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Power, Inequality and the Bargain: The Role of Bargaining Power in the Law of Contract - Symposium Introduction

Daniel D. Barnhizer
Michigan State University College of Law, barnhize@law.msu.edu

FOREWORD

POWER, INEQUALITY AND THE BARGAIN: THE ROLE OF BARGAINING POWER IN THE LAW OF CONTRACT—SYMPOSIUM INTRODUCTION

Daniel D. Barnhizer[*]

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Approximately eighty years ago, the Arizona Supreme Court first explicitly acknowledged "inequality of bargaining power" between individual employees and their employers as a justification for regulating employment contracts through workers' compensation statutes.[1] As that court noted, legal models for regulating the contractual interactions between employers and employees—developed during the previous economic era dominated by principles of freedom of contract and a strong *laissez faire* approach to economic regulation—no longer made sense in the then-modern industrial economy.[2] Inequality of bargaining power provided the legal, political, and moral rhetoric necessary to justify a clean break between the freedom of contract and *laissez-faire* doctrines of the late nineteenth century and the progressive and realist doctrines deemed necessary by many courts and commentators to respond to the challenges of industrialization and modernization.

Just as dramatic social, political, and economic changes at the turn of the twentieth century drove the development of concepts such as "inequality of bargaining power" to critique prevailing contract ideology, the turn of the twenty-first century may be a similarly transformative era for American

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* Associate Professor of Law, Michigan State University College of Law. J.D. 1995, Harvard Law School; B.A. 1991, Miami University.

1. Ocean Accident & Guarantee Corp. v. Indus. Comm'n of Ariz., 257 P. 644, 645 (Ariz. 1927) ("Our enlightened modern thought realizes that an equality of bargaining power between two such unequal parties is impossible, and has attempted to equalize the balance through the labor unions and state regulation of industry; but old ideas die hard, and the pathways of progress are strewn with the fragments of legislation designed for this purpose but wrecked on the insistence of court after court that the state must not interfere with the 'free right of contract.'"), *rev'd on other grounds* Indus. Comm'n v. Watson Bros. Transp. Co., 256 P.2d 730 (Ariz. 1953).

2. *See id.* ("But of even greater influence [on judicial decisions to invalidate workers' compensation and other labor and employment regulations] was the fact that most men, and particularly most lawyers, were still governed by the old school of economics of which Adam Smith, Ricardo, Malthus, and Mills were shining lights, and in which the doctrine of laissez faire was considered to be the rule which the state should observe in regard to the relation of employer and employee.").

contract law. This symposium explores the appropriate role of bargaining power as a legal concept within contract law in the now-mature information era. Each of the following articles approaches bargaining power disparities from a different perspective to assess the impact of this phenomenon on contract law and to suggest how contract law and theory can best respond to the challenges raised by asymmetries in the parties' bargaining power.

The opening article for this symposium is offered by W. David Slawson, who has been writing on bargaining power and related doctrines for over 35 years.[3] His article, *Contractual Discretionary Power: A Law to Prevent Deceptive Contracting by Standard Form*,[4] addresses an injustice arising from the phenomenon that he calls "deceptive contracting by standard form." He begins by describing the dilemma from which this injustice derives. On the one hand, there are many things that a producer needs to include in its contracts with consumers in order to protect its interests in the transaction. On the other hand, neither the producer nor the consumer would be willing to spend the time that would be needed to educate the consumer enough about these things to make the consumer's agreement to them meaningful. Moreover, Slawson asserts, consumers could never be educated enough to understand some of these things, because only a lawyer specializing in the field or an expert in the product could adequately understand them.

As a result, Slawson concludes, there has seemed to be no alternative to allowing the producer to set the terms of its contracts, with or without the agreement of the consumer. With a few, rarely applied exceptions, therefore, the standard forms that producers provide are regarded as the contracts, and the promises and representations by which the products were sold are ignored. Unfortunately, however, the effect has been to license deceptive contracting. Producers induce consumers to buy their products with promises and representations that they then nullify or contradict with their standard forms.

