ARTICLES

EMPTY PROMISES*

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ABSTRACT

Consumer contracts are pervasive. Yet, the promises that make up these contracts are becoming increasingly empty, as sellers reserve the power to modify their contracts unilaterally. While some modifications benefit both sellers and consumers, others increase seller profits at the consumer's expense. The law's goal should be to facilitate good modifications, while preventing bad ones. Currently this goal is not met. The problem is twofold. First, consumers fail to appreciate the risk of unilateral modification and thus fail to demand a commitment by sellers to avoid inefficient modifications. Second, and more important, even if consumers demand a commitment to make only mutually beneficial modifications, existing commitment mechanisms—consumer assent to modifications, judicial review of modifications, and seller reputation—are inadequate. We propose a novel commitment mechanism: adding Change Approval Boards ("CABs") as parties to consumer contracts. These CABs would selectively assent to, or withhold assent from, contractual changes

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that sellers wish to make, according to each CAB's modification policy. We envision a market for CABs—multiple CABs, each striking a different balance between flexibility and security, offering a range of modification policies from which consumers can choose. The market-based CAB system promises to deter abusive term changes while retaining the flexibility to change consumer contracts when change is justified.

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I. INTRODUCTION

Pacta sunt servanda. Agreements must be kept. But what if the agreement itself says that it need not be kept, that one of the parties can unilaterally change the terms of the agreement or nullify it entirely? What

does it mean to keep such an agreement? Does it even make sense to call it an "agreement"? These are not abstract philosophical questions. Empty promises are becoming increasingly common across a wide range of consumer contracts.

In their contracts, sellers are routinely making promises while reserving the right to renege on them: Credit card issuers may promise a 10 percent interest rate and then change it to a 20 percent interest rate. Amazon promised a text-to-speech function on its electronic reading device, the Kindle, and then decided to remove this feature.[1] And a broad range of sellers—from credit card issuers to cellular service providers to satellite television companies—promised their customers accountability for any wrongdoing and then added arbitration clauses, with "no class actions" provisions, that practically eviscerated that accountability.[2]

These contracts are designed to govern long-term economic relationships between sellers and consumers. Many things can change over the course of a long-term relationship. So it should not be surprising that the contracts that govern these relationships are often modified. But are they modified too often? Are sellers modifying these contracts opportunistically, making use of their de facto, if not de jure, power to modify consumer contracts *unilaterally*?

Enormous amounts of scholarly attention have been devoted to problems surrounding the initial agreements signed by consumers: Do consumers read these agreements? Do they understand them? Are they coerced into signing them?[3] When initial agreements can be modified unilaterally, many of these issues seem beside the point. We believe that much more attention should be paid to the implications of modifications of consumer contracts.[4]

1. *See infra* notes 56–57 and accompanying text.

2. *See infra* Part II.B.

3. The relevant literature is vast. For an excellent introduction to the literature, see MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT (1993). Early contributions include KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 362–71 (1960); and Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173 (1983). More recent contributions include Oren Bar-Gill, Exchange, *The Behavioral Economics of Consumer Contracts*, 92 MINN. L. REV. 749 (2008); and Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203 (2003).

4. The small body of recent literature that is on point includes Peter A. Alces & Michael M. Greenfield, *They Can Do What!? Limitations on the Use of Change-of-Terms Clauses*, 26 GA. ST. U. L. REV. 1099 (2010); Peter A. Alces & Jason M. Hopkins, *Carrying a Good Joke Too Far*, 83 CHI.-KENT L. REV. 879 (2008); Curtis Bridgeman & Karen Sandrik, *Bullshit Promises*, 76 TENN. L. REV. 379 (2009); David Horton, *The Shadow Terms: Contract Procedure and Unilateral Amendments*, 57 UCLA

In the business-to-business ("B2B") context, contract modification is generally thought of as a bilateral process, culminating in the consent of both parties.[5] It is not so in the business-to-consumer context. In theory, contract law permits a seller to modify a contract only with the assent of the consumer—in other words, modifications proposed by sellers require mutual assent.[6] But sometimes sellers circumvent this requirement by

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L. REV. 605 (2010); Eric Andrew Horwitz, *An Analysis of Change-of-Terms Provisions as Used in Consumer Service Contracts of Adhesion*, 15 U. MIAMI BUS. L. REV. 75 (2006); and Daniel Watkins, *Terms Subject to Change: Assent and Unconscionability in Contracts that Contemplate Amendment*, 31 CARDOZO L. REV. 545 (2009). All of these articles provide detailed descriptions of how these contracts are treated under current law and propose legislative or judicial responses. Most of these articles offer little analysis of the economic implications, either positive or negative, of permitting unilateral modifications of consumer contracts. David Horton discusses some of the negative economic implications but his analysis is limited to modifications of procedural terms. *See* Horton, *supra*. In addition, as we discuss *infra* in Part IV, the responses they propose are unsatisfactory in various respects. Hugh Collins discusses all of these issues, including the economic ones, but his discussion is limited to English law and does not focus on the special concerns that arise in the consumer setting. *See* Hugh Collins, *Discretionary Powers in Contracts*, *in* IMPLICIT DIMENSIONS OF CONTRACT: DISCRETE, RELATIONAL AND NETWORK CONTRACTS 219 (David Campbell, Hugh Collins & John Wightman eds., 2003). We also do not believe that the judicial solution he favors is adequate for the contracts in which we are interested. *See id.* Our focus on how contractual relationships evolve over time is presaged by the literature on relational contracts. That literature, however, either focuses on business-to-business contracts or examines changes in legal rights that are permitted by open-ended terms of initial agreements or are accomplished by mechanisms other than unilateral modification, including arbitral awards and mutual assent. *See, e.g.*, Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981) (analyzing contracts in which the parties are incapable of reducing important terms of the arrangement to well-defined obligations); Ronaldo Porto Macedo Jr., *Relational Consumer Contracts: New Challenges for Brazilian Consumer Law*, 12 SOC. & LEGAL STUD. 27, 31 (2003) (describing relational contracts as those that establish "institutional processes" for adjustment); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 865, 868, 886–87 (1978) (noting in passing the use of "one-party control of terms" in certain consumer transactions, but focusing on flexibility in interfirm and intrafirm contracts).

5. *See infra* note 80 and accompanying text.

6. Contract law recognizes several ways to modify or discharge a contractual duty with the assent of the person to whom the duty is owed ("the obligee"). *See* RESTATEMENT (SECOND) OF CONTRACTS § 89 & ch. 12 introductory note (1981). The language of section 89 is ambiguous on this point, but the accompanying commentary makes it clear that only situations involving assent of the obligee—or, more typically, express agreement between the parties—are contemplated. The Restatement (Second) of Contracts makes no provision for modifying a contractual duty based solely on the assent of the person who owes the duty (the "obligor"). To the contrary, it suggests that no contractual duty will arise if an obligor attempts to make its performance entirely optional by reserving the right to make such modifications. *See id.* §§ 1, 2 cmt. e (defining a contract as a kind of "promise" and suggesting that a statement that makes performance entirely optional will not constitute a "promise"). The term "contract modification" is also often used to describe the imposition of new duties on one or both parties. The conventional view is that creation of a contractual duty requires a promise from the obligee, which also implies assent. *See id.* §§ 1, 4 (defining a contract as a binding promise

expressly reserving the right to modify terms unilaterally in the initial agreement.[7] In other cases, mutual assent is ostensibly required but sellers enjoy de facto power to modify contracts unilaterally because consumers are in no position to express meaningful assent. Consumers might not even know that a contract is being modified, for example, if they fail to read a bill-stuffer modification notice. Even if they see the modification notice, consumers may not be able to evaluate accurately the implications of the modification. And finally, the cost of exiting long-term relationships with sellers, usually the only alternative to modified contracts, will often deter consumers from objecting to the modification.

Sellers have been subject to increasing public scrutiny for their alleged abuse of the power to modify consumer contracts unilaterally. Credit card issuers have been subject to increasing public and political pressure, which culminated in the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "CARD Act").[8] The CARD Act limits issuers' ability to modify their contracts and increase interest rates. Cell phone companies, airlines with frequent-flier programs, cable television companies, and Internet service companies are also angering their customers by unilaterally modifying contracts.[9]

The public outrage is justified. Empty promises are prone to abuse and should not be offered in the guise of real promises. True, some modifications are mutually beneficial responses to circumstances not

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and a promise as a manifestation of assent). Thus, a modification that imposes new duties upon a consumer will also require the consumer's assent.

The statement in the text has to be qualified in one respect. In principle, a modification that merely imposes new duties on the seller will not require the assent of the consumer. *See id.* § 89 & ch. 4, topic 2, introductory note (suggesting that mutual assent is not required to make a promise to modify a duty under an executory contract binding). We are not concerned with such modifications in this paper.

7. Purists will object that in this scenario the contract is not being modified but rather is being altered or changed pursuant to a discretionary power reserved in the original contract. *See* Watkins, *supra* note 4, at 550–53 (distinguishing alterations from modifications). In what follows we refer to both types of changes as "modifications." We do this not only for the sake of convenience, but also to emphasize that in consumer settings changes of terms pursuant to discretionary powers often serve as functional equivalents of unilateral modifications.

8. *See* Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (codified in scattered sections of 15 U.S.C.); Press Release, Office of the Press Secretary, The White House, Fact Sheet: Reforms to Protect American Credit Card Holders: President Obama Signs Credit Card Accountability, Responsibility, and Disclosure Act (May 22, 2009), *available at* http://www.whitehouse.gov/the_press_office/Fact-Sheet-Reforms-to-Protect-American-Credit-Card-Holders.

9. *See* Brian Grow et al., *Credit Cards: Behind the Consumer Rage*, BUS. WK., May 11, 2009, at 48.

anticipated or addressed at the time of the initial contract. Permitting unconstrained unilateral modification of consumer contracts, however, can result in substantial reductions in social welfare.[10]

The root of the problem is that when sellers impose modifications unilaterally there is no guarantee that the modifications will be mutually beneficial; sellers are likely to propose unilateral modifications that serve their own interests, but not necessarily those of consumers. This reality raises three main concerns. First, many consumers will fail to appreciate the risk that sellers will impose self-serving modifications. Thus, consumers may enter into welfare-reducing contracts (that is to say, contracts that leave them worse off than if they had not contracted at all). Second, even if the contracts they sign are not welfare reducing (that is, contracting is still better for the consumer than not contracting), consumers in many cases would be better off if sellers offered contracts that set some constraints on unilateral modification. Third, sellers' unchecked power to modify contracts prevents the efficient operation of markets for consumer products. Comparison shopping becomes meaningless when the product or contract can be changed easily soon after the purchase is complete. This fact in turn undermines competition.

Existing responses to the unilateral modification problem are imperfect. The CARD Act, while curbing several abusive practices, has only limited ambition with respect to unilateral modifications. It prohibits only certain interest rate changes. Many other types of modifications are left untouched.[11] It is telling that an earlier version of a bill that matured into the CARD Act would have imposed a general ban on provisions that allow unilateral changes in terms.[12] This general ban did not make it to the final CARD Act.[13] Moreover, it is questionable whether Congress has the institutional competence to police modifications of consumer contracts effectively. There is reason to doubt Congress's ability to distinguish effectively between harmful and benign modifications, especially since the fairness and efficiency of rates, fees, and other contractual terms can change with economic circumstances.

Other responses are also insufficient. For instance, some have

10. *See infra* Part III.

11. *See* Credit Card Accountability Responsibility and Disclosure Act.

12. *See* S. 414, 111th Cong. § 172 (as reported by S. Comm. on Banking, Hous. & Urban Affairs, Apr. 29, 2009), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s414rs.txt.pdf.

13. *See* Credit Card Accountability Responsibility and Disclosure Act.

proposed that sellers be forced to disclose the existence of provisions that allow unilateral changes in terms ("change-of-terms" clauses), and perhaps even how they are likely to be used.[14] This proposal would place the responsibility on consumers to police sellers through the consumers' decisions at the times of the initial contracts. Other proposals would reinstate the mutual consent requirement and eliminate the unilateral modification phenomenon.[15] Consumers would be charged with policing contract modifications at the time modifications are proposed. Proponents of this approach use various contract law doctrines to discourage the use of change-of-terms clauses, including canons of construction that allow the provisions to be read narrowly, as well as the doctrines of unconscionability and promissory fraud.[16] Yet another set of proposals would rely on either Congress or the courts to police sellers through bans on enforcement of specific types of modifications. We do not believe that any of these responses would succeed in preventing undesirable modifications while permitting beneficial modifications.

We propose a new approach. Rather than relying on consumers' vigilance, ad hoc legislation, or common law adjudication, we would encourage sellers and consumers to enlist the aid of specialized bodies in policing the modification of consumer contracts. At the heart of our proposal are contracts that require changes to be approved and certified by a third party called a Change Approval Board ("CAB").[17] The seller and consumer would add the CAB as a party to their contract. The CAB would not scrutinize the initial contract, but it would have to approve any changes the seller proposes to make to the initial contract. Since a contract can generally be modified only with the assent of all parties to it,[18] the CAB would be able to prevent any unjustified term change simply by withholding assent. The CAB would provide fair-minded sellers a means of ensuring consumers that only mutually beneficial term changes will be made.

The CAB could be a government-sponsored body appointed by the Federal Trade Commission. But there need not be only one CAB. In addition to the government-sponsored CAB, we envision the creation of

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14. *See infra* Part IV.A.

15. *See infra* Part IV.B.

16. *See infra* notes 97–106 and accompanying text.

