An Economic Analysis of Consumer Protection in Contract Law

By Stefan Haupt[*]

A. Traditional Justification of Consumer Protection: The Doctrine of Inequality of Bargaining Power

The traditional justification of consumer protection is founded on the notion of restraining the monopoly power of huge companies[1] and the potential that they posses to influence consumers via advertising that limits consumers' ability to verify what is in their own best interest.[2] This theory refers not to the individual consumer in a concrete situation, but stresses a general economically weaker position of the consumer *vis-à-vis* the suppliers. Consumers are seen as less knowledgeable and as economically inferior to producers and traders.[3] So a large deviation between the ideal of consumer sovereignty[4] and reality is presumed.[5] The power imbalance on the market ("countervailing power") leads to demand for market reconciliation, compensation or balancing. According to this conception the state must support the consumers as weaker market participants during the counterweight

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[1] Friedrich Keßler, *Contracts of Adhesion: Some Thoughts About Freedom of Contract*, 43 COLUMBIA LAW REVIEW 629, 632, 640 (1943).

[2] HANS-BERND SCHÄFER/CLAUS OTT, LEHRBUCH DER ÖKONOMISCHEN ANALYSE DES ZIVILRECHTS, 321-322 (3rd ed. 2000).

[3] THIERRY BOURGOIGNE, ÉLEMENTS POUR UNE THEORIE DU DROIT DE LA CONSOMMATION 72-73, 128-129 (1988); STEPHEN WEATHERILL, EC CONSUMER LAW AND POLICY 60 (1997).

[4] A term created by William H. Hutt *Economics and the Public. A Study of Competition and Opinion*. 257 (1936).

[5] STEFAN MITROPOULOS, VERBRAUCHERPOLITIK IN DER MARKTWIRTSCHAFT 30-32 (1997).

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formation.[6] Producers are seen to possess "sovereignty," corporations are powerful and able to bring their goods onto the market and they can manipulate the consumers to buy them.[7] Disadvantageous transactions are thought to result from the exploitation of a seller's bargaining advantages *vis-à-vis* the individual consumer.[8] There is a widespread chance of exploitation as a consequence of the discrepancy between the economic power of the producer or supplier and that of the consumer.[9] So the theory of inequality of bargaining is grounded on the notion of plain disproportion in size and resources between market actors on both the supply side and demand side.[10]

This traditional concept to justify consumer protection regulation seems widely baseless. Monopoly power does only affect *quantity* by restricting it, which seems to be an issue for competition law, while consumers face market inefficiency due to *quality* reductions of contract parameters like the rights and obligations deriving from a transaction.[11] Problems of consumer protection occur often in markets characterized by the existence of many small producers or suppliers, than in monopolistic markets where a large corporation is cooperating with a large advertising industry.[12]

Therefore, in the next chapters, other reasons are examined concerning why markets sometimes fail and why consumers might have to be protected.

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[6] JOHN KENNETH GALBRAITH, AMERICAN CAPITALISM. THE CONCEPT OF COUNTERVAILING POWER 108-154 (2nd ed. 1956); BOURGOIGNE, *supra* note 3; KONSTANTIN SIMITIS, VERBRAUCHERSCHUTZ – SCHLAGWORT ODER RECHTSPRINZIP? 97-136 (1976).

[7] JOHN KENNETH GALBRAITH, DIE MODERNE INDUSTRIEGESELLSCHAFT 195 (1973); NORBERT REICH, MARKT UND RECHT 218 (1977); BOURGOIGNE, *supra* note 3, at 6, 10, 72-73, 128-129, 161.

[8] Hugh Beale, *The Inequality of Bargaining Power*, 6 OXFORD JOURNAL OF LEGAL STUDIES 123 (1986); Manfred Wolf, *Party Autonomy and Information in the Unfair Contract Term Directive*, *in* PARTY AUTONOMY AND THE ROLE OF INFORMATION IN THE INTERNAL MARKET 313, 323 (Stefan Grundmann/Wolfgang Kerber/Stephen Weatherill eds., 2001); Hans-W. Micklitz, *The New German Sales Law: Changing Patterns in the Regulation of Product Quality*, 25 JOURNAL OF CONSUMER POLICY 379, 386-389 (2002); Spencer Nathan Thal, *The Inequality of Bargaining Power Doctrine – The Problem of Defining Contractual Unfairness*, 8 OXFORD JOURNAL OF LEGAL STUDIES 17 (1988).

[9] BOURGOIGNE, *supra* note 3.

[10] Gillian Hadfield/Robert Howse/Michael J. Trebilcock, Rethinking Consumer Protection Policy: Remarks to the University of Toronto Faculty of Law (20 June 1996).

[11] FERNANDO GOMEZ POMAR, EC CONSUMER PROTECTION LAW AND EC COMPETITION LAW: HOW RELATED ARE THEY? A LAW AND ECONOMICS PERSPECTIVE 8 (InDret Working Paper No. 113, 2003).

[12] SCHÄFER/OTT, *supra* note 2, at 322.

B. Economic Analysis of Effects of Certain Devices of Consumer Law

In the following the effects of some examples of measures of E.C. consumer protection are analyzed by adding some economic insights to the traditional justifications.

I. Mandatory Disclosure of Information

The most widely used means of consumer law of the European Union is to obligate suppliers to reveal certain information to consumers.[13] The priority of duties to inform has not only been emphasized in the consumer protection programs from 1975 to 1990,[14] in both of the 3-year consumer protection action plans 1990-1992[15] and 1993-1995[16] or in the Commission communication about consumer protection priorities 1996-1998,[17] but, furthermore, Article 153 EC-Treaty expresses that "in order to promote the interests of consumers and to ensure a high level of consumer protection, the Community shall contribute…to promoting their *right to information*…."

This concept of the Community is based on the idea that sufficiently informed consumers can help themselves, while their autonomy of will could still be guaranteed.[18] Information remedies may allow consumers to protect themselves according

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[13] Michael Martinek, *Unsystematische Überregulierung und kontraintentionale Effekte im Europäischen Verbraucherrecht oder: Weniger wäre mehr*, *in* SYSTEMBILDUNG UND SYSTEMLÜCKEN IN KERNGEBIETEN DES EUROPÄISCHEN PRIVATRECHTS 511, 518 (Stefan Grundmann ed., 2000); Christian Twigg-Flesner/Stephen Weatherill/Chris Willett, *Law, Information and Product Quality. Introductory Remarks by the Editors of the Special Issue*, 25 JOURNAL OF CONSUMER POLICY 291, 293 (2002).

[14] For example: Council Resolution of 14 April 1975 on a preliminary programme of the European Economic Community for a consumer protection and information policy, O.J. EC 1975 C 92/1; Council Resolution of 19 May 1981 on a second programme of the European Economic Community for a consumer protection and information policy O.J. EC 1981 C 133/1; Council Resolution of 23 June 1986 concerning the future orientation of the policy of the European Economic Community for the protection and promotion of consumer interests, O.J. EC 1986 C 167/1.

[15] Three year action plan of consumer policy in the EEC 1990-1992, COM (90) 98 final, 3 May 1990.

[16] Second Commission three-year action plan 1993-1995: placing the single market at the service of European consumers, COM (93) 378 final, 28 July 1993.

[17] Communication from the Commission - Priorities for Consumer Policy 1996-1998, COM (95) 519 final, 31. October 1995.

[18] MARTINEK, *supra* note 13, at 518.

to their personal preferences instead of causing the problem for a regulator to compromise diverse preferences with a common product or service standard.[19]

Rules making disclosure of information mandatory have an especially crucial role in the directives concerning consumer credits,[20] insurances,[21] package travel,[22] timesharing[23] and distance contracts.[24]

1. Superfluity of Disclosure Laws

Mandatory duties to inform might be needless, if the free market by itself produces a sufficient amount of information.[25] Producers or suppliers cannot exploit consumers by charging them a higher price, if they cannot easily distinguish informed and uninformed consumers. As long as it is not sufficiently difficult for enough consumers to acquire information by engaging in comparison-shopping, mandatory intervention seems not necessary.[26]

Even unfavorable information that can be costlessly verified by consumers will be voluntarily disclosed by privately informed sellers.[27] Information is verifiable,

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[19] Howard Beales/Richard Craswell/Steven C. Salop, *The Efficient Regulation of Consumer Protection*, 24 JOURNAL OF LAW & ECONOMICS (J.L. & ECON.) 491, 513 (1981).

[20] EC Directive 87/102 relating to the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit, O.J. 1987 L 42/48, amended by EC Directive 90/88, O.J. 1990 L 61/14 and in O.J. 1998 L 101/17.

[21] EC Directive 92/96 of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance and amending EC Directives 79/267 and 90/619 (third life assurance Directive), O.J. 1992 L 360/1.

