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Title
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Publication Date
2010-04-12

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April 12, 2010

Two Different Kinds of Procedural and Substantive Unconscionability

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Ever since Arthur Leff introduced the concepts,[1] courts and scholars have distinguished between procedural and substantive aspects of unconscionability. To be sure, neither of these concepts can be defined precisely, but the difference in their focus can at least be sketched. Substantive unconscionability refers to the terms of the contract itself (the contract's "substance"), and asks whether those terms are unreasonably favorable to the stronger party. Procedural unconscionability, by contrast, refers not to the contract's terms but to the circumstances in which the weaker party purportedly consented to those terms – in other words, to the "process" by which that apparent consent was obtained. Thus, questions about whether the weaker party truly understood the contract that he signed, or about whether he had any "meaningful choice" in the matter (as one leading opinion put it[2]), are questions about procedural rather than substantive unconscionability.

Obviously, this brief description skates over many crucial issues, such as what makes a contract's terms "unreasonably" favorable (substantive unconscionability), or what makes a party's choice less than "meaningful" (procedural unconscion-

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* William F. Baxter–Visa International Professor of Law, Stanford Law School. This is an extremely preliminary draft; please do not quote or cite it without permission.

1. Arthur Allen Leff, *Unconscionability and the Code – The Emperor's New Clause,* 115 U. Pa. L. Rev. 485, 486–87 (1967).

2. Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965).

ability). Perhaps because there is no consensus on such matters, there is also no consensus as to how these two aspects of unconscionability should be combined in deciding which contract terms will be struck down. While it is often said that a successful unconscionability challenge requires both substantive *and* procedural unconscionability, some courts have held that one or the other by itself may suffice.[3] Others have suggested a kind of sliding scale, in which even a small amount of procedural unconscionability may combine with a high degree of substantive unconscionability to invalidate a challenged clause.[4] But as long as substantive and procedural unconscionability cannot themselves be defined with any specificity, legal tests that turn on the "amounts" or "degrees" of those concepts are difficult to make sense of.

In this paper, I argue that certain forms of procedural and substantive unconscionability are marked by important differences in kind, not merely by differences in degree. First, on the procedural side I distinguish between (1) problems with the agreement process that cannot be corrected cost-effectively, and (2) problems that can and should be corrected. The first category might also be called "procedural unconscionability as market failure," since market failures cannot always be corrected, at least not at an acceptable cost to consumers. On the other hand, the second category can be called "procedural un-

3. Adler v. Fred Lind Manor, 153 Wash.2d 331, 103 P.3d 773 (2004); Maxwell v. Fidelity Financial Services, Inc., 184 Ariz. 82, 907 P.2d 51 (1995).

4. Armendariz v. Foundation Health Psychcare Services, Inc., 24 Cal.4th 83, 6 P.3d 669 (2000); Higgins v. Superior Court, 140 Cal.App.4th 1238, 45 Cal. Rptr.3d 293 (2006).

conscionability as correctable behavior," since this category consists of those problems that could have and should have been prevented – for example, if a seller deliberately lied about her contract, or made her contract *unnecessarily* difficult for customers to understand.[5] Put differently, my second category of procedural unconscionability requires a judicial evaluation of the stronger party's behavior, and a finding that her behavior was wrong, or at least that her behavior should have been altered in some way. By contrast, my first category ("procedural unconscionability as market failure") can be present even if we believe the stronger party should not have behaved any differently than she did.

I further argue that these two kinds of procedural unconscionability have different implications for how substantive unconscionability should be assessed. The mere fact that a market failure could not have been prevented (at an acceptable cost) does not mean that courts should automatically reject any unconscionability challenge, for even an unpreventable market failure is still a market *failure*. It is therefore possible, even in these cases, that courts could help consumers and improve the market's operation by rejecting certain contract terms. In these "market failure" cases, however, rejecting some terms could harm consumers rather than benefit them, depending on the exact mix of costs and benefits produced by the

5. For convenience in the use of pronouns, all of my examples will involve a (stronger) female party who drafted the contract, and a (weaker) male party who is now challenging the enforceability of the contract's terms. I will also occasionally refer to the stronger party as a seller and the weaker party as a consumer – but nothing turns on these labels, and the same analysis would apply if the weaker party were an employee, a franchisee, a tenant, etc.

challenged terms. In these cases, therefore, courts should not strike a contract term without finding that consumers would in fact benefit by eliminating the challenged term. As such a finding will usually require some form of cost benefit analysis (broadly defined), I will call this "substantive unconscionability as cost-benefit analysis of contract terms."

In other cases, though, substantive unconscionability need not require any cost-benefit analysis of the challenged terms. If a court has already made the finding required by my other category of procedural unconscionability ("procedural unconscionability as correctable behavior"), and thus has determined that the stronger party really should have behaved differently than she did, a court can strike down clauses that benefit the stronger party as a way of penalizing that party for her improper behavior – behavior which, by hypothesis, the court has already decided should have been changed. In other words, the purpose (and desired effect) of substantive unconscionability in this set of cases is not to permanently alter the *terms* of contracts, but to deter the stronger party from the particular *behavior* that the court believes should have been altered. In these cases, therefore, contract terms can be struck with very little attention to the costs and benefits of the challenged terms – much as courts already do in cases involving outright fraud or duress, where the resulting contract is unenforceable without regard to its substantive reasonableness. I will call these cases "substantive unconscionability as deterrence," to distinguish them from cases where substantive unconscionability requires closer attention to the costs and benefits of the challenged terms.

In short, my thesis is that procedural and substantive unconscionability cannot be defined independently of one another. Instead, the two concepts interact in important ways, as summarized in the following chart:

Procedural unconscionability as market failure (section I of the paper)	Procedural unconscionability as cost-benefit analysis of behavior (section III)
Substantive unconscionability as cost-benefit analysis of contract terms (section II)	Substantive unconscionability as deterrence (section IV)

The column on the right says that if a court is confident (when it finds procedural unconscionability) that the stronger party should have behaved differently, it can "throw the book" at that party by striking down even otherwise reasonable contract terms, so the inquiry into substantive unconscionability can be brief. But if (as in the left-hand column) a court is unable to say that the stronger party should have altered its behavior in any way, the inquiry into substantive unconscionability must then be more rigorous, to ensure that weaker parties really will benefit from striking the challenged terms. In other words, a court must scrutinize *either* the costs and benefits of the stronger party's behavior, *or* the costs and benefits of the contract terms – but it may not be necessary to scrutinize *both*. The remaining sections of the paper elaborate on these points.

I. Procedural Unconscionability as Market Failure

A. The a priori skeptic's argument

The significance of market failures is best understood in light of the skeptical (or anti-unconscionability) argument to which "market failure" is a possible reply.[6] This argument begins with the premise that in a perfect market – one with no market failures – sellers will offer every contract term that consumers are willing and able to pay for. To be sure, those terms may not necessarily be "fair" according to some external or non-market standard. But even if the terms are grossly unfair, the skeptical argument says that it may still be unwise (and unhelpful for consumers) to strike those terms.

More specifically, this skeptical argument notes that consumers and other weaker parties are rarely made better off – and are very likely to be made worse off – if the law intervenes to make them purchase something they are unwilling or unable to pay for. The argument then claims that this is precisely what will happen if the unconscionability doctrine is applied in a perfect market, because striking terms in a perfect market will leave consumers with a contract that they almost surely were unwilling or unable to pay for. This latter claim rests on the theory that, if consumers had been willing and able to pay for

6. For examples of this argument – each more nuanced than my brief description can do justice to – see Richard A. Epstein, *Unconscionability: A Critical Reappraisal,* 18 J. Law & Econ. 293 (1975); or Michael J. Trebilcock, *The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords,* 26 U. Toronto L.J. 359 (1976).

a contract without the struck terms, a perfect market would have already made such a contract available. If such a contract, then, had *not* previously been available to consumers, that can only be because they were unable or unwilling to pay for it. And in that case (the argument concludes), any mandate that consumers be given such a contract is more likely to hurt consumers than to help them.

