

European Master Program in Law & Economics

Unfair Terms in Standard Form Contracts

A Law & Economics Analysis of Key Issues in the Implementation of
the Consumer Directive on Unfair Terms

Master Thesis

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“The need for consumer protection relating to contracts is as old as the world. The first consumer contract was concluded between a woman and a snake: The snake sold an apple to the woman on the basis of a misleading advertising the product did not have the qualities announced by the seller and there was a contractual term excluding any liability of the snake for any damage resulting from the defective product. As you know we are still suffering from this original damage.”¹

¹ See Mario Teneiro (Head of Unit C2, DG XXIV), Minutes of the conference "The Directive on « Unfair Terms », five years later - Evaluation and future perspectives" organised by the European Commission, 1.-3. July 1999: p. 233. Available at http://ec.europa.eu/consumers/cons_int/safe_shop/unf_cont_terms/event29_en.htm (15. 6. 2007)

Authorship Declaration

I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I gratefully acknowledge the supervision and guidance I have received from Prof. Dr. Hans-Bernd Schäfer.

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1. INTRODUCTION

If each standard form term added to the contract increases the firm's benefits by shifting risk to the consumer, but simultaneously lowers the price consumers are willing to pay for the good, standard form terms can be mutually beneficial, as consumers might prefer to take some risk in exchange for a lower price. Why then interfere?

This first statement misses out one crucial point, namely it is only true in a perfect market without market failure. A major concern with regard to standard form terms – where firms are able to excessively shift risk to the consumer – derives from the recognition that asymmetric information is pervasive when standard form contracts are present. At the same time, most scholars agree that standard form contracts form an important part of today's economic reality. Thus, the challenge for law & economics theory is to observe inefficiencies and to establish a meaningful approach for correcting the negative effects created by asymmetric information.

This paper is divided in two parts. After a short introduction to standard form contracts, the first part aims at providing a fairly detailed review of the existing literature concerning the costs and benefits of such contracts as well as the justifications for intervention. The focus of the second part is on the European Council Directive 13/93/EEC on unfair terms in consumer contracts. Due to the limited scope of the paper, this section analyses and highlights some major differences in the implementation of the Directive among the Member States from a legal point of view as well as from an economic perspective, thereby focusing on Article 3, 5 and 6. To illustrate some differences in the implementation in more detail, the Austrian and German approach has been used to exemplify. In addition, the Annex to Article 3 will also be analysed in the light of the economic effects of different implementation methods. The order chosen for analysing the Articles results from their interrelation and is therefore not chronological. Finally, a brief case study will demonstrate the relevancy of the analysis in respect to some practical considerations also emphasised in the conclusion.

Part I

2. STANDARD FORM CONTRACTS – AN INTRODUCTION

2.1. Introduction

“[T]he formation of a contract requires a bargain in which there is a manifestation of mutual assent to the exchange and a consideration.”² The Restatement (Second) illustrates a traditional notion as to the creation of contracts. One fundamental principle in this respect - at least in most jurisdictions - is that parties bargain over an item in order to reach such mutual assent, since without assent there is no contract.³ Traditionally, according to the subjective theory, mutual assent requires a true meeting of minds, which is the actual concurrence of the parties’ subjective intentions. In later times, this interpretation has been replaced by the objective doctrine. According to the latter, the decisive element in the formation of contracts is the external or objective appearance of the parties’ intentions as manifested by their action.⁴ Furthermore, it is generally assumed that parties when signing a contract have read and understood the agreement and thus will not be released from the binding force even if this assumption has proved wrong.⁵ Some jurisdictions, like the common law regimes, require a further condition, namely that of consideration. This concept essentially represents the idea that every promise requires a counter-performance or return promise.⁶ This notion however does not create any problems specific when using standard form contracts and thus will not be discussed in the following.

This traditional process for the formation of contracts as briefly explained above is no longer the representative procedure for parties to enter into binding agreements. For the last decades the development of mass production and economies of scale gave rise to a new type of contract, allowing market participants to engage in several transactions on a standardised base,⁷ which I will henceforth refer to as standard form contracts and consequently standard form terms.⁸

² Restatement (Second) of Contracts § 17 (Requirement of a bargain).

³ Kessler, *Contracts of Adhesion* 1943: 630.

⁴ See Farnsworth 1990: §3.6; Similar doctrines can be found in other jurisdictions as well, such as the “Abstraktionsprinzip” in Germany and the “Vertrauenslehre” or “objektiver Erklärungswert” in Austria.

⁵ See Rakoff 1983: 1187; See Katz 1990: 521.

⁶ For more information see Farnsworth 1990: §2.3.

⁷ See Kessler 1943: 631; See Slawson 1971: 530

⁸ Sometimes in the literature referred to as boilerplates or contracts of adhesion. Whereas, the latter is used to indicate the existence of a monopoly or at least strong bargaining power; See Kessler 1943: 632.

According to Slawson, already in 1971, standard form contracts amounted for more than 99% of all contracts.⁹ It has been shown in the literature that legal systems reflect the particularity of this type of contract by treating them differently as compared to “ordinary” contracts. Some jurisdictions explicitly distinguish between contract terms included into a contract without the other party knowing or even considering the term, and those ones negotiated between the parties.¹⁰ This distinction can be found for instance in the US Restatement (Second) of Contracts § 211¹¹ or in Art. 3 of the European Consumer Directive¹².

2.2. Characteristics of Standard Form Contracts

As a first characteristic, standard form contracts are typically used by corporations which bargain over the same product or service on a regular base, thereby employing the same form for all or most of their transactions.¹³ Secondly, standard form contracts are drafted in advance by lawyers investing a considerable amount of time to optimise the contract, thereby mainly focusing on companies’ interests.¹⁴ Thirdly, standard form contracts are presented to consumers as a pre-printed document, containing numerous terms often written in small print and generally hardly understandable for consumers or even legal experts.¹⁵ Fourthly, firms typically present such contracts on a so-called take-it-or-leave-it basis,¹⁶ which means that consumers are often short of the opportunity to negotiate over particular terms incorporated into the standard form contract. Fifthly, consumers often encounter standard form contracts in situations where they lack the time of reading and are also not expected to do so or even receive the standard form contract after the transaction took place.¹⁷ Sixthly, most of the pre-printed terms typically specify “the breath of the parties’ obligations to one another”¹⁸, are commonly related to events in the future and frequently concern relatively low probabilities of risk.¹⁹ In contrast, the so-called performance

⁹ Slawson 1971: 529.

¹⁰ See Rakoff 1983: 1174.

¹¹ „Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.“, cited by Farnsworth 1990: §4.26, 487.

¹² European Council Directive 93/13/EEC of 5th April 1993 on Unfair Terms in Consumer Contracts.

¹³ See Kessler 1943: 631.

¹⁴ See Rakoff 1983: 1222; Eisenberg 1995: 243.

¹⁵ See Rakoff 1983: 1177; Eisenberg 1995: 242f.

¹⁶ See Kessler 1943: 632 (relating it to the bargaining power of firms); See also Rakoff 1983: 1177; Hillman & Rachlinski 2001: 7.

¹⁷ See Farnsworth 1990: §4.26, 480; Eisenberg 1995: 242; Meyerson 1993: 1270; See Mann 2006: 902.

¹⁸ See Korobkin 2003: 1204.

¹⁹ “While there was some measure of negotiation on matters of immediate impact such as the amount of rent and the length of the lease, there proved to be little negotiation about more typical fine print terms, especially when such terms dealt with remote, though serious, contingencies rather than problems of frequent occurrence.“, See Mueller 1970: 275; See also Burke 2000: 16-17; Eisenberg 1995: 240.

terms, to which Llewellyn refers to as *dickered terms*²⁰, are occasionally open for negotiation. These terms are directly related to the good, such as the quality, quantity, and the price of a product or service.²¹

A few scholars mention in their definition of standard form contracts some additional features. For example Rakoff points out that standard form contract are only signed by the adherent and that the adherent only enters into a few transactions represented by the type of form.²² In my opinion these further assumptions are not necessarily true for all standard form contracts – as for instance a receipt at a dry-cleaner including the general terms and conditions is neither signed nor an infrequent transaction - and thus are not part of my definition.

3. VARIOUS EFFECTS OF STANDARD FORM CONTRACTS

3.1. Transaction Costs

Every market operation creates transaction costs for the parties involved, which can be relatively small or rather high compared to the surplus created. The main costs are the ones created by searching and locating opportunities to exchange goods and services. These costs can vary highly, depending on the industry structure. Further expenses arise due to negotiation over the terms of exchange, which also relates to the allocation of risk. Finally, expenditures associated with the enforcement of contracts are also to be considered within the scope of transaction costs.²³

3.1.1. Costs of Negotiation

Mass production of goods and services characterise today's economy and made standard form contracts a necessary device to allow businesses to permanently engage in numerous transactions, thereby offering the same rights and obligations to all consumers. Slawson, in this respect, compares standard form contracts and other mass-produced goods in an industrial economy and points out that without using a standardised product a firm loses its ability to spread costs over a large number of products. Thus, "the rational decision is therefore normally either not to offer non-standard products or to charge much higher prices for them".²⁴

²⁰ Llewellyn 1960: 370.

²¹ See Farnsworth 1990: §4.26, 479.

²² Rakoff 1983: 1177.

²³ See Cooter & Ulen 2004: 220.

²⁴ Slawson 1971: 531.

Furthermore, it does not only reduce costs and time of negotiation for the seller, but also for consumers as they may save costs of legal advice, which would be indispensable in many circumstances due to consumers' lack of information and knowledge.²⁵ The few terms finally negotiable, often concern main features of the good or service and are commonly easy to observe, thus bearing low costs for consumers.²⁶

Another relevant aspect elaborated by Rakoff relates to the typical vertically integrated structure of modern businesses. In his view, standard form contracts could solve the principle-agent problem²⁷, leading to an efficient use of expensive managerial and legal talent. Thereby he clearly disagrees with Kessler's approach, who argues that only firms with high bargaining power employ standard form contracts.²⁸ Rather, if large enterprises could not make use of standard form terms, the discretion left to the employees at the bottom of the hierarchy would create huge costs in respect of their monitoring and training.²⁹

3.1.2. Allocation of Risk

An optimal allocation of risk, implying that some risk gets shifted to the consumer, might be returned by lower prices for the good or service.³⁰ In this respect, law and economics literature analyses the optimal allocation of risk by looking at the party best capable of bearing the risk at lowest costs, thereby taking the effects on both parties' incentives into account.³¹ An efficient allocation of risk is also essential to overcome the problem of moral hazard or post-contractual opportunism due to asymmetric information between the firm and the consumer. Policy makers aim in principle at protecting consumers. Nevertheless, when all costs in case of a product's failure are borne by the firm, consumers might act opportunistically. Thus, consumers knowing that their product is fully covered by a warranty, might excessively use the good or take an inefficient level of care.³² A suboptimal

²⁵ See Slawson 1971: 531.

²⁶ Economists distinguish between three types of product attributes: (1) search goods: consumers can learn about their characteristics before the purchase, (2) experience goods: consumers can learn about the characteristics only after the purchase and (3) credence goods (trust goods) which are unobservable"; See Nelson 1970: 311ff; Darby and Karni 1973: 67ff.

²⁷ This problem typically arises when the welfare of one party (called the principle) depends on actions taken by another party (called the agent) and can not be perfectly observed by the principle, See Hansmann and Kraakman 2004: 21.

²⁸ See Kessler 1943: 632.

²⁹ See Rakoff 1983: 1223; Posner 2003: 115.

³⁰ See Kessler 1943: 632; Rakoff 1983: 1230.

³¹ „Repair by the consumer or the manufacturer are substitutes, and the consumer can be expected to purchase repair services as part of the warranty wherever the manufacturer's price is less than the consumer's cost of providing the repair himself.”, See Priest 1981: 1308, 1313; for “Comparative Advantage Explanation”, See Schwartz & Wilde 1983: 1398.