[22] EC Directive 90/314 on package travel, package holidays and package tours, O.J. 1990 L 158/59.

[23] EC Directive 94/47 on the protection of purchasers in respect of certain aspects of contracts relating to the purchase of the right to use immovable properties on a timeshare basis, O.J. 1994 L 280/83.

[24] EC Directive 97/7 on the protection of consumers in respect of distance contracts, O.J. 1997 L 166/19.

[25] ROGER J. VAN DEN BERGH, COMPETITION LAW AND CONSUMER PROTECTION LEGISLATION, IN ECONOMIC ANALYSIS OF LAW. A EUROPEAN PERSPECTIVE 25 (Hatzis ed., forthcoming 2003); GOMEZ, *supra* note 11, at 12.

[26] ERIC A. POSNER, ECONOMIC ANALYSIS OF CONTRACT LAW AFTER THREE DECADES: SUCCESS OR FAILURE? 14 (John M. Olin Law & Economics, Working Paper No. 146, 2nd series); Alan Schwartz/Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 UNIVERSITY OF PENNSYLVANIA LAW REVIEW (U. PA. L. REV.) 630 (1979).

[27] Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure about Product Quality*, 24 J.L. & ECON. 461 (1981); GOMEZ, *supra* note 11; VAN DEN BERGH, *supra* note 25.

when consumers can *ex post* determine its truthfulness readily once it is disclosed.[28] Especially producers or suppliers who have favorable verifiable information have an incentive to disclose it.[29] Unraveling will take place when consumers have the ability to draw conclusions from non-disclosure, in a way that they expect the worst possible news concerning the content of the private information from a silent producer or supplier. The producer or supplier with the best private information will reveal it and will trigger a process of unraveling of decreasingly beneficial news of suppliers, until only the one with the worst news is left over without unraveling. Consumers' expectations are thereby eventually met as all information is disclosed voluntarily except for the most unfavorable news.[30]

As soon as producers or suppliers who engage into dishonest behavior are confronted with effective remedies of consumers, they will prefer to disclose true information, if they want to stay in the market. When high-value producers can distinguish themselves from low-value suppliers, non-disclosure or wrong information will not be maintained, because some buyers then will be willing to pay more – a confidence premium – as they trust the producer.[31]

Alternatively, there will be in other cases no voluntary unraveling of information.[32] This may be, for example, the case if the producer or supplier has not obtained the relevant piece of information him or herself. There will also be no voluntary disclosure if consumers' preferences are heterogeneous. Many dimensions of "high" quality are evaluated very subjectively by consumers. Eventually, unraveling will not occur if the information is not understood by a sufficient number of consumers, for example because they do not have the required technical expertise, and the information is therefore unverifiable.[33] Then, the consumer may be in a position to be deceived, for example, by unscrupulous fly-by-night producers or suppliers, which

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[28] GOMEZ, *supra* note 11; VAN DEN BERGH, *supra* note 25.

[29] E. POSNER, *supra* note 26.

[30] Sanford J. Grossman/Oliver Hart, *Disclosure Laws and Takeover Bids*, 35 JOURNAL OF FINANCE 323 (1980); GROSSMAN, *supra* note 27; Paul R. Milgrom, *Good News and Bad News: Representation Theorems and Applications*, 12 BELL JOURNAL OF ECONOMICS 380 (1981).

[31] DOUGLAS G. BAIRD / ROBERT H. GERTNER / RANDAL C. PICKER, GAME THEORY AND THE LAW 90 (2nd print.) (1995).

[32] GOMEZ, *supra* note 11, at 13; VAN DEN BERGH, *supra* note 25, at 26.

[33] VAN DEN BERGH, *supra* note 25, at 26-27; Michael J. Fishman/Kathleen M. Hagerty, *Mandatory Versus Voluntary Disclosure in Markets with Informed and Uninformed Customers*, 19 THE JOURNAL OF LAW, ECONOMICS & ORGANIZATIONS 45 (2003).

is especially possible if there are low barriers to entry, many sellers, and the rate of entry and exit in the market on the producers' side is high.[34]

2. Optimal Instead of Maximal Information

Informational duties are only justified if the benefits to the consumers, by having enhanced consumer choices, outweigh the administrative costs plus the compliance costs of the regulatory intervention. Hence, a comprehensive cost-benefit analysis is required.[35]

Also there can be the danger of an information overload.[36] Some kind or amount of information might be not only non-useful for the consumer but even irritating or distracting and could trigger adverse effects. The consumer could be found in resignation instead of reasonable analysis of an offer.[37] Besides renunciation or underestimation of information there can also be a tendency to selective processing of data and then often not in its most relevant point.[38] Especially consumers under time-pressure tend to recognize and consider, instead of all available data in their full meaning, only certain key information, so called chunks, like the price or the brand.[39] With an increasing amount of available information, the subjective feeling of security of the consumer increases as well, though his objective decision-making efficiency is decreasing due to the information overload, which makes the effects even worse.[40] For example, a consumer who made a decision with the feeling of security that it was the right one, because he got so much information, will not see any reason to study again the mandatorily provided information within a cooling-

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[34] Gillian Hadfield/Robert Howse/Michael J. Trebilcock, *Information-Based Principles for Rethinking Consumer Protecting Policy*, 21 JOURNAL OF CONSUMER POLICY 131, 155 (1998); GOMEZ, *supra* note 11, at 13.

[35] VAN DEN BERGH, *supra* note 25, at 25, 27-28; BEALES/CRASWELL/SALOP, *supra* note 19, at 533; HADFIELD/HOWSE/TREBILCOCK, *supra* note 10, at 50, 51, 54.

[36] EVERETT M. ROGERS/REKHA AGARWALA-ROGERS, COMMUNICATION IN ORGANIZATIONS 90 (1976); GERAINT HOWELLS/THOMAS WILHELMSSON, EC CONSUMER LAW 309 (1997).

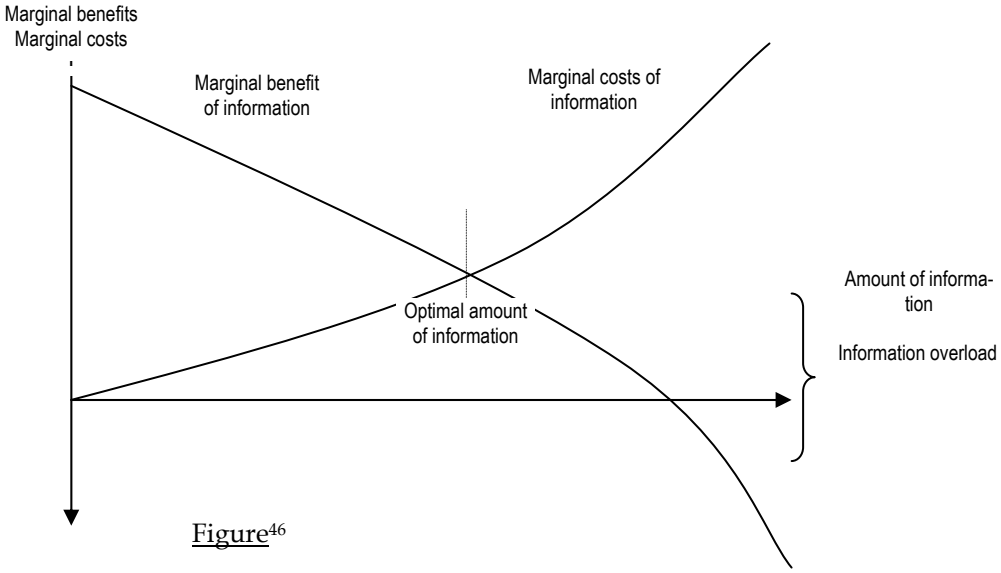
[37] MARTINEK, *supra* note 13, at 520.

[38] GEROLD BEHRENS, KONSUMENTENVERHALTEN – ENTWICKLUNG, ABHÄNGIGKEITEN, MÖGLICHKEITEN 157 (2nd ed. 1991); Stefan Grundmann, *Information, Party Autonomy and Economic Agents in European Contract Law*, 39 COMMON MARKET LAW REVIEW (COMMON MKT. L. REV.) 269, 286 (2002).

[39] ALFRED KUß, KÄUFERVERHALTEN 57 (1991).

[40] HANS WERNER HAGEMANN, WAHRGENOMMENE INFORMATIONSÜBERLASTUNG DES VERBRAUCHERS 96 (1988); HERMANN BERNDT, KONSUMENTSCHEIDUNG UND INFORMATIONSÜBERLASTUNG 211 (1983).

off period.[41] It seems to be that with a rising quantity of information the quality of consumers' decisions cannot be improved proportional, so that, therefore, the marginal utility of information is decreasing.[42] If too much and too detailed information is offered, consumers are often not able to take up, to understand and process the data.[43] Therefore it is important to find the optimal, instead of the maximal, amount of information that has to be disclosed.[44] This should not go beyond the point where marginal costs of additional information duties exceed their marginal benefit.[45]



Figure[46]

[41] MARTINEK, *supra* note 13, at 527.

