 2, at 10 (“Sellers benefit from the divergence between perceived and actual benefits and between perceived and actual prices. They will design their contracts and prices to maximize this divergence.”).

79. In part, this is based on the relative interests and situations of the parties. *See* Eisenberg, *supra* note 54, at 243 (concluding that the “asymmetrical incentives [based on the repeat nature of many transactions for the preparers of form contracts] almost always work to heavily slant form contracts in favor of form givers”). In other words, the relative inequalities in knowledge provide an opportunity for one party to extract benefits from the other. *See* Hillman & Rachlinski, *supra* note 45, at 440 (“[B]usinesses have incentives and opportunities both to allocate the risks of the contract efficiently and to impose hidden risks on consumers where possible.”); Meyerson, *supra* note 1, at 605 (“Because consumers lack the knowledge to evaluate the cost of [a] risk, a rational seller will draft contract terms that shift risks to the consumer.”). The motivation to do so generally is understood to be a factor in the drafting party’s attorneys’ behavior as well. *See* Prentice, *supra* note 57, at 386 (“Farnsworth . . . has noted that in his own experience in legal practice, ‘no one in any of the corporations or in the law firm ever suggested that the forms should be drafted other than as one-sidedly in the interests of the corporate client as possible.’” (quoting E. Allan Farnsworth, *On Trying to Keep One’s Promises: The Duty of Best Efforts in Contract Law*, 46 U. PITT. L. REV. 1, 44 (1984))). Beyond the underlying incentives to exploit such situations, Bar-Gill also suggests that drafting parties must exploit non-drafting parties’ weaknesses or lose ground to competitors (who will). *See* Bar-Gill, *supra* note 55, at 1373 (“Such biased contracting is not the consequence of imperfect competition. On the contrary, competitive forces compel sellers to take advantage of consumers’ weaknesses.”).

80. Oren Bar-Gill & Kevin Davis, *Empty Promises*, 84 S. CAL. L. REV. 1, 5 (2010) (noting the increased public scrutiny for sellers’ ability to modify contracts unilaterally).

81. Bar-Gill and Davis note that “there is no guarantee that the modifications will be mutually beneficial; sellers are likely to propose unilateral modifications that serve their own interests, but not necessarily those of consumers.” *Id.* at 6. This is based on drafting parties’ knowledge of how non-drafting parties interact with such contracts. *See* Meyerson, *supra* note 75, at 1290-91 (“Since the drafters are aware that consumers do not read their contracts, the drafters know that the contract will not inform consumers of their legal rights.”).

be able to prepare the contract in a manner designed to induce quick assent.<sup>82</sup> In particular, contracts could be designed to exploit the various decision-making biases of the general consumer.<sup>83</sup> By using lengthy contracts, for example, a drafting party may be able to overwhelm the non-drafting party's ability to detect unfavorable contractual terms.<sup>84</sup> The appearance of contracts combined with particular cognitive biases of the non-drafting parties may strongly deter the non-drafting party from resisting the contract's terms.<sup>85</sup> Indeed, con-

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82. Drafting parties can deter non-drafting parties from even attempting to read or negotiate a contract by increasing the costs of doing so through particular contract design. See Hillman & Rachlinski, *supra* note 45, at 479 ("Just as businesses utilize fine print and hidden terms in the paper world to increase the costs of finding and reading terms, certain methods of presentation of the terms and conditions can also discourage e-consumers from reading the boilerplate."). Time and other constraints can also be utilized to discourage reading or negotiating contracts. See Shmuel I. Becher & Tal Z. Zarsky, *E-Contract Doctrine 2.0: Standard Form Contracting in the Age of Online User Participation*, 14 MICH. TELECOMM. & TECH. L. REV. 303, 313 (2008) (noting that "in many instances consumers enter SFCs [standard form contracts] under unfavorable circumstances . . . frequently characterized by noise, time constraints and vendors' attempts to manipulate consumers"). Consequently, non-drafting parties may be effectively deterred. David Horton, *Flipping the Script: Contra Proferentem and Standard Form Contracts*, 80 U. COLO. L. REV. 431, 435 (2009) ("[B]ecause standard-form contracts are non-negotiable and consist of a maze of inscrutable fine print, a reasonable consumer would probably not spend time trying to decipher their terms.").

83. For example, contract decisions may not be made based on all of the relevant facts or factors. See Korobkin, *supra* note 52, at 80 ("Cognitive limitations on human beings' abilities to process information often cause individuals making contracting decisions to narrow their focus to a relatively small number of 'salient' decision attributes and ignore the [rest] . . .").

84. If there is too much material within the contract, the non-drafting party may choose to ignore most of the terms. See Sovern, *supra* note 8, at 1678-79 ("Too much information appears to cause many consumers to adopt strategies to reduce the amount of information to a more manageable amount when making decisions. Consequently, many consumers undoubtedly 'manage away' the small print.") (footnote omitted). Similarly, drafting parties can manipulate and format the contract language to make it more difficult to locate or understand important terms. See Hillman & Rachlinski, *supra* note 45, at 446 ("Businesses also can create boilerplate that is difficult to read by using small print, a light font, and all-capital lettering and by burying important terms in the middle of the form."); Meyerson, *supra* note 1, at 598 ("The cost to the consumer is made all the more excessive by the high cost of understanding a term's legal significance. Again, some sellers try to increase this cost by hiding the term's meaning in obscure 'legalese.'") (footnote omitted).