³² See Priest 1981: 1314.

allocation of risk could impose high costs on firms, leading to an increase in the price for the good or service. Consequently, when consumers are the cheapest risk avoider and the ones controlling the probability of the product's failure, they should also bear the risk.³³ In situations where the risk is independent of each party's behaviour it should be allocated at the party best capable to insure against the risk ("cheapest insurer").³⁴

For the assessment of the optimal division of risk, one could consider companies as being in the best position to allocate it efficiently, as standard form contracts represent an expert's view on the transaction.³⁵ Rakoff on the contrary, disagrees with the idea that firms are the better drafting parties for the reason that it is rather the firm's lawyer drafting the standard form contract than businessmen themselves. Moreover, as lawyers primarily aim at insulating their clients from any risk, they will pursue this goal even in matters where businessmen would be willing to take over some risk in favour to their consumers.³⁶

The allocation of risk is therefore one of the major concerns, when raising the question whether and to what extent law should enforce standard form contracts as consumers are unlikely to have read the standard form terms or even if read, they are unlikely to have understood the long and complex terms used in a standard form contract.³⁷ For this reason, too much risk might be shifted to the consumers.

3.1.3. Uncertainty Costs

Standard form contracts enable companies to make risk better calculable as standardization facilitates the accumulation of experience. For example, when courts interpret a specific term in a standard form contract, firms may rely on this interpretation also for similar terms in the future.³⁸ Furthermore, risk which is difficult to calculate or imposes high costs can be excluded completely or precisely defined in advance for all future situations.³⁹ By contrast, standard form terms when withstood judicial scrutiny can reduce the risk and costs of litigation for the company, as the standard form term has been proved to be adequate. Additionally, when consumers can learn about the meaning of particular terms,

³³ See Parisi 2004: 17; See also Schäfer/Ott 2005: 401ff.

³⁴ See Schäfer/Ott 2005: 406-407.

³⁵ See Llewellyn 1960: 334.

³⁶ Rakoff 1983: 1205.

³⁷ See Rakoff 1983: 1179, 1226; See also Meyerson 1990: 597f; for efficient search strategies see Schwartz & Wilde 1979: 643ff; for empirical evidence Mueller 1970: 274-277.

³⁸ See Farnsworth 1990: §4.26, 479.

³⁹ See also Kessler 1943: 631.

allowing them to litigate over the unfair ones, a migration of reasonable terms might be observed over time.⁴⁰

3.2. Strategic Use of Standard Form Contracts

The above given overview – reflecting the conventional view on transaction costs - has focused so far mainly on the relation of lowering the transaction costs and the effects thereof on firms and consumers as well as the risks created due to informational asymmetry. Another motivation for firms to employ standard form contracts – which is less apparent at first glance - has been developed by Giló & Porat.⁴¹ Since not much attention has been paid to these risks and benefits by courts and other scholars so far, the following subsection will provide a brief review of their arguments.

3.2.1. *“Segmentation of Consumers”*⁴²

Firms might have an incentive to screen out unwanted consumers or to only transact with a specific group of market actors. Therefore, businesses could use standard form contracts to raise the costs for some consumers in order to discourage them from entering into the contract.⁴³ Another motivation to use standard form terms is the perspective to indirectly price discriminate between different consumers. Firms thereby offer special discount rates for consumers willing to make an extra effort, such as filling out an additional form which has to be returned to the supplier. Hiding such terms in standard form contracts increases the chance that either only price conscious or marginal buyers will discover the clause or it favours sophisticated consumers capable of identifying such terms.⁴⁴ Furthermore, standard form terms can serve the purpose to gather information about consumer’s preferences, enabling firms to act accordingly.

3.2.2. *“Prevention of Competition and Cartel Stabilization”*⁴⁵

When evaluating the probability of a cartel to be sustainable, the literature on industrial organisation stresses the trade-off between the short term gains for firms when deviating and the long term gains from the collusive relationship. Since the complexity of standard

⁴⁰ See Hillman & Rachlinsky 2001: 11.

⁴¹ Giló & Porat 2006.

⁴² See Giló & Porat 2006: 8ff.

⁴³ e.g. creating high initial transaction costs to make the transaction only attractive for repeat consumers, See Giló & Porat 2006: 8-9.

⁴⁴ „In the beneficial terms case, however, it seems that those who do not appreciate the beneficial terms and therefore do not receive them, cannot argue that their expectations were frustrated: they got exactly what they expected to get.“, See Giló & Porat 2006: 20.

⁴⁵ See Giló & Porat 2006: 28ff.

form contracts makes it difficult for consumers to compare the contracts of competing firms, they are unlikely to recognise if the price cutting firm is offering a better deal. This reduces firms' incentives to compete, since the short term gains – by stealing only some of the competitor's consumers - might be relatively small, which in return facilitates collusive agreements. Additionally and quite intuitively, if consumers have difficulties to fully assess the value they receive due to complex contract terms, firms can raise prices even absent collusion. Complexity can also create a barrier to entry for new firms as consumers might be reluctant to change from the incumbent to the new firm, even though it offers a better deal. Furthermore Gilo & Porat conclude that beneficial standard form terms - only available to consumers who read and understand the provisions – make collusion even more sustainable than value reducing terms.⁴⁶

3.2.3. Balancing standard form terms

Firms are commonly aware of the danger that courts overturn unfair terms in standard form contracts. In order to reduce this risk, companies could include standard form terms into the contract, which viewed in its entirety might be considered as fair by the court. Although in reality consumers are not only not aware of the unfair terms but also of the beneficial ones, which in fact deters consumers to take advantage of the beneficial option while the firm benefits from the unfair term.⁴⁷

3.2.4. Signalling

Signalling serves as an information revealing function in case of asymmetric information.⁴⁸Firms in many circumstances have more information about the likelihood of a product failure compared to the consumer. Assuming that consumers only know the average market failure rate, they will not be willing to pay a price above average for the high quality goods. Therefore, firms might insert different types of warranties in their standard form contracts to signal their quality. Since high quality producers face lower defect rates and thus lower warranty costs, they will offer a warranty which exceeds the price received by low quality sellers and consequently would cause a loss to them.⁴⁹This price mechanism

⁴⁶ e.g. If a firm offers a boilerplate provision, which grants a special discount to consumers who fill out a certain form and mail it back to the firm, competitor could only steal the non-readers and even those ones would not necessarily switch, See Gilo & Porat 2006: 36.

⁴⁷ See Gilo & Porat 2006: 43ff.

⁴⁸ See Akerlof 1970: 488-500; Spence 1973: 355-374 (effects of signalling, using the job market as an example); See also Priest 1981: 1303ff.

⁴⁹ See Wehrt 2000: 182-184.

yields a separation equilibrium, which enables firms to produce high quality products and in return receive an adequate price, while consumers obtain credible information.⁵⁰

Yet, Gilo and Porat claim that warranties in standard form contracts additionally offer a credible signal for non-negotiability, indicating that the terms in all or most of their contracts will be maintained and cannot be waived. This is essential, as warranties only offer a credible signal for high quality when the same terms apply to all or at least most consumers, otherwise firms would have little incentive to maintain high quality. Similar, firms can employ standard form terms to commit themselves towards their commercial buyers that neither of them is receiving a special benefit or treatment compared to the others.⁵¹

3.3. Conclusion

In essence, no modern scholar argues that standard form contracts should be banned altogether and generally acknowledges their necessity for today's commerce, but they come at costs. The analysis given by Gilo & Porat mainly extends the number of risks associated to them and opens up the view for considering other areas of law to complement consumer law policies. Furthermore, it might increase courts' attentiveness to engage in broader enquiries before concluding the adequacy of a standard form term.

So far, we have seen the costs and benefits of standard form terms. Still, it does not provide an answer why the market left on its own will not create efficient outcomes, when consumers and firms bargain over a good or service. The answer to this question is now the main subject matter of the section below.

⁵⁰ See Parisi 2004: 14.

⁵¹ Gilo & Porat 2006: 46ff; For an analysis of the employment of boilerplates among sophisticated parties, See Ahdieh 2006: 1033-1074.

4. JUSTIFICATION FOR INTERVENTION

One of the fundamental concepts of economic analysis of law is the assumption of utility maximisation, meaning that market actors behave in a way to maximise their own private benefits. According to conventional microeconomic theory, under the ideal conditions of a perfectly competitive market – which includes strictly rational market actors and complete information - such utility maximising behaviour will lead to an efficient allocation of resources.⁵² Consequently, contracts between buyers and sellers will only consist of efficient terms, since an inefficient standard form term would make both parties worse off.⁵³ The economic rationale for intervening in markets, hence potentially interfering with the principle of freedom of contract, departs from the assumption of a perfectly functioning market in which regulation would not be required and the law needs nothing more than to enforce such contracts.⁵⁴ Rather, when transaction costs are high and thus contracts are incomplete or imperfect, government intervention might enhance efficiency.

4.1. Inequality of Bargaining Power

Kessler, in his seminal article on contracts of adhesion, wrote that “Standard contracts are typically used by enterprises with strong bargaining power. The weaker party, in need of the goods or services, is frequently not in the position to shop around for better terms, [...]”⁵⁵

According to Kessler, the existence of standard form contracts derives from the monopoly power of firms or from collusion within an industry, which leaves consumer no alternative other than to accept or refuse the contract as a whole. Moreover, the principle of freedom of contract enables enterprises to use standard form contracts to legislate in a “substantially authoritarian manner”⁵⁶. This means that firms can design one sided terms, which are binding upon consumers, in the same way as the state can impose legal rules upon its subjects. This notion of market power as analysed by Kessler is the concept to which Priest refers to as the exploitation theory⁵⁷. In sum, firms will exploit consumers due to their superior bargaining power facilitated by a change in the market structure from a competitive to a monopolistic one. In addition, it is assumed that consumers are easily manipulated by firms and thus will

⁵² See Cooter & Ulen 2004: 15-17, 217ff; Adam Smith 1776 cited by Mankiw 2004: 10; “Der vollständige Vertrag”, See Schäfer/Ott 2005: 393, 401f.

⁵³ See Korobkin 2003: 1208.

⁵⁴ See Cooter & Ulen 2004: 218.

⁵⁵ Kessler 1943: 632; contrary to this view see Trebilcock 1976: 364.

⁵⁶ Kessler 1943: 640.

⁵⁷ Priest 1981: 1299.

not be able to make rational decisions. On grounds of these assumptions, extensive regulation and court's intervention are indispensable in order to protect consumers.⁵⁸

4.2. Asymmetric Information

Returning to the idea of a perfect competitive market without market failures, consumers would evaluate the costs of each standard form term included in the contract by the firm. As a result, each standard form term added to the contract increases the firm's benefits by shifting risk to the consumers, but simultaneously lowers the price consumers are willing to pay for the good. Thus, the firm has an incentive to add clauses only up to the point where the marginal benefit of the last term equals the marginal cost.⁵⁹ Banning harsh standard form terms would under these conditions be detrimental for consumers who wish to accept the terms in exchange for a lower price.⁶⁰ Even in a monopolistic market, where firms can set the terms without competitive pressure, standard form terms will be efficient as long as consumers are perfectly informed.⁶¹

The situation changes as consumers typically do not know the content of the standard form contracts, which is under most circumstances a rational response to too high information costs associated with the assessment.⁶² This behaviour in turn enables the drafter to incorporate one sided clauses. According to Akerlof's "market for lemons", asymmetric information will lead to a decrease in the quality of the goods, in this case in the quality of standard form terms. This process of adverse selection is contingent on consumers' inability to identify sellers offering "high quality" standard form terms and those sellers offering only "low quality" terms, which in the end will drive out the high quality ones.⁶³ Therefore, as consumers only focus on some central contract terms – mainly the price – competition will only take place with respect to these terms and drives out efficient standard form terms for a "harsh-term-low price contract".⁶⁴ A solution to this problem

⁵⁸ See Schäfer 2000: 559.

⁵⁹ See e.g. Meyerson 1990: 589ff; Hatzis 2006: 4.

⁶⁰ Hence, decision makers should rather try to move the market towards a competitive equilibrium than regulating prices or prohibiting specific standard form terms, See Schwartz & Wilde 1979: 667.

⁶¹ Schäfer demonstrates in an economic model that in a competitive market as well as in a monopolistic market standard form contracts will only consist of efficient terms. But in the presence of asymmetric information, consumers will only consider the price and believe that the standard form terms are fair, thus will bear too much risk. Consumer surplus will decrease as well as total welfare. If consumers learn over time and hence discount the price, producer surplus will also decrease. See Schäfer 2002: 292-302.