[42] HOLGER FLEISCHER, INFORMATIONSASYMMETRIE IM VERTRAGSRECHT 115 (2001); Roger J. Van den Bergh, Wer schützt die europäischen Verbraucher vor dem Brüsseler Verbraucherschutz? Zu den möglichen adversen Effekten der europäischen Richtlinien zum Schutze des Verbrauchers, *in* EFFIZIENTE VERHALTENSSTEUERUNG UND KOOPERATION IM ZIVILRECHT, BEITRÄGE ZUM V. TRAVEMÜNDER SYMPOSIUM ZUR ÖKONOMISCHEN ANALYSE DES RECHTS 27-30 März 1996, 77, 84 (Claus Ott/Hans-Bernd Schäfer eds., 1997).

[43] SANDRA KIND, DIE GRENZEN DES VERBRAUCHERSCHUTZES DURCH INFORMATION 442 (1998).

[44] FLEISCHER, *supra* note 42, at 116; Holger Fleischer, *Vertragsschlußbezogene Informationspflichten im Gemeinschaftsrecht*, 2000 ZEITSCHRIFT FÜR EUROPÄISCHES PRIVATRECHT 772, 798 (2000).

[45] VAN DEN BERGH, *supra* note 25, at 25; Wein, Consumer Information Problems – Causes and Consequences, *in* PARTY AUTONOMY AND THE ROLE OF INFORMATION IN THE INTERNAL MARKET 80, 81 (Stefan Grundmann/Wolfgang Kerber/Stephen Weatherill eds., 2001).

[46] Inspired by Wein. WEIN, *supra* note 45.

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Specific empirical studies are needed to find out exactly which kind of information really matters for the consumer.[47] Simple and short, clear, recognizable, understandable and processable information should be revealed.[48] The consumer should have the right to choose if he is satisfied with that information or if he or she wants further information so that no consumer has to receive information (for which he also has to pay) that he does not really want.[49]

The regulator will not set optimal information duties if he does not know what information is relevant for the consumer and/or if he does not have incentives to fix the optimal level because of the influence of interest groups.[50]

3. Allocation of Duties

Information duties have to be efficiently allocated, which requires that the producer or seller should have the duty to disclose the information if he or she is the cheapest information producer and cheapest-cost-avoider who can produce or provide the knowledge at least cost and knows best the value of the knowledge. This might be the case if the examination of the product or service quality is too expensive for the demand side like in the case of goods that are bought only quiet seldom, goods or services that are demanded more often but that are very expensive (cars, for example) or things the quality of which cannot be evaluated precisely even after longer use (*credence* qualities).[51]

There should be no incentives to produce redistributive instead of productive information.[52] There should be a duty to reveal safety information that can damage property or persons if it is not disclosed.[53] A duty to reveal entrepreneurial information should be compensated adequately, for example, by granting a (intellectual)

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[47] VAN DEN BERGH, *supra* note 42, at 85.

[48] MARTINEK, *supra* note 13, at 530.

[49] VAN DEN BERGH, *supra* note 42, at 85.

[50] Thomas Eger, Kommentar zu Grundmann – Europäisches Verbrauchervertragsrecht im Spiegel der ökonomischen Theorie, *in* VEREINHEITLICHUNG UND DIVERSITÄT DES ZIVILRECHTS IN TRANSNATIONALEN WIRTSCHAFTSRÄUMEN 322, 327 (Claus Ott/Hans-Bernd Schäfer eds., 2002).

[51] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 99 (4th ed. 1986).

[52] ROBERT COOTER/THOMAS ULEN, LAW AND ECONOMICS 273 (2000).

[53] COOTER/ULEN, *supra* note 52, at 275.

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property right, because otherwise incentives to produce information would be undermined.[54] To maintain the incentive for knowledge production, information that increases value should not lead to an information duty.[55] In the case of information that decreases value, it should be differentiated. In many cases, like hidden product defects, an information duty would be efficient. The situation could be different where a mandatory disclosure of knowledge would prevent speculative transactions that have a socially valuable function.[56] There should be no disclosure duties with evident defects and with circumstances where a forced disclosure would leave the seller no incentive to acquire the relevant information.[57] It is not only important to give incentives for information production but also to create incentives to use fortuitously discovered knowledge.[58] Complete equality of information between contracting parties would be the "death of information" because all incentives for the production of new knowledge would be lost.[59]

4. The E.C. Directives

The E.C. timesharing directive,[60] as an example, includes an overload of informational duties that confuse than help the consumer and produce unnecessary high costs.[61] Besides a duplication of some information that has to be disclosed, there seems to be another problem: Although the approximately ninety different kind of informational duties have very different economical importance (that is the benefit

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[54] Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 JOURNAL OF LEGAL STUDIES 1, 14 (1978); FRIEDRICH AUGUST VON HAYEK, INDIVIDUALISMUS UND WIRTSCHAFTLICHE ORDNUNG 103-108 (1952).

[55] Hans-Bernd Schäfer, *Ökonomische Analyse vorvertraglicher Aufklärungspflichten*, *in* ÖKONOMISCHE PROBLEME DES ZIVILRECHTS, BEITRÄGE ZUM 2. TRAVEMÜNDER SYMPOSIUM ZUR ÖKONOMISCHEN ANALYSE DES RECHTS 21–24 März 1990, 117, 134 (Claus Ott/Hans-Bernd Schäfer eds., 1991); Claus Ott, *Vorvertragliche Aufklärungspflichten im Recht des Güter- und Leistungsaustausches*, *in* ÖKONOMISCHE PROBLEME DES ZIVILRECHTS, BEITRÄGE ZUM 2. TRAVEMÜNDER SYMPOSIUM ZUR ÖKONOMISCHEN ANALYSE DES RECHTS 21–24 März 1990, 142, 153 (Claus Ott/Hans-Bernd Schäfer eds., 1991).

[56] SCHÄFER, *supra* note 55, at 127.

[57] MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 112 (2nd print.) 1997).

[58] TREBILCOCK, *supra* note 58, at 113.

[59] Oskar Morgenstern, *Vollkommene Voraussicht und Wirtschaftliches Gleichgewicht*, 6 ZEITSCHRIFT FÜR NATIONALÖKONOMIE 337 (1935); FLEISCHER, *supra* note 42, at 187.

[60] , *supra* note 23.

[61] Hans-Bernd Schäfer, Grenzen des Verbraucherschutzes und adverse Effekte des Europäischen Verbraucherrechts, in Systembildung und Systemlücken *in* KERNGEBIETEN DES EUROPÄISCHEN PRIVATRECHTS 559, 566 (Stefan Grundmann ed., 2000).

of complying with them is greater for some duties than others), the EC directive gives them the same importance. This makes it especially difficult for the consumer to process the data selectively and does not permit him or her to choose compliance with certain duties, which provides most benefits in case they are not able to comply with all of them.[62] Important "chunks," brands with a good reputation, are not common in the timesharing branch.[63] So it would be helpful if there was the duty to disclose just a few easily understandable and comparable key figures, like, for example, the total price for acquiring the timesharing right and the total amount of costs per year.[64]

Informational duties in the E.C. doorstep sales directive[65], distance sales directive[66] and electronic sales directive[67] might be justified by risks of deception and fraud due to a relatively high proportion of small and quickly exiting firms in these markets.[68]

The consumer credit directive[69] requires disclosure of the annual percentage rate (APR) and the total cost of the credit. Standardized disclosure duties measuring and expressing one or more key parameters or variables relevant to a transaction[70] generally have the disadvantage that, first, they may induce producers or suppliers to concentrate quality efforts on the variables included in the standard at the expense of others left out and, second, the required disclosure might replace other information that the producer or supplier would have revealed.[71] Regarding consumer credit, there might be an increase in compliance and litigation costs and,

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[62] MARTINEK, *supra* note 13, at 521, 522.

[63] KIND, *supra* note 43, at 514.

[64] MARTINEK, *supra* note 13, at 522, 526, 529, 530.

[65] EC Directive 85/577 to protect the consumer in respect of contracts negotiated away from business premises, O.J. 1985 L 372/31.

[66] *Supra* note 24.

[67] EC Directive 2000/31 of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market ('Directive on electronic commerce'), O.J. 2000 L 178/1.

[68] GOMEZ, *supra* note 11, at 13-14.

[69] *Supra* note 20.

