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Contracts as Commodities: The Influence of Secondary Purchasers on the Form of Contracts

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Contracts as Commodities: The Influence of Secondary Purchasers on the Form of Contracts

Henry T. Greeley*

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I. INTRODUCTION

In 1970 Professor Arthur Leff brought a new vision to a half century of debate about standard form contracts¹ by pointing out that con-

* Associate Professor of Law, Stanford Law School. I would like to thank Robert C. Ellickson, Lawrence M. Friedman, Paul Goldstein, Mark G. Kelman, A. Mitchell Polinsky, and Howard Williams for useful comments on drafts of this Article. I would also like to acknowledge the continuing influence of my Contracts professor, the late Arthur Leff, an extraordinary teacher and scholar. Thomas Haensly provided valuable help as my research assistant. This research was supported by a bequest from the Claire and Michael Brown Estate.

1. Of the works written before 1970 dealing with contracts of adhesion, perhaps the most important are Isaacs, *The Standardizing of Contracts*, 27 YALE L.J. 34 (1917); Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943); Llewel-

sumer contracts should be seen not primarily as "contracts," but as "things," intangible products, sold to the consumer.² As "things," Leff argued, form contracts should be subject to the same kinds of warranty laws as tangible goods. The debate about form contracts in consumer transactions continues, but, as Leff predicted, the debate largely has ignored his insight concerning the nature of the pieces of paper involved.³

In the midst of this debate, there has been little analysis in the legal literature, and none in the economics literature, of why standard form contracts are used. Most authors merely revisit the reasons listed by Karl Llewellyn in 1939:

Nothing can approach in speed and sanity of readaptation the machinery of standard forms of a trade and for a line of trade, built to meet the particular needs of that trade. They save trouble in bargaining. They save time in bargaining. They infinitely simplify the task of internal administration of a business unit, of keeping tabs on transactions, of knowing where one is at, of arranging orderly expectation, orderly fulfillment, orderly planning. They ease administration by concentrating the need for discretion and decision in such personnel as can be trusted to be discreet. This reduces human wear and tear, it cheapens administration, it serves the ultimate consumer. Standardizing contracts is in this a counterpart of standardizing goods and production processes, as well as a device for adjustment of law to need.⁴

Combined, Leff's insight and Llewellyn's analysis point to another

lyn, *What Price Contract?—An Essay in Perspective*, 40 YALE L.J. 704 (1931); and Llewellyn, *Book Review*, 52 HARV. L. REV. 700 (1939).

2. Leff, *Contract as Thing*, 19 AM. U.L. REV. 131 (1970).

3. About the same time as Leff, Professor David Slawson came to a similar conclusion, although without making the semantic jump that marks Leff's work. Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529 (1971). Examples of the more recent work concerning contracts of adhesion include two additional Slawson articles—Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1 (1974), and Slawson, *The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms*, 46 U. PITT. L. REV. 21 (1984). For an economics perspective on adhesion contracts, see Kornhauser, *Unconscionability in Standard Forms*, 64 CALIF. L. REV. 1151 (1976); Schwartz & Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983) [hereinafter Schwartz & Wilde, *Imperfect Information*]; Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979) [hereinafter Schwartz & Wilde, *Intervening in Markets*]; and Trebilcock & Dewees, *Judicial Control of Standard Form Contracts*, in *THE ECONOMIC APPROACH TO LAW* (P. Burrows & C. Valjanovski ed. 1981). For a critical legal studies perspective, see Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173 (1983). Professors Charles Goetz and Robert Scott in their article Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261 (1985), make a fascinating general argument about the role of the state in providing standard implicit terms to contracts.

4. Llewellyn, *Book Review*, *supra* note 1, at 701; see also RESTATEMENT (SECOND) OF CONTRACTS § 211 comment a (1979). The only addition to Llewellyn's list that I have seen is one author's suggestion that form contracts are used to maintain status and income differentials in the selling organization. Rakoff, *supra* note 3, at 1223-24.

pressure for standardization in some kinds of products. Leff's contractual "things" implicated continuing rights and duties for both sides. Leff dealt with "things" retailers sold to consumers, but in some industries either party to the initial sale may resell some of its rights and duties to third parties. For example, a lender first "sells" a mortgage to a home owner and then sells its interest in the mortgage to another financial institution. When secondary sales are common, the forms are, for many purposes, more akin to frozen pork bellies than to what lawyers consider contracts.⁵ They are contracts as commodities.

This Article addresses the effects of secondary purchasers⁶ on the standardization of form contracts. I became interested in this topic while teaching about oil and gas leases in one class and about residential mortgages in two others. I concluded that secondary purchasers should encourage retailers to standardize their forms across an industry. To my surprise, I discovered that no writers on form contracts had explored or mentioned the effect, or, in fact, acknowledged the existence of secondary purchasers. I also discovered a more complicated pattern of form standardization than I had expected. This Article explores those complications in order to explain how contracts are used in the "real world."

The Article first describes both the theoretical and empirical effects of secondary purchasers on form contracts. It then discusses the process of standardization, both for tangible products and for several examples of contractual commodities. After examining several factors that help explain when and why form contracts are standardized, the Article considers changes in policy that might follow from the analysis.

II. SECONDARY PURCHASERS AND THE PRESSURE TO STANDARDIZE

This section first creates a simple model of the decisions by consumers and secondary purchasers to buy a contract commodity. It then shows how the existence of secondary purchasers additionally presses retailers to standardize the contracts they use in their business, first

5. By the term "contracts," I include documents, such as leases, mortgages, and securities, that the law does not necessarily categorize as contracts. Earlier writers focused largely on consumer purchases and, as a result, necessarily did not discuss these other form documents. I do not believe that the analysis of such forms in this context is affected by their use to convey property instead of promises.

