The Unconscionability of a Liquidated Damage Clause: A Practical Application of Behavioral Decision Theory

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The Unconscionability of a Liquidated Damage Clause: A Practical Application of Behavioral Decision Theory

Paul Bennett Marrow*

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I. Introduction

Judicial determinations as to what is and what is not unconscionable, and therefore unenforceable, are largely subjective. This reality raises many practical difficulties for the draftsman and the litigator when attempting to counsel a client and predict the viability of a given contract provision. Unfortunately, the judiciary has not been able to clearly delineate comprehensive rules. For the practitioner this is particularly frustrating since the law is a pragmatic profession.

This article will examine and evaluate two distinct sets of core factors that underpin the existing rules. The first set of factors is rational in nature. Rational factors are defined as those discovered by searching the observable and displayed activities and conduct of the parties to the contract. Rational factors are founded on the judicial assumption that contracting parties will always act consciously to protect their own economic self-interest and that in doing so they will only seek to influence the conscious behavior of the other party to the contract. As a result of this hypothesis, cases involving unconscionability reveal fact patterns that address conscious and overt actions by one party that are interpreted and reacted to by a conscious and rational actor. This assumption supports the general premise that contracting parties know, or should know, what they are doing and that therefore they should be responsible for their contractual obligations. A conscious failure to protect one's own self-interest is usually not grounds for judicial involvement. In other words, courts should not protect contracting parties from making a bad deal. Judicial involvement, therefore, is limited to prevention of overreaching which has the appearance of a strong-arm tactic and which results in a profoundly unreasonable covenant.
A second set of core factors exist, factors that are often unrecognized when evaluations of risk are made. Understanding how these distortions operate and how they can be taken advantage of by a sophisticated player might help to explain why people enter into inadvisable arrangements, some of which we can characterize as being unconscionable. The resulting understanding has important implications for the analysis of the law. Professor Sunstein observes:

Analysis of law should be linked with what we have been learning about human behavior and choice. After all, the legal system is pervasively in the business of constructing procedures, descriptions, and contexts for choice . . . . [L]aw can construct rather than elicit preferences . . . externally, by affecting what happens in ordinary transactions, market and nonmarket.1

In recent years legal scholars have applied nonrational factors to generally explain the behavior of juries and judges when considering a great variety of cases.2 Some effort has been made to use these factors to explain contract formation.3 But application of this research to the practical task of establishing a particular theory of liability has been investigated only on a very limited basis, mostly in the area of products liability with an emphasis on tobacco litigation.4 No effort has been made to apply this research to support the theory of contractual unconscionability. The closest that anyone has come is one study which discusses breakdowns that can occur in the relationship

between a stockbroker and a customer.\(^5\) In this article I will argue that an understanding of Behavioral Decision Theory ("BDT") can be used as a viable tool for attacking some types of contractual provisions and establishing the existence of contractual unconscionability.

To date two significant efforts have been undertaken to try to link BDT to the practicalities of litigation.\(^6\) While legal arenas differ - tobacco injury claims and claims of miscreant conduct by securities brokers - both identify market manipulation which is designed to disarm as a sound reason for relieving the manipulated party of his duty to care for himself. Manipulation thwarts the ability to make a rational decision. In both situations the suspect tampering involves the consumer’s ability to understand and evaluate the assumption of risk. This conclusion has significant implications for all legal analysis and I will attempt to show how it impacts issues of contract negotiation and formation, and the theory of contractual unconscionability.

Contract formation and negotiation present a unique challenge for the application of BDT. It is almost impossible to prove whether a contracting party signs a particular contract solely because of a cognitive distortion. Of course, when things fall apart and a lawsuit is considered, all parties, if asked, can be expected to claim that they each fell victim to their failure to really understand what was motivating them, and we usually disregard such statements as being self-serving. But that does not mean that cognitive distortions did not play a role in the formation of the now disputed contract, and it is useful to understand how such distortions work and the extent to which they can be manipulated so as to influence negotiation and contract formation.

An understanding of cognitive psychological principals might help explain why people enter into bad deals in the first place, and may help identify inappropriate attempts to influence judgments that relate to the assumption of risk. The purpose of this article is to show that the manipulation of known cognitive imperfections is valid circumstantial evidence of, at


\(^6\) See Gould, supra note 3; Berman, supra note 4.
the very least, procedural unconscionability, which is to say an
intention to overreach and take unfair advantage.

For purposes of focusing the discussion, this article will
consider the question of predicting a determination about un-
conscionability within the context of a unique type of liquidated
damage clause commonly used by service providers in the emer-
gency response industry. But the principles explained and the
observations made here may have broad application to all con-
tracts whenever there is a suspicion that the taint of unconscio-
nability might be present.

In Part II of this article, I will review rational factors that
courts have identified when considering the enforcement of liq-
uidated damage clauses and in determining whether contract
clauses in general are unconscionable. In Part III, I will review
nonrational factors as suggested by BDT. In Part IV, I will re-
view efforts to date to link BDT and nonrational factors to ex-
isting legal theories and, in particular, to the relationship
between the securities broker liability and the investor, and the
law of products liability. Finally, in Part V, I will apply both
types of factors to a special category of liquidated damage
clauses to illustrate and assist in an understanding of how the
law of contracts should be expanded to include principles devel-
oped by theorists concerned about economics and psychology.

II. An Overview of the Law of Liquidated Damage Clauses
and the Theory of Unconscionability

Courts rarely strike liquidated damage clauses on the
grounds of unconscionability. The vast majority of cases chal-
enging these clauses are resolved by determining if the pre-
scribed formula is a penalty and/or results in a windfall.
However, there exists a unique class of clauses which is some-
times scrutinized by asking the question “Does this clause yield
an unconscionable result?” This class is made up of clauses
which have the appearance of being exculpatory, or defensive,
even though they technically are not, because the amount pro-
vided for in the formula is nominal. Such scrutiny notwith-
standing, courts appear very reluctant to strike this special
class of clauses on the grounds of unconscionability. I will ar-

gue throughout this article that the reason is that the factors considered to determine unconscionability are limited and do not include "nonrational factors." This argument suggests that if nonrational factors are given serious consideration, courts will become more inclined to find these "exculpatory" clauses unconscionable.

A. An Overview of the Law Concerning the Viability of Liquidated Damage Clauses

A liquidated damage clause is, from the perspective of the draftsman, a default term; one that quantifies and assigns risk associated with a default by any party to a contract. Sometimes the parties understand the scope of the assumption of risk and the implications of the allocation. But not infrequently one party is totally unaware of the implications. Often the clause comes about as a result of negotiation, the draftsman being told to capture the settled wishes of the parties. On occasion the draftsman has the upper hand in that he prepares a clause taking into account only the concerns of his client, his product being presented for acceptance or rejection by the other parties to the contract. This scenario is commonplace in situations where standard forms - printed contracts - are used. Depending on the setting, such clauses are sometimes, but rarely, the subject of future negotiations.

Liquidated damage clauses are designed, for the most part, to accommodate real life commercial concerns by predictably controlling the risks associated with human behavior. The average businessperson comes into contact with a variety of providers, purchasers and end-users. This can mean exposure to quixotic expectations and the unpredictability and expense associated with litigation. Believing that, unless such conditions are somehow controlled, the risk involved is not worth the reward, many providers of goods or services will demand as a condition for performance an agreement restricting the magnitude of claims. Oftentimes the motivation is not just a check on the mercurial but reflects concern about non-performance or faulty performance, in which case the emphasis is on providing for a predictable measure of damage to compensate for such dereliction. Liquidated damage clauses are acceptable to reinstate the status quo while controlling costs. This is accomplished if the
estimate of damage bears a reasonable relationship to the amount of probable loss flowing from a breach or default. Contracting parties are permitted to employ these clauses to reduce or eliminate speculative damages.\textsuperscript{8,9} These clauses can also serve to allocate both known and unknown risks. Liquidated damages can serve as a reasonable estimate of losses resulting from a defect in a product provided in accordance with a contract.

Keeping in mind that all liquidated damage clauses are at best an estimation, they appear to fall into three broad categories: (1) those which are ultimately overly sufficient, (2) those which are ultimately sufficient, and (3) those which are ultimately insufficient. Questions of appropriateness arise when categories (1) and (3) come into play.

When the agreed-upon damage formula is disproportionately large compared to probable loss, sometimes called an

\begin{quote}
\footnotesize
8. In other words, "Liquidated damages provisions are enforceable if but only if two conditions are satisfied: (I) Actual damages are difficult to estimate; and (II) the amount fixed in the provision is a reasonable estimate of actual loss." Melvin A. Eisenberg, The Limits of Cognition and the Limits of Contract, 47 STAN. L. REV. 211, 225 (1994); see also Restatement (Second) of Contracts § 356(1) cmt. b (1979):

[Two factors combine in determining whether an amount of money fixed as damages is so unreasonably large as to be a penalty. The first factor is the anticipated or actual loss caused by the breach. The amount fixed is reasonable to the extent that it approximates the actual loss that has resulted from the particular breach, even though it may not approximate the loss that might have been anticipated under other possible breaches . . . . The second factor is the difficulty of proof of loss. The greater the difficulty either of proving that loss has occurred or of establishing its amount with the requisite certainty . . . the easier it is to show that the amount fixed is reasonable.

\textit{Id.}

9. Compare Restatement (Second) of Contracts § 356(1) (1979):

Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty[1,]

with U.C.C. § 2-718(1) (1997):

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.
\end{quote}
overly sufficient liquidated damage clause, the result is often determined to be an unenforceable penalty. In other words, if one party is allowed to receive more than he or she objectively deserves, with no concern about how that result was arrived at, courts will refrain from enforcement on the grounds that the result could operate so as to permit windfall profit.

Antithetically, if the agreed-upon damage formula is so lopsided as to be inconsequential when compared to probable loss, or an insufficient liquidated damage clause, the result often gives the appearance of being exculpatory in nature and possibly unconscionable, which is to say suggestive of an unfair advantage or overreaching likely to result in surprise should it be exercised.

1. Insufficient Liquidated Damage Clauses

Almost all clauses in this category involve a concern about faulty performance of a service contract, and frequently the clause operates in a manner that appears to approach exculpation from liability. These contracts usually arise in the consumer arena. As a general proposition, these provisions are enforceable unless there is a special relationship between the parties or liability is imposed by statute or public policy.

When it comes to performance by licensed professionals under the supervision and control of the state, such as accountants, architects, dentists, doctors, lawyers, most mental health professionals, nurses, optometrists, podiatrists and veterinarians to name but a few, as a matter of law, no limits can be placed on liability for faulty performance. Many professions deem any attempt to limit liability an unethical act. These rules have evolved from recognition that professional status creates a “special” relationship between the parties. The state, by requiring a license, also undertakes the obligation to regulate to


11. See RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1979). Eisenberg observes that unconscionability probably is not an issue because that concept has as a foundation conscious or intentional exploitation or other unfair conduct. Eisenberg, supra note 8, at 234; see also RESTATEMENT (SECOND) OF CONTRACTS § 208 (1979).
protect the public. Absent such a "special" relationship, the parties are left to contract as they see fit, free from interference by the state and subject only to the rules governing privately imposed penalties and unconscionable agreements.\textsuperscript{12}

a. \textit{Insufficient Liquidated Damage Clauses That Limit Damages to Reimbursement of a Fee Paid for a Service Without Concern for Actual Damages}

The most common example of this type of clause is found in contracts used in connection with advertising in the yellow pages. Oftentimes, when a consumer places an advertisement in the yellow pages, in the fine print appears language limiting the publisher's liability for mistakes or omissions to the amount that the consumer pays for the advertisement. Usually the consumer is required to sign an acknowledgment that he or she has read the agreement and understands its terms and restrictions. A majority of jurisdictions around the United States uphold these agreements on the (questionable) grounds that:

— even if there is a disparity in bargaining powers between the parties, they are free to contract as they see fit so long as their doing so does not condone an action otherwise prohibited by law;\textsuperscript{13}

— while alternate yellow pages might not exist, there are other mediums for advertising and therefore the consumer is not left without an alternative;\textsuperscript{14}

— these agreements have a rational business reason for being, i.e., they limit the liability of the publisher which in

\textsuperscript{12} However, permitting limitations on liability when there is no special relationship is also troublesome. Anyone who bargains for a service is entitled to be made whole if performance is less than adequate or, at the very least, to an assurance that the law will not create a disincentive for proper or complete performance. An insufficient liquidated damage clause can operate as a disincentive for proper performance and, for this reason, should be carefully scrutinized for signs of unconscionability. This argument will be expanded upon in Part V of this article.


turn makes it possible for a reduced cost for the advertisement;\(^\text{15}\) and

– the public interest is not harmed by such agreements since the impact is limited to the consenting parties.

The argument that by reducing the exposure of the publisher it is possible to reduce the cost of advertising is particularly troubling. Market forces and competition arbitrate prices, not liquidated damage clauses.\(^\text{16}\)

In recent years, however, some courts have begun to recognize the discrimination and overreaching inherent to such “reimbursement only” clauses. Decisions are beginning to appear striking the limitation on damages on the grounds of unconscionability because:


16. These clauses are not normally present in contracts for television or radio advertising. For example, the standard form Television Contract recommended by the American Association of Advertising Agencies (1981 version) widely used by television stations and advertising agencies throughout the country makes no mention of any consequences flowing from the failure of a television station to actually air an advertisement as required by the contract. The only reference to any such failure contemplates circumstance beyond the station's control. Article 4: Failure to Telecast, provides:

(a) If due to any cause beyond the STATION's control, there is an interruption or omission of any commercial announcement or program contracted to be telecast hereunder, STATION may suggest a substitute time period for broadcast of the interrupted or omitted commercial announcement or program. If no such time period, or makegood, is acceptable to AGENCY, STATION shall allow AGENCY 1) with respect to a program, a prorata reduction in the time and/or program changes hereunder in the amount of money assigned to such charges at time of purchase and 2) with respect to a commercial announcement, an acceptable makegood, or a reduction in the time charges equal to the amount of money assigned to the commercial announcement at time of purchase.


The business circumstances surrounding other advertising media are quite different than those found in the publishing of a telephone directory. Advertisements in a phone directory are there for a full year, and so is the mistake. But if an advertisement is placed with a radio or television station, any mistake is most likely going to be eliminated immediately, thereby reducing the damages to the advertiser. Nevertheless, situations can occur where a mistake involving a radio or television advertisement could have serious consequences such as the failure to run an ad on time for a one time event.
such clauses do more than limit the liability of the publisher; they are exculpatory in nature, shielding the publisher from liability for negligent actions and are therefore unconscionable and against public policy;\footnote{17 See Pigman v. Ameritech Publ'g, Inc., 641 N.E.2d 1026 (Ind. Ct. App. 1994): The controlling factor is not whether there are other methods of advertising available, as some jurisdictions have held, but whether such other methods are tied directly to telephone service. It is this nexus between regulated telephone service and Yellow Pages commercial advertising which invokes greater judicial scrutiny for public policy considerations. The exculpatory clause in API's contract results from its monopoly status and decisive bargaining advantage over subscribers, which are derived from API's unique and important public service function. Although Yellow Pages advertising is a matter of private contract, API enjoys an exclusive advertising business which is tied to the telephone company's public utility service. Thus, a subscriber's lack of meaningful choice cannot be justified as the product of the free bargaining of the parties. Id. at 1035 (citations omitted); Disc. Fabric House of Racine, Inc. v. Wis. Tel. Co., 345 N.W.2d 417 (Wis. 1984): When performing a negligent business act as here, the Telephone Company is not cleared of fault by the contract clause but rather is relieved of liability for that fault. To say that the clause is limiting rather than exculpatory because the clause considers a return of part or all of the applicable charges for the advertisement, does not consider the complete elimination of all resulting financial injuries caused by the negligent act. For the telephone company to return the charges, which were not earned due to its negligent breach of contract, does not consider the resulting injury to the customer caused by it negligent or tortious act in not publishing the advertisement for which the customer had contracted. This is not a limiting clause but a clause that made the contract an exculpatory one in its nature. Id. at 419; Allen v. Mich. Bell Tel. Co., 171 N.W.2d 689 (Mich. Ct. App. 1969): The parties to this suit are not in positions of equal bargaining power. It is common knowledge that defendant's yellow pages is the only directory of classified telephone listings freely distributed to all the telephone subscribers in the Flint area. It is not disputed that the contract signed by the parties was a form prepared by the defendant and used by the defendant in all subscriptions for advertising in the yellow pages. Nor is it argued by the defendant that the plaintiff could have bargained for different terms in the contract. It was strictly a "take it or leave it" proposition. Under the circumstances the plaintiff had the option of agreeing to the offered terms or doing without advertising in the yellow pages. There being no competing directory or means of communicating with the same audience of potential customers except possibly at prohibitive (and by comparison totally disproportionate) cost, doing without in this case was not a realistic alternative. Clearly the challenged term is substantively unreasonable. It relieves the defendant from all liability — its only obligation is to return the agreed contract price paid for the service it did not perform. We have concluded that this provision is unreasonable and, accordingly, we decline to enforce it.}{17}
— the consumer is in a grossly inadequate bargaining position and lacks meaningful alternatives;¹⁸
— the actual out of pocket damages experienced by the consumer for the mistake by the publisher can be so great that limitations reflecting the cost of the advertisement are per se unfair and unenforceable; and
— the publisher oftentimes will solicit advertising promising results that are denied when a negligent omission occurs.¹⁹

b. **Insufficient Liquidated Damage Clauses That Specify a Sum Certain Without Concern for Actual Damages**

Examples of contracts of this type are burglar and fire alarm monitoring agreements, sprinkler installation agree-

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*Id.* at 693-94.