[70] GOMEZ, *supra* note 11, at 15; GRUNDMANN, *supra* note 38, at 273.

[71] BEALES/CRASWELL/SALOP, *supra* note 19, at 523; GOMEZ, *supra* note 11, at 15.

also, only already well-informed and wealthy borrowers might benefit.[72] Alternatively, the APR and the total cost figure convey in a complexity-reducing, homogenous and quiet user-friendly and computable way the most relevant information regarding a consumer credit and make it easier for consumers to shop around for more attractive offers, which might have contributed to the fact that grossly excessive interest rates and prices seem to have vanished.[73]

II. Granting of Cooling-off Periods

1. Beneficial and Adverse Effects

Another widespread tool in European Community law to protect consumers is cooling-off periods. Within a specified period of time, the consumer has the right to withdraw from a concluded contract.[74] Cooling-off periods are only justified if they are necessary as a remedy for inefficiencies.[75]

First, such market failure could arise out of the fact that consumers do not act always rationally[76] but have instable preferences depending on the situation in which they have to make decisions, like, for example, if they are under stress. A withdrawal right might be a justified remedy if it makes it possible for the consumer to rethink his or her short-term choice and to reflect more on his long-term preferences.[77]

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[72] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 408 (5th ed. 1998); Richard Hynes/Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AMERICAN LAW AND ECONOMICS REVIEW 168, 194-195 (2002).

[73] GOMEZ, *supra* note 11, at 15; Stefan Grundmann, *Consumer Law, Commercial Law, Private Law: How can the Sales Directive and the Sales Convention be so Similar?*, 2003 EUROPEAN BUSINESS LAW REVIEW 237, 252 (2003); Stefan Grundmann, *Verbraucherrecht, Unternehmensrecht, Privatrecht - warum sind sich UN-Kaufrecht und EU-Kaufrechts-Richtlinie so ähnlich?*, 202 ARCHIV FÜR DIE CIVILISTISCHE PRAXIS 40, 63-64 (2002); GRUNDMANN, *supra* note 38, at 273, 287.

[74] Pamaria Rekaiti/Roger J. Van den Bergh, *Cooling-Off Periods in the Consumer Laws of the EC Member States. A Comparative Law and Economics Approach*, 23 JOURNAL OF CONSUMER POLICY 371 (2000).

[75] SCHÄFER, *supra* note 61, at 567; VAN DEN BERGH, *supra* note 42, at 85, 86; MICHAEL BÜTTER, IMMOBILIEN-TIME-SHARING UND VERBRAUCHERSCHUTZ 73 (2000).

[76] HERBERT A. SIMON, MODELS OF MAN 5th print. 241 (1967); Thomas S. Ulen, *The Present and Future State of Law and Economics*, *in* 2 NEW DEVELOPMENTS IN LAW AND ECONOMICS, ERASMUS PROGRAMME IN LAW AND ECONOMICS 320 (Claus Ott/Hans-Bernd Schäfer eds., 1999); E. POSNER, *supra* note 26, at 33; GOMEZ, *supra* note 11, at 14.

[77] REKAITI/VAN DEN BERGH, *supra* note 74, at 375-378; GOMEZ, *supra* note 11, at 15.

Second, situational monopolies situations, due to particular circumstances, where consumers in a "lock-in" position are wrongly convinced that it will be more costly to seek alternative producers or suppliers for a product that is presented as being unique, for example in door-to-door or distant selling, may justify cooling-off periods.[78]

Finally, information asymmetries, which are especially likely to occur with *experience goods* or services, where quality can be evaluated only after contracting at the time of consumption,[79] or with *credence goods* or services, where the effects of use or consumption are only known years, if ever, after contracting or can be assessed only with highly technical help,[80] may lead, due to adverse selection,[81] to market failures, which can justify the withdrawal remedy, as the consumer gets extra time to acquire the relevant information.[82] These effects are less likely with *search goods* or services, where the consumer can recognize the quality on inspection prior to contracting.[83] Informational asymmetries are typical for distance transactions, where the consumer and the producer or supplier are physically separated, so that the consumer is by nature of the contract inadequately informed, even with *search goods*, as prior inspection is impossible.[84]

Cooling-off periods give producers or suppliers an incentive to set product or service prices corresponding to actual quality and not in excess of the full-information value and thereby induce sellers to reveal through the price mechanism information about the quality.[85]

Alternatively, the adverse effects that cooling-off periods may create have to be taken into account in a cost-benefit analysis.

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[78] REKAITI/VAN DEN BERGH, *supra* note 74, at 378-379.

[79] Philip Nelson, *Information and Consumer Behavior*, 78 JOURNAL OF POLITICAL ECONOMY 311, 312 (1970).

[80] Michael R. Darby/ Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 67-69 (1973).

[81] George. A. Akerlof, *The Market for Lemons: Qualitative Uncertainty and the Market Mechanism*, 84 QUARTERLY JOURNAL OF ECONOMICS 488 (1970).

[82] REKAITI/VAN DEN BERGH, *supra* note 74, at 379; VAN DEN BERGH, *supra* note 42, at 87.

[83] NELSON, *supra* note 79.

[84] REKAITI/VAN DEN BERGH, *supra* note 74, at 379-380; Michael Frings, *Das neue Verbraucherschutzrecht im BGB 2000*, 2002 VERBRAUCHER UND RECHT 390, 396 (2002).

[85] VAN DEN BERGH, *supra* note 42, at 87; REKAITI/VAN DEN BERGH, *supra* note 74, at 381.

First, there is the danger of moral hazard and *ex post* opportunism on part of the consumers that may be tempted to misuse their right by using the good or service and later withdrawing claiming bad quality.[86]

Second, delay and uncertainty increases the cost of the transaction, which is in effect completed only after expiration of the withdrawal right.[87]

Third, supply may be reduced and the spectrum of products or services offered may shrink due to the risk of the possible withdrawing and the compliance costs and suppliers could even leave the market.[88] Producers or suppliers could decide to wait for the cancellation right to expire, before they supply the product or service, if they are not allowed to waive the right of cancellation.[89]

Additionally, there might be cases where some consumers might not exercise their withdrawal right because they are not willing to admit to themselves that they made a mistake by signing the contract in the first place.[90]

Hence, in determining the optimal length of a cooling-off period, there has to be a trade-off made between allowing the consumer sufficient time to obtain and process all relevant information regarding the transaction, on the one hand, and, on the other hand, preventing transaction costs from rising in excess of the benefits achieved.[91] In the case in which the consumer is the cheapest information-cost provider and the cooling-off period is long enough to permit him or her to obtain all

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[86] REKAITI/VAN DEN BERGH, *supra* note 74, at 382; VAN DEN BERGH, *supra* note 42, at 87; Hans-Peter Schwintowski, *Contractual Rules Concerning the Marketing of Goods and Services – Requirements of Form and Content versus Private Autonomy*, *in* PARTY AUTONOMY AND THE ROLE OF INFORMATION IN THE INTERNAL MARKET 331, 346 (Stefan Grundmann/Wolfgang Kerber/Stephen Weatherill eds., 2001).

[87] REKAITI/VAN DEN BERGH, *supra* note 74, at 383.

[88] MARRINAN BAREFOOT & ASSOCIATES, INC./ANJAN V. THAKOR/JESS C. BELTZ, COMMON GROUND: INCREASING CONSUMER BENEFITS AND REDUCING REGULATORY COSTS IN BANKING 26 (1993); REKAITI/VAN DEN BERGH, *supra* note 74, at 384; VAN DEN BERGH, *supra* note 42, at 88, 94-95; George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE LAW JOURNAL 1521, 1522 (1987); BÜTTER, *supra* note 75, at 73.

[89] REKAITI/VAN DEN BERGH, *supra* note 74, at 384.

[90] Ian Ramsay, *Consumer Protection*, *in* I THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 410, 412 (Peter Newman ed., 1998).

[91] REKAITI/VAN DEN BERGH, *supra* note 74, at 385.

the relevant information, informational duties on part of the producers or suppliers may become superfluous.[92]

2. The E.C. Directives

The doorstep selling directive[93] and the distant selling directive[94] both grant a cancellation right within seven days. For *search good* characteristics, this period seems long as the quality can be inspected as soon as the good is in the hands of the consumer. However, for *experience good* and *credence good* qualities this is too less time for an evaluation. So, in this case, a cooling-off period could be rather justified with instable preferences[95] than as an efficient remedy to cure information asymmetries.[96] Though in distant selling cases the buyer has to pay for the transport of sending back the good, new costs for the seller arise by having to inspect and repack the rejected good again and also, in many cases, the good then has the value of a used item instead of a new one. It might be questionable if the benefits for the consumer still outweigh these substantial costs.[97]

The timesharing directive[98] allows for a 10 days withdrawal right. Timesharing contracts typical regard the use in a holiday resort in a foreign country in a specific period of the year. So, for a consumer to be able to judge the quality, he normally has to at least spend a holiday there, which usually will not be directly after signing the contract. Hence, time-sharing has typical *experience good* qualities[99] and a 10-day period seems too short. Alternatively, granting a substantially longer period involves the danger of moral hazard. Therefore, the supplier should obtain a rental payment right in case of cancellation.[100]

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[92] VAN DEN BERGH, *supra* note 42, at 87; REKAITI/VAN DEN BERGH, *supra* note 74, at 390.