Obviously, a key step in this argument is the premise that a perfect market will offer all contracts (and all combinations of contract terms) that consumers are willing and able to pay for. This is the step at which "market failure" can be raised as a response by defenders of the unconscionability doctrine. In markets that are less than perfect, market failures may prevent sellers from offering various contract terms *even if consumers are both willing and able to pay for those terms.* In imperfect markets, then, it is theoretically possible that consumers could be made better off by the unconscionability doctrine, if that doctrine is used to mandate contract terms that consumers would indeed be willing and able to pay for, but which are not currently available to consumers because of the market failures. Of course, the possibility that such terms could exist (without already being available) is exactly the possibility the skeptical argument denies, in markets that are perfect. When markets are imperfect, though, the *possibility* that such terms might exist can no longer be ruled out a priori.

The academic literature on market failures is extensive, and I have nothing to add to that literature here. My own goals, to which I return in section I.C, are merely to show that (1) not all market failures can cost-effectively be prevented, and (2) that

the question of whether any given failure could not have been corrected is largely irrelevant to the use of unconscionability I am discussing here. For some readers, though, these points will be easier to see after I discuss (in sections I.B and I.C) specific examples of market failure. Readers who are already familiar with the literature on market failures should feel free to skip directly to section I.D (on page 25).

B. False or irrelevant market failures

What counts as a market "failure" depends partly on what one expects successful markets to achieve. When considering the unconscionability doctrine – and more particularly, when considering the skeptical argument discussed above – the criterion for success is whether sellers have an incentive to offer every contract term that would leave consumers better off, so that there is nothing left for a court to accomplish by mandating contract terms. The criterion for market "failure," then, is whether there could instead be some contract terms that sellers would *not* have any incentive to offer, even though consumers would benefit from those same terms if the terms were mandated by a court.

Judged by this criterion, some admitted shortcomings of markets should perhaps not be counted as "market failures" at all. For example, it is well-known that markets respond to purchasing power, so the goods and contracts offered in markets will reflect buyers' differential ability to pay. This means that poor buyers with little purchasing power are likely to obtain fewer of the goods that they desire; they may also obtain less favorable contract terms, if (say) they cannot afford the prod-

ucts with the most generous warranties. This differential ability to obtain desirable goods and contracts could easily be called a market "failure," at least from some perspectives, especially if the initial distribution of purchasing power was itself regarded as unjust.[7]

For purposes of responding to the skeptic's argument, however, this sort of market failure is irrelevant. The unconscionability doctrine may be able to mandate more generous contract terms for poor buyers, but it does so without giving those buyers any more money to pay for the more generous terms, and without doing anything else to redress the unjust distribution of purchasing power. Against this kind of "market failure," then, the skeptic's argument has all its original force: Mandating that poor consumers be given terms they are unable to afford is unlikely to help those consumers, and will usually leave them worse off. To be sure, there are some circumstances in which poor consumers could indeed be benefited by mandatory terms – but that will usually be because of *other* shortcomings of the market (as I discuss in section I.C), not because of any "market failure" produced by lack of wealth alone. The point I am making is thus a more general one: even if some feature of a market might count as a "failure" when considering some *other* proposed reform (e.g., a plan to redistribute wealth more broadly) it need not be counted as a market failure when assessing a different, more limited reform.

7. For various versions of this argument (in contexts not involving the unconscionability doctrine), see Edwin C. Baker, *Starting Points in Economic Analysis of Law,* 8 Hofstra L. Rev. 939 (1980); Duncan Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique,* 33 Stan. L. Rev. 387 (1981).

A similar point has been made about several factors sometimes mentioned in court opinions as possible indicia of procedural unconscionability. Courts and commentators sometimes point to the fact that modern sellers are unwilling to negotiate with customers over individual terms of their contract, presenting the contract instead on a "take it or leave it" basis (the so-called "contract of adhesion"[8]). However, the absence of such negotiations does nothing to respond to the skeptical argument – the criterion for market "failure" that I am using here– for it does nothing to increase the likelihood that a term that consumers truly want (and are able to pay for) will nevertheless not be offered on the market. To the contrary, as Lewis Kornhauser in particular has emphasized,[9] the economic theories on which the skeptical argument is based typically assume a total *absence* of individualized negotiations. Pointing out that the real world actually corresponds to that assumption is thus a poor way to attack or respond to those theories. Presumably for this reason, more recent analyses of "contracts of adhesion" often define them so as to require some other market failure, over and above the mere refusal to negotiate.[10]

8. E.g., Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract,* 43 Colum. L. Rev. 629 (1943).

9. Lewis A. Kornhauser, *Unconscionability in Standard Forms,* 64 Calif. L. Rev. 1152 (1976).

10. E.g., Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction,* 96 Harv. L. Rev. 1173, 1176–80 (1983) (defining contracts of adhesion as those which are offered by the seller on a take-it-or-leave-it basis *and* are full of fine print that most buyers are unlikely to understand). This definition thus builds in an additional market failure relating to imperfect buyer information, which I will discuss infra in section I.B.3.

Finally, the same can be said of at least some references to "unequal bargaining power" as a possible market failure. This issue is more complex, for there is no standard definition of unequal bargaining power, with the result that that phrase is used to refer to many different things. Sometimes it refers to actual monopoly power on the part of the seller, and sometimes it refers to limited information on the part of the buyer; since each of these is a real and potentially relevant market failure, I discuss them separately in section I.B. To the extent, however, that "unequal bargaining power" means anything other than these – for example, if it refers to differences in size or wealth between buyers and sellers, or to the fact that buyers need the product or cannot afford to do without it – these are irrelevant as market failures (for my purposes) for the same reason that a take-it-or-leave-it bargaining posture is irrelevant. That is, the economic theories on which the skeptical argument relies do not themselves presuppose that buyers and sellers have equal size or wealth, or that their bargaining power is "equal" in any other sense. As a consequence, pointing out that buyers and sellers are *not* always equal in these respects does nothing to respond to the skeptic's argument.[11]

11. For similar criticisms of "unequal bargaining power" as a useful concept in thinking about unconscionability, see Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, With Special Reference to Compulsory Terms and Unequal Bargaining Power,* 41 Md. L. Rev. 563 (1982); and Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability,* 70 U. Chi. L. Rev. 1203, 1259–68 (2003).

C. Potentially relevant market failures

Accordingly, I now turn to the factors that respond to the skeptical argument on its own terms, by explaining why there could be contract terms that would in fact leave buyers better off (if such terms were mandated by a court), but which nevertheless will not be offered by sellers who respond only to market incentives. These are the "market failures" that are potentially relevant to unconscionability, and there are many that economists have identified. To be sure, most formal economic analyses address the effect of market failures on *product quality,* rather than on the contract terms that accompany a product. But this difference is insignificant: the contract terms (good or bad) that accompany a product can be thought of as simply one more dimension of that product's "quality," so economic analyses of product quality carry over quite easily to the analysis of contract terms.[12]

1. Imperfect buyer information. I begin with the market failures that can occur when buyers are not perfectly informed about sellers' contract terms. In the simplest case, a buyer who does not understand the difference between two sellers' contracts might just make a mistake, rejecting the better of the two contracts and choosing instead the contract that was less well-suited to his preferences or needs. In such a case, we could no longer assume (as the a priori skeptic would have it) that this buyer could only be made worse off if a court were to mandate

12. This similarity between contract terms and product quality has also been noted in the legal literature – most famously, of course, by Arthur Leff. Arthur Allen Leff, *Contract as Thing,* 19 Am. U. L. Rev. 134 (1970).

the terms of the other contract instead.