Deceptive contracting through a producer's power to include oppressive terms in a standard form contract is a natural consequence of the objective theory of contract and the so-called "duty to read" that deems consumers' signatures on standard forms to be objective manifestations of assent regardless of whether the consumer ever read or understood the standard form. Traditionally, courts have recognized only two general contract defenses against deceptive contracting—unconscionability and *contra proferentum*—and one additional doctrine—reasonable expectations—that has

3. *See, e.g.*, W. David Slawson, *Standard Form Contracts and Democratic Control of the Lawmaking Power*, 84 HARV. L. REV. 529 (1971); W. David Slawson, *The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms*, 46 U. PITT. L. REV. 21 (1984); W. DAVID SLAWSON, BINDING PROMISES (1996).

4. 2006 MICH. ST. L. REV. 853.

been limited to policing deceptive contracting in insurance contracts. As Slawson observes, all three doctrines have proved unsatisfactory for regulating deceptive contracting practices. After analyzing the shortcomings of the doctrines of unconscionability, *contra proferentum*, and reasonable expectations to regulate deceptive contracting, Slawson turns to the heart of his proposal. He begins with the proposition that a contract consists of the parties' objective manifestations of mutual assent. Because the objective theory of contract requires courts to assess each party's assent from the perspective of a reasonable person standing in the shoes of the other party to the contract, it follows that a contract between a producer and a consumer consists only of the actual representations and promises made between the parties and those parts of the standard form that the producer should reasonably expect the consumer to read and understand. Thus, a standard form becomes part of the contract of sale only to the extent it comports with the terms actually agreed to by the parties.

With this background, Slawson details the most important concept of his article, which he terms the "contractual discretionary power." This power arises where the contract, expressly or impliedly, leaves a party with discretion over how or whether to perform a contractual obligation. Requirements contracts, for example, give the buyer discretion to determine the quantity term by altering its requirements. Similarly, options give the optionee discretion over when or if to exercise the option. And producers necessarily retain a contractual discretionary power to provide additional terms to the parties' contract through standard forms. But while virtually all contracts provide one or both parties with such a contractual discretionary power, that power is necessarily subject to implied limitations that the discretion cannot be exercised to nullify or contradict terms of the parties' contract. From these foundations, Slawson concludes that a contract between a producer and a consumer does not include any standard form terms that nullify or contradict the other terms and representations actually made between the parties.

Slawson further concludes that an express recognition of the limits of the contractual discretionary power discussed above would greatly improve judicial treatment of deceptive contracts. The indefinite and ad hoc procedural and substantive unconscionability analyses would be replaced by the simpler and more easily generalizable question of whether the standard form terms nullified or contradicted the parties' contract of sale. Similarly, replacing *contra proferentum* with a contractual discretionary power analysis would obviate the need for determinations and assessments of ambiguity in favor of an analysis of how a reasonable person would interpret the parties' objective manifestations of mutual assent. An analysis of whether the producer's standard form abused the contractual discretionary power would likely achieve the same result as under the reasonable expectations doctrine; the former doctrine is more easily generalized outside the insurance context

because of its focus on objective manifestations of the parties' endogenously created agreement rather than the imposition of exogenously determined "reasonable expectations." Finally, explicit recognition and application of the law of contractual discretionary power would expose deceptive contracting by producers to regulation through claims of fraud, unfair and deceptive consumer trade practices, and unfair competition.

Larry A. DiMatteo, in *Penalties as Rational Response to Bargaining Irrationality*,[5] approaches the problem of bargaining power from a Behavioral Decision Theory ("BDT") perspective. In this original piece of empirical scholarship, DiMatteo analyzes power relations in the context of cognitive biases as they relate to the negotiation of liquidated damages clauses. Noting that contract law's failure "to distinguish a highly negotiated clause between parties of relatively equal bargaining power and a clause that is not a product of negotiation, such as in an adhesion contract between parties of unequal bargaining power, is contradictory to a system reliant on consent and personal autonomy,"[6] this article reports and analyzes the results of two experimental surveys testing the impact of cognitive biases on parties negotiating a liquidated damages provision in a new home purchase contract. Based upon the results of these empirical surveys, DiMatteo concludes that while parties of relatively equal bargaining power do demonstrate some irrational use of heuristics and biases, negotiated penalty clauses between parties of equal bargaining power may be a rational response to bargaining irrationality and should be presumptively enforceable.