⁶² e.g. costs of acquiring and understanding the content, search costs for alternatives, costs to assess and compare the other sellers' conditions. See e.g. Meyerson 1990: 600; De Geest 2002: 214.

⁶³ Akerlof 1970: 489-492; See also Nagel and Eger 2003: 143.

⁶⁴ This might be beneficial for some consumers, but detrimental for those ones preferring a higher price for better terms, See Goldberg 1974: 487.

as stated in most literature on asymmetric information is offered, when firms are able to signal their quality, thereby enabling consumers to choose a higher price for better standard form terms (See also 3.2.4).⁶⁵

4.3. Bounded Rationality

When traditional law and economics scholars analyse markets or legal rules and their implications for markets, they start with the assumption of a strictly rational decision maker.⁶⁶ The main challenge of the recently developed behavioural approach to law and economics is the replacement of the perfectly rational decision maker with a bounded rational one, i.e. an individual that is not only affected by emotions and motivations, but also exhibits limited cognitive resources, leading to some systematic errors.⁶⁷ Behavioural analysis recognises that efficiency does not only require individuals to read the terms, but also to fully incorporate the information into their purchase decisions.⁶⁸

Tversky and Kahneman found a wide set of deviations from the standard decision making, from which some of them are of particular importance for consumers' evaluation of contract terms.⁶⁹ For instance, it can be observed that individuals' preferences are not independent of the framing and wording of the content. Thus, the way firms formulate their contract clauses, can manipulate consumer decisions. Furthermore, individuals' categorise information and base their judgments on the degree to which the information is representative for a category.⁷⁰ Another distinctive feature is that individuals substitute the ease of recalling certain events with the probability of their occurrence. Consequently, people overestimate the probability of memorable events and vice versa. Moreover, individuals' judgments are affected by the desirability of their outcome. If a certain event is highly wanted, individuals tend to exhibit overconfidence with respect to their own abilities and skills and over-optimism concerning the likelihood of the event.⁷¹ In addition, they only focus on a limited number of factors instead of analysing all information available.

⁶⁵ Firm's reputation and good will could also be a useful measure other than intervention, See Schäfer 2000: 562; See also Bebchuk & Posner 2006.

⁶⁶ "[A]ll human behaviour can be viewed as involving participants who (1) maximize their utility (2) form a stable set of preferences and (3) accumulate an optimal amount of information and other inputs in a variety of markets." See Gary S. Becker 1976: "The Economic Approach to Human Behavior", p 14, cited by Jolls, Sunstein and Thaler 2000: 14.

⁶⁷ See Tversky and Kahneman 1974: 1124-1131; Kahneman and Tversky 1984: 341-350; Tor 2002: 484.

⁶⁸ See Eisenberg 1995: 214; Korobkin 2003: 1217-1218.

⁶⁹ Tversky and Kahneman 1974: 1124-1131; Kahneman and Tversky 1984: 343-344.

⁷⁰ e.g. If a bank tailor resembles the stereotype of a "trustworthy and competent bank tailor", consumers will underestimate the risk that he acts opportunistically or in the banks sole interest.

⁷¹ See Hillman 2000: 723-724; for an explanation of disproportionately high liquidated damages clauses see Eisenberg 1995: 225ff.

Korobkin reviewed in his article several empirical data, showing that consumers select only a small number of attributes in standard form contracts for closer investigation.⁷²

Finally, courts and other institutions are also not fully insulated from heuristics and biases, rather they exhibit other deficiencies. Noteworthy, although not only specific to courts, is the hindsight bias. It follows from behavioural studies that actors tend to overestimate the ex ante predictability concerning the likelihood that an event occurs, after having learned that it actually happened.⁷³

4.4. Conclusion

Market intervention justified by the exploitation theory is not well founded and nowadays mainly a legal argument. Instead, as standardisation lowers transaction costs (See 3.1) competitive firms as well as monopolists have an incentive to use standard form contracts. The fact that many firms in an industry use the same standard form terms, is not sufficient to conclude the existence of a cartel as it could just as well indicate a high level of competition among the firms.⁷⁴ A change in ideology was initiated by Akerlof's "market for lemons"⁷⁵ (See 4.2), which offers the main justification for government intervention.

Yet, Schwarz and Wilde developed a model, which indicates that even under imperfect information the market will offer efficient prices and contract terms if a sufficient number of informed consumers exist in the market. Thus, their core idea is that in a competitive market informed consumers will generate efficient terms also for uninformed consumers.⁷⁶ This approach, however, seems plausible in respect of performance terms and for terms easy comprehensible or concerning risk which materialises frequently enough in order to allow consumers to learn over time. But considering the large number of terms used in standard form contracts, the relatively low probability of risk concerned and factors such as time pressure, the costs to search for another seller and the level of education necessary to understand the full context of the terms, it is rather unlikely that this model will hold for many terms used in standard form contracts.⁷⁷

⁷² See Korobkin 2003: 1227.

⁷³ e.g. Individuals might be found negligent in situations where they have taken an efficient level of precaution ex ante, See Korobkin & Ulen 2000: 1095-1100.

⁷⁴ See Trebilcock 1976: 364-365; Schwarz & Wilde 1979: 651-656.

⁷⁵ Akerlof 1970: 488-500.

⁷⁶ Schwarz & Wilde 1979: 638; For a critical approach, stating that a small number of uninformed consumers suffice to create inefficient standard form terms, See Gazal 1999.

⁷⁷ See also Meyerson 1990: 600-603;

From the above given short insight to behavioural law and economics, some additional explanation for the tension between the principle of freedom of contract (whereby every bargain should be enforced), which rests on the premise that parties are the best judges of their own utility, acting with full cognition and the limited enforcement of contracts in reality, might be inferred.⁷⁸ Hence, behavioural decision making might broaden the scope for legal intervention.

⁷⁸ See Eisenberg 1995: 212.

Part II

5. INTRODUCTION TO THE DIRECTIVE 93/13/EEC

5.1. History and some Empirical Evidence

In 1993 the Commission began analysing certain types of standard form contracts offered to consumers throughout the Member States (“MS”). The findings of the studies showed that standard form contracts are omnipresent, difficult to observe and to understand for consumers. This led to the conclusion that the European Union (“EU”) can not rely on market forces to solve the problem of unfair terms. Rather, due to the increase in cross-boarder transactions and companies operating on an international basis, consumers face more frequent contracts drawn up in a foreign language and governed by a legal system different to their own which makes it even harder for them to assess the information.⁷⁹ This tenor was also confirmed after the enactment of the directive by the ECJ in the case *Océano*, declaring: “[...] it should be noted that the system of protection introduced by the Directive is based on the idea that the consumer is in a weak position vis-à-vis the seller or supplier, as regards both his bargaining power and his level of knowledge”.⁸⁰

The implementation of the European Council Directive 93/13/EEC on unfair terms in consumer contracts as of 5 April 1993 (“the Directive”) was the tipping point for a wide range of consumer law policies. The approach employed in the Directive is based on minimum harmonisation, thereby allowing MS to implement or maintain more stringent provisions in their national laws (See Art. 8 of the Directive). The implementation of the directive was followed by a significant increase in consumer litigation. Out of a total of 7.649 cases in 2000, only about 3.000 decisions were made up to January 1st 1995, whereby the first case dates back to the year 1931.⁸¹ The latest number of decisions available amounts to 12.566.⁸² The vast majority of terms considered to be unfair concern obligations imposed on consumers such as exclusion or limitation of rights, penalty clauses and special charges. Followed by terms waiving and limiting professional’s liability and the way standard form contracts are presented to consumers.⁸³ In 2000 real estate and financial

⁷⁹ See Report from the Commission 2000: 5, 9, 25.

⁸⁰ See joined cases C-240/98 to C-244/98 of the ECJ.

⁸¹ Also significant, is the increase in preventive measures against unfair terms by more than 50% from 1995 – 2000, See Graph 6 in Annex III of the Report from the Commission 2000.

⁸² Unfortunately, this number dates back to 2003/2004 as the Commission suspended to update the CLAB Database.

⁸³ See Graph 10 in Annex III of the Report from the Commission 2000.

services were the sectors where most unfair terms were found. In respect to the latter most of the terms were either related to bank accounts or consumer credits.⁸⁴

5.2. Main Goals of the Directive 93/13/EEC

The broader goal of the European Community (“EC”) is the establishment and enhancement of a single internal market, which also requires the harmonisation of consumer laws among the MS.⁸⁵ “[A]cquirers of goods and services should be protected against the abuse of power by the seller or supplier, in particular against one-sided standard contracts and the unfair exclusion of essential rights in contracts”.⁸⁶ The Directive’s main focus is (1) to provide a distinct system of control of the content of standard form terms and (2) to assert the principle of transparency.

6. ANALYSING THE STRUCTURE AND MAIN FEATURES OF THE DIRECTIVE 93/13/EEC

6.1. Composition of the Directive

The central article in the Directive is Art. 3 (1), composed of a general clause for determining whether a standard form term is considered to be unfair. In addition, Art 3 (3) refers to an indicative non-exhaustive list of terms in the so-called Annex, which supplements the general conditions for the ease of the assessment. If the court ascertains that a standard form term is regarded as unfair, it follows from Art. 6 that the term shall not be binding upon consumers. Another main element of the directive contains Art. 5, which constitutes the principle of transparency and sets the standard for courts’ interpretation in case of ambiguous standard form terms. Finally, the directive requires under Art. 7 that MS shall provide an effective system to prevent the use of unfair standard form terms.⁸⁷ In particular persons or organisations with a legitimate interest in protecting consumers (e.g. consumer organisations) shall be granted the right to take actions according to national law.

⁸⁴ See Graph 11 and 12b in Annex III of the Report from the Commission 2000.

⁸⁵ See Streinz 2003: 14-15.

⁸⁶ See recital 9 of the European Council Directive 93/13/EEC.

⁸⁷ „Although the Directive allows Member States to choose between a legal procedure and an administrative one, all countries have opted for the legal procedure.“, See Report from the Commission 2000: 21.

6.2. Law and Economics Analyses of Article 3 (1) of the Directive
-The “unfairness” test-

“A contractual term which has not been individually negotiated shall be regarded as unfair, if contrary to the requirement of good faith, it causes a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer.”⁸⁸

6.2.1. a legal perspective

From a legal point of view, Art. 3 (1) draws attention to three conditions: Firstly, terms which have not been individually negotiated. Secondly, terms causing a significant imbalance and are contrary to the requirement of good faith and thirdly, terms which are to the detriment of consumers.

6.2.1.1. “negotiated terms”

The Directive excludes contractual terms which have been individually negotiated. This on the one hand has proved reasonable as none of the cases collected in the CLAB database contained individually negotiated standard form terms. On the other hand firms – respectively their lawyers – tried to apply this condition in their own advantage, by including terms by which consumers declare that the contract has been individually negotiated (See 6.6.4 – Case Study).⁸⁹ Nevertheless, the burden of proof whether a term was individually negotiated or not, is on the firm and Art. 3 (2) states, that it is not sufficient to negotiate certain aspects of a contract to exclude the application of this rule. Besides, ten MS provide in extension to the minimum requirement of the directive for review of individually negotiated terms, hence allowing courts and other authorities to also monitor such contract terms.⁹⁰

6.2.1.2. “significant imbalance and the principle of good faith”

The second condition refers to a significant imbalance between the parties’ rights and obligations other than the main subject matter of the contract as defined under Art. 4 (2). Yet, some countries did not adopt Art. 4 (2), so that in principle the monitoring of the

⁸⁸ See Art. 3 (1) European Council Directive 93/13/EEC.

⁸⁹ See Report from the Commission 2000:14.