Bell prepared the contract in question. This State should examine this contract with an impartial but critical eye in determining whether it is unconscionable against [plaintiff], who did not participate in its drafting. . . . It is crucial to understand that this case involves an individual versus a monopoly. We do not have two corporations dealing at arms length nor two individuals dealing at arms length. We have a factual scenario where the bargaining power is wholly unequal. As a result of that economic inequality and monopoly of Bell, the terms of this contract became substantively unreasonable and should not be enforced.


It is . . . the opinion of this court that the provision is substantively unreasonable. The defendant attempts to relieve itself from all liability for its negligence, except for a return of the contract price. While it is clear generally that parties to a contract are free to negotiate into the contract who shall bear the risk for various contingencies that might arise, the facts of this case indicate that enforcement of the challenged provision would be unfair. There is no question that the telephone company enjoyed a superior bargaining position to that of the plaintiff. Plaintiff had no opportunity to negotiate with defendant regarding this provision. Since this clause shifts substantially what a reasonable subscriber would expect to be the risk-bearing obligations of the parties, it would be unconscionable to require the plaintiff to be bound by it.

*Id.* at 819.

19. Art's Flower Shop *v.* Chesapeake and Potomac Tel. Co., 413 S.E.2d 670 (W. Va. 1991). "We fail to comprehend how the appellees can so blithely argue that the limitation of liability clause is valid and equitable after publicity proclaiming that no businessman can expect growth without their services." *Id.* at 675.
ments, and agreements for unlicensed personal monitoring services.

In all of these situations, the consumer is asked to accept the company's total exculpation of liability or a limitation on damages, usually (at least in New York) of no more than $250 per incident. If a contract involves the installation of a permanent alteration to a premises such as a sprinkler system, the liquidated damage provision is sometimes deemed void and unenforceable by statute. However, where the agreement involves only monitoring of a burglar or fire alarm installed at a premises, such clauses are found to be enforceable on the grounds that the consumer would otherwise receive a benefit disproportionate to the fee charged for the service actually rendered. Some of these cases turn on the fact that the agreement in question contained a clause giving the consumer the option to pay an additional fee for more protection, while others have upheld the provision without a clause giving the consumer this option. The suitability of such clauses is discussed in detail in Part V of this article.


21. "Disproportion," as a theory, is applied to situations where the damage claim is restricted by circumstances of the relationship between the parties. See M.N. Kniffin, A Newly Identified Contract Unconscionability: Unconscionability of Remedy, 63 NOTRE DAME L. REV. 247 (1988). Professor Kniffin distinguishes this theory from theories involving liquidated damage clauses where the clause calls for damages that are unfairly large in comparison to the projected or actual loss, describing the latter as being an "avoidance of unconscionability of remedy." Id. at 274 & nn.198-99.
c. Insufficient Liquidated Damage Clauses That Fix the Measure of Damage to an Uncertain Future Date or Time

One unique type of underliquidated damage clause is measured against the standards for unconscionability. These are clauses that fix the measure of damage as of a certain date in the future. When the date arrives, the specified measure of damage can be substantially below the actual damages. These clauses are usually upheld for the following reasons:

— the clause is arrived at after careful negotiation between two sophisticated parties;
— the clause reflects the declared intentions of both parties, i.e., there is no hint of surprise;
— the allocation of risk occurs in the context of a business transaction; and
— usage of the clause is dictated by custom in the unique business environment.22

2. Overly Sufficient Liquidated Damage Clauses

Overly sufficient liquidated damage clauses are almost always struck on the grounds that the provision is a penalty. Unconscionability is not an issue in these cases because the inappropriateness of the clause can be addressed using an alternate and less complex theory. I am including the following brief discussion of this type of clause because at least one study suggests that they should be analyzed using the theory of unconscionability.23 I will discuss this work in greater detail in Part IV of this article.

a. Contracts That Involve Down Payments and Advances

Down payments and advances are sometimes made as an expression of goodwill and to confirm an intention to enter into

an agreement. Payments given in anticipation of a contract as an expression of good faith are by definition conditional. If the agreement does not materialize, such payments are best returned. Otherwise, the effect is a forfeiture or penalty for failure to enter into what has become a non-agreement.

Where an agreement has been reached, the purpose of such payments is transformed into a control mechanism for the conduct of the party making the payment. So long as the control is commercially reasonable, and therefore not a penalty, these payments need not be returned in the event of default. For instance, a payment made as security against property damage is generally thought to be commercially reasonable provided that there is a rational relationship between the payment and the forecast of possible damage.24

24. When does an estimate of damage bear a reasonable relationship to the amount of probable loss likely to flow from a default or breach? While this is an issue that must be disposed of on a case-by-case basis, there are some rules to keep in mind. An overliquidated damage clause involving a down payment or advance is more likely to be found to be a penalty when:

— only one party to a contract has exclusive control and knowledge of the information needed to establish the amount provided for as liquidated damages;
— the result is a windfall;
— the provision is clearly intended to coerce performance rather than compensate for a breach, the clause will be struck as a penalty; and
— the damages flowing from the breach are otherwise easily ascertainable.

Eisenberg points out that there are two points in time that the parties intend as a reference point for the determination of actual damages: the time of contract and the time of breach.

The theoretical and practical differences between these two approaches are great. For example, suppose the amount of actual damages will depend on the difference between the contract price and the market price at the time of breach. Under the time-of-contract approach, requirement [sic] I will almost always be satisfied, because a future market price can almost never be predicted when a contract is made. In contrast, under the time-of-breach approach, requirement [sic] I will almost never be satisfied, because market price is usually easy to determine at the time of breach.

Eisenberg, supra note 8, at 230. Eisenberg goes on to observe that there is ambiguity as to the reasonable estimate of actual loss.

Requirement II — that the amount fixed in the liquidated damages provision is a reasonable estimate of the actual loss — is subject to the same ambiguity as requirement I. Requirement II may mean any of the following: (A) that the liquidated damages must be a reasonable estimate of probable loss, looking forward from the time the contract is made; (B) that the liquidated damages must not be disproportionate to the loss that is actually sus-
 LIQUIDATED DAMAGE CLAUSE

...tained; (C) that the liquidated damages must satisfy either test A or test B; or (D) that the liquidated damages must satisfy both test A and test B. I will call test A a purely "forward-looking" standard, and tests B, C, and D "second-look" standards.

Id. at 232.

There are many examples of such clauses. Security deposits are commonplace in real estate leasing as well as in purchase and sale agreements for both real and personal property. At issue is the purpose for the security. When given to secure the property owner against physical damage resulting from abuse or mistreatment of the property, retention of the deposit as liquidated damage is appropriate because of the difficulty with ascertaining actual damages. Where the issue involves default in performance of the covenant to pay rent during the term of the lease, the rules become more complex. Courts will order reimbursement where the sum deposited is available to the landlord no matter when in the term of the lease the default may occur. Thus, where a lease gives the landlord the right to retain a lump sum partial payment of the total rent as the sole measure of damages, the provision can be struck as a penalty because the sum bears no relationship to the actual damage experienced by the landlord. However, once the lease has commenced, a provision entitling the tenant to early termination of the lease upon the forfeiture of the security deposit is enforceable and not a penalty as the tenant has received something of value in exchange for the security deposit. See generally Patel v. St. Andrews Assoc., 512 N.Y.S.2d 758 (N.Y. City Ct. 1987).

When down payments are concerned, the rules governing relinquishment seem to depend on the nature of the contract. In connection with the sale of any property, it is commonplace for the buyer to make a down payment in advance of the closing. Some states, notably New York, subscribe to the minority (harsh) view entitling the seller to retain the down payment without concern for whether or not the size of the deposit is otherwise a penalty. Maxton Builders, Inc. v. Galbo, 502 N.E.2d 184, 189 (N.Y. 1986); Lawrence v. Miller, 86 N.Y. 131, 137 (1881); Zahl v. Greenfield, 556 N.Y.S.2d 393, 394 (N.Y. App. Div. 1990). Compare Amtorg Trading Corp. v. Michle Print Press & Mfg. Co., 206 F.2d 103, 107 (2d Cir. 1953), with 5 Arthur L. Corbin, A Comprehensive Treatise on the Working Rules of Contract Law §§ 1122 - 1135 (1964), and Restatement (Second) of Contracts § 374 (1979). The minority rule seems to hold that deposits of up to 10% of the total purchase price are a commercially reasonable estimate of actual damages in the event of default. See Maxton Builders, Inc., 502 N.E.2d at 189. This rule can have serious malpractice overtones for attorneys. See Logalbo v. Plishkin, Rubano & Baum, 558 N.Y.S.2d 185, 187 (N.Y. App. Div. 1990). Liquidated damage clauses providing for less than the amount of the deposit cannot be used to defeat this rule where the result would be unreasonably disproportionate to the probable loss in the event of a breach. Collar City P'ship v. Redemption Church of Christ of the Apostolic Faith, 651 N.Y.S. 2d 729, 730 (N.Y. App. Div. 1997). However, when a liquidated damage clause provides that the down payment shall constitute a portion of the liquidated damage, the balance to be determined upon resale of the property by the owner, the clause will fail, the seller's sole remedy being limited to the amount of the down payment. Blackman v. Genova, 704 N.Y.S.2d 86, 87 (N.Y. App. Div. 2000); Chateau D’If Corp. v. City of New York, 641 N.Y.S.2d 252, 254 (N.Y. App. Div. 1996). But see McLacklan v. Thompson, 470 N.Y.S.2d 104, 106 (N.Y. Sup. Ct. 1983) (when a liquidated damage clause, which provided for forfeiture of payments made up to 25% of the purchase price, was upheld as being a reasonable forecast of just compensation for the harm caused by a breach).
b. *Formula Clauses for Non-Performance*

Illustrations of this type of clause include:

- per diem payments for late performance in construction contracts;
- early termination payment clauses;
- payments required under contracts with restrictive covenants such as employment agreements;
- acceleration clauses for breach of leasing agreements; and
- payments of fees associated with enforcement of loan agreements.

There is commercial justification for clauses that establish a formula for the liquidation of damages in the event of non-performance. Again, the purpose for the clause is to control the behavior of the performing party. For example, an owner of property may want to establish the consequences for non-performance by a contractor and this is allowed provided that the clause does not impose a penalty.

Per diem clauses are commonplace in construction contracts; the contractor agreeing to a per diem damage in the event of a failure to complete on a timely basis. Contractors are

These rules are not consistent with the view that a liquidated damage clause is a penalty when it is determined that the result yields a windfall or operates as a bludgeon to compel performance. Nevertheless, New York is steadfast and buyers of real property need to be very careful when considering the consequences of a default. The rules change, however, when the contract involves the purchase of a cooperative apartment on the grounds that the sale involves personal property and is thus governed by Article 2 of the U.C.C. See generally Silverman v. Alcoa Plaza Assoc., 323 N.Y.S.2d 39, 40-41 (N.Y. App. Div. 1971); Chien v. Tova Realty, 573 N.Y.S.2d 855, 857 (N.Y. City Ct. 1991). Here, the determination is for the court to make in light of the provisions of § 2-718(1) of the U.C.C., and the rules appear to be the same as would otherwise govern windfall profits and penalties. U.C.C. § 2-718(1) (1997).

not in a position to argue that these clauses are per se unreasonable, even when the owner prepares them, since there is a benefit that flows from the insulation against potentially unlimited liability. Even the argument that the magnitude of the per diem sum is unreasonable lacks merit since the contractor is under no compulsion or obligation to enter into the contract in the first place. Problems arise when the owner tries to attack the clause because the actual damages exceed the contractual limitation. The decisions appear uniform in holding that the clauses are indeed binding as against the property owner with the exception of when there is delay brought on by the contractor.\textsuperscript{25}

Employment agreements sometimes have liquidated damage provisions linked to restrictive covenants. How they are viewed has a great deal to do with who is seeking enforcement. Liquidated damage clauses designed to address a breach of an employee’s restrictive covenant are appropriate since damages from such a breach are “inherently incapable of accurate determination.”\textsuperscript{26} Lump sum agreements of this type can usually be

\textsuperscript{25} See Hartford Elec. Applicators of Thermalox v. Alden, 363 A.2d 135, 141 (Conn. 1975); Morgan v. Town of Burlington, 55 N.E.2d 758, 760 (Mass. 1944); Redlinger & Hanson Co. v. Parker, 243 N.W. 792, 796-97 (N.D. 1932); Mosler Safe Co. v. Maiden Lane Deposit Co. 93 N.E. 81, 83 (N.Y. 1910); Flour Mills of Am. v. Am. Steel Bldg. Co., 449 P.2d 861, 871 (Okla. 1968). Closely related to the per diem clause is an early termination payment clause. Here the obligor agrees to a formula payment equal to a percentage of the total due under the contract in the event of an early termination. \textit{Diversified Waste Disposal v. Haines Rd. Serv. Ctr.}, No. 95-030258 (Justice Ct. Town of Bedford, N.Y. Nov. 6, 2001) is an example. There the obligor ran a service station and the plaintiff provided waste disposal services. The contract contained a clause obligating the obligor to pay as “liquidated damages and not as a penalty an amount equal to 30% of the aggregate monthly service charge . . . for the balance of the term of [the contract].” The obligor prematurely terminated the agreement. The clause was found to be a penalty as the sum calculated under the contract was the same amount no matter how trivial the breach. If the clause requires the defaulting party to pay the entire balance due under the contract without regard to the value of the services rendered on a quantum meruit standard, the problem becomes the antithesis of the concern discussed above where there is retention of a retainer also without consideration for the quantum meruit standard. \textit{Id.}

\textsuperscript{26} Sometimes it is the employee who seeks enforcement of the liquidated damage clause. Such was the case in \textit{Boyle v. Petrie Stores Corp.}, 518 N.Y.S.2d 854, 860 (N.Y. Sup. Ct. 1985), in which the employee, who had a five year employment agreement for service as the CEO was summarily dismissed by the chairman of the board after two months on the job. The employee brought suit seeking enforcement of the liquidated damage clause in the amount of $2,000,000. The de-
enforced by an employer without concern for the sum being deemed a penalty.

c. Acceleration Clauses for Breach of Contract

Where an acceleration clause merely restores the status quo, it is usually found to be commercially reasonable. Acceleration clauses will usually be enforced where property has changed hands in exchange for a promise to pay or repay. These are situations where the acceleration accomplishes no more than was contemplated by the parties in the first place.

For example, if a lender who has actually advanced funds faces non-payment of an installment, acceleration of the balance due on the promissory note will accomplish full repayment, something to which the parties have already agreed. All that has changed is the timing of the repayment. Similarly, acceleration will be recognized where there is an installment sale and property has changed hands in exchange for a promise to pay the purchase price in the future.27

3. Summary

At the outset of this Section, the observation was made that where the liquidated damage clause is disproportionately large compared to probable damages, courts will refuse to enforce such a clause on the grounds that the result is an unenforceable penalty. Conversely, if the clause is lopsided so as to be inconsequential when compared to probable loss, the result is analyzed by application of rules governing unconscionability.