DiMatteo begins with a description of his experimental survey which involved twelve scenarios in the context of a buyer and home-builder negotiating whether to include a penalty clause in a new home building contract. Variations in these scenarios tested the presence and impact of four cognitive biases: availability, status quo, reputation effects, and signaling. DiMatteo's findings support the conclusion that the experimental survey participants were susceptible to the reputation effect, status quo bias, and availability bias. The statistical results did not support statistically significant indications of either signaling effects or that varying the buyers' prior experience (on-time or late delivery) and builder reputation (good or bad) would cause the parties to view the penalty clause as either punitive or compensatory.

DiMatteo next offers a detailed critique of the law of liquidated damages. In particular, the judicial refusal to enforce penalty clauses, even where those clauses are efficient and were the product of negotiation between parties of relatively equal bargaining power, produces inefficient outcomes. While some commentators have suggested that consumer irra-

5. 2006 MICH. ST. L. REV. 883.
6. *Id.* at 887.

tionality justifies the mandatory rule that penalty clauses are unenforceable, DiMatteo's conclusion is markedly different. Although the current regime for regulating liquidated damages clauses may be warranted for protecting consumers with weak bargaining power, that rationale fails where the parties possess relatively equal bargaining power. In that situation, DiMatteo convincingly argues, courts should enforce party-negotiated damages terms without regard to whether those terms appear to impose a penalty.

DiMatteo strengthens this conclusion by arguing that negotiated penalty clauses represent a rational response to bargaining uncertainty and irrationality. First, while a homebuyer who overestimates the value of a negotiated penalty clause will forgo a Pareto optimal home building arrangement, the resulting contract will still likely be Pareto superior to other options such as buying an existing home instead of building. Second, contract damages generally undercompensate for breach given the costs of litigation and limitations on recovery. Negotiated penalty clauses protect both parties against these risks. Third, negotiated penalty clauses can provide benefits in reduced negotiation and litigation costs. And fourth, a rule presuming the enforceability of negotiated penalty clauses better comports with the underlying rationales of contract law such as private autonomy, promise-making, consent, and efficiency.

In the final section, DiMatteo generalizes from his empirical findings to develop broader conclusions for adapting the insights of BDT to the problem of defining the role of rationality in contract law. While BDT potentially undermines contract law's assumption of rationality by showing that individuals systemically behave irrationally because of cognitive biases and heuristics, it does not necessarily demonstrate that human decisionmaking is hopelessly irrational. Rather, BDT demonstrates the adaptive capacities of the human mind to develop strategies for coping with uncertainties, limited information, and other sources of irrationality. Thus, while individual terms—such as the penalty clauses studied in this article—may be irrational in the sense that they fail to achieve an optimal outcome, such terms are rational in the sense that they preserve a deal that the parties rationally prefer to other, less-valuable outcomes such as impasse. The resulting hybrid of rational-irrational decisionmaking by contracting parties is also subject to change and development over time as parties' experiences modify the degrees of irrationality the parties will bring to future bargaining. As DiMatteo concludes, contracts should thus be assessed as mixtures of rational-irrational and efficient-inefficient attributes. "In the end, the contract or deal should be assessed in its totality when gauging whether it reaches an acceptable level of overall rationality and efficiency."[7]

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7. *Id.* at 920.

Blake D. Morant's contribution, *The Salience of Power in the Regulation of Bargains: Procedural Unconscionability and the Importance of Context*,[8] uses the foil of federal government contract law to explore an expanded use of context in analyzing procedural unconscionability in common law contracts. Federal government contract law specifically accounts for power disparities that affect the bargaining behavior between the government and its contractors. In contrast, the general common law of contract has largely ignored these power relations, policing them largely through ad hoc inquiries into substantive abuses while ignoring procedural contextual factors that may provide both a more certain and a more generalizable basis for regulating abuses of bargaining power.