85. Once given to the non-drafting party, the written contract may come to represent the status quo that is unlikely to be challenged. Prentice, *supra* note 57, at 372 ("When form givers hand form contracts to form takers, the form takers are likely to view the contracts as embodying the status quo and will for this reason, among others, be reluctant to attempt to alter them."). Along the same lines, "densely typed provisions" can induce deference "to the contract's printed authority." Shell, *supra* note 43, at 1369. Given the persistence of the status quo bias in contract negotiations, Korobkin hypothesizes that "contracting parties can gain a powerful advantage in negotiations by providing a set of draft terms as the basis for detailed negotiations with their contracting partners." Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583, 1627 (1998).

trol of the initial document likely is in and of itself a significant advantage to the drafting party.<sup>86</sup>

More fundamentally, arguments about meaningful consent to such contractual terms may in fact arise from the principal-agent problem that exists with respect to the task of preparing the contract. When the misalignment of interests, information, and control between the agent (the drafting party) and the principal (the non-drafting party) makes legal observers uncomfortable, it may signal a level of discomfort with assigning reflexive legal validity based upon objective consent to the contract.<sup>87</sup> To be clear, though, this misalignment exists to some extent each time a contract is prepared. Scholars, however, typically only suggest reforms in those instances where the principal cannot monitor or remediate the agent's opportunistic behavior (drafting a one-sided contract). If the other party to a contract cannot meaningfully monitor the agent's activities, then perhaps the principal's empowerment (or ratification) of the drafting party's preparation of the contract (by executing the contract) should be given less legal significance or at least invite more judicial or legislative scrutiny.

The behavioral economics critique of consumer contracts also can be understood in this manner. Traditional economic theory would describe the monitoring issues that arise in the consumer context as a problem of an information asymmetry.<sup>88</sup> If the buyer does not have enough information because of the method of disclosure or similar issues, then the seller will be able to exploit this asymmetry to her advantage. Behavioral economics, on the other hand, focuses on sys-

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86. See Korobkin, *supra* note 85 (“The inertia theory suggests that . . . it might be possible for a party to convince an opposing negotiator that her uniquely preferred set of contract terms will be enacted through ‘inaction’ rather than action, even if those terms are uncommon in the industry in question and contrary to legal defaults.”). Of course, control of the document may be a function of bargaining power as opposed to a negotiated outcome. See Danielle Kie Hart, *Contract Law Now—Reality Meets Legal Fictions*, 41 U. BALT. L. REV. 1, 20 (2011) (“Because contracts are made binding . . . the party that gets to dictate or impose terms during contract formation will usually get to keep and use those terms in the event of any subsequent contract dispute. Clearly, the party that has the ability to impose terms during contract formation is the party with the bargaining power to do so.”) (footnote omitted).

87. If, for example, we do not believe that consumers can act in their own best interests when facing such contracts, then perhaps others should act in their stead. See, e.g., Rachlinski, *supra* note 62, at 1182 (“These cognitive problems that people arguably encounter when they think about how and whether to enter into contracts undermine the basis for freedom of contract. . . . Regulatory or judicial intervention in contracts could thus save people from themselves.”).

88. See, e.g., Hülsmann, *supra* note 19, at 36 (noting that conventional theory “explains moral hazard as a consequence of the fact that market participants are unequally well informed about economic reality”). Certain judicial doctrines, such as unconscionability, arguably arose based on such a classical understanding of the agency problem. See Meyerson, *supra* note 1, at 613 (“The classic case of *Williams v. Walker-Thomas Furniture Co.* can be understood as judicial condemnation of the disparity of information between buyer and seller.”) (footnote omitted).

tematic limitations on the ability of the buyer to detect or prevent opportunistic behavior (as opposed to the information asymmetry itself).<sup>89</sup> If buyers are unable, because of cognitive limitations, to act (completely) rationally, then sellers will be able to exploit these limitations in their contracts.<sup>90</sup>

### B. *The Failure of Traditional Reforms*

The economic analysis outlined above allows us to better understand and critique contract law reforms as they address the fundamental agency issue of contract preparation. Existing contractual reforms are, explicitly or implicitly, based on improving the ability of the principal to monitor the agent, or empowering others to monitor the agent, to determine whether the agent has performed properly or legally. These reforms focus on the principal's ability to control and not the agent's underlying incentives to perform at a lower level and to conceal deficiencies. Each of these reforms in some sense is an agency cost that a party incurs, regardless of whether the cost is incurred voluntarily.

As an example, reforms often attempt to address the consent problem in standard form contracts, discussed in Part III.A., by attempting to provide the principals (the non-drafting parties) with additional information. These reforms presumably would permit the principals to monitor more effectively the contract's preparation.<sup>91</sup> For example, many statutes now require particular contracts to contain particular sets of disclosures and particular styles or formats of disclosures.<sup>92</sup> Under the reforms introduced by the Credit Card Ac-

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89. As Bar-Gill explains, “[t]he behavioral-economics theory of contract design is an imperfect-rationality theory, not an imperfect-information theory.” BAR-GILL, *supra* note 2, at 21; *see also* Petersen, *supra* note 2, at 289 (suggesting that the “agency framework [in the mathematical literature] would be strengthened by taking the notion of bounded rationality seriously”).

90. *See, e.g.*, BAR-GILL, *supra* note 2, at 7-8 (“The behavioral-economics theory rests on two tenets: (1) Consumers’ purchasing and use decisions are affected by systematic misperceptions (2) Sellers design their products, contracts, and prices in response to these misperceptions.”); Issacharoff & Delaney, *supra* note 51, at 162 (“Behavioral literature suggests that companies should be expected to design contractual offers in anticipation of the predictable decisional heuristics of consumers, such as overconfidence.”).