⁹⁰ These are the Nordic Countries (Denmark, Finland, Sweden), furthermore Belgium, Czech Republic, France, Latvia, Luxembourg, Malta and Slovenia, See Schulte-Nölke, Twigg-Flesner and Ebers 2006: 364 (the information and comparison drawn in the compendium is based on the state as of mid 2006).

main subject matter and the adequacy of the price is possible.⁹¹ To establish a significant imbalance, courts are required to compare the consumer's position under the standard form term with the underlying default rules. Consequently, if the default rule is significantly more advantageous than the standard form term, the presence of a significant imbalance has been established.⁹²

The relation to the requirement of good faith is not yet clear and is applied by the MS in different ways, thereby raising several questions regarding its relation to the requirement of significant imbalance and the relation to Art. 4 (1).⁹³ Some countries did not mention this condition explicitly, whereas other countries even emphasize the principle of good faith in their consumer law provisions. For instance § 6 of the Austrian Consumer Protection Act ("KSchG") refers to § 879 (3) of the Austrian Civil Code ("ABGB"), which directly only refers to a significant imbalance.⁹⁴ In contrast, § 307 (1) of the German Civil Code ("BGB") emphasizes the principle of good faith.⁹⁵ Nevertheless, the difference between the laws might not be as severe as it seems at first glance as it depends on the legal practice. Moreover, § 879 (1) ABGB provides a general clause which comprises a principle⁹⁶ similar to that of good faith found under German law.⁹⁷ Additionally, § 879 (3) ABGB could be interpreted as reflecting the principle of good faith as it requires an overall assessment of all circumstances of the case in order to conclude a significant imbalance and not only with regard to a single standard form term. This entails an ex ante assessment by courts and subsequently a comparison in respect to the underlying default rules.⁹⁸

6.2.1.3. "consumer standard form contracts"

The Article's last condition requires that the standard form term is detrimental for consumers, thereby making clear that it only affects the relationship between firms and consumers but excludes business to business ("B2B") and private to private ("P2P")

⁹¹ See Schulte-Nölke, Twigg-Flesner and Ebers 2006: 374.

⁹² See Schulte-Nölke, Twigg-Flesner and Ebers 2006: 366; See also Krejci in Rummel 2000: § 879, mn.. (margin number) 240.

⁹³ See Schulte-Nölke, Twigg-Flesner and Ebers 2006: 366.

⁹⁴ "einen Teil gröblich benachteiligt", See § 879 (3) ABGB.

⁹⁵ "gegen Treu und Glauben" but subsequently states „unangemessen benachteiligen“ which could be interpreted as a significant imbalance, See MünchKommBGB (Kieninger) 2007: § 307, mn 31-32

⁹⁶ "gegen die guten Sitten", See § 879 (1) ABGB

⁹⁷ Besides, the principle of good faith is not alien to the Austrian jurisprudence, See Barta 2004: 752-753.

⁹⁸ See Krejci in Rummel 2000: § 879, mn. 240.

agreements. However, the national laws also diverge in this respect in the way that some countries apply the rules to some extent also in B2B and P2P contracts.⁹⁹

6.2.2. an economic perspective

The legal analysis highlighted some differences in the implementation and application of Art. 3 (1) among the MS. The attempt of this section is to shed some light on the economic effects of the different approaches employed. In particular the effects of including or excluding individually negotiated terms as well as the main subject matter according to Art. 4 (2). Furthermore, some insights to the impact of the principle of good faith and on the limited scope of protection to B2C standard form contracts will be provided in the following.

6.2.2.1. “including or excluding negotiated terms”

As stated already earlier in the first part, economists distinguish between three types of product characteristics: search goods, experience goods and credence goods (See 3.1.1). According to Nelson, individuals maximize their expected utility if “a person will search until the marginal cost of search becomes greater than the marginal expected return”.¹⁰⁰ In cases where search costs are too high, consumers can instead use his experience to determine the quality of a good.¹⁰¹

Now, a standard form term can be viewed as a good which belongs to one of the three categories. In a standard form contract potentially negotiable – if at all - are the price and performance terms related to the good (See 2.2).¹⁰² These terms, will typically form part of the first category or might require some experience.¹⁰³ Therefore, it seems reasonable to assume that the costs to acquire information is low enough or that consumers can learn easy enough, to create an efficient price or performance standard.¹⁰⁴ If consumers do not face the problem of asymmetric information for these terms, courts should refrain from making them subject to judicial control. This conclusion would even be stronger, when according to Schwarz and Wilde in a competitive market one third of price conscious

⁹⁹ For instance Germany and Austria, See Schulte-Nölke, Twigg-Flesner and Ebers 2006: 357.

¹⁰⁰ Nelson 1970: 313.

¹⁰¹ See Nelson 1970: 327.

¹⁰² See also Goldberg 1974: 485.

¹⁰³ See Meyerson 1990: 597.

¹⁰⁴ “[I]gnorance is irrational when the expected benefits from being informed exceeds the cost of acquiring information”, See Cooter & Ulen 2004: 221; See also Schäfer/Ott 2005: 504ff; Ulmer, Brandner and Hensen 2006: § 307, mn. 39.

consumers suffice to reach the competitive equilibrium price.¹⁰⁵ Apart from low transaction costs, the same counts for the specific case when the transaction volume is sufficiently high, thereby making it worthwhile to incur costs for review.¹⁰⁶

In contrast, those terms which are typically referred to as standard form terms (See 2.2) rather exhibit features of credence goods, meaning that their content will not be known to consumers even after repeated purchase.¹⁰⁷ As the costs of acquiring information will generally be too high, asymmetric information will prevail (See 4.2). Consequently, a review of non negotiated terms by courts – due to the too high information costs – seems necessary to protect consumers.

6.2.2.2. “including or excluding the main subject matter”

The main subject matter as well as the relation between price and quality are product aspects which consumers typically consider when purchasing a good. Consequently, “There is no signing without reading with respect to price.”¹⁰⁸ Therefore, in order to uphold the principle of freedom of contract and to avoid uncertainty over contract terms by making them subject to judicial review, it appears reasonable to exclude the main subject matter and the price/quality relation from the scope of the directive.

A related question is whether an unfair standard form term could be justified by a lower price. As consumers are heterogeneous, some – in particular low income consumers – might prefer to waive some protection instead of forgoing the good as such. But if this is prohibited by law, the effect is a higher price or in other words a statutory insurance equal for all consumers - leading to an adverse effect, where the poor consumers in principle have to subsidise the rich.¹⁰⁹ A superior solution would be to provide consumers with a “product package” according to their preferred insurance and price level.¹¹⁰

¹⁰⁵ Schwarz & Wilde 1979: 653.

¹⁰⁶ See Schäfer 2002: 306-307.

¹⁰⁷ See Meyerson 1990: 597.

¹⁰⁸ See De Geest 2002: 230.

¹⁰⁹ See Van Den Bergh 1997: 82-83; See also MünchKommBGB (Kieninger) 2007: § 307 mn. 41.

¹¹⁰ See Schäfer 2000: 564.

6.2.2.3. “principle of good faith and its relation to significant imbalance”

Even though the principle of good faith is familiar to civil law systems as well as common law ones, it lacks a clear legal definition. Macksay & Leblanc define good faith from a law and economics perspective as “the exact opposite of opportunism”¹¹¹ and propose a three-step test to establish the absence or presence of good faith.¹¹²

Pineau et al for instance provides for a legal definition stating that “one should not profit from the inexperience or vulnerability of other persons to impose on them draconian terms, to squeeze out advantages which do not correspond to what one gives them.”¹¹³ From a law and economics perspective, this definition could be translated in a way that one party should not benefit from an unfair standard form contract, thereby imposing costs on the other party. Again rephrased, a standard form contract should make at least one party better off without making the other party worse off, thereby achieving a so-called Pareto improvement.¹¹⁴

Consequently, the relation between the principle of good faith and significant imbalance is such that it is not sufficient to isolate a single standard form term to establish a significant imbalance or to infer the welfare effects of a standard form contract. Rather, the principle of good faith requires courts to assess all circumstances before concluding that a standard form term is unfair according to Art. 3 (1). Courts could in a first step prove that the standard form term at issue has not been individually negotiated and seems to exhibit a significant imbalance. In a second step, they would have to assess all circumstances – according to the principle of good faith – in order to conclude that a significant imbalance is still present which renders the clause invalid.¹¹⁵ In doing so, courts are required to evaluate all circumstances from an ex ante perspective, as the particular unfairness lies in the asymmetric information at the moment when parties enter into the contract, leading to decisions which are detrimental for the party’s own utility.¹¹⁶

¹¹¹ Macksay & Leblanc 2003: 26.

¹¹² It requires (1) a certain level of informational asymmetry, (2) one party uses the asymmetry to its own advantage thereby exploiting the other party and (3) the exploitation has to have some significance, See Macksay & Leblanc 2003: 12-15.

¹¹³ Pineau, Jean, Burman, Danielle and Gaudet, Serge (2001), “Théorie des obligations”; cited by Macksay & Leblanc 2003: 9.

¹¹⁴ For Pareto efficiency see e.g. Schäfer/Ott 2005: 26ff, 422.

¹¹⁵ See e.g. Trebilcock 1976: 376ff (providing a good measure for how broad such enquiries should be using the case *Macaulay vs. Schroeder Publishing Co Ltd*).

¹¹⁶ See Schäfer/Ott 2005: 422.

To conclude, the principle of good faith seems to be a necessary prerequisite for an efficient assessment of standard form contracts and a requirement different from establishing a significant imbalance of a single standard form term. It follows that a standard form term can create a significant imbalance to the detriment of consumers but nevertheless be in line with the principle of good faith. In this respect the firm gains vis-à-vis the court more room for defence. However, an assessment of the overall balance of a standard form contract requires courts to analyse and compare the costs and benefits of the different standard form terms. In particular, courts have to consider the different probabilities of the likelihood that events included or excluded by such terms actually occur in order to assess the overall balance of the standard form terms. This task can be extremely difficult, time consuming and costly. Therefore, some unfair standard form terms which impose unreasonable high risks or costs on consumers should not be subject for being counterbalanced by beneficial contract terms (See 6.3.2.1). Moreover, the possible negative effects of balancing unfair standard form terms as pointed out by Gilo and Porat call for a cautious approach (See 3.2.3).

6.2.2.4. “consumer standard form contracts”

The remaining issue covered by Art. 3 (1) is whether it seems reasonable from an economic perspective to narrow the scope of protection to standard form contracts between consumers and firms.¹¹⁷ The trigger for the EC to engage in consumer protection was the concept of inequality in bargaining power, still emphasised by the ECJ (See 4.1 and 5.1). This theory is also the basis for a multitude of national courts among different MS in order to refrain from enforcing standard form terms contrary to the principle of *pacta sunt servanda*.¹¹⁸

However, modern law and economics theory has shown that the justification for a content control of standard form contracts is based on asymmetric information (See 4.2) and not due to superior bargaining power of the firm.¹¹⁹ Therefore, the scope for protection should depend on whether asymmetric information is able to hinder a party – consumers as well as firms – to make an efficient decision. In this respect, the implementation of Art 3 (1) of the Directive into the German Civil Code is exemplary for two reasons: Firstly, the justification

¹¹⁷ For a precise definition of consumer and firm (respectively seller or supplier), See Art. 2 of the Directive.

¹¹⁸ See Krejci in Rummel 2002: Vor § 1 KSchG mn. 2; Barta 2004: 112; See also Schulte-Nölke, Twigg-Flesner and Ebers 2006: 333-336.

¹¹⁹ For an economic model see Schäfer 2002: 292ff.

for courts intervention is based on asymmetric information, which even found its way into the accompanying commentary of § 307 BGB.¹²⁰ Secondly, as the connecting factor for intervention is asymmetric information and not superior bargaining power it is sensible that the German legislator implemented the specific law on standard form contracts (“AGBG”) into the BGB, thereby extending the scope beyond consumer standard form contracts.¹²¹

6.3. Law and Economics Analysis of Article 3 (3) of the Directive -The Annex-

“The Annex shall contain an indicative and non-exhaustive list of the terms which may be regarded as unfair.”¹²²

6.3.1. a legal perspective

The wording of the above cited Article gave rise to different interpretations among the MS with regard to the nature of the terms included in the Annex, which justifies a closer look.

6.3.1.1. “the nature of the annex”

The Annex of the Directive contains a list of 17 types of contractual terms which may be regarded as unfair, meaning that such terms used in a contract are not unfair per se. As it was not clear from the Directive, the European Court of Justice (“ECJ”) clarified the legal nature of the Annex by declaring that the Annex “is of indicative and illustrative value, it constitutes a source of information both for the national authorities responsible [...] and for individuals affected by those measures.”¹²³ Furthermore, advocate general Geelhoed states that “Unlike in the national law of certain Member States, no distinction is made in the Annex to the Directive between a so-called black list [...] and a grey list[...]”.¹²⁴ However, he concludes – thereby referring to the Commissions original proposal to the Annex - that the initial intention was to create a list of terms which should always be regard as unfair, but at the end was designed as an indicative list.¹²⁵ However, 59% of the standard form terms assessed by courts in respect of

¹²⁰ See MünchKommBGB (Kieninger) 2007: § 307 mn. 39.