Morant begins his analysis with a review of the classical and neoclassical themes of contract theory. Classical contract theory is grounded in principles of formalism and private autonomy that function fairly only when bargaining parties possess roughly equal bargaining power or when the stronger party does not opportunistically abuse its greater bargaining power. In contrast, neoclassical contract theory recognizes the failure of a formalistic, abstract rule system to account for inequities arising from bargaining power disparities. Neoclassical theory thus envisions a more flexible approach to contract formation and enforcement that specifically attempts to account for the context in which the parties made their contract, including any disparities of bargaining power between the parties.

Unconscionability doctrine developed from these neoclassical approaches to contract and provides a mechanism for remedying unfair contracts created as a result of unequal bargaining power. After surveying the law of unconscionability, Morant observes that the doctrine has had only limited utility. In particular, unconscionability has remained overly vague, and courts have largely failed to analyze contextual factors giving rise to unconscionability, resulting in a highly fragmented focus on the substantive unfairness of particular contractual terms. Thus, decision makers often address the abusive nature of certain types of terms, such as accelerated payments, default clauses, and remedial terms, and give short shrift to procedural unconscionability factors based upon the context of the parties' bargaining. Morant suggests that the deficiencies of unconscionability doctrine could be remedied to some extent if decision makers shifted their focus to analyzing the procedural context of purportedly unconscionable bargains, rather than the unfairness of the terms themselves.

The article next draws examples of the benefits of such a contextual approach to unconscionability analyses from the field of federal government contract law. While heavily formalized, federal government contract law nonetheless remains concerned with the context of the bargaining process

8. 2006 MICH. ST. L. REV. 925.

and purposefully seeks to remedy some clear bargaining power disparities resulting from the fact that government bargaining power is usually strong. With respect to unconscionability in government contracting, decision-makers appear to place greater emphasis on analysis of procedural unconscionability factors that illustrate potential inequalities of bargaining power between the parties. Morant suggests that common law decision-makers could profitably transfer this focus on procedural context to unconscionability determinations in other judicial forums.

Morant concludes by building on his fundamental thesis that unconscionability analysis would be greatly improved by a shift in focus to contextual factors relating to procedural unconscionability. Drawing upon the expertise of government contracting decision-makers in analyzing such factors, Morant observes that fact finders in other forums "can, and must, explore the bargaining context fully to determine the merits of a claim."[9] Necessarily, these decision-makers have a duty to explore not just the substantive unconscionability of particularly onerous terms but also the procedural unconscionability revealed by analysis of the context in which the bargain was made. Bargaining power disparities represent a key aspect of that contextual investigation. By thus broadening the inquiry to encompass a meaningful review of both procedural and substantive factors giving rise to unconscionability, common law decision-makers may better substantiate and justify intervention on the basis of bargaining power asymmetries that interfere with the consensual nature of the contracting process.

Rachel Arnow-Richman's article, *Cubewrap Contracts and Worker Mobility: The Dilution of Employee Bargaining Power via Standard Form Noncompetes*,[10] tackles the difficult problems of oppression and exploitation through superior bargaining power resulting from employer contracting practices. The article specifically analyzes the failure of doctrines relating to enforcement of noncompetition clauses in employment contracts to account for the weaker bargaining position of workers who must accept such terms as conditions of their employment. In that context, noncompetition agreements are often imposed through what Arnow-Richman terms "cubewrap" contracts—employment agreement terms imposed upon a new employee after formation of an oral contract of employment.

The article first surveys judicial treatments of noncompetition agreements. Arnow-Richman observes that courts justify intervention to invalidate or reform private employment contracts on the basis of inequality of bargaining power between employer and employee. Despite this bargaining power justification—which in other contexts examines the relationship between the parties at the time of contracting—courts review noncompetition

9. *See id.* at 957.
10. 2006 MICH. ST. L. REV. 963.

agreements based upon the balance of harms between the parties and the reasonableness of the restrictions placed upon the employee. Moreover, courts routinely reform such clauses, rather than invalidating them entirely. This post hoc focus, according to Arnow-Richman, ignores the power imbalances created by employer contracting practices that permit employers to impose noncompetition clauses upon employees that they would not have otherwise accepted and with which they would not otherwise comply.

