THE ROLE OF INFORMATION DEFICIENCIES IN CONTRACT ENFORCEMENT

Ann-Sophie Vandenberghe[*]

Abstract

Information deficiencies play an important role in contract enforcement. Courts frequently refuse to enforce contractual terms when one of the parties lacks information. The difficult question is where the line is drawn (or should be drawn) between information deficiencies of which the law will take account and those which it will disregard. This article sets out the economic framework for determining when it is appropriate to shift responsibility for information deficiencies from one contracting party to the other. The overriding objective from an economic perspective is to ensure that the party who can produce and reveal information at least cost produces the optimal amount of honest information in society. The economic duty-to-inform doctrine provides simple rules to achieve that purpose. Greater intervention on the basis of information deficiency is warranted in cases where a special relationship of trust exists between contracting parties. The reason for this is that an adviser (agent) in a trust relationship is contractually bound by a greater duty to inform the principal, including a duty to provide information and advice about the principal's needs. The economic theory on which judicial control and regulation of contract terms rests (and which also limits its scope of applicability) is that people tend to sign contracts without reading them.

1 Introduction

> The premises of economics push in the direction of freedom of contract, and this current can be resisted only with difficulty. If parties are rational, they will enter contracts only when it is in their self-interest, and they will agree only to terms that make them better off. Courts that refused to enforce these terms would make it more difficult for future parties to use contracts to enhance their joint well-being. Therefore, courts should enforce the terms of the contract.[1]

Under the principle of freedom of contract, courts are required to enforce the contractual terms that are the result of a voluntary agreement between contracting parties. This rule is beneficial for society, because it protects individual autonomy and enhances welfare by facilitating the realisation of preferences through the use of contractual exchanges.

And yet, courts do not always enforce (the terms of) contracts. They often refuse to enforce terms that seem unfair, that is to say, terms that significantly disadvantage one of the parties. Widespread judicial scrutiny of transactions can interfere with freedom of contract and may be perceived as a form of paternalism, because it runs counter to the notion that people themselves know best what is in their own interests. How do courts justify interferences with freedom of contract? Interferences are commonly based on: (1) lack of information or (2) inequality of bargaining power.

Lack of information often plays a role in a court's decision not to enforce the contract. Courts sometimes decide that a contract is unfair because one party was improvident, ignorant, inexperienced or unsophisticated. Lack of information plays a role in all of these cases. Long-standing doctrines of fraud and mistake deal with information problems at the pre-contractual stage. Courts may invalidate a contract when one party was imperfectly informed or mistaken about a relevant aspect of the contractual exchange. Even the doctrine of incompetence deals with a particular type of information problem, namely that incompetent persons, like children, lack information about their own needs and preferences. Courts relieve parties from their contractual obligations to

[*] Ann-Sophie Vandenberghe is Assistant Professor of Law and Economics, Rotterdam Institute of Law and Economics, Erasmus School of Law.

[1] E. Posner, 'Economic Analysis of Contract Law After Three Decades: Success or Failure?' (2003) 112 *Yale Law Journal* 829 at 842.

protect them against their own ignorance or lack of information. But, in doing so, the consequences of the mistake or ignorance of one contracting party are shifted to the other party who relied on the contract's validity.

Information deficiency plays an important role in contract enforcement, although it matters in some cases but not in others. Courts sometimes relieve individuals of the responsibility for their apparent choices, but in other cases they will not allow a person to avoid his contractual obligations because he was imperfectly informed. It is not always clear where the dividing line is to be drawn between information deficiencies of which the law will take account and those which it will disregard.

This article sets out the economic framework for determining when it is appropriate to shift responsibility for information deficiencies from one contracting party to the other.

Modern economic analysis does not presuppose that people are perfectly informed and that they make perfect decisions. Instead, it is recognised that decision-making is costly and that acquiring and processing information (including information about one's own needs and preferences) may be costly. An overview of pre-contractual information costs appears in section 2. Moreover, market forces may not be strong enough to cure information problems. Legislative or judicial intervention may then be needed to solve these problems in order to avoid the resulting misallocation of resources. The legal duty to inform is an appropriate legal instrument for solving information problems.

The economic purpose of a legal duty to inform is to overcome information asymmetries by giving incentives to market actors to produce and reveal more – and more honest – information. The difficulty lies in determining the precise extent of the duty to inform. From an economic perspective, the question is how to ensure that the party who can produce and reveal information at least cost produces and conveys the optimal amount of honest information in society. The economic duty-to-inform doctrine, described in section 3, provides simple rules to achieve that purpose.

In many legal systems, courts are more willing to relieve a party from disadvantageous contractual obligations if the parties are in a special relationship of trust. In section 4, it is argued that greater intervention on the basis of information deficiency is warranted when parties are in such a special relationship. The reason is that an adviser (agent) in a trust relationship is contractually bound by a greater duty to inform. Various legal rules and doctrines may be understood as providing incentives to the adviser in a trust relationship to give more – and more honest – information, including information about the other party's (principal's) needs.

Lack of information is one reason for courts to interfere with freedom of contract; inequality of bargaining power is another one. Courts sometimes decide that a contract is unfair because of the unequal bargaining power of the seller and the buyer and that this inequality may justify avoidance of the contract. Nonetheless, economists typically argue that courts should not avoid contracts because of the unequal bargaining power of the parties. The reason is that inequality of bargaining power, which may exist in various forms, including contracts offered on a take-it-or-leave-it basis, could not account for the prevalence of harsh contract terms that are not desired by the parties. The unequal bargaining power argument for interference with freedom of contract and the counter-arguments given by economists are outlined in section 5.

The economic theory on which judicial control of contract terms rests is that people tend to sign contracts without reading them. The causes of the signing-without-reading problem, the inefficiencies resulting from it and its implications for the standard of judicial control, its scope of application and the applicable form of legislative action are the subject of section 6.

2 Imperfect Information and the Formation of Contracts

2.1 Introduction

In early economic analyses, information problems were assumed away. A strong version of the rational choice model was used, according to which it is assumed that individuals are perfectly informed and make perfect decisions. However, in modern economic studies, weaker versions of the rational choice model are used. The weaker versions of the rational choice model do not presuppose zero costs of acquiring and processing information or zero decision costs.[2] In extreme cases, involving incompetence, information and decision costs may be so high that a person is no longer able to look after his own best interest.

In a world in which all information could be produced and made available at no cost, contracting parties would be perfectly informed. However, in the real world, producing and communicating information is costly. Section 2.2 provides an overview of the information costs at the pre-contractual stage. However, the fact that producing and communicating information is costly does not necessarily imply that an insufficient amount of information is available in markets. Market forces exist that remedy information problems. However, as shown in section 2.3, market forces are generally not strong enough to solve all information problems. Legal measures may be needed to ensure that the optimal amount of honest information is produced in society.

2.2 Pre-Contractual Information Costs

2.2.1 Information Production Costs and Communication Costs

When people contemplate the possibility of concluding a contract, they need information on many issues in order to be able to assess the value of the exchange. Producing information is costly. Moreover, because information is asymmetrically distributed, parties need to exchange information. Costs need to be incurred to convey and communicate information from one contracting party to the other. De Geest gives an overview of the pre-contractual information and communication costs:[3]

- search costs: people need information on potential contractual partners and on the products and services they supply;
- information on the characteristics or attributes of the product;
- information on the characteristics of the producer: this type of information is especially important for contracts *intuitu personae*;
- information on the potential circumstances surrounding the contract: complete and perfect contracts require information about all future states of the world in order to allocate risks appropriately;
- information about one's own needs and preferences: a person's willingness to pay depends on his ability to pay, which includes information about his own financial situation and possibilities;
- information on the production costs: this information is needed by the producers in order to calculate the price, as well as by consumers, who need to know at what price they could produce the relevant products and/or services themselves;
- information about alternative contracting parties on the market: this includes information on the market price and the market demand curve;

[2] G. Stigler, 'The Economics of Information' (1961) 69 *Journal of Political Economy* 213.
[3] G. De Geest, *Economische analyse van het contracten- en quasi-contractenrecht* (Economic analysis of contract and quasi-contract law) (1994) at 82-88.