¹²¹ See Schäfer 2002: 306; Similar the general provision in the Austrian Civil Code, See Krecji in Rummel 2000: § 879 mn. 244.

¹²² See Art. 3 (3) of the European Council Directive 93/13/EEC.

¹²³ See case C-478/99, Commission vs. Kingdom of Sweden, para. 22 (The ECJ acknowledged contrary to the European Commission’s claim that it is sufficient to implement the Annex into the preparatory work).

¹²⁴ See Opinion of Advocate General C-478/99, Commission vs. Kingdom of Sweden, para. 26.

¹²⁵ See Opinion of Advocate General C-478/99, Commission vs. Kingdom of Sweden, para. 27-28; See also Schulte-Nölke, Twigg-Flesner and Ebers 2006:375.

their unfairness were deemed to be covered by one or more of the terms as defined in the Annex.¹²⁶

6.3.1.2. “implementation in the member states”

As according to Article 249 EC the choice of form and methods for the implementation of a directive is in principle left to the MS as long as it does not undermine the effectiveness of the directive, the Annex has been transposed in different ways. More precise, the integration into national law ranges from MS implementing the Annex as a black list, to countries which did not formally integrate the Annex into their law at all.¹²⁷ For instance under § 6 (1) KSchG virtually all terms stated in the Directive belong to a black list, whereas under §§ 308 – 309 BGB a black and grey list coexists. Clearly, the disparity among the MS affects the legal assessment of unfair terms by national judges. Whereas standard form terms employed in a contract will be always declared invalid by the judge if they form part of a black list, a grey list only offers a presumption of unfairness but has to be decided on basis of the case in question. In addition, a grey list also raises the issue of whether the burden of proof shall be upon the seller or the consumer. Interestingly, an Austrian representative explained that the criterion for the assessment of unfairness of a clause is stricter under Austrian law when the seller is in a monopoly position, but the burden of proof is upon the consumer.¹²⁸

6.3.2. *an economic perspective*

The above accomplished legal analysis has shown some of the different ways of implementation without answering which system might be superior. Therefore, the following section serves the purpose for giving some considerations in this respect.

6.3.2.1. “black list vs. grey list”

In order to analyse the pros and cons of the two different approaches, one has to examine the particular features of each type. In my perspective, the concept of mandatory rules and default rules seems a good starting point for a comparison of the two lists.

¹²⁶ See Graph 8 of the Report from the Commission 2000.

¹²⁷ For a detailed list of the transposition of each paragraph in the Annex among all MS, See Schulte-Nölke, Twigg-Flesner and Ebers 2006:375 ff.

¹²⁸ See Minutes of the conference "The Directive on « Unfair Terms », five years later - Evaluation and future perspectives", Workshop 3 (1999): 142.

Default rules fill gaps in incomplete contracts, thereby lowering transaction costs for the parties as well as for courts. One type of default rule is the so-called majoritarian default rule, which increases efficiency when left in place by the parties. Nevertheless, if this rule is inefficient for a minority of contractual parties, they can contract around and if it turns out that the rule is inefficient for the majority of parties – due to empirical data for instance – the lawmaker can react and change the rule. Turning to mandatory rules it becomes clear that the market can not learn from inefficient rules, as parties have no alternative other than to comply with the law.¹²⁹

Similar, if the Annex of the Directive is implemented as a grey list, it lowers transaction costs for the assessment of whether a clause is unfair or not compared to a broad enquiry under the general clause of Art. 3 (1). Furthermore, standard form terms which are beneficial for a minority of consumers, could be adopted into the contract but are considered to be unfair unless the contrary has been proved. This could be a beneficial solution for both - consumers and firms - if for instance, firms employ an acceptable way to make consumers aware of the risk they take in exchange for a low price.¹³⁰ This idea seems also in line with Van den Bergh's critic on poor consumers subsidising the rich and corresponds with the aim that consumer protection law should mimic the parties' rights and obligations the same way as if they would have contracted around.¹³¹

On the contrary, standard form terms which are always considered inefficient should be absolutely forbidden and thus should be part of a black list.¹³² The main difficulty of this practice is to establish a procedure which ensures that these standard form terms are inefficient in fact. Standard form terms causing significant harm on consumers could also justify the establishment of a black list, even if under some very unlikely or rare conditions they can be beneficial. For instance, penalty clauses are generally considered to be inefficient, as the agreed overcompensation for breach of contract leads to inefficient performance in cases where the costs of performance exceed the benefits to all parties.¹³³

¹²⁹ See Cooter & Ulen 2004: 210ff.

¹³⁰ See also De Geest 2002: 226.

¹³¹ Van den Bergh 1997: 83.

¹³² See De Geest 2002: 225.

¹³³ See Cooter & Ulen 2004: 254; Penalty clauses have to be distinguished from liquidated damages. The latter do not aim at overcompensating the other party.

Thus, it seems reasonable when MS decide to include penalty clauses into their black list, even though under some very particular conditions they could be beneficial.¹³⁴

Consequently, it can be concluded that a mix of the two lists appears to be most suitable. However, the Annex of the Directive was not designed as a black list, therefore MS should be aware that the terms in the Annex need some careful evaluation before being implemented into a national black list. In contrast, the grey list should be as comprehensive as possible. Although it is true that a grey list causes more uncertainty for the parties than a black list, nevertheless it provides more certainty than courts assessment of standard form terms according to the general clause of Art. 3 (1).¹³⁵

6.3.2.2. “the burden of proof”

Even though it seems intuitively convincing that the burden of proof for the unfair nature of a standard form term should be upon the seller or supplier, as – according to legal tradition – the consumer is in the weak position compared to the former. However, from a law and economics perspective the burden of proof should be upon the party being in the best position to provide evidence at lowest costs (“least cost avoider”).¹³⁶ Of course, in many circumstances the firm will be in the better position to provide evidence of whether a standard form term could be considered to be unfair or not. This is especially true in respect to objective measures or data,¹³⁷ e.g. probability and frequency of product failure, costs to provide services, market structure and so forth. In this view, the approach employed under Austrian law where the consumer should provide evidence of a firms monopoly power (See 6.3.1.2), seems to contradict with the notion of the least cost avoider.¹³⁸ However, under some circumstances in order to prevent opportunistic behaviour it could be justified to impose the burden of proof on the consumer. For instance, the proof that a preclusion of certain damages from a warranty is unfair should be upon the consumer if in the vast majority of situations the damage is depending on the consumers’ maintenance.¹³⁹

¹³⁴ e.g. in respect to a penalty clause against the drafter of a standard form term reflecting the highest possible loss, as it might be extremely costly to draft individual damage clauses for each consumer; See De Geest and Wuyts 1999: 157-158.

¹³⁵ See Beale 1995: 246.

¹³⁶ For the optimal allocation of the burden of proof, See Hay 1997: 651-679.

¹³⁷ See Van den Bergh 1997: 93.

¹³⁸ Apart from the arguable approach that the burden of proof is on the consumer, the underlying assumption that there is a higher probability of unfairness in case of monopoly power is also contrary to modern economic theory.

¹³⁹ See also Parisi 2004:31

6.4. Law and Economics Analysis of Article 6 (1) of the Directive
-The Consequence of Unfairness-

“Member States shall lay down that unfair terms used in a contract concluded with a consumer by a seller or supplier shall [...] not be binding on the consumer and that the contract shall continue to bind the parties upon those terms if it is capable of continuing in existence without the unfair terms.”¹⁴⁰

6.4.1. a legal perspective

In essence, Art. 6 entails that the contract shall in principle continue to be in force, although without the unfair term. It is quite obvious that this Article creates some problems in respect of its interpretation, as the definition is fairly vague with regard to the meaning of “not be binding on the consumer”. This imprecision led to different practices by national legislators.¹⁴¹ In this respect of major legal relevance is whether an unfair term shall be considered to be absolute or relative void.¹⁴² Followed by a second question namely whether the standard form term should be substituted by a default rule or adjusted by courts’ interpretation.

6.4.1.1. “absolute void or relative void”

Some clarification – as to the absolute or relative voidness - was provided by the ECJ in *Océano*¹⁴³, where the ECJ held that a national court has to assess the unfairness of a jurisdiction clause *ex officio* in order to satisfy Art. 6 and to support the aim defined in Art. 7 of the Directive. In the case *Cofidis*¹⁴⁴ the ECJ extended the previous decision and held that a national court should not be powerless to declare a standard form term unfair, because of a national time limit on the court’s power for assessing such terms. Finally, in the case *Mostaza Claro*¹⁴⁵ the ECJ emphasised once more – this time concerning an arbitration clause – that the court has to establish the unfairness of a standard form term, “[...] even though the consumer has not pleaded the invalidity in the course of the arbitration proceedings, but only in that of the action for annulment.”¹⁴⁶

¹⁴⁰ See Art. 6 (1) of the European Council Directive 93/13/EEC.

¹⁴¹ See Schulte-Nölke, Twigg-Flesner and Ebers 2006: 384.

¹⁴² Due to the ambiguous meaning of the expressions, I will confine myself to the Austrian interpretation: An absolute void contract has no legal force; this has to be administered by courts *ex officio* and can be invoked by everyone without expiring date. In contrast, relative void means that a contract term is valid, until the contractual partner (here: consumer) challenges the contract before the competent court (not *ex officio*), See Krejci 1981: 174f; Barta 2004: 343-344.

¹⁴³ See joined case C-240/98 to C-244/98: para 26-29; See also Schulte-Nölke, Twigg-Flesner and Ebers 2006: 385.

¹⁴⁴ See case C-473/00:para 34-36; See also Schulte-Nölke, Twigg-Flesner and Ebers 2006: 385.

¹⁴⁵ See case C-168/05; See also Schulte-Nölke, Twigg-Flesner and Ebers 2006: 386-387.

¹⁴⁶ See case C-168/05: para 39.

When considering the decisions in light of the above stated distinction between absolute and relative voidness, the ECJ's pleadings rather refer to the former. More precisely, the ECJ insists on national courts to decide *ex officio*, hence without requiring consumer's plea and also deemed the time fixing as inappropriate. For this reason, the definition of absolute voidness under Austrian law seems in line with the ECJ's decisions.¹⁴⁷ However, according to the Austrian Supreme Court's interpretation of § 879 (3) ABGB and § 6 KSchG, unfair standard form terms are in principle relative void.¹⁴⁸ German law in contrast regards unfair standard form terms as absolute void.¹⁴⁹ Therefore, the remaining question is whether relative voidness can guarantee a sufficient level of protection for consumers or if absolute voidness is required.

6.4.1.2. "courts interpretation of unfair standard form terms"

With regards to the second issue, the possibility of courts to adjust an unfair standard form term in a way that the term is still acceptable, is not mentioned in the Directive and has not been decided so far by the ECJ. However, as recital 21 of the Directive requires unfair terms to not be binding upon consumers, a mere reduction of the content might not satisfy the provision.¹⁵⁰ German law explicitly regulates under § 306 (2) that in case of an unfair standard form term the underlying default rule is applicable.¹⁵¹ Austrian law in contrast has no such rule in the Civil Code. Rather, prevailing case law of the Supreme Court holds that "Führten diese Beweisaufnahmen zur Beurteilung daß die Voraussetzungen für eine Nichtigkeit nach § 879 Abs. 3 ABGB gegeben wären, bedeute dies aber nicht den gänzlichen Wegfall der vereinbarten Konventionalstrafe. Die Konventionalstrafe wäre dann vom Gericht [...] festzusetzen [...]"¹⁵² (emphasis added) However, preventive measures taken in collective proceedings require courts to interpret a standard form clause in the utmost consumer "unfriendly" manner.¹⁵³ Given that and the fact that out of a total of 2886 cases on unfair consumer terms in

¹⁴⁷ For the Austrian definition see fn. 142.

¹⁴⁸ Yet for the courts to apply § 879 (3) it is sufficient that they can derive the parties intention conclusive from the claim ("schlüssige Einrede"), which expands the courts ability to become proactive, See 6 Ob 523/85, 6 Ob 55/02k; See also Krejci in Rummel 2002: § 6, mn. 9-10.