Insufficient liquidated damage clauses are unique in that they give the appearance of exculpation from liability. This in

fendant contended that the clause was in actuality a penalty. The court upheld the provision noting that both parties to the contract were sophisticated and had adequate counsel and the plaintiff was aware of the "mercurial reputation" of the chairman who had engineered the termination. Id. at 891.

27. Leases are an area where such clauses appear frequently. Typically the landlord requires a clause entitling acceleration upon failure of the tenant to make a periodic payment as called for in the lease. When the acceleration is not accompanied by termination of the lease or when the tenant is not denied access to the premises as a consequence of the non-payment, absent a proven claim of fraud or exploitive overreaching, the acceleration clause will be enforced. However, when there is termination or a lockout, acceleration is deemed an unenforceable penalty. These rules extend to leases for personal property.
turn raises concerns about the possibility of overreaching and the potential for unfair surprise, both of which suggest the presence of unconscionability. Overreaching suggests dark motives and the possibility of some form of inappropriate manipulation. I submit that nonrational factors should be included in any attempt to establish unconscionability. The basis for this argument is that nonrational factors are by their very nature subject to possible manipulation, and where that can be shown to have occurred, the results can include the acceptance of an unconscionable provision.

B. Overview of the General Rules Governing Unconscionability

Contracts can be said to be unconscionable when they are found to create a profoundly adverse and unfair result, one that is one-sided or oppressive or likely to produce unfair surprise and one that comes about because of an overreaching.\(^\text{28}\) What is and what is not unconscionable is a legal conclusion arrived at by a three-step analysis. "Markers" suggesting unconscionability are first identified. Next, a determination is made as to whether the suspect clause actually operates in a one-sided, oppressive or unfair manner. If the provision is commercially reasonable, it is not one-sided, oppressive or unfair.\(^\text{29}\) Finally, a judgment is made about the circumstances that gave rise to the contract, the concern being whether there was a disparity in bargaining position or an intentional attempt at adumbration. The entire analysis rests on an evaluation of the "above board" tactics employed by the parties in negotiating the contract.

Traditionally, contractual unconscionability was a common law doctrine. During the middle half of the last century, the doctrine was given statutory recognition with respect to sales contracts and leases for commercial goods in the Uniform Commercial Code.\(^\text{30}\) A few states have adopted similar language in

\(^{28}\) Paul Bennett Marrow, Contractual Unconscionability: Identifying and Understanding its Potential Elements, 72 J. N.Y. St. B.A. at 18, 22, 24 (Feb. 2000).

\(^{29}\) Id. at 24.

\(^{30}\) National Conference of Commissioners on Uniform State Laws, Uniform Commercial Code § 2-302 and § 2A-108 define unconscionability as follows:

U.C.C. § 2-302. Unconscionable Contract or Clause.

(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may
statutes that give courts broad discretion to reform many specific types of contracts.\textsuperscript{31} Under all these statutory schemes, the courts are left to police \textit{what they define} to be unconscionability. The statutes themselves are silent as to what constitutes an unconscionable contract or term.\textsuperscript{32}

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refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

(2) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.

U.C.C. § 2-302 (1997);


(1) If the court as a matter of law finds a lease contract or any clause of a lease contract to have been unconscionable at the time it was made the court may refuse to enforce the lease contract, or it may enforce the remainder of the lease contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

(2) With respect to a consumer lease, if the court as a matter of law finds that a lease contract or any clause of a lease contract has been induced by unconscionable conduct or that unconscionable conduct has occurred in the collection of a claim arising from a lease contract, the court may grant appropriate relief.

(3) Before making a finding of unconscionability under subsection (1) or (2), the court, on its own motion or that of a party, shall afford the parties a reasonable opportunity to present evidence as to the setting, purpose, and effect of the lease contract or clause thereof, or of the conduct.

(4) In an action in which the lessee claims unconscionability with respect to a consumer lease:

(a) If the court finds unconscionability under subsection (1) or (2), the court shall award reasonable attorney's fees to the lessee.

(b) If the court does not find unconscionability and the lessee claiming unconscionability has brought or maintained an action he [or she] knew to be groundless, the court shall award reasonable attorney's fees to the party against whom the claim is made.

(c) In determining attorney's fees, the amount of the recovery on behalf of the claimant under subsections (1) and (2) is not controlling.


32. Some states have adopted a provision applicable to cooperatives and condominiums which does, in part, assist in the definition. \textit{Alaska Stat.} § 34.08.790 (2000) is an example:

§ 34.08.790. Unconscionable agreement or term of contract.
As noted earlier in this article, the courts have identified "rational" factors that are used to determine the presence of an unconscionable provision. The interpretation focuses on the objective data reflected in the fact pattern presented for consideration. While little has been written about rational factors, any careful study of the reported decisions will yield information as to their substance. At the heart of any analysis is a search for facts and circumstances that suggest an unfair advantage and overreaching resulting in a contract "such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other."33

Scholars and the courts have struggled for years trying to define unconscionability, and the upshot of all the efforts is that no one really knows what it is until they see it.34 The procedural/substantive paradigm suggested in the 1960's by Professor Arthur Leff has been accepted by a number of courts as the op-

(a) Upon finding as a matter of law that a contract or contract clause was unconscionable at the time the contract was made, a court may refuse to enforce the contract, may enforce the remainder of the contract without the unconscionable clause, or may limit the application of the unconscionable clause in order to avoid an unconscionable result.

(b) Whenever it is claimed or appears to the court that a contract clause is or may be unconscionable, the parties, in order to aid the court in making the determination, must be afforded a reasonable opportunity to present evidence as to (1) the commercial setting of the negotiations; (2) whether a party has knowingly taken advantage of the inability of another party reasonably to protect personal interests by reason of physical or mental infirmity, illiteracy, inability to understand the language of the agreement, or similar factors; (3) the effect and purpose of the contract or clause; and (4) any gross disparity, if a sale, at the time of contracting, between the amount charged for the property and the value of the property measured by the price at which similar property was readily obtainable in similar transactions. A disparity between the contract price and the value of the property measured by the price at which similar property was readily obtainable in similar transactions does not, of itself, render the contract unconscionable.


ervative standard. But this approach is not without difficulties. Things are rarely as neat as the paradigm suggests. Must both types of unconscionability be present for a contract to be struck and to what degree? Most courts and commentators suggest that this is the case, but this rule is not without exceptions.

35. See Arthur A. Leff, Unconscionability and the Code - The Emperor's New Clause, 115 U. Pa. L. Rev. 485, 487 (1967). Leff defines "bargaining naughtiness" as "procedural unconscionability." "Substantive unconscionability" is deemed the "evils" flowing from the contract. Id.


Generally a finding of unconscionability requires that a court find both "procedural" and "substantive" unconscionability. Accordingly, courts also should seldom invalidate a contract, or a term of a contract, that is not substantively unconscionable solely on the basis of one party's conduct. Unconscionability is not intended to allow disturbance of allocation of risks because of superior bargaining power, and in those cases that call out for relief the conduct will often constitute an invalidating cause, such as fraud or duress. Consistent with the provisions of Section 2A-108(2) and the Uniform Consumer Credit Code (Section 5.108), however, in an appropriate case a court may invoke procedural unconscionability to invalidate a term or contract. For example, a court might invalidate a contract because of high pressure sales tactics used in a consumer buyer's home even though the conduct does not constitute fraud or duress.

Id.

37. If an otherwise fair and just agreement is entered into as a result of procedural irregularities, an overreaching for example, one wonders - so what? Imagine a purchaser who because of overreaching by a seller agrees to purchase twice as much of a product than is actually required. Clearly there is nothing inappropriate about a commitment to purchase a product. But what about the overreaching that leads to the purchasing of an unneeded quantity? There is nothing per se "unjust" about someone making a mistake, regardless of the circumstances. Could it really be that the claim of the purchaser of procedural unconscionability is nothing more than a veiled attempt to transfer the risk for a mistake? "Equity will not relieve a party of its obligations under a contract merely because subsequently, with the benefit of hindsight, it appears to have been a bad bargain." Raphael v. Booth Mem. Hosp., 412 N.Y.S.2d 409, 411 (N.Y. App. Div. 1979). Conversely, it has been held that certain types of clauses are so substantively offensive that even though there was no evidence of any procedural irregularity, a court can still strike the clause. This was the case in Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569, 574 (N.Y. App. Div. 1998). In Gillman v. Chase Manhattan Bank, 73 N.Y.2d 1 (1988), the Court of Appeals held that where a provision is so outrageous as to warrant holding it unenforceable, it is appropriate to do so on substantive grounds alone. Id. at 12. In State v. Wołowitz, 468 N.Y.S.2d 131 (N.Y. App. Div. 1983), the court held: "However, in general, it can be said that procedural and substantive unconscionability operate on a 'sliding scale'; the more questionable the meaning-
The Leff paradigm does not really address the question of what is meant by unconscionable. It only tells us when in the contracting process the unconscionable conduct attaches to the agreement. For the attorney and the client, what is most important is a workable definition of what unconscionability actually is so as to make contractual relations possible and practical.

It is submitted that the definition is a pragmatic judgment flowing from a three-step legal analysis. First, a search is made to identify if certain “markers,”38 are present suggesting cause for suspicion. This is followed by an investigation seeking facts showing that a suspect clause acts in a profoundly unreasonable manner. Finally, a search is made for facts or circumstances confirming that there is overreaching.

“Markers” of unconscionability come in two forms, general markers and unique markers. General markers can include:

— a standard form contract;
— a contract presented without explanation;
— a contract that is not subject to negotiation; or
— a contract prepared by the party benefiting from the suspect clause.

Unique markers can include:

— a stipulated amount of liquidated damage that is typically very small when compared to the actual damage experienced; or


38. The concept of “markers” is not entirely new. Karl N. Llewellyn, in speaking to the role of courts in the process, provides a basis for the idea: “[B]ut courts' business is eminently the marking out of the limits of the permissible, and the reading of fair understanding, and the adaptation to the modern form-pad bargain of older rules based on the individualized writings of an earlier day - and still applicable to such writings.” KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 367 (1960) (quoting Karl N. Llewellyn, 52 HARV. L. REV. 700, 704 (1939)).
— a provider or supplier that is a large organization and sometimes even a monopoly sanctioned by law.

These markers, even if all are present, are not enough to support the determination of unconscionability. The provision must also operate to create a profoundly unreasonable result and there must be evidence of overreaching. The challenge of trying to define what is meant by "profoundly unreasonable" is formidable.

Two threshold precepts must be present before concluding that any covenant is operating in an unreasonable manner:

— the effect is profoundly discriminatory as to one of the contracting parties; or
— the clause contains language that attempts to sanction abusiveness, arbitrariness or the imposition of a needlessly burdensome condition.

Overreaching is a case-based question of fact. Courts look for fact patterns that reveal strong-arm-like tactics; for example, when there is a conscious effort to intentionally obscure the real meaning of a contractual provision to the extent that one party is profoundly handicapped and unable to understand the terms agreed to or where one party is profoundly handicapped by virtue of non-disclosure of relevant circumstances.

39. This may seem harsh, especially in marginal situations. However, it is consistent with the general reluctance of courts to correct mistakes in judgment.

40. This condition is usually met when any of the following are found to be present:

— the benefit conferred bears no reasonable relationship to the subject matter of the agreement;
— the provision imposes a condition that is impossible to meet;
— the covenant confers an unfettered power to act arbitrarily;
— the covenant denies a court the power to exercise judicial discretion; or
— the covenant sanctions an act that is unto itself against public policy.

41. This condition is usually met when any of the following are found to be present:

— one party is entitled to abuse the dignity or well-being of the other;
— the terms of the covenant reveal overreaching;
— the covenant is one of adhesion;
— exploitation; or
— one party is denied all recourse from defects discovered upon delivery.
C. Summary

From the above it is clear that not all liquidated damage clauses are subject to review against the standards of unconscionability. Only those that can be characterized as insufficient liquidated damage clauses come within the reach of the theory of unconscionability. Unconscionability involves concerns about covenants that yield profoundly unreasonable results, and that suggest overreaching and unfair surprise.

Courts usually make their determinations about unconscionability by seeking evidence of rational factors. In Section IV, I will review some of the nonrational factors I believe should be considered and which could facilitate the creation of a connection between the doctrine of unconscionability and the insufficient damage clause.

III. Nonrational Factors and Behavioral Decision Theory (BDT)

A. Overview

Much has been written on cognitive psychology. The purpose of what follows here is to provide no more than an overview to familiarize those readers who have had little or no exposure to the concepts involved.42 My list of effects, biases and heuristics is not complete. Only those that have a direct bearing on contract formation, assumption of risk and the possibility for manipulation are discussed. Others have been identified, and continue to be routinely identified, by economists and psychologists and may have implications for application to situations that involve contractual challenges that are not grounded in unconscionability or which involve many other types of covenants.43

During the middle portion of the last century, legal scholars began to pay serious attention to the work of economists who


43. A detailed listing of effects, biases and heuristics can be found in Cass R. Sunstein, Behavioral Analysis of Law, 64 U. Chi. L. Rev. 1175 (1997) and Hanson & Kysar, supra note 42.
were developing theories about how people make decisions. The earlier theorists assumed a rational choice model, i.e., that contracting parties bargain rationally, taking into account their respective economic self-interests44 and that the parties are rational in "choosing the best means to the chooser's ends."45

It should come as no surprise that human beings are capable of making inadvisable decisions while at the same time believing that they are doing just the opposite. Mindful of this reality, cognitive psychologists have challenged the assumption of rationality asserting that people very often make decisions using filters which yield cognitive distortions, errors and illusions, and sometimes these errors are systemic. In other words, people are sometimes led astray by effects and biases of which they are totally unaware, resulting in outcomes that can be unfortunate. They may make decisions that are not in their own best interest and they can even do so without realizing what is actually going on. Understanding the dynamics of how these misconceptions come about and how they can be applied to issues involving the assumption of risk can have very powerful results.46

Cognitive psychologists have concluded that decision making is a dual process involving an interaction between a rational system, which is deliberative and analytical, and an experiential system, which encodes reality in how we feel about the information we are receiving and processing:


For example, a rational person who wants to keep warm will compare the alternative means known to him of keeping warm in terms of cost, comfort, and other dimensions of utility and disutility, and will choose from this array the means that achieves warmth with the greatest margin of benefit over cost, broadly defined. Rational choice need not be conscious choice.

Id.

46. "The deviations of actual behavior from the normative model are too widespread to be ignored, too systematic to be dismissed as random error, and too fundamental to be accommodated by relaxing the normative system." Daniel Kahneman & Amos Tversky, Rational Choice and the Framing of Decisions, 59 J. Bus. S251-52 (Supp. 1986).
There is no dearth of evidence in everyday life that people apprehend reality in two fundamentally different ways, one variously labeled intuitive, automatic, natural, non-verbal, narrative, and experiential, and the other analytical, deliberative, verbal, rational.\textsuperscript{47}

The cognitive oddities that have been identified are numerous. It has been proposed that since the list is potentially endless and without limiting principals, caution is required when attempts are made to couple cognitive psychology to legal analysis.\textsuperscript{48} Professor Rachlinski suggests that connections between cognitive psychology and the law are appropriate if three basic observations about human judgment and choice are kept in mind: "(1) people rely on attention and memory as if both are limitless and infallible...; (2) the brain makes many automatic inferences outside of the range of conscious thought; and (3) people rely on fixed reference points to evaluate choices, paying more attention to changes in the status quo than to absolute values."\textsuperscript{49}

\textsuperscript{47} Seymour Epstein, Integration of the Cognitive and Psychodynamic Unconscious, 49 AM. PSYCHOLOGIST 709, 710 (1994).

\textsuperscript{48} Rachlinski, supra note 44, at 748-49; see also Posner, supra note 45.