6. I refer to secondary purchases and secondary purchasers rather than secondary markets because traditional "markets" are not present in all of these contexts. While true secondary markets exist for corporate securities and residential mortgages, some of the contracts discussed in this Article, such as oil and gas leases, are traded less formally. The incentive toward standardization that this Article sets forth depends not on the existence of an organized, face to face competitive market, but instead on the expectation that contracts may well be resold to secondary purchasers, through a formal "market" or otherwise.

within a single firm and then between all firms in an industry.⁷

A. *Deciding to Buy: A Model for Consumers and Secondary Purchasers*

Assume that those who "buy" goods, whether tangible goods or contracts such as a home mortgage, consider the following three factors in determining the cost of an offered contract: Information costs; price; and administration costs. These costs exist whether the buyer is the consumer or a secondary purchaser. In the case of the home mortgage, for example, the home owner "buys" the mortgage from a lender, who in turn sells its interest in the mortgage to a secondary purchaser.

The buyer's information costs include search costs in finding the contractual product and costs incurred by taking the time to read, understand, and compare the contract to competing alternatives. In some cases, these costs might be trivial; while in others, they could include substantial expenses such as lawyers' fees. The price is the net present value of the buyer's outlays to acquire the contract. The buyer's administration costs are the net present value of the time and money the buyer expects to spend dealing with the contract in the future, both in the contract's normal operation and in its operation when things go wrong, with an adjustment for the probabilities that various problems might occur. For the consumer purchasing a home mortgage, normal administration costs include the time, stamps, and checking account fees incurred in making monthly mortgage payments. The costs of dealing with problems such as erroneous notices of default are termed abnormal administration costs in this Article. For a secondary purchaser of mortgages, normal costs include the accounting time and effort in sorting, recording, and depositing mortgage checks, while foreclosure expenses are an example of abnormal administration costs.⁸

A buyer following this simple model will purchase a tangible good or a contractual good when the difference between the good's expected value and cost, including all three components, is both positive and

7. There are two sets of buyers and sellers in these transactions: a business enters into a transaction with a consumer that involves a contract, and the business then sells the contract to a secondary purchaser. The buyers and sellers can become confusing, so for the purposes of this Article I refer to the three sets of parties as consumers, retailers, and secondary purchasers, even though the parties may not fit into the customary meanings of those terms.

8. The relative importance of these three costs to contract commodities probably is not inherently different from their importance on average to more tangible goods. Although the information costs and administration costs of buying a loaf of bread are usually infinitesimal, other tangible products, such as automobiles, have significant information and administration costs. Contract commodities, however, almost always entail some information and administration costs. Such contracts set up a continuing relationship that requires administration and, usually, education of the purchaser to the terms and conditions of the contract.

greater than the expected net value of other uses of that time and money. Thus, a seller of these products may employ several strategies to make its product more attractive to purchasers. It could increase the product's expected usefulness, lower the product's price, or lower the buyer's information or administration costs. Standardizing form contracts can implement the last strategy.

Limited by two additional assumptions, this simple model of purchasing decisions demonstrates why the retailer's strategy of reducing information and administration costs is more effective with secondary purchasers of contracts than with consumers. First, the secondary purchasers generally purchase many of these contracts, while consumers purchase few—at most, one every few years. Thus, lenders expect to sell home mortgages not to small individual investors, but to major financial institutions, which buy thousands or even millions of mortgages. Second, secondary purchasers are more concerned than consumers with the “fine print” of a contract, provisions that do not bear substantially on the price or other terms of the transactions. The strongest justification for this assumption is that the fine print enumerates relatively low probability events. An individual homeowner may not worry substantially about a provision that governs the effect of an improbable event on her mortgage, regardless of the magnitude of the possible loss. A secondary purchaser with a large portfolio of contracts faces a larger probability that a fine print provision will affect some of those contracts.⁹

9. This argument is that a rational consumer would not care about the fine print; but it is not an argument based on risk aversion. While an individual homeowner might be expected to be more risk averse than an institutional investor in mortgages, even with a risk aversion premium, the low probability of an occurrence keeps a consumer from shopping for fine print. Similarly, an institutional investor who invests in mortgages still cares about the fine print because the negative effect of the fine print is not a random event that the investor could diversify to avoid. On the contrary, unlike the specific risks on an individual stock, an investor can completely prevent the occurrence of some fine print losses by examining the fine print before purchasing.

As an alternative explanation for consumer indifference to fine print, one might argue that consumers are irrationally ignorant of and unconcerned about fine print. This proposition may well be true of most consumers, who neither understand all the clauses of a mortgage nor consider hiring an attorney to explain them. That argument would break down if some significant number of consumers did care about the fine print. As Professors Alan Schwartz and Louis Wilde have shown, a small minority of careful shoppers may drive a market to an appropriate outcome. *See generally* Schwartz & Wilde, *Imperfect Information*, *supra* note 3. Thus, if some careful shoppers exist and a retailer appeals to those careful shoppers by standardizing its fine print, then markets should work to standardize form contracts even without secondary purchasers. The low probability of a clause coming into effect undercuts this point, because even careful individual shoppers, quite rationally, are not concerned about some of the fine print.

B. Standardization of a Single Retailer's Contracts

Contract standardization within a firm is encouraged when the firm sells the contracts to a secondary purchaser rather than holding them. Take the example of a lender that sells its mortgages to a secondary purchaser. The secondary purchaser saves both information costs and administration costs when all the mortgages from the lender have one form.