- information on the applicable law: information about default rules, mandatory rules and rules of evidence; and
- information on the actual terms included in the contract.

2.2.2 Decision Costs

People have to make decision costs. In other words, they need to invest an amount of cognitive effort to think through the options and select the product that meets their needs and desires best. People often have to invest a significant amount of cognitive energy into making sure that they have thought through their options and selected a product that meets their needs and desires.

2.2.3 Lie Costs and Verification Costs

Market actors may invest a huge amount of effort to mislead other parties. They may try to 'hide' negative aspects of a product or 'inflate' its positive aspects. The costs of producing false information are 'lie costs'. These are a waste of resources because they create no value.[4]

The lie costs of some parties may lead to verification costs of other parties.[5] Because some parties do not reveal information in an honest manner, trust levels may decrease. People will spend resources on verifying whether the information given to them is correct and honest. Verification costs are a waste of resources because information will unnecessarily be duplicated when it turns out that the information originally provided was in fact correct.

It is not always possible to verify whether information given by one party is false or honest. A distinction must be made between verifiable and non-verifiable information.[6] Non-verifiable information consists of subjective opinions or statements about which there is no scientific consensus. For example, when a car dealer declares that 'Toyota is the best', it is impossible for third parties to determine whether the costs involved in this statement are to be classified as information costs or as lie costs.

2.3 Market Forces to Remedy Information Problems

It is sometimes argued in the economic literature that competitive market forces are strong enough to provide the optimal amount of information, thereby removing the need to have legal rules to overcome information asymmetries. It is true that market forces may cure informational problems through voluntary disclosure of information, but it does not make legal rules unnecessary. In any case, it takes time for market forces to solve informational problems. Legal rules may speed up the process.

Moreover, market solutions may not be perfect. Take the example of warranties.[7] Competitive pressures make sellers offer warranties (enforceable guarantees) for particular characteristics of their products. A warranty is a guarantee of results and therefore an indirect statement on quality, but it is an imperfect solution. The reason for this is that a seller who provides a warranty also has to bear the losses resulting from events that he cannot know (external factors) and from the buyer's (non-verifiable) moral hazard. Signalling is another way in which markets may overcome informational problems.[8] However, signalling is also imperfect, because it may induce people to invest too much in signalling.

[4] R. Posner, *Economic Analysis of Law* (1992) at 110.
[5] De Geest, above n. 3, at 87.
[6] Id., at 86.
[7] S.J. Grossman, 'The Informational Role of Warranties and Private Disclosure about Product Quality' (1981) 24 *Journal of Law and Economics* 461.
[8] A. Spence, 'Job-Market Signaling' (1973) 87 *Quarterly Journal of Economics* 355.

In addition, market forces only provide solutions under certain conditions. For example, sellers have incentives to provide information to otherwise uninformed buyers, but only when the benefits of doing so outweigh the costs of information disclosure. Voluntary disclosure can sometimes be expected, since it will be to the advantage of various sellers to point out that their product or service has attributes that are more advantageous to many consumers than the product or service of their competitors. The principal situation in which voluntary disclosure of information will not occur is where the revelation of information would tend to cause many consumers not to buy the product at all. No seller of the product will have an incentive to disclose that kind of information. Sellers will also not reveal information that makes a particular product more attractive than consumers expect if other sellers of such products would also gain from that information. Gabaix and Laibson[9] present a model of consumer myopia that explains why firms often shroud the negative attributes of their products, particularly high prices for complementary add-ons. They show that competition will not induce firms to reveal information that would improve market efficiency. Firms will not educate the public about the add-on market, even when unshrouding is free. The reason for this is a phenomenon that they call 'the curse of debiasing'. Debiasing improves consumer welfare, but no firm can capture or even partially share these benefits. Educating a consumer about competitors' add-on schemes effectively teaches that consumer how to profitably exploit those schemes, thereby making it impossible for the educating firm to profitably attract the newly educated consumers.

Finally, in some situations in which there is a good deal of voluntary disclosure, the information may not be stated in a standardised manner and therefore does not facilitate comparative shopping. Legislative intervention may be needed to ensure that information is presented in a standardised way.

In general, market forces are not strong enough to perfectly solve asymmetric information problems. Regulation is required through legislation or in the form of general contract doctrines.

3 The Legal Duty to Inform

3.1 Introduction

The presumption that an exchange is value-maximising is valid only when there is no force, fraud, mistake or incompetence. For example, the fact that parties accept the offer is no evidence that the sale will increase value if one or both of the parties are mistaken or imperfectly informed about the object or terms of the exchange.

Cases in which one of the contracting parties is imperfectly informed about relevant aspects of the contract are addressed in law through the doctrines of mistake and fraud and through the legal duty to inform. When a person's consent has been vitiated by a mistake (or fraud), courts may invalidate the contract. In doing so, a person who has made a mistake is able to shift the consequences to the other party: the costs that the other party has made in relying upon the validity of the contract will be wasted and he will lose whatever benefit he expected to obtain from the contractual exchange. However, all legal systems agree that not every mistake entitles a promisor to evade the consequences of his promise. The difficulty with which legal systems must cope is where to draw the dividing line between mistakes of which the law will take account and those which it will disregard.

Under the will or autonomy-based theory of contract, legal enforcement of contracts is justified in order to respect the autonomous will of people. Consequently, there is no justification to grant legal force to contracts that do not reflect the true and free will of people. A party whose will or intention is vitiated by a mistake (or deceit or duress) can claim that the contract is void. However, it has also been recognised in law that, as a basis for contractual enforcement, the 'will theory' would create too much uncertainty

[9] X. Gabaix and D. Laibson, 'Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets' (2006) *The Quarterly Journal of Economics* 505.

in any transaction. A perfectly voluntary or free will is elusive. Legal systems therefore also take into account the other contracting party's reasonable reliance on the validity of the contract. Not every mistake entitles a promisor to evade the consequence of his promise.

Nevertheless, there is no simple test in law to tell us in which of these cases the contract can be avoided by the mistaken party and in which it cannot. However, based on the law and economics literature concerning information imperfections, De Geest and Kovac have developed an economic duty-to-inform doctrine that provides simple rules for cases involving mistake, fraud and information imperfections in general.[10]

3.2 The Economic Duty-to-Inform Doctrine

When one contracting party is mistaken or imperfectly informed about an aspect of the contract, including his own reasons for contracting, it can no longer be presumed that the contract is value-maximising. However, De Geest and Kovac start by saying that the mere fact that a party is imperfectly informed should not be a reason to invalidate the contract.[11] The reason for this is that parties never have perfect information at the time of contracting. They have always more information ex post than *ex ante*. In this sense, they are always mistaken. If every mistake would be a valid reason to avoid the contract, no contract would ever be binding. The costs of opportunistic behaviour would increase if contracts could be set aside too easily: a party that has the right to avoid the contract could threaten to use this right in order to induce the other party to agree to a change in the terms of the original contract in favour of the threatening party. Moreover, the invalidation of a contract is costly. The transaction costs that were incurred for the conclusion of the invalidated contract are wasted, and additional transaction costs need to be incurred to contract for the transfer of the returned goods to another party. Sellers who know that part of the contracts they conclude could be avoided at the wish of buyers will seek compensation for these costs by charging higher product prices to consumers who are careful as well as those who are not. This may result in adverse selection. Some of the careful consumers will refrain from buying products because they are unwilling to pay extra for the right to avoid the contract.

From an economic perspective, rules should be designed to ensure that the party who can produce and reveal information at least cost produces the optimal amount of honest information in society.