\textsuperscript{49} Rachlinski, supra note 44, at 740. Rachlinski explains:

First, people make inferences based on attention and memory as if these processes are infallible, even though both are error-prone. Overoptimism results, in part, because people mistakenly assume that failure is unlikely, simply because they have difficulty imagining the details of how failure can occur. People's reliance on memory and attention also accounts for other phenomena that legal scholars have found useful, including the representativeness and availability heuristics. These cognitive processes are also closely tied to "support theory," which holds that people make choices based on the strength of the arguments that they can generate either in support of or in opposition to a decision. People mistakenly act as if the strength of arguments that they can generate in support of an option relates perfectly to the desirability of an option; the strength of arguments, however, often depends upon factors irrelevant to its merits. This phenomenon explains aversion to ambiguity, because ambiguity clouds the arguments that support undertaking an option.

Second, the brain conducts a significant amount of automatic processing outside of people's awareness. This phenomenon makes it difficult for people to control their inferential processes. The hindsight bias occurs because people naturally make inferences about the underlying conditions that led up to an outcome when they learn how events actually unfold. Consequently, even when told to disregard the outcome, people have difficulty ignoring the inferences derived from learning that outcome. Automatic
As a starting point, psychologists theorize that a series of "effects" exist which serve to mold or structure how people approach the decision-making process and, for purposes of this article, the assumption of risk. These effects have to do with how information is presented and the context in which a decision or judgment is reached. Effects tend to trigger cognitive biases used by people to perceive and use information. Included on the list of such effects are the following phenomena:

- endowment effects;
- loss aversion;
- framing;
- extremeness aversion;
- illusion of control; and
- affect (heuristic).

Empirical evidence of the existence of these effects confirms their reality and shows the interplay between these effects and how specific biases and heuristics account for some human judgments. These studies have become the foundation of processing also accounts for seemingly unrelated phenomena, such as anchoring.

Third, people tend to rely on fixed reference points in making decisions, which causes them to pay more attention to changes in the status quo than to absolute levels of wealth or risk. This observation explains several BDT phenomena upon which legal scholars have relied heavily: the status quo bias, framing, and the endowment effect.

Taken together, these three observations account for most of the phenomena BDT describes that are relevant to law. They also support an important corollary: people do not possess a fixed set of preferences that they seek to satisfy with their choices, as economic models usually assume. BDT researchers, especially the psychologists, reject this model of choice. Instead, BDT holds that people construct preferences on the spot to suit mentally available desires in any given context. The phenomena that BDT describes support the notion that preferences fluctuate and demonstrate that basic axioms upon which economic models rely, such as intransitivity and invariance, simply fail to describe human choice.

*Id.* at 750-52 (footnotes omitted).
BDT. BDT is focused on the limited capacity of people to gather, process and use information.

The list of biases used by people to assist in the making of judgments and decisions is lengthy. The common denominator is that biases come about because people sometimes lack the ability to evaluate risk and properly process information. Cognitive biases are mechanisms used to evaluate information that we receive. Included on the list are:

- cognitive dissonance;
- self-serving bias;
- unrealistic optimism;
- overconfidence;
- cooperation;
- fairness;
- appearance of fairness;
- availability;
- anchoring and adjustment;
- representativeness; and
- status quo bias.

50. BDT, a part of the so-called cognitive revolution, displaced behavioral psychology during the 1960s. "BDT relies upon inferences that psychologists make about cognitive process and is therefore a radical departure from behaviorism and from micro-economic theory." Rachlinski, supra note 44, at 740. BDT is patterned after studies dealing with perception and memory. See Daniel Kahneman & Amos Tversky, On the Reality of Cognitive Illusions, 103 PSYCHOL. REV. 582 (1996).


B. Effects

Effects involve the positioning of information. Effects have the function of triggering biases that are used by people to receive, evaluate and utilize information. Because effects can be manipulated and in turn can manipulate which biases are triggered, they are relevant to the understanding of contract formation.

1. Endowment Effect

People will often place a higher value on something they already own than the identical item owned by someone else. This effect represents a resistance to parting with something, not an increase in value to the owner. In other words, people construct a preference that is reflected in a change in value in the case of an owner. For example, in one experiment, subjects were given either a coffee cup or $6.00. The mug owners consistently valued their newly attained mugs at twice the value that the cash holders did. In another study subjects were asked to imagine owning a coffee mug and then asked to predict a selling price. They were then given a coffee mug and asked at what price they would want to sell the mug. Prior to receiving the mug, the average selling price was $3.73. Once they had received the mug, the average price jumped to $5.40. In yet another experiment students were asked to imagine that they held one of two hypothetical jobs, the first of which paid a higher salary and the second of which provided better working conditions. The students were asked to decide whether they preferred to remain in the assigned job or switch to the other. Regardless of the job to which they were hypothetically assigned, most elected to remain where assigned rather than trade.

56. Daniel Kahneman & Amos Tversky, Choices, Values and Frames, 39 Am. Psychologist 341, 348 (1984). This suggests new meaning to the devil you know is better than the devil you do not!
The endowment effect has serious implications for contract formation. If a party perceives that he or she is endowed with a right, they may be more reluctant to part with it than if they are not so endowed. This phenomenon can be manipulated, i.e., the perception of being or not being endowed can be positioned so as to influence a willingness to part with the perceived endowment.

2. Loss Aversion

Loss aversion is quite similar to the endowment effect. People seem to place greater emphasis and weight on the possibility of losing what they already have than on gaining what they do not have. Studies have shown that people are acutely averse to losses and they dislike losses more than they are gratified by equivalent gains, i.e., they will move to eschew losses rather than obtain gains of a similar measure.57 Whether or not a given event is perceived as a loss or a gain is a function of how the event is framed, which is to say, how it is presented. The status quo is usually the reference point and it is possible to manipulate the frame so that the perception is of a loss or a gain, depending on the result that is desired.58 For example, consider a parent who tells a child that a certain behavior will be awarded as opposed to telling the child that a certain behavior will be punished.59

The implications of loss aversion are that people are more willing to assume risk in order to protect something they already have or won rather than potentially gain something they do not yet have. The determinant is the positioning of the choice relative to the desire to avoid a loss.

3. Framing

Choices often depend on how the outcome is framed. For this reason, the framing effect is the most exploitable of all the effects.60 People are both risk tolerant and risk averse. Fram-

57. See generally Daniel Kahneman, et al., supra note 54; Sunstein, supra note 43, at 1179.
60. Hanson & Kysar, supra note 42, at 684.
ing assists in determining how risk is viewed and how it is ultimately embraced or repudiated.61

The framing effect is pervasive and robust. Professors Kahneman and Tversky note:

It is as common among sophisticated respondents as among naive ones... In their stubborn appeal, framing effects resemble perceptual illusions more than computational errors.62

This phenomenon has implications for the analysis of the underliquidated damage clauses. These clauses have to do with the promisor's performance and the promisee's wish that the promisor actually perform. These concerns make up the frame for a decision about a limitation on damages. Rejection of a demand for limitation leaves the promisee in an unacceptable position, i.e., not winning the promisor's commitment to perform. Therefore, the framing of the choice creates an opportunity to have performance with a limitation or, in the alternative, no performance. The promisee is more likely to accept the limitation because of the framing effect even though that choice is arguably the riskier alternative.63

4. Extremeness Aversion

People are also averse to extremes. Whether something is perceived as an extreme depends in large part on the position of the choice relative to others. In one experiment subjects were asked if they preferred a less expensive and smaller radio,

61. In one experiment university employees were asked to choose between a bond fund (safe) and a stock fund (risky). Information was given about the historical performance of each fund. One group of employees was given information about the distribution of one year's rates of return. The other group was given information about the distribution of thirty-year rates of return. A majority of those shown information about one year's rates of return choose the bond fund. A majority of those shown the information about the thirty-year rates of return choose the stock fund. In other words, the manner in which the outcome was framed altered the decision. Hanson & Kysar, supra note 42, at 685 & n.243. In another experiment subjects were offered a hypothetical choice between a sure loss of $50 and a 25% chance to lose $200. A majority chose the former when it was presented as insurance but chose the latter when that option was presented as a question of gambling. Baruch Fischoff, Cognitive Liabilities and Product Liability, 1 J. PROD. LIA. 207, 213 (1977).


choice A, to a more expensive and larger radio, choice B. The subjects preferred choice A. But when the same subjects were given an additional choice, a very expensive and large radio, choice C, many who had previously selected choice A changed their minds and asked for choice B.64

This effect can have serious implications for contract formation. If a clause is positioned as an extreme, it is less likely to be accepted not because of the contents but because of the setting. But, if it is positioned as a compromise, there is a far greater likelihood that it will be included in the contract. Thus, the draftsman has the option available to position a given clause so as to appeal to the desire to avoid an extreme and to accept compromise.

5. Illusion of Control

People have a tendency to treat chance events as if they involve skill and hence are within their control.65 In one experiment, students stated whether they were better or worse than the average person at predicting the outcome of a coin toss. The researchers provided rigged feedback on predictions and convinced the subjects that luck was not involved but rather that the subjects were good or bad predictors. Moreover, the same subjects reported that they were sure that their performance would improve with practice.66

Creating an illusion of control can have robust results. By appealing to the desire to control, the draftsman can oftentimes win acceptance of a provision if the other party concludes that the provision was his idea in the first place.

6. Affect (Heuristic)

Studies have shown that the perception of risk and the response to it are linked to the degree to which the hazardous event evokes feelings of dread. Building on this research are

65. Hanson & Kysar, supra note 42, at 658.
subsequent studies that have shown that judgments about risk and benefit are negatively correlated. Thus the greater the perceived benefit, the lower the perceived risk and vice versa. Professors Alhakami and Slovic have found that the inverse relationship between perceived risk and perceived benefit is linked to the strength of positive and negative emotion associated with an event. The result implies that people base their judgments not only on how they think about something but how they feel about it.\textsuperscript{67}

There is a second dimension to be considered.

The affect heuristic also predicts that using time pressure to reduce the opportunity for analytic deliberation (and thereby allowing affective considerations free rein), should enhance the inverse relationship between perceived benefits and risks. . . . Finucane and others showed that the inverse relationship between perceived risks and benefits increased under time pressure, as predicted. These . . . experiments with judgments of benefits and risks are important because they support the contention . . . that affect influences judgment directly and is not simply a response to a prior analytic evaluation.\textsuperscript{68}

Affect, therefore, acts as a filter through which risk is perceived and evaluated. If there is an emotional perception of an overall benefit resulting from a covenant, there is likely to be a lowering of a perception of risk involved and vice versa. In other words, a positively motivated decision maker is likely to play down risk and accept a covenant that allocates risk.

C. \textit{Biases and Heuristics}

Biases and heuristics have to do with how people receive, evaluate and utilize information. It should be no surprise that people have limited capacities for the understanding and handling of information. This limitation of capacity is known as "bounded rationality,"\textsuperscript{69} which is to say that there are "limitations of computational ability, ability to calculate consequences,\textsuperscript{67,68,69}


\textsuperscript{69} Garvin, \textit{supra} note 63, at 141 & nn.324-36 (1998).
ability to organize and utilize memory, and the like.\textsuperscript{70} Cognitive psychologists have determined that people tend to set an initial target level of aspiration or satisfaction, and once that target has been met, they terminate the search for an alternative. In other words, once information is received which is good enough to meet the established expectation, consideration of alternatives is abandoned. This is called "satisficing\textsuperscript{71} and it has serious implications for theories involving contract formation.

The process of setting the target is assisted by the use of biases and heuristics. Biases and heuristics fall into three broad categories: (1) those which rely on experience, (2) those which involve self-perception by others, and (3) those which involve the perception of a person's position relative to a fixed reference point.

1. Biases and Heuristics That Deal With Decision Making Based on Experience

a. Overconfidence and Unrealistic Overoptimism

People tend to be overconfident with respect to the future and this is true even when they understand the actuarial probabilities of such events.\textsuperscript{72} It appears that the reason for this bias is that people have a general tendency to use past experience as the foundation for predicting the future. The result is that people very often underestimate risk. This is because the assessment of risk is based on a belief that adverse low-probability risks will not occur.\textsuperscript{73}

\textsuperscript{70} Eisenberg, supra note 8, at 214.


\textsuperscript{72} In one study the respondents correctly estimated that 50% of all marriages in the United States would end in divorce but all predicted that their own chances of entering into a marriage that would end in divorce were zero. Lynn A. Baker & Robert E. Emery, When Every Relationship Is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage, 17 LAW & HUM. BEHAV. 439, 443 (1993).

\textsuperscript{73} Sunstein, supra note 43, at 1183. Furthermore, Garvin notes:

In any event, to the extent that those about to contract are overly optimistic, they will undervalue the risk of breach, and thus will set too low a risk premium. Indeed, they might not set one at all, if their over-optimism proves excessively ebullient. . . . And over-optimism might affect one's willingness to invoke the mechanism of assurance; if one thinks the other party likely to

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This phenomenon, which is found in people of all social categories, makes people resistant to information that suggests the need for caution. For this reason, overconfidence and unrealistic overoptimism are biases that are most likely to be manipulated so as to disarm an individual who is considering the assumption of a risk.\textsuperscript{74}

b. \textit{Availability}

Closely related to overconfidence and unrealistic optimism is the phenomenon of availability. Judgments about the future are often driven by the ease with which people can recall previous occurrences of an event or the ease with which they can picture an event occurring in the future. As a result, people will often permit available information, i.e., information based on available experience, to dominate the decision-making process even when they become aware that more reliable statistical evidence exists. In other words, we use availability as a substitute for rigorous probing when we lack information and this state of mind exists even if we are aware that more probative information exists, information that we have not yet reviewed.\textsuperscript{75} This can lead to powerful systemic errors in judgment. Sunstein has pointed out that "availability cascades" are robust and can result in inappropriate perceptions.\textsuperscript{76}

The phenomenon of availability has significant implications for contract formation. A decision maker confronting a choice between accepting or rejecting a covenant involving the assumption of risk can be expected to rely on previous experiences. The availability and utilization of experiences involving the acceptance or rejection of risk, without any provision being made for the dissimilarity of risk, may result in an unfortunate decision.

\textsuperscript{74} Hanson & Kysar, supra note 42, at 657-58.
\textsuperscript{75} Id. at 662-64.
\textsuperscript{76} Sunstein, supra note 43, at 1188.
c. **Cognitive Dissonance**

Cognitive dissonance is a tendency to repudiate or downplay information that contradicts more favorable information about oneself. This bias can seriously affect judgment. In the face of known risk, a person might develop an opinion that they themselves are relatively immune from the consequences of the risk. In other words, there is a dangerous chance of undervaluing a risk because of a misplaced trust in one's own beliefs. This can become particularly acute where there are repeat reinforcements of the misplaced trust, such as when one enters into multiple contracts with the same party about whom the promisee has reason to believe there is a potential problem, such as creditworthiness. If all previous contracts were performed, it is easy to assume that all future contracts will also be performed.\(^77\)

Perceptions of risk can be influenced by cognitive dissonance. If a decision maker previously developed the opinion that a specific type of loss cannot happen to him, that opinion is likely to be carried forward and applied to new risks without serious statistical evaluation being made of the new risk.

d. **Representativeness**

Representativeness refers to a tendency to evaluate the frequency or likelihood of an event by the degree to which it resembles something else in the same class. This desire to see patterns can generate unrealistic expectations about the patterns and this in turn can result in systematic errors in evaluating future risk.\(^78\)

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77. Garvin, *supra* note 63, at 148 n.362. Garvin suggests that in contrast, in a single shot transaction, the phenomenon is less robust. "Salient risks would thus be less dissonant." *Id.*


Based on the work of cognitive psychologists, especially Tversky and Kahneman, Arrow observes that "[i]t is a plausible hypothesis that individuals are unable to recognize that there will be many surprises in the future; in short, as much other evidence tends to confirm, there is a tendency to underestimate uncertainties."

In fact, empirical evidence shows that people often not only underestimate but ignore low-probability risks. In interviews with 2055 homeowners living in flood-prone areas throughout the United States and 1006 home-
The implications of representativeness for risk acceptance or rejection are obvious. If the decision maker assumes that a new risk resembles prior risks, even though it really does not, an error in judgment is quite likely. It behooves the person seeking to avoid risk to present it in such a manner that it resembles previously encountered risks. This type of manipulation is most likely to occur in situations where the parties do business together on a regular basis.

2. **Biases and Heuristics That Involve Self-Perception by Others**

   a. **Cooperation, Fairness and the Appearance of Fairness**

Because we live in a structured society where we interact with others, people will seek to cooperate and act fairly. Moreover, they want others to perceive that they are cooperating and acting fairly. As a result, people sometimes sacrifice their own economic self-interest in order to either be fair or appear to be fair.  