[93] Article 5.

[94] Article 6.

[95] Michael Frings, *Das neue Verbraucherschutzrecht im BGB 2000*, 2002 VERBRAUCHER UND RECHT 390, 396.

[96] REKAITI/VAN DEN BERGH, *supra* note 74, at 386.

[97] SCHÄFER, *supra* note 61, at 567; Gralf-Peter Calliess, *Das Zivilrecht der Zivilgesellschaft*, *in* RECHTSVERFASSUNGSRECHT 20 (Christian Joerges/Gunther Teubner eds., forthcoming 2003).

[98] *Supra* note 23, art. 5.

[99] BÜTTER, *supra* note 75, at 71.

[100] REKAITI/VAN DEN BERGH, *supra* note 74, at 387-388; VAN DEN BERGH, *supra* note 42, at 87-88.

The cooling-off period in the second life insurance directive[101] (Art. 15) is 14 to 30 days. This does not seem to be an appropriate remedy for information asymmetries since the quality will only be revealed when the life insurance has to be used. It seems preferable to regulate the contents of insurance contracts by prohibiting certain clauses.

III. Substantive Quality Regulation: Standard-form Contracts

E.C. consumer law also intervenes in parties' autonomy of will by quality regulation prohibiting terms in standard-forms, which are most written contracts[102] in directive 93/13.[103]

Generally, substantive intervention can only be efficient when the regulator has complete knowledge of what completely informed parties would have stipulated, if the regulator has the incentive to legislate optimal rules (because he is not influenced by interest groups) and if consumers' preferences are sufficiently homogeneous to justify certain standardizations in quality regulation.[104]

Standard-form contracts can promote price competition by reducing product differentiation and reducing the transaction costs of negotiating and writing individual contracts (both among traders and between consumers and traders) and, hence, can increase efficiency.[105]

Regulation of standard-forms is often justified by claiming these contract terms were manifesting a monopoly situation and indicating unequal bargaining power that left consumers in a take-it-or-leave-it position.[106] The European Court of Justice (ECJ) holds the view that "…the consumer is in a weak position *vis-à-vis* the seller

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[101] Second EC Directive of the Council of 8 November 1990 for the approximation of the laws, regulations and administrative provisions 90/619, O.J. 1990 L 330/50 on life insurance contracts.

[102] ROBERT COUTER/THOMAS ULEN, LAW AND ECONOMICS 278 (3rd ed. 2000).

[103] EC Directive 93/13 on unfair terms in consumer contracts, O.J. 1993 L 95/29.

[104] EGER, *supra* note 50, at 327-328.

[105] COUTER/ULEN, *supra* note 52, at 279; VAN DEN BERGH, *supra* note 25, at 35; R. POSNER, *supra* note 72, at 102; Michael J. Trebilcock/Donald N. Dewees, *Judicial Control of Standard Form Contracts*, *in* THE ECONOMIC APPROACH TO LAW 93, 96 (Paul Burrows/Cento G. Veljanovski eds., 1981); TREBILCOCK, *supra* note 57, at 119.

[106] KEßLER, *supra* note 1, at 632, 640; WOLF, *supra* note 8, at 323.

or supplier, as regards both the bargaining power and his level of knowledge."[107] The monopoly power argumentation is not very convincing as standard-forms can also be found in quite competitive markets.[108] Besides, competition law is a more suitable remedy, if significant market-structure problems arise from collusions between firms offering a standardized set of contracts.[109] Additionally, it might be asked why monopolists should have an incentive to decrease quality instead of decreasing quantity and increasing prices.[110]

A better justification for the regulation of standard-forms might be found, again, in informational asymmetries.[111] Consumers have limited access to the relevant information, limited data processing capabilities and limited resources to fully recognize and consider all add-on clauses. Not only is the amount concerned in these standard-form clauses usually significant, but, also, an average consumer is generally not able to evaluate the full consequences of these terms without support of a lawyer.[112] A further problem besides understanding what a particular clause means is applying this information to the personal circumstances of the individual consumer.[113] This may have the consequence that the costs for a serious evaluation of the clauses are higher than the consumer's expected benefits from the contract. When calculating, if an analysis of the clauses is worthwhile, the consumer has to take into account that the clauses are to a great extent for events with a relatively small probability. As a continuously increasing effort to understand the clauses does not lead to a continuously increasing profit in understanding, consumers usually decide to spend no resources for an evaluation.[114] Consumers usually sign contracts including standard-forms without reading them, which is then rational igno-

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[107] Joined Cases C-240/98 to C-244/98 ECJ. *Océano Grupo Editorial SA v. Rocío Marciano Quinterno and others*.

[108] COUTER/ULEN, *supra* note 52, at 279; VAN DEN BERGH, *supra* note 25, at 34; TREBILCOCK, *supra* note 57, at 119.

[109] VAN DEN BERGH, *supra* note 25, at 35; GOMEZ, *supra* note 11, at 6, 8.

[110] Roger J. Van den Bergh, Standard Form Contracts, E.M.L.E. lecture slide 9.

[111] Argument first developed by W. David Slawson in his article *Standard Form Contracts and Democratic Control of Lawmaking Power*. W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARVARD LAW REVIEW 529, 530, 531, 544 (1975).

[112] MICHAEL ADAMS, ÖKONOMISCHE THEORIE DES RECHTS: KONZEPTE UND ANWENDUNGEN 123 (2002).

[113] VAN DEN BERGH, *supra* note 25, at 36.

[114] ADAMS, *supra* note 112, at 124; Hans-Bernd Schäfer, *Entwicklung und Begründung von Schutznormen im Vertragsrecht*, 2001 GERMAN WORKING PAPERS IN LAW AND ECONOMICS paper 21 13 (2001).

rance[115] and efficient behavior when transaction costs for studying and comparing different sets of clauses exceed the benefit of reducing the probability that a clause will cause a problem. Alternatively, a producer or supplier can make use of economies of scale by drafting a standard-form only once for use in innumerable transactions and, therefore, spread costs an infinite number of times.[116] As a result consumers generally do not shop around for more attractive offers of standard-form clauses. Due to the reticence of consumers to inspect standard-forms before contracting, these transactions have *experience good* qualities or even *credence good* qualities.[117] Competition does not guarantee anymore that consumers acquire the demanded quality of the good or service.[118] Due to adverse selection, only the worst standard-forms might maintain on the market.[119] Repetitive transactions could cure this market failure depending on to what extent and how fast new transactions are rejected by the same or other notified consumers.[120] If suppliers of bad quality goods suffer a sufficiently large decrease in demand in the next transaction period, they will have incentives to raise quality again in order to prevent the decrease of quantity exceeding their higher potential profit.[121]

In certain markets, consumers at the margin that shop around for better offers might protect the majority of consumers who fail to analyze standard-forms. Producers and suppliers may respond if a sufficient number of informed consumers makes clear that they do not accept certain clauses. The market failure will persist if the value of marginal consumers' transactions is less than the gain a producer or supplier can realize by exploiting infra-marginal consumers or if the producer or supplier can discriminate between marginal and infra-marginal consumers.[122] Also,

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[115] GOMEZ, *supra* note 11, at 16; VAN DEN BERGH, *supra* note 25, at 37.

[116] GRUNDMANN, *supra* note 73/2, at 62; GRUNDMANN, *supra* note 73/1, at 251; GRUNDMANN, *supra* note 38, at 275-276.

[117] VAN DEN BERGH, *supra* note 25, at 36.

[118] ADAMS, *supra* note 112, at 124-125.

[119] ADAMS, *supra* note 112, at 126; VAN DEN BERGH, *supra* note 25, at 35-36.

[120] Gerald R. Butters, *Equilibrium Distributions of Sales and Advertising Prices*, 44 REVIEW OF ECONOMIC STUDIES 465 (1977); Peter A. Diamond, *A Model of Price Adjustment*, 1977 JOURNAL OF ECONOMIC THEORY 165 (1977); Richard Schmalensee, *A Model of Advertising and Product Quality*, 86 JOURNAL OF POLITICAL ECONOMY 485 (1978); Carl Christian von Weizsäcker, *A Welfare Analysis of Barriers to Entry*, 1980 BELL JOURNAL OF ECONOMICS 399 (1980).