¹⁴⁹ See Ulmer, Brandner and Hensen 2006: § 307, mn. 106.

¹⁵⁰ See Nölke, Twigg-Flesner and Ebers 2006: 386.

¹⁵¹ This is undisputed in respect to collective proceedings and seems prevailing jurisprudence and doctrine for individual proceedings, See Ulmer, Brandner and Hensen 2006: § 306, mn. 14; For counter arguments see MünchKommBGB (Basedow) 2007: § 306, mn. 12-14.

¹⁵² "If evidence would prove that the conditions under § 879 (3) ABGB were fulfilled, it can nevertheless not be concluded that the liquidated damage clause as a whole has to be abolished. The amount for the liquidated damage clause would then have to be assessed by the court [...]" (rough translation made by the author), See 1 Ob 581/83, also confirmed in 3 Ob 2004/96v, 4 Ob 119/03h; For critique see Koziol Welser I 2006: 183.

¹⁵³ See e.g 2 Ob 523/94 (first ruling on the subject), 7 Ob 4/07z (latest ruling).

Austria 2855 were preventive measures,¹⁵⁴ the impact of the interpretation of § 879 (3) might be less significant than expected.

6.4.2. an economic perspective

Law and economic scholars' analysed at length different ways for "filling gaps in incomplete contracts"¹⁵⁵, thereby reconstructing a perfect contract.¹⁵⁶ The problem of standard form contracts is somehow different. Although these contracts might come close to a perfect contract, they do not coincide with the economic concept of a Pareto improvement, where at least one party is better off and nobody is worse off.¹⁵⁷ Hence, the challenge for courts is to refrain from enforcing such standard form terms, thereby artificially creating a gap which has to be filled by way of interpretation.

6.4.2.1. "absolute void vs. relative void"

Clearly, the reason for the ECJ decision to require national courts to invalidate standard form terms *ex officio* is to provide a very high standard of consumer protection against unfairness. Yet, is there something to gain when looking at the two alternatives from an economic perspective? Strictly speaking, can we discover a difference in costs and benefits whether a term is absolute void – meaning *ex officio* and without limitation of time - or relative void?

The Austria Civil Code for instance distinguishes between the two concepts based on whether a transaction is violating fundamental principles of the legal system or if it violates provisions aiming at protecting one party of a transaction, whereas the former leads to absolute voidness.¹⁵⁸ This distinction could be a useful approach for an economic analysis. On the one hand, if it can be assumed that individuals attach a high value to fundamental rights – e.g. right to physical integrity, sanctity of ownership, privacy protection and so forth – every infringement has the potential to cause a substantial harm, thus high costs, to the individual and society as a whole. On the other hand, absolute voidness might create a higher level of uncertainty, as firms would always have to take into account the risk of a lawsuit without limitation of time. This could influence firms' evaluation when setting the

¹⁵⁴ According to CLAB Database.

¹⁵⁵ See Ayres and Gertner 1989: 87ff.

¹⁵⁶ A contract is perfect or complete, when the parties have specified all possible conditions and allocated the risk to one or the other party; See Cooter & Ulen 2004:218; Schäfer/Ott 2005: 401.

¹⁵⁷ See Schäfer/Ott 2005: 25, 426; "[...] rather than view the standard form contract as a voluntary agreement, we view it instead as private legislation;". See Goldberg 1974: 484.

¹⁵⁸ See e.g. Koziol/Welser I 2006: 181-182.

price for a product, leading to a higher price (See 3.1.3). Nevertheless, a firm might also be the better “risk bearer”, among other things because they are considered to be risk neutral, whereas individuals are risk averse. A final argument in favour of absolute voidness is the concern that asymmetric information might prevent consumers to familiarise with the content of a standard form contract and deprive them from legal actions.¹⁵⁹

Consequently, there is a trade off between the cost to society when unfair standard form terms remain undetected and the increased costs of uncertainty to firms. Hence, a feasible answer could be to distinguish according to the magnitude of harm created by certain types of standard form terms in order to attach absolute or relative voidness. Whether or not all terms of a black list fulfil the conditions to be considered absolute void would require a detailed analysis of each single term. A possible solution is provided under the KSchG where unfair standard form terms are relative void, but if a fundamental right is infringed, the standard form term can be invalidated under the general rule of § 879 (1) ABGB and thus is absolute void.¹⁶⁰ However, even if there is no absolute voidness under national laws, one should not forget that all MS established or empowered an authority to file claims in the name of consumers, which mitigates consumers disadvantage in case of relative voidness.

6.4.2.2. “default rules vs. individually tailored rules”

When courts instead of enforcing, disregard or change contract terms it means that law regulates the contract. The difference to the general idea of default rules is that regulations are mandatory and can not be excluded by the parties.¹⁶¹ Hence the approach employed by courts has to be considered carefully, in particular with regard to the efficient level of tailoring default rules in respect to the costs and incentives created.

Ayres and Gertnert distinguish between untailored default rules or so-called majoritarian default rules and tailored default rules, providing the parties with “what they would have contracted for”.¹⁶² Apparently a tailored default rule is much more expensive, as it requires courts to assess ex post what the parties would have wanted at the time of contracting. In addition, it lowers the incentives for parties to contract ex ante, thereby externalising the

¹⁵⁹ See Schulte-Nölke, Twigg-Flesner and Ebers 2006: 385-386.

¹⁶⁰ See Krejci 1981: 176.

¹⁶¹ See Cooter & Ulen 2004: 218.

¹⁶² Ayres and Gertnert 1989: 91.

costs on courts. Besides, there is a potential cost due to the risk of judicial errors when trying to reconstruct the parties' intention.¹⁶³

The legal analysis of standard form terms has shown that courts either define the rights and obligations between a consumer and a firm according to the underlying default rule or adjust – thus tailor – the standard form term as to the extent that it passes the “fairness test”¹⁶⁴. In this respect it should be noted, that it is not clear whether a rule passing the fairness test according to courts interpretation also reflects what the parties would have agreed if bargained for ex ante. Moreover, it is doubtful that the incentives of this approach are desirable with regard to firm's behaviour.

The different incentives become quite comprehensible when considering the following case where a firm imposes a very high liquidated damage clause on the consumer, which is deemed unfair. If the court decides to disregard the clause, the firm can only ask for the actual damage occurred. Furthermore, the firm has the burden of proof with regard to the accuracy of the amount demanded, which could be extremely difficult and costly to calculate.¹⁶⁵ In contrast, if the court decides to alter the unfair liquidated damage clause to an amount which it deems fair, the costs for the assessment are mainly upon the court. After all, the firm finds itself in the position as if it would have negotiated fair terms in advance.¹⁶⁶ Moreover, if the court reduces just as much as necessary to pass the fairness test the firm might even reap the whole surplus of the hypothetical bargain. Hence, there is no incentive for the firm to change unfair standard form terms, as long as a sufficiently large share of the consumer will not go to court.¹⁶⁷

Clearly, the first approach offers the better incentive to prevent ex ante that firms employ unfair standard form terms. Unfortunately, in reality it is not always as clear as in the above case whether a standard form term is considered to be unfair or not. Consequently, it seems reasonable to mitigate the full consequences of the invalidity of standard form terms, for cases which are unforeseeable for firms.¹⁶⁸

¹⁶³ See Ayres and Gertner 1989: 118.

¹⁶⁴ Which refers to the “geltungserhaltende Reduktion” according to German and Austrian law.

¹⁶⁵ See Nagel and Eger 2003: 202.

¹⁶⁶ See Schäfer 2002: 308.

¹⁶⁷ See Schäfer 2002: 308.

¹⁶⁸ See MünchKommBGB (Basedow) 2007: § 306, mn. 13-14.

6.5. Law and Economics Analysis of Article 5 of the Directive
-The Principle of Transparency-

“In the case of contracts where all or certain terms offered to the consumer are in writing, these terms must always be drafted in plain, intelligible language. Where there is doubt about the meaning of a term, the interpretation most favourable to the consumer shall prevail. [...]”¹⁶⁹

6.5.1. a legal perspective

The EC recognises the principle of transparency as a fundamental prerequisite to enable consumers to make their decisions in full knowledge of the facts. According to recital 20 of the Directive, Art. 5 shall enhance the control of the content by consumers at the time of conclusion, by giving them the opportunity to examine all the terms. Some additional interpretation views that standard form terms which contradict with the principle of transparency are to be assessed in lights of Art 3. Unclear are the legal consequences of Art. 5, as there is no further specification aside from requiring the most favourable interpretation for consumers (*contra proferentem* rule).¹⁷⁰

6.5.1.1. “implementation of Art. 5 among the MS”

The implementation of Art. 5 sent. 1 did not create notable problems among the MS, as the vast majority transposed it literally into their national laws.¹⁷¹ However the application and the legal consequences seem more ambiguous and led to several different interpretations under national laws. For instance, the benchmark of the average consumer able to interpret a standard form term varies considerably among the MS, leading to different standards for what is deemed a plain and intelligible language. Notable, according to German case law standard form terms shall under some circumstances also be binding upon consumers, even if it requires the consumer to make some effort in order to understand the information included in a standard form contract.¹⁷² Furthermore, German law provides in its general clause under § 307 (1) sent. 2 - in addition to § 305c (2) BGB (*contra proferentem* rule) - that an unclear standard form term might suffice to create an inappropriate disadvantage. Thus, a standard form term can be invalidated solely on

¹⁶⁹ See Art. 5 of the European Council Directive 93/13/EEC.

¹⁷⁰ See Report from the Commission 2000: 18; Nölke, Twigg-Flesner and Ebers 2006: 392-396.

¹⁷¹ See Nölke, Twigg-Flesner and Ebers 2006: 393.

¹⁷² See Nölke, Twigg-Flesner and Ebers 2006: 394.

grounds of intransparency under § 307 (1) sent. 2.¹⁷³ The Austrian approach defines in § 6 (3) KSchG that unclear standard form terms are invalid. However, § 915 (2) ABGB contains the general *contra proferentem* rule for interpretation of contract terms, thereby creating a tension in relation to § 6 (3) KSchG. Nevertheless it seems that § 6 (3) KSchG – which requires to invalidate unfair standard form terms – narrows the scope of § 915 (2) ABGB in cases of consumer standard form terms § 6 (3).¹⁷⁴

6.5.1.2. “relation between the principle of transparency and the general clause”

A major critic found by German scholars as well as Austrian is that the principle of transparency bears the risk that courts might tend to justify their decisions on grounds of the intransparency of a standard form term, as this might be easier to establish than an investigation according to the general clause. Disagreement persists also whether the principle of transparency should only be interpreted as to evaluate the term regarding its design and appearance or creates part of the content review.¹⁷⁵

6.5.2. *an economic perspective*

The legal analysis highlighted some problems regarding the application and interpretation of Art. 5. Of particular interest is, whether the principle of transparency of standard form terms seems reasonable from an economic perspective? How should the MS set the benchmark for transparency and is the *contra proferentem* rule an efficient solution to discourage firms from employing intransparent standard form terms?

6.5.2.1. “the principle of transparency”

“Transparency policy has broad appeal across the political spectrum, partly because it is difficult to argue that providing information has negative consequences.”¹⁷⁶ Within the EC, the concept of disclosure plays a fundamental role in consumer regulations and therefore has been widely adopted. The basic idea is that sufficient information will enable consumers to protect themselves, without requiring too much market intervention.¹⁷⁷ Certainly, disclosure has many positive aspects but nevertheless is not an omnipotent tool: Firstly, because transparency alone does not solve the problem of asymmetric information.¹⁷⁸ Secondly, disclosure imposes costs on

¹⁷³ See MünchKommBGB 2007: § 307, mn. 51-53; See also Nölke, Twigg-Flesner and Ebers 2006: 398.

¹⁷⁴ See Krejci in Rummel 2002: § 6 (3), mn. 206.

¹⁷⁵ See MünchKommBGB (Kieninger) 2007: § 307, mn. 53.

¹⁷⁶ See Fung, Graham and Weil 2003: 37.

¹⁷⁷ See Martinek 2000: 518.