In other words, people sometimes make decisions that

owners in earthquake-prone areas in California, Kunreuther and Slovic found that many residents had little idea of the real probability of a future disaster or of their own potential damage from such an occurrence. Of the uninsured subjects in the flood-prone-area survey, 29 percent expected that they would suffer no damage in a severe flood, and 26 percent expected that their damage would be $10,000 or less. Of the uninsured respondents in the earthquake-prone-area survey, 12 percent expected that they would suffer no damage in a severe earthquake, and 19 percent expected that they would suffer damages of only $10,000 or less. Even many interviewees who had informed notions of expected losses and premium costs declined to buy insurance in the manner predicted by the expected-utility model.

*Id.* at 223 (alteration in original) (footnotes omitted) (quoting Kenneth J. Arrow, *Risk Perception in Psychology and Economics*, 20 ECON. INQUIRY 1, 5 (1982)).

79. Sunstein, *supra* note 43, at 1186-87. Sunstein describes the “ultimatum game” as an example of the desire to cooperate and appear to be fair at the cost of economic self-interest.

The people who run the game give some money, on a provisional basis, to the first of two players. The first player is instructed to offer some part of the money to the second player. If the second player accepts that amount, he can keep what is offered, and the first player gets to keep the rest. But if the second player rejects the offer, neither player gets anything. Both players are informed that these are the rules. No bargaining is allowed. Using standard assumptions about rationality, self-interest, and choice, economists predict that the first player should offer a penny and the second player should accept. But this is not what happens. Offers usually average
are against their economic self-interest on the grounds that their doing so is in the best interests of society.

Because of this phenomenon, people are sometimes reluctant to confront for fear that in doing so they will appear to be uncooperative. This bias can be easily manipulated by techniques such as expression of irritation or a declaration that resistance to acceptance suggests that the decision maker is not really serious about entering into an agreement in the first place. Another approach might be to defer from discussing risk until all other issues are resolved and giving the appearance of accepting the decision maker’s position on all other issues so that when risk is presented, the decision maker will refrain from confrontation for fear of appearing to be uncooperative.

3. Biases and Heuristics That Involve the Perception of a Person’s Position Relative to a Fixed Reference Point

   a. Anchoring and Adjustment

   When people undertake to make an estimation of the possibility of a future event happening, they frequently “anchor” onto some initial possibility and then fail to adjust carefully when new information becomes available. If the initial anchor is to an arbitrary or nonrational perception, systematic errors can appear since the initial value was skewed. In other words, once the fixed reference point is established, people tend to be anchored to it and the results are often systematically erroneous. This bias can be easily manipulated by use of the framing

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80. Langevoort, supra note 42, at 1504; Sunstein, supra note 43, at 1188.
81. See Hanson & Kysar, supra note 42, at 667-69.

For instance, in one of Tversky and Kahneman’s experiments, subjects were asked to estimate the number of African countries in the United Nations as a percentage of total membership. Before the subjects responded, however, a large wheel of chance was spun in the subjects’ presence. Though the wheel contained numbers from one to one hundred, it was rigged to land either on ten or sixty-five. When the wheel landed on ten, subjects estimated that African countries comprised twenty-five percent of the United Nations; when the wheel landed on sixty-five, the estimation
effect to trigger anchoring to a misconception or to a pre-established reference point.

b. Hindsight Bias

Closely related to anchoring is the hindsight bias. Individuals tend to overstate the predictability of a past event, which is to say that once someone learns of an event, there is a tendency to believe that it was more likely to occur than before they learned of the event. 82

c. Status Quo Bias

Preferences of a decision maker can depend on how that person perceives options relative to the status quo. If given a choice between options that represent deviations from the status quo, people will tend to gravitate towards the option that represents the least deviation. A liquidated damage clause is a default term. If the parties perceive such a term as very little deviation from the status quo, there is a likelihood that they will accept or reject the terms on that basis without a clear understanding of what the implications of the term really are, or they will act in an inefficient manner when selecting such a term. 83 This may serve to explain, in part, why a promisee would accept an insufficient liquidated damage clause as a solution to addressing the issue of a default by a promisor; a decision that, with the advantage of hindsight, might appear to be nonrational.

Korobkin demonstrated this bias in an experiment involving subjects who were asked to advise a shipping company during negotiations with a commercial customer. Subjects in one group were asked to recommend a per-package dollar amount that the shipping company should pay to contract around a provision that imposed consequential damages in the event of de-

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fault. Subjects in a second group were asked to recommend an amount that the shipping company should demand if it were to accept full liability in an amount that exceeded a statutory default rule, the status quo, specifying limited liability. The scale was from one to ten dollars. Subjects in the first group recommended a maximum of $4.46 to limit consequential damages. Subjects in the second group recommended a minimum of $6.96 as the price to accept full liability. In a second experiment, subjects were asked to choose between “pay your own fees” or “loser pays” attorney fee provisions. According to the study, 72% of the subjects presented with a “loser pays” default rule preferred to retain the provision and 59% of the subjects presented with the “pay your own fees” alternative preferred to retain that clause rather than change to the “loser pays” alternative.

D. Summary

From the foregoing, two points become clear. Decision making and contract formation involve more than just the assumption that parties will be rational and approach a contract with only their respective economic well-being in mind. In addition, it is clear that to the extent that nonrational factors may be at work in the contract formation process, many of these factors can be manipulated so as to influence the final decision. If only one party is aware of these dynamics, that party is in a position to use this information to his or her advantage. This alone should not be grounds for judicial intervention. But, when there is evidence of such manipulation together with the appearance of possible overreaching and unfair surprise, judicial inspection becomes more appropriate. In Part V, I will apply these conclusions to insufficient liquidated damage clauses to illustrate a practical use of BDT and the theory of contractual unconscionability.

IV. Efforts to Link BDT to the Law

In Part IV of this article, I will review how BDT has already been used to support liability theories in areas of securities law.

84. Id. at 637-41.
85. Id. at 646-47.
and product-liability law. Emerging from these efforts are two common elements that have important implications for other areas of legal policy and, in particular, matters involving the interpretation of contracts. In matters involving competitive markets, BDT can be used:

— to explain and prove motivations to manipulate; or
— to deflect anti-paternalistic policy arguments asserted to diminish the law's involvement in the protection of sophisticated operatives.

Within the context of commercial relationships, manipulation is something less than fraud or deceit. Manipulation is not the same thing as false advertising. Manipulation involves conscious effort to disarm the customer or consumer. Manipulation thwarts the ability to make a rational decision. Perhaps manipulation is what the famous boxing promoter Don King had in mind when he coined the phrase "trickeration."

Commercial relationships very often involve an allocation of risk, and parties to transactions, as a part of normal negotiations, can be expected to consciously allocate risk. Where negotiations are not possible, such as where a consumer acquires a product "off the shelf" at a retail outlet, the law weighs overriding contractual provisions, and allocates the risk associated with the product by implying warranties and requiring disclosure of the possible harm the product can cause. As we shall see, providers of goods and services have an economic incentive to complete a transaction and if they perceive that the issue of risk allocation might interfere with their goal, they have reason to try to play down or even trivialize the topic through manipulation.

The implications of such manipulation are particularly important and germane to the issue of the sophisticated customer or consumer. Prototypical legal doctrine demands that the sophisticated participant must employ all resources available for the evaluation of risk and holds the sophisticated participant accountable for failure to do so. BDT becomes relevant to establish the possibility that the sophist's need to meet his or her obligation may have been manipulated.

Not all manipulation is objectionable. Indeed, responsible advertising and promotion are not only acceptable but required
by our economic system. As long as the intention is to stimulate discretionary purchases, direct the consumer to a particular product or service, or encourage a consumer to that which he was already prepared to do, manipulation is appropriate. But when the goal becomes the subjugation of the consumer's ability or willingness to appreciate the subtleties of the assumption of risk, the picture changes dramatically.

A. Overview

To date, two major efforts have been made to link BDT to legal theories involving liability. Professor Donald Langevoort has applied BDT to the direct one-on-one relationship between the stockbroker and a customer. He suggests that BDT can be used to explain “why otherwise sophisticated investors seem with disturbing frequency to buy investments they later claim not to have fully understood, thereby adding unanticipated risk to their portfolios.” Langevoort concludes that “the issue of trust emerges as the pivotal consideration” and that BDT supports the argument that this manipulation by stockbrokers can be established through a circumstantial case, the elements of which are motive and opportunity.

Professors Jon Hanson and Douglas Kysar have applied BDT to situations where there is no direct one-on-one relationship between parties, an example of which is the relationship between the manufacturer and the consumer. They argue that there is room in our law for enterprise liability (sometimes also called strict liability) flowing from manipulations of consumers by manufactures that use knowledge of psychology and human behavior to pursue commercial goals at the expense of the consumer. Together, these studies suggest that the link be-

87. Id. at 628-29.
88. Id. at 631.
tween BDT, as it exists today, and the law is robust, meaningful and transferable to many other areas of the law.

As was noted in Part II of this article, important efforts have been made to address the question of whether or not BDT can satisfactorily explain why courts are willing to become involved in the evaluation of overly sufficient liquidated damage clauses. Professor Robert Hillman notes that "[j]udges exuberantly police agreed damages in part because of their perception of the planning parties' cognitive limitations. Judges believe that parties at the bargaining stage are generally too optimistic that nothing will go wrong and therefore devote their limited bargaining energies and abilities to other issues." While this work does not directly discuss insufficient liquidated damage clauses and the issue of manipulation, the analysis has application to the argument that BDT can provide relevant evidence of unconscionability.

B. Securities Law and BDT

Langevoort explores the relationship between the stockbroker and the customer noting that both are impelled by a relationship founded on trust. The customer is motivated to establish trust by circumstances such as a lack of time and ability to evaluate investment alternatives, or an anxiety about investing because of an aversion to loss. The broker is motivated to establish trust so that he or she can proceed with the transaction. The customer's perspective, if known and appreciated by the broker, creates a propitious situation for the opportunistic broker and the possibility for improper manipulation.

Possibilities for manipulation occur at a variety of times during the relationship, such as when recommendations are

90. Hillman, supra note 23, at 737.
91. "By practical necessity, they [customers] must rely on others; by motivation, they are often strongly inclined to do so." Langevoort, supra note 86, at 678.
92. See id. at 699.

While the possibilities of outright broker deceit or simple investor greed are hardly trivial, a large middle ground of such decisions can be explained by the confluence of motivational influences. The influences lead the investor, without realizing it, toward rationalization and wishful thinking, often triggered by the intervention of a broker who has learned to take advantage of those motivations and guide them toward the desired investment.

Id.
made by the broker and when subsequent reliance is invited by the broker on issues involving informational details. At the heart of the possibility for such opportunism are the principals of BDT. Langevoort notes:

If one clear message can be derived from Part I [the study of BDT], it is that it is difficult to cause investors to act cautiously once they are motivated to buy. To the extent that an investment decision reflects some need or desire beyond the simple expectation of profit, most forms of information and warnings inconsistent with the desired course will be ignored, filtered out, or rationalized away.93

Langevoort points to a number of identified cognitive distortions that may be involved in decisions to accept the broker's recommendation and thereafter trust the broker. Included on the list, any one or more of which contribute to the end result, are: risk aversion, status quo bias in risk taking, loss aversion, framing and overconfidence.

In sum, many motivations are likely to cause even experienced investors to assume significant risk. To some extent, this analysis substantiates the claim that risk taking is the investor's own choice, and, hence, responsibility. But recognize two further points. First, many of these motivations will be unconscious, with influences that cannot readily be characterized as deliberate choice. Motivated reasoning is often formed as self-serving inference and wishful thinking, in which the underlying desires affect, if not control, decision making. Yet these desires are masked from consciousness by selective perception and rationalization. The investor motivated to take risk is equally motivated to see the investment decision as reasonable and rational. In this sense, risk taking will often take the form of failing to perceive and appreciate risk as opposed to the deliberate assumption of risk. Second, it is precisely these motivations that some brokers will try to manipulate to create customer demand for investment products.94

Stockbrokers, of course, are motivated to bring about transactions to earn a fee.95 It follows that the purpose of the rela-
tionship with the customer from the broker’s perspective is to convince the customer to accept the transaction. If the impetus for a transaction is a recommendation by the broker, the broker must position the recommendation in such a way that it does not scare off the customer. The broker is thus motivated to downplay what the broker believes the customer will perceive as a negative, and this suggests that the broker has good reason to want to play down risks or even trivialize them.

The broker seeks to spur the customer to become a party to an investment transaction that by definition involves financial risk. To insure success, a sophisticated broker might use, to his or her advantage, knowledge about the customer’s psychology and behavior. Overcoming the customer’s propensity for loss adversity and reinforcing the expectation that reliance on the broker can reduce this anxiety, both become essential elements of the sales pitch.96 The strategy to win over the customer usually includes an appearance of personal friendship because “[c]onventional social mores do not allow challenges to the credibility of information offered by a ‘friend’.”97 Once the decision to trust is made, the customer develops a strong need to justify the decision, i.e., reliance on the biases of anchoring and cognitive dissonance. The customer commits to trust the broker and thereafter is disposed to defend that decision and to resist any

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96. “This strategy may both prompt a greater willingness to take risk and exacerbate the sense of being overwhelmed by the uncertainty and range of information. A natural human response to this anxiety and anticipatory regret is to externalize the dilemma by seeking out someone to whom to transfer the responsibility.” Langevoort, supra note 86, at 654.

97. Id.
information that suggests that the commitment may be unwise. Thus, the relationship founded on trust creates the opportunity for overreaching by the broker.98

Nevertheless, many courts hold the broker's recommendations reckless as a matter of law if the proposal for an investment is accompanied by a written disclosure memorandum. However, if that memorandum contains disclaimers or other types of cautionary language, the customer, whether sophisti-

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98. See id. at 659-61.

Imagine, for instance, a customer who has developed a relationship with a broker over the past year and followed ten recommendations. This well-trained broker never "guaranteed" any short-term results, instead stressing the high likelihood of positive returns. The broker also ensured that the customer felt significantly involved in the investment decision, that is, that the ultimate decision was the customer's. In these circumstances, behavioral considerations may conspire against any prompt realization of overreaching by the broker.

The first reason is motivational. Having committed to both the relationship with the broker and the particular transaction, the customer is motivated to bolster these decisions, finding it ego-threatening and shameful to conclude that he or she acted on bad advice. Such an inference might also threaten other significant needs — status or friendship, for example — that the investment account serves. The natural tendency, then, is to seek non-threatening explanations for the misfortune.

Now consider the number of recommendations. Even if performance has been poor on average, simple chance dictates that some of the ten probably did well. Markets, after all, are volatile and unpredictable. Indeed, if the broker did a good job of selling even a fairly low-quality security, there can be a short-term price run-up simply because of the induced demand. So long as the customer was not on the tail end of the sales program, some positive feedback will occur. In addition, nearly all investments are open-ended: poor performance is seldom established conclusively, since a turnaround is always possible. Investors have a well-documented tendency to hold on to losing investments too long; in fact, some customers may view poor performance as an opportunity to escalate commitment by purchasing even more of the stock at a cheaper price.

The customer thus has ample means to rationalize short-run poor performance of an individual investment as something other than the product of bad advice and bad decisions. Blaming external circumstances such as timing, market influences, or luck is also useful. Not until repeated, sustained losses gradually eliminate alternative explanations, or an investment catastrophe presents an overwhelming circumstantial case, will customers finally acknowledge that bad investment decisions produced their losses. At this point, they can blame either themselves or their brokers. Only then will large numbers, particularly those with healthy levels of self-esteem — blame their brokers, terminate the account, and (if they are angry enough and sufficient sums are at stake) bring suit.