The purchaser reduces information costs because it does not have to dicker over a slightly different price for each different form, it does not have to examine each individual mortgage to discover whether the terms are legal or prudent, and it does not need to involve its own hierarchy in either effort. In this respect, a standardized form has the same information-cost reducing function as a seller's good reputation.

In theory, a secondary purchaser has a strong incentive to purchase only a standardized form mortgage even if it purchases only two of them. If the purchaser buys only standardized mortgages, then the additional or marginal cost to read and understand the form is zero after the first purchase. These costs might be so small as to be invisible in the purchase of any one mortgage, but when secondary purchasers buy hundreds, thousands, or tens of thousands of contracts, the information cost savings from standardization can be enormous and very visible.

Similarly, the secondary purchaser's administration costs are lower if the lender's mortgage forms are internally standardized. Contract administration costs arise when the secondary purchaser has to deal with the borrower in, for example, a collection dispute.¹⁰ Dealing with a borrower is much simpler and therefore much cheaper if the servicer of the mortgage knows the terms of each mortgage without reading the fine print. For example, a secondary purchaser's employee could make accurate statements over the telephone to a borrower about the mortgage without having to locate, retrieve, and read that particular borrower's mortgage.¹¹

An individual borrower, by contrast, derives no direct advantages in her mortgage "purchasing" decision from a lender's internal standardization. First, although a borrower might benefit by not having to

10. The retailer in some secondary purchaser situations retains these administrative functions even after selling the contract. For example, a savings and loan or other institution that sells a mortgage often remains the servicing agent for the purchaser of the mortgage. Pressure from the secondary purchaser does not necessarily operate as a force for standardization in those situations, although, of course, contract administration is then cheaper and a direct benefit for the retailer with standardized contracts.

11. Similarly, if, as Rakoff postulates, the retailer is motivated to use form contracts by considerations of intrafirm status and hierarchy, the secondary purchaser may well find standardized forms useful for those purposes. *See generally* Rakoff, *supra* note 3.

compare different forms offered by one lender, the model set forth above assumes that the borrower, quite rationally, does not read or care about the fine print. Standardizing the fine print, therefore, does not reduce her information costs.¹² To the extent that a borrower reads the mortgage after the purchase and thus incurs administration costs, standardization again fails to lower her costs. The borrower buys only one contract whether or not the lender uses only one mortgage form and, in the normal or abnormal administration of their relationship, the borrower deals with one and only one form. Of course, to the extent that the use of a standardized form lowers the lender's costs or increases the resale value of the mortgage to the lender, some of those gains may be passed on to the borrower through a lower price, depending on the structure of the market involved. The borrower, however, does not realize the savings directly.

Because the secondary purchaser's information and administration costs are lower if a lender uses one standard form for all its mortgages, that lender gains a competitive edge and may be able to get a higher price from the secondary purchaser than the lender who offers a package of varying mortgages. The lender gains no similar advantages at the borrower's level because standardization does not make the mortgage more valuable to the borrower. Therefore, lenders who resell their mortgages have greater incentives to standardize their forms than lenders who hold their mortgages.

Secondary purchasers do not constitute an irresistible force. The savings to be gained from standardizing only lower the information costs of a secondary purchaser of mortgages; standardization does not eliminate them. For example, the secondary purchaser still may need to determine whether intrinsic fraud might render the mortgage unenforceable even in the hands of a bona fide purchaser for value, whether the real estate securing the mortgage has the stated value, whether the borrowers are creditworthy, or, for that matter, whether the borrowers or the security even exist.¹³

12. If an unusually acute consumer cares about the fine print in the mortgage, in contrast to the assumption made above, *see supra* note 9, she still may not save information costs as a result of intrafirm standardization. The concerned consumer's information costs remain unchanged if the firm would have offered her one and only one mortgage form, but not necessarily the same contract offered to all other borrowers. She has to read and evaluate only one form in either case. A lender's internal standardization would reduce the information costs of this atypical informed borrower only if the lender otherwise would offer her a choice of forms.

13. Standardization, in another sense, could reduce the costs of purchasing mortgages from a credible lender. A secondary purchaser of mortgages might be willing to rely on a lender's representations that each of the borrowers met certain previously accepted credit standards or that the real estate had been appraised by previously agreed upon appraisal standards. The secondary purchaser then could avoid examining the creditworthiness of each borrower or the value of each parcel of real estate securing the mortgage. That kind of "process" standardization can be con-

Standardization may also have costs. "Nonstandard" situations may demand nonstandardized contracts. According to the argument Professors Goetz and Scott have called the "Expanded Choice postulate," however, if the value gained in a transaction by a "custom tailored" contract exceeded the value gained from standardization, a firm would not standardize in the first place and there would be no costs.¹⁴

Finally, the needs of secondary purchasers are not the only reasons for standardization. As Llewellyn noted,¹⁵ there are a host of good reasons for a firm to standardize its contracts. The existence of secondary purchasers for those contracts just adds one more reason.

Whether the existence of secondary purchasers pushes a company to standardize its forms depends on the individual circumstances. It seems clear, though, that the existence of secondary purchasers is a force encouraging standardization. The size of the effect may vary, but its direction is constant. Thus, in markets with secondary purchasers, retailers should ensure that their contract form is acceptable not only to themselves and their consumers, but also to secondary purchasers.¹⁶

C. *Standardization of Contracts Within an Industry*

Secondary purchasers encourage industry-wide standardization as well as standardization within a single firm. A secondary purchaser who

tained as a term of the contract between the lender and the secondary purchaser. The inclusion of this term represents a form of standardizing the sold commodity, although it is not a part of what lawyers call the standard form contract between the lender and the borrower. Government entities can enforce such standardization, as they have at least partially in residential mortgage markets. Federal regulators or insurers of banks and thrifts require those institutions to follow written credit policies and to obtain appraisals on specified forms before extending residential loans. The regulators have done so out of concern for the safety of bank and thrift loans, not for the information costs of secondary purchasers. Nevertheless, those costs should have been reduced as a result of these requirements.