[121] ADAMS, *supra* note 112, at 127-128.

[122] VAN DEN BERGH, *supra* note 25, at 37-38; TREBILCOCK, *supra* note 57, at 120.

there can arise a collective choice problem can arise when all consumers try to free-ride on the monitoring of others.[123]

Two scenarios might be distinguished: either producers or suppliers are able to discriminate between consumers or not. If they cannot, and consumers have homogenous preferences, a critical number of marginal consumers may discipline the market,[124] which might be a figure of one-third.[125] If tastes are heterogeneous, marginal consumers have to be typical consumers.[126] If producers or suppliers are able to discriminate because they can recognize an uninformed consumer, which is especially the case where negotiations take place and high-price and infrequent transactions are made, the market failures won't be cured even with a majority of informed consumers.[127]

This scenario may justify substantive quality regulation intervention.[128] For markets that are reasonably functioning and without consumer discrimination, informational remedies like requirements of conspicuousness and of bold type seem sufficient. For markets where consumers are discriminated against and substantial market failures arise, inefficient clauses that informed marginal consumers would not accept should be prohibited, like, for example, a clause exempting liability for intentional losses, which would encourage opportunism and destructive conduct.[129] A black list could reduce uncertainty, would make it for markets possible for markets to adjust prices and still might leave room for learning processes.

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[123] TREBILCOCK, *supra* note 57, at 120; Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 Michigan Law Review, 215, 287 (1990).

[124] TREBILCOCK/DEWEES, *supra* note 105, at 108; VAN DEN BERGH, *supra* note 25, at 38.

[125] Alan Schwartz/Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979).

[126] VAN DEN BERGH, *supra* note 25, at 38; TREBILCOCK/DEWEES, *supra* note 105, at 108.

[127] TREBILCOCK/DEWEES, *supra* note 105, at 111; VAN DEN BERGH, *supra* note 25, at 38.

[128] VAN DEN BERGH, *supra* note 25, at 38-39; Gerrit De Geest, *The Signing-Without-Reading Problem: An Analysis of the European Directive on Unfair Contract Terms*, *in* KONSEQUENZEN WIRTSCHAFTSRECHTLICHER NORMEN, FESTSCHRIFT FÜR CLAUS OTT 213, 225 (Hans-Bernd Schäfer/Hans-Jürgen Lwowski eds., 2002); GRUNDMANN, *supra* note 38, at 276.

[129] VAN DEN BERGH, *supra* note 110; DE GEEST, *supra* note 128.

The list of clauses in the Annex of the E.C. directive is less clear-cut since it is not binding but only indicative and still the specific circumstances of the case have to be regarded.[130]

Besides, the directive also applies only to consumers (Art. 2 b), though for a professional it might be rational not to carefully examine all clauses as well and, therefore, informational market problems in transactions with another businessperson on the demand side might arise similarly.[131]

IV. Mandatory Legal Warranties

Finally, the E.C. legislator uses an obligatory legal guarantee as a device intended to protect consumers.

A warranty is a legally enforceable claim of a party against the producer, supplier, retailer or seller in case the subject of the transaction reveals itself defective, faulty or otherwise unsuitable for the agreed purpose.[132] It is a promise of one party to bear certain responsibilities if the quality or the performance of the item does not conform to the specifications and legitimate expectations of the other party.[133]

Economically, both legal and conventional (by parties agreed) guarantees have three main functions: 1. Risk spreading and insurance; 2. Information production, revealing and signaling; 3. Incentives for performance and risk reduction.[134]

1. Risk-spreading and Insurance

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[130] VAN DEN BERGH, *supra* note 25, at 39-40; DE GEEST, *supra* note 128.

[131] Gerrit De Geest, Law & Economics: Contracts, Bachelor Economics, Utrecht University, Block 3, 2002-2003, 26; DE GEEST, *supra* note 128, at 228-229.

[132] FERNANDO GOMEZ POMAR, DIRECTIVE 1998/44/EC ON CERTAIN ASPECTS OF THE SALE OF CONSUMER GOODS AND ASSOCIATED GUARANTEES: AN ECONOMIC PERSPECTIVE 3-4, (InDret 04/2001, 2001); JUERGEN NOLL, LEGAL WARRANTIES, ADVERSE SELECTION AND CONSUMER PROTECTION 1 (working paper, 2002); R. POSNER, *supra* note 51, at 83.

[133] FRANCESCO PARISI, THE HARMONIZATION OF LEGAL WARRANTIES IN EUROPEAN LAW: AN ECONOMIC ANALYSIS 8 (GEORGE MASON UNIVERSITY SCHOOL OF LAW, Law and Economic Working Paper Series 01-20, 2001).

[134] PARISI, *supra* note 133, at 8; NOLL, *supra* note 132, at 1; THOMAS EGER, EINIGE ÖKONOMISCHE ASPEKTE DER EUROPÄISCHEN VERBRAUCHSGÜTERKAUF-RICHTLINIE UND IHRE UMSETZUNG IN DEUTSCHES RECHT 8-18 (2002 GERMAN WORKING PAPERS IN LAW AND ECONOMICS, paper 6, 2002); GOMEZ, *supra* note 132, at 4-9.

A guarantee serves as a type of implicit insurance policy[135] conferring on the seller the position of an insurer since the non-conformity of the good is an uncertain and undesirable event. Suppliers with a sufficiently huge quantity of production can make use of the "law of the large number" since they are able to determine precisely enough the probability and the associated expected costs of product defects and can add this "insurance premium" to the production costs.[136] The buyer might wish to have insurance coverage against adverse eventualities, which could be provided by a warranty if it guarantees, for example, repair, replacement or money return under specified circumstances. In exchange, the price of the good will be proportionally higher because the promised measures are costly for the seller. The highest willingness to pay more for the product because of this extra service will have a risk-adverse buyer,[137] while a risk-lover will not be willing to pay for this additional feature.

If the risk of the good's inconformity is exogenous and information about the quality is symmetrical, the risk-spreading role is especially important. The optimal allocation of the risk in order to find the superior risk-bearer in terms of the optimal type of warranty depends then on the party's degree of risk aversion.[138]

A full warranty with complete coverage, so that the buyer is after compensation indifferent with or without the good's non-compliance, seems optimal if the buyer is risk-averse and the seller is risk-neutral. No guarantee at all makes sense if the seller is risk-averse and the buyer is risk-neutral. A partial warranty, so that each party has to bear a portion of the costs in case of an adverse eventuality, should be considered if both buyer and seller are risk-averse. Any guarantee coverage form zero to complete and any allocation of the risk is indifferently optimal since there are no incentives to reallocate when both parties are neutral to the risk.[139]

2. Information Production, Revealing and Signaling

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[135] Geoffrey Heal, *Guarantees and Risk Sharing*, 44 REVIEW OF ECONOMIC STUDIES 549 (1977); Thomas Wein, *Das neue Gewährleistungsrecht aus ökonomischer Sicht*, 2002 WIRTSCHAFTSWISSENSCHAFTLICHE STUDIEN 477 (2002); Thomas Wein, *Eine ökonomische Analyse der Verbrauchsgüterrichtlinie zum Gewährleistungsrecht*, 52 JAHRBUCH FÜR WIRTSCHAFTSWISSENSCHAFTEN 77, 80 (2001).

[136] WEIN, *supra* note 135/1, at 477-478; WEIN, *supra* note 135/2, at 80.

[137] Gomez, *supra* note 132, at 4.

[138] NOLL, *supra* note 132, at 2; PARISI, *supra* note 133, at 10-11.

[139] PARISI, *supra* note 133, at 11-12; GOMEZ, *supra* note 132, at 4.

A guarantee can also communicate, reveal and signal the quality of a good to the buyer.[140] The optimal type of warranty depends on the parties' previous access to this information.

A full warranty would be optimal if the seller possesses private information that is not available for the buyer. This can prevent adverse selection since it makes it possible for buyers to conclude from the type of warranty the quality of the product. The price of the guarantee will be at least equal to the costs of expected claims.[141]

No guarantee will be optimal if the buyer possesses private information, which is not available for the seller. In this case, high-loss and low-loss buyers cannot be distinguished by sellers and a discount will be preferred by low-loss buyers.[142]

A partial warranty is optimal in bilateral asymmetric information situations, where both parties possess private information that is not known by the other party. Low-defect-rate sellers will contract with buyers that are more sensitive and high-defect-rate sellers are going to make transactions with buyers with small individual losses.[143]

A guarantee does not signal quality information if there is no corresponding informational asymmetry between the contractual parties.[144]

3. Incentives for Performance and Risk-reduction

As far as the probability and magnitude of non-compliant goods depends on buyers' and sellers' behavior, guarantees, finally, may also provide incentives to produce and preserve quality for example, to avoid costs from potential claims by buyers.[145]

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[140] A. Michael Spence, *Consumer Misperceptions, Product Failure and Producer Liability*, 44 REVIEW OF ECONOMIC STUDIES 561 (1977); GROSSMAN, *supra* note 27; WEIN, *supra* note 135/1, at 478; WEIN, *supra* note 135/2, at 81.