Id. (footnotes omitted).
cated or not, has a duty to read the memorandum and the failure to do so precludes the assertion of claims of fraud. 99 Nevertheless, Langevoort points out that most nonprofessional investors and many sophisticated investors simply do not read legal disclosure documents, and asks if in some cases this is the result of a broker's conduct. He suggests that if the need to read is knowingly manipulated by the establishment of a trusting relationship, it may be unfair to hold the customer to the obligation of self-help. He observes that most investors rely on recommendations from their broker as a way to save time, expense and the effort associated with the education process. In essence, many investors who trust their broker pay their broker to do the reading and the investors do so precisely because they are persuaded of the broker’s trustworthiness. 100

Brokers have reason to discourage a customer from reading disclosure materials for fear that a careful reading will dissuade the customer from proceeding with the investment. In other words, brokers may wish to manipulate the customer’s desire not to read the materials out of fear that such scrutiny may become a deal breaker. This perhaps explains why some brokers wait until the last possible minute to deliver disclosure documents to the customer or sometimes insist that disclosure docu-

100. See Langevoort, supra note 86, at 682-84.

Our behavioral analysis demonstrates quite clearly why investors rarely read (or read carefully). Investors rely on brokers’ recommendations as a way to save time and expense, and to avoid the overwhelming learning difficulties in evaluating investment options themselves. Most sophisticated investors are busy with stressful lives and careers, and both want and need to rely on someone else for investment guidance. In the context of a full-service brokerage arrangement, they pay for the ability to rely, the ability to shift responsibility for evaluating the risk-return probabilities of countless investment options. They will do this as long as they are persuaded, rightly or wrongly, of the broker’s trustworthiness.

Reading a prospectus after accepting the recommendation of a broker whom the customer is inclined to trust, then, is inconsistent with several phenomena: (1) the time-saving and responsibility-shifting reasons for using that broker in the first place, (2) the cognitive commitment to the broker as a credible source of recommendations, and (3) the preference for making the investment. The motivation is not to read unless suspicions have otherwise been aroused.

Id. (footnote omitted).
ments are really only necessary to "satisfy the damn lawyers." Brokers hope to benefit from the customer's propensity for anchoring to the brokers' recommendation and may be seeking to capitalize on an unwillingness of the customer to accept information suggesting that it may be unwise to proceed.\textsuperscript{101} He thus concludes: "The customer's duty to read should be excused in any setting where it is reasonable to rely generally on the broker's recommendations."\textsuperscript{102}

Langevoort's observations have application to the theory of unconscionability. The theory of unconscionability was developed in large measure to protect consumers from the possibility of disparate bargaining power and from a lack of understanding about what covenants might actually mean. However, in situations where the parties to a contract are business people operating in a commercial setting, it is often said that there is a "presumption of conscionability."\textsuperscript{103}

This principle is strikingly similar to the doctrine that there is a duty to read. As with that duty, if manipulation comes into the mix, not only should the presumption of conscionability be defeated, but the resulting contract should be subject to scrutiny under the theory of unconscionability on the grounds that the manipulation could result in disparity in bargaining power, overreaching and unfair surprise.

C. \textit{The Law of Products Liability and BDT}

Hanson and Kysar are concerned with the more distant relationship that exists between a manufacturer and customer

\textsuperscript{101} See id. at 684.

If there are so many reasons to expect that customers will rarely read prospectuses relating to securities recommended by their brokers, why does the duty to read survive and prosper? . . . Some judges may simply underestimate the regularity with which investors do not read, and thus treat those whose claims are litigated as aberrant. We have seen that this perception may well reflect an unrealistic bias. Other judges may be trying to channel behavior by creating an incentive to read. However, even putting aside the use of "recklessness" as a vehicle for this sort of functionalism, this argument also seems troublesome if we accept trust as widespread and predictable.

\textit{Id.}

\textsuperscript{102} Id. at 685.

and how competitive market forces and BDT impact upon that relationship. They share Langevoort's worry about the potential for manipulation because of the relative disparity between the manufacturer and the consumer as pertains to information about the product. Their concern is that the manufacturer more times than not has control over the context in which a decision maker evaluates risk. They argue that market forces create strong incentives for the manufacturer to manipulate the consumer's risk perceptions and that with the assistance of sophisticated marketers, manufacturers use lessons learned from BDT research to trigger cognitive imperfections in the customer.105

Consumers do exhibit systematic and predictable cognitive biases that the careful psychological researcher or the clever marketer can induce. Put differently, individual perceptions can be studied, isolated, and manipulated by those in a position to influence the individual's perceptual context.106

And:

A key implication of our analysis for products liability law is that consumer susceptibility to manufacturer manipulation significantly weakens otherwise considerable market-provided incentives for safety. More specifically, because of the problem of market manipulation, many consumers are likely purchasing too many risky products.107

Given the competitive nature of the marketplace, the manufacturer essentially has no choice but to consider manipulation of the consumer's risk perceptions and will do so in whatever

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105. Hanson & Kysar, supra note 42, at 693.
106. Id. at 723.
107. Hanson & Kysar, Some Evidence, supra note 89, at 1428.
108. Hanson & Kysar, supra note 42, at 722.

Consumers, regardless of whether they would otherwise systematically over- or underestimate product risks, are susceptible to manipulation by manufacturers due to their cognitive anomalies. This susceptibility to manipulation produces an opportunity for exploitation that no profit-maximizing manufacturer can ignore. We view this latter point as the single most significant implication to be drawn from the behavioral research for scholars of products liability law.

Id. (emphasis added).
manner that best serves its need to maximize profits. It follows that the manufacturer will seek to lower the consumer’s risk estimate as much as possible since in doing so the manufacturer increases the likelihood of a purchase at the lowest cost to the manufacturer. When the need to make a sale becomes sufficiently compelling, manipulation can extend to disarming the consumer’s ability to fully appreciate and evaluate risk. At the core of the manipulation are cognitive biases and BDT.109

Much like it is being in the interest of the hunter to know the behavior patterns of the prey, it is in the interest of the manufacturer to know as much as possible about the psychology and behavior of the consumer. So it should not be a surprise that manufacturers in this country spend upwards of eight billion dollars annually assessing consumer psychology and purchasing habits, and then follow up by spending many tens of billions more annually on advertising and promotion.110 It is a pretty good bet that this massive effort would not be made if manufacturers did not believe that the results were needed for economic success. But more importantly, Hanson and Kysar point out that the cognitive biases and heuristics identified by cognitive psychologists are a road map for anyone who wants to structure advertising and promotional efforts to manipulate

109. Id. at 726.

Cognitive biases present profit-maximizing opportunities that manufacturers must take advantage of in order to stay apace with competition. Whether by design or not, the market will evolve to a state in which only firms that capitalize on consumer cognitive anomalies survive. Thus, even if consumers initially approach a product greatly overestimating its safety risks, manufacturers will attempt to counteract that misperception through calculated marketing techniques or other bias manipulations. Even if the overwhelming majority of cognitive biases point toward overestimation of product risks, manufacturers will selectively target only those biases that lead to underestimation of risks. Indeed, even if the behavioral researchers themselves have failed to discover a particular bias, the forces of the market will lead manufacturers to exploit it; that is, manufacturers will behave as if they know the behavioral literature and then some. They have all the incentives to discover the biases even if they do so unwittingly and even if they and we cannot name them. Again, not only can manufacturers achieve these effects, but the hidden hand of market forces requires that they do so in order to remain competitive.

Id. (emphasis added) (footnote omitted).

110. Hanson & Kysar, Some Evidence, supra note 89, at 1429-30.
consumers. They cite studies performed by Kahneman and Tversky as particularly instructive:

The similarity between those market beliefs and the cognitive heuristics identified by Daniel Kahneman and Amos Tversky, two principal founders of behavioral research, is striking. Both market beliefs and cognitive heuristics allow people to simplify decision making through short cuts or rules of thumb; both mechanisms, when manipulated by researchers or marketers, can also lead to consistently misguided decision making.111

Although we find this debate over the ultimate impact of advertising fascinating, our purpose here is far more limited: to show that manufacturers have in place a well-funded and extensive research system for studying consumer behavior. In fact, they have the fruits of $8 billion per year in marketing research expenditures when it comes to understanding consumer behavior and psychology. The resulting studies and analyses provide the tools that manufacturers need to shape consumer perceptions of their products, to alter consumer behavior in the purchasing context, and to influence consumer-safety risk assessments. Moreover, as one can see, this research substantially overlaps with general behavioral research. Sometimes this overlap is explicit: a recent textbook on consumer behavior, for instance, included an entire section on “Heuristics.” Even without an explicit reference, perusal of the literature gives one a sense that marketing researchers are keenly aware of the works of Kahneman, Tversky, and other behavioral researchers. Indeed, Tversky once remarked that his findings would have been familiar to “advertisers and used-car salesmen,” even though his findings were not familiar to classical economists.112

Hanson and Kysar present the tobacco industry as a case study of manufacturer manipulation as supported by BDT.113 They point to industry behavior designed to generate positive first impressions - a positive affect - with young smokers,114 conduct that is consistent with trying to take advantage of the affect heuristic which in turn leads to a marked tendency of individuals with a positive affective response to underestimate risks and to misinterpret or ignore evidence suggesting that

111. Id. at 1433 (footnote omitted).
112. Id. at 1439 (footnotes omitted).
113. Id. at 1467-1553.
114. Id. at 1506-07.

https://digitalcommons.pace.edu/plr/vol22/iss1/2
there is a danger associated with certain conduct. They point to evidence that cigarette manufacturers have developed ways to take advantage of framing effects by describing their products so as to minimize smokers' perceptions of the associated risk, as for instance by calling certain brands "lights." They also point to consumer conduct which they believe confirms the effectiveness of the manipulation. Studies show that smokers experience an optimism bias, which is to say that they underestimate the risk to themselves while acknowledging that there is greater risk to others from the smoking. Similarly, there is evidence that the availability heuristic plays a role, as does the representativeness bias. Seeking to take advantage of these cognitive misconceptions, manufacturers provide little information about the product hoping to take advantage of the availability heuristic, i.e., the tendency of people to systematically underestimate risks about which there is relatively little information. Where information is provided, it either explicitly or implicitly suggests that the product is reasonably safe in an at-

115. See Hanson & Kysar, Some Evidence, supra note 89, at 1481-82.

In the spring of 1972, Dr. Claude Teague, then assistant chief of research and development at RJR, wrote a memo discussing what motivates different groups of smokers to smoke, including the marketing of cigarettes to youths. The memo describes the profile of an ideal cigarette for a beginning smoker (between ages thirteen and seventeen) as mild tasting so as not to put them off in the beginning, containing lower-than-normal nicotine because children's bodies have not yet acclimated to nicotine, and being promoted with a simultaneous emphasis on togetherness and individuality. The new campaign that RJR established as a result was Joe Camel, described by the ad copy as a "smooth character" and the "quintessential party animal," who was "done up in a tuxedo and sunglasses, with a cigarette adangle from his pendulous lips and a bevy of adoring (human) beauties nearby." The smooth character appears to have appealed to underage consumers. Studies published in a 1991 issue of the Journal of the American Medical Association found that Joe Camel is almost as familiar to six-year-old children as Mickey Mouse, that the campaign has enticed thousands of teens to smoke the brand, and that Camel's popularity with twelve- to seventeen-year-olds has surged. Those studies showed that roughly ninety percent of six-year-olds knew there was a connection between Joe Camel and cigarettes and ninety-eight percent of high school students understood, more specifically, the link between Joe and the Camel brand. In three years, the brand jumped from three percent to over thirteen percent of the market, and its consumer niche shifted from the over-fifty smoker to the under-twenty one smoker.

Id. (emphasis added) (footnotes omitted).

116. Id. at 1507.
tempt to take advantage of the representativeness bias. They also point to a strong preference by people to be seen as cooperative and suggest that when cigarette manufacturers portray themselves as deeply concerned for the well-being of the smoker and are willing to assist and cooperate in research of smoking risks, they are really trying to appeal to the smoker's willingness to approve cooperation and thereby lower the smoker's perception of the risks of smoking.\(^{117}\)

Hanson and Kysar argue that just the possibility that manufacturers can manipulate consumer product perceptions is reason enough for enterprise liability as an alternative to the more traditional theories of products liability and regulation. "Under an enterprise liability regime, the market would force manufacturers to experiment with product warnings by altering their form and content to overcome consumer cognitive failings to produce effective informational disclosures. Corporate manipulation of risk perceptions would be replaced by corporate management of risk information."\(^{118}\) They conclude that it is fair to predicate this theory of liability on behaviorism.

If consumers buy more of a product when it is labeled seventy-five percent fat free, rather than twenty-five percent fat, we do not know which label more effectively alerts consumers' [sic] to their true preferences. We do know, however, that consumers perceive the product differently depending on the manufacturer's use of a non-substantive information frame. That fact alone represents evidence that, under certain circumstances, consumer perceptions of product risks can be altered by manufacturer manipulation. Accepting that possibility, all the logic of economic theory tells us that manufacturers will manipulate consumer perception in the direction that benefits them most - toward the underestimation of product risks. And all the evidence of consumer product markets suggests that this manipulation has been successful and will continue to be so until policymakers take behavioralism as seriously as marketers do.\(^{119}\)

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117. *Id.* at 1514-16, 1526-27.
118. *Id.* at 1561.
119. *Id.* at 1572. Hanson and Kysar are not without critics. See James A. Henderson & Jeffrey J. Rachlinski, *Product-Related Risk and Cognitive Biases: The Shortcomings of Enterprise Liability*, 6 ROGER WILLIAMS U. L. REV. 213 (2000). Henderson and Rachlinski do not reject the principles of BDT. Nor do they deny that BDT has application to legal analysis. Their problem is with the broad sweep of the Hanson and Kysar suggestion that manipulation supports enterprise liabil-

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Hanson and Kysar's conclusions seem to parallel Langevoort's conclusion concerning the duty to read in that they believe that manipulation and the attempt to seduce a consumer to acquire or use a dangerous product trumps any responsibility that the consumer might have with respect to the use of the product. In other words, Joe Camel's manipulations are so insidious that a smoker's use of tobacco does not, in and of itself, relieve the manufacturer of liability simply because a label appears on the package warning the consumer of dire consequences associated with smoking. The authors of both studies are proponents of a paternalistic approach, supported by psychological research, that essentially advocates protecting people from being inappropriately manipulated. Their conclusion in every situation. They concede that economic forces can and do induce manufacturers to undertake advertising campaigns that can be manipulative but maintain that the existing liability system does a good job in controlling abuse. Id. at 242-44. Nor do they believe that enterprise liability has no place in our legal system.

For some types of products, a strict liability insurance regime such as EL [enterprise liability] can be more workable. Some product-related risks confront the consumer with a "take it or leave it" choice to either use or consume the product, thereby exposing herself to the risk of injury or avoiding the risk altogether. Once use or consumption occurs, the risk of harm cannot cost-effectively be reduced by the consumer's conduct. These harms are akin to spinning a kind of negative "roulette wheel"; the product leaves most consumers unharmed, but visits great harm upon some unfortunate individual, through no fault of their own. Each consumer, in the words of a carnival pitchman, "pays her money and takes her chances."

These "roulette-style" injuries are more amenable to a strict liability insurance scheme than those product-related injuries caused by the interplay of the consumer and the manufacturer. The relevant risks presented by such products are known at the time of sale and problems of causation, at the time of accidental injury, are relatively manageable. Moreover, adverse selection is contained by the fact that both the risk of defect and the projected severity of physical injury in connection with new product use or consumption are essentially identical for all users and consumers. . . . [O]nce new products are purchased and used or consumed, users and consumers have no significant control over the risks posed by manufacturing defects. This significantly reduces, if not eliminates, the threat of moral hazard.

Id. at 242-43. Their position is that manufacturers' manipulations are real and identifiable using BDT. But they maintain that manufacturers' manipulations can be used to raise as well as lower consumer perceptions of risk and therefore cannot be used to support a strict liability system. Id. at 244-55.

120. See Henderson & Rachlinski, supra note 119 at 226-28.
sions have application to the theory of contractual unconscionability.121

D. BDT and the Overly Sufficient Liquidated Damage Clause

Professor Hillman asks if BDT can be used to explain why courts are so willing to become involved in determining the validity of a liquidated damage clause.122 While he does not say so directly, his analysis is limited to situations involving the overly sufficient liquidated damage clause. Even though he concludes that the answer is no, he does find room for BDT as a partial explanation.