Other consequences of imperfect information are more subtle, for they can affect the mix of terms that become available on the market (rather than altering a buyer's choice from among the existing alternatives, as in the preceding paragraph). Specifically, suppose buyers are perfectly informed about differences in the price that different sellers charge, but they are less than perfectly informed about differences in different sellers' contract terms. Suppose further that buyers' imperfect information about contract terms leads them to underestimate the significance of any differences between different contracts. In the extreme case, suppose buyers believe (not necessarily correctly) that "all contracts are pretty much the same."[13]

In such a market, each seller could make her product appear more attractive to buyers by offering less generous contract terms – say, a limited warranty that reduces the seller's costs by shifting more risks to buyers – while simultaneously reducing the price of her product, to reflect the reduction in her costs. To be sure, sometimes this combination of a lower price and less generous terms might be what buyers truly prefer – but it is also possible that the new combination might sur-

13. For formal economic models of these informational conditions (with respect to product quality rather than contract terms), see Michael Spence, *Consumer Misperceptions, Product Failure and Producer Liability,* 44 Rev. Econ. Stud. 561 (1977), and George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism,* 84 Q.J. Econ. 488 (1970). Spence's model assumes only that buyers underestimate by *some* amount the difference between different sellers' qualities. Akerlof makes the more extreme assumption that buyers believe any difference between sellers to be zero.

vive even if in fact it was *not* the combination buyers preferred. Instead, buyers whose imperfect information took the form posited above could incorrectly *perceive* the new combination to be an improvement, because these buyers would be perfectly informed about the benefits of the new combination (the reduction in the price) but would underestimate the drawback of the new combination (the less generous contract terms). And if all buyers shared this pattern of misperception, competitive pressures could then force *every* seller to switch to the apparently more attractive combination, with the result that a combination that was truly better for buyers (one with a higher price but more generous contract terms) could nevertheless disappear from the market entirely. In George Akerlof's memorable phrase, we could be left with a "market for lemons" in which only inferior contracts were available to buyers.[14]

Notice, by the way, that this form of imperfect information can be present even if not a single buyer misperceives the costs of the contract he actually signs.[15] Indeed, if competitive pressures do cause all combinations but an inferior one to disappear from the market, buyers might then be 100% accurate in

14. Akerlof, supra note 13. In the law-and-economics literature, discussions of this form of imperfect information (and its relevance to the unconscionability doctrine) include Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand,* 17 J. L. & Econ. 461 (1974); Kennedy, supra note 11, at 597–603; Avery W. Katz, *Your terms or mine? The duty to read the fine print in contracts,* 21 RAND J. Econ. 518 (1990); and Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines,* 60 U. Chi. L. Rev. 1, 49–50 (1993).

15. Both the Akerlof and the Spence model (cited supra in note 13) involve buyers' beliefs that are entirely accurate in equilibrium.

assmuing that "all [remaining] contracts are pretty much the same." The problem, instead, is that buyers might not be perfectly informed about other contracts that will never be offered in equilibrium (contracts that are "off the equilibrium path") – and the reason those other contracts will not be offered is precisely because buyers' misperceptions would make those contracts unprofitable for sellers to offer.

Notice, too, that this form of market failure need not result in sellers reaping excess profits from their less generous contract terms. To the contrary, as long as buyers are accurately informed about sellers' *prices* (as posited above), sellers' competition to make sales should lead prices to fall until any excess profits have been dissipated and each seller is earning a normal rate of return. The problem, though, is that even if buyers are paying a fair price for what they are getting, they are not necessarily getting the combination of price and terms that they would prefer. If so, then it is indeed possible (at least theoretically) that courts could make buyers beetter off by mandating terms that were not currently being offered by the market. This possibility, of course, is exactly what a "market failure" argument must show to respond to the a priori skeptical argument discussed earlier.

2. Imperfect buyer rationality. More recent work in behavioral law and economics emphasizes the possibility that buyers, even if they have all the right information, may not act rationally in assessing the significance of contract terms. For example, buyers may systematically underestimate the likelihood of certain low-probability events, such as the likelihood of a defect that would trigger a limited warranty; or they may

underestimate the likelihood that they themselves will ever default on the contract, thus leading them to discount the risk that they will ever have to pay a penalty or termination fee.[16]

If buyers are imperfectly rational in this way, the effects can be similar or even identical to those described in the preceding subsection dealing with imperfect information. In particular, if buyers are perfectly rational in their ability to understand a product's price (usually a more salient feature of any deal), and if their irrationality leads them to discount the significance only of other, *non-price* terms, the resulting competitive dynamic will be exactly the same as that described in the Spence or Akerlof models. That is, buyers will be incorrectly attracted to a combination of a lower price (fully perceived by buyers) and less generous non-price terms (irrationally discounted by buyers), so sellers who offer such a combination will attract more customers. In the extreme case, competitive pressures may lead to another "market for lemons" in which all sellers offer the apparently more attractive combination, even if the opposite combination (high price and more generous non-price terms) would be more attractive to buyers whose rationality wasn't clouded. Thus, in this case too it is possible that buyers could be better off if courts were to mandate contract terms not currently available on the market.

16. Examples of this argument include Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contracts,* 47 Stan. L. Rev. 211 (1995); Oren Bar-Gill, *Seduction by Plastic,* 98 Nw. U. L. Rev. 1373 (2004); and Korobkin, supra note 11. For a more formal economic model, see Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law,* in A. Mitchell Polinsky & Steven Shavell (eds.), Handbook of Law and Economics (Elsevier, 2007), vol 1, at 40–46.

3. Imperfect seller information. Less obviously, perhaps, imperfect information on the part of *sellers* may also lead markets to generate less-than-efficient contract terms, through what is sometimes called a signalling equilibrium.[17] This can occur if buyers differ in the risks they bring to a transaction – for example, if some buyers are more likely to default on a contract than others. If so, sellers would prefer to know each buyer's riskiness so they could refuse to deal with the especially risky ones (or charge them a higher price to cover the extra risk). If, however, sellers lack reliable information about buyers' risks, it will be hard for sellers to make such adjustments.

This is where signalling may play a role. If certain contract terms are known to be especially attractive to high-risk buyers, or if other terms are attractive to low-risk buyers but relatively unattractive to high-risk buyers, sellers may realize that contracts containing those terms are more likely to be agreed to by high-risk than by low-risk buyers (or vice versa). In effect, a buyer's willingness to agree to such a term could "signal" to the

17. For formal economic models see, e.g., Janusz Ordover & Andrew Weiss, *Information and the Law: Evaluating Legal Restrictions on Competitive Contracts,* 71 Am. Econ. Rev. Papers & Proceedings 399 (1981); Samuel A. Rea, Jr., *Arm-Breaking, Consumer Credit, and Personal Bankruptcy,* 22 Econ. Inquiry 188 (1984); Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency,* 6 J. L., Econ., & Org. 381 (1990); and Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach,* 9 J. L., Econ., & Org. 230 (1993). Less technical discussions include Douglas G. Baird, Robert H. Gertner & Randal C. Picker, Game Theory and the Law 142–147 (1994); and Richard Craswell, *Freedom of Contract,* in Eric A. Posner (ed.), Chicago Lectures in Law and Economics (2000).

seller something about that buyer's likely risk level. This information, in turn, could help the seller fine-tune her decisions about what price to charge, or whether to accept that contract at all.

To be sure, it is not necessarily against buyers' interests to have sellers to use contract terms as signals. In particular, low-risk buyers can benefit from this practice if it helps sellers recognize them as posing a lower risk, and thus allows sellers to deal with them at a lower price. By comparison, sellers who lack any such signals (and who lack other reliable information about buyer risks) can do no better than to charge all buyers an average price reflecting an average level of risk. For low-risk buyers, this average price can easily be worse than the lower price they might otherwise pay in a separating equilibrium.