91. Once informed, the non-drafting party supposedly will be in a better position to determine whether the drafting party drafted a one-sided contract and act accordingly. *See* Ian Ayres & Alan Schwartz, *The No-Reading Problem in Consumer Contract Law*, 66 STAN. L. REV. 545, 549-50 (2014) (“Legislatures and regulators commonly respond to the no-reading problem by requiring ever-widening sets of disclosures and initialing procedures that are meant to induce consumers to become informed about particular terms before becoming bound.”).

92. These procedural “protections are intended to improve the process by which the terms become part of the contract by attempting to increase the chance that the consumer has in fact read and consented to the provisions.” Erin Ann O’Hara, *Choice of Law for In-*

accountability Responsibility and Disclosure Act, credit card issuers must disclose certain terms “clearly and conspicuously.”<sup>93</sup> Similarly, under the Uniform Commercial Code, certain waivers of contractual rights or warranties must also be disclosed in a particular manner.<sup>94</sup>

Each of these reforms seems designed, at least in part, to address the inability of the party that did not prepare the contract to detect such important contractual provisions.<sup>95</sup> In economic agency terms, this means that the reforms are designed to empower the principal to monitor the drafting party’s actions rather than empowering another to act on the principal’s behalf.<sup>96</sup> If the party is unable to do so on her own, then the reform may require the agent (the drafting party) to assist the party through disclosure to detect the drafting party’s inclination to draft one-sided (important) provisions.

The ability of these reforms to assist such principals is highly questionable, however.<sup>97</sup> From an economic agency perspective, it appears that certain principals are unwilling or unable to utilize or comprehend such additional information to avoid one-sided contracts.<sup>98</sup> Passive disclosure, regardless of the improved substance, format, or font, with respect to the information contained in lengthy

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*ternet Transactions: The Uneasy Case for Online Consumer Protection*, 153 U. PA. L. REV. 1883, 1920 (2005).

93. Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, § 103, 123 Stat. 1734, 1741 (codified as amended at 15 U.S.C. 1637).

94. See, e.g., U.C.C. § 2-316(2) (2012) (requiring any exclusion or modification to the implied warranty of merchantability to be “by a writing and conspicuous”).

95. Legislation can provide some protection (to be enforced by courts) “by enhancing the likelihood that the consumer is at least aware of a provision before signing the standard form.” O’Hara, *supra* note 92, at 1921.

96. Hart explains “disclosure statutes protect the parties’ freedom of contract—the classical autonomy value—by continuing to allow the parties to contract for essentially whatever they want.” Hart, *supra* note 86, at 26 (footnote omitted).

97. Bar-Gill and Davis “are skeptical, however, about the efficacy of disclosure mandates” (with respect to unilateral modifications of contracts). “We are not confident that consumers would be able to use this information to avoid sellers who either propose welfare-reducing initial contracts or who are likely to propose welfare-reducing modifications.” Bar-Gill & Davis, *supra* note 80, at 28-29. Ayres and Schwartz have suggested that the premise that mandating more conspicuous disclosure will assist or encourage non-drafting parties to read “founders on the avalanche of real-world evidence that virtually no one wants to read contract terms regardless of how accessibly rendered those terms are.” Ayres & Schwartz, *supra* note 91, at 550. On the other hand, Bar-Gill has recognized, at least with respect to certain consumer transactions, that “disclosure has been effective to at least some extent.” BAR-GILL, *supra* note 2, at 33.

98. As Hart notes:

To be a rational actor therefore presupposes that one will not only have access to the information relevant to one’s decision but will also be able to understand it and make effective use of it. Unfortunately, none of this is true in general and not when it comes, more particularly, to contracts.

Hart, *supra* note 86, at 48 (footnote omitted).



standard form contracts may not improve the ability of non-drafting parties (principals) to comprehend and change one-sided contracts.<sup>99</sup>

The use of legislative requirements with respect to the disclosure and format of disclosure of material contractual terms is also generally problematic. Such requirements represent the legislature's understanding of what information is salient and understandable by the non-drafting party. That the legislature does a good job of determining how and what disclosures to mandate is arguable at best.<sup>100</sup> Such mandates also require adjudicators to determine whether a particular disclosure standard, such as "clear and conspicuous," has been met. Adjudicators may not be well-positioned to determine what a clear and conspicuous disclosure is, particularly if the standard is understood as requiring disclosure that would actually be read by many or most non-drafting parties. As with other determinations, there is no empirical evidence that adjudicators perform well in this area. For example, courts have often relied on the existence of a non-disclosing party's act in response to disclosure to determine that disclosure was properly made. If a consumer "clicked" her assent to an online license agreement, that is typically understood as signifying proper disclosure and assent, even if the click box has little or no more significance to the consumer than would purely passive disclosure of the license agreement.<sup>101</sup>

Another set of reforms appear to be directed at enabling others to act on behalf of the principal (the party that did not prepare the contract) to control or deter the agent (the drafting party) from preparing a one-sided contract. First, the evolution of the unconscionability doctrine may be seen as a judicial and legislative response to the inability of certain contracting parties to detect *ex ante* that the drafting party prepared an unfair contract. The unconscionability doctrine is a defense in civil litigation that may limit the enforceability of a con-

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99. This may be due in part to the sheer volume of information disclosed in a contractual transaction. See Bar-Gill & Davis, *supra* note 80, at 29. Bar-Gill argues accordingly that "[h]eaps of paper blindly signed at the closing of a mortgage and the impenetrable fine print of a credit card contract are extreme examples of disclosure regulation gone wrong." BAR-GILL, *supra* note 2, at 36. As discussed in Part III *supra*, very few individuals read standard form contracts. See Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 671 (2011).