17. We first introduced the CAB idea in Oren Bar-Gill & Kevin Davis, *Flexible, Responsible Credit-Card Reform*, BUS. WK., May 5, 2009, http://www.businessweek.com/bwdaily/dnflash/content/may2009/db2009055_207548.htm.

18. *See supra* note 6 and accompanying text.

multiple private CABs, each applying different certification standards. In order to facilitate comparison shopping, we would insist that for each product, sellers offer at least one contract overseen by a strict CAB that would deny all—or virtually all—term changes. But sellers could also offer contracts associated with more lenient CABs. Risk-averse consumers who care deeply about their peace of mind, and are willing to pay for this peace of mind, would choose a contract with a higher price and a CAB that imposes stricter conditions on changes. Consumers who prefer a lower price and are willing to accept the risk of potentially costly term changes would choose a more lenient CAB. In short, market forces could play a significant role in shaping the system.

The remainder of this Article is organized as follows: Part II describes the reality of unilateral modification of consumer contracts. Part III explains the problem of opportunistic, welfare-reducing modifications. Part IV reviews existing responses and their limitations. Part V presents and defends our proposal to establish a CAB system. Part VI extends the analysis, and the CAB proposal, to the context of employment contracts.

II. THE UNILATERAL MODIFICATION REALITY

A. EROSION OF THE MUTUAL ASSENT REQUIREMENT

Contracts are supposed to be the product of mutual assent.[19] Contractual revisions, or modifications, are similarly supposed to be the product of mutual assent.[20] This ideal is not borne out in the world of consumer contracts. Much ink has been poured on the limits of assent to consumer contracts.[21] But in the initial contract stage the consumer at least has the freedom to decline the product, and its accompanying contract, and buy from a different seller, or not buy at all. At the modification stage, even this freedom is significantly eroded.[22]

In theory, the consumer must assent to any modification of the initial

19. *See supra* note 6 and accompanying text.
20. *See supra* note 6 and accompanying text.
21. *See supra* note 3 and accompanying text.
22. The distinction between a modification and a new contract can be hard to draw. For example, the relationship between a credit card issuer and a cardholder can be viewed as a series of short-term contracts, especially if the issuer, in its term sheet, reserves the right to terminate the relationship at any time for any reason. Under this interpretation, a term change is not a modification of an existing contract, but rather an offer to enter into a new short-term contract on different terms.

contract.[23] Moreover, contract law generally requires affirmative assent, by communication or by conduct; assent by silence is generally insufficient.[24] In practice, however, sellers have found ways to circumvent these requirements.

To begin with, sellers commonly try to replace the traditional standards for determining assent with their own standards by including a change-of-terms clause in the initial contract. For example, a credit card contract might say, "We may change any term, condition, service or feature of your account at any time. We will provide you with notice of the change to the extent required by law."[25] This remarkable provision purports to allow the seller to change terms—subject presumably to the implied duty of good faith[26]—without any further (express) manifestation of assent on the part of the customer. The underlying theory seems to be that assent to the change-of-terms clause in the initial contract constitutes assent to subsequent modifications.[27]

Unilateral contract modifications can also involve somewhat less drastic departures from traditional standards for determining assent. Sellers do not necessarily want to take the position that no assent is required to effect a modification. Instead many sellers with change-of-terms clauses in their initial contracts—even broadly worded ones—take the position that failure to object to a proposed change, or continuing to use a seller's product or service after receiving notice of a change, qualifies as assent.[28]

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23. *See supra* note 6 and accompanying text.

24. *See* RESTATEMENT (SECOND) OF CONTRACTS § 69 (1981) (describing the only cases in which silence and inaction operate as an acceptance). There are, however, exceptions to the affirmative assent rule. In particular, if the seller has a right to terminate the contract and the consumer is aware that the seller is only continuing to perform under the expectation that the modified terms will apply, then continued use of the product or service by the consumer might constitute assent. *See id.* § 69(1)(a). In fact, under these circumstances, the seller's modification may be construed as an offer to renew the contract, only with different terms—an offer that consumers then accept by performing their obligations under the contract (for example, using a credit card to make purchases and paying the issuer at least a minimum amount each month).

25. Badie v. Bank of Am., 79 Cal. Rptr. 2d 273, 277 (Ct. App. 1998) (quoting the "Change of Terms" provision in customer agreements for Bank of America–issued Visa and MasterCard credit cards).

26. *See infra* note 108 and accompanying text.

27. *See* Watkins, *supra* note 4, at 551. The Restatement (Second) of Contracts endorses this theory. RESTATEMENT (SECOND) OF CONTRACTS § 69(1)(c) & cmt. d ("Explicit statement by the offeree, usage of trade, or a course of dealing between the parties may give the offeror reason to understand that silence will constitute acceptance.").

28. *See, e.g.*, Stinger v. Chase Bank, USA, N.A., 265 F. App'x 224, 226–27 (5th Cir. 2008) (noting the argument that a cardholder's failure to object in writing constituted an intent to be bound to unilateral changes in an arbitration clause); Mattingly v. Hughes Elecs. Corp., 810 A.2d 498,

Some sellers do not even have to write a change-of-terms clause into their contracts in order to make this argument. Some states, including, most notably, Delaware, have enacted legislation that expressly permits credit card issuers to change the terms of credit card contracts unilaterally so long as customers are given a certain number of days to opt out by sending a written notice rejecting the changes.[29] The changes become effective if the customer either fails to opt out or, regardless of whether the customer attempts to opt out, continues to use the credit card after the fifteen-day period has expired. As a result, both silence and continued use of the credit card are treated as equivalent to assent. More generally, the Uniform Consumer Credit Code allows a creditor to "change the terms of an open-end credit account" unilaterally. This mandate is qualified by only a notice requirement, and even this requirement applies to only a subset of term changes (specifically, changes to finance charges and interest rates).[30]

Abandoning the rule that affirmative assent is required to make an effective contract modification allows sellers to modify their contracts unilaterally without obtaining meaningful assent from consumers. In the first place, many customers do not read the bill-stuffers that sellers use to announce contract modifications. It is difficult to see how the fact that these customers fail to object to the modification and continue to use a seller's product provides any evidence of meaningful assent. In addition, sellers' preferred modification procedures put the onus on consumers to take affirmative action to avoid assenting to a proposed modification. For many consumers the costs of those actions—typically, sending a rejection notice and switching to another seller—outweigh the relatively small perceived benefits.[31]

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504 (Md. Ct. Spec. App. 2002) (discussing DIRECTV's claim that the plaintiff's continued use of its service constituted assent to a new arbitration clause); Citibank (S.D.), N.A. v. Wilson, 160 S.W.3d 810, 811–12 (Mo. Ct. App. 2005) ("Citibank argues that South Dakota law governs its contractual relationship with Wilson and contends that . . . it could unilaterally change the terms of their contract and Wilson would not have to expressly assent . . . for there to be a valid, binding agreement.").

29. DEL. CODE ANN. tit. 5, § 952 (2001). *See also, e.g.*, Edelist v. MBNA Am. Bank, 790 A.2d 1249, 1257–58 (Del. Super. Ct. 2001) (finding that "Delaware statutory law controlling [the user's] account permits [the issuer] to unilaterally amend agreements by notice and an opt-out provision").

30. UNIF. CONSUMER CREDIT CODE § 3.205 (1974). As of January 1, 2010, eleven states and Guam had adopted versions of either the 1968 or 1974 Uniform Consumer Credit Codes. *See* Legal Info. Inst., Cornell Univ. Law Sch., Consumer Credit: An Overview (2010), http://topics.law.cornell.edu/wex/consumer_credit/. It is worth noting, however, that state legislation pertaining to changes to credit card agreements is supplemented by Regulation Z under the Truth in Lending Act, which now requires issuers to give a minimum of forty-five days notice of many changes. *See* Regulation Z, 12 C.F.R. § 226.9(c)(2) (2010).

31. Empirical evidence suggests that switching costs are substantial. *See* Joseph Farrell & Paul

To be fair, some courts have refused to abandon the requirement of affirmative assent to contract modifications. These courts, in decisions that we discuss in greater detail below,[32] typically police unilateral modifications by construing change-of-terms clauses narrowly to permit only modifications made in good faith[33] or, occasionally, finding some other basis to invalidate attempts to rely on such clauses (or on similar statutory provisions).[34] In many American jurisdictions, though, the requirement of affirmative, meaningful assent has been completely eroded. The result is that sellers can basically make any modification they want, subject only to constraints that apply to all contracts, such as the doctrine of unconscionability, regardless of whether they have been modified.[35]

Klemperer, *Coordination and Lock-In: Competition with Switching Costs and Network Effects*, *in* 3 HANDBOOK OF INDUSTRIAL ORGANIZATION 1967, 1980–81 (Mark Armstrong & Robert H. Porter eds., 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=917785. In the credit card market, average switching costs were estimated to be $150. *See* Haiyan Shui & Lawrence M. Ausubel, Time Inconsistency in the Credit Card Market (May 3, 2004) (unpublished working paper at 1), *available at* http://ssrn.com/abstract=586622; David B. Gross & Nicholas S. Souleles, *Do Liquidity Constraints and Interest Rates Matter for Consumer Behavior? Evidence from Credit Card Data*, 117 Q.J. ECON. 149, 171, 179 (2002) (finding only limited switching, which implies substantial switching costs). In the bank loan market, one study estimated switching costs equal to 4.12 percent of the customer's loan. *See* Moshe Kim, Doron Kliger & Bent Vale, *Estimating Switching Costs: The Case of Banking*, 12 J. FIN. INTERMEDIATION 25, 44 (2003) (analyzing data from the Norwegian bank loan market). In the cell phone market, switching costs approximately equal the price of an average phone. *See* Oz Shy, *A Quick-and-Easy Method for Estimating Switching Costs*, 20 INT'L J. INDUS. ORG. 71, 78–79 (2002) (analyzing data from the Israeli cell phone market). For more discussion of switching costs in the cellular phone market, see Harald Gruber & Frank Verboven, *The Evolution of Markets Under Entry and Standards Regulation—The Case of Global Mobile Telecommunications*, 19 INT'L J. INDUS. ORG. 1189 (2001). Evidence of substantial switching costs has been found in the (land) phone services market. *See* Christopher R. Knittel, *Interstate Long Distance Rates: Search Costs, Switching Costs, and Market Power*, 12 REV. INDUS. ORG. 519, 532–34 (1997); V. Brian Viard, *Do Switching Costs Make Markets More or Less Competitive?: The Case of 800-Number Portability* (Stanford Univ. Graduate Sch. of Bus., Working Paper No. 1773R2, 2005), *available at* http://ssrn.com/abstract=371921. And evidence of substantial switching costs was found in the electricity market. *See* Michael Waterson, *The Role of Consumers in Competition and Competition Policy*, 21 INT'L J. INDUS. ORG. 129, 137–141 (2003); Chris M. Wilson & Catherine Waddams Price, *Do Consumers Switch to the Best Supplier?* (CCP Working Paper No. 07-6, 2007), *available at* http://ssrn.com/abstract=982530 (identifying consumers in the U.K. electricity market who did not switch from one provider to another despite substantial available savings).

32. *See infra* Part II.B.

33. *E.g.*, Stone v. Golden Wexler & Sarnese, P.C., 341 F. Supp. 2d 189, 196–98 (E.D.N.Y. 2004); Badie v. Bank of Am., 79 Cal. Rptr. 2d 273, 280–85 (Ct. App. 1998).

34. *See, e.g.*, Ingle v. Circuit City Stores, Inc., 328 F.3d 1165, 1179 (9th Cir. 2003) ("[W]e conclude that the provision affording Circuit City the unilateral power to terminate or modify the contract is substantively unconscionable."); Discover Bank v. Shea, 827 A.2d 358, 363 (N.J. Super. Ct. Law Div. 2001) (holding that under New Jersey law, the Delaware law authorizing unilateral amendments violates public policy and so cannot be given effect).

35. *See, e.g.*, Bank One, N.A. v. Coates, 125 F. Supp. 2d 819, 836 (S.D. Miss. 2001) (upholding

B. UNILATERAL MODIFICATION—EVIDENCE

How often are consumer contracts modified? Are these modifications welfare enhancing, reflecting an adjustment of the contract to changing circumstances, or do they simply redistribute resources from consumers to sellers, reducing total welfare along the way? Examining the practices of credit card issuers, cellular service carriers, and other sellers of consumer products and services provides some preliminary answers to these questions.

We first note the increasing prevalence of change-of-terms clauses. Such clauses are now common in contracts that accompany a wide range of products and services, including credit cards, landline and cellular telephone services, cable and satellite television services, investment services, customer loyalty reward programs, online retail services, and online marketplaces (for example, eBay and Craigslist).[36] It is fair to assume that sellers are reserving the right to modify their contracts unilaterally for a reason.

Credit card issuers have been making good use of their change-of-terms clauses. A national telephone poll conducted in June 2009 on behalf of Credit.com suggests that credit card contracts are frequently modified. A third of cardholders reported that their card companies had made one or more changes recently, 19% reported increases in their interest rates, 18% reported reductions in their credit limits, 14% reported increases in fees, 12% reported increases in their minimum payments due, and 9% said that their rewards programs were reduced.[37]

Modification of credit card contracts was one of the main concerns addressed by the CARD Act.[38] The CARD Act's legislative history includes numerous descriptions of modifications, including modifications that may not have been motivated by efficiency alone. Senator Christopher

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a unilateral addition of a binding arbitration provision); Hutcherson v. Sears Roebuck & Co., 793 N.E.2d 886, 900 (Ill. App. Ct. 2003) (same); Joseph v. M.B.N.A. Am. Bank, N.A., 775 N.E.2d 550, 553–54 (Ohio Ct. App. 2002) (same).