Economically optimal rules give incentives to the *least-cost information gatherer* to produce and communicate information.[12] In most cases, sellers are the least-cost information gatherer. The reason for this is that they often acquire information as a by-product of owning and using the product (e.g. sellers know that the house they are selling has latent defects), that they have economies of scale in producing information or that they are more likely to be professionals than buyers (e.g. an antique dealer knows whether the object he is selling is an authentic antique or a mere copy).[13] If a buyer is mistaken or imperfectly informed about an attribute of the exchanged object for which the seller is the least-cost information gatherer, the seller should be sanctioned for not having produced and revealed the pertinent information to the buyer. The sanction may consist of the invalidation of the contract or a price reduction.

While sellers are the least-cost information gatherer in most cases, they are not so in all cases. In nearly all cases, the buyer is the least-cost information gatherer about his own wants, needs and preferences.[14] Posner argues that there should be no duty for sellers to disclose when only the consumer has the requisite information. This is the case, for

[10] G. De Geest and M. Kovac, 'The Formation of Contracts in the Draft Common Frame of Reference' (2009) *European Review of Private Law* 113.

[11] Id., at 120.

[12] A. Kronman, 'Mistake, Disclosure, Information, and the Law of Contracts' (1978) *Journal of Legal Studies* 1.

[13] De Geest and Kovac, above n. 10, at 113-132.

[14] An exception exists for parties who are in a relationship of trust. Here, the seller (agent) is explicitly asked to give advice on the needs of the buyer (principal).

example, when the performance of the product depends on the consumer's tastes, which may not be known to the manufacturer: 'Only the consumer knows whether the sweater is soft enough, the cantaloupe ripe enough – for him.'[15] A person who is mistaken about his own needs, motives or reasons for contracting should not be entitled to invalidate the contract. Examples of this include a person who decides to make a particular purchase because of an error in his own calculations or a person who buys one hundred bottles of water for a birthday party because he mistakenly thinks that his guests are teetotallers. This lack of intervention in contracts in cases where a buyer is mistaken about certain aspects on which he is the least-cost information gatherer, encourages people to act with prudence and to become optimally informed about their needs before contracting.

Hence, from an economic perspective, the question of liability for non-disclosure should turn on which of the parties to the transaction, seller or buyer, can produce, convey or obtain the pertinent information at the lowest cost.[16] However, there are cases in which neither party is able to produce the information at a reasonable cost.[17] In that case, analytically speaking, there is no longer an information problem but a problem of risk allocation.[18] Who should bear the risk that something happens that makes performance more or less valuable to the buyer? For example, who should bear the risk that the purchase of a wedding dress in anticipation of a wedding becomes less valuable if the wedding is cancelled? From an economic point of view, the superior risk bearer should bear that risk. The superior risk bearer is the party who is in the best position to prevent the risk from materialising (precaution) or is better able to insure against the risk (superior insurer).

There are limitations on the duty to inform when viewed from an economic perspective.[19] The first limitation is that information should not be communicated if the other party already has or should have the information concerned (e.g. in the case of clearly visible defects). It would be a waste of resources if a party had to incur costs to communicate information that the other party already has in its possession. The second limitation is that information should not be communicated if the information production and communication costs exceed the value of the information to the other party. Third, there should be no duty to reveal entrepreneurial information. Entrepreneurial information is costly to produce, valuable to third parties and is not protected under intellectual property laws. The rule that a person may conceal entrepreneurial information preserves incentives to invest in the production of entrepreneurial information by allowing the investor to obtain returns on his investment. Fourth, there should be no duty to be honest about non-verifiable information. A subjective statement may reflect an honest opinion or it may be a lie. However, third parties, like courts, are unable to find out whether the person who made the subjective statement gave his honest opinion or told a lie.

3.3 Rules on Mistake in the Draft Common Frame of Reference

The previous paragraph describes the *economically* optimal doctrine. It does not describe existing laws and doctrines. It is not within the aim of this article to carry out a thorough analysis of existing national laws and doctrines with a view to determining whether they allocate liability for information deficiencies in similar ways as the economic duty-to-inform doctrine. However, in what follows, I will briefly investigate whether the general rules on mistake in the Draft Common Frame of Reference contain elements that may be considered relevant from an economic perspective in determining whether a duty to inform should exist, such as the relative costs of information. The Draft Common Frame of Reference provides principles, definitions and model rules of European private law.

[15] Posner, above n. 4, at 112.
[16] Id., at 111.
[17] The costs of producing information are not reasonable from an economic perspective when marginal information production costs are higher than marginal ignorance costs.
[18] De Geest and Kovac, above n. 10, at 120.
[19] Id., at 123-124.

These model rules, with comments and notes, bring together rules derived from the legal systems of the EU member states and the overarching Community law.[20]

Article II. – 7:201 DCFR on mistake 'seeks to set out principles which strike a fair balance between the voluntary nature of contract and protecting reasonable reliance by the other party. It does not purport to lay down rules which are "common principles" to be found in different laws, though it reflects what is found in many of them.'[21] The principle laid down in Article II. – 7:201 DCFR is that a party may avoid a contract for mistake when the other party has not acted in good faith, has taken deliberate advantage or has behaved carelessly but that a party may not avoid a contract for mistake when the mistake was inexcusable in the circumstances. As such, the question of liability for mistake under the DCFR turns on which one of the parties is to blame for the mistake. The text of this article does not explicitly mention that the blameworthiness of the parties is a matter of their relative information costs, which is the determining factor according to the economic duty-to-inform doctrine.

Comment E on Article II. – 7:201 DCFR specifies that 'a party should not normally be permitted to remain silent, with the deliberate intention of deceiving the other party, on some point which might influence the other party's decision on whether or not to enter the contract.'[22] The following illustration is given:

> A sells her house to B without revealing to B that A knows there is extensive rot under the floor of one room. She does not mention it because she assumes B will be aware of the risk of it from the fact that there are damp marks on the wall and will have the floor checked. B does not appreciate the risk and buys the house without having the floor checked. B may avoid the contract.[23]

The outcome of this case corresponds with that implied by economic analysis. Party A has at little or no costs acquired information that the other obviously does not have and which is crucial to the contract. To obtain this information herself, Party B would have to check the floor, most likely by hiring an expert, which involves substantial costs. In this case, Party A is the least-cost information gatherer, and the cheapest way in which Party B may become informed is to oblige Party A to reveal to Party B what Party A already knows, namely by imposing upon A a duty to inform that there is rot under the floor. The sanction for non-disclosure is that Party B may avoid the contract. Requiring Party B to be aware of potential defects and to incur costs to investigate the property would be a more costly and less efficient solution. The outcome of the case given as an illustration in Comment E corresponds to that implied by economic analysis, but in the comment the outcome is obtained through application of the general legal principle of good faith, not by applying economic reasoning.

Comment E further specifies that silence is incompatible with good faith unless there is a good reason for allowing the party to remain silent, for example 'when the knowledgeable party has only gained the knowledge at considerable expense, or in highly competitive commercial situations.'[24] This exception to the general rule corresponds with the exception for entrepreneurial information included in the economic duty-to-inform doctrine.

3.4 Implications of Behavioural Insights

Legal scholars are increasingly making use of existing scholarship in both cognitive psychology and behavioural economics, which suggests that human behaviour often deviates from rational choice in systematic and predictable ways, to explain legal phenomena and to argue for legal reforms.[25] Numerous tests done by psychologists and experimental economists have shown that people often do not exhibit the kind

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[20] C. Von Bar and E. Clive (eds.), *Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference*, Volume I (2010) at 1.
[21] Id., at 457.
[22] Id., at 460.
[23] Id., at 460.
[24] Id., at 460.
[25] C. Jolls, Cass R. Sunstein and R. Thaler, 'A Behavioral Approach to Law and Economics' (1998) 50 *Stanford Law Review* 1471-1550.

of reasoning ascribed to agents in rational choice models, particularly with regard to decisions made in the face of uncertainty and risk. Psychologists hypothesise that subjects make systematic errors by using decision 'heuristics', or rules of thumb, which fail to accommodate the full logic of a decision. These systematic errors are often referred to as 'biases', and this general topic often carries the label 'heuristics and biases'. The study of heuristics and biases tends to be dominated by attempts to expose systematic errors in human judgment and decision-making.[26]