100. Some have suggested that mandated disclosure is applied too much and without a proper focus. See Ben-Shahar & Schneider, *supra* note 99, at 684.

101. See, e.g., RADIN, *supra* note 32, at 25 ("Because information asymmetry is so prevalent in the context of deploying and receiving boilerplate, it would be problematic to assimilate the kind of nonunderstanding behavior that occurs in the context of clicking 'I agree' to the ordinary conception of consent."); Eric A. Zacks, *Contracting Blame*, 15 U. PA. J. BUS. L. 169, 192 n.70 ("Notwithstanding the above decisions' emphases on such actions [such as clicking], [l]awyers, law students, and even law professors are quick to acknowledge that they themselves rarely read the forms they sign or the agreements they click through on the Internet.") (second alteration in original) (quoting Warkentine, *supra* note 14, at 515) (internal quotation marks omitted).

tract or particular contractual terms.<sup>102</sup> Even if a contract appears to have been formed based upon the manifestation of objective consent to the contractual promise (and the presence of consideration), the circumstances surrounding the contract's formation as well as the substantive unfairness of the transaction may negate the consent's legal effect.<sup>103</sup> A legal finding of unconscionability generally requires the presence of two separate factors, substantive unconscionability and procedural unconscionability.<sup>104</sup> Substantive unconscionability is based on the unfairness of the contract or a particular provision itself (such as onerous terms); procedural unconscionability is based upon the factors affecting the process by which consent was obtained, such as unequal bargaining power, whether the contract was offered on a "take-it-or-leave-it" basis, the use of "pressure" techniques to compel signature, and certain personal characteristics of the parties such as age and sophistication.<sup>105</sup>

These circumstances can also be understood as those that justify permitting the principal (the non-drafting party) to avoid liability under a contract when the agent (the drafting party) has acted wrongfully by preparing a one-sided contract and the principal is unable to detect or prevent the agent from doing so.<sup>106</sup> The factors underpinning a finding of procedural unconscionability generally are relevant to the ability of the principal to detect and control the agent's malfeasance in the performance of a task.<sup>107</sup> If, for example,

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102. See RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981); U.C.C. § 2-302 (2010).

103. RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. a (1981) ("Relevant factors [in finding unconscionability] include weaknesses in the contracting process like those involved in more specific rules as to contractual capacity, fraud, and other invalidating causes[.]").

104. Melissa T. Lonegrass, *Finding Room for Fairness in Formalism—The Sliding Scale Approach to Unconscionability*, 44 LOY. U. CHI. L.J. 1, 8 (2012) ("With the assistance of contracts scholar Professor Arthur Leff, courts employing section 2-302 quickly developed a two-part analytical structure for the doctrine, which involves analysis of both 'procedural' and 'substantive' unconscionability."). In some cases, however, all that is needed for a finding of unconscionability is one of the two "types." *Id.* at 19 (finding that a "growing minority of courts have applied a 'single-prong' approach to the doctrine, under which extreme evidence of one type of unconscionability alone is used to justify an overall finding of unconscionability, without inquiry into the second prong").

105. This analysis is obviously applicable to standard form contracts, where contracts are often not read or difficult to read. See David Gilo & Ariel Porat, *The Hidden Roles of Boilerplate and Standard-Form Contracts: Strategic Imposition of Transaction Costs, Segmentation of Consumers, and Anticompetitive Effects*, 104 MICH. L. REV. 983, 984 (2006) (noting that "courts are suspicious of [consumer standard form contracts] and sometimes find them unenforceable under the doctrine of unconscionability"); Hillman & Rachlinski, *supra* note 45, at 457 ("When a form contract contains incomprehensible boilerplate, fine print, or otherwise hidden terms that undermine the user's purpose of contracting or otherwise 'shock the conscience,' courts unhesitatingly apply unconscionability.").

106. Indeed, Warkentine specifically notes that the lack of consumer sophistication or access to counsel is important to a finding of unconscionability with respect to standard form contracts. Warkentine, *supra* note 14, at 483.

107. This can be justified both in terms of information and control asymmetries. Gillette explains that "[l]egal defenses to enforcement of contract terms, such as unconsciona-

the parties have relatively unequal bargaining power, then the drafting party (the agent and presumably the party with superior bargaining power) will be able to prepare a one-sided contract without the ability of the other party (the principal) from detecting or counteracting such preparation. Similarly, if the contract is offered to the principal (the party that did not prepare the contract) on a “take-it-or-leave-it” basis, then the principal will be unable to change or modify any one-sided contractual provisions, even if detected by the principal.<sup>108</sup>

Unconscionability has been largely unsuccessful in policing consent concerns because of factors that can be understood from an agency perspective.<sup>109</sup> To the extent that a standard is not set forth in a statute and is developed through common law (such as with unconscionability), the application of the standard necessarily represents a sort of ad hoc decision-making by the judge as to whether the agent did a good job. There is no empirical evidence, for example, that judges make “good” unconscionability decisions or the existence of a standard against which unconscionability decisions could be measured. From an economic agency perspective, this suggests that the “agency costs” associated with the use of courts or legislative action are high relative to the effectiveness or benefit of engaging such additional monitors of drafting party’s actions.

Because unconscionability requires courts to make a subjective determination in each instance where the defense is raised, such determinations “have little value as precedents.”<sup>110</sup> The “fact sensitive” nature of each decision means that neither agents (drafting parties) nor principals (non-drafting parties) can anticipate in advance whether a particular contract or contract term will be enforceable.<sup>111</sup> The drafting party, when drafting, has to assess the likelihood of particular contractual features being detected or attacked as unconscionable (which may be doubtful) as well as a particular judge de-

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bility, are consistent with this argument, insofar as application of the defenses typically depend on the drafters’ possession of information that adherents to the contracts lack.” Gillette, *supra* note 41, at 117. Bar-Gill, on the other hand, implies that control of contract design by the drafting party may be the more relevant factor. Bar-Gill, *supra* note 55, at 1423 n.211.