¹⁷⁸ See Schäfer 2002: 305.

the disclosing party, which might be passed on to the consumers.¹⁷⁹ This however appears less problematic in respect to Art. 5 as it only regards the formulation of the standard form terms and not the amount of disclosure, but nevertheless has to be considered.

A detailed study of different disclosure systems by Fung, Graham and Weil suggests that the area of disclosure policy requires three broad characteristics in order to make transparency sustainable.¹⁸⁰ Their findings also allow to draw some conclusions for the implementation of the principle of transparency in consumer standard form contracts.

Firstly, the presence or creation of intermediaries representing information users seems crucial for sustainable transparency.¹⁸¹ In this respect, the EC by requiring MS to empower persons or organisations to take actions in consumer's interest appears a meaningful approach. Consumer associations might be best capable to overcome the problem of information asymmetry as the cost/benefit ratio is different to them than to a single consumer (See 4.2). This is in particular true, as transparency alone is unlikely to lower the costs sufficiently, in order to make it worthwhile for consumers to engage in information shopping. Furthermore, intermediaries are in a better position to monitor, negotiate and impose pressure on companies, as they build a better counterweight to business organisations compared to dispersed consumers.¹⁸²

Secondly, information has to be readily interpretable by intermediaries and/or information users.¹⁸³ Market studies are typically conducted by consumer organisations and they also function as consumer advisors, consequently they seem to have most information regarding how consumers receive information contained in standard form terms and what kind of formulation typically misleads them. Additionally, in some countries consumer groups are already the major force to combat unfair standard form terms through preventive measures (for Austria see 6.4.1.2).¹⁸⁴ Therefore, to overcome the varying benchmarks among the MS, a national authority – e.g. a committee consisting of members of consumer organisations and professionals – could be permanently established. Their main task would be to assess the existing standard form terms within different industries, in

¹⁷⁹ See Van den Bergh 1997: 84.

¹⁸⁰ Fung, Graham and Weil 2003: 37.

¹⁸¹ See Fung, Graham and Weil 2003: 38.

¹⁸² See also Fung, Graham and Weil 2003: 5.

¹⁸³ See Fung, Graham and Weil 2003: 38-39.

¹⁸⁴ See Graph 7 in Annex III of the Report from the Commission 2000.

order to define whether the terms meet the standard of being written in a plain and intelligible language. Of course, finally it is up to the court to set the standard of transparency, but the authorities could act as an authorised expert. As a result, this approach would facilitate harmonisation among the MS if each national authority would provide for a lists of “proved clauses”, also available to firms. Furthermore, Fung, Graham and Weil present in their paper - using the example of nutritional labels - that standardisation of the labelling has improved consumers ability to quickly understand and compare the information.¹⁸⁵ Similar, if consumer groups provide lists of accepted clauses, firms’ standard form terms might converge over time, making it easier for consumers to compare.¹⁸⁶

Another argument to support the notion of a national authority setting the benchmark is that a too high standard of transparency could harm firms and subsequently consumers as it might increase uncertainty. If it is unclear for the firm when drafting a standard form contract whether a clause is sufficiently transparent – thereby creating the risk of future litigation – or it requires a disproportionately high investigation effort, firms might adjust the price.¹⁸⁷ Therefore, the approach employed under German law, where some effort by consumers is expected when assessing the transparency of a standard form term, seems sensible. Besides, it should be kept in mind that standard form terms typically concern legal matters. Thus, apart from the fact that consumers typically do not read the terms even if written in a clear language, one should not overvalue their ability and knowledge to assess the full breath of such terms (See 6.6.3).¹⁸⁸ Rather, transparency should enhance authorities’ ability to assess whether a standard form term is unfair.

Thirdly, the analysis of Fung, Graham and Weil concludes that the disclosing party has to derive some benefits from transparency in order to make it sustainable.¹⁸⁹ In some MS an open dialogue, at which consumer associations negotiate ex ante with business communities over standard form terms, seems an established tradition.¹⁹⁰ This looks like a valuable approach, as ex ante negotiations prevent unfair standard form terms already at the early

¹⁸⁵ Fung, Graham and Weil 2003: 25-27, 39.

¹⁸⁶ Leaving aside potential problems regarding the strategic use of such standard form terms, in particular in respect to competition law (See also 3.2).

¹⁸⁷ “Disclosers’ costs increase with the amount, scope, and/or level of detail of information provided to users”, See Fung, Graham and Weil 2003: 17.

¹⁸⁸ For empirical study, See Mueller 1970: 274; See also MünchKommBGB (Kieninger) 2007: § 307, mn. 53; Ulmer, Brandner and Hensen 2006: § 307, mn. 10ff, 323ff.

¹⁸⁹ Fung, Graham and Weil 2003: 39-40.

¹⁹⁰ See Report from the Commission 2000: 9.

stage of designing, whereas courts can only remove such terms in a given case ex post. To increase the incentives for companies and business organisations to engage in ex ante negotiations, a paradigm similar to the business judgment rule¹⁹¹ could be considered. For instance, standard form contracts which have been negotiated ex ante should create a strong presumption of fairness in case of legal actions. The same could be applied to those terms which form part of a proved-list of standard form clauses as reasoned above. If the benefit firms obtain from unfair standard form terms are lower than the benefit of a proved or negotiated one, firms will have an incentive to employ the latter.

With a view to the commission's recommendation of aiming at moving away from the "negative" system - which looks at the ex post abolishment of unfair standard form terms, - to a "positive" one, the above illustrated concept could foster this goal.¹⁹²

6.5.2.2. "the contra proferentem rule"

According to the directive, the only consequence of an intransparent standard form term is the interpretation most favourable to the consumer.¹⁹³ This so-called contra proferentem rule can be viewed as a penalty default rule, as it targets to penalise the better informed party in order to foster information revelation. Thus, it does not aim at reconstructing the complete contract but rather at controlling its content.¹⁹⁴

Penalty rules are rules which most parties of a contract would not have chosen. Rather, they provide the contracting parties – here the seller and suppliers - with incentives to avoid ambiguous contracts, thereby lowering informational asymmetry between the parties and courts.¹⁹⁵ However, the contra proferentem rule also gives rise to critique as courts might solve the apparent unfairness in a single case, but nevertheless do not create the same incentives to firms for a change of standard form terms as if the court would refrain from enforcing the clause completely.¹⁹⁶ Consequently, the disadvantages and costs to firms when employing intransparent standard form clauses is supposed to be higher in cases where the rule is neglected entirely by courts. It follows from this critique that the standard form term although interpreted in favour to the consumer is still more beneficial to the

¹⁹¹ The business judgment rule is a concept familiar to corporate law in common law countries, which insulate to a certain extent the board of directors from liability in respect to their decisions.

¹⁹² The UK approach seems in this respect remarkable, See Report from the Commission 2000: 24.

¹⁹³ See also recital 20 of the Directive.

¹⁹⁴ See Salvador Coderch and Ruiz Garcia 2001: 5, 10.

¹⁹⁵ See Salvador Coderch and Ruiz Garcia 2001: 12; Ayres and Gertner 1989: 97.

¹⁹⁶ See Schäfer 2002: 306.

firm than the underlying default rule when the standard form term remains not enforced. Hence, firms will have less incentive to change the term. This seems convincing when considering intransparent and unfair standard form terms. But in cases where a standard form terms is intransparent but nevertheless fair, an interpretation most favourable to consumers could be more harmful to the firm than an underlying majoritarian default rule.

After all, as already emphasised in the previous section, if the requirement of transparency is ambiguous in itself – i.e. difficult for firms to ensure ex ante that the language used is deemed plain and intelligible according to courts' interpretation – it could be reasonable to mitigate the risk. In addition, when courts initially base their decisions only on intransparency as it is simpler to apply, firms will as a consequence rely on the fair nature of the content of their standard form terms. However, if firms still face the risk that courts in a second period will nevertheless declare the same standard form term unfair it increases uncertainty even more.¹⁹⁷ Hence, to avoid ambiguity when declaring a standard form term intransparent courts should also consider giving some explanation regarding the fairness of the content.

6.6. The Case

Due to the necessary limited scope of this thesis the last section only briefly discusses some selected standard form terms of a financial institution. The aim is to point out some economic considerations, which can be inferred from the courts decisions or should be considered from an economic perspective. The following standard form terms¹⁹⁸ are taken from a case, which had been decided on March 20, 2007 and found considerable public interest. The Austrian Supreme Court – in a 52 page long decision - analysed and decided that a large number of the general terms and conditions and standard form terms of credit agreements employed by a financial institution were deemed unlawful.¹⁹⁹ The plaintiff is a party according to § 29 KSchG,²⁰⁰ thus empowered to take preventive actions in the interest of consumers.

¹⁹⁷ See MünchKommBGB (Kieninger) 2007: § 307, mn. 53.

¹⁹⁸ See Annex for the full text of the standard form terms and Case 4 Ob 221/06p of the Austrian Supreme Court.

¹⁹⁹ See 4 Ob 221/06p.

²⁰⁰ „Arbeiterkammer“.

6.6.1. “all expenditures are borne by the consumer”

The bank imposed in five standard form terms all costs for actions taken by the bank – essentially in cases where the consumer fails to fulfil contractual obligations - on the consumer without limit of scope.²⁰¹ In order to induce consumers to comply with the contractual obligations, the court pointed out it can be justified to impose the costs upon them. Nevertheless, the wording of these standard form terms allows the bank to claim all expenditures including excessive and/or inappropriate ones. Thus the inappropriate scope was the reason for rendering them unfair.²⁰²

The court’s decision seems to provide effective incentives for the bank to change these standard form terms, as within the course of a preventive measure the interpretation has to be in the utmost consumer unfriendly manner (See 6.4.1.2). The court obliges the bank to limit the scope of the terms to appropriate and necessary expenses. The decision seems appropriate as the court does in principle not require to change the allocation of costs, thereby recognising consumers incentives to fulfil the obligations following the contract, but enhances the efficient use of resources, as consumers are only obliged to bear adequate costs. For instance, one clause requires the consumer to inform the bank in case of a change of permanent residence or place of employment, otherwise all disadvantages for the bank shall be born by the consumer. Clearly, the allocation of costs seems efficient as the consumer is in a better position to provide this information at least cost. Nevertheless, the bank should only be able to claim reasonable costs in case the consumer fails to fulfil this obligation.

6.6.2. “disclaimer of liability”

The bank excludes any liability in case of a misuse of codes necessary for telephone requests about account information.²⁰³ In another provision, the bank excludes slight negligence for all damages caused.²⁰⁴ With regard to the first disclaimer, any kind of bank’s liability is excluded, as according to the bank the consumer is in the better position to control the risk. The court ruled that such a standard form term is unfair. However, a partial exclusion might be appropriate but is not to decide by the court in a preventive

²⁰¹ See Annex of the thesis: standard form terms 3, 5, 13, 14, 22.

²⁰² See 4 Ob 221/06p: 8-9 and 18-20.

²⁰³ See clause 38 of the Annex.

²⁰⁴ See clause 39 of the Annex.

measure.²⁰⁵ Concerning the second disclaimer, the court established that a general disclaimer for slight negligence is detrimental for consumers.²⁰⁶

From an economic perspective, if the consumer is best able to control the risk at lowest costs, it should be upon him. For cases which can neither be controlled by the firm nor by the consumer, the court would be required to impose the costs on the party best capable of bearing the cost (See 3.1.2).²⁰⁷ Although intuitively the bank seems to be the cheapest insurer, court's assessment would be of high value for an efficient allocation. The failure to do so, might be a downside of preventive measures which only require courts to establish the unfairness of a standard form term if interpreted in the utmost consumer unfriendly manner, but does not offer an efficient solution for future standard form terms.

The second disclaimer – for slight negligence – appears to create an efficient incentives structure. Thus the courts decision seems sensible although mainly based on the weak position of the consumer vis-à-vis the bank.²⁰⁸ However, if the bank is only liable for gross negligence, the banks' agents are likely to take an inefficient level of care also in cases where the risk is fully controlled or could be avoided at least cost by the bank. Exclusion for slight negligence of some damages could be reasonable if returned by lower prices or other benefits. However, a general preclusion seems inappropriate as the possible costs imposed on consumers appear hardly assessable in advance and have the potential to be disproportionately high.