For example, the principal concern with regard to credit borrowing is the cognitive bias for risk underestimation and irrational discounting (myopia). This is an acute problem in credit borrowing, because the repayment terms for typical debt products usually stretch out for years. Compounding this problem is a complex pricing structure, which often makes credit borrowing difficult to price.[27] Accordingly, one of the problems is that debtors often cannot appreciate what they are getting themselves into: unserviceable levels of debt. If debtors make systematic errors in judgment due to risk underestimation, myopia or some other psychological impediment, then they will make bad choices and do themselves harm, for example by taking out unaffordable credit, if left to their own devices. The problem is aggravated when sophisticated lenders strategically exploit the consumer's behavioural biases by designing and shaping contracts around the consumers' systematic deviations from perfect rationality. According to Bar-Gill, such biased contracting is not the consequence of imperfect competition. On the contrary, competitive forces compel sellers to take advantage of consumer's weaknesses.[28] In the borrowing context, lenders may adopt a particular business model, called the sweatbox model, which is a two-stage model that entices all borrowers at the outset with low rates but then cranks up the heat through late payment fees and penalty rates for the 'sweaters'. The way lenders lure debtors into their sweatbox is by preying upon their underestimation of risk and optimism biases.[29]

The behavioural account of consumer contracting, which is based on models of consumer markets in which sophisticated firms interact with boundedly rational consumers and consumers who may have psychological biases, may be used to explain specific legal rules. For example, under the EU Consumer Credit Directive, creditors bear the responsibility of individually checking the creditworthiness of the consumer.[30] This rule may be considered as an exception to the general assumption that each person is in the best position to assess whether a particular purchase is affordable based on personal information regarding a person's ability to pay. For example, when an individual consumer buys a television set, it is generally the consumer who is better situated than the electronics store to know whether the purchase is affordable. This presumption may be reversed in the borrowing context when consumer biases are taken into account. Consumers (debtors) are thought to be worse decision-makers than lenders when it comes to borrowing money. Lenders are thought to have a better idea of how much money a given debtor can afford to pay on a monthly basis without suffering financial distress. The reason is that debtors suffer from psychological impediments that may be debiased in the professional lending setting by creditors with superior cognitive

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26 P. Slovic and S. Lichtenstein, 'Comparison of Bayesian and Regression Approaches to the Study of Information Processing in Judgment' (1971) 6 *Organizational Behavior & Human Performance* 649-744; A. Tversky and D. Kahneman, 'Judgment under Uncertainty: Heuristics and Biases' (1974) 185 *Science* 1124-1131.

27 One particular mistake that may lead to 'incorrect' pricing is called 'use-pattern mistake'. People often misperceive their future use of the product. For example, they underestimate the likelihood of paying late on their credit card bills. See O. Bar-Gill, 'Bundling and Consumer Misperception' (2006) 72 *University of Chicago Law Review* 33; O. Bar-Gill, 'The Behavioral Economics of Consumer Contracts' (2008) 92 *Minnesota Law Review* 749.

28 O. Bar-Gill, 'Seduction by Plastic' (2004) 98 *Northwestern University Law Review* 1373.

29 J.A.E. Pottow, 'Private Liability for Reckless Consumer Lending' (2007) *University of Illinois Law Review* 405 at 416.

30 Directive 2008/48/EC of 23 April 2008 on credit agreements for consumers, OJ 2008 L 133/66. According to Article 8 (Obligation to assess the creditworthiness of the consumer) of the Directive: 'Member States shall ensure that, before the conclusion of the credit agreement, the creditor assesses the consumer's creditworthiness on the basis of sufficient information, where appropriate obtained from the consumer, and, where necessary, on the basis of a consultation of the relevant database.'

capacities. One could argue that lenders have an incentive to assess whether the debtor can afford the product even in the absence of a legal requirement to do so. However, it has been shown that business models exist under which it is profitable for lenders to extend credit to debtors who very likely cannot repay (i.e. to make 'reckless' loans), contrary to the conventional perspective of minimising risk and avoiding defaults.[31] Under such conditions, it makes sense to make lenders responsible for individually checking the creditworthiness of the consumer and to render unaffordable credit off-limits.

The movement within legal scholarship, which is referred to as 'behavioural law and economics', builds on the core insights of law and economics scholarship but supplements it with a subtle view of how and why and when humans make mistakes in judgment.[32] Instead of a strict adherence to rational choice theory, the new movement adopts a more subtle and context-dependent view of how individuals behave for the purpose of legal analysis. Based on the relevant decision-making capacities of actors in a specific setting, it can be used to formulate specific normative policies.[33] For example, the finding that debtors are worse decision-makers than lenders in the borrowing context may be used to support specific rules that shift some of the responsibility for making appropriate borrowing decisions towards the lenders. The basic tenet of economic analysis, that the question of liability in cases of imperfect information should turn on which of the parties to the transaction can produce information and avoid mistakes at lower costs, remains unchallenged. A major contribution of behavioural analysis is to point out – based on improved accounts of how people actually behave in specific contexts – which one of the parties to a specific type of transaction is in the best position to produce correct information at the lowest cost to avoid costly mistakes in specific settings.

4 Relationships of Trust: Greater Duty to Inform

4.1 Introduction

In many legal systems, courts are more willing to relieve a party from disadvantageous contractual obligations if the parties are in a special relationship of trust. According to Article II. – 7:207 (unfair exploitation) of the Draft Common Frame of Reference:[34] '[a] party may avoid a contract if, at the time of the conclusion of the contract: (a) the party … had a relationship of trust with the other party …; and (b) the other party knew or could reasonably be expected to have known this and, given the circumstances and purpose of the contract, exploited the first party's situation by taking an excessive benefit or grossly unfair advantage.'

If the parties are in a special relationship of trust – a relationship such as exists between patient and doctor; or a client and a legal or other professional adviser – then any contract made between them that is disadvantageous to the weaker party is presumed to be due to the undue influence of the other party or to an abuse of the trust reposed in said party.

A strong asymmetry of information exists in trust relationships. One party is very well informed and the other is almost ignorant. However, this fact alone cannot justify the differential legal treatment of trust relationships. Information asymmetry between seller and buyer characterises almost all transactions. The difference with trust relationships is that in such relationships, the agent (adviser) is explicitly asked (and often paid) to give honest information. The other party (principal) is therefore entitled to

31 R.J. Mann, 'Bankruptcy Reform and the "Sweat Box" of Credit Card Debt' (2007) *University of Illinois Law Review* 375.
32 T. Ulen, 'The Growing Pains of Behavioral Law and Economics' (1998) 51 *Vanderbilt Law Review* 1747-1763.
33 R. Korobkin and T. Ulen, 'Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics' (2000) 88 *California Law Review* 1051-1144.
34 Von Bar and Clive, above n. 20.

look to the other for full and honest information and proper advice. The duty to inform in trust relationships is therefore much greater, and greater intervention on the basis of information deficiency is warranted (see section 4.2 below).

The duty of care resulting from the good faith obligation in agency relationships (section 4.3), the suitability doctrine (section 4.4) and the duty imposed upon advisers to inform their customers about their compensation schemes (section 4.5) may be understood as legal rules that provide incentives to advisers in a trust relationship to give more – and more honest – information, including information about the needs of the other party (principal).

4.2 Greater Duty to Inform in Relationships of Trust and Confidence

Individuals often make decisions based on the advice or guidance provided by more informed professionals. When parties are in a special relationship of trust, the duty to inform should be much greater. The reason is that an adviser (agent) in a trust relationship is contractually bound by a greater duty to inform. In situations in which a person is quite helpless to protect himself, he may 'hire' someone with superior information to look out for his best interests. The person with superior knowledge (the agent) is explicitly asked (and often paid) to give advice on the needs of the other party (principal).