For the same reason, though, the use of signalling terms can sometimes be disadvantageous to buyers whose risks are greater than average. Moreover, some signalling terms could even leave *all* buyers disadvantaged, so that buyers as a class would benefit if those terms could be banned. After all, any given signal can have costs as well as benefits, and the fact that a particular signalling term is widely or even universally used does not mean that its benefits must necessarily outweigh its costs (as the skeptical argument would conclude in a market with perfect information). To the contrary: a signalling term that is so widely used that *all* buyers agree to it would not effectively distinguish between low-risk and high-risk buyers, so that term would produce no signalling benefits at all. However, such a term might nevertheless continue to be used, if any buyer who rejected that term would thereby be identified as

a higher-than-average risk and charged a higher price. The problem, in a nutshell, is that signalling terms can be perfectly rational for individual buyers who use them to obtain a purely positional benefit ("I'm lesss risky than that other buyer is") – so they can still be individually rational even if their effect on buyers as a class is negative.

4. Monopoly sellers. Perfect markets are usually said to require perfect competition, so the idea that monopolies can cause markets to fail is a familiar one. In particular, having a monopoly may enable a seller to charge prices that are higher than efficiency would dictate. Thus, if we were debating whether consumers could benefit if courts regulated sellers' *prices*, the presence (or absence) of a monopoly would indeed be significant.

In most unconscionability cases, however, the issue is not whether the seller's price should be regulated, but whether the court should strike one or more of the seller's *non-price* terms. In debating this question, the relevance of monopoly power is more complex. Under some conditions, a monopolist profits most by offering exactly the terms that buyers most prefer, for this will make her product as attractive as possible to buyers and will thus allow her to charge an even higher price. When these conditions hold, it might be unwise for a court to mandate some other term instead, because that other term would likely be one that buyers do not prefer (if they did prefer it, the seller would already be offering it). In other words, under some conditions the presence of a monopoly does nothing to defeat the premises of the skeptical, anti-unconscionability argument.

Under other conditions, though, a monopolist could in-

deed have an incentive to choose terms that are less than ideal for her buyers.[18] This possibility arises because of what is in essence another signalling problem, based (again) on imperfect information by the seller. Specifically, monopolist sellers usually profit most if they can practice price discrimination, charging the highest prices to those buyers who value their product most, while charging lower prices to those who otherwise might not purchase the product at all. But many monopolists may have difficulty knowing which buyers are the ones who desire their product the most, unless they can find contract terms that will be differentially attractive to buyers who place a high or a low value on the product – or, in other words, unless they can find contract terms that will serve as a reliable signal of how much buyers value the product. If contract terms can be found that would serve as a reliable signal, sellers may then profit by insisting those terms, even if the terms' other benefits (apart from whatever they contribute to more effective price discrimination) are less than the terms' costs. In that case, it is *possible* that buyers as a whole would benefit if courts were to forbid the use of those terms.

It should be noted, though, that the terms that might be

18. For formal economic models (focusing mostly on product quality rather than on contract terms per se), see A. Michael Spence, *Monopoly, Quality, and Regulation,* 6 Bell J. Econ. 417 (1975); Richard Schmalansee, *Market Structure, Durability, and Quality: A Selective Survey,* 17 Econ. Inq. 177 (1979); David Besanko, Shabtai Donnenfeld & Lawrence J. White, *Monopoly and Quality Distortion: Effects and Remedies,* 102 Q.J. Econ. 743 (1987); and Steven Matthews & John Moore, *Monopoly Provision of Quality and Warranties: An Exploration in the Theory of Multidimensional Screening,* 55 Econometrica 441 (1987).

banned (under any of the signalling theories) will not necessarily be those that are "harshest" on buyers, in the sense of leaving buyers with fewer rights or requiring buyers to bear more of the risks. Instead, there might be some cases in which the only way to benefit buyers as a class would be to prohibit certain clauses that were overly *generous* to buyers. For example, if a monopolist could better sort its customers by offering a liquidated damage clause exposing the monopolist to large damage liabilities (in the event that the monopolist breached), it is possible that buyers could be made better off only if the courts ordered the monopolist to adopt a less generous damage liability instead.[19]

I should add, though, that in both of these signalling models it may be difficult to figure out whether buyers will in fact benefit from a ban on certain terms. Imperfect price discrimination can produce conflicting welfare effects, which makes it difficult to judge the effects on buyers of any particular instance.[20] Moreover, if some signalling terms are banned, sellers

19. For formal models with this property, see Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Default Rules,* 100 Yale L.J. 615, 661–664 (1990); and Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules,* 101 Yale L.J. 729, 744 (1992). Similarly, the articles by Spence; by Besanko, Donnenfeld and White; and by Matthews and Moore (cited supra in note 18), all left open the possibility that buyer welfare might in some cases be improved by requiring the monopolist to produce a *lower* quality of product (or *less* generous contract terms) than she would otherwise prefer to offer.

20. Basil Yamey, *Monopolistic Price Discrimination and Economic Welfare,* 17 J. L. & Econ. 377 (1974); Richard Schmalensee, *Output and Welfare Implications of Monopolistic Third-Degree Price Discrimination,* 71 Am. Econ. Rev. 242 (1981).

may fall back on other, less perfect signals, which could leave buyers either worse off or better off as a result. Alternatively, if no other reliable signals are available, sellers might respond by adopting an less informed pricing method – say, by charging all buyers the same average price, with no discrimination for differences in risk or differences in demand – and this, too, may leave buyers either better off or worse. In a nutshell, the difficulty is that banning certain contract terms does not by itself do anything to eliminate the underlying problems of monopoly power and/or imperfect seller information. This makes it difficult to predict whether the next best response by the monopolist or the uninformed seller will in fact leave buyers better off.

5. *Economies of scale and buyer heterogeneity.* Finally, there is one other possible "market failure" that does not depend on imperfect information at all. If buyers differ in the contract terms that they prefer, and if economies of scale prevent sellers from customizing their contracts (or any other relevant features of the deal) for each group of buyers separately, then whatever terms sellers offer will necessarily be a compromise, pleasing some buyers but not others. In such a market, there is no guarantee that the compromise that maximizes the seller's profits will necessarily be the one that maximizes the satisfaction of buyers as a class. As a result, it would again be theoretically possible for buyers' welfare to improve if courts were to order sellers to adopt some compromise other than the one that sellers actually chose.

The economics of this issue are complex,[21] but the basic point is that sellers, if left to choose their own contract terms, will profit by choosing the terms that attract the most buyers (at any given price). This means that sellers will be acutely sensitive to the preferences of the *marginal* buyers: the ones who are just on the fence as to whether to buy the product or not, and whose decision could therefore be affected by the seller's choice of contract terms. At the same time, sellers can largely ignore the preferences of the inframarginal buyers, for these are the ones who will buy the product regardless of what terms the seller chooses (within reason). However these inframarginal buyers will still be affected by the seller's choice of contract terms, so any attempt to judge the effect on buyers as a class should consider the effect on both kinds of buyers. Of course, if both kinds of buyer have identical preferences concerning contract terms, any decision the seller makes to satisfy the marginal buyers will necessarily satisfy the inframarginal buyers as well, so we will not have to worry about a market failure. But if the marginal and inframarginal buyers differ in their preferences for contract terms, the terms chosen by the seller (to

21. For more technical economic discussions (focusing on product quality rather than on contract terms), see Michael Spence, *Product Differentiation and Welfare,* 66 Am. Econ. Rev. Papers & Proceedings 407 (1976); Avinash K. Dixit & Joseph Stiglitz, *Monopolistic Competition and Optimum Product Diversity,* 67 Am. Econ. Rev. 297 (1977); Kelvin Lancaster, Variety, Equity and Efficiency: Product Variety in an Industrial Society (1979). The argument that this might justify judicial regulation of contract terms – though framed in terms of antitrust law rather than the unconscionability doctrine – is advanced in William S. Comanor, *Vertical Market Restrictions and the New Antitrust Policy,* 98 Harv. L. Rev. 983, 986–90 (1985).

appeal to the infra-marginal buyers) may not be the terms that maximize the welfare of buyers as a whole. In this case, too, we cannot rule out the possibility that buyers as a whole could benefit if courts invalidate certain terms.