108. Consumers engaged in occasional purchases often have difficulty evaluating “self-serving contract terms” prepared by repeat sellers. See Gillette, *supra* note 6, at 680.

109. Scholars have noted the difficulty in demonstrating the factors that comprise unconscionability. See Lonegrass, *supra* note 104, at 45 (“Because strong evidence of procedural deficiency has historically been required to justify judicial intervention, courts employing a conventional approach are unlikely to find the procedural prong satisfied in the absence of multiple factors traditionally associated with lack of choice . . . .”); Warkentine, *supra* note 14, at 472 (“[A]n unconscionability approach requires the challenging party to meet the extremely high burden of showing a serious defect in the bargaining process . . . . Most plaintiffs will have a hard time making the necessary showing.”).

110. Warkentine, *supra* note 14, at 484.

111. *Id.*

termining that such term is in fact unconscionable. Given that many of these adjudicative determinations, whether in arbitration or otherwise, may be made on a one-off basis, there is little to deter drafting parties from being as aggressive as possible with respect to drafting standard form contracts. To the extent that a particular contract with a consumer is successfully attacked, that does not mean that the drafting party will not enjoy the benefits of the contract made with all other similarly situated consumers (who do not contest the contract).

### C. Reforms Suggested by Economic Theory

Economic theory indicates that there is another way in which the principal-agent problem can be addressed in the contract preparation context. This method would involve realigning the incentives and interests of the agent with those of the principal.<sup>112</sup> As discussed above, it is the differing interests of the parties that result in the incentives for the agent to perform in a way that is most favorable to the agent and to conceal from the principal the deficiencies in such performance. To date, however, most contractual reforms are explicitly or implicitly based on improving the ability of the principal to monitor or empowering others to monitor agents to determine whether agents have performed properly or legally. These reforms focus on the principal's ability to control and not the agent's underlying incentives to perform at a lower level and to conceal deficiencies. By focusing on the agent's incentives, contract law reforms would better be able to address the relationship structure that inherently provides the agent with more control.

An example of altering the focus from the principal's information level to that of the agent's incentives can be seen in the employment context. In this instance, a business owner (the principal) may have delegated certain duties or tasks to her employees (the agents). To prevent the employees from shirking or taking private benefits, the owner may attempt to monitor the employees or employ others, such as managers, to monitor. The effort to alleviate the information asymmetry is expended by the principal (or others on behalf of the principal), and the agent's underlying incentives and interests are not fundamentally addressed, except to the extent that the agent is concerned about detection. In contrast, by setting up profit-sharing arrangements such that the agent is entitled to additional compensa-

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112. These would include the incentive to perform better as well as to share information. See Jensen & Meckling, *supra* note 26, at 308 ("The *principal* can limit divergences from his interest by establishing appropriate incentives for the agent . . . [that are] designed to limit the aberrant activities of the agent."); Milena Popović et al., *The Agency Dilemma: Information Asymmetry in the "Principal-Agent" Problem*, 62 J. THEORY & PRAC. MGMT. 13, 13-14 (2012) (describing economic literature regarding creating incentives to share privately-held information and initiating information-gathering strategies).

tion if the business performs well, the principal directly addresses the agent's incentives and interests and diminishes one of the fuels for the principal-agent problem.<sup>113</sup> The agent will now be incentivized to perform at the level desired by the principal to help the business perform well so that the agent is entitled to additional compensation. Since the underlying interests of the agent do not conflict with those of the principal, the principal presumably does not need to monitor the agent as much because the information asymmetry (that still exists) between the two parties has been mooted.

The issue now is how to apply these sorts of incentive structures to the contract preparation context. It is difficult to imagine a compensatory scheme whereby non-drafting parties would pay drafting parties based on whether the overall contract appeared as the non-drafting party would desire. As described elsewhere, part of the issue in the contract preparation context is that the non-drafting party often is not in a position to determine whether the drafting party has prepared a desirable contract.<sup>114</sup> Unlike the business situation, the agent's performance cannot be linked directly to the principal's success because the principal's success (possessing a desirable contract from the drafting party's perspective) is inevitably in conflict with the agent's success (possessing a desirable contract from the non-drafting party's perspective).

Nevertheless, there are related incentives of the agent that can be addressed. In the employment context, the employee may have an incentive not only to shirk but also the incentive to conceal the deficiencies in the performance. A profit-sharing approach addresses the former, which correspondingly eliminates the concern about the latter. In the contract preparation context, however, it is difficult to address the incentive for poor performance.

Instead, the focus in the contract preparation context should be on altering the drafting party's incentives to conceal the deficient performance, even if that means not attempting to realign the drafting party's incentives to do so. There may be mechanisms that act as an information-sharing device by placing the burden of disclosing poor performance on the agent instead of placing the burden on the principal to detect poor performance. Accordingly, this Article is searching for devices that alter the drafting party's incentives to hide poor

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113. By conditioning the agent's compensation based on an observable outcome, the principal can influence the agent's performance. See SALANIÉ, *supra* note 19, at 107. This assumes, however, that the agent is willing to assume the risk associated with not achieving the desired outcome. See Eisenhardt, *supra* note 9, at 61. Moreover, it may be difficult to "envision, create, and enforce specific agent outcomes." Gregory Dawson et al., *Information Asymmetry in Information Systems Consulting: Toward a Theory of Relationship Constraints*, 27 J. MGMT. INFO. SYS. 143, 151 (2011).