Given the circumstances and the purpose of the contract, the adviser (agent) should disclose entrepreneurial information, give his honest opinion even when the information is non-verifiable or controversial and provide information on the principal's needs. The agent in a trust relationship should determine and inform the principal about his needs, whether the contract provides benefits for which the principal is willing and able to pay and whether the principal is willing and able to bear the risk contained in the contract. An agent who fails to disclose this kind of information breaches his contractual obligations. Professional advisers are also bound by the rules of their deontological code to give honest information; it is not permitted to tell lies. This allows the principal to spend less time and money verifying the information given by the agent.

The implication of the greater duty to inform is that a greater intervention on the basis of information deficiencies is warranted when parties are in a trust relationship. In section 3.2 above, it was stated that, in general, each person is the least-cost information gatherer on his own needs. It follows that courts should enforce the contract when a person is mistaken about his own needs. This rule should be reversed when parties are in a trust relationship. A person who finds out that the contract he signed (through intervention of a person with whom he has a special relationship of trust) does not correspond with his wants and needs should be entitled to escape (part of) his contractual obligations. This rule sanctions the adviser (agent) in a trust relationship for failing to give information and advice about the needs of the other party (principal).

4.3 Good-Faith-Based Duty of Care in Agency Relationships

Financial service providers in the Netherlands have a duty of care towards their clients arising out of the general obligation of good faith in agency relationships. When financial institutions advise on which financial product to purchase, they have a duty to give honest information on the risk associated with the product, to warn customers that particular products may be too risky and to investigate whether the product that is recommended is within the customer's risk threshold.

In a recent Dutch case, the court in Alkmaar[35] found the defendant (a bank) liable for non-disclosure of information on the single premium insurances that were sold to the plaintiffs. The plaintiffs went to the bank for a loan of €50,000. In addition to the loan, the bank sold the plaintiffs five single premium insurance policies to cover the risk that the plaintiffs would not be able to repay the loan in case of death, disability or unemployment. The premiums for these policies, which amounted to €20,000 in total,

35 Rechtbank Alkmaar, 106424, 3 February 2010.

had to be paid up front and at once and were financed by means of an additional loan. According to the court, a professional financial service provider, like the defendant, should have informed the plaintiffs of the disadvantage of having to pay extra interest when premiums are financed through an additional loan. The defendant should have informed the plaintiffs of possible alternatives that had no such disadvantages, like paying the premiums in monthly instalments. The defendant was therefore held liable for the losses suffered by the plaintiffs resulting from the defendant's non-disclosure of information.

4.4 Suitability Doctrine

Article 19(4) of the Markets in Financial Instruments Directive (MiFID)[36] provides as follows:

> When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him.

The concept of suitability expresses a home truth about investing – investment decisions can be made only in light of the goals and needs of the person for whom they are made. Investors vary with respect to the degree of risk that they are able and willing to assume in their investments, and their portfolios should reflect their differing risk thresholds. Consequently, a security that is suitable for one investor may be unsuitable for another. Imposition of any suitability doctrine has a revolutionary flavour, because it shifts the responsibility for making inappropriate investment decisions from the customer to the broker-dealer.

When a broker-dealer recommends a security to a customer, he has a responsibility to determine that the security he recommended is within a particular customer's risk threshold. This implies that the broker-dealer must consider: (1) whether the security satisfies the individual customer's risk preferences or willingness to bear risk (i.e. investment objective); and (2) whether the risk is one which the investor has the capacity or ability to bear, notwithstanding customer preferences and desires.

With suitability being defined with respect to both the willingness and capacity of the customer to bear risk, the broker-dealer must obtain complete information about each customer's investment objective and financial background, including his other security investments, his home, savings account, job prospects and other significant non-security assets and liabilities.

According to Mundheim, the theory on which any doctrine of suitability must rest (and which limits its applicability) is that customers tend to rely on their broker-dealer: 'The broker-dealer community has made the investing public aware that it has the special skills needed to deal with such intricate merchandise as securities, and the public has been encouraged to – and has – relied on the superior skills of the broker-dealer community in its securities transactions.'[37]

It is not proposed that the law absolutely prohibits a broker from selling a security that would not be within the particular customer's risk threshold. If an investor persisted in requesting such a security, the broker is permitted to make the sale, provided that he first warns the investor that the purchase is dangerous and imprudent. Cohen states that the requirement to warn customers about purchases that would result in imprudent levels of risk would increase the flow of information available to the investor and protect against the hazards of high-pressure security salesmanship: 'Investment in securities can be fantastically complicated and technical for the lay investor, and brokers typically exert

[36] Directive 2004/39/EC of 21 April 2004 on Markets in Financial instruments (MiFID), OJ 2004 L 145/1.
[37] R. Mundheim, 'Professional Responsibilities of Broker-Dealers: The Suitability Doctrine' (1965) *Duke Law Journal* 445 at 450.

a great influence over customers' investment choices. Without a compulsory warning, a customer may be influenced by his broker to express a preference for a risk which he does not fully understand and which he is not really willing to undertake.'[38]

The recommendation of a particular security to a particular customer involves an exercise of judgment by the broker-dealer at the time of the sale. The suitability standard should not be a vehicle for second-guessing the judgments of broker-dealers. According to Mundheim, a broker-dealer should only be found to have violated his responsibility

> if no reasoning broker would have recommended the particular security to the particular customer in light of information about the customer which the broker-dealer knew or should have known. This review must be made in the light of the circumstances which existed at the time the recommendation was made. Price information of the security after it was purchased – whether favorable or unfavorable – should be irrelevant in determining whether the recommendation was suitable when made.[39]

The suitability doctrine would be an invitation for disappointed customers to benefit from the 'positive' risks associated with their investment but to shift 'negative' risks towards their broker-dealers, if price information on the security after it was purchased was relevant in determining whether the recommendation was suitable when made.

4.5 The Duty to Inform about Compensation Schemes

Article 26(b)(1) of Directive 2006/73/EC specifies that 'investment firms must disclose to the client the existence, nature and amount of the fee, commission or benefit paid or provided to or by a third party, in a manner that is comprehensive, accurate and understandable prior to the provision of the relevant investment or ancillary service.'[40] The Dutch legislator has mandated disclosure of the commission paid to all intermediaries who sell complex financial products (including insurance intermediaries and mortgage brokers).[41]

In general, the law does not require sellers to disclose information about their compensation scheme. Under the economic duty-to-inform doctrine, the same result would be obtained because such information is entrepreneurial or because the cost of communicating information about the compensation scheme is higher than the value of that information to the buyer. Buyers can usually make an informed choice when they have information on the price and quality of a product or service. How much a salesperson earns on the sale of the product is usually irrelevant to the quality of the buyer's purchase decision.

How can a duty to inform about compensation schemes be justified? For cases in which buyers rely on the seller's superior information to give advice on the purchase decision, the seller's objectivity and independence are critical for the quality of the buyer's purchase decision. However, particular compensation schemes may cause pervasive conflicts of interest. In business involving an adviser-advisee relationship, conflicts of interest may compromise the adviser's objectivity and independence.

There are many different types of compensation system for intermediaries, but the great majority of advised products and services are sold on the basis of commission (i.e. *commission-based advice*). Commission can be defined as a payment to an intermediary conditional on the purchase of the product. The payments are usually made by the product provider to the intermediary. The consumer pays indirectly for the advice through higher prices (higher premiums in case of insurance or higher interest rates in case of loans) paid to the product provider. Moreover, consumers only pay for the advice when they effectively buy the product. A person who obtains advice but subsequently decides not to buy the product obtains the advice for free. However, there is no such thing as a 'free lunch'. Advisers get compensation for the 'wasted' advice costs from those buyers who do buy the product, as they pay higher prices. An alternative compensation system is the

38 S. Cohen, 'The Suitability Rule and Economic Theory' (1971) 80 *Yale Law Journal* 1604 at 1622.
39 Mundheim, above n. 37, at 474-475.
40 Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ 2006 L 241/26.
41 Besluit Gedragstoezicht financiële ondernemingen Wft.

fee-based system. Under this system, the buyer always pays for the advice, whether or not he subsequently decides to buy the product. The fee may be a fixed fee or an hourly fee for advice.