The relationship between marginal and inframarginal buyers is also important in another way, for it influences the price that sellers will charge if new contract terms are mandated. As discussed above, it is usually difficult to make buyers better off by mandating a term that buyers are either unwilling or unable to pay for. If, however, different buyers differ in their willingness to pay for a term, and if the inframarginal buyers all value that term more highly than the marginal buyers do, mandating the term could then leave some or all of the inframarginal buyers better off.[22]

The reason has to do with the price that sellers will charge if additional terms are mandated. Sellers' ability to raise prices usually depends on the preferences of the marginal buyers, since (by definition) they are the ones whose purchases will be lost if the price increase is too large. But any price increase that leaves marginal buyers just indifferent to the mandatory term must leave inframarginal buyers better off than they were before the mandate, *as long inframarginal buyers all value the new term equally or more highly than marginal buyers do.*[23] Granted,

22. For an early (and still influential) instance of this argument, see Bruce Ackerman, *Regulating Slum Housing Markets on Behalf of the Poor: Of Housing Codes, Housing Subsidies, and Income Redistribution Policy,* 80 Yale L.J. 1093 (1971). For a more recent discussion, with citations to the now extensive literature, see Richard Craswell, *Passing On the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships,* 43 Stan. L. Rev. 361, 372–83 (1991).

23. As others have pointed out, and I discuss at more length elsewhere (id.

this assumption may not hold in very many real markets – but when it does, those markets could provide another case in which mandating terms could leave the inframarginal buyers better off.

In short, there are a number of possible "market failures" that might lead sellers to adopt terms that are less than ideal for at least some buyers, and thus a number of *possible* situations in which we cannot reject the unconscionability doctrine a priori (as the skeptical argument would have us do in perfect markets). The next two sections of the paper advance two points about this collection of market failures. First, section I.C makes the small but important point that many of these market failures have nothing to do with any bad behavior on the part of sellers. Next, section II of the paper argues that even when one of these market failures is present, courts still should not strike down any challenged term without an extended and rigorous examination of substantive unconscionability – quite possibly a more rigorous examination then any court is capable of performing.

D. Market failures and sellers' behavior

I begin, though, with the smaller point. Much as we may want a villain to blame for every problem we face, the fact is that many of the "market failures" described above are not due to any undesirable behavior by sellers. This is not to say that sellers are incapable of contributing to market distortions, for they certainly are (and I consider those cases later, in section

at 380–83), this assumption is crucial to the 1971 Ackerman argument.

III). My point here, though, is that many market failures are *not* the result of improper seller behavior – so a showing that no seller has behaved improperly will not suffice to refute or negate the market failure.

For example, consider the market failures that might arise when one seller has a monopoly (discussed in section I.B.4). While some monopolies may be unnecessary, or even illegitimately acquired, others are "natural monopolies" that cannot be prevented (e.g., if there is only one feasible spot for a bridge across a river), or cannot be prevented except at an unacceptable cost (perhaps we could build two competing bridges, side by side, but that would double the total construction costs). Similarly, heterogeneous buyer preferences may sometimes lead to market failures (as discussed in section I.B.5), but few would suggest that *those* failures could or ought to be prevented by somehow persuading buyers to all hold identical preferences instead. In these cases, a showing that no seller had done anything that contributed to the market failure would be entirely beside the point. In particular, such a showing would do nothing at all to negate the possibility that makes market failures of interest – i.e., the possibility that some or all buyers might be made better off if courts were to mandate a particular contract term.

Market failures based on imperfect information or buyer irrationality (sections I.B.1 through I.B.3) are more complex. Inadequate information can sometimes be cured or reduced through mandatory disclosures – for example, sellers could do

more to try to inform buyers about their contract terms[24] – and some forms of irrationality might be correctable through better consumer education, or just by changing the format in which information is presented to consumers.[25] However, information is often costly to communicate, both in terms of its direct costs and in terms of the time and effort buyers spend attending to these communications.[26] Thus, while is is true that sometimes sellers could do *more* to convey information effectively, in some cases we may still have market failures after sellers have made all the effort we would want them to make.

I mention this point in part to distinguish these cases from those where sellers have indeed made inadequate effort, which I discuss later in section III. But this point is also important because it has not always been understood by courts, who sometimes write as if the absence of seller misbehavior must mean that the market is working perfectly.

For example, in the Supreme Court's *Carnival Cruise* de-

24. As one writer has asserted, "A seller of a product which is accompanied by a standard form can make a buyer's expectations on any point as clear as the seller wants them to be. The seller could clearly advertise what a buyer should expecct, for example, or he could cleaerly state what the buyer was getting in a standard form which the seller took steps to insure was actually read and understood by the buyer…." W. David Slawson, *Mass Contracts: Lawful Fraud in California,* 45 S. Cal. L. Rev. 1 (1974).

25. For discussions of this possibility, see Christine Jolls & Cass R. Sunstein, *Debiasing Through Law,* 35 J. Legal Stud. 199 (2006) and the literature cited there.

26. As Jolls and Sunstein (id.) certainly recognize. For further discussions of these trade-offs, see Richard Craswell, *Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere,* 92 Va. L. Rev. 565 (2006) and the literature cited there.

cision,[27] the Court rejected passengers' challenge to the enforceability of a forum selection clause, which would have required passengers to go to Florida to litigate any tort claims against the cruise company. In upholding the validity of the forum selection clause, the Court did not consider any possible market failures based on inadequate information – for example, the "market for lemons" argument discussed supra in section I.B.1 – apparently in the belief that the passengers had waived those arguments. What the passengers actually said, however, was that they did "not contest … that the forum selection clause was reasonably communicated to the respondents, *as much as three pages of fine print can be communicated.*"[28]

This passage clearly highlights the difference between finding a market failure, and finding that a seller has behaved improperly in some way. That is, it may well be true that the cruise company in this case had done all that we would want them to do to publicize the forum selection clause and call it to their customers' attention, especially since there were doubtless many other clauses in those three pages of fine print that could also have been given more prominent disclosure. Truly *full* disclosure might include things like giving every potential buyer a short course in civil procedure and personal jurisdiction, so they could understand the significance of a forum selection clause – but let us stipulate that it is not a bad thing if sellers stop somewhere short of that point.[29] Even if we

27. Carnival Cruise Lines, Inc., v. Shute, 499 U.S. 585 (1991).

28. Id. at 590, quoting the Respondents' Brief at 26 (emphasis added).

29. I discuss the factors involved in that judgment at more length in Craswell, *Taking Infomation Seriously,* cited supra in note 26.

agree, though, that sellers should stop short of that point, it hardly follows that the level of disclosure attained at the optimal stopping point must be enough to prevent a "market for lemons" (or any other market failure). In some cases, the best that can practicably be done may not be good enough to prevent a market failure, because some market failures may be practicably unpreventable.