36. *See* Alces & Greenfield, *supra* note 4, at 1101–06.

37. *See* CardWeb.com, Card Changes (June 24, 2009), https://www.cardweb.com/cardflash/2009/06/24/.

38. *See* Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (codified in scattered sections of 15 U.S.C.). As a result, credit card issuers raced to modify their contracts—increasing rates, adding fees, and cutting credit limits—before the CARD Act's forty-five-day notice requirement for term changes took effect. *See* Ron Lieber, *Maybe It's Time to Change Credit Cards*, N.Y. TIMES, Aug. 22, 2009, at B1.

Dodd, chairman of the Senate Banking Committee, noted modifications that shortened the payment period.[39] Travis Plunkett, legal director of the Consumer Federation of America, discussed modifications that systematically reduced cardholders' credit limits as they paid down balances, so that cardholders were always near the limit and at risk of paying overlimit fees.[40] And Edmund Mierzwinski of U.S. PIRG, the Federation of State Public Interest Research Groups ("PIRGs"), noted how contracts were modified to include "universal default" provisions.[41]

But the most salient modifications in the legislative history of the CARD Act were modifications that increased rates and fees on existing balances.[42] Issuers defended these modifications as examples of efficient risk-based pricing that lower the cost of credit, increase access to credit, and enable a more diverse range of credit products.[43] While risk-based pricing is efficient, it is questionable whether modifications that increase rates and fees are indeed risk based.[44] Issuers also argue that these modifications address a moral hazard problem: cardholders take actions that increase the risk of nonpayment, thus raising the cost of credit for other

39. *See* 155 CONG. REC. S2149–50 (daily ed. Feb. 11, 2009) (statement of Sen. Dodd).

40. *See Modernizing Consumer Protection in the Financial Regulatory System: Strengthening Credit Card Protections: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 199 (2009) [hereinafter *Modernizing Consumer Protection Hearing*] (statement of Travis B. Plunkett, Legis. Director).

41. *See Consumer Debt: Are Credit Cards Bankrupting Americans?: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 111th Cong. 42 (2009) (statement of Edmund Mierzwinski, Consumer Program Director, U.S. Public Interest Research Group) [hereinafter *Consumer Debt Hearing*].

42. *See The Credit Cardholders' Bill of Rights Act of 2009 and The Consumer Overdraft Protection Fair Practices Act of 2009: Hearing on H.R. 627 and H.R. 1456 Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Servs.*, 111th Cong. 205–07 (2009) (statement of Montrice Godard Yakimov, Managing Director for Compliance & Consumer Protection, Office of Thrift Supervision) [hereinafter *CARD Act and Overdraft Protection Hearing*]; *Modernizing Consumer Protection Hearing*, *supra* note 40, at 61–62 (statement of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center); *id.* at 102–05 (statement of James C. Sturdevant, Principal, Sturdevant Law Firm); *id.* at 196–97 (statement of Travis B. Plunkett); 155 CONG. REC. S2149 (daily ed. Feb. 11, 2009) (statement of Sen. Dodd).

43. *See, e.g.*, *CARD Act and Overdraft Protection Hearing*, *supra* note 42, at 93–95 (statement of Kenneth J. Clayton); *Modernizing Consumer Protection Hearing*, *supra* note 40, at 83–85 (statement of Kenneth J. Clayton, Senior Vice President and General Counsel, Card Policy Council, American Bankers Association); *id.* at 110–13 (statement of Linda Echard, President and CEO, ICBA Bancard); *id.* at 130–31 (statement of Oliver I. Ireland); JONATHAN M. ORSZAG & SUSAN H. MANNING, AN ECONOMIC ASSESSMENT OF REGULATING CREDIT CARD FEES AND INTEREST RATES 9–15 (2007), *available at* http://www.aba.com/aba/documents/press/regulating_creditcard_fees_interest_rates 92507.pdf.

44. *See Modernizing Consumer Protection Hearing*, *supra* note 40, at 60 (statement of Adam J. Levitin).

cardholders.[45] The moral hazard argument is theoretically valid but at least partially undermined by the evidence. To prevent moral hazard, cardholders must know which actions lead to increased rates and fees. But cardholders are often unaware of the range of actions that lead to fee and rate hikes such as, for example, opening an additional line of credit or having a bona fide dispute with a landlord and pursuing their rights under the lease agreement.[46]

While modifications to credit card contracts that increase rates and fees have attracted most of the scrutiny from Congress, modifications that add mandatory arbitration clauses are the ones that have received the most intense scrutiny from the courts.[47] Arbitration can be welfare enhancing. An expert, unbiased arbitrator can often resolve disputes better, and at a lower cost, than a court. But given the specific language of the arbitration clauses that were added to credit card contracts, it is not clear that efficiency was the motivation for these modifications. First, questions have been raised about potential proissuer bias of the arbitration fora that are chosen by the issuers in their form contracts.[48] More importantly, many arbitration clauses prohibit class-wide relief, and by doing so they effectively bar the typically small claims that cardholders have. From an efficiency perspective, these class-barring arbitration clauses, by substantially reducing deterrence and accountability, enable, and even

45. *See, e.g.*, ORSZAG & MANNING, *supra* note 43, at 11–12.

46. *See Modernizing Consumer Protection Hearing*, *supra* note 40, at 61 (statement of Adam J. Levitin).

47. *See, e.g.*, Homa v. Am. Express Co., 558 F.3d 225 (3d Cir. 2009); Hoffman v. Citibank (S.D.), N.A., 546 F.3d 1078 (9th Cir. 2008) (per curiam); Eaves-Leanos v. Assurant, Inc., No. 3:07-CV-18-S, 2008 U.S. Dist. LEXIS 32651 (W.D. Ky. Apr. 18, 2008); Dumanis v. Citibank (S.D.), N.A., No. 07-CV-6070 (CJS), 2007 U.S. Dist. LEXIS 81586 (W.D.N.Y. Oct. 31, 2007); Stone v. Golden Wexler & Sarnese, P.C., 341 F. Supp. 2d 189 (E.D.N.Y. 2004); Perry v. FleetBoston Fin. Corp., No. 04-507, 2004 U.S. Dist. LEXIS 12616 (E.D. Pa. July 6, 2004); Beneficial Nat'l Bank, U.S.A. v. Payton, 214 F. Supp. 2d 679 (S.D. Miss. 2001); Bank One, N.A. v. Coates, 125 F. Supp. 2d 819 (S.D. Miss. 2001); Marsh v. First USA Bank, N.A., 103 F. Supp. 2d 909 (N.D. Tex. 2000); Discover Bank v. Superior Court, 113 P.3d 1100 (Cal. 2005); Szetela v. Discover Bank, 118 Cal. Rptr. 2d 862 (Ct. App. 2002); Hutcherson v. Sears Roebuck & Co., 793 N.E.2d 886 (Ill. App. Ct. 2003); Discover Bank v. Shea, 827 A.2d 358 (N.J. Super. Ct. Law Div. 2001); Johnson v. Chase Manhattan Bank USA, N.A., 784 N.Y.S.2d 921 (Sup. Ct. 2004); Joseph v. M.B.N.A. Am. Bank, N.A., 775 N.E.2d 550 (Ohio Ct. App. 2002); Horton, *supra* note 4 (discussing the frequency with which contract drafters in various markets unilaterally amend procedural terms).

48. *See, e.g.*, *Beneficial Nat'l Bank, U.S.A.*, 214 F. Supp. 2d at 690–91 (rejecting a cardholder's bias argument); *Bank One, N.A.*, 125 F. Supp. 2d at 835–36 (same); *Marsh*, 103 F. Supp. 2d at 924–26 (same); Complaint, Swanson v. Nat'l Arbitration Forum, Inc., No. 27-CV-09-18550 (Minn. Dist. Ct. July 14, 2009), 2009 WL 2029918; Consent Judgment, Swanson v. Nat'l Arbitration Forum, Inc., No. 27-CV-09-18550 (Minn. Dist. Ct. July 28, 2009).

encourage, issuers to engage in profit-maximizing but welfare-reducing practices (including the practice of making inefficient modifications).[49]

Cellular service contracts provide another example of frequently modified consumer contracts. Moreover, a review of these modifications suggests that they are not all benign adjustments to changed economic circumstances. For example, in 2005, Verizon modified at least some of its contracts to ban class arbitration.[50] More recently, Verizon modified its contract again, clarifying that if the "no class arbitration" clause is struck down, there will be no arbitration at all.[51] Conditioning the applicability of the mandatory arbitration provision on the validity of the "no class arbitration" clause reveals that carriers want arbitration less for its inherent efficiency and more as a means to ban the aggregation of claims.

In a similar vein, early in 2009, AT&T modified its arbitration clause by, among other changes, requiring a consumer who sues AT&T and loses to pay AT&T's arbitration fees.[52] This change makes the mandated

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49. This problem has been recognized by several courts. *See, e.g.*, *Hoffman*, 546 F.3d at 1083 (holding that class arbitration waivers may effectively operate as exculpatory clauses); *Discover Bank*, 113 P.3d at 1109 (same); *Szetela*, 118 Cal. Rptr. 2d at 868 ("[A class arbitration waiver] serves as a disincentive for Discover to avoid the type of conduct that might lead to class action litigation in the first place. . . . Discover has essentially granted itself a license to push the boundaries of good business practices to their furthest limits . . . ."); *Shea*, 827 A.2d at 367 ("By depriving cardmembers of any forum in which they could reasonably vindicate their rights, Discover seeks to leave itself in a position where it could completely avoid accountability."). And, recently, one major issuer has decided to backtrack and remove the mandatory arbitration provision from its contracts. *See* Jonathan Stempel, *Update 3—Bank of America Ends Arbitration of Card Disputes*, REUTERS, Aug. 13, 2009, http://www.reuters.com/article/marketsNews/idINN1326119520090813?rpc=44.

50. Litman v. Cellco P'ship, No. 07-CV-4886(FLW), 2008 U.S. Dist. LEXIS 87570, at *3 (D.N.J. Sept. 29, 2008). Another cell phone service provider, Powertel, unilaterally modified its contract using a bill stuffer, adding a class arbitration waiver. Powertel, Inc. v. Bexley, 743 So. 2d 570, 572, 576 (Fla. Dist. Ct. App. 1999). This modification was deemed unconscionable. *Id.* at 577.

51. *See* Verizon Wireless, Customer Agreement (May 13, 2010), http://www.verizonwireless.com/b2c/globalText?textName=CUSTOMER_AGREEMENT&jspName=footer/customerAgreement.jsp.

52. Christopher Price, *AT&T Generally Unaware of New Contract Changes, Refuses to Waive Termination Fees*, PHONENEWS.COM, May 3, 2009, http://www.phonenews.com/att-generally-unaware-of-new-contract-changes-refuses-to-waive-termination-fees-7753/. AT&T made the modifications mentioned above unilaterally and customers who attempted to respond by terminating their service contracts, which typically run for two years, were charged an early termination fee. AT&T's stance on early termination fees was controversial because in 2008, under the auspices of the CTIA, the international association for the wireless telecommunications industry, all carriers agreed that consumers would be allowed to terminate their contracts, without paying an early termination fee, following any material change to the terms of service. *See id.*; CTIA, Consumer Code, http://www.ctia.org/content/index.cfm/AID/10352/ (last visited June 12, 2010). In defending its insistence on charging early termination fees following these changes, AT&T adopted a very narrow definition of a material change. AT&T argued that according to its "internal policy" there are only two

arbitration risky, in many cases prohibitively risky, so it is difficult to see how it confers any benefit on the customer.[53]

Moving beyond arbitration, in 2008, carriers increased the price charged per text message.[54] This kind of modification simply redistributes wealth from customers to carriers.

Amazon's electronic reading device, the Kindle, and its accompanying license agreement provide yet another example.[55] In the Kindle license, Amazon retains the right to "modify, suspend, or discontinue the Service at any time."[56] This clause was recently invoked when Amazon retracted the text-to-speech feature that originally came with its second-generation Kindle, the Kindle 2.[57]

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types of changes that allow termination without incurring an early termination fee: (1) a price increase, and (2) a material decrease in the geographic area in which the airtime rate applies. *See* Christopher Price, *AT&T Clarifies Position on ETF & Material Changes, Argues Only Two Situations Allow Terminating Contract*, PHONENEWS.COM, May 8, 2009, http://www.phonenews.com/att-clarifies-position-on-etf-material-changes-argues-only-two-situations-allow-terminating-contract-7802/. AT&T is not alone. In June 2009, a consumer complained that Verizon refused termination (without paying an early termination fee) after it increased its administrative charges from $0.85 to $0.92. *See* Posting of Christine to Consumer Complaints About Verizon Wireless, http://www.consumeraffairs.com/cell_phones/verizon_wireless.html (June 11, 2009).

53. Change-of-terms clauses have been used to add or change arbitration clauses in other markets as well. For example, DIRECTV, a satellite television provider, included a change-of-terms clause in its subscription agreement and used it to add an arbitration clause. DIRECTV, Inc. v. Mattingly, 829 A.2d 626, 629 (Md. 2003). This particular modification was struck down for lack of sufficient notice. *Id.* at 639.

54. *See* Ronen Halevy, *T-Mobile Raising Per-Message SMS Rates to 20 Cents*, BERRYREVIEW.COM, July 1, 2008, http://www.berryreview.com/2008/07/01/t-mobile-raising-per-message-sms-rates-to-20-cents/.

55. This example is taken from Randal C. Picker, *The Mediated Book* 4–6 (Univ. of Chi. Law & Econ., Olin Working Paper No. 463, 2009), *available at* http://ssrn.com/abstract=1399613.