Whereas the fees paid directly by the customers do not affect the recommendations, commissions do affect recommendations. With commission-based advice, there is a risk of biased advice. Advice can be biased in three different ways.

The first type of bias is *product bias*. In advising across a range of product types, advisers recommend a product type that provides them with the highest commission even though the product type does not fit best with the needs of the customer. The second type of bias is *provider bias*. Within a particular product type, advisers recommend the provider that pays them the highest commission even though other providers' products offer better terms to the consumer. The third type of bias is *sales bias*. Commission provides incentives for intermediaries to sell a product, even when the 'best' advice might be not to purchase or to continue holding on to the product. This sales bias results from the intrinsic feature of commission-based advice that advisers only get paid for their advice when they actually sell the product. This may induce them to selectively disclose information (e.g. to hide bad information on the product) in order to effectuate the sale.

Safeguards to ensure the objectivity of advice may be needed to reduce biases in advice. One possible measure is to impose upon advisers a duty to inform their customers about their compensation schemes. Disclosure affords a forewarning of biased advice, and advisees may adjust for the bias. Some authors cast doubts on the effectiveness of disclosure in reducing adviser's bias.[42] Advisees may not adequately adjust for the bias. Additional safeguards to ensure the objectivity of advice, such as regulation of the way compensation schemes are structured, may therefore be needed.

5 Judicial Control of Contract Terms: Inequality of Bargaining Power

5.1 Inequality of Bargaining Power

The notion of inequality of bargaining power in the market for contracts pervades discussions about the regulation of contract terms for reasons of fairness.[43] The question arises whether it is still right to treat freedom of contract as a central pillar of the legal system. Should it not be limited *ex lege* wherever the parties to a contract are unequal in bargaining power, 'parity of contract' is disturbed and the weaker party needs protection? Is it not time to replace or supplement the principle of freedom of contract with a principle of 'contractual justice'? Under such a principle, there should be equality in contracts as regards knowledge of the facts, in the exchange itself and in the subject matter of the contract for contracts to be valid and enforceable. Courts would be required to set aside contracts (or contractual terms) that were unequal or unfair.

A general legal requirement for the terms of a contract to be fair, so that they will be legally unenforceable if they are not, interferes with freedom of contract. The principle of freedom of contract rests on the assumption that each person is the best judge of what he wants and is willing and able to pay for. A person who enters on a voluntary basis into an agreement will surrender only as much as he is willing to give in order to obtain in exchange something he values more. It is assumed that people only agree to terms that leave them better off. If consent can be observed, it can be inferred that the contract enhances value. When a person who enters into a contract does so of his own free will and is capable of looking after his own interests, it is the responsibility of each person to act with prudence and to decide for himself on the price and other terms on which he is prepared to purchase. It is the agreement, as reached by two parties entering into a contract with a proper understanding of the bargain they are making, which then

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42 D. Cain, G.F. Loewenstein, and D.A. Moore, 'The Dirt on Coming Clean: Perverse Effects on Conflicts of Interest' (2005) 34 *Journal of Legal Studies* 1.; D. Schwarcz, 'Beyond Disclosure: The Case for Banning Contingent Commissions' (2006) 25 *Yale Law & Policy Review* 289.

43 K. Zweigert and H. Kotz, *An Introduction to Comparative Law* (1998) at 331.

determines the price and the other terms of the exchange – and nothing else. If the meaning of a clause is clear, the principle of freedom of contract requires that it must be applied and that the courts have no power to relieve one party of its clearly expressed obligations. If a courts declared void a particular contractual arrangement on the grounds that it was substantively unfair according to the fairness standard used, future parties for whom this particular arrangement is value-maximising would no longer be able to adopt it.

Moreover, widespread judicial scrutiny of contract terms may interfere with the principle of individual autonomy of which the freedom of contract principle is a manifestation. A rational person capable of determining his fate must be given the freedom to shape his life responsibly. He must be allowed to decide for himself whether or not to make a contract, towards whom he will undertake a legally recognised obligation and what the content must be. States, and by extension courts, should protect the freedom of the individual and safeguard his power of self-determination. The normative justification for courts to enforce contractual obligations is that they are 'willed' by the parties. Under judicial scrutiny, on the other hand, the court substitutes its judgment for that of the individuals involved.

In the case of inequality of bargaining power, however, courts and legislators express their doubts that the contract contains terms that the parties want and desire. In this case, it is presumed that the stronger party will force terms on parties that do not want them. From this point of view, the contract terms gain their effectiveness not from the private autonomy of the parties but from the submission of one party. Such terms must therefore be denied effectiveness if they contradict the principle of good faith and fairness. Contract terms are thought to be suspect and intervention is deemed to be necessary whenever terms are agreed without any negotiations at all and in cases where one of the parties does not have any influence on the terms of the deal. This is the way in which contracts are often concluded today. The need for judicial and regulatory control of standard form contracts became apparent when business organisations of all types, suppliers of goods, insurance companies and banks had developed standard contract conditions that deviate from the default rules and seriously disadvantage consumers. It was assumed, at least in consumer settings, that deviations from the legal default rules in standard form contracts are not based on the free will of the contracting parties but that they are the result of inequality of bargaining power. In a contract based on standard terms, there must therefore be some kind of justification for a departure from the legal default rules.

Economists, on the other hand, argue that inappropriate terms in standard form contracts are not the result of unequal bargaining power. Rather, inefficient contract clauses result from the failure of customers to read or understand the content of the contract.[44] The use of standard form contracts is typically characterised by imperfect information on the part of some of the parties to those contracts. The failure to read standard form contracts may be the result of a rational decision to save on transaction costs. However, the supplier of standard form contracts may exploit this fact by inserting inefficient clauses into the contract. The behavioural account of standard form contracts assumes that buyers, when confronted with standard form contracts, only compare a limited number of product and contract attributes when contemplating purchase, because they are boundedly rational rather than fully rational decision-makers.[45] As a result, competition between sellers will generate an efficient level of quality for the attributes that buyers consider ('salient attributes') but low levels of quality for 'non-salient' attributes. For all propositions (unequal bargaining power, failure to read or bounded rationality), the legal implications are much the same: courts should be cautious about enforcing standard form contracts.

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[44] M.J. Trebilcock, *The Limits of Freedom of Contract* (1993).

[45] R. Korobkin, 'Bounded Rationality, Standard Form Contracts, and Unconscionability' (2003) 70 *University of Chicago Law Review* 1203.

5.2 An Economic View of the Unequal Bargaining Power Argument for Judicial Control

The notion of inequality of bargaining power is an intuitive idea, but one that deserves careful examination in order to assess whether it could account for the prevalence of unfair contract terms. Several variants of inequality of bargaining power exist, including: (1) monopoly power; (2) differences in wealth between the parties; and (3) standard contract terms offered on a take-it-or-leave-it basis.

Inequality of bargaining power may exist in a monopolistic market. When only one firm sells products in a particular market, it is called a monopolist. When trading partners are limited, bargains can be very one-sided. Faced with no alternatives, buyers have no choice but to accept the terms determined by the monopolist. Monopolists are able to charge higher prices, that is to say, monopoly prices, when no other suppliers are competing for customers. Inequality that stems from monopoly power would be a market failure, except that (a) firms are rarely monopolist and (b) even if they are, one cannot possibly account for the prevalence of unfair contract terms (i.e. harsh non-price terms) by reference to that monopoly power. The second point needs further clarification. A rational monopolist also has an incentive to offer the contract terms that parties desire, because in doing so it can maximise its profits.[46] The party with market power will offer terms if the other parties want them, but will not force terms on parties that do not want them. The reason that monopolists offer the terms that parties want is that they can charge a fee for it. The fee or price increase compensates the monopolists for the costs of offering the terms, and the customers accept the fee or price increase because the benefits of the terms are higher than the fee they have to pay for them. The inefficiency of a monopoly lies in the price, not in the quality of the products or the contract clauses. This theoretical claim has been supported by empirical evidence. Florencia Marotta-Wurgler has analysed software licence agreements drawn from many distinct segments of the software industry to empirically investigate the relationship between competitive conditions and the quality of standard form contracts. She has found little evidence for the concern that firms with market power, as measured by market concentration or market share, require consumers to accept particularly one-sided contract terms. In other words, firms in both concentrated and unconcentrated segments of the software market, and firms with large and small market shares, offer similar terms to consumers.[47]

Inequality of bargaining power may also be thought to exist when one contracting party is wealthier than the other contracting party. With their superior bargaining power, firms are able to 'outbid' customers for contract terms. Because customers need money more than firms, they may accept particular contract terms in return for a price decrease. For example, a debtor might be willing to accept a harsh remedial term in return for a lower interest rate. If this is the sense in which inequality of bargaining power is thought to exist between sellers and buyers, it demonstrates not market failure but market success. A market is successful when it moves resources from lower-valued to higher-valued uses. In order to increase wealth, parties must have different endowments, and this suggests that the parties to a contract generally will have unequal bargaining power.