In another leading case,[30] computer buyers challenged the enforceability of a clause that would have required them to submit to arbitration any disputes they might have with the seller. The arbitration clause came packaged in the box along with other documents when the computer was delivered, but that clause had not been mentioned during the earlier phone conversation in which the buyers had placed their orders. Rejecting the argument that the arbitration clause should not be enforceable if it was not disclosed orally during the phone conversation, Judge Frank Easterbrook reasoned as follows:

> Practical considerations support allowing vendors to enclose the full legal terms with their products. Cashiers cannot be expected to read legal documents to customers before ringing up sales. If the staff at the other end of the phone for direct-sales operations such as Gateway's had to read the four-page statement of terms before taking the buyer's credit card number, the droning voice would anesthetize rather than enlighten many potential buyers. Others would hang up in a rage over the

30. Hill v. Gateway 2000, Inc., 105 F.3d 1147 (1997).

> waste of their time. And oral recitation would not avoid customers' assertions (whether true or feigned) that the clerk did not read term X to them, or that they did not remember or understand it.... Customers as a group are better off when vendors skip costly and ineffectual steps such as telephonic recitation, and use instead a simple approve-or-return device. Competent adults are bound by such documents, read or unread.[31]

Here, too, let us assume that Judge Easterbrook is right that it would not have made sense for the seller to make any more advance disclosure than it actually made, if the costs of greater telephonic disclosure would have outweighed its limited benefits. In other words, let us assume that if the case were to arise again, we would not want the seller to alter anything at all about its selling techniques. Nevertheless, this assumption does not preclude the possibility that the market for mail-order computers might be marked by an informational market failure. Just as in the *Carnival Cruise* case, "the best that should practicably be done" will not necessarily be the same as "good enough to make the market work perfectly."

In fairness, this computer case was litigated under the doctrines of offer and acceptance rather than being litigated under the doctrine of unconscionability, so Judge Easterbrook may have had no reason to be thinking in terms of potential market failures. It is also possible that Judge Easterbrook (and the

31. Id. at 1149.

Supreme Court in *Carnival Cruise*) may have been implicitly thinking of a different kind of procedural unconscionability: the kind that *does* require seller misconduct, which I discuss infra in section III. But this is precisely the point of my paper: that there is a significant difference between the kind of procedural unconscionability that rests on actual seller misconduct, and the kind of procedural unconscionability that rests on marketwide conditions that are practicably beyond any single seller's control. While either or both of these may satisfy the procedural aspect of an unconscionability test, their implications for the substantive aspect of that test are dramatically different … as I now propose to show.

II. Substantive Unconscionability as Cost-Benefit Analysis of Contract Terms

A. Substantive unconscionability in theory

In this section, I will assume that a market is characterized by one of the market failures discussed earlier, in section I.B. Given how we have defined "market failure," this means that it is at least *possible* that consumers in this market could benefit if courts were to strike one or more of the contract terms drafted by sellers. But which terms should the courts strike?

The answer should not be "all of them," for the presence of a market failure does not imply that consumers are made worse off by every term that a seller drafts. Put differently, a market failure may be a *necessary* condition for buyers to benefit from striking a contract term, but it can hardly be a *sufficient* condition. Even in imperfect markets, some terms may be

perfectly reasonable ones, like (say) a clause excluding from a car's warranty coverage any damage that was deliberately self-inflicted by the buyer. If a clause like that were ruled unenforceable, then (even in an imperfect market) sellers would have to raise their prices to reflect the additional warranty coverage. As a result, buyers who don't intentionally damage their cars would end up paying extra, to pay for the warranty coverage of those buyers who do.

This point is more general, for almost all clauses that are challenged under the unconscionability doctrine would, if they were struck, impose costs as well as benefits on buyers. The benefits to buyers are usually obvious – for example, if a limit on warranty coverage is struck down, buyers will benefit from being able to collect more often on their warranties; and if a ban on class actions or class arbitration is struck down, buyers will more often be able to participate in classwide suits, at what should be a lower cost than bringing individual litigation. The problem, though, is that any benefit to buyers will often count as a cost to sellers – for example, if sellers end up having to pay out more often on their warranty coverage; or if they are subjected to greater number of class actions, and end up paying out more in judgments or settlements. As each of these will increase sellers' costs, they can also be expected to increase sellers' prices, at least over the long run. And if buyers do have to pay higher prices, that will impose a real cost on buyers as well.

This, in turn, can make it hard to determine whether buyers get any *net* benefit if a court strikes the challenged term. Of course, the mere fact that prices rise does not by itself imply that buyers do not benefit on balance, for buyers will also be

getting something if the term is struck: they will get a more generous warranty, for example, or a greater right to benefit from class-wide dispute resolutions. In some cases, those extra rights might be worth enough to buyers to outweigh the higher price they will pay – a result that will be particularly likely if the extra rights produce overall efficiency benefits, such as a better allocation of risks between buyers and sellers, or more optimal incentives for sellers to take care in designing and producing their products.

In other cases, though, the extra rights may *not* be worth the higher prices that buyers will have to pay – a result that is particular likely if the extra rights produce efficiency *losses*, by (say) creating incentives for moral hazard on the part of consumers, or by increasing litigation costs beyond any benefits those costs might produce. In short, giving buyers additional rights (at the cost of a higher price) can easily leave buyers better off on balance or worse off on balance. The only way to predict whether buyers are likely to benefit in any particular case is to try to assess those costs and benefits directly, in some form of cost-benefit analysis of the challenged term.

Indeed, in many cases the problem will be more complicated than merely assessing the direct costs and benefits of a given clause. The added complication comes from the fact that we are trying to make that assessment in a market that is imperfect in some way, and most market failures or imperfections introduce additional complications of their own. If the seller is a monopolist, for example, the new price she will charge (if one of her terms is banned) will be different – possibly higher; possibly lower – than the price that would be charged in a compe-

titive market, and this difference will have to be taken into account in determining whether buyers are likely to benefit on balance from striking the clause.[32]

Alternatively, if the market failure stems from imperfect buyer information (or imperfect buyer rationality), those imperfections may complicate *buyers'* responses if the challenged clause is struck. For example, even if perfectly informed buyers would in fact benefit (on balance) from a more extensive warranty, uninformed or irrational buyers may not realize they are gettting a more extensive warranty, or they may over- or underestimate the significance of that warranty. As a result, these buyers may incorrectly stop purchasing the product (if they fail to realize that they're getting a more generous warranty for the now-higher price); or they may alter their other behavior in undesirable ways, such as failing to adjust the precautions they take or the amount of other insurance they buy.[33] This, too, will make it harder to judge whether buyers would truly benefit on balance if a challenged clause were to be struck.

In short, while it is theoretically possible (in imperfect markets) for buyers to benefit if a contract term is struck, it may not be at all easy to determine whether buyers would in fact benefit in any given case. This naturally raises questions about whether courts are even capable of conducting the kind of cost-benefit analysis that would be necessary to make such

32. See the economic articles cited supra in note 18.

33. For formal models of these effects, see Rea, supra note 17; and Samuel A. Rea, Jr., *Workman's Compensation and Occupational Safety Under Imperfect Information,* 71 Am. Econ. Rev. 80 (1981). A less technical discussion can be found in Craswell, supra note 22, at 391–95.

decisions. As Benjamin Hermalin and Michael Katz concluded (with reference to market failures involving signaling):

> By restricting the set of possible contracts, the courts can eliminate certain kinds of signaling – and their associated distortions – thereby restoring efficiency. How one would practically implement a rule of judicial modification based on this kind of informational asymmetry is, however, an open question.[34]

To answer that question, we can only look to cases in which courts have attempted to balance the relevant costs and benefits, to see how good a job the courts have done.

B. Cases applying a cost-benefit analysis to contract terms

There are no such cases. Or if there are, they must be few, as I haven't found them so far. Most opinions don't explicitly recognize that there *are* any relevant costs and benefits, much less try to compare them in any way. [35] [This section will be expanded, or not, based on what further research reveals.]

34. Hermalin & Katz, supra note 17, at 248–49. For similar concerns about judicial competence more generally (beyond the context of signalling models), see Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis,* 127 U. Pa. L. Rev. 630, 678–82 (1979). Similar concerns are discussed in, e.g., Craswell, supra note 14, at 29–31; Korobkin, supra note 11, at 1247–54; and Kennedy, supra note 11, at 603 ("It all depends on empirical information that nobody seems to have.").