56. Amazon.com, Amazon Kindle: License Agreement and Terms of Use (Feb. 9, 2009), http://www.amazon.com/gp/help/customer/display.html/ref=hp_rel_topic?ie=UTF8&nodeId=200144530.

57. Greg Sandoval, *Amazon Retreats on Kindle's Text-to-Speech Issue*, CNET NEWS, Feb. 27, 2009, http://news.cnet.com/amazon-retreats-on-kindles-text-to-speech-issue/. It is true though that Amazon's modification came in response to complaints by the Authors Guild that this new feature would put pressure on the audio books market and, moreover, would violate the copyright holders' rights. *See* The Authors Guild, E-Book Rights Alert: Amazon's Kindle 2 Adds "Text to Speech Function" (Feb. 12, 2009), http://www.authorsguild.org/advocacy/articles/e-book-rights-alert-amazons-kindle-2.html. But these complaints seem unfounded. *See, e.g.*, Posting of Michael Kwun to Deeplinks Blog, http://www.eff.org/deeplinks/ (Feb. 11, 2009).

III. THE COST OF UNILATERAL MODIFICATION

We have shown that in some jurisdictions sellers enjoy virtually unfettered authority to modify their contracts, while in others they are subject only to a rather weak duty of good faith. We have also shown that there are important markets in which sellers frequently resort to that authority. We now describe the social costs of the status quo and its permissive approach to unilateral modifications. These costs will generally be somewhat larger in the jurisdictions in which modifications are unrestricted and somewhat smaller in the jurisdictions in which modifications are subject to the duty of good faith.

We begin this part, however, by noting the benefits of unilateral modifications. These benefits provide a benchmark for the ensuing discussion of the adverse welfare consequences of unilateral modifications. These adverse consequences can be divided into two categories. We discuss ex post costs first and then proceed to the ex ante costs of unilateral modifications. We conclude this part with a comparison between the social costs of unilateral modifications of consumer contracts and the thoroughly studied costs of modifications of B2B contracts.

A. THE BENEFITS OF UNILATERAL MODIFICATIONS

It is important to recognize the potential benefits of contract modification, even unilateral modification. In the absence of such benefits, the solution to the unilateral modification problem would be quite simple: a general ban on unilateral modifications of consumer contracts.

The benefits of modifications arise from the dynamic environment in which long-term consumer contracts operate. A long-term contract purports to govern the parties' relationship over a substantial period. If circumstances change over time, then the optimal terms also change over time. Modification allows the contract to keep up with changing circumstances without incurring the costs of drafting an initial contract that provides for all future contingencies.[58] Consequently, it is often mutually

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58. *See, e.g.*, Perry v. FleetBoston Fin. Corp., No. 04-507, 2004 U.S. Dist. LEXIS 12616, at *13–14 (E.D. Pa. July 6, 2004) (accepting the issuer's argument that "change in terms procedures are necessary 'due to the ever-changing economic conditions, the fast-moving and highly competitive credit card marketplace, and the fact that open-end or revolving credit card agreements are generally indefinite in duration,'" but limiting the issuer's ability to make unilateral changes to such terms as "previously contemplated by the original agreement, so long as cardholders do not accept the unilateral change by continuing to use their cards"); Stone v. Golden Wexler & Sarnese, P.C., 341 F. Supp. 2d 189, 198

beneficial to permit modification.[59]

Modifications can be welfare enhancing from both an ex post and an ex ante perspective. Consider a modification of a credit card contract that increases the interest rate. If the interest rate increase is triggered by an increase in default risk because, for example, the borrower's credit rating dropped, then the modification may be ex post efficient. The higher interest rate can be beneficial to the issuer, as it compensates for the increased default risk. And it can be beneficial to the borrower, at least if the alternative is termination of the account by the issuer. More importantly, raising interest rates in response to increased default risk is ex ante efficient, as it allows issuers to charge lower initial interest rates. Absent the option to adjust in response to new information about risk, issuers will set higher initial rates for all borrowers, forcing low-risk borrowers to cross-subsidize high-risk borrowers (or those who are likely to become high-risk borrowers).

But these benefits can be secured by bilateral modifications, respecting the mutual consent requirement. They do not, in and of themselves, justify unilateral modifications. The efficiency argument for unilateral modifications requires another element: the cost of securing meaningful assent from many dispersed consumers. Securing the express assent of thousands, or millions, of consumers to every modification can be very expensive. These costs will translate into higher prices for consumers.[60] Moreover, in some cases, uniformity of treatment is important to sellers; it would be prohibitively costly for them to deal on different terms with consumers who have and have not provided express assent. For these reasons, unilateral modifications can be efficient, and even beneficial to consumers.

(E.D.N.Y. 2004) ("To be sure, flexibility is important to the credit industry, since credit card companies are parties to long-term contracts with countless customers."). *See generally* Collins, *supra* note 4 (characterizing change-of-terms clauses as responses to uncertainty about future events that might require adaptation of the contract).

59. In other words, modification is a remedy for contractual incompleteness. If, at the time of contracting, parties had perfect information about all future contingencies and could costlessly negotiate and write a complete state-contingent contract, then modification would be superfluous. Of course, contracting costs are often high, and complete contracts are rare. Thus, the ability to modify the contract is often welfare enhancing. *See* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 319 (2004).

60. *See Stone*, 341 F. Supp. 2d at 198 (accepting, at least in principle, the issuer's argument that flexibility is necessary and that requiring explicit consent to every change would burden the industry significantly).

B. THE EX POST COSTS OF UNILATERAL MODIFICATIONS

When both parties to a contract—the seller and the buyer—express meaningful assent to a modification, the modification can be assumed to be mutually beneficial (Pareto optimal) from an ex post perspective. This is not so when the modification is unilaterally imposed by the seller. If effective assent by the consumer is not required, there is no guarantee that the modification will be beneficial to the consumer. In fact, sellers will have a strong incentive to make modifications that increase their profits, regardless of the adverse consequences to consumers.

Consider the following example: A credit card provides an expected benefit of $100 to the consumer at a cost of $80 to the issuer. South Dakota recently established a specialized credit card court. The issuer is considering a modification to its credit card contracts: adding a forum selection clause that would give sole jurisdiction to the South Dakota court. Given the expertise of the court, as well as its anticipated proissuer bias, the modification would reduce the issuer's costs by $20 (from $80 to $60), and reduce the value of the card to the consumer by $80 (from $100 to $20)—an inefficient modification since the issuer's $20 gain would be outweighed by the consumer's $80 loss. If mutual assent is required, this inefficient modification will not occur; the consumer would never consent. But if mutual assent is not required, if the issuer can unilaterally change the contract, then the inefficient modification may well occur. The seller will modify the contract and enjoy the cost reduction of $20, ignoring the harm imposed on the consumer.

C. THE EX ANTE COSTS OF UNILATERAL MODIFICATIONS

Some might argue that the legal system should aim to prevent all modifications that are inefficient when made (ex post). There is obviously some merit to this view if the issue is analyzed solely from an ex post perspective. Considering the matter at the time of the initial contract, however (that is to say, from an ex ante perspective), may lead to a more nuanced conclusion. Given the cost of policing modifications ex post, a rational, informed consumer might agree to a change-of-terms clause, recognizing that the clause will result in some ex post inefficient modifications (whose costs are likely to fall entirely on the consumer's shoulders), so long as the risk of inefficient modifications is outweighed by the prospect of efficient modifications.

In this section, we concentrate on situations in which modifications are inefficient when judged from the time of the initial contract (ex ante).

There are at least three kinds of ex ante inefficiency that concern us. We are most concerned about contracts that are inefficient when made, in the sense that they are expected to cause a net reduction in the welfare of consumers who enter into them. As a secondary matter, we are also concerned about contracts that do enhance the welfare of consumers who sign them but that could have been designed to enhance consumer welfare even more. Finally, we are concerned about contracts that could not do a better job of enhancing the welfare of the sellers and consumers who are parties to them, but that impose disproportionate costs on other participants in the market. We trace these ex ante costs back to three features of the status quo: (1) customers make mistakes in assessing the risk of modifications; (2) sellers lack cost-effective mechanisms of committing themselves to refrain from modifications; and (3) sellers fail to consider the systemic costs of contracts that permit unilateral modification.

1. Welfare-Reducing Initial Contracts

Rational, informed consumers can be expected to weigh properly the benefits of ex post efficient modifications against the costs of ex post inefficient modifications. These super-consumers will enter contracts that permit unilateral modifications only when modifications are efficient on balance—that is, only when they are ex ante efficient. But most consumers are imperfectly informed or imperfectly rational, and as a result they misperceive the risk of unilateral modifications (by inaccurately estimating either the likelihood of a modification, the harm from a modification, or both).[61]

To begin with, a consumer who fails to appreciate the risk of an inefficient modification might not insist on a mutual assent requirement for modifications and enter into welfare-reducing contracts—contracts that impose more costs than benefits. Consider the following variation on the previous example: Under the terms of the initial contract a credit card provides an expected benefit of $100 to the consumer at a cost of $80 to the issuer. At the ex ante stage, when the parties enter into the initial credit card contract, there is a 50% chance that South Dakota will establish a credit card court. Therefore, there is a 50% chance that the issuer will have an opportunity to modify the contract and add a forum selection clause that reduces the issuer's costs by $20 (from $80 to $60), but also reduces the value of the card to the consumer by $80 (from $100 to $20). A rational

61. *See infra* notes 62–64 and accompanying text.

informed consumer will realize that, by entering into this contract, he or she secures an expected benefit of \$60 ($0.5 \times \$100 + 0.5 \times \$20$). Since the issuer will insist on a price—a combination of interest and fees—of at least \$70 ($0.5 \times \$80 + 0.5 \times \$60$), to cover the cost of providing credit, the parties will not reach an agreement, and the inefficient trade will be avoided.

Now consider an imperfectly informed or imperfectly rational consumer who mistakenly believes that the probability of a modification is only 20% and that, if the issuer modifies the contract, the value will be reduced by only \$50 (from \$100 to \$50). This consumer will think that, by entering into this contract, he or she secures an expected benefit of \$90 ($0.8 \times \$100 + 0.2 \times \$50$). Since the issuer will still accept a price of at least \$70 ($0.5 \times \$80 + 0.5 \times \$60$), the parties may well reach an agreement and the inefficient trade will occur.

It is important to recognize that ex post inefficient modifications, such as the one described above, are not the only means that can create ex ante distortions. If consumers underestimate the risk of modifications then even modifications that are efficient ex post might cause consumers to enter into contracts that are welfare reducing from an ex ante perspective. Reconsider the previous example, but now assume that the forum selection clause would reduce the value of the card to the consumer by \$10 (from \$100 to \$90)—an efficient modification. The expected value of the card to the consumer is thus \$95 ($0.5 \times \$100 + 0.5 \times \$90$). But, since the consumer mistakenly believes that the probability of a modification is only 20%, the perceived expected value is \$98 ($0.8 \times \$100 + 0.2 \times \$90$). Consequently, the consumer would be willing to pay a price of \$97, say, for a card that is worth only \$95. In other words, the consumer would get a card that should not be in the consumer's purse.

Different inefficiencies arise when consumers *over*estimate the risk of an inefficient modification. In this case consumers may fail to enter into contracts that would enhance their welfares. Reconsider the ex post inefficient modification that reduces the issuer's costs by \$20 (from \$80 to \$60) and reduces the value of the card to the consumer by \$80 (from \$100 to \$20). But now assume that the probability of this modification is only 20%, such that the contract is ex ante efficient: the expected value of the card to the consumer is \$84 ($0.8 \times \$100 + 0.2 \times \$20$) and the expected cost to the issuer is \$76 ($0.8 \times \$80 + 0.2 \times \$60$). This efficient contract will not be signed if the consumer mistakenly believes that the probability of a modification is 50%. The consumer will think that, by entering into this contract, he or she would secure an expected benefit of \$60

($0.5 \times \$100 + 0.5 \times \$20$), and will not be willing to pay the minimum price that the issuer will demand: $76.

While both under- and overestimation are possible, there is reason to believe that consumers will tend to underestimate the cost of modifications. First, consumers might not know that sellers, in their form contracts, retain the right to change their contracts unilaterally.[62] Second, cognitive biases might distort consumers' perceptions of the modification risk. Optimistic consumers might underestimate the likelihood of a unilateral modification or the magnitude of the harm from a unilateral modification.[63] Finally, sellers will have a strong incentive to encourage underestimation of the modification risk, as doing so allows them to charge higher prices and even to sell low-quality, welfare-reducing goods and services.[64]

We recognize that imperfectly informed and imperfectly rational consumers might underestimate or overestimate numerous costs and benefits associated with goods and services, leading to similar ex ante distortions. The cost of unilateral modifications is just one type of cost that might be underestimated or overestimated. Still, the ex post cost of unilateral modifications can be substantial, and thus, the ex ante misperception of this cost may lead to substantial ex ante distortions.

2. Contracts That Fail to Maximize Welfare

The status quo of unilateral modification also imposes costs on

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62. For example, evidence suggests that many consumers have a poor understanding of their credit card contracts. *See* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 27–29 (2008).

63. In a series of articles, one of us has argued that underestimation of future costs explains contract design and market outcomes in several markets. *See* Bar-Gill & Warren, *supra* note 62, at 46–64 (consumer credit markets); Oren Bar-Gill & Rebecca Stone, *Mobile Misperceptions*, 23 HARV. J.L. & TECH. 49, 80–96 (2009) (cellular service market); Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1395–1411 (2004) (credit card market); Oren Bar-Gill, *supra* note 3, at 754–90 (consumer product and service markets); Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1118–39 (2009) (subprime mortgage market).