[141] EGER, *supra* note 134, at 10-12; PARISI, *supra* note 133, at 12-14.

[142] PARISI, *supra* note 133, at 14-15; Roger J. Van den Bergh, Warranties, E.M.L.E. lecture slide 6.

[143] SPENCE, *supra* note 140, at 570; PARISI, *supra* note 133, at 15; Klaus Wehrt, Warranties, in Encyclopedia of Law and Economics vol. III 179, 184 (Boudewijn Bouckaert/Gerrit De Geest eds., 2000); NOLL, *supra* note 132, at 2.

[144] PARISI, *supra* note 133, at 10, table 1; VAN DEN BERGH, *supra* note 142, at 6.

[145] GOMEZ, *supra* note 132, at 6; NOLL, *supra* note 132, at 2; PRIEST, A THEORY OF CONSUMER PRODUCT WARRANTY 1309; PARISI, *supra* note 133, at 16.

The optimal type of warranty depends on the nature of the relevant risks. A full guarantee is appropriate when the risk of product failures is controllable by the seller as cheapest-risk-avoider. If, alternatively, the risk is in the hands of the buyer, who is in this case cheapest-risk-avoider, no warranty would be optimal since any form of warranty would lower the buyer's incentive to behave appropriately and carefully. If the risk depends on both parties' behavior, a partial guarantee might be one solution and, with exogenous risks that are not controllable by any party, warranties do not provide relevant incentives.[146]

4. The E.C. Directive

The E.C. imposed and regulated by directive 1999/44[147] a mandatory legal warranty for consumer sales fixing a general minimum guarantee duration of 2 years starting from the time of delivery (Art. 5).

This intervention would be justified, if, first, competitive market forces do not sufficiently induce producers and suppliers to offer an optimal level of warranties, and, secondly, buyers and sellers have not diverse preferences and cost functions that lead sellers to choose different levels of protection for the buyers.[148]

The maximization of the three conflicting economic functions that guarantees can serve usually requires different types of guarantees and a trade-off and optimal balancing - which in free markets usually results not in full guarantees but in a majority of partial warranties.[149]

Every imaginable degree of guarantee coverage is determined by three different variables: risk aversion, information access, and risk control. For example, the only scenario justifying a mandatory full guarantee is when at the same time the buyer is risk-averse, the seller has private information and controls the risk.[150]

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[146] VAN DEN BERGH, *supra* note 142, at 7; PARISI, *supra* note 133, at 16-18.

[147] EC Directive 99/44 of from 25 May 1999 on certain aspects of the sale of consumer goods and associated guarantees, O.J. 1999 L 171/12.

[148] WEIN, *supra* note 135/2, at 81; NOLL, *supra* note 132, at 6; PARISI, *supra* note 133, at 5-6.

[149] NOLL, *supra* note 132, at 3; PARISI, *supra* note 133, at 33, 36; GOMEZ, *supra* note 132, at 19-20; WEIN, *supra* note 135/2, at 81.

[150] PARISI, *supra* note 133, at 10, table 1.

The fact that the application of the directive is mandatory makes the rule inflexible. For example in the case that both parties have full information about the risk it would be more efficient, from an economic point of view, to agree mutually and adjust the guarantee in order to be able to fix a lower price and to spread the risk efficiently. This is also true for cases where the buyer knows the risk much better than the seller, for example, where he had the good in his possession as a lessor before.[151] Hence, the buyer has to buy mandatory insurance coverage for two years, which leads to moral hazard problems, as he or she has fewer incentives to invest in maintenance and servicing of the product, which, in turn, will raise overall costs for society.[152]

If consumers would tend to steadily underestimate the risk of product defects,[153] one could argue that they, therefore, would request less guarantee protection than socially optimal. Alternatively, a regulator generally faces the same misperception problems as an individual. It seems that at least a single and homogenous legally obligatory guarantee will hardly be pareto-optimal for the infinite diversity of goods, risks of failures and different kind of consumers that fall under the rule of the E.C. directive. The quantity of knowledge that would need to be acquired and processed by a legislator who wanted to form a sufficiently diversified mandatory regulation would be immense and seems not feasible.[154] A waivable default-rule, as mostly the outcome of the market forces, seems to be more suitable to foster efficiency and to lower transaction costs than an obligatory regime that leaves no autonomy to the parties to meet their individual interests with the selection of an individual guarantee device.[155]

In consequence, the directive does not protect all costumers' preferences to the same extent. The directive harms a certain amount of market actors since they get *too much protection*. The sector of low-priced goods will be cut-off and the price level will rise as the directive promotes incentives to the outstanding producers to provide more reliable products. Since certain transactions in the low-price segment do

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[151] VAN DEN BERGH, *supra* note 142, at 10; MARTINEK, *supra* note 13, at 537,547.

[152] SCHÄFER, *supra* note 61, at 565; WEIN, *supra* note 135/2, at 80.

[153] Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STANFORD LAW REVIEW 211 (1995); Challenged by Alan Schwartz and Louis L. Wilde in *Imperfect Information in the Markets for Contract Terms: The Examples of Warranties and Security Interests.* Alan Schwartz/Louis L. Wilde, *Imperfect Information in the Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VIRGINIA LAW REVIEW 1387 (1983).

[154] GOMEZ, *supra* note 132, at 19.

[155] PARISI, *supra* note 133 , at 34.

not occur anymore - for example, the professional market for used cars older than five years old vanished;[156] this results in a deadweight loss for society. [157]

Additionally, there is a reduction of informational value, as setting an obligatory minimum time-period that makes it now infeasible for buyers to differentiate between suppliers in the lower-quality category, which terminates the signaling function in respect to these products.[158] At the same time, sellers cannot distinguish anymore – since they cannot make different insurance offers (under 2 years) anymore - between buyers who use the product intensively with a high-risk probability and buyers who produce a lower risk and therefore are less willing to pay for insurance (and to co-finance the high-risks now as well).[159] So, there are *too few protections* as well, since the directive does not improve informational flows of the market, but obstructs (all three of) its natural functions and, furthermore, because the scope of application restricted to natural but not legal persons is too narrow, as the protection-justifications risk-spreading, quality-signaling and risk-reduction apply to them in the same way.[160]

Finally, adverse distributional effects can be expected by the directive as the costs of the mandatory guarantee regime are passed on to the buyers, who have to pay more for their products. Additionally, intensive and regular product-users benefit more than others.[161]

Summarized, the ratio of costs and benefits of products tends to not correspond to consumer preferences anymore, due to the E.C. warranty rule.[162]

V. Legal Paternalism

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[156] Gerhard Wagner, *The Economics of Harmonization: The Case of Contract Law*, 39 COMMON MKT. L. REV. 995, 1020 (2003).

[157] NOLL, *supra* note 132, at 8; MARTINEK, *supra* note 13, at 537; SCHÄFER, *supra* note 61, at 565; WAGNER, *supra* note 156.

[158] NOLL, *supra* note 132, at 6, 8.

[159] SCHÄFER, *supra* note 61, at 565.

[160] PARISI, *supra* note 131, at 19; SCHÄFER, *supra* note 61, at 566.

[161] MARTINEK, *supra* note 13, at 537; SCHÄFER, *supra* note 61, at 565.

[162] SCHÄFER, *supra* note 61, at 565.

Eventually, the E.C. legislator uses paternalistic rules in order to protect consumers. Interventions are paternalistic that try to influence individuals' preferences and decisions in order to bring benefits to them.[163] It is argued that market actors' present interests might not always match with their own best long-term preferences.[164]

A first reason for this phenomenon could be cognitive incapacity that results in individuals lacking the ability to build constant or reasoned preference formations so that their willpowers are shapeless or even paralyzed. However, it is obviously difficult to determine which level of irresponsibility or cerebral lack of ability is sufficient to justify intervention. The need to define specific legal categories always bears the danger that they are both over- and under-inclusive as certain individuals will always be more (or less) sophisticated and mature than others.[165]

A second ground for intervention might occur when consumers' choices do not reflect underlying preferences in cases where the individual has a constant and reasoned formation of preferences, but choices that are made in specific situations are incoherent with the individuals preference scheme, for example, due to oppression or informational failures.[166]

It seems questionable if a legislator is really able to respond to the broadly varying risk-benefit preferences of consumers.[167] Furthermore, just as consumers' revealed preferences may not promote their well-being and consumers repeatedly make cognitive errors, regulators are subject to similar mistakes and problems might even be augmented by social influences and interest-group pressure.[168]

However, generally paternalistic rules may be justified in certain situations if they raise social welfare.[169]

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[163] Paul Burrows, *Analyzing Legal Paternalism*, 15 INTERNATIONAL REVIEW OF LAW AND ECONOMICS 459, 495 (1995); VAN DEN BERGH, *supra* note 42, at 95; GOMEZ, *supra* note 11, at 11.