35. For criticisms of the existing case law on this point, see Korobkin, supra note 11, at 1273–77; or Stephen Ware, *Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements,* 2001 J. Dispute Res. 89 (2001).

C. *The one-sidedness test*

Instead, courts usually talk about substantive unconscionability as a function of the "one-sidedness" of the challenged term, with unconscionable terms being those that are unreasonably one-sided. The vagueness of a term like "unreasonable" is of course obvious – but this test is also deficient in two other ways, at least if we are concerned about market failures.[36]

First, the test is underinclusive, for in markets characterized by market failure there is no reason courts should limit their attention to clauses that favor *sellers*. To the contrary, at least some of the market failures discussed above imply that buyers could also be made better off if courts banned some clauses that appear to favor *buyers*.[37] Thus, if the goal of unconscionability is really to mandate terms that could leave buyers better off, there is no reason to restrict courts' attention to only half of the potentially relevant terms.

Second, any test based on one-sidedness will also be overinclusive – or else it will be seriously indeterminate, depending on how finely particular terms are individuated. For example, if one term offers buyers additional warranty coverage, but at the same time limits the amount buyers can recover under the warranty, should we treat that clause as not being one-sided at all, because it gives buyers something they would not otherwise have? Or can we separate this clause into two components, and treat the second component (the part limiting buy-

36. I will consider a different possible justification for this test in section IV.

37. See especially the discussion of monopoly power (section I.C.4) and imperfect seller information (section I.C.3).

ers' recovery) as being one-sided, because that part *taken by itself* benefits only the seller? Separating terms into arbitrarily small components can lead to absurdity, for even a term requiring the buyer to pay something for a product is "one sided" in a formal sense, if we isolate it from the seller's return obligation to actually deliver the product. But if we say instead that some components *cannot* be isolated in this way, there is then no obvious place to draw the line, other than (perhaps) refusing to look at individual terms at all, and requiring courts to evaluate the entire contract taken as a whole. But this kind of overall evaluation is something courts have been unwilling to do – and in any case, an evaluation of the contract *as a whole* would not help courts figure out whether buyers would benefit if any *particular terms* in the contract were banned. In the end, the only way to answer that question is to conduct an actual cost-benefit analysis of the sort described earlier in section II.A.

D. The pragmatic skeptic's argument

If courts are unwilling or unable to evaluate the costs and benefits of particular contract terms, as the preceding section might suggest, that could provide the basis for a different sort of skeptical or anti-unconscionability argument.[38] The skeptical argument considered earlier was an a priori argument,

38. See, for example, Schwartz & Wilde, supra note 34. Similar skepticism about court decisions under one line of cases involving the "reasonable expectations" doctrine – a doctrine that has much in common with unconscionability – can be found in Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured,* 67 Va. L. Rev. 1151 (1981).

which held that (in perfect markets) it would not even be *possible* for courts to make buyers better off by striking contract terms. This second argument, by contrast, rests on a more pragmatic skepticism, which questions courts' ability to *succeed* in making buyers better off (even in markets where such improvements would be theoretically possible).

In sections III and IV of the paper, however, I consider an alternative version of the unconscionability doctrine that eliminates the need for courts to evaluate the costs and benefits of particular contract terms. Instead, in this version courts must evaluate the costs and benefits of the seller's marketing and negotiating behavior, and should find procedural unconscionability only if the court concludes that the seller's behavior should have been altered in some way. If so – and if the court is confident in this conclusion – the court can then proceed to strike down almost any clause that benefits the seller, without a rigorous analysis of substantive unconscionability.

III. Procedural Unconscionability as Cost-Benefit Analysis of Seller Behavior

Imagine a contract containing a term with the potential to impose costs on the buyer. Suppose that the contract is a long one, which consumer buyers typically do not read; and suppose also that the seller did nothing to highlight that term or draw it to buyers' attention. Suppose further that a court subsequently finds that the seller could have done more than it did to inform buyers about this term, *and that it would have been efficient for the seller to do so.* And suppose, finally, that the court reaches this last conclusion only after careful analysis of *all* the

costs and benefits associated with greater disclosure – including, perhaps, the risk that greater disclosure might have had no effect (if consumers paid no attention to it); or the risk that disclosure about one term might make matters worse by overloading consumers' attention spans, or by distracting them from other information about terms that might have been even more significant.

In such a case, we might find procedural unconscionability in the seller's failure to make the additional, cost-effective disclosure. That is, rather than define procedural unconscionability in terms of broad market conditions, or market failures that could not practicably have been prevented by anyone, we can instead define it in terms of particular seller behavior that a court thinks should have been altered. Defining procedural unconscionability in this way would make it roughly similar to liability for design defects under products liability law, where sellers can be held liable for failing to take cost-effective steps to improve a product's design. The similarity is that, in each case, the seller is responsible only if a court concludes that some alternative design (or some alternative form of disclosure) would, in fact, have been preferable to the one the seller actually chose.

To be sure, this is not how procedural unconscionability is currently defined. As discussed earlier,[39] courts often describe procedural unconscionability using such phrases as "unequal bargaining power" or "contracts of adhesion," which typically refer to conditions that no seller could possibly alter, at least not at an acceptable cost. However, the kind of procedural un-

39. See section I.A, supra.

conscionability I described in this section *would* fit well with passages like the ones quoted earlier from the *Carnival Cruise* case and *Hill v. Gateway*: passages in which the court argued (or the challengers conceded) that further disclosures by the seller would either have been ineffective, or would have done more harm than good.[40] While those passages were entirely irrelevant to the question of whether there was likely to be a market failure, they are highly relevant to the question of whether the seller should have done anything other than what she did.

Moreover, one advantage of this form of procedural unconscionability is that it eliminates, or at least reduces, the need for courts to be able to evaluate the costs and benefits of the challenged contract's terms. To the contrary: the goal of this version of the unconscionability doctrine is not to improve the contract's terms, but to rather improve the seller's pre-contractual behavior. (To borrow another distinction from Arthur Leff, the goal of this version of unconscionability is "deal control" rather than "goods control."[41]) Of course, we can hope that if sellers' pre-contractual or marketing behavior improves, sellers will eventually be forced to improve their contract terms as well – but that would be a long-term or indirect result, which would not require the courts *themselves* to decide which contract terms would be an improvement. As I will discuss in section IV, this greatly reduces the burden on courts when assessing substantive unconscionability.

On the other hand, this version of unconscionability *does*

40. See the text supra at pages 28–30.

41. Leff, *Contract as Thing* (cited supra in note 12) at 148.

require courts to evaluate the costs and benefits of sellers' pre-contractual behavior – its disclosures, its marketing strategies, and so on – and a pragmatic skeptic might question whether courts are well-suited to that task. Neither courts nor litigants[42] have shown much interest in this sort of cost-benefit inquiry, at least not in connection with the unconscionability doctrine; and courts' experience with the analogous issues under products liability law may not inspire confidence, either.[43] Some regulatory agencies have taken a more systematic approach to these issues, and I have argued elsewhere that contract law might usefully learn from their experience.[44] But there is still plenty of room for a reasonable skeptic to wonder about just how good courts will be at deciding which forms of pre-contractual behavior ought to be altered.

In any case, my aim here is not to defend this version of unconscionability, but merely to show how it *differs* from the version of unconscionability discussed earlier in sections I and II. In addition to imposing different demands on courts at the procedural stage of the inquiry, this version also differs in the

42. Recall that the challengers in *Carnival Cruise* (supra note 27) chose not to press the issue of whether the cruise line should have done more than they did to make consumers aware of the form selection clause.