114. See *infra* Part II.D.

performance and thereby permit the non-drafting party to determine when and how the drafting party has made effective disclosure.

It may be argued that existing reforms such as mandated disclosure or unconscionability are in some respects an attempt to realign the incentives of the non-drafting party to conceal deficient performance.<sup>115</sup> If the drafting party (the agent) wants to receive the benefits of a particular provision or contract, then the drafting party needs to ensure that the contract complies with the regulation or that the other party to the contract is aware of and able to negotiate the provision. The agent, in other words, is incentivized to share the information regarding the one-sided nature of the contract with the principal. If the other party to the contract accepts the one-sided nature of the contract after an opportunity to negotiate or reject the contract, then the drafting party will be able to enjoy the benefits of the one-sided contract without fear of a court rejecting the contract (because of a defense like unconscionability or unfair surprise). Thus, courts and legislatures may attempt to address the principal-agent problem in contract drafting by aligning the interests of the parties.

These approaches, however, do not actually alter the incentives of the agent to conceal a deficient performance.<sup>116</sup> The burden is on the principal to argue that the performance was deficient and should not be respected from a legal standpoint. Next, the agent is only incentivized to prepare a contract sufficient to convince a judge after the fact that the contract was prepared adequately, if the agent anticipates the court actually determining that adequate disclosure was not made.<sup>117</sup> As discussed above, there are significant reasons to doubt the ability of adjudicators and legislatures in determining when effective disclosure has been made when such assessments are made on an ad hoc basis, and neither adjudicators nor legislatures have an economic incentive to ensure effective disclosure. Accordingly, the drafting party may only be concerned with appearances for the adjudicator's sake, not the non-drafting party's.<sup>118</sup>

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115. Ayres and Schwartz come very close to using agency language in describing this situation: "Consumer protection law responds to the [assumption of risk] doctrine by attempting to induce firms to create a real opportunity for consumers to read." Ayres & Schwartz, *supra* note 91, at 549.

116. Ben-Shahar and Schneider document ways in which mandated disclosure may be resisted or undermined by drafting parties. As they note, "an enterprise that unscrupulously withholds information before a mandate might well continue to do so afterward." Ben-Shahar & Schneider, *supra* note 99, at 698. Similarly, disclosing parties can technically comply with the mandate but undermine the purpose of meaningful disclosure. *Id.* at 701.

117. I have argued elsewhere that adjudicators' impressions regarding the contract process and context can be exploited through strategic contract design. Zacks, *supra* note 101, at 180.

118. This assumes that contract drafters are even worried at all about what adjudicators might do in response to a failure to comply with mandated disclosure requirements. See Ben-Shahar & Schneider, *supra* note 99, at 701 ("Do evaders risk trouble? If, like

A different reform to address the agent's incentive to conceal deficient performance is shifting the burden of proof of performance onto the agent. In this instance, the proof of performance would be demonstrating that the contracts were not drafted in such a way as to conceal the terms in question, or put affirmatively, that the contracts were drafted sufficiently so as to be understood by the contract recipient or the general pool of contract recipients.<sup>119</sup>

Under such an approach, drafting parties will need to ensure that their contractual provisions are sufficiently understandable or else face the risk that they would not be enforced.<sup>120</sup> An important benefit of this approach is that by reducing the incentive of the agent to conceal a deficient performance, the principal will now be in a better position to detect a deficient performance. Instead of the legislature having to determine what constitutes adequate disclosure or a court or non-drafting party having to assess whether the drafting party acted appropriately with respect to disclosure, the drafting party will essentially perform that task for them.<sup>121</sup>

By reducing the incentive to conceal one-sided provisions, the drafting party would be expected to make better disclosure. The drafting party will be motivated to make effective disclosure, particu-

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Holmes's bad man, they ask what 'courts are likely to do in fact,' they generally answer 'not much.' "). If they are, then perhaps the contract can be drafted to "provide attributional 'clues' that inform and reassure judicial interpreters that a particular contracting party is more blameworthy than another." Zacks, *supra* note 101, at 171.

119. This could be applied to different types of standard form contracts. For example:

[T]he terms of a credit card agreement would be deemed to be unenforceable unless the Issuer could establish that the Holder was (or should have been) aware and understood the significance of the applicable terms at the time the credit card agreement was executed. . . . Issuers also would be permitted to establish that the interest rate was disclosed such that Holder understood it, or to lessen the impact of a subjective standard, that a credit card holder in Holder's situation would reasonably be expected to understand it.

Zacks, *supra* note 3, at 1506. Others have argued for a purely subjective approach, meaning that the drafting party herself (as opposed to members of a cohort) would have to demonstrate that the non-drafting party actually understood the term. *See, e.g.*, Warkentine, *supra* note 14, at 473 (describing her proposal for a "knowing assent" requirement, including that "the importance of [the] term be explained so that the adhering party understands its significance").

120. Again in the credit card contract context, I have argued that "altering the presumption of enforceability of credit card agreement with respect to pricing and cost terms incentivizes [credit card] Issuers to make better and more complete disclosure of the material terms of credit card agreements." Zacks, *supra* note 3, at 1509.

121. This is a superior method relative to relying on regulators to figure out what type of disclosure to require and to do so effectively. Ben-Shahar and Schneider suggest "it is the regulatory dynamic of this institution [mandated disclosure]—the desire to solve too many problems by informing unsophisticated decisionmakers and expecting them to make affirmative thoughtful decisions—that undermines the system." Ben-Shahar & Schneider, *supra* note 99, at 745.

larly to the extent that the drafting party actually values a particular one-sided provision, in which instance the drafting party will be motivated to receive the benefit of the one-sided provision by ensuring effective disclosure.