[164] HADFIELD/HOWSE/TREBILCOCK *supra* note 10, at 16; BURROWS, *supra* note 163; GOMEZ, *supra* note 11, at 11; TREBILCOCK, *supra* note 57, at 147.

[165] TREBILCOCK, *supra* note 57, at 150.

[166] TREBILCOCK, *supra* note 57, at 151, 152.

[167] HADFIELD/HOWSE/TREBILCOCK, *supra* note 10, at 17.

[168] Cass R. Sunstein, *Behavioral Law and Economics: A Progress Report*, 1 AMERICAN LAW AND ECONOMICS REVIEW 115, 146 (1999); W. Kip Viscusi, FATAL TRADEOFFS 149 (1992).

[169] GOMEZ, *supra* note 11, at 11.

Door-to-door transactions could be an example for a specific situation where consumers' choices might sometimes be inconsistent with their usual (long-term) preference-structure and therefore may justify E.C. legislative intervention in form of a withdrawal right.[170]

Alternatively, banning smoking advertisements[171] seems not to always promote social welfare, since it reduces costs for producers and makes lower prices possible, which can lead to higher consumption than before due to the fact that the demand reacts in a rather inelastic manner to changes in the quantity of advertisement but in a quite elastic manner to changes in prices.[172]

C. The Distribution of Effects of Consumer Law

Finally, it should be examined to what extent inefficient consumer protection rules can be explained by distributional considerations. There is criticism that specific interests of certain groups were implemented into E.C. consumer law, for example, granting special privileges for public enterprises.[173]

First, it seems that information that has to be revealed due to consumer protection rules by producers or suppliers is used less by consumers with lower incomes. Empirical studies show that information provided in connection with consumer credit is less understood and processed by "poor" consumers.[174] Other studies reveal that product labels are regarded by consumers with higher than with low incomes.[175]

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[170] TREBILCOCK, *supra* note 57 , at 151.

[171] E.g. Article. 13 of EC Directive 89/552 of 3 October 1989 on the coordination of certain provisions laid down by Law, Regulation or Administrative Action in Member States concerning the pursuit of television broadcasting activities, O.J. 1989 L 298/23, amended by EC Directive 97/36 of 30 June 1997 amending EC Directive 89/552 on the coordination of certain provisions laid down by law, regulation or administrative action in Member States concerning the pursuit of television broadcasting activities, O.J. 1997 L 202/60.

[172] Lynne Schneider/Benjamin Klein/Kevin M. Murphy, *Governmental Regulation of Cigarette Health Information*, 24 J.L. & ECON. 575 (1981); VAN DEN BERGH, *supra* note 42, at 96.

[173] Hans-W. Micklitz, *Zur Notwendigkeit eines neuen Konzepts für die Fortentwicklung des Verbraucherrechts in der EU*, *in* 2003 VERBRAUCHER UND RECHT 2, 7 (2003).

[174] Frank J. Angell, *Some Effects of the Truth-in-Lending Legislation*, 44 JOURNAL OF BUSINESS 78 (1971); OGUS, REGULATION. LEGAL FORM AND ECONOMIC THEORY 129 (1994); VAN DEN BERGH, *supra* note 42, at 97-98.

[175] Robert J. Gage, *The Discriminating Use of Information Disclosure Rules and the Federal Trade Commission*, 26 UCLA LAW REVIEW 1037, 1052 (1979); WESLEY A. MAGAT/W. KIP VISCUSI, INFORMATIONAL APPROACHES TO REGULATION 121-123, 157 (1992); VAN DEN BERGH, *supra* note 42, at 98.

Similar results have been shown in the secondhand car market.[176] Complex and onerous revelation duties provide for the well-educated consumer little information that this kind of consumer is not already familiar with and offers for simpler consumers little information that this type of consumer is able or willing to utilize and are, hence, promoting middle-class than lower-class consumers.[177]

As a consequence, consumers with lower incomes may subsidize consumers with higher incomes. E.C. consumer policy might seem, generally, to be addressed to better earning consumers, as the travel package[178] and time-sharing[179] directive concern at least not the consumers who cannot effort to travel in their holidays.[180] The E.C. regime, which is supposed to protect weak, inferior consumers, instead benefits the more informed and more responsible consumers.[181]

Second, reversals of burden of proof to the detriment of producers, like in the E.C. directive concerning misleading advertising (Art. 6) or in the consumer sales directive (Art. 5, Section 3) may constitute a market barrier for new companies since costs for proving are fixed costs, which are lower per unit for big companies than for smaller ones.[182]

But, even more general, regarding any kind of measures suppliers are obliged to take by consumer law that produce additional costs and risks, big companies can spread them over huge turnovers and can make use of the "law of the big number," while small and medium-sized enterprises (SMEs) usually are not able to self-

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[176] Kenneth McNeil/John R. Nevin/David M. Trubek/Richard E. Miller, *Market Discrimination Against the Poor and the Impact of Consumer Disclosure Laws: The Used Car Industry*, 13 LAW & SOCIETY REVIEW 695 (1979); DENNIS W. CARLTON/JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 624 (1994); VAN DEN BERGH, *supra* note 42, at 98.

[177] Hanno Merkt, *Disclosure Rules as a Primary Tool for Fostering Party Autonomy*, *in* PARTY AUTONOMY AND THE ROLE OF INFORMATION IN THE INTERNAL MARKET 230, 232 (Stefan Grundmann/Wolfgang Kerber/Stephen Weatherill eds., 2001); Robert L. Jordan/William D. Warren, *A Proposed Uniform Code for Consumer Credit*, 8 BOSTON COLLEGE INDUSTRIAL AND COMMERCIAL LAW REVIEW 441, 449 (1967).

[178] *Supra* note 22.

[179] *Supra* note 23.

[180] VAN DEN BERGH, *supra* note 42, at 98.

[181] MICKLITZ, *supra* note 173, at 11.

[182] Yale Brozen, *Are New FTC Policies Inhibiting Competition?*, 2 JOURNAL OF ADVERTISING 28 (1973); VAN DEN BERGH, *supra* note 42, at 99.

insure these risks and often third-party-market-insurance is not obtainable at reasonable cost.[183]

As a consequence, E.C. consumer law seems to be one-sided. On the supplier side it favors huge groups – though it is widely "justified" with the danger of too large enterprises – with high turnovers and their own legal departments, while, for SMEs, it constitutes barriers to entering markets. On the demand side, the "high" level of consumer protection mainly seems to serve interests of a risk-averse middle-class, while consumers with incomes below average may be driven out of certain markets by too high prices when they cannot afford full comprehensive insurances (designed for "richer" consumers) for their products and services.[184]

Besides, E.C. consumer law may also disfavor consumers from small E.C. member states. Article 5 of the Rome Convention,[185] stating that, generally, in cross-border business-to-consumer ("B2C") transactions, the law of the state of the (passive) consumer's regular residence is applicable ("buyer-based jurisdiction" or "country of destination" approach), may have the adverse effect that Europe-wide-selling producers and suppliers may tend to hesitate to serve very small countries with low business volume when transaction costs to comply with that regime are relatively too high.[186] Otherwise, by the consumer-state-principle, again, large companies are favored, which can afford to pay lawyers familiar with the relevant regimes, again, creating barriers to market entry for SMEs.

So, it seems that E.C. consumer law has not only on the consumer side, but also on the supplier side, more beneficial effects on richer and stronger market-actors and more adverse effects on poorer and weaker parties.[187]

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[183] CALLIESS, *supra* note 97, at 21; Gralf-Peter Calliess, *Coherence and Consistency in European Consumer Contract Law: a Progress Report*, 4 GERMAN LAW JOURNAL 333, 337 (2003).

[184] CALLIESS, *supra* note 97, at 21; Gralf-Peter Calliess, *Nach der Schuldrechtsreform: Perspektiven des deutschen, europäischen und internationalen Verbrauchervertragsrechts* 10-11, recently published *in* 203 ARCHIV FÜR DIE CIVILISTISCHE PRAXIS.

[185] Rome Convention.

[186] CALLIESS, *supra* note 184, at 15-16; CALLIESS, *supra* note 97, at 25; CALLIESS, *supra* note 183, at 337-338.

[187] VAN DEN BERGH, *supra* note 42, at 98.