14. Goetz & Scott, *supra* note 3, at 262. The "Expanded Choice postulate" urges that the existence of a voluntary standard form contract imposes no costs because the parties for whom the standard form is not optimal will contract around it. Professors Goetz and Scott criticize this argument in the context of government imposition of standard implied terms through, for example, the *Uniform Commercial Code*, stressing the barriers to nonstandard forms from judicial interpretation and coordination costs. The application of these criticisms, and others, to industry-developed standard contracts is discussed *infra* text accompanying notes 91-95.

Nonstandard forms also may provide the retailer with another advantage. A consumer's preference between several contract forms may give the retailer some valuable information about that consumer. For example, if a borrower chose a mortgage that put at risk the proverbial "pound of flesh," the lender learns something valuable about the borrower's view of the probability of default.

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

16. This fact has at least one important consequence: increased oversight of the form. The secondary purchaser will want to make sure that it will be legally able (or, as a matter of public relations or policy, willing) to enforce the important terms of the contracts. This additional level of legal and prudential oversight of the transaction should discourage gross errors of judgment or legal analysis.

buys contracts from a number of retailers within an industry prefers not only that each retailer use one preapproved form for its sales, but also that all retailers from which it plans to buy contracts use the same preapproved form. Just as uniformity of one retailer's forms reduces a secondary purchaser's information and administration costs in transactions with that retailer, so does uniformity throughout the industry decrease the secondary purchaser's costs by lowering both its information costs in shopping among retailers and its administration costs. And just as consumers have no direct cost savings from one firm's decision to standardize its form contracts, they also have no direct gains from industry-wide standardization.¹⁷ The analysis for industry-wide standardization is the same as it is for firm-wide standardization.

The cost savings to the secondary purchaser should push retailers toward industry-wide standardization. Those savings ultimately may accrue to consumers, retailers, secondary purchasers, or some combination thereof, depending on how competitive the secondary purchaser-retailer and retailer-consumer markets are, but the savings should drive retailers to standardize regardless of who eventually benefits. Either retailers capture the savings themselves through higher prices from secondary purchasers, or those savings allow them to compete effectively for secondary purchasers or consumers.

As in the single retailer example, there are costs to industry-wide standardization. Some firms may face markets for which the industry-wide standard form is not appropriate either for consumers or for secondary purchasers. For example, a lender might have to deal with unusual state laws or might lend to particularly high or low risk borrowers. If the form was voluntary and the gains from using a unique form outweighed the forgone gains that otherwise stem from standardization, then that lender would not use the industry's standard form.

Similarly, some pressures for industry-wide standardization continue even without secondary purchasers. For example, an industry-wide standard contract should reduce costs directly for retailers by limiting the time and expense a retailer spends drafting or deciding among various contracts.¹⁸

17. In theory, there still may be some small information or administrative cost savings to a consumer from using an industry-wide standardized form. The consumer's direct costs may be unchanged, but the costs of consulting third parties about the contract—financial planners before buying, attorneys after buying—might be slightly lower because those third parties would be familiar with the forms. The practical effects of such possible savings on consumer decisions seem minimal.

18. Additionally, the existence of an industry-wide standard form gives consumers, retailers, and secondary purchasers potentially valuable information about the terms that their competitors have accepted. By using the industry standard form, they do not place themselves at a competitive disadvantage; by negotiating an advantageous amendment to the industry standard form, they

A recent example from financial markets illustrates the advantages of standardized form contracts, both for individual firms and across an industry. Interest rate and currency swaps allow firms to change the interest rate, term, or currency of their financial liabilities by trading those liabilities with another firm for liabilities of equivalent value. For example, a firm that owes 10 million dollars can use a currency swap to trade its liability under that debt with another firm that owes an equivalent amount in Swiss francs. Although this type of swap market is less than ten years old, liabilities worth greater than 300 billion dollars are traded each year.

In March 1987 *The Wall Street Journal* reported that the International Swap Dealers Association had developed a standard contract to govern swaps. The report estimated that by standardizing the documentation the new contract could save companies as much as ten thousand dollars in legal costs on each swap and also facilitate assigning swaps to new buyers, which would aid the developing secondary market.¹⁹

In at least some contexts, industries do standardize their forms, but how and when? The third section of the Article discusses how tangible goods are standardized. The fourth section examines the standardization of three kinds of form contracts.²⁰

III. STANDARDIZATION OF TANGIBLE PRODUCTS

The economy is full of formally and informally standardized products, from motor oil to paper towels to "IBM PC compatible" computers. Until recently, product standards had attracted little attention from economists and lawyers. Economist David Hemenway wrote the first major analysis of the process of product standardization in 1975.²¹

improve their relative position.

19. Monroe, *Dealers Design a Standard Contract for Swaps of Interest Rates, Currencies*, Wall St. J., Mar. 4, 1987, at 38, col. 1. Note that the standard contract here, the "swap," is the form used to transfer other contracts. The secondary market referred to by *The Wall Street Journal* is a secondary market in the swaps, not in the underlying contractual liabilities.