Hillman points out that courts appear to have three core concerns about the formation process associated with the liquidated damage clause:

121. Henderson and Rachlinski urge caution:
The psychological research does, generally speaking, support paternalistic or quasi-paternalistic legal reforms such as EL, that are designed to protect people from themselves. This general tendency must be treated with some nuance and context, however, as it is more compelling in some circumstances than others. Psychology's support for paternalism must also be weighed against other, non-psychological concerns. Furthermore, rational actor models of human behavior have proven enormously valuable and stunningly accurate for most purposes and should not be discarded without solid evidence that they have failed. Finally, the courts and the legislatures, with centuries of experience, are entitled to some respect on psychological issues. Those who would use psychology to advance reforms should carefully consider the possibility that the law has already noted the existence of the psychological phenomena and developed suitable, if unavoidably imperfect, responses.

Id. at 256 (footnotes omitted).

122. "The mystery is why courts are so willing to police agreed damages when they are so reticent to interfere with other contract provisions." Hillman, supra note 23, at 726.

In reality, courts often overturn liquidated damages clauses as "penalties," with greater zeal and vigor than they strike other contract terms. Courts will deem a term a "penalty" if it calls for damages that bear no reasonable relation to the forecast of actual damages. Courts also strike damages provisions as penalties if, at the time of contracting, it appeared that a court would have little difficulty ascertaining actual damages in the event of a breach. Courts also police liquidated damages provisions based on actual outcomes. Unable to resist interceding when actual damages turn out to be disproportionate to an agreed remedies clause, many courts invalidate such clauses as penalties.

Id. (footnotes omitted).
— deficiencies in the bargaining process;\textsuperscript{123}
— coercion;\textsuperscript{124} and
— limitations of cognition.\textsuperscript{125}

These three concerns are not dissimilar from the concerns raised by courts when considering the theory of contractual uncon(497,139),(612,151)

\textsuperscript{123} Id.

Modern courts therefore reinforce their antipathy to penalties by finding the bargaining process deficient. For example, courts generalize that parties do not negotiate agreed remedies provisions. Instead, courts believe that promisors share an “illusion[] of hope” that nothing will go wrong and consequently fail to bargain adequately over remedial provisions.

\textit{Id.} at 727 (footnotes omitted).

\textsuperscript{124} Id.

In addition, courts apparently believe that promisors are peculiarly susceptible to being coerced into agreeing to penalty provisions. Little evidence from actual cases supports this assertion and nothing about the nature of agreed remedies explains why promisees would have more leverage with respect to these clauses than any other clause.

\textit{Id.} at 728 (footnotes omitted).

\textsuperscript{125} See Henderson & Rachlinski, supra note 119, at 728.

Another alleged deficiency in the bargaining process with respect to agreed remedies is “the limits of cognition” of contracting parties in this context. Professor Eisenberg asserts that although parties can easily understand terms “such as subject matter, quantity, and price,” they cannot comprehend “the scenarios of breach” and the “application of a liquidated damages provision” to these scenarios. In addition, parties discount the probability of breach based on a cost-benefit analysis tainted by optimism about performance. For these reasons, parties may fail to focus on liquidated damages provisions when agreeing to a contract, thereby supplying courts with a justification for scrutinizing these provisions more closely.


\textsuperscript{126} See id.

In light of these considerations and because of the contributions of agreed damages provisions, perhaps courts should abandon the special tests for agreed damages and simply apply traditional policing doctrines, such as unconscionability and duress. Courts employing this approach would strike an agreed damages provision only if they found it “oppressive” or the product of “unfair surprise.”

\textit{Id.} at 738 (footnote omitted).
Hillman is cautious about the application of BDT to legal analysis, insisting that first there must be clarification about which particular cognitive processes actually occur in the formation of a contract.\(^{127}\) He also suggests that there is still an unfilled need to develop data on simulations of decision making in the full range of contractual situations.\(^{128}\) In addition, he notes that different parties approach a given transaction from unique perspectives and this reality must be taken into account when considering the application of BDT.\(^{129}\)

\(127\) See Hillman, supra note 23, at 730.

Legal analysts must clarify the extent to which particular cognitive processes actually occur in the exchange setting. For example, analysts debate whether contract default rules, such as the award of expectancy damages, enjoy an endowment effect. Perhaps parties at the bargaining stage view expectancy damages as an entitlement and therefore value that remedy more than other remedial alternatives such as liquidated damages. On the other hand, neither party really "owns" the right to expectancy damages until the parties enter a contract and one party breaches. As a result, the endowment effect may not apply.

Id. (emphasis omitted) (footnotes omitted).

\(128\) See id.

Before legal analysts rely on behavioral studies, they also need to obtain or develop data based on simulations of decision making in the full range of contractual transactions. For example, the parties may absorb and process information about the importance of a liquidated damages provision very differently, depending upon whether they are experienced business people, business novices, or individuals making a formal or informal agreement. The parties' perceptions of liquidated damages may be very different, for example, depending on whether they recently experienced a contract breakdown and judicial enforcement (or rejection) of such a provision. Whether the parties have an interest in a long-term relationship as opposed to a one-shot deal also probably influences their perceptions of agreed damages. For example, parties who have invested in long-term relations may discount information that would make them feel insecure. No single description of cognitive processes can either fully explain the legal approach to agreed damages or prescribe the law that should apply to all exchange transactions.

Id. (footnote omitted)

\(129\) See id. at 731.

Not only can disparate contexts lead to different cognitions, but each party to a particular transaction may have different motivations, experiences, practices, and goals. Certainly, each party's outlook can influence the way that party receives and processes information. For example, different levels of experience may lead to conflicting views of the likelihood of contract default and of the probability that a court will enforce an agreed damages provision. If one party has enjoyed great success in avoiding contract breakdowns and is therefore too optimistic about the outcome of the current transaction, but the other party, fresh from a broken deal, overesti-
These cautions notwithstanding, Hillman concludes that BDT is relevant:

It should be clear by now that the decision-making techniques, heuristics, and biases that cognitive theory explains apply to decision makers in the legal system.

... ...

BDT does shed some light on the mystery of agreed damages. Judges exuberantly police agreed damages in part because of their perception of the planning parties' cognitive limitations. Judges believe that parties at the bargaining stage are generally too optimistic that nothing will go wrong and therefore devote their limited bargaining energies and abilities to other issues. People's aversion to penalties and windfalls also undoubtedly enhances the judicial appetite for devouring agreed damages clauses. Moreover, judges probably fail to account for their own cognitive biases, such as their tendency to remember outrageous agreed damages clauses and to believe too optimistically that they are not susceptible to the hindsight bias or the framing effect.

Prescriptively, BDT demonstrates that many reasons for "strict scrutiny" of agreed damages clauses may be only half right. Other cognitive heuristics and biases suggest that, on the whole, parties may especially value their agreed damages provision, spend lots of time refining it, account for it when assigning other rights and duties in the contract (such as price), and generally believe it is fair. In light of conflicting evidence on the nature of the parties' bargaining and given contract law's apparent focus on only part of the story, BDT helps show the absence of a persuasive justification for special judicial treatment of agreed damages clauses. In addition, BDT substantiates this position by underscoring judicial decision-making foibles in this realm. BDT's focus on the bargaining process also emphasizes the value of rules that presume the enforceability of agreed damages clauses in order to encourage parties to improve their decision making by reading and studying their agreed damages provisions.130

mates the possibility of default, it is not self-evident which party the law of agreed damages should favor.

Id. (footnote omitted).

130. Id. at 735-37 (footnotes omitted).
E. Summary

From these studies we can see that the propensity for manipulation is potentially widespread throughout the commercial world. We also learn from these studies that manipulation can be employed to adversely impact the decision-making process by disarming a consumer and that BDT can play a role in the process. In Section V of this article, I will argue that contract formation is such an area and that this is especially so in situations involving the unconscionability of an insufficient liquidated damage clause.

V. BDT as Applied to the Theory of Unconscionability and Insufficient Liquidated Damage Clauses

At the beginning of this article, I observed that contract formation and negotiation present a unique challenge for the application of BDT. It is both difficult to prove that someone accepted a provision solely because of a cognitive distortion and difficult to prove which bias(s) or heuristic(s) might be directly influencing the decision. I also noted that this does not mean that cognitive distortions are not involved in the final mix that results in an erroneous decision.

Evidence concerning human dynamics and consumer psychology, all else being equal, is relevant and has a bearing on the overall conditions that exist at the time of a decision. This is especially true if ambient circumstances include unacceptable manipulation. Through careful analysis using the principals of BDT, it is possible to find direct and indirect evidence of unsuitable manipulation in a variety of locations. The places to look include:

— the nature of the relationship between the contracting parties;
— the profile of the consumer;
— the contour of the business environment; and
— the text of promotional materials and commercials.

As Hanson and Kysar point out:

We found empirical evidence of our market manipulation hypothesis in a variety of places, including the consumer marketing literature, the consumer psychology literature and actual market
behavior. . . . Although that particular evidence may not have provided direct proof of risk-related manipulation, it did support such an inference.\textsuperscript{131}

And:

Even absent more direct evidence, the evidence of cognitive psychologists and decision theorists would be adequate to show that market manipulation is a natural and logical consequence of cognitive biases and manufacturer profit motives.\textsuperscript{132}

I also submit that legal policy decisions that reject unconscionability in situations involving an insufficient liquidated damage clause on substantive grounds are in error because the supporting legal reasoning is slightly out of focus.

In order to completely appreciate this argument and how it applies in a case involving an insufficient liquidated damage clause, the reader is reminded of the three examples of insufficient liquidated damage clauses discussed above in Section II of this article. I identified them to be:

- Insufficient liquidated damage clauses that limit damages to reimbursement of a fee paid for a specific service without concern for actual damages. Typical of this type are contracts for advertisements in the yellow page directories.
- Insufficient liquidated damage clauses that specify a sum certain without concern for actual damages. Typical of this type are contracts for emergency response services.
- Formula clauses which are dependent upon conditions that are likely to exist on a particular date.

In this Part, I will focus on the insufficient liquidated damage clause that specifies a sum certain without concern for actual damages, which are often found in service contracts for emergency response programs.\textsuperscript{133} The very nature of the emer-

\textsuperscript{131} Hanson & Kysar, A Response, supra note 89, at 263.
\textsuperscript{132} Id. at 289.
\textsuperscript{133} We have already seen that there is a trend with respect to yellow page or phone directory contracts containing insufficient damage clauses to hold such clauses unconscionable, when applying rational principles. See supra notes 10-12 and accompanying text. Formula clauses that are dependent upon conditions that are likely to exist on a particular date in the future are rarely contested on the grounds of unconscionability because they come about by careful negotiation and
gency response industry and the relationship of the provider to the consumer presents an unusual mélange of circumstances that together can support a claim of contractual unconscionability. Service providers, as we shall see, have cause to want to manipulate a consumer's perceptions about risk, use tactics that can only be explained in the context of a desire to gain an unfair advantage, and do so in a business environment that affords the service provider an unfettered (and uncontrolled) opportunity to do so.

A. Overview

Emergency response programs are offered by service providers that agree to remotely monitor security and request assistance from police and fire departments and/or medical service providers in an emergency. Two broad segments characterize the industry:

— burglar and fire monitoring; and
— personal emergency response monitoring.

The service sector of the emergency response industry is totally unregulated, leaving the consumer to fend for himself. The sole remedy available to the consumer is judicial supplication for any perceived inequity. Courts, for their part, have limited authority to support intervention absent a claim by the consumer of contractual unconscionability.

Service providers range in size from international companies like ADP, which have a world-wide presence, to local companies, which do business in a limited number of markets. All providers, regardless of size, provide similar services to customers who share common concerns. The consumers' perspective is not lost on these providers. Service providers thus have designed their promotional materials of all types accordingly. Promotional materials, whether in the form of fliers and mailers, newsprint advertising, or commercials seen or heard on the electronic media, are similar in nature and designed to appeal to consumers who, by definition, are searching for someone trustworthy and acceptable to provide security services.

involve conditions that are known to all parties to the contract. See supra note 23 and accompanying text.
Potential customers considering monitoring services are concerned about:

— safety;
— security; and
— control through intervention.

Providers are well-aware of these concerns. Indeed, they know a great deal about prospective customers and have many resources available to assist them in any quest to understand and predict consumer behavior. These resources include trade groups and associations, industry specific consultants and advertising agencies that provide industry-wide information and statistics on monitoring and security, as well as numerous publications and studies describing consumer research and focus group revelations about consumer behavior and habits. Consultants and advertising agencies assist in tailoring overall customer behavioral and preference studies to the peculiarities of specific markets.

Providers have three initial goals when seeking a first-time customer:

— providing assurance that customer concerns are being addressed;
— directing the customer to the provider's specific products; and
— motivation of the customer to want to purchase equipment and/or monitoring services.

Promotional efforts are designed to accomplish five essential objectives, all of which are linked to trusting the service provider:

— win the confidence of the customer;

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— create the image that the monitoring company is professional and capable of handling the task of monitoring and reporting incidents;

— assure the customer that the staff of the monitoring organization is professionally trained;

— create the impression that the customer’s well-being is the paramount consideration of the monitoring company; and

— assure the customer that in an emergency, assistance will be called for on a timely basis.

Promotional materials contain claims and statements such as:

— “With [service] you are protected from the serious effects of accidents, poor health or panic. You’ll have contact with the outside world 24 hours a day, 7 days a week - even though you live alone”;

— “Feel secure knowing that you’re receiving the best service available from a company that you can trust”;

— “Rest easy with the assurance that help is only the press of a button away”;

— “This year as many as 1,500,000 people will have heart attacks. . . . Death can usually be avoided when help arrives in time”;

— “As crime rates sky rocket, your chances of being at risk also increase. Do not take a chance with your life”;

— “[Provider] is a high technology company with years of experience and a tradition of excellence. You’ll feel confident knowing that you’re part of the [provider’s] family. [Provider] - the company that cares”;

— “Within seconds, our high-speed computers call up your vital life-saving information while simultaneously putting you in direct ‘HANDS FREE’ TWO WAY VOICE COMMUNICATION with concerned professionals that care”;

— “It [the service] helps save lives”; and

— “Keep your family safe for less than a $1 a day.”

135. The statements quoted are from written promotional materials disseminated by monitoring service companies doing business in the metropolitan New York area.
Testimonials are a commonly used promotional tool. Some companies distribute to potential customers question and answer sheets with titles such as "OVERCOMING RESISTANCE" which are intended to give family members or friends ammunition to persuade an elderly or infirmed loved ones to accept the system into their home. These materials and advertisements almost always omit any discussion of issues involving assumption of risk.

In the burglar and fire alarm monitoring services segment of the security industry, two agreements are typically used; one for the sale and installation of the monitoring equipment and another for monitoring services. The equipment is designed so that in the event of an incident, it will either place a telephone call to the offices of the service provider or directly to the fire and/or police department. When the call is made to the offices of the monitoring company, usually the service provider tries to call back the customer to confirm that there is, in fact, a problem and the alarm is not spurious. Once the nature of the emergency is determined, the provider calls the appropriate agency for assistance. If the equipment fails to work for any reason, the call for help may never be placed. Similarly, if a call to the monitoring company is not answered or is mishandled once received, the subsequent call to the fire or police departments may never be made.

Some monitoring service agreements involve a personal emergency response system and a promise to provide assistance in the event of a physical mishap such as a heart attack or, in the event of a criminal intrusion, when there is a risk of physical harm to the customer. These agreements more times than not are with the elderly or infirm. Equipment is normally leased to the consumer although there are some situations where a "panic button" is included with burglar and/or fire alarm equipment that are sold to the customer. Usually the equipment includes a small pendant that is worn in some fashion by the customer. In an emergency, a button on the pendant, if suppressed, transmits a signal to a nearby unit that, in turn, places a telephone call to a central monitoring station. An operator evaluates the nature of the emergency and contacts a variety of service providers, including ambulances, doctors and the police, in an effort to provide assistance. Communications be-
between the customer and the operator are through the pendant itself. If the monitoring company fails to answer the call or if the operator who does answer the call mishandles the situation, the prompt request for assistance may not be made.