64. *See* Kevin E. Davis, *The Demand for Immutable Contracts: Another Look at the Law and Economics of Contract Modifications*, 81 N.Y.U. L. REV. 487, 494–98 (2006) (observing that the ability to modify contracts creates incentives for parties to misrepresent—or at least fail to disclose—their willingness to perform their contractual obligations). *Cf.* Edward L. Glaeser, *Psychology and the Market*, 94 AM. ECON. REV. (PAPERS & PROC.) 408, 409–11 (2004) ("Markets do not eliminate (and often exacerbate) irrationality . . . . The advertising industry is the most important economic example of these systematic attempts to mislead, where suppliers attempt to convince buyers that their products will yield remarkable benefits. . . . It is certainly not true that competition ensures that false beliefs will be dissipated. Indeed, in many cases, competition will work to increase the supply of these falsehoods . . . .").

rational and informed consumers who would benefit from having a greater range of choices among methods of policing contract modification. Currently, consumers who wish to enter into a contract with a seller face a single choice: a contract that can be modified easily by sellers—subject to a weak good faith requirement or to no requirement at all, depending on the jurisdiction.[65] For some consumers, this is the optimal choice. Other consumers (for example, consumers who are more averse to risk) prefer stricter modification policies. These consumers would be willing to pay a higher price for a contract that cannot be modified easily. Still other consumers might prefer contracts that exempt certain key terms from unilateral modification. In general, given the heterogeneity of consumer preferences, consumers would benefit—everything else being equal—from a choice among multiple modification policies with varying degrees of strictness and varying criteria for permissible modifications. In the current situation, the benefit of choice is lost.

Why has the market (or, more accurately, markets) for consumer goods and services converged on a contractual norm that enables unilateral modification? The answer, we think, has two parts: imperfect information and imperfect commitment options. In large part, the unilateral modification problem can be traced back to the imperfect information and imperfect rationality of consumers. In essence, if consumers do not fully appreciate the problem of unilateral modification, they will not demand restrictions on sellers' power to modify consumer contracts unilaterally.[66] So, an important part of the problem is a lack of demand for a commitment by sellers to refrain from certain types of modifications. The second part of the problem is that, even if consumers demanded a commitment to refrain from certain types of modifications, existing commitment mechanisms suffer from substantial shortcomings.

There are three main commitment mechanisms: seller reputation, enforcement by courts, and meaningful mutual assent. None of these mechanisms is sufficiently effective. In theory, reputation forces can support a commitment by sellers to avoid certain undesirable modifications. In practice, however, reputation is an inadequate commitment device. The main reason is that a seller's reputation depends

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65. *See infra* note 108 and accompanying text.

66. Imperfect information alone is not enough; imperfect information can result in both under- and overestimation of the unilateral modification risk. And overestimation will generate a demand for restrictions on sellers' power to modify consumer contracts unilaterally. Imperfect rationality implies that underestimation will dominate overestimation.

on many factors other than modification policy, including product quality, customer relations, and so forth. Accordingly, a seller's general reputation may be affected only marginally by an unattractive modification policy. In some sense, this is an information problem. If consumers could acquire and process sufficient information to support a more refined reputation system, then sellers could develop a reputation for modification policies independent of their general reputation. Such a refined reputation system is not realistic.

The second available commitment device is the court system. In theory, sellers could write in their contracts, for example, "We promise to make only fair and efficient modifications." The courts would police modifications accordingly, enforcing only modifications that they deemed fair and efficient.[67] Alternatively, the courts might, as some courts already do,[68] fashion their own limits—for example, "good faith"—on the kinds of unilateral modifications they will enforce.

The judicial commitment mechanism has three main shortcomings, however. First, it entails potentially high litigation costs. Second, it creates uncertainty. And this uncertainty is augmented by institutional constraints that prevent courts from developing the competence to police modifications effectively according to the contractually specified standard.[69] Third, the judicial commitment mechanism lacks flexibility. Courts would likely apply a single standard to all consumers—to consumers who prefer a stricter modification policy and to those who prefer a more lenient

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67. This is more than a mere theoretical possibility. As discussed above, cellular service contracts subject modifications to a "no material adverse effect" standard. *See* Verizon Wireless, Customer Agreement, *supra* note 51 ("We may change prices or any other term of your Service or this agreement at any time, but we'll provide notice first, including written notice if you have Postpay Service. If you use your Service after the change takes effect, that means you're accepting the change. If you're a Postpay customer and a change to your Plan or this agreement has a material adverse effect on you, you can cancel the line of Service that has been affected within 60 days of receiving the notice with no early termination fee."). In principle, sellers could specify more specific rules for policing modifications. For example, credit card issuers can specify that they will only increase rates by up to X percent and only if the cardholder's credit score drops by more than Y points. Such a specific rule would be easy for courts to apply, and litigation costs should be correspondingly low. The problem with specific rules is that they presume an ability to predict the specific modifications that could arise. But the raison d'être of modifications is to enable midstream adjustments, in response to changed circumstances, in situations in which it is inefficient to write more complete ex ante contracts that specify obligations for all contingencies.

68. *See supra* Part II.B.

69. Similar problems would arise if, instead of reviewing modifications by the court after the fact, sellers were to seek declaratory judgments before implementing each modification. Moreover, this version of the court-based commitment mechanism adds another cost element—the cost of delay in implementing desirable modifications.

modification policy. Consumers would not be able to choose a modification policy that suits their preferences.[70]

The third commitment mechanism is mutual assent. By requiring consumers to express assent to the proposed modification, sellers could commit, in theory, to making only mutually beneficial modifications. So why would rational and informed consumers allow unilateral modifications? The answer, as already suggested, boils down to costs. Meaningful assent, of thousands or millions of consumers, is costly to obtain.[71]

3. Contracts That Create Systemic Costs by Reducing Competition

The widespread use of contracts subject to more or less unconstrained unilateral modification is also problematic because it tends to reduce competition. The problem is that when terms are subject to unilateral modification, the initial contract provides relatively little information about the terms on which sellers will ultimately provide their products.[72] Consumers could invest in keeping abreast of all modifications (for example, by making sure to read all bill-stuffers carefully) and stop using the product or service when a harmful modification is made. But staying informed in the face of a stream of modifications is more costly than simply reading the initial contract.[73] And, as argued above, even if consumers were to notice a harmful modification, they may continue to use the good or service, given the high cost of exit.[74] Moreover, since exit would be unlikely, even in the face of a harmful modification, the incentive to stay informed about modifications would be reduced. Finally, even if consumers stay informed about modifications, it remains true that it will be difficult for them to obtain meaningful information about a seller's products by reading the initial contract.

This informational problem cannot be mitigated by third-party intermediaries such as *Consumer Reports*. Unilateral modifications also

70. It is possible, however, that different courts would use different standards for policing modifications and sellers would use forum selection clauses to present consumers with a choice among the different standards.

71. *See supra* note 60 and accompanying text.

72. *See Modernizing Consumer Protection Hearing*, *supra* note 40, at 47–48 (statement of Adam J. Levitin) (arguing that term changes "obfuscate the true cost of using credit").

73. *See* Bar-Gill & Warren, *supra* note 62, at 13; Horton, *supra* note 4, at 609. *Cf.* Davis, *supra* note 64, at 497 (arguing that permitting modifications with mutual assent "tends to increase the cost to customers of identifying [sellers] whose costs of performance are truly low").

74. *See* Horton, *supra* note 4, at 609; *supra* note 31 and accompanying text.

make it more difficult for third-party intermediaries to provide meaningful information to consumers. The ease of product change would require *Consumer Reports*—and the consumers who rely on *Consumer Reports*' help—to exert constant vigilance in order to keep up.[75] Such vigilance is costly, perhaps prohibitively so.[76]

The upshot is that unilateral modifications make it difficult for consumers to become informed about the terms being offered by sellers. Uninformed consumers cannot comparison shop effectively. And without comparison shopping, the level of competition in the market is low, with all the distortions that typically entails.[77] In particular, if consumers cannot shop around, then sellers have limited incentives to reduce prices or to improve the quality of their products and services.[78]

D. COMPARISON: MODIFICATION OF B2B CONTRACTS

It is instructive to compare briefly the modification of consumer contracts, which we focus on, with the modification of B2B contracts. There is a vast literature on the modification of B2B contracts, and this literature is also concerned with the welfare costs of contract modification.[79] But the welfare costs of modifying B2B contracts can be

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75. Bar-Gill & Warren, *supra* note 62, at 16.

76. *See id.*

77. *See* David Gilo & Ariel Porat, *The Hidden Roles of Boilerplate and Standard-Form Contracts: Strategic Imposition of Transaction Costs, Segmentation of Consumers, and Anticompetitive Effects*, 104 MICH. L. REV. 983, 1004–08 (2006) (discussing the anticompetitive effects of contracts that prevent comparison shopping).

78. Reduction in competition caused by the use of readily modifiable contracts need not involve individual consumers' signing welfare-reducing contracts. Rational, informed consumers will avoid welfare-reducing transactions. It may also be the case that competition-reducing contracts strike an optimal balance between flexibility and transparency for the customers who enter into them. Consequently, there may be no grounds for complaining that the contracts fail to maximize the welfare of those who sign them. The problem here is that sellers and their customers have no incentive to take into account the fact that by signing readily modifiable contracts, they may prejudice other participants in the market. For example, suppose that a credit card issuer faces exceptionally strong reputational sanctions if it makes modifications that are inefficient ex post. That issuer and customers who are aware of its reputation may find it optimal to sign a contract that contains a change-of-terms clause with no express constraints on unilateral modifications. Customers who read the change-of-terms clause and are unaware of the issuer's reputation, however, may rationally avoid contracting with the issuer. Moreover, other issuers will have no incentive to offer innovative terms in order to compete for customers. This lack of incentive is because customers who stop reading when they find the change-of-terms clause, or who realize that any terms they do read are subject to modification at any time, will have no way to determine which issuer is offering superior terms.

79. In the economic literature, see, for example, PATRICK BOLTON & MATHIAS DEWATRIPONT, CONTRACT THEORY 32–33, 36 (2005), the leading textbook on contract theory, which deals extensively

different from the welfare costs of unilaterally modifying consumer contracts that we identified above.

First, the literature on modification of B2B contracts assumes that all modifications are subject to the mutual assent requirement.[80] As a result, ex post efficiency costs are largely ignored by this literature. Second, different ex ante costs are brought to the fore in B2B and consumer cases. For instance, the B2B literature emphasizes how the prospect of modification distorts incentives to make ex ante reliance investments.[81] Finally, the systemic effects on the level of competition are less salient in the B2B context.

IV. EXISTING SOLUTIONS AND THEIR LIMITS

The process of contracting between businesses and consumers is afflicted by many well-known problems. There are also several standard legal responses to these problems, namely, disclosure requirements, formal prerequisites to contract formation, and substantive restrictions on contractual terms. We consider each of these standard responses in turn and show why none is an adequate response to the problems posed by unilateral modifications of consumer contracts.[82]

A. DISCLOSURE

One response to the unilateral modification problem is mandatory disclosure—requiring sellers to disclose information about the likelihood and nature of possible modifications, whether pursuant to a change-of-terms clause or otherwise, in a format that makes them conspicuous to

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with renegotiation—the economists' term for modification. In the law and economics literature, see, for example, SHAVELL, *supra* note 59, at 314–20; Oren Bar-Gill & Omri Ben-Shahar, *The Law of Duress and the Economics of Credible Threats*, 33 J. LEGAL STUD. 391 (2004); Davis, *supra* note 64; Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203 (1997).

80. While the mutual assent requirement is often implicit in this literature, the economic term for modification, "renegotiation," suggests that both parties must agree to the modification. Moreover, this literature generally assumes that contracts will be renegotiated whenever a *mutually* beneficial modification exists, again suggesting that mutual assent is required. *See, e.g.*, BOLTON & DEWATRIPONT, *supra* note 79, at 541; SHAVELL, *supra* note 59, at 316–17.

81. *See, e.g.*, BOLTON & DEWATRIPONT, *supra* note 79, at 36, 450–56; SHAVELL, *supra* note 59, at 317–18; Bar-Gill & Ben-Shahar, *supra* note 79, at 412–17; Davis, *supra* note 64, at 498–501.

82. Horton also considers some of these standard responses. Horton argues that unilateral modifications should be banned. *See* Horton, *supra* note 4, at 660–67.

consumers.[83] The model might be federal legislation such as the Truth in Lending Act, which requires certain terms of credit card contracts to be "clearly and conspicuously" disclosed in credit card applications and solicitations.[84] This standard focuses on the disclosure of contract terms, such as a change-of-terms clause, and requires the disclosures to be "in a reasonably understandable form" and "readily noticeable to the consumer."[85] An even more robust disclosure requirement would force sellers to disclose not only the existence of change-of-terms clauses in their contracts, but also information about how frequently the clauses have been invoked in the past and the likelihood they will be invoked in the future.[86] The law does not currently require this kind of disclosure (leaving aside cases in which a seller knows in advance that it is going to make a modification that will substantially reduce the value of the contract to the consumer and so runs afoul of prohibitions on bait-and-switch tactics).

So what do we think of mandatory disclosure as a response to the problem of consumer contract modifications? The short answer is it probably cannot hurt, but it should not be the only response. We favor requiring sellers to disclose the fact that their contracts contain change-of-terms clauses, and in the most conspicuous fashion possible. This requirement is consistent with our view that if a contract includes a change-of-terms clause, that clause is the single most important provision of the contract; some might say that it is almost pointless to read any of the other provisions. Further disclosure about how the change-of-terms provision will be used is also beneficial in principle. We have identified imperfect consumer information as one of the main sources of the unilateral modification problem.[87] Disclosure is the natural response to lack of information.