20. The discussion in the text assumes that secondary purchasers buy the entire contract, but the same effects might occur when only a portion of the contractual rights or duties is resold. Thus, in cash consumer sales, the retailer might "resell" some of its contractual warranty obligation by insuring itself. The insurance company involved may want to approve a standard form of warranty used before issuing insurance. Variation in warranty terms would increase the costs to the insurance company of determining the degree of liability it is being asked to assume and of administering its payment obligations.

21. D. HEMENWAY, *INDUSTRYWIDE VOLUNTARY PRODUCT STANDARDS* (1975). Most of the recent discussions of standardization have focused on interchangeability standards, also called "network externalities." Major concerns have included the effects of standardization on subsequent innovation and the possible uses of standardization to increase a manufacturer's market power. See, e.g., J. FARRELL & G. SALONER, *ECONOMIC ISSUES IN STANDARDIZATION*, (Department of Economics, Mas-

Hemenway divided product standards into three major classes: single product standards, intermediate standards, and interchangeability standards. Single product standards define the characteristics of a product and ensure its uniformity. For example, the Society of Automotive Engineers issues motor oil standards defining 10-W-30 motor oil. Intermediate standards describe products used in physical connection with other standardized products. For example, paper towel dispensers must meet size standards if paper towel sizes are standardized. What Hemenway called interchangeability standards (often termed "network" standards) are the standards needed to use a common network. Thus, interchangeability standards for telephones are those standards that must be met for a telephone to use the regular telephone network.

Some standards are ancient. Defined weights and measures date at least to the Old Testament. An English dictionary is a more recent standard. In the United States, "time" itself is an even more recent legally defined standard, set initially in the 1880s by the most affected industry, the railroads, and eventually enforced by federal legislation.²² Product standards, however, first became significant during the 1910s and 1920s with the growth of the automobile industry. The relatively small number of automobile manufacturers sought and obtained agreements on standardized parts from their suppliers through the private Society of Automotive Engineers. During the 1920s the Commerce Department's Division of Simplified Practice, with the encouragement of Secretary of Commerce Herbert Hoover, convinced businesses in less concentrated industries to collaborate on product standards. The fed-

sachusetts Institute of Technology Working Paper No. 393, 1985) (source on file with Author)); Farrell & Saloner, *Standardization, Compatibility and Innovation*, 16 RAND J. ECON. 70 (1985); Katz & Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424 (1985).

22. Before the 1880s, each town kept its own "time," based more or less exactly on when the sun was directly overhead in the town's particular location. As a result, major cities, even those in close proximity, kept time that varied by several minutes. This variation made little difference until the spread of railroads; railroads found it too difficult and confusing to adopt the local time of each stop. In order to schedule trains efficiently and safely, the entire railroad system had to know exactly when a train would be on each track—and it had to agree on the "when." The major Canadian and American railroads met in two conventions in October 1883 and divided the United States into roughly the present four time zones for the purposes of train scheduling. While most railroads and localities adopted railroad time, a few continued to keep their own time, or more commonly, to keep the time of an adjacent zone. During World War I, following the lead of the European combatants, Congress decided that the war effort required daylight savings time, set within standard time zones. The result was legislation that authorized the Interstate Commerce Commission to set and enforce time zones. In 1967 the Commission gladly acquiesced when Congress transferred this thankless task to the newly created Department of Transportation. The Transportation Department still controls the nation's time, which today mainly involves reviewing applications for changes in the coverage of daylight savings time. See ASSISTANT GEN. COUNSEL FOR REGULATION, U.S. DEP'T OF TRANSP., *STANDARD TIME IN THE UNITED STATES* (1970).

eral government's National Bureau of Standards continued to encourage standardization throughout the New Deal and World War II.²³

Since World War II, voluntary but formal standardization has increased greatly. In 1977 the Department of Commerce estimated the total number of standards at 25,000; other estimates about that time put the total between 25,000 and 50,000. Growth was explosive, with an earlier private report suggesting that the number of standards would double during the 1970s. Some of these standards are in fact codes, such as the National Fire Protection Association's Life Safety Code, which contains thousands of individual standards.²⁴

Even the product standardization process has been standardized.²⁵ A large number of private organizations specialize in writing particular kinds of standards. These standards-setting groups include organizations that cross industry lines, such as the National Fire Protection Association, the American Society for Testing and Materials, or Underwriters Laboratory, as well as smaller groups that focus on a single industry, such as the Society of Automotive Engineers.

The American National Standards Institute (ANSI) coordinates the process. ANSI recommends the procedures to be followed by individual standards-setting groups. The standards-setting procedure approved by ANSI resembles a particularly excruciating administrative rulemaking,²⁶ but if a group follows the ANSI-recommended proce-

23. See generally D. HEMENWAY, *supra* note 21.

24. See U.S. DEP'T OF COMMERCE, REPORT ON VOLUNTARY STANDARDS AND TESTING LABORATORY ACCREDITATION 11 n.19 (July 8, 1977) [hereinafter VOLUNTARY STANDARDS REPORT], cited in R. DIXON, STANDARDS DEVELOPMENT IN THE PRIVATE SECTOR: THOUGHTS ON INTEREST REPRESENTATION AND PROCEDURAL FAIRNESS 2 (1978).

25. See generally D. HEMENWAY, *supra* note 21, and R. DIXON, *supra* note 24, for a discussion of the process of standard making.