Most of the agreements currently in use in both industry segments contain language that is similar if not identical to the following:

It is understood and agreed that [the provider] is not an insurer of person, life, limb or property and that insurance, if any, covering personal injury, life and property loss or damage shall be obtained by the [customer], if so desired. [The provider] is being paid for the monitoring of a system designed to reduce certain risks. [The provider] and the [customer] acknowledge that the amounts being charged are not sufficient to in any way guarantee that no loss or damage will occur, and that [provider] is not assuming responsibility for any personal injury, life or property loss or damage, which may occur even if due to [provider's] negligent performance or failure to perform any obligation under this Agreement or failure of the system to operate as intended, or for any reason whatsoever. Since it is impractical and extremely difficult to fix actual damages which may arise due to improper monitoring of the system, the failure of services, or the failure to perform said services, if not withstanding the above there should arise any liability whatsoever on the part of [provider], it is agreed that such liability shall be limited to two hundred fifty ($250) dollars. This sum shall be complete and exclusive and shall be paid and received as an exclusive remedy and not as a penalty.\(^{136}\)

Some agreements specifically include in the $250 limitation claims for acts of gross negligence.\(^ {137}\)

Price is a major concern from the perspective of both the provider and the consumer. Cost efficiency guarantees access to a broad consumer market. Service fees for home monitoring of all types are usually quite modest, in the area of about $30.00 per month. Many providers guarantee that the cost of the mon-

\(^{136}\) Contract on file with author.

\(^{137}\) In many states public policy does permit exculpation for acts of negligence unless there is a statute that creates a specific exception. Examples of such exceptions are found in N.Y. GEN. OBLIG. §§ 5-321, 5-322, 5-322.1, 5-323, 5-324, 5-325, 5-326 (2001). However, in these jurisdictions parties cannot contract to exculpate acts of gross negligence and contracts containing such provisions are void as against public policy. Metro. Prop. & Cas. Ins. Co. v. Budd Morgan Cent. Station Alarm Co., 95 F. Supp. 2d 118 (E.D.N.Y. 2000).
onitoring service will not increase as long as the customer subscribes to the service.

Some agreements provide the consumer with the option to hold the provider liable for damages exceeding $250 provided that the customer pay a fee proportioned to the increased amount of damages. More often than not, this option is not exercised. It is not clear if the reason for this is oversight, lack of understanding about the option, or sensitivity to paying the fee.

The actual agreements are standard form, preprinted and almost always are drafted and prepared by the provider. They are almost never the subjects of negotiations. In markets such as metropolitan New York, all providers use basically the same form of agreement, all of which contain the $250 limit on damages for negligence (and in some cases gross negligence).

Providers do not willingly reveal that the final agreement will contain a liquidated damage provision. Disclosures about the terms of the actual agreement are never made in the promotional materials. In some cases the monitoring companies will even refuse to provide copies of their standard form agreement prior to a sales session, which is usually conducted at the customer’s home or place of business.

The focus of the sales session is reinforcement of the appropriateness of the customer’s trust in the provider. No mention of the liability limitations is made unless the customer raises the question directly. No information is provided as to the consequences of such a clause.

B. BDT as Evidence of Manipulation

To some the principles of BDT may seem like fuzzy psychology, and speculation, and of little evidentiary value. But, the incredulous approach ignores the reality that sometimes behav-

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138. Some agreements contain language similar to the following: In the event that the [consumer] wishes [provider] to assume a greater liability, the [consumer] may, as a matter of right, obtain from [provider] a higher limit by paying an additional amount proportioned to the increase in said damages, but such additional obligation shall in no way be interpreted to hold or constitute [provider] and insurer. Any request by the [customer] pursuant to this paragraph, shall be given to [provider] in writing by certified mail, return receipt requested. Contract on file with author.
ior cannot be explained except in the context of principles such as those developed by researchers interested in BDT. BDT offers, for the most part, circumstantial evidence from which any fact finder can reasonably deduce intentions to overreach and to seek an unfair advantage. The evidence that BDT provides goes to the issue of procedural unconscionability. BDT provides an elucidation which, when coupled with rational factors, collectively can support the conclusion of unconscionability. In cases where courts have previously held that unconscionability was not established using rational factors alone, the tide could well turn if nonrational factors are added to the mix.

All general markers of unconscionability are usually present in monitoring service agreements. In Part II of this article I identified general markers to be:

— a standard form contract;
— a contract presented without explanation;
— a contract that is not subject to negotiation; and
— a contract prepared by the party benefiting from the suspect clause. 139

At least one unique marker is also present, i.e., the insufficient liquidated damage clause. Since this type of clause gives the appearance of being profoundly discriminatory, it suggests that the covenant could be operating in an unreasonable manner. The question is whether or not this marker's presence, and the circumstances surrounding its being there in the first place, as understood within the context of the principles of BDT, are evidence of procedural unconscionability. It is submitted that this question is best answered in the affirmative.

1. Procedural Unconscionability

In Part IV of this article I noted that affects set the stage for the decision-making process and trigger a cascade of biases and heuristics. Within the context of the emergency response industry, we shall see that affects are skillfully used by the service providers to condition the customer to trust the provider and position the customer to rely on a predictable assortment of biases and heuristics. The end result is an agreement that in-

139. See supra Part II B.
volves the assumption of risk without the customer even being aware that the issue is involved.

The emergency response industry is, like most other industries, competitive. Participants are in the business to make a profit. It is in the collective best interest of all service providers to reduce the cost of doing business to the lowest most efficient level in order to win broad appeal to as many consumers as possible. One way to keep costs to a minimum is to eliminate liability for negligent acts. To accomplish this goal, providers could simply insist on a clause requiring complete exculpation. But this strategy might appear unreasonable and be interpreted in many jurisdictions as against public policy. By contrast, most jurisdictions permit parties to include reasonable liquidated damage provisions. Challenges that a particular liquidated damage clause is unreasonable are far easier to defend against because they are disposed of on a case-by-case basis, whereas challenges involving public policy have ubiquitous implications.

At the outset the provider has the upper hand because the provider is in a position to direct the customer’s attention to matters that the provider believes will occasion the customer to purchase equipment and/or subscribe for services. The provider is framing choices for the customer against a backdrop created by the customer’s known concerns and preferences. Promotional materials appear to be designed with the effect of control in mind. The customer is known to be seeking assistance because of a desire to gain control over circumstances beyond the customer’s control. The promotional materials suggest that the customer has two choices: control, as is professionally offered by the service provider, or no control. Similarly, a choice is offered between safety, security and prompt action as opposed to the possibility of catastrophic loss of life and/or property.

But, unbeknownst to the customer the provider is also framing the customer’s choice about the risk associated with the provider’s non-performance. The customer is encouraged to accept the provider as a valuable, professional and trustworthy resource. Non-performance is not even mentioned. Against this backdrop the customer is asked to accept that it is reasonable for the customer to assume all risk (less $250) for the provider’s non-performance. This strategy suggests that the provider has
determined that raising the issue could scare off the customer. In fact there is no other reasonable explanation for non-disclosure. The strategy is remarkably similar to the one utilized by the securities brokers who distract their customers from the contents of disclosure documents. Both the securities broker and the service provider appear concerned that if the issue of risk is identified, the customer will become uneasy, demur and refuse to assume the risk.

The promotional materials typically used by service providers are, on their face, designed to fully capture the tendency for experiential thinking about risk. A customer's experiences are most likely going to be limited to risks involving physical debilitation, i.e., heart attack, stroke or a fall resulting in a broken bone, or the destruction or loss of property resulting from fires, water damage, or theft. Most customers have no reason to be concerned about the failure of the monitoring company to perform because the customer is not likely to have had an experience involving such a possibility. Hence, this risk remains beyond the horizon of the decision maker's immediate concerns.

Once the customer considers the promotion and a decision is made to explore the matter further, BDT suggests that the customer will do so subject to a cascade of biases. For example, the customer can be expected to anchor to that decision. The materials are also likely to trigger the status quo bias, the status quo being safety and security.

The framing and control effects may also trigger other biases such as cognitive dissonance. The consumer has made a decision about the consumer's condition, i.e., the consumer is now "safe" since the consumer has decided to rely on the provider. Fears of debilitation, destruction or loss of property because of fire or theft have been addressed and the consumer is not likely to want to receive information that suggests that the decision is possibly flawed or involves implications the customer has yet to consider. The customer is focused on the future and is gratified by the possibility of assistance being available when and if it is needed.

Since there has been no disclosure, the availability bias probably is not in play. But consider if disclosure is made. Consumers have limited information available about the risks associated with the losses resulting from debilitation, fire or theft,
and have virtually no information about either the possibility or the consequences of a failure of the provider to perform. The only available data comes from the provider, usually in the form of promotional pieces. This suggests that the availability bias, reinforced by "satisficing," will restrict the investigation to the promotional materials. In other words, the availability bias conditions the consumer to accept an assumption of risk by relying almost exclusively on information prepared by the service provider.

Disclosure after the decision to subscribe will most likely be accepted without question because of the tendency to rely on the cooperation bias. Throughout the relationship that exists prior to disclosure, the provider assures the consumer of the provider's concern for the well-being of the consumer and exhibits an apparently sincere willingness to cooperate. This strategy suggests an intention to discourage the decision maker from confrontation for fear of appearing to be uncooperative. This scenario may explain why disclosure occurs at the last moment during the face-to-face meeting with the customer. It may also explain why some providers refuse to provide copies of any agreement prior to the face-to-face meeting.

The foregoing analysis of the circumstances leading up to contract acceptance provides an explanation for why service providers structure the information they disseminate and why they follow up in the manner that they do. Indeed, there is no other explanation for tactics such as silence about the issue of assumption of risk and the refusal to provide copies of the proposed contract prior to the personal sales visit. BDT can thus be seen as a valuable tool for identifying and explaining the motivation and intent of the service provider.

2. **Substantive Unconscionability**

Non-performance of an obligation to perform a service such as monitoring can result in loss of health, life and property. The insufficient liquidated damage clause can yield results that the consumer neither comprehends nor appreciates when the agreement is first entered into. Failure to disclose the assumption of liability for a provider's non-performance or unfavorable terms

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140. See supra note 71 and accompanying text.
until the last moment suggests that it is appropriate to conclude that the provider is hoping for blind acceptance. Against this backdrop, the arguments developed to date to justify upholding and enforcing the insufficient liquidated damage clause on substantive unconscionable grounds require rethinking.

Decisions that reject claims of unconscionability and uphold the insufficient liquidated damage clause are contrived in that they are supported by one or more of two faulty suppositions:

— that the fee charged for monitoring services is too small to justify extending liability; or
— that doing so might otherwise result in customers viewing providers as insurers and this perception might encourage consumers to dispense with purchasing their own insurance coverage.141

To begin, both arguments assume that the consumer is aware of the content and implications of an insufficient liquidated damage clause and is aware of possible alternatives. As we have already seen, in reality, this often is not the case.

Condoning the clause on the grounds that the fee paid is too small to warrant extended liability encourages non-performance by the provider that thereby has nothing to lose by a default in performance. Leading up to the contract, the consumer is almost always promised monitoring coupled with a promise to promptly summon assistance so as to reduce or eliminate physical harm, property damage or loss by virtue of theft. Enforcement of the clause means that if the provider is negligent, the consumer is left to suffer the totality of the consequences that the service was supposed to minimize. In other words, by enforcing the clause, courts are voting against meaningful accountability and are creating a disincentive for responsible behavior. Most other service providers are, at law, fully accountable without concern for the magnitude of the fee paid. Compounding the mistaken analysis, which looks to the magnitude of the fee charged, is the fact that monitoring service providers seek to create the impression that a “special relationship”

141. See supra note 20.
actually exists at least up until the point in time when being a professional gives rise to the possibility of extended liability.

Declaring such clauses unconscionable on substantive grounds would have the limited effect of requiring responsible behavior and perhaps forcing providers to reconsider their cost structure to make provision for errors and omissions liability coverage from a third party.142

People routinely invite contractors and other service providers onto their premises and liability for negligence is supported without concern for how large the fee paid to the invitee may have been. Imagine how peculiar it would be if an electrician who is paid $250 as a fee for installing a fixture was allowed exculpation as a defense from liability for faulty workmanship notwithstanding the reality that the installation set off a fire which destroyed the entire premises.

Some courts have expressed a concern that if these provisions are found unenforceable, the practical effect would be to excuse a property owner from having to secure appropriate insurance and this might unfairly shift the risk of loss to the provider.143 This argument appears to have little relevance to contracts for assistance in situations involving physical debilitation since insurance is not available in this arena. To the extent that it has been associated with other insufficient liquidated damage clauses, it is founded on untenable legal assumptions.

142. Professor Warren argues that these clauses should be enforced only if the court first determines that the breach involved was the type of breach that the parties intended to be covered by the clause, and if the court finds otherwise, it will not enforce the agreement. Warren, supra note 10. Eisenberg suggests that this is in fact the better approach to deciding if an overliquidated damage clause is indeed a penalty. Eisenberg, supra note 8, at 234-35.

Under a cognitive approach to the liquidated damages principle, therefore, courts should formulate and apply the principle as follows: If, in the breach scenario that has actually occurred, liquidated damages are significantly disproportional to real losses (that is, losses in fact, not simply legal damages), the provision is unenforceable unless it is established that the parties had a specific and well-thought-through intention that the provision apply in a scenario like the one that actually occurred.

*Id.* In short, both Warren and Eisenberg are arguing that even if the provision would otherwise be a penalty, if there is clear evidence that the parties had intended this as a result, then the agreement should be enforced.

143. Warren, supra note 10, at 912 n.78.
Phone directory contracts involve the possibility of damages for the loss of business. The damages that flow from phone directory cases can be addressed by business interruption insurance. This reality has not stopped courts from finding insufficient liquidated damage clauses in phone directory contracts to be unconscionable on the grounds that doing so might discourage the advertiser from carrying business interruption insurance. So why should monitoring service agreements be treated any differently? I submit they should not be treated any differently.

Moreover, people secure their own insurance coverage for reasons that would not be disturbed just because the provider has extended liability. Fire and theft insurance pays for losses without the claimant having to bear the burden of establishing misfeasance or malfeasance. The insured need only establish that an insured loss has occurred. This suggests that people obtain insurance because doing so is efficient and results in timely compensation for a loss. In addition, people who secure insurance do so after considering whom they are doing business with and the likelihood that the insurance carrier will live up to its contractual commitments. This valuable benefit is lost if reliance is placed on the service provider that may or may not secure coverage or may secure coverage from a financially inferior carrier.

These arguments aside, if the practical effect of the insufficient liquidated damage clause is profound discrimination against the consumer, courts should conclude that substantive unconscionability is present. As we have already seen, these clauses operate to confer an unfettered right enabling the provider to act arbitrarily and confers on the provider the benefit of freedom from liability, which bears no reasonable relationship to the representations made and obligations assumed by the provider.

VI. Conclusion

People are complex and sometimes they do strange and foolish things. This should not be a surprise to even the most naïve. Our system of jurisprudence requires that people live by their contractual commitments and therefore with the results of their mistakes. However, when any party to a contract tries to
take unfair advantage of human foibles, the playing field is no longer even and this becomes more acute if the decision maker is not only unaware, but also unable to detect what is going on. Positioning a decision maker by disarming his ability to protect himself is inappropriate at best and, under some circumstances, despicable and any contract that results should be suspected as being unconscionable.

BDT is not for everyone and every agreement. Responsible manipulation is permissible. By responsible it is meant that the manipulation is designed to stimulate no more than what the party being manipulated would have done anyway. Manipulating the purchase of one toothpaste in favor of another is harmless from the consumer’s perspective since the consumer is in the market for the product in any event. Risk, however, falls into a different category and should not to be equated with involuntary purchases. The presence of risk means that adverse consequences are possible. Any consumer who is being asked to accept risk of any kind is entitled to an assurance that there are not dark forces at work of which the decision maker is both unaware and unable to detect. Manipulation of a consumer’s ability to comprehend and appreciate risk can result in a playing field that is tilted in favor of the party with whom the consumer is dealing. Sophistication and the ability to protect oneself become meaningless if the decision maker’s astuteness is interfered with and such treacherous conduct should not be tolerated without consequence. An understanding of human dynamics and psychology as presented by BDT can serve to identify when such insidious forces are at work.

BDT and unconscionability have application to other types of contractual arrangements. Wherever a specific marker suggesting unconscionability is found, the practitioner should give thought to the application of BDT to explain the presence of that marker. BDT also has application in any situation where, by law, an actor is charged with the duty to self-help and there is a possibility of inappropriate manipulation. In all situations BDT should be seen as just one element of proof and not as conclusive evidence. But, it should always be considered as an appropriate part of the mix.