We are skeptical, however, about the efficacy of disclosure mandates. We are not confident that consumers would be able to use this information

83. Peter Alces and Jason Hopkins point out that in the context of many agreements between banks and their customers, many consumers do not even have access to copies of their agreements. The authors propose to combat pernicious terms in bank-customer agreements by having the Federal Reserve Board establish an online clearinghouse in which banks are required to reproduce the terms of their agreements. Although Alces and Hopkins devote a great deal of attention to the pernicious nature of change-of-terms clauses, they do not propose that any special steps be taken to bring those clauses to customers' attention. *See* Alces & Hopkins, *supra* note 4, at 904–06.

84. Truth in Lending Act of 1968, 15 U.S.C. § 1632(a) (2006).

85. Regulation Z, 12 C.F.R. pt. 226, supp. I, § 226.5, para. 5(a)(1), cmt. 1 (2010).

86. *See* Curtis Bridgeman, *Misrepresented Intent in the Context of Unequal Bargaining Power*, 2006 MICH. ST. L. REV. 993, 1008–09 (2006).

87. *See supra* Part III.C.1.

to avoid sellers who either propose welfare-reducing initial contracts or who are likely to propose welfare-reducing modifications. The disclosure solution relies on policing by consumers at the ex ante contracting stage. The claim is that informed consumers, through their contractual choices, will drive sellers to offer efficient contractual terms, including efficient modification rules. This claim assumes that disclosure will result in a critical mass of informed consumers able to provide meaningful assent to change-of-terms clauses. Consumers suffer from information overload and are already bombarded with a large number of mandatory disclosures. There is a real danger that information contained in additional disclosures either will be ignored or will crowd out other important information.[88] This is a particularly salient concern with proposals to have sellers disclose information about the likelihood that, or the circumstances in which, change-of-terms clauses will be invoked.

But even if disclosure could solve the imperfect information problem, we are still left with the inadequate commitment mechanisms problem. As argued above, the available commitment mechanisms—seller reputation, courts, and mutual assent—suffer from substantial limitations.[89] Disclosure would help consumers recognize these limitations, but it would do little to overcome them.

B. REQUIRING MEANINGFUL ASSENT TO EACH CHANGE

This is perhaps the most obvious response to the unilateral modification problem. If the problem is unilateral modification, why not insist on bilateral modification? Why not require meaningful consumer assent to each proposed change? We first outline the doctrinal paths that could lead back to a meaningful mutual assent requirement. We then ask whether this outcome, if possible, would be desirable.

1. Reviving Mutual Assent

The most significant steps toward reviving the mutual assent requirement involve limiting the effects of change-of-terms clauses as well

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88. For evidence that consumers spend little time reading terms of contracts, see Yannis Bakos, Florencia Marotta-Wurgler & David R. Trossen, *Does Anyone Read the Fine Print? Testing a Law and Economics Approach to Standard Form Contracts* (NYU Ctr. for Law, Econ. & Org., Working Paper No. 09-40, 2009), *available at* http://ssrn.com/abstract=1443256 (finding that only one or two out of every one thousand retail shoppers chose to view the license agreements of sixty-six companies selling software online).

89. *See supra* Part III.C.

as clauses or legislative provisions that permit failure to object to a modification to qualify as assent, thereby encouraging sellers to ensure that customers assent to contract modifications in a fashion that meets the traditional requirements for contract formation.

Along these lines, several courts have construed change-of-terms clauses narrowly. In the leading case of *Badie v. Bank of America*,[90] the court offered several justifications for this approach. In the first place, the court held that even though a change-of-terms clause gave a bank unlimited power to change the terms of its credit card contracts, the implied duty of good faith in performance meant that the bank could only make changes that were within the reasonable contemplation of the parties at the time of the initial contract.[91] Second, the court argued that in the absence of substantive limitations on the bank's power to change the terms of its credit card contracts, its promise would be illusory and so the contract might be unenforceable.[92] As a third argument, the *Badie* court relied on the traditional rule that in cases of ambiguity, contracts are to be interpreted most strictly against the drafter.[93] Finally, the *Badie* court held that agreements to waive constitutional rights, such as the right to a jury trial and the right to select a judicial forum for dispute resolution, must be "clearly apparent in the contract," "unambiguous," and "unequivocal."[94] So, for example, in *Badie* itself the court concluded that a broadly worded change-of-terms clause in an initial credit card contract that made no reference to alternative dispute resolution did not meet the standard for a constitutional waiver and so could not justify enforcement of a change that purported to add an arbitration clause.[95]

A more radical way of trying to ensure that sellers obtain meaningful assent to modifications from consumers would be to discourage the use of change-of-terms clauses altogether, rather than merely construing them narrowly. The same approach could be taken with the practice of treating failure to object to a modification as assent. If successful, this strategy would force sellers to secure assent to specific modifications shortly before

90. Badie v. Bank of Am., 79 Cal. Rptr. 2d 273 (Ct. App. 1998).

91. *See id.* at 284.

92. *See id.* at 284–85.

93. *See id.* at 286 (citing Cal. Civ. Code § 1654 (West 1998); Oceanside 84, Ltd. v. Fidelity Fed. Bank, 66 Cal. Rptr. 2d 487, 492 (Ct. App. 1997); Powers v. Dickson, Carlson & Campillo, 63 Cal. Rptr. 2d 261, 266–67 (Ct. App. 1997)).

94. *Id.* at 289 (quoting Trizec Props., Inc. v. Superior Court, 280 Cal. Rptr. 885, 887 (Ct. App. 1991)).

95. *See id.* at 289–90.

the modifications take effect. For instance, sellers might begin requiring that consumers "opt in" to modifications by mailing signed confirmations or at least clicking "I agree" on Web-based forms.

Legislatures, of course, could ban enforcement of change-of-terms clauses and the practice of treating failure to object as assent. The Truth in Lending Act, or at least the regulation promulgated under it, takes this approach. Regulation Z, promulgated by the Federal Reserve Board, sets out a general prohibition on the use of change-of-terms clauses in home equity loans and then enumerates several circumstances in which changes are permitted.[96]

If legislatures do not act, then courts might step in. For courts, the most straightforward way of discouraging the use of change-of-terms clauses and reliance on deemed assent is to rely on the doctrine of unconscionability.[97] In most jurisdictions, unconscionability requires a showing of both procedural and substantive unconscionability.[98] Change-of-terms clauses and the treatment of failure to object as assent are potentially relevant to the existence of both factors. Some courts may treat the absence of express assent as an indicator of procedural unconscionability in the course of determining whether a specific modification is unconscionable. So, for example, the fact that a consumer contract is modified to add an arbitration clause using the procedure specified in a change-of-terms clause might be treated as evidence that the consumer did not have a meaningful choice in agreeing to the arbitration clause—a classic indication of procedural unconscionability.[99]

An alternative and more far-reaching approach is to hold that change-of-terms clauses, or similar clauses that treat failure to object as assent, are

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96. Regulation Z, 12 C.F.R. § 226.5b (2010). The commentary to the regulation adds, "A creditor may not include a general provision in its agreement permitting changes to any or all of the terms of the plan. For example, creditors may not include 'boilerplate' language in the agreement stating that they reserve the right to change the fees imposed under the plan . . . ." *Id.* pt. 226, supp. I, § 226.5b(e), para. 5b(f)(3)(i), cmt. 2. *See also* Alces & Greenfield, *supra* note 4, at 1127.

97. *See* Horwitz, *supra* note 4, at 100–05 (discussing the doctrine of unconscionability as a legal defense to the unfairness of a change-of-terms provision).

98. *See* 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 4.28, at 508–09 (1990) ("Most cases of unconscionability involve a combination of [substantive and procedural] unconscionability; and it is generally agreed that if more of one is present, then less of the other is required.").

99. *See Badie*, 79 Cal. Rptr. 2d at 287 ("[T]here is nothing about the original terms that would have alerted a customer to the possibility that [Bank of America] might one day in the future invoke the change of terms provision to add a clause that would allow it to *impose* [alternative dispute resolution] on the customer.").

substantively unconscionable.[100] If adopted widely, this approach would have particularly far-reaching effects because most consumer contracts entail a certain amount of procedural unconscionability. A holding that a change-of-terms clause is substantively unconscionable would typically lead to the conclusion that the clause is unenforceable. This result would in turn suggest that any modifications adopted in reliance on the clause are also unenforceable. By contrast, finding that a change-of-terms clause is an indicator of procedural unconscionability would only knock out modifications that are substantively unconscionable in their own right.

A novel proposal to discourage the use of change-of-terms clauses and similar devices involves an expansion of the doctrine of promissory fraud. Curtis Bridgeman and Karen Sandrik argue that a seller should be liable in promissory fraud if it makes a contractual promise without possessing "the intention to perform that its promise implied."[101] They would treat the existence of a change-of-terms clause as "strong, prima facie evidence" of such an intention.[102] Both the existing doctrine of promissory fraud and federal and state laws that bar bait-and-switch tactics allow a seller to be held liable if it offers a contract that it intends not to perform in accordance with its initial terms.[103] Bridgeman and Sandrik would go beyond existing law, however, by imposing liability on sellers who simply intend to keep open the option of not performing.[104] So, for example, if a credit card company signed up every person in Florida to a credit card agreement that

100. *See, e.g.*, Ingle v. Circuit City Stores, Inc., 328 F.3d 1165, 1172–73, 1179 (9th Cir. 2003) (finding a provision in an arbitration agreement with employees substantively unconscionable where it afforded the employer the unilateral power to terminate or modify the agreement).

101. Bridgeman & Sandrik, *supra* note 4, at 399.

102. *Id.*

103. *See, e.g.*, COLO. REV. STAT. § 6-1-105(1)(n) (2002); N.Y. GEN. BUS. LAW § 396 (McKinney 2009); TEX. BUS. & COM. CODE ANN. § 17.50(a)(1) (Vernon 2009); Rossman v. Fleet Bank (R.I.) Nat'l Ass'n, 280 F.3d 384, 396 (3d Cir. 2002) ("Bait advertising, although not necessarily literally false . . . is nonetheless considered deceptive, insofar as it suggests the product advertised is actually offered and intended to be sold, when the real intention is simply to create a contact with the buyer that allows the seller to switch the consumer to a more profitable sale."); FTC Guides Against Bait Advertising, 16 C.F.R. § 238.0–.4 (2010); RESTATEMENT (SECOND) OF TORTS § 530(1) (1977).

104. *See* Bridgeman & Sandrik, *supra* note 4, at 398–400. The existing doctrine of promissory fraud's requirement of intention not to perform and intent to deceive precludes liability in this situation. *See, e.g.*, Saia Food Distribs. & Club, Inc. v. SecurityLink from Ameritech, Inc., 902 So. 2d 46, 56–57 (Ala. 2004) (quoting Waddell & Reed, Inc. v. United Investors Life Ins. Co., 875 So. 2d 1143, 1160 (Ala. 2003)); Bulbman, Inc. v. Nev. Bell, 825 P.2d 588, 592 (Nev. 1992) ("The mere failure to fulfill a promise or perform in the future . . . will not give rise to a fraud claim absent evidence that the promisor had no intention to perform at the time the promise was made."); RESTATEMENT (SECOND) OF TORTS § 530 cmt. b ("To be actionable the statement of the maker's own intention must be fraudulent, which is to say that he must in fact not have the intention stated.").

contained a 5 percent fixed rate of interest, but within a few months raised the rate to 30 percent relying on a change-of-terms clause, affected consumers could sue the issuer for promissory fraud. According to Bridgeman and Sandrik, the issuer ought to be liable so long as at the time of the initial contract it intended to keep the option of raising interest rates open, regardless of whether it actually intended to raise interest rates.

Promissory fraud carries with it liability for both compensatory and punitive damages.[105] Moreover, this liability would not be a purely theoretical prospect—Bridgeman and Sandrik suggest that consumers could raise promissory fraud not only as a defense to claims by sellers, but also as affirmative claims in their capacity as plaintiffs in a class action.[106] Consequently, if Bridgeman and Sandrik's proposal were adopted, sellers would have to think twice before adopting change-of-terms clauses.

2. Do We Want Mutual Assent?

What do we think of the idea of limiting the effects of change-of-terms clauses and similar provisions? Would these limitations encourage sellers to obtain affirmative assent to contract modifications? Is this desirable?

Some of the proposed limits on change-of-terms clauses would induce sellers to adopt narrower clauses that explicitly list the types of changes that might be effected and perhaps even state the circumstances under which those changes are likely to be proposed. This outcome would impose a substantial informational burden on consumers and, thus, would suffer from problems similar to those of the disclosure solution.

While some proposed limits on change-of-terms clauses and similar provisions would result in a more limited domain for unilateral modifications, others would subject the majority of modifications to a meaningful mutual assent requirement. In other words, they would discourage reliance on change-of-terms clauses or similar devices altogether and encourage sellers to seek affirmative assent to specific modifications immediately before the modifications take effect. We are less enthusiastic about these measures. If disclosure is a way of relying on ex ante policing by consumers, insisting on affirmative assent to individual

105. *See* Bridgeman & Sandrik, *supra* note 4, at 398.

106. *See id.* at 400 ("[W]hen millions of consumers have relatively small injuries, the type of injury that will typically be caused by bullshit promises, the class action is the only efficient and effective way to compensate the individuals for their losses . . . .").

modifications would be a way of relying on consumers' ex post policing. Unfortunately, this is not the best way to police the modification of consumer contracts. As we have shown, many contract modifications ought to be permitted. Requiring consumers to provide meaningful affirmative assent to individual modifications would tend to increase the cost of effecting both desirable and undesirable modifications. Inevitably, some desirable modifications would be thwarted.