26. For example, the National Fire Protection Association (NFPA), a very active ANSI-approved standards-setting body, follows a 10 step process in adopting a standard:

- 1) After receiving a request for standardization, the NFPA publishes a notice of intent to consider the request, seeking public comments.
- 2) The NFPA's Standards Council considers the request and the public comments.
- 3) If the request and comments indicate a possible need for a standard, the NFPA organizes a Technical Committee to review the proposal in detail.
- 4) The NFPA solicits proposals for a draft text of the standard.
- 5) The Technical Committee acts on the proposed texts, and after documenting various views, from Committee members and others, drafts a standard, which must be supported by two-thirds of the Committee.
- 6) The NFPA publishes the draft standard with the Technical Committee's comments in the NFPA Technical Committee Reports to obtain outside views.
- 7) The Technical Committee considers the public comments on the draft standard.
- 8) The draft standard, with comments and changes, is published again, this time in Technical Committee Documentation.
- 9) After any changes by the Technical Committee in response to public comments, the proposed standard is presented for open debate (including comments from nonmembers) at an NFPA meeting.

dures, then the resulting standard has the status of an "American National Standard," in addition to being the standard of the originating group. Although no juridical force flows from recognition of a standard as an American National Standard, recognition adds credibility and status. ANSI also can ask a standards making organization to set a standard on a particular subject or it can pass directly on a proposed standard submitted to it by an organization or person.

Consumer group complaints of a lack of consumer representation and small business complaints of anticompetitive activity made the standardization process controversial in the 1970s. A Federal Trade Commission report, several sets of Congressional hearings, and a report from the Department of Commerce seem to have led only to consumer representatives on more committees.²⁷

Some products are more likely to be standardized than others. As Hemenway points out, most industry-wide voluntary standards govern intermediate goods, which are used in the production of some other goods. The pressure for standards typically comes from consumers of those intermediate goods. Standardization is most likely when those consumers are a relatively small number of firms, as in the automobile industry, in which each firm has significant knowledge of and interest in standardization. Standardization is less likely when the product is sold to unconcentrated industries and least likely when the product is sold to the general public.²⁸ Government intervention, of course, can change those probabilities.

IV. CONTRACTS, SECONDARY PURCHASERS, AND THE STANDARDIZATION OF FORMS: THREE EXAMPLES

This section examines three examples of contract commodities that are resold to secondary purchasers: residential mortgages, oil and gas leases, and corporate securities. Although other examples are possible,²⁹

10) After debate, the NFPA membership then votes on whether to adopt the standard. R. DIXON, *supra* note 24, at 71 app. C.

27. R. DIXON, *supra* note 24; see FEDERAL TRADE COMMISSION, *Study of Standards and Certification* (1972); *Hearings on Voluntary Industrial Standards, Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm.*, 94th Cong., 1st Sess. (1975); *Hearings on S. 3555, Voluntary Standards and Certification Act, Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm.*, 94th Cong., 2d Sess. (1976); *Hearings on Energy Conservation—Home Heating Systems, Before the Subcomm. on Energy and Power of the House Comm. on Interstate and Foreign Commerce*, 95th Cong., 1st Sess. (1977); VOLUNTARY STANDARDS REPORT, *supra* note 24, cited in R. DIXON, *supra* note 24, at 2. Concerns about the antitrust implications of standardization continued into the 1980s. See text accompanying notes 86-88.

28. D. HEMENWAY, *supra* note 21, at 78-79.

29. For example, negotiable instruments might be characterized as "form contracts" that have been standardized by legislative action within states and, through the *Uniform Commercial Code*, between states. Similarly, insurance policies are also contracts that are "traded" in a second-

I selected these three either because of my familiarity with the industry or because the industry has spawned an extensive literature. For each example, the subsection describes the nature and extent of the secondary purchasers involved and the degree of intra-industry standardization of the contract forms involved.

A. Residential Mortgages

Mortgages and deeds of trust are essentially contracts, particularly when viewed in the context of their associated loan applications and notes.³⁰ The mortgagee generally promises to advance funds; the mortgagor promises to make certain payments and gives the mortgagee certain rights in the real property that secures the obligation. The most important right that the mortgagor gives to the mortgagee is the right to foreclose, but other rights, such as the right to enjoin waste, also are granted either in the instrument or by law.

Residential mortgages have been resold at least since the 1930s. In February 1938, President Roosevelt chartered the Federal National Mortgage Association (FNMA, also known as Fannie Mae), pursuant to authority granted by the National Housing Act of 1934. From 1938 through 1968, the FNMA purchased and resold residential mortgages that either were insured by the Federal Housing Administration (FHA) or guaranteed by the Veteran's Administration (VA) with funds acquired, directly or indirectly, from the Treasury.³¹ The FNMA also acquired certain direct lending obligations for residential construction of particular federal interest, such as subsidized low income housing. In

ary market. Rather than directly sell their interests in insurance policies to secondary purchasers, insurance companies "reinsure" issued policies with "reinsurance" companies. These companies, for a fee, assume all or part of the liability involved in the insurance policy. The reinsurers need information about those contracts even though, unlike investors in stocks or in residential mortgages, they technically are not "buying" the contracts. To the extent the insurance policies are uniform, the reinsurers' information costs decline.

In some states, state regulations ensure that major varieties of insurance are sold through state-wide standard contracts. For example, state insurance regulatory commissions may dictate some of the terms that firms must include in automobile liability policies, while authorizing certain optional terms. A reinsurer then can accept a package of automobile liability insurance policies from a given state without having to examine the terms and conditions of each individual policy. Instead, it only needs to determine the policy limits and optional terms involved. Although insurance regulators may not require standard policy forms for the purpose of improving the marketability of policies to reinsurers, that improvement has been a result.

30. In this Article, the term "mortgage" includes both mortgages and deeds of trust, as well as the notes they secure.

31. Congress gave the FNMA statutory authority to acquire conventional loans under certain restrictions in 1938, but the FNMA never exercised that authority. In 1948 Congress revoked it. Liebold, *Uniform Conventional Mortgage Documents: FHLMC Style*, 7 REAL PROP. PROB. & TR. J. 435, 437 n.13 (1972).