Finally, inequality of bargaining power may be said to exist when the contract is from its inception an act of submission to a take-it-or-leave-it standard form contract with no possibility to negotiate its terms. Regulation of standard form contracts is based on the argument that standard contract terms – those offered on a take-it-or-leave-it basis with no opportunity for negotiation – are sufficiently suspect to satisfy the unequal bargaining proposition. In this respect, take-it-or-leave-it agreements are sometimes called 'contracts of adhesion' to reflect the lack of bargaining power.[48] Under a traditional law and economics analysis, however, the adhesive or standardised nature

[46] A. Schwartz, 'A Reexamination of Nonsubstantive Unconscionability' (1977) 63 *Virginia Law Review* 1053 at 1071-1076.
[47] F. Marotta-Wurgler, 'Competition and the Quality of Standard Form Contracts: The Case of Software License Agreements' (2008) 5 *Journal of Empirical Legal Studies* 447.
[48] F. Kessler, 'Contracts of Adhesion – Some Thoughts About Freedom of Contract' (1943) 43 *Columbia*

of the contract does not make it suspect. Standard form contracts are the equivalent of standardised products. Most products in modern markets are standardised. For example, all refrigerators are offered on a take-it-or-leave-it basis; you cannot ask the producer to design and produce a unique refrigerator, like a four-door refrigerator.[49] The take-it-or-leave-it characteristic does not make the consumer uninterested in information about the quality of the goods. The consumer may still decide whether to spend money on that product or on another one (either a similar product from a competitor or a different type of product). Consumers may equally decide whether to accept the standard terms of one supplier or those of another one. If one supplier offers unattractive terms, a competing supplier wanting to attract customers, will offer more attractive terms.

Economists conclude that unequal bargaining power, in its different variants, cannot account for the prevalence of unfair contract terms. This is not to say that unfair contract terms do not exist. The claim made by economists is simply that they are not the result of unequal bargaining power. Their existence is the result of something else. That something else is the signing-without-reading problem, which is the subject of the next section.

6 Judicial Control of Contract Terms: The Signing-Without-Reading Problem

6.1 Introduction

Contract law provides a set of default rules that apply unless parties have agreed explicit terms to the contrary. While default terms may be efficient for the majority of contracting parties, a minority of parties may be better off adopting explicit terms that deviate from the default rule. Parties are free to decide on their own terms, and freedom of contract requires courts to enforce the explicit terms of the contract.

However, courts do not always enforce the explicit terms of the contract. They may refuse to enforce terms that seem unfair. For example, Article II. – 9:403 DCFR states that ‘in a contract between a business and a consumer, a term [which has not been individually negotiated] is unfair … if it is supplied by the business and if it significantly disadvantages the consumer, contrary to good faith and fair dealing.’ An unfair term is not binding on the party that did not supply it (Article II. – 9:409 DCFR). Under the DCFR, courts may set aside a contract term that significantly disadvantages the consumer in comparison with the default rule that would otherwise be applicable, unless it can be shown that the (disadvantageous) deviation from the default rule is justified and not contrary to good faith and fair dealing.[50] Judicial control is also possible in the case of contract terms between parties that are not businesses (Article II. – 9:404 DCFR) and in the case of contract terms between businesses (Article II. – 9:405 DCFR), but different fairness criteria apply than in the case of contracts between a business and a consumer.

The economic theory on which judicial control and regulation of contract terms rests is that people have a tendency to sign contracts without reading them. The following sections outline the causes of the signing-without-reading problem (section 6.2), the inefficiencies resulting from it (section 6.3) and its implications for the standard of judicial control, the scope of its applicability and the form of legislative action (section 6.4).

Law Review 629; T.D. Rakoff, ‘Contracts of Adhesion: An Essay in Reconstruction’ (1983) 96 *Harvard Law Review* 1174.

49 Schwartz, above n. 46, at 1069.

50 Von Bar and Clive, above n. 20, at. 635. The rules on unfair terms in the DCFR are modelled on Directive 93/13 of 5 April 1993 on unfair terms in consumer contracts, OJ 1993 L 095.

6.2 The Signing-Without-Reading Problem

In an ideal world, people would read contracts before they sign them. In the real world, however, few people do so. And those that do read contracts often do not fully understand them. Not knowing the terms of the contract is a special form of information asymmetry. One party is not fully informed about the content of the contract, whereas the other party, usually the drafter of the contract, knows the exact terms of the contract.

At first sight, the solution to this type of information problem is simple. In most cases, misunderstandings can be avoided by reading the contract. The law could therefore insist that parties should read contracts before signing them and sanction parties that neglect to do so. The sanction could consist of acting as if they had read all the contract terms and had consented to them by signing the contract. This implies that courts would not invalidate contracts (or contract terms) when one party was not informed because of its failure to read the content. This sanction would create an incentive to read before signing.

In reality, the problem is more complex. Reading contracts costs time, and time (given the concept of opportunity costs) is money. Since rational parties balance the costs and benefits of reading documents, it can be rational not to read. However, if the drafters of the contract know that some parties will not read the document before signing it, they can abuse that fact and incorporate unfair clauses that benefit the drafters at the expense of the signers.[51]

6.3 Inefficiencies Resulting from the Signing-Without-Reading Problem

The signing-without-reading problem causes several inefficiencies.[52] First, inefficient clauses are adopted in the contract. An inefficient clause creates higher costs for one party (the signer) than it brings benefits to the other party (the drafter). Second, in the case of signing-without-reading, the same market failures may occur as in the case of asymmetric information on the quality of the goods. Akerlof explains how asymmetric information on the quality of goods may lead to adverse selection, meaning that good quality products may be driven from the market by bad quality products.[53] The same process may evolve when buyers are not informed of the content of the contract. Goldberg argues that because the majority of consumers do not notice good contract clauses, harsh-term, low-price contracts will drive out efficient ones, even in competitive markets.[54] Finally, consumers who do not trust sellers may either stop buying goods because of the risk that inefficient terms are adopted in the contract or may spend too much effort on reading contracts to avoid being bound by inefficient contract terms.

Market forces are not strong enough to solve the signing-without-reading problem. Schwartz and Wilde[55] are optimistic that informed shoppers will be able to discipline the market. Consumers who lack information have incentives to acquire information. Some consumers will acquire information more easily than others; these are the people who read standard form contracts. However, the other consumers can free-ride on the efforts of the first group. If sellers cannot easily distinguish between informed and uninformed consumers, they cannot exploit the latter by including inefficient terms in their contract.

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51 G. De Geest, ‘The Signing-Without-Reading Problem: An Analysis of the European Directive on Unfair Contract Terms’, in H. Schäfer and J. Lwowski (eds.), *Konsequenzen wirtschaftsrechtlicher Normen* (2002) 213 at 214.

52 Id., at 217-218.

53 G. Akerlof, ‘The Markets for “Lemons”: Qualitative Uncertainty and the Market Mechanism’ (1970) 84 *Quarterly Journal of Economics* 488.