C. REFUSING TO ENFORCE SPECIFIC MODIFICATIONS

The third category of responses to problems with consumer contracts involves imposing substantive restrictions on permissible modifications that are imposed prior to formation of the initial contract and apply regardless of whether consumers assent to the modifications in question. The CARD Act represents an application of this tactic to credit card modifications—Congress has singled out specific kinds of modifications and deemed them unenforceable.[107] The specificity of the CARD Act is exceptional, though, and limited to credit card contracts. Most contract modifications are measured against more open-ended standards. For example, both the common law and article 2 of the Uniform Commercial Code suggest that contract modifications must comply with a standard of fairness or good faith.[108] The fairness and good faith standards represent the opposite extreme from the standards set by the CARD Act because they are so exceptionally open-ended. Intermediate approaches are also possible.[109]

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107. *See supra* note 38 and accompanying text.

108. *See* U.C.C. § 2-209 cmt. 2 (2000); RESTATEMENT (SECOND) OF CONTRACTS § 89 (1981).

109. See, for example, the UNIF. RESIDENTIAL LANDLORD & TENANT ACT § 3.102(a) (1972), *as reprinted in* Horwitz, *supra* note 4, at 96 ("A landlord, from time to time, may adopt a rule or regulation, however described, concerning the tenant's use and occupancy of the premises. It is enforceable against the tenant only if (1) its purpose is to promote the convenience, safety, or welfare of the tenants in the premises, preserve the landlord's property from abusive use, or make a fair distribution of services and facilities held out for the tenants generally; (2) it is reasonably related to the purpose of which it is adopted; (3) it applies to all tenants in the premises in a fair manner; (4) it is sufficiently explicit in its prohibition, direction, or limitation of the tenant's conduct to fairly inform him of what he must or must not do to comply; (5) it is not for the purpose of evading the obligations of the landlord; and (6) the tenant has notice of it at the time he enters into the rental agreement, or when it is adopted."); OFFICE OF FAIR TRADING, UNFAIR CONTRACT TERMS GUIDANCE 52–53 (2008), *available at* http://www.oft.gov.uk/shared_oft/reports/unfair_contract_terms/oft311.pdf (describing limitations that make change-of-terms clauses more likely to be compatible with the Unfair Terms in Consumer Contracts Regulations, 1999, S.I. 1999/2083 (U.K.)).

Another example can be found in Regulation Z, which enumerates permissible unilateral changes to home equity loans. These include changes "that will unequivocally benefit the consumer throughout

These kinds of substantive constraints on consumer contract modifications are potentially valuable ways of discouraging undesirable modifications. Out of necessity, the most appropriate constraints will tend to be relatively open-ended, particularly when they apply to contracts that govern long-term, complex relationships. For the same reasons that parties are unable to draft an initial contract that obviates the need for modification by being perfectly tailored to every contingency that might arise, it would likely be impossible for the parties or anyone else to specify in advance the nature of the modifications that might be proposed. Given the costs of specifying optimal state-contingent contractual obligations over the course of a long-term relationship, the best that might be done would likely be to set fairly open-ended constraints on sellers' ability to make unilateral modifications—constraints that are to be given content only after specific modifications have been proposed.

Our concern about any sorts of substantive constraints on modifications is that they will bar desirable modifications as well as undesirable ones. This concern is particularly significant when the constraints, such as those contained in the CARD Act, are formulated long before the relevant modifications will be implemented, when the consequences of both the modifications and the constraints on the power to modify are difficult to anticipate. On the other hand, constraints whose content is specified only after a modification has been implemented expose sellers to considerable uncertainty about their legal rights as well as relatively substantial litigation costs. Of course, the risk of barring desirable modifications is also likely to be pronounced when the constraints are defined by institutions—specifically courts and legislatures—that lack specialized expertise with the kind of contract at issue. These concerns mirror the shortcomings of the court-based commitment mechanism described above,[110] since it would be the courts that police modifications under this approach.

Another factor to consider is that consumers may want different levels

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the remainder of the plan" or are "insignificant." Regulation Z, 12 C.F.R. § 226.5b(f)(3) (2010). A different approach would be to bar unilateral modifications that deviate from terms that are being offered to new consumers. Such behavior might be evidence of deceptive conduct. *See* Rossman v. Fleet Bank (R.I.) Nat'l Ass'n, 280 F.3d 384, 389 (3d Cir. 2002) (involving a credit card issuer that claimed that increased interest rates forced it to modify its no-annual-fee commitment while it allegedly continued to offer no-annual-fee cards to new customers). We are reluctant to endorse this proposal in which no element of deception is present as there may be legitimate reasons for a seller to bind new and existing customers to different terms.

110. *See supra* notes 67–70 and accompanying text.

of protection against the risk of undesirable modifications, especially since greater protection entails higher prices. In theory, a court can provide varying degrees of protection to different consumers in different circumstances by, for example, interpreting a change-of-terms clause more broadly or more narrowly. In practice, courts do not have the institutional competence to make such adjustments, and they know not to try.[111] A solution based on ex post policing by courts does not solve the absence of choice problem.

Ideally, both consumers and bodies with more specialized expertise than courts would have a say in fashioning the constraints to be imposed on sellers' ability to modify consumer contracts. None of the proposals we have canvassed have these features.[112]

D. THE WAY FORWARD

This survey of the limits of standard responses to the problem of consumer contract modifications also suggests the contours of a superior alternative. This alternative would give effect to provisions of initial contracts that give sellers authority to make unilateral modifications so long as sellers obtain meaningful assent from consumers to those provisions. Sellers' authority to adopt such unilateral modifications would be subject to substantive constraints defined in the initial contract, again in a way that involves consumers' meaningful assent. These limits may include open-ended standards, but if they do, these standards would be fleshed out by a body with specialized expertise with the relevant type of contracts. Finally, the process of giving content to substantive constraints would ideally occur sometime after a specific modification has been proposed but before the modification has been implemented.

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111. For example, it would be unheard of for a court to reason as follows: "This consumer paid a lower price, so he or she must have accepted the risk of a broader range of unilateral modifications."

112. There is precedent for having an administrative agency involved in crafting constraints on sellers' ability to modify consumer contracts. In the United Kingdom, the Office of Fair Trading ("OFT") has issued detailed guidance on the kinds of change-of-terms clauses that it considers to be in contravention of the Unfair Terms in Consumer Contracts Regulations, 1999, S.I. 1999/2083 (U.K.) (which implements the European Community's Unfair Contract Terms Directive 93/13, 1993 O.J. (L 95)). OFFICE OF FAIR TRADING, *supra* note 109, at 52–53. As all systems that rely on constraints formulated prior to the time of a specific modification, this one risks barring some beneficial modifications. Moreover, the guidance only sets out the views of the OFT on when it is likely to initiate judicial proceedings to enforce the regulations, but "the final decision on whether a term is unfair rests with the courts." *Id.* at 7. Consequently, except to the extent that the courts defer to the OFT, this scheme remains vulnerable to the concerns about lack of expertise, delay, and litigation costs that we associate with court-based systems.

V. A NEW APPROACH

We propose a new solution to the problem of unilateral modifications. At the heart of our proposal is a specialized body, which we call a Change Approval Board ("CAB"). As its name suggests, the CAB would be charged with approving any modification of the consumer contract. In essence, the CAB would perform the review function that consumers cannot, or simply do not, perform. It would serve as an agent of the consumer.

A. ADDING A CAB TO A CONTRACT

The seller and consumer would add the CAB as a party to their contract. The CAB would not scrutinize the initial contract, but, as a party to the initial contract, the CAB would have to approve any changes the seller proposes to make to the initial contract.[113] Our proposal builds on a basic tenet of contract law—that contracts can be modified only with the assent of all parties to the contract.[114] The CAB would be able to prevent any unjustified term change simply by withholding assent.

Our proposal relies more on market forces and less on regulation. CABs could be private bodies, with a membership that would represent both industry and consumer perspectives. More importantly, CAB participation would be voluntary. The CAB would be invited, by the seller and the consumer, to join as a party to the contract. More realistically,

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113. In this respect, the CAB would function in a similar manner to the "representative trustee technique" described in Davis, *supra* note 64, at 518–37. We do not believe, however, it will be necessary for CABs to adopt the complex organizational form associated with the representative trustee technique in order to fulfill their mandates. The CAB would *not* function in the same fashion as mechanisms for preapproval of *initial* contracts. In certain markets, the initial contracts would require approval from a government agency. In a similar vein, some have proposed a certification process, whereby a government or nongovernment body would certify initial contracts. *See* Shmuel I. Becher, *A "Fair Contracts" Approval Mechanism: Reconciling Consumer Contracts and Conventional Contract Law*, 42 U. MICH. J.L. REFORM 747 (2009); Clayton P. Gillette, *Pre-approved Contracts for Internet Commerce*, 42 HOUS. L. REV. 975 (2005). These proposals are materially different from our proposal since review of the initial contract according to standards established by law is likely to be more demanding than review of only proposed changes to the initial contract against standards established by the initial contract. Since our focus is on the problem of contract modification, we do not express an opinion on the desirability of approval or certification mechanisms that focus on the initial contract. We note, however, that our approach, focusing on the review of modifications, is perfectly consistent with a preliminary review of the initial contract. In fact, we would argue that any review or certification of the initial contract should ask if the seller has added a CAB to the initial contract and what modification policy the CAB has adopted.

114. *See supra* note 6 and accompanying text.

sellers would offer contracts with CABs as a commitment not to make harmful modifications. And consumers would choose contracts with CABs as CABs promise protection against harmful modifications.

An important function of the CAB would be to provide an effective commitment mechanism in light of the inadequacy of the existing commitment mechanisms—seller reputation, courts, and mutual assent.[115] We have argued that meaningful assent by consumers is, for the most part, impractical. The CAB system would allow consumers to delegate control to an agent, the CAB, who would review modifications for them. Instead of a court that lacks the necessary institutional competence, the CAB would bring market-specific expertise to the modification review process. The CAB would also eliminate much of the uncertainty and litigation costs of the court-based commitment mechanism.

Finally, the CAB system would not rely on the noisy signal embodied in a seller's general reputation. To be sure, reputation would still play a crucial role, but it would be the CAB's reputation, not the seller's. The CAB's reputation would provide a more informative signal for consumers. A seller's general reputation provides a noisy signal for the seller's modification policy because a seller's reputation depends on many things other than modification policy, including product quality, customer relations, and so forth. The CAB's reputation, on the other hand, would depend only on its modification policy (and how it adheres to its stated policy). The reputation signal would be much clearer for CABs.[116]

Market forces, bolstered by reputational concerns, will guarantee that the CAB fulfills its modification-review role. Consumers would only sign contracts with CABs that maintain a reputation for rejecting unjustified modifications.[117] And sellers who seek a commitment device, to assure consumers that they will make only justified changes, would not hire a CAB with a tarnished reputation. Consequently, a CAB that wants to be hired would work hard to protect its reputation.

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115. *See supra* Part III.C.2.

116. Under our proposal, consumers will make purchase decisions based on two reputational signals: the seller's general reputation and the reputation of the CAB that the seller includes in its contract. Arguably, the informational burden under our proposal is as great as under a system in which sellers develop more refined reputations—a general reputation and a modification-related reputation. Still, we believe that linking the two reputation signals to two separate bodies would facilitate a cleaner modification-related reputation signal.

117. Recall that a contract with a CAB would cost more. Consumers will refuse to pay higher prices for a contract with a CAB that does not protect their interests.

The operation of the CABs would not be costless. Sellers would pay the CABs to join as parties to their contracts. And this cost would likely be passed through to consumers. Importantly, consumers would bear this cost only if they value the CAB's protection. Otherwise, they would opt for a contract with no CAB.

The CAB system would reduce the welfare costs of unilateral modifications that we identified in Part III. First, the ex post cost imposed by welfare-reducing modifications would be reduced since these modifications would be barred by the CAB. The ex ante costs would also be reduced. By reducing the risk of harmful modifications, the CAB would also reduce the likelihood that an underestimated risk would drive consumers into welfare-reducing transactions. Finally, by restricting contract modifications, the CAB would restore incentives to comparison shop among initial contracts and thus enhance competition.

The CAB system would embody lessons drawn from the failure of existing solutions, as described in Part IV. It would restrict unilateral modifications without requiring costly consumer assent to each change. Through meaningful ex ante assent to a CAB, consumers could delegate ex post control over modifications to an expert body rather than to a court. As a result, modifications would be reviewed in real time. They would not be reviewed many months or years before being made, when the reasons for the modification cannot be anticipated, as is the case when legislators or administrative agencies attempt to police contract modifications before the modifications have been proposed. And they would not be reviewed after the fact by a court, thus avoiding uncertainty and litigation costs.

B. A MARKET FOR CABS

We envision a market for CABs. In this market, different CABs will apply different certification standards. Stricter CABs will deny more modifications. More lenient CABs will approve more modifications. The CAB system would thus solve the absence of choice problem that we identified in Part III. Since modifications proposed by sellers reduce the sellers' costs or increase their profits, sellers would charge higher prices for contracts with stricter CABs.

Risk-averse consumers who care deeply about their peace of mind would choose a contract with a higher price and a CAB that imposes stricter conditions on changes. Consumers who prefer a lower price and are willing to accept the risk of potentially costly term changes would choose a more lenient CAB or even a CABless contract. And there is another

dimension along which CABs could vary: some CABs could approve all ex post efficient modifications, while other CABs could approve only modifications that satisfy an ex ante efficiency test, as well as an ex post efficiency test.[118] Market forces, driven by consumer demand, would play a significant role in shaping the CAB system.