1968 Congress split the FNMA into two entities.³² The legislation gave secondary market operations to a federally chartered but privately owned corporation, which retained the name FNMA. The other functions were delegated to the newly created Government National Mortgage Association (GNMA or Ginnie Mae).

While the FNMA provided a secondary market for federally insured or guaranteed loans, "conventional" mortgage loans were the subject of limited secondary activity. Although thrift associations originated most of these conventional mortgages, some were issued by mortgage bankers, who then sold the mortgages to long-term investors.

Congress passed the Emergency Home Finance Act of 1970 as a reaction to a shortage in housing finance caused by tight money.³³ The Act authorized the FNMA to purchase conventional mortgages, under certain restrictions, and created a new federally owned corporation, the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), to purchase mortgages, conventional or otherwise, from thrift associations. The stated intent of the Act was to promote the development of a national secondary market in conventional mortgages. The newly private FNMA financed its purchases largely by issuing bonds secured by the mortgages it bought. The FHLMC purchased mortgage loans with funds obtained from both the federal treasury and its own mortgage-backed bonds.

During the 1970s, private markets in residential mortgages expanded tremendously as lenders in regions with above average housing activity sold mortgages to financial institutions in areas of limited housing activity. The originating lender could sell entire mortgages or percentage "participations" in mortgages. In most cases, the originating institution retained the duty to "service" the mortgage in return for a servicing fee.

More recently, private institutions have begun to purchase mortgages to back two new forms of securities: mortgage pool participations and private mortgage-backed bonds. Mortgage pool participations allow an investor to buy a fractional interest in mortgages that the issuing institution has bought and assembled as a "pool." Private mortgage-backed bonds technically are debts of the issuing institution, but are secured by the residential mortgages.³⁴ For federal income tax purposes, a trustee holds the mortgages and distributes principal and interest payments to the security holders. The securities can be either "straight

32. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 476 (1968).

33. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, 84 Stat. 450 (1970).

34. The first of these securities was a private, mortgage-backed bond issued by the Bank of America in 1977. Lance, *Balancing Private and Public Initiatives in the Mortgage-Backed Security Market*, 18 REAL PROP. PROB. & TR. J. 426, 430 (1983).

pass-through" securities, in which an investor in the security receives a certain percentage of the proceeds from the pool of mortgages; "fully modified pass-through" securities, in which the issuer guarantees the investor a preset return, regardless of the actual payments made on the mortgage pool; or "partial modified pass-through" securities, in which the issuer guarantees the investor's previously set rate against some risks, but not against mortgage default.³⁵

Institutional secondary purchasers would have benefited from the reduced information costs that national mortgage standardization brings, but the standardization that did develop was limited by differences in state property law. Early in their existence, the FHA and VA, federal agencies that insure or guarantee certain mortgages, developed state-by-state standard mortgage forms for the mortgages presented to them. Industry associations, including the influential United States League of Savings and Loan Associations, also proposed various model mortgage forms. Nevertheless, mortgage lenders did not standardize mortgages nationally until the creation of the FHLMC.

In 1970 the FNMA and the newly formed FHLMC decided to write a uniform mortgage document. The FHLMC is a federal instrumentality controlled by the Federal Home Loan Bank Board (FHLBB), and the FNMA, although now a private entity, retains important links to the Federal government (including five Presidential appointees on its fifteen-member board). Nevertheless, this standardization was not a "governmental" act. As the FHLMC's first general counsel wrote, the FHLMC "has the authority to require any mortgage which it buys to be on a particular form, but any private corporation has the same power."³⁶

In January 1972 the FNMA and the FHLMC, after obtaining industry and consumer representative comments, published separate forms on which all mortgages that it bought would have to be written.³⁷ The forms contained one group of uniform covenants, applicable to mortgages from any state. The drafters included standard riders, which contained nonuniform covenants, to be used in individual states. At first the FNMA and FHLMC forms had a few significant differences, but the two bodies eventually compromised on a mutual form, which, by 1983, was used in about eighty percent of all residential loans in the United States.³⁸ Federal mortgage purchasing requirements do not bind

35. *Id.*

36. Liebold, *supra* note 31, at 437.

37. One participant in the FHLMC/FNMA standard form process has written an interesting account of the evolution of the form. Jensen, *Mortgage Standardization: History of Interaction of Economics, Consumerism and Governmental Pressure*, 7 REAL PROP. PROB. & TR. J. 397 (1972).

38. Lance, *supra* note 34, at 438.

the newer private secondary markets. Nevertheless, the mortgage pools³⁹ generally have limited the mortgages they are willing to buy to mortgages that conform to federal requirements.

The recent introduction of adjustable rate mortgages (ARMs) has counteracted some of the standardizing work of the FNMA and the FHLMC. Federal and state regulations have limited the permissible varieties of ARMs, but a large number of options are still available. The options available to the consumer and retailer (in this case the mortgagor and mortgagee) using an ARM include the ability to select any one of a number of interest rate indices, the freedom to negotiate different limits on interest rate changes in a given year or during the life of the loan, and the ability to allow or ban negative amortization.