Thus, for example, anecdotal evidence suggests that employers commonly impose cubewrap contract terms by requiring the new employee to accept those terms after accepting the employment offer and incurring all the costs of changing jobs. Like the analogous shrinkwrap contracting practice in which a consumer who has already incurred the costs of acquiring a new product will be reluctant to return it in the face of new terms underneath the shrinkwrap, employers likely recognize that new employees are unlikely to reject such post-hire modifications because of the costs of immediately seeking new employment. On the back end of the employment relationship, employers benefit from judicial uncertainty about the enforceability of overbroad noncompetition terms. They are able to promote an internal culture that reaches beyond legally recognized rights and discourage employees from violating even the unenforceable terms of such agreements.

Arnow-Richman concludes that an explicit recognition of the structural bargaining power issues created by the front end cubewraps and the back end exploitation of overbroad noncompetition clauses could improve judicial policing of such clauses. To that end, Arnow-Richman recommends two changes to existing noncompetition doctrine. First, courts should refuse to enforce cubewrap contract terms where those terms could have been provided before the employee accepted the offer of employment. By making such cubewrap terms unenforceable, courts would provide employers incentives to disclose potentially problematic employment terms during the initial employment negotiation process. Second, Arnow-Richman recommends that the back end psychological pressures created by employers' use of overbroad and legally unenforceable noncompetition clauses could be remedied to some extent by the development of industry standards regarding the reasonableness of noncompetition clauses. While using industry standards to remedy abuses by employers in a particular industry may appear counterintuitive at first, Arnow-Richman notes that employers appear on both sides of litigation regarding the enforceability of noncompetition clauses. Employers in the process of developing industry standards would therefore have incentives to protect both their interests in protecting information held by exiting employees and their interests in hiring new employees from other employers in that same trade or industry.

Curtis Bridgeman, in his essay *Misrepresented Intent in the Context of Unequal Bargaining Power*,[11] approaches the problem of bargaining power asymmetries in the context of misrepresented promissory intent and promissory fraud. With this article, Bridgeman offers both a critique of Ian Ayres's and Gregory Klass's recent book, "Insincere Promises"[12] and his own original theoretical analysis of legal rules necessary for policing contracts in which the stronger party retains the contractual discretion to limit or refuse performance. Bridgeman's analysis throughout supports his thesis and ultimate conclusion that "in cases of great inequalities of bargaining power, courts should respect a party's reservation of a right not to perform only if the promisee has information—from the promisor, if necessary—about the likelihood of performance."[13]

Bridgeman's analysis begins with a review and critique of Ayres's and Klass's theory of insincere promises. Ayres and Klass propose that our legal conception of the meaning of promises is flawed because it presumes that promises always denote the promisor's complete or absolute intention to perform the promise. Ayres and Klass argue for a more sophisticated understanding of promises that recognizes that promisors may communicate not just an intent to perform but also a less-than-complete, or partial, intent to perform the promise. In other words, lay practice recognizes that some promises are more sincerely meant than others. Bridgeman terms such less-than-fully-warranted promises "probably promises."

Although this insight is useful, Bridgeman critiques it on two levels. First, it is difficult to see how contract or promissory fraud doctrines should treat a breach of such probably promises. Clearly the promisor may avoid promissory fraud claims based upon misrepresentation of a present intent not to perform because by definition probably promises expressly communicate that the promisor at least partly intends not to perform. But it is also unclear how contract law should respond to a breach of a probably promise where the promise expressly indicated that while there was some intent to perform at the time of making the promise, there was also some intent not to perform. Damages calculations in that situation are similarly problematic.

Second, Bridgeman points out that contract law already provides mechanisms whereby parties can qualify their intent to perform their promises. These include take-or-pay contracts, liquidated damages terms, and placing conditions on the obligation to perform. Most significantly, parties with strong bargaining power may simply reserve the right not to perform the contract and avoid making a promissory commitment altogether. Bridgeman supports this observation with specific examples drawn from

11. 2006 MICH. ST. L. REV. 993.