54 V. Goldberg ‘Institutional Change and the Quasi-Visible Hand’ (1974) 17 *Journal of Law and Economics* 461.

55 A. Schwartz and L. Wilde, ‘Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis?’ (1979) 127 *University of Pennsylvania Law Review* 630.

However, Gazal has shown that we can only expect efficient standard form contracts in markets in very implausible situations.[56]

6.4 Solutions for the Signing-Without-Reading Problem

6.4.1 Judicial Control of Contractual Terms

Asymmetric information on the terms included in the contract cannot be solved by increasing the amount of information obtained by consumers on the content of the contract. As noted above, information could be increased if consumers would read the contract, but a duty-to-read is too costly a solution. An entitlement to avoid the contract when a consumer can show that he was mistaken about the content of the contract due to signing without reading, similar to the doctrine of mistake, would also be difficult to implement. It is very difficult to prove a signing-without-reading problem in a direct way. Instead, substantive regulation of the content of contracts terms through judicial control is justified in this case as an implicit evidence rule. How can a signing-without-reading problem be inferred from the terms of the contract? The fact that the contract contains a term that informed and rational parties would never accept is implicit evidence that one of the contracting parties did not read or understand the contract.[57] What terms would informed and rational parties never accept? These are terms that do not enhance the joint value of the contracting parties or inefficient terms. Examples include terms of which the costs to one party are much higher than the benefits they bring to the other party. In such cases, the value decrease to one party is larger than the value increase to the other party, resulting in a net reduction of total value. Under an efficiency approach to the standard for judicial control, courts would set aside contract terms that do not enhance the joint value of contracting parties.

6.4.2 Which Terms Should Be Subjected to Judicial Control?

The economic rationale for judicial control of contract terms is the signing-without-reading problem. It follows that such control should be confined to terms that people lack incentive to read or pay attention to. There is no need for judicial control of contract terms for which no signing-without-reading problem exists. It is difficult to prove the absence of a signing-without-reading problem, but its absence may be inferred on the basis of substantive or procedural evidence. Substantive evidence relates to the substance of clauses, whereas procedural evidence relates to the circumstances of contracting.

Procedural evidence of the absence of a signing-without-reading problem exists when the contract term was clearly individually negotiated. People obviously pay attention to the terms that they negotiate on an individual basis. However, even when terms are individually negotiated (in which case it may be assumed that people read the contract before signing), some people may not fully understand what they read. This is the signing-without-understanding problem. For example, people may not fully understand the legal consequences of a clause. Evidence of the absence of signing-of-understanding problems exists when the terms are drafted in plain and intelligible language.[58] Terms that have been drafted in advance (whether or not as part of a standard contract) are not individually negotiated. For such terms, signing-without-reading problems may be presumed, unless make-read techniques are so obviously attention-attracting (e.g. with very clear warnings) that the consumer must have been aware of the clause before signing.

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56 O. Gazal, ‘Economic Analysis of Unfair Terms in Standard Form Contracts’, Erasmus Programme in Law and Economics Discussion Papers on Law and Economics No. 100 (1999).

57 De Geest, above n. 51, at 225.

58 Compare with Article II. – 9:402(1) DCFR (duty of transparency in terms not individually negotiated): ‘A person who supplies terms which have not been individually negotiated has a duty to ensure that they are drafted and communicated in plain, intelligible language.’

Substantive evidence of the absence of a signing-without-reading problem exists for the subject matter of the contract and the price-related terms.[59] These are aspects that people take into account when buying a product or service. Finally, there is no need to check the fairness of terms that deviate from the default rules when the drafter's costs of the deviation from the default rule are higher than his costs under the default rule. In this case, the drafter will have to charge a higher price than competitors who apply the default rule or deviate from the default rule in a way that is less costly to them. Uninformed consumers pay attention to prices (salient terms) but not to other terms (non-salient terms). Hence, uninformed consumers choose the contract with the lowest price. The fact that people choose the more expensive contract is substantive evidence that they are informed about the content of the contract, otherwise they would not choose it.[60] There is no signing-without-reading problem with respect to more expensive terms, which offer more protection to consumers than the default rules.

6.4.3 Legislative Action: Black Lists and Grey Lists

Legislators have developed lists of contract terms that may be regarded as unfair. There are two types of lists: black lists and grey lists.

Clauses that are put on the black list are considered unfair in all circumstances. They are always prohibited. From an economic perspective, it is appropriate to put contract terms that are inefficient in all circumstances on the black list. Examples of such terms include terms 'giving the seller or supplier the right to determine whether the goods or services supplied are in conformity with the contract, or giving him the exclusive right to interpret any term in the contract.' Such terms allow the supplier to play the role of judge. The supplier, however, is not a neutral judge. He has an incentive to change the terms in his own favour. Rational parties would never accept such clauses.[61]

When clauses are inefficient for one group of consumers and efficient for another group, determining the optimal policy is more complex. According to De Geest: 'Restricting contractual freedom, on the one hand, leads to social losses by not allowing a minority of consumers to adopt clauses that are efficient to them. Allowing contractual freedom, on the other hand, leads to social losses by introducing signing-without-reading problems.'[62] The best policy option according to De Geest is to adopt a *grey list* of suspicious clauses. These clauses are void in principle, unless there is evidence of true consent. Evidence of true consent may exist when the contract was clearly individually negotiated (and the terms are drafted in plain and intelligible language) or when the make-read techniques are so obviously attention-attracting (e.g. a very clear warning) that the consumer must have been aware of the clause before signing the contract.

An example of terms that may be put on the grey list are those 'inappropriately excluding or limiting the legal rights of the consumer *vis-à-vis* the seller or supplier or another party in the event of total or partial non-performance or inadequate performance by the seller or supplier of any of the contracting obligations.' Such terms are inefficient for most contracting parties because they give sub-optimal incentives to the supplier to perform his obligations, but may be efficient for some parties when, for some reason, the consumer is in the best position to bear the risks of the supplier's non-performance. To ensure that these terms are only part of the contract between parties for whom they are efficient, they should only be enforced when evidence of true consent exists in one of the ways mentioned above.

[59] Compare with Article II. – 9:406(2) DCFR (exclusions from unfairness test): 'For contract terms which are drafted in plain and intelligible language, the unfairness test extends neither to the definition of the main subject matter of the contract, nor to the adequacy of the price to be paid.'
[60] De Geest, above n. 51, at 227.
[61] Id., at 232-233.
[62] Id., at 226.

7 Conclusions

Information deficiencies play an important role in contract enforcement. Courts frequently refuse to enforce contracts when one of the parties lacks information. In that way, a person who lacks information is able to shift the consequences to the other party. When is it appropriate to shift responsibility for information deficiencies from one contracting party to the other?

From an economic perspective, it is appropriate to impose liability on the seller when he can produce, convey or obtain the pertinent information at lower cost, unless the information is entrepreneurial, non-verifiable, already known to the buyer or not valuable for the buyer. The buyer, on the other hand, should bear responsibility for information deficiencies related to his own needs, unless contracting parties are in special relationship of trust. In most cases, people are in the best position to know what their own needs are. It is accordingly the responsibility of each person to act with prudence and invest a certain amount of cognitive effort to ensure that he has thought through his options and selected a product that best meets his needs and desires.In a relationship of trust, on the other hand, the adviser (agent) is contractually bound by a greater duty to inform, including a duty to give information and advice about the principal's needs. Greater intervention on the basis of information deficiencies is therefore warranted for trust relationships.

It is not within the aim of this article to conduct a thorough analysis of existing national laws and doctrines with a view to determining whether they allocate responsibilities for information deficiencies in similar ways as economically-inspired rules and doctrines would. Nevertheless, a preliminary analysis of the DCFR and European regulation on financial transactions reveals that they provide outcomes that largely correspond to those implied by economic analysis.

The economic theory of judicial or legal regulation of contract terms rests on the tendency of people to sign contracts without reading them. The implications of this theory are that courts should set aside (or legislators should prohibit) contract terms that rational, informed parties would never accept but that judicial control is unwarranted in cases where substantive or procedural evidence exists that there is no signing-without-reading problem.