43. For criticisms of these decisions (from a variety of perspectives), see James A. Henderson, Jr. & Aaron D. Twerski, *Doctrinal Collapse in Products Liability: The Empty Shell of Failure to Warn,* 65 NYU L. Rev. 265 (1990); Howard Latin, *"Good" Warnings, Bad Products, and Cognitive Limitations,* 41 UCLA L. Rev. 1193 (1994); Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis,* 97 Yale L.J. 353 (1988); Victor E. Schwartz & Russell W. Driver, *Warnings in the Workplace: The Need for a Synthesis of Law and Communication Theory,* 52 U. Cin. L. Rev. 38 (1983).

44. Craswell, supra note 26.

demands it makes at the substantive stage.

IV. Substantive Unconscionability as Deterrence

If courts are confident that the seller's precontractual behavior should have been different, it may then be possible for courts to strike down nearly any term of the contract (or even any component of a term), both to penalize that seller and to deter other sellers from committing similar procedural violations. Of course, the term or component that is struck must be one that would otherwise benefit the seller, for no seller would be deterred by the threat that a court might invalidate a clause that the seller would happily be free of. From this standpoint, though, there is some sense to the "one-sidedness" test discussed earlier in section II.C. Terms (or components of terms) that benefit the seller are precisely the ones whose invalidation *would* inflict a loss on the seller, so these are the terms whose invalidation can serve as a deterrent.

The more significant point, though, is that the term that is struck need not be judged under the cost-benefit test appropriate to theories of unconscionability that rest on market failure, as was discussed earlier in section II. Instead, under the version of unconscionability being considered now, even clauses that would *pass* a cost-benefit test (i.e., those that provide net benefits to buyers) can be struck down without making buyers worse-off, because under this version of unconscionability, those clauses will not be invalidated permanently. Instead, under this version of unconscionability sellers can avoid having their terms struck down by altering their precontractual behavior, so that they are no longer guilty of any procedural

unconscionability. This was not an option for the version of unconscionability considered earlier (sections I and II), where procedural unconscionability could be found in market failures that no individual seller could cost-effectively correct. As a result, any court that bans a term based on uncorrrectable market failures must be willing to accept that ban as more or less permanent, because those market failures are unlikely to soon disappear. But a court that bans a terms under the version of unconscionability considered here (sections III and IV) need not be as worried about a permanent ban, as long as sellers can avoid such a ban by altering their precontractual behavior in desirable ways. This is why a court following this version of unconscionability need not be so concerned about the costs and benefits of the challenged contract term – but it is also why such a court must be critically concerned with the costs and benefits of the challenged precontractual behavior. If the court instead finds procedural unconscionability in behavior that should not have been altered – for example, in behavior whose benefits to buyers far outweigh its costs – it will then be doing buyers a disservice if it tries to deter that behavior by threatening to invalidate the seller's terms.

This last point merits elaboration, for it will not always be enough (under this version of unconscionability) to find that the seller's precontractual behavior was *wrongful* in some way. True, a word like "wrongful" is sometimes used to mean "conduct that ought to be altered;" but it can also be used to mean something closer to strict liability, or to "morally deserving of responsibility for any untoward consequences."

For example, if a seller knew that her product was defect-

ive, we might say that it was "wrong" for the seller to sell the product in that condition, even if the defect was not so serious that we think the seller shouldn't have sold the product at all, and if we do not think it would have been worth making costly improvements to the product to fix the defect, and (possibly) even if we do not think the defect was significant enough that the seller should have spent more time and money warning buyers about it. In that case, of course, all we would really mean by "wrongful" is something like "the seller should be responsible for the costs of the defect, since she was the one who decided to sell the product without fixing it" – and such a conclusion about the seller's responsibility might even be morally justified, especially if seller liability would in fact benefit buyers (under the cost-benefit test described in section II). My claim here, however, is that this form of responsibility should *not* justify a court in striking down some other contract term, under the version of unconscionability I am considering here (i.e., to deter the seller from undesirable precontractual behavior). Deterring undesirable behavior makes sense only after we have identified behavior that we think truly ought to be *altered* – and that decision will usually require some form of cost-benefit test applied to the behavior itself.

Having said this, I should note that deterring undesirable behavior may still require some attention to the substance of the challenged clause, especially if there is any uncertainty about when the test for procedural unconscionability will be satisfied. If courts stand ready to invalidate terms that are extremely valuable to sellers – terms whose loss would cost sellers billions of dollars, for example – the threat of such loss-

es would make sellers extremely careful not to be guilty of any procedural unconscionability. True, we presumably want to give sellers *some* incentive to avoid procedural unconscionbility (at least under the version of unconscionability being considered here), and in some cases even the incentive created by the threat of a billion dollar loss might be a good thing. And if sellers know exactly what they need to do to avoid procedural unconscionability, even the threat of a billion dollar loss would produce no adverse effects, because sellers could avoid that threat with confidence simply by avoiding procedural unconscionability.[45]

If, however, sellers are not always sure how to avoid procedural unconscionability – as is likely if courts are unable to articulate clear standards for the procedural part of the inquiry – then the threat of excessive penalties may produce less desirable effects, leading either to overdeterrence or (in some cases) underdeterrence of seller behavior.[46] If so, then the choice of which terms to be invalidated would have to include a consideration of the size of the loss that each term's invalidation would inflict on sellers, and of the effect of that loss on deterrence. Obviously, this would complicate the analysis required of courts at the substantive stage of the inquiry.

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45. The more general version of this point, with implications far beyond the doctrine of unconscionability, is nicely made in Robert Cooter, *Prices and Sanctions,* 84 Colum. L. Rev. 1523 (1984). I discuss the application of this point to unconscionability in Craswell, supra note 14.

46. On overdeterrence and underdeterrence more generally (beyond the doctrine of unconscionability) see, e.g., John E. Calfee & Richard Craswell, *Deterrence and Uncertain Legal Standards,* 2 J. L., Econ., & Org. 279 (1986).

V. Conclusion

I have described two different ways in which the unconscionability doctrine might be structured, each with its own version of procedural and substantive uconscionability. In the first version, described in sections I and II, courts are willing to count any form of market failure as procedural unconscionability (even if the failure could not practicably have been prevented), but the test for substantive unconscionability requires some form of cost-benefit analysis, to ensure that buyers will be better off on balance if the challenged term is struck. In the second version of unconscionability, described in sections III and IV, courts do not find procedural unconscionability unless they can identify some behavior that the seller should have changed – but having found such behavior, courts are free to strike certain terms even if those terms would not violate the cost-benefit test that defines substantive unconscionability under the first version of that doctrine.

Each of these versions places different demands on courts, so I have not tried to identify one or the other version as unambiguously superior. Indeed, the two versions are not mutually exclusive, for we could also have a regime in which contract terms were struck if they failed *either* of the two versions of unconscionability. That is, if courts were confident that the seller's precontractual behavior should have been altered, they could proceed (in most cases) to strike the challenged term under the second version of unconscionability. At the same time, if courts were truly confident that striking a term would produce net effects that were positive for buyers, it could pro-

ceed to strike that term (in most cases) under the first version of unconscionability. Thus, to succeed under either version, the challenger would have to advance some form of cost-benefit analysis, showing that buyers would benefit either from altering the seller's precontractual behavior or from altering some particular term. As each of these showings may be hard or easy in particular cases, there is no need to specify in advance just which of these showings must be made.

What I do claim, however, is that we should resist any third version of unconscionability in which challengers need not make *either* showing: neither that buyers would benefit (on net) if the seller's behavior changed, or that buyers would benefit (on net) if a particular clause was struck. Unfortunately, this is an approximate description of unconscionability as currently applied by courts. Courts find procedural unconscionability based on broad market failures that cannot practicably be corrected, or even on pseudo-market failures such as contracts of adhesion, without identifying any particular behavior of the seller that truly should have been altered. But courts then find substantive unconscionability based on simple tests like whether the challenged term is "one-sided": tests that are inadequate to show that buyers would in fact benefit from striking the challenged term. Current doctrine thus combines the two versions I have described, but does so in a way that produces the worst of both worlds.