12. IAN AYRES & GREGORY KLASS, INSINCERE PROMISES: THE LAW OF MISREPRESENTED INTENT (2005).

13. Bridgeman, *supra* note 11, at 995.

standard form contracts in the shipping and transportation industries. In both industries, Bridgeman reviews instances of the shipper or transportation line reserving the right to alter published schedules, itineraries or fee schedules for any reason, at any time, often without notice. Intriguingly, Bridgeman also describes situations in which consumers with strong bargaining power—usually identified by their willingness to pay more for a particular good or service—can contract for compliance with published schedules or cause the producer to provide information regarding the likelihood of performance.

Bridgeman does not take issue with the general practice of parties with strong bargaining power inserting such reservations into their form contracts. Rather, the problem arises from a corollary of Ayres's and Klass's proposition that promises can communicate a range of levels of promissory intent and sincerity. Specifically, promises to perform with a reservation of a right not to perform are potentially misleading if the consumer has no information regarding the actual likelihood of performance. Bridgeman proposes adopting a new rule to permit producers to continue making highly qualified or non-committal contracts but refuses to enforce those reservations unless the producer provided the weaker party with information on how often the producer actually performs. As Bridgeman concludes, rather than create new categories of promises that courts may not be competent to assess, his proposed rule preserves the ability of strong parties to make contractual reservations where it is efficient to do so. At the same time, weaker consumers benefit from access to greater information. And courts remain competent to police this bargaining power relationship through actions in breach of contract and promissory fraud.

The final article in the symposium by James F. Hogg, *Consumer Beware: The Varied Application of Unconscionability Doctrine to Exculpation and Indemnification Clauses in Michigan, Minnesota, and Washington*,[14] analyzes the doctrinal issues in contexts involving unfair surprise caused by the inclusion of exculpation or indemnification clauses in consumer contracts. Hogg traces the historical development of unconscionability doctrines relating to such clauses, observing that exculpatory clauses are held unconscionable in two contexts: (1) the producer requiring agreement to the term provides a public service and (2) the term is otherwise not fairly bargained for. From this doctrinal history, Hogg next analyzes Minnesota courts' recent attempts to develop the common law of unconscionability in the context of exculpation and indemnification clauses. The most recent decision appears to break these two clauses apart. His analysis shows that with respect to exculpation clauses, Minnesota courts have employed a standard that examined both prongs of the historical standard and a rela-

14. 2006 MICH. ST. L. REV. 1011.

tively detailed analysis of factors contributing to the parties' relative bargaining power, recent cases appear to ignore any claims of unequal bargaining unless the producer provides a public service. The most recent decision suggests, however, that indemnification clauses may not be enforceable in consumer contracts.

Hogg contrasts these developments in Minnesota law with treatments of exculpation and indemnification clauses in Washington, Michigan, and damages restrictions in the Uniform Commercial Code. Unlike Minnesota's apparent trend toward restricting consumer access to unconscionability relief from oppressive or unfairly surprising exculpatory clauses, Washington courts have maintained different standards for assessing such terms in commercial and consumer contexts because of the inherent bargaining power disparities associated with consumer contracting. In contrast, Michigan courts have gone far in eviscerating unconscionability protections against unfairly surprising exculpatory clauses in some circumstances by adopting a strong textualist, freedom-of-contract approach to contractual interpretation. These Washington and Michigan cases implicitly frame the choice facing Minnesota courts over whether and how to develop and reform their treatment of unconscionability analyses in the context of exculpation and indemnification clauses. Hogg concludes with recommendations that such reforms should focus on remedying the informational disparity that generates the unfair surprise associated with such clauses, including plain English drafting, conspicuousness, and a producer duty to explain or offer an opportunity to negotiate the clauses.

In conclusion, I would be remiss if I failed to express my deepest gratitude and thanks to each of these contributors and to the other participants at the March 30, 2006 symposium, including Omri Ben-Shahar, Emily Houh, and Julian Abel Cook III. To some of these participants—in particular W. David Slawson, Larry A. DiMatteo, and Blake D. Morant—I already owe a profound debt for their inspiration, advice, and major contributions to my own interest in and understanding of the difficult and slippery concept of bargaining power in contract law. But I am no less privileged and honored by the opportunity to work with and receive the insights offered by Curtis Bridgeman, Rachel Arnow-Richman, and James Hogg. The articles that follow and the other contributions at the symposium represent truly outstanding contributions to our understanding of the difficult problem of power asymmetries in contract law.