In general, this approach may be subject to the same criticisms as described above for unconscionability, specifically that adjudicators would be making determinations of what constitutes adequate disclosure on an ad hoc and perhaps inconsistent basis. What distinguishes this approach from other legislative or judicial responses is the standard against which the disclosure would be measured. Since the presumption would be that contractual terms are not enforceable in the absence of effective disclosure, the general deference that courts give to contracts under the traditional duty to read would be removed. In addition, the court's inquiry would be limited to determining the adequacy of disclosure instead of multiple factors such as the substantive fairness (as in the case of substantive unconscionability) or whether the non-disclosing party reasonably should have expected a particular term (as in the case of the doctrine of "reasonable expectations").<sup>122</sup>

Moreover, courts should also be limited to ascertaining whether a majority of consumers would have understood the contract term in question. Accordingly, the drafting party could demonstrate it had met its burden by establishing as an empirical matter that the contract terms were understandable by most parties in the non-drafting party's situation (such as being a consumer). An example of utilizing this evidentiary approach is suggested by Ayres and Schwartz, who propose requiring the drafting party to make effective disclosure of unexpected contract terms by demonstrating through empirical studies that a majority of consumers who read the disclosure in the required warning format regarding unexpected terms also understand them.<sup>123</sup>

Ayres and Schwartz suggest using a "cautionary standardized box" required by the Federal Trade Commission in which all deviations from the consumers' established expectations would be disclosed.<sup>124</sup> As a threshold matter, although there is some evidence that utilizing a simple format works, the suggestion that a box is ideal should be rejected, particularly in the absence of empirical evidence

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122. The Restatement (Second) of Contracts §211 provides that "[w]here the [drafter] has reason to believe that the party manifesting such assent [to the contract] would not do so if he [or she] knew that the writing contained a particular term, [that] term is not part of the agreement." Ayres and Schwartz, *supra* note 97, at 559 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (1981)) (internal quotation marks omitted). Determining what consumers expect is difficult for courts. *See id.* at 560.

123. Ayres and Schwartz, *supra* note 97, at 584.

124. *Id.* at 580.



that it is the most effective format.<sup>125</sup> Instead, the burden should remain upon the drafting parties to demonstrate empirically that the disclosure was effective, including through the use of the format of disclosure chosen. It is possible that there is a more effective format for disclosure of unexpected or material contract terms that is only discoverable through empirical testing.

Drafting parties should be encouraged to develop and to continue to develop effective means of disclosures. To the extent that a particular format or manner of disclosure becomes stale with overuse, drafting parties would be forced to come up with new methods. In addition, it would be a competitive advantage to have a superior contractual disclosure mechanism because fewer contracts of the particular seller would be unenforceable. As a result, one could imagine sellers competing on this particular dimension and developing better formats and disclosure features, and it does not make sense to imagine that the ideal format is already known. This completely upends the current regime, which in some sense encourages a race to the bottom and under which sellers may be penalized in the marketplace to the extent that they do not exploit consumers through their contracts as much as possible.<sup>126</sup>

In any event, an approach based on empirical determinations of effective disclosure addresses the drafting party's incentives as well as the limitations of outside monitoring agents to determine what constitutes effective disclosure. Rather than making a subjective determination of whether contractual terms were effectively disclosed, the adjudicator would assess the data and methodology used by the preparing party to determine that a particular contract term was effectively disclosed.<sup>127</sup> Drafting parties would be unable to defend

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125. In defense of their suggestion for a "warning box," Ayres and Schwartz note that prior "findings imply that disclosure information, in a clear and simple format, may have a positive effect on decisions." *Id.* at 553 n.25 (citing Vanessa G. Perry & Pamela M. Blumenthal, *Understanding the Fine Print: The Need for Effective Testing of Mandatory Mortgage Loan Disclosures*, 31 J. PUB. POL'Y. & MKTG. 305, 307 (2012)). Ayres and Schwartz suggest that using the same format for all types of consumer contracts will "facilitate consumer learning and also comparison shopping when several sellers are available." *Id.* at 583.

126. Hanson and Kysar argue in an earlier work that competition forces sellers to exploit cognitive biases to their advantage. They suggest:

[O]ne might say that the evolutionary forces of the market will force the parties in the dominant position to behave 'as if they know and understand how best to use the teachings of the behavioral literature to manipulate other actors for gain. . . . Manufacturers, to survive, *must* behave 'as if they are attempting to manipulate consumer risk perceptions.

Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 747 (1999).

127. Ayres and Schwartz suggest that this is the proper approach as well, warning that "[c]ourts . . . should not engage in free-floating assessment of whether the disclosure is comprehensible." Ayres & Schwartz, *supra* note 97, at 584. Instead, courts should attempt

standard form contracts simply as they appeared, but instead would have to utilize resources to determine and defend particular disclosures.

Under an approach that places the burden of demonstrating effective disclosure upon the drafting party, the drafting party will be forced to determine the materiality and importance of various contractual terms. It probably is impossible to make effective disclosure to a consumer of all of the terms that are contained in a ten-page standard form contract. Consumers would no longer be forced to make the impossible assessment of which terms are important, and instead drafting parties will need to make determinations as to which terms are valuable enough to justify spending resources to determine how to make effective disclosure of such terms. Terms that are not as valuable will be ignored and disclosed ineffectively (and, consequently, not enforced) or deleted from the contract. Moreover, to the extent that the inclusion of additional unimportant terms impedes consumer understanding of other material terms, drafting parties should be expected to remove immaterial terms or terms that match statutory default terms.