This CAB market would respond to the rigidity of existing solutions described in Part IV. While legislators and courts are institutionally limited in their ability to tailor modification-review policies to individual consumers and to specific circumstances, the CAB system is specifically designed for heterogeneous preferences and circumstances. More importantly, the CAB market would enable consumers themselves to choose the level of review that is right for them.[119]

We acknowledge that choosing among CABs would impose an informational burden on consumers. This burden would increase with the number of CABs as different CABs adopt different modification policies and specialize in different market segments.[120] While an increased informational burden should raise concern, the magnitude of this concern should not be overestimated. In fact, there is no reason to believe that a large number of CABs will emerge. Rather, it is possible that the market will be led by two or three prominent CABs with known standards and corresponding reputations. These leading CABs could then have several divisions specializing in different markets. The specialized divisions would contribute market-specific expertise, while reflecting and reinforcing the unitary reputation of the CAB to which each belongs.

Even with a manageable number of CABs, critics might argue that it is unrealistic to expect that consumers will shop for the optimal CAB. We respectfully disagree. With the power of unilateral modification, sellers can render any term of the initial contract meaningless. If there is one thing that

118. Recall that CABs would not scrutinize initial contracts. A CAB applying an ex ante standard would still be applying it at the ex post modification stage, asking, "Would both parties approve the modification had they considered it ex ante?" Of course a CAB, whether applying an ex ante or ex post standard, would indirectly affect the design of the initial contract as sellers would recognize their more limited ability to change the contract.

119. This feature of CABs mitigates certain concerns about proposals to have administrative agencies preapprove initial contracts. Clayton P. Gillette, for one, has raised doubts about whether administrative agencies are likely to adopt standards of review that will be consistent with maximizing consumers' ex ante welfare, particularly in the face of consumer heterogeneity. *See* Gillette, *supra* note 113, at 1001–12. Allowing consumers to set the applicable standard addresses this concern.

120. Moreover, sellers can be expected to adjust certain terms in their initial contracts to the CABs they adopt. If the CAB system induces greater complexity and reduced standardization of consumer contracts, this would further increase the informational burden on consumers.

consumers should shop for, it is a modification policy as embodied in the chosen CAB.[121] This is not to say that all consumers will be sufficiently informed to choose the CAB that is best for them. There will always be uninformed consumers who will be induced to select a contract with a lenient CAB (or no CAB at all), even without enjoying the corresponding price reduction. Courts should protect these consumers by invoking standard tools such as the unconscionability doctrine, rules against deceptive acts and practices, and so forth.

C. THE RISK OF CAPTURE

There is a risk that CABs will be captured by sellers and abdicate their role as agents of consumers. The concern is that CABs that deal repeatedly with a handful of sellers and which may derive substantial financial benefits from being nominated in those sellers' contracts will tend to slant their determinations to favor the interests of sellers. While acknowledging this risk, we believe that two features of our proposal respond to this concern. First, based on experience with other areas of consumer regulation, we expect the involvement of organized consumer groups in CABs to do a great deal to counteract any biases toward sellers.[122] Second, an efficient market for CABs would tend to encourage CABs to promote the interests of consumers. The risk of capture is greatest when the reviewing body is a monopolist, usually a government-sponsored monopolist. But our proposal envisions a market with several competing CABs. Competition greatly reduces the risk of capture (by either seller or consumer interests). If consumers are sufficiently informed and CABs compete for these informed consumers, the risk of capture is minimized.

D. THE CASE FOR GOVERNMENTAL NUDGES[123]

No new legislation is required to create CABs. Ideally, the market would create the system on its own. In reality, coordination problems and

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121. This claim is clearly valid for products and services, such as credit cards, in which the entire value of the product or service is defined by the contract. When the contract is ancillary to a physical product that cannot easily be changed or modified, then this claim needs to be weakened.

122. *See* Gillette, *supra* note 113, at 1008–12 (arguing that consumer groups have proven to be effective opponents to sellers in regulatory settings, though their interests may be more aligned with the interests of group leaders than constituents).

123. *Cf*. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008) (identifying mild forms of government intervention and describing them as "nudges").

perhaps even antitrust concerns require government intervention.

To overcome these problems, the government could provide the first, model CAB. For example, the Federal Trade Commission or, in financial product markets, the proposed Consumer Financial Protection Agency,[124] could establish a CAB and invite—or perhaps even require—sellers to add this CAB as a party to their contracts. Initially, if necessary, the government could fund the CAB, thus reducing the price increase that a contract with a CAB would entail. Of course, this government subsidy would have to be phased out if a private CAB market is to develop.[125]

Government intervention is also justified in order to ensure that CABs fully address the concerns about consumer contract modification we identified in Part III. CABs are designed primarily to respond to the shortcomings of existing commitment mechanisms—namely, seller reputation, courts, and mutual assent—and help sellers and consumers maximize the value of contracting. The creation of CABs would not respond directly to concerns about consumer misperception. In other words, there is no guarantee that consumers who underestimate the risks associated with unilateral modification will assign the correct value to a contract containing a CAB. The creation of CABs also would not respond to our concern that if left to their own devices, even sophisticated sellers and consumers will systematically ignore the effects of signing readily modifiable contracts on the incentives to comparison shop and on competition.

There are at least two responses to these problems that can easily be combined with our CAB proposal. First, to address concerns about imperfect consumer information, the government could embark on an educational campaign that would increase awareness of the unilateral modification problem. The public outcry over unilateral modifications of

124. *See* H.R. 4173, 111th Cong. (2009) (proposing to establish a new Consumer Financial Protection Agency).

125. Our proposal is qualitatively different from existing mechanisms that include a much broader governmental role. For example, insurance companies often cannot increase their rates without first obtaining the approval of a state regulator. *See, e.g.*, FLA. STAT. § 627.062 (2009); N.J. STAT. ANN. § 17:29A-14 (West 2009); TEX. INS. CODE ANN. § 1153.051(c) (Vernon 2009). The regulator can be viewed as a CAB. But contrary to our proposal, which encourages the creation of private CABs alongside the government-sponsored CAB, the state insurance regulator is a monopolistic CAB. Moreover, whereas the insurance regulator derives its authority from specific legislation, our CABs would derive their authority from private contracts. For discussion of these and other preapproval mechanisms for consumer contracts, see Becher, *supra* note 113; and Gillette, *supra* note 113.

credit card contracts[126] suggests that there already exists a relatively broad foundation on which this educational campaign can build. Second, in order to give sellers and consumers a nudge toward facilitating comparison shopping, in cases in which uniformity of treatment is not critical, sellers could be required to offer at least one version of each of their products pursuant to contracts that do not permit unilateral modifications. This requirement would give consumers a set of unmodifiable contracts to use for comparison shopping and thereby stimulate competition.[127]

VI. EXTENSION: EMPLOYMENT CONTRACTS

The recent literature on unilateral contract modifications has focused on contracts involving consumer products—credit cards, cellular service, and so forth.[128] The underlying concerns arise, however, whenever the law permits unilateral modification of mass-market contracts involving relatively unsophisticated, or perhaps just rationally inattentive, parties. Accordingly, the problems identified with respect to consumer contracts arise also in the context of employment contracts.

Unilateral modification of employees' rights is a prominent and controversial feature of U.S. employment law and practice. Some courts hold that the binding terms of an employment relationship can only be modified with the express assent of both the employer and employee.[129] But even these courts are more willing to enforce unilateral modifications if the initial contract contains some sort of change-of-terms clause.[130] Moreover, many courts have held that employer-initiated modifications are effective against employees who continue working after receiving notice of the proposed modifications, even in the absence of a change-of-terms

126. *See supra* note 8 and accompanying text.

127. *Cf.* Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong. § 136 (2009) (proposing to establish a new Consumer Financial Protection Agency that could force sellers to offer plain vanilla products to facilitate comparison shopping, among other things). A contract prohibiting unilateral modifications is an example of a plain vanilla product. *See id.*

128. *See supra* note 4 and accompanying text.

129. *See, e.g.*, Brodie v. Gen. Chem. Corp., 934 P.2d 1263, 1268 (Wyo. 1997) ("[W]e do not consider the employer's concern about negotiating employment contracts on an individual basis significant enough to outweigh our understanding that employees would risk losing a valuable contractual right without their consent."); Doyle v. Holy Cross Hosp., 708 N.E.2d 1140 (Ill. 1999) (focusing on the consideration requirement, not on the assent requirement).

130. *See, e.g.*, O'Brien v. New Eng. Tel. & Tel. Co., 664 N.E.2d 843, 848–49, 848 n.3 (Mass. 1996) (discussing the possibility that an employer had the right to amend its employee manual unilaterally); Lincoln v. Wackenhut Corp., 867 P.2d 701, 705 (Wyo. 1994) (describing a disclaimer preserving an employer's right to alter the language of its employee handbook).

clause, on the theory that an employee who continues to work under such circumstances has manifested assent through performance.[131] The American Law Institute has endorsed a version of this last approach. According to the latest draft of the Restatement (Third) of Employment, terms initially incorporated into an employment contract by mutual assent of the parties can be modified only with mutual assent of the parties.[132] Terms that were originally promulgated by unilateral employer statements (such as statements in employee handbooks), however, can be modified unilaterally, so long as they do not, through detrimental reliance or otherwise, create "vested or accrued employee rights."[133]

The advantages and disadvantages of permitting unilateral modification of employment contracts are the same as those we have associated with contracts for consumer products. On the one hand, permitting unilateral modification avoids the transaction costs of securing express manifestations of assent from individual employees, particularly in cases in which uniform treatment of employees is important.[134] On the other hand, there is the danger of giving effect to modifications that are highly prejudicial to employees—a danger that is especially problematic in situations in which employees fail to appreciate the risk of such modifications at the time of the initial contract. A second problem is that it is at best unclear whether employers can make binding commitments to refrain from unilateral modifications. For example, in one leading case, an employer was permitted to modify a "Management Employment Security Policy" unilaterally, even though it had initially announced, "This policy will be maintained so long as there is no change that will materially affect

131. *See, e.g.*, Asmus v. Pac. Bell, 999 P.2d 71, 78–79 (Cal. 2000) (permitting an employer unilaterally to modify a unilaterally implemented employment security policy despite the employer's statement that it would continue the policy so long as it did not undergo changes materially affecting its business plan achievement); Bankey v. Storer Broad. Co. (*In re* Certified Question from the U.S. Court of Appeals for the Sixth Circuit), 443 N.W.2d 112, 120 (Mich. 1989) (holding that an employer may, without an express reservation of the right to do so, unilaterally change its written policy from discharge for cause to termination at will, provided reasonable notice is given); Fleming v. Borden, Inc., 450 S.E.2d 589, 594–96 (S.C. 1994) (holding that terms of employment contracts can be altered unilaterally with reasonable notice).

132. RESTATEMENT (THIRD) OF EMPLOYMENT LAW § 2.05(c) & cmt. b (Tentative Draft No. 2, 2009) (explaining that employee rights created by express agreements cannot be modified unilaterally).

133. *Id.* § 2.05. Comment b to section 2.05 suggests that a multifactored test is used to identify vested or accrued rights. The relevant factors include "the text of the statement, other policies of the employer, the employer's course of conduct, and usages in the particular industry or occupation." *Id.* § 2.05 cmt. b.

134. *Id.* § 2.05 cmt. e ("[R]equiring express agreement by employees to changes in employer statements would be unworkable for companies with large workforces and would undermine sought-for uniformity of treatment among similarly situated employees.").

[the employer's] business plan achievement."[135] Finally, widespread reliance on contracts that are subject to unilateral modification tends to undermine employees' ability to use initial terms of employment as a basis for comparison shopping among employers, to the detriment of labor market competition.

Since these problems are similar to the problems we identified in the consumer context, we believe that the solutions we recommend in the consumer context are applicable in the employment context.[136] In other words, we believe that more emphasis ought to be placed on requiring disclosure of the existence of change-of-terms clauses in employment contracts and on educating employees about the significance of these clauses. We also think that modifications of employment contracts could be governed by some sort of independent-yet-nonjudicial body that could approve changes to employment contracts in accordance with preestablished standards. Finally, it would be useful to encourage employers to offer terms of employment that cannot be modified unilaterally, at least as an option in settings in which uniformity of treatment is not of overriding importance.

VII. CONCLUSION

Modifications of consumer contracts pose a unique problem. Since consumers do not have the information and incentives to police modifications effectively, sellers can, and do, make unilateral changes that reduce the total value of transactions. Since consumers cannot protect themselves, we propose to enlist a third party to protect them: the CAB. Importantly, we do not ask the government, through legislation or regulation, to police modifications. We show that, perhaps with a small governmental nudge, a private market for CABs could arise. The CAB system promises to deter abusive term changes while retaining the flexibility to change consumer contracts when change is justified.

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135. *Asmus*, 999 P.2d at 73. *Asmus* is cited with approval by the Reporter for the American Law Institute because the Management Employment Security Policy was adopted unilaterally. *See* RESTATEMENT (THIRD) OF EMPLOYMENT LAW § 2.05 reporters' notes cmt. a, at 97. A plausible argument, however, could be made that the text of the Management Employment Security Policy caused it to create a vested or accrued right immune from unilateral modification under section 2.05.

136. We acknowledge, however, that some of the problems we identify may be less severe in employment settings because (1) the scope for welfare-reducing modifications is limited by the special regulations that apply to employment contracts, and (2) on account of the high stakes in many employment disputes, litigation costs present less of an obstacle to policing of modifications by the courts.