*6.6.3. "prohibition on encumbrance and sale"*²⁰⁹

The bank included in another standard form term, that the consumer provides the bank with a mortgage or priority right when enforcing a claim against the consumer by a legal action. Furthermore the consumer refrains from using the right of encumbrance and sale vis-à-vis the bank.²¹⁰ The court of first instance, followed by the court of appeal, decided that the term is unfair according to the general clause. However, the Supreme Court

²⁰⁵ See 4 Ob 221/06p: pp. 44-45

²⁰⁶ See 4 Ob 221/06p: pp. 45-46

²⁰⁷ See Schäfer/Ott 2005: 406ff.

²⁰⁸ See 4 Ob 221/06p: p. 45; See also case 4 Ob 179/02f of the Austrian Supreme Court.

²⁰⁹ Veräußerungs- und Belastungsverbot.

²¹⁰ See clause 11 of the Annex.

ultimately established the inapplicability on bases of intransparency of the standard form term according to § 6 (3) KSchG, but left the question of its fairness undecided.²¹¹

This ruling reflects the problem stated earlier when courts base their decision on intransparency but leave the question of unfairness unanswered. As a result, it creates uncertainty whether it is sufficient to simply change the phrasing of the standard form term or if the bank is required to adjust the content. Therefore, the bank runs the risk of prospective litigation over the modified term. Secondly, this standard form term defines complicated procedural matters. Hence, it seems ambiguous of what can be expected and required from the “average” consumer, as it appears unlikely that even put in different words the effect and scope of such a provision is accessible to them. Furthermore, it may be questioned to what extent legal terminology can and should be translated into a consumer friendly language, without simultaneously increasing uncertainty when finally lawyers litigate over the meaning of such terms. Therefore, with respect to procedural matters or legal concepts, a lower measure for the transparency test might be more efficient. For instance, an assessment of whether a standard form term appears to be clear and unambiguous for consumer organisations as intermediaries, which facilitates the organisations ability to observe unfair terms when scanning the market. If in a second step the term has also been proved fair (See 6.5.2.1), financial institutions might have a higher incentive to employ such terms ex ante in order to avoid uncertainty.

6.6.4. “the consumer acknowledges to have read and understood all conditions and obligations”

In a number of standard form terms the consumer acknowledges and declares several facts as existing or not existing, e.g. to have fully understood the content of the general terms and conditions or that no legal proceeding is pending in front of a court.²¹² The court established that such standard form terms are unfair as they shift the burden of proof to the consumer.²¹³ According to the prevailing doctrine and § 6 (1) lit. 11 KSchG, the burden of proof can not be changed to the disadvantage of the consumer. The court refers in its ruling to another decision, in which a consumer together with a supplier had to confirm the receipt of all components of a technical device, by ticking of a checklist.²¹⁴ The court

²¹¹ See 4 Ob 221/06p: pp. 16-17.

²¹² See clause 25, 27 and 28 of the Annex.

²¹³ See 4 Ob 221/06p: pp. 28-33.

²¹⁴ See 4 Ob 221/06p pp. 30-31.

established that this checklist can be of some value for considerations of evidence, but nevertheless does not lead to a change in the burden of proof. However, the court refused to apply the same interpretation to the present case.

Assuming that the consumer typically does not read the declarations he made vis-à-vis the bank, it seems justified that the court deemed this type of standard form terms unfair. Nevertheless, in order to impose the burden of proof efficiently (See 6.3.2.2), the court would have to consider each single declaration included in the standard form contract. Furthermore, the approach employed in the decision to which the court refers to, appears not only to be suitable for the receipt of goods, as the checklist solves the problem of asymmetric information. Rather, the court would have to establish for which declarations such a checklist seems appropriate.

7. CONCLUSION

Law and economics literature has recognised asymmetric information as the main market failure in relation to standard form contracts. On this basis, a certain degree of intervention can be justified to enhance efficiency. Yet, standard form contracts are still beneficial as they lower transaction costs. The European Commission took a big step towards regulating standard form contracts when enacting the European Council Directive 13/93/EEC, which aims at protecting consumers. According to the ECJ, the rationale of intervention is based on the so-called “exploitation theory” where one party abuses its superior bargaining power vis-à-vis the other party.²¹⁵ This partially explains the limited focus on consumer standard form contracts only.

The approach employed in the Directive is based on minimum harmonisation. The EC has expressed its preference for such harmonisation as it would enable MS to implement more stringent provisions.²¹⁶ However, the legal analysis in the above found that it is precisely this discretion that leads to some important difficulties and undesirable differences in the Directive’s implementation. For instance, where some MS permit the review of negotiated standard form terms as well as the main subject matter, others explicitly exclude this type of terms. Further differences relate to the treatment of unfair standard form terms, e.g. absolute or relative voidness and its interpretation. Additional inconsistencies stem from the principle of good faith and the principle of transparency. Finally, the Annex of the Directive has also been implemented differently among the MS.

Apart from differences in implementation, MS’ ability to impose more stringent provisions – which at a first glance seems beneficial for consumers – might in some cases lead to adverse effects to the detriment of consumers and thus paradoxically lead to results contrary to the aim of the Directive.²¹⁷ Thus, the economic analysis focused on efficiency gains and losses due to the different implementations. For instance, to exclude negotiated terms and the main subject matter seems appropriate when asymmetric information is unlikely to prevent parties from concluding mutually beneficial contracts. Still, law should primarily aim at creating incentives for both parties to efficiently rely on the contract. This is crucial as it influences both parties’ willingness to invest in negotiations and consumers’ effort to

²¹⁵ See Nölke, Twigg-Flesner and Ebers 2006: 335.

²¹⁶ See Report from the Commission 2000: 5.

²¹⁷ See Schäfer 2002: 307.

engage in comparison shopping, that in turn enhances competition among firms. Thus, courts should refrain from enforcing standard form terms only where market failures are present.²¹⁸ Another finding, concerns different levels of transparency among MS for approving a standard form term as written in a plain and intelligible language. In this respect, more power given to consumer organisations or other intermediaries could enhance efficiency, since transparency in itself does not suffice to solve asymmetric information, but at the same time however, might significantly increase firms cost that are likely to be passed on to consumers. Overall, the questions addressed in this paper stress the importance of balancing both parties' interests in a way they would have contracted in a world without transaction costs.²¹⁹

Finally, it follows from the case decided by the Austrian Supreme Court that although the incentives created in a preventive action indeed seems to discourage firms from employing unfair standard form terms, they also create uncertainty. On the one hand, it might be extremely difficult for firms to sufficiently foresee a court's decision or to adequately amend the terms following a decision to avoid further disputes.²²⁰ This might be a downside of preventive measures, as courts are only required to declare a standard form term unfair if interpreted in the utmost consumer unfriendly way. Unfortunately, the court does not provide any meaningful guidelines as to what is deemed fair. On the other hand, firms might also decide to simply replace the unfair standard form term with another onerous one, again burdensome for consumers and costly for society as once again resources have to be devoted to find and invalidate such standard form terms.²²¹ Apart thereof, however, court decisions only become effective *inter partes*, but do not at the same time prevent other firms from employing the same or similar terms.²²²

Thus, in order to avoid the above stated problems as well as court errors and the difficult task to an *ex post* reconstructing of what the parties would have decided in an *ex ante* setting, it seems promising to focus more on the possibility of *ex ante* negotiations.²²³ Clearly, *ex ante* negotiations allow the use of the superior knowledge of consumer organisations and professionals compared to courts. Therefore, it increases certainty and

²¹⁸ See Nagel and Eger 2003: 128; Schäfer 2002: 309.

²¹⁹ See Schäfer/Ott 2005: 393, 401-402.

²²⁰ See Nagel and Eger 2003: 127.

²²¹ See Report from the Commission 2000: 20.

²²² See Report from the Commission 2000: 22-23.

²²³ See also Report from the Commission 2000: 24.

avoids some of the costs related to ex post assessment by courts. However, firms will only have an incentive, if the benefits from ex ante negotiations are higher than those from using unfair standard form terms. Therefore, it might be necessary to consider some benefits for firms, e.g. concept similar to business judgment rule.

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2 Ob 523/94

4 Ob 179/02f

APPENDIX

Terms employed by the financial institution²²⁴

3. Alle Kosten und Barauslagen, welche zur Geltendmachung und Verfolgung des Eigentumsrechtes der Bank aufgewendet werden, hat der Kreditnehmer der Bank zu tragen.“

5. Weiters ist der Kreditnehmer verpflichtet, außer den bei der BANK üblichen Mahn- und Inkassospesen, alle der BANK bei Verfolgung ihrer Ansprüche auflaufenden Kosten, Spesen und Barauslagen, aus welchem Titel sie immer resultieren, zu bezahlen. Er hat daher neben den gerichtlichen Gebühren und Kosten auch die außergerichtlichen Kosten der BANK und ihrer Beauftragten für alle Interventionen, die ihnen im Zusammenhang mit der Forderungsbetreibung notwendig und zweckdienlich erscheinen, voll zu ersetzen. Die BANK darf alle vorerwähnten Auslagen dem Kreditnehmer kontokorrentmäßig (durch Zuschlag zum Kapital) anlasten.

11. Die Kreditnehmer verpflichten sich schon mit Unterfertigung des Kreditantrages, der BANK bei gerichtlicher Betreibung ihrer Forderung den Erwerb von Pfandrechten an Immobilien oder deren Zwangsversteigerungen allenfalls durch Abgabe entsprechender Erklärungen (Vorrangseinräumung) in verbuchungsfähiger (gemeint wohl verbücherungsfähiger) Form zu ermöglichen. Sie verzichten der BANK gegenüber insbesondere auf die Geltendmachung ihrer Rechte aus bestehenden Veräußerungs- und Belastungsverboten.

13. Verletzt der Kreditnehmer vertragliche Verpflichtungen oder tritt die vorzeitige Fälligkeit aus welchem Grunde immer ein, darf die BANK dem Kreditnehmer das Benützungsrecht am Kaufgegenstand entziehen und entweder den Kreditnehmer verpflichten, den Kreditgegenstand samt Zubehör (bei KFZ samt Zulassungsschein, Schlüssel, etc) auf eigene Kosten und Gefahr der BANK zu übergeben, oder selbst den Kaufgegenstand auf jede ihr geeignete Art und Weise, auch ohne Mitwirkung des Kreditnehmers, jedoch immer auf seine Kosten, sicherzustellen. Der Kreditnehmer verzichtet auf die Geltendmachung einer Besitzstörung und auf etwaige Schadenersatzansprüche.

14. Etwaige Verbesserungs- und alle Verwertungskosten gehen zu Lasten des Kreditnehmers.

22. Der Kreditnehmer hat die BANK von jedem Wechsel seines Wohnsitzes, gewöhnlichen Aufenthaltes und Arbeitsplatzes zu verständigen. Im Unterlassungsfall gilt jede schriftliche Mitteilung, die an die letztbekannte Anschrift des Kreditnehmers erfolgt, als allen Erfordernissen genügend. Alle Nachteile und Kosten, die der BANK durch Nichteinhaltung dieser Verpflichtung entstehen, hat der Kreditnehmer zu tragen bzw. zu ersetzen.

²²⁴ See Case 4 Ob 221/06p of the Austrian Supreme Court

25. Die Kreditnehmer erklären, dass sie voll geschäftsfähig sind, kein Vermögensverzeichnis gelegt haben und keine gerichtlichen oder außergerichtlichen Verfahren irgendwelcher Art anhängig sind.

27. Die Kreditnehmer erklären hiemit ausdrücklich, dass sie sämtliche Punkte dieses Kreditanbotes, sowie die Geschäftsbedingungen der BANK, die einen wesentlichen Bestandteil dieses Angebotes bilden, gelesen und erstanden haben und mit ihnen vollständig einverstanden sind.

28. Soweit vorstehend keine anders lautenden Regelungen getroffen wurden, finden die „Allgemeinen Geschäftsbedingungen der österreichischen Kreditunternehmungen“ in der jeweils geltenden Fassung Anwendung. Deren Kenntnisnahme wird hiemit durch den Kreditnehmer ausdrücklich bestätigt.

38. Die BANK übernimmt keinerlei Haftung bei eventuellen Schäden aus dem Missbrauch des Codes.

39. Die BANK haftet für Schäden, die sie oder ihre Erfüllungsgehilfen grob schuldhaft verursacht haben, nicht jedoch für leichte Fahrlässigkeit.