It may be, as discussed in Part III, that consumers simply will not read or understand particular types of disclosures. In such circumstances, to the extent that drafting parties are unable to find a way in which to make effective disclosure, such terms should be disallowed. If meaningful consent to particular terms cannot be achieved because of the nature or biases of consumers regardless of the form of disclosure, then such terms should not be deemed assented to regardless of how clear or conspicuous the disclosure may appear on an *ex post* basis.

This is not to suggest, however, that all terms that cannot be effectively disclosed will be unenforceable. For example, the drafting party might be permitted to demonstrate empirically that particular terms match the expectations of the non-drafting parties, in which case such term would be enforceable.<sup>128</sup> There is little danger in enforcing terms that the consumer expects. It is only when the non-drafting party cannot, either because of ineffective disclosure or otherwise, understand the contractual terms that such terms would not

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to make an "objective validation of the disclosure's impact on consumers' ability to describe correctly the terms of the contract." *Id.*

128. Ayres and Schwartz suggest that only unexpected terms need to be regulated by requiring drafting parties to demonstrate effective disclosure and assent to such terms. Ayres & Schwartz, *supra* note 91, at 552 ("The law of contractual assent, we argue, best implements this goal [of making 'party assent real'] by permitting firms to enforce even poorly disclosed or hidden terms if consumers expect and understand what those terms do while regulating only those terms that consumers incorrectly believe are more favorable to them than they actually are.").

be enforced. By changing presumptions of enforceability and requiring the agent to deploy resources to demonstrate effective disclosure, the agent's interests in achieving effective disclosure match those of the principal, and the imbalance in control in the underlying transactions can start to be addressed as well.

#### IV. CONCLUSION

The economic analysis of the agency relationship that exists in the contract preparation context is instructive as to understanding the behavior of contracting parties, contract law doctrine concerning legal consent to contract, and possible contract law reforms. Understanding the structural principal-agent problem involved in preparing contracts is fundamental to comprehending why particular contracts appear as they do as well as to determining when particular contractual doctrines should be applied. This Article has explored the ways in which principals and agents act and respond in different contract preparation contexts as well as various legislative and judicial responses.

As explained in this Article, the principal-agent problem manifests itself because drafting parties can, in certain instances, prepare contracts in a manner that serves the drafting party's interests at the expense of the non-drafting party's interests. In certain contexts, contracts may actually embody or entrench a principal-agent problem, which is almost directly opposed to the understanding of contracts as helping to address the problem as it exists between two promising parties. As such, contract preparation (and execution) is not necessarily a solution to asymmetries of interests, information, and control. It is the tool used to exploit the asymmetries and in fact embodies the asymmetries.

We have a discomfort about contracts that rely on consent where we know empirically that one side has not read the provisions and is being forced in some sense to agree to a contract that it cannot and will not negotiate. We have developed theories about unconscionability and unfair surprise, and we even have established federal and state watchdog agencies to help protect those who are not in a position to enter into a classical contract.

Nevertheless, the tension arises because of the duty to read, which if imposed to its logical ends, would swallow unconscionability and unfair surprise. Somewhere along the line, we acknowledged (through the work of Llewellyn and others) that the duty to read could not actually be logically realized in all situations given the bargaining power disparities between the parties and the actual contracts that existed in the world. To some, this encouraged the development of theories about the reasonable expectations of the parties

and legal fictions about blanket assent, which purport to address the problem but are unsatisfying because they never directly solve our concern about contracts that are prepared with the knowledge that the other side will not have a chance to read them and will not in fact read them.

Solutions to date have been to focus on the flow of information from the drafting party to the non-drafting party, as required *ex ante* by statutory rules about the type and manner of disclosures and *ex post* by judges about the propriety of the contracting process. These approaches have ultimately proven unsatisfying because they do not address the fundamental incentives of the drafting party to conceal. Instead, these approaches attempt to diagnose the symptoms that arise from such incentives and curtail the symptoms. If the font size being used by drafting parties is too small, then perhaps the statute may require a larger font, or the judge may find that the provision was unconscionable.

As a result, the monitors are always playing from behind and unable to anticipate the next wave of contract drafting techniques. If, for example, the rule requiring drafting parties to demonstrate the salience and understanding of terms had applied when drafting parties began introducing click-screen agreements, then perhaps litigation outcomes would have been based on informed consent rather than judges' *ad hoc* assessments of what a "click" actually means to a consumer purchasing something on the Internet. In some sense, while legislatures and judges are currently trying to figure out the legitimacy of current practices based upon a presumption of validity, companies are already evolving to find new methods of strategic drafting. Without new approaches that recognize and appreciate the lessons from principal-agent framework as it applies to the contract preparation context, contract law reforms will continue to be churned out in a retrospective and ultimately ineffective fashion.

There are approaches that incorporate lessons from economic theory and, consequently, could prove more successful than previous reforms. Reforms to date have not forced drafting parties to ascertain the most effective methods of disclosure and instead have relied on piecemeal determinations by courts and legislatures. These reforms have not addressed the underlying incentives of the drafting party (the agent) to obfuscate or use ineffective disclosure methods. Reforms based in economic theory, such as reversing the presumption of enforceability in the absence of empirical data, would address these incentives and force drafting parties to do a cost-benefit analysis with respect to making effective disclosure, and receiving the benefit, of each contractual term. In future work I hope to explore other reforms suggested by economic agency theory that may prove effective in the contract-drafting context. By recognizing and applying lessons from

economic agency, contract law reforms can be designed to achieve the desired goal of meaningful assent.