Standardizing influences, however, have begun to affect ARMs. On October 12, 1987, the FNMA announced that it was standardizing its purchases of adjustable rate mortgages.⁴⁰ The FNMA had purchased adjustable rate mortgages since 1981, but only by negotiating individual purchases with specific lenders. The FNMA's policy now is to purchase ARMs if they are tied to an index rate of one-year United States Treasury securities and to include provisions limiting interest rate changes to not more than two percentage points per year and not more than six percentage points over the life of the loan.⁴¹ The FHLMC announced the next day a plan to purchase more ARMs.⁴² According to the *Wall Street Journal*, the president of the FHLMC stated that "creating a security from convertible ARMs will help standardize the ARM securities market and establish a 'solid secondary market for convertible loans.'"⁴³

B. Oil and Gas Leases

Landowners or owners of mineral interests enter into oil and gas leases in order to have oil or gas companies explore for, develop, and produce oil and gas deposits. These leases, which perhaps more accurately are characterized as part real property conveyance and part contract, give the lessee the right to explore for, drill for, and, if successful, produce oil and gas. In addition, these leases give the lessee all surface

39. The mortgage pools, of course, face these same pressures to standardize as a result of the information costs of purchasers of *their* securities in what amounts to a tertiary market for residential mortgages.

40. McQueen, *Fannie Mae to Start Standardized Plan for Buying ARMs*, Wall St. J., Oct. 13, 1987, at 55, col. 1.

41. *Id.*

42. McQueen, *Freddie Mac to Buy \$2.1 Billion Loans to Aid Adjustable Rate-Mortgage Sector*, Wall St. J., Oct. 14, 1987, at 42, col. 1.

43. *Id.*

easements necessary for those operations. The oil and gas leases used in the industry are an odd mix of standardization and variety; they almost always establish the same basic relationships, but they vary widely in their fine print.⁴⁴

The lease ordinarily conveys to the lessee the exclusive right to explore, drill, and produce hydrocarbons for a stated period of time—the “primary term.” If during the primary term of the lease the lessee succeeds in producing commercial amounts of oil or gas, then the lease remains in force as long as commercial production continues. Generally, the lessor receives a cash bonus, an annual “delay rental” for years during the primary term without drilling or production, and, as a royalty, a percentage or fractional share of any production. In most leases, express terms permit either party to assign the lease, in whole or in part.

Secondary sales of identifiable oil and gas leases do not occur in public markets and therefore are hard to quantify. Nevertheless, they take place constantly. An oil or gas company in the business of exploring, drilling, and producing—termed an “operating company”—often will assign, in whole or in part, leases it initially acquired. For legal or economic reasons, another company may be willing to pay a premium for a lease in order to assemble a contiguous block of leases. Alternatively, the assigning company’s interest in the lease may wane based on its market situation or its assessment of the area’s geology. Finally, even when the original lessee wants to develop the area, it may assign a lease, in whole or in part, to pay for services, to raise capital, or just to spread the risks of exploration.

Some property is leased, not by operating companies, but by another important player in the industry, independent “leasehounds” or “landmen.” Landmen work as independent contractors, oil company employees, or on their own behalf. In addition to obtaining leases for operating companies, landmen often will buy up what they perceive to be undervalued oil and gas leases as speculative investments. If the oil industry later becomes interested in the region, then the landmen will sell the lease to an operating company.

Largely as a result of these various lease assignments, oil companies acquire interests in leases written on a variety of different preprinted forms. The companies recognize the problems that varying lease forms can cause. As one attorney for Exxon has written:

Exxon Company, U.S.A. stewards over 120,000 leases and maintains an enormous staff to perform this function. This function is greatly aided when the staff is familiar with and understands the terms of each individual lease and knows that the form has been drafted to avoid ambiguities and internal conflicts. If each of the 120,000 or so lessors insisted that his or her form be utilized for lease negotiations,

44. See Pierce, *Rethinking the Oil and Gas Lease*, 22 TULSA L.J. 445, 447-57 (1987).

Exxon's stewardship function would become not only much more difficult but also much more costly.⁴⁵

In spite of this recognition, the oil and gas industry has not standardized its lease forms even though the overwhelming majority of private oil and gas leases are embodied in preprinted forms, which are presented to the landowner by the lessee.⁴⁶ Legal printing companies, individual landmen, or major oil companies may have drafted any given form.⁴⁷ Most forms have the same general size, shape, and terms. Many are entitled "Revised Producers 88," based on a popular lease form first printed in 1916, although that title has no descriptive meaning.⁴⁸ The forms usually are preprinted except for blanks for the insertion of a description of the property; the amounts of the royalty (usually), delay rentals, and bonus; the lessor's signature; and a notary's acknowledgement.

In their terms, these preprinted forms are both uniform and distinctive. All the forms contain certain crucial clauses, such as the *habendum* clause, the definition of the royalties, or the force *majeure* clause. In addition, almost all leases contain one or more varieties of clauses on certain other topics. For example, almost all leases contain one or more clauses dealing with the extension of the primary term of the lease as a result of the lessee's efforts. Any one of the hundreds of different preprinted forms, however, might employ different lease clauses to cover these extensions. A particular lease might have: 1) a dry hole clause, allowing the lessee to extend the primary term by drilling another well immediately after completing a dry hole; 2) a well completion clause, allowing a lessee to extend the primary term while completing a well begun during the primary term; 3) a continuous operations clause, allowing the lessee to continue the primary term as long as the lessee maintains drilling operations on the parcel; 4) a cessation of production clause, allowing the lessee to preserve its lease by specified actions if commercial production is interrupted; or 5) any combination of

45. R. HEBERT, *NEGOTIATING A LEASE: LESSEE'S PERSPECTIVE* 1 (1985) (source on file with Author).

46. The text discusses leases of privately owned land. The federal government leases hydrocarbon rights on its own form leases, which incorporate by reference an extensive body of federal regulations. Other large lessors, such as the State of California, the University of Texas system, and Stanford University, try to insist on using their own lease forms.

47. It will be interesting to see whether technology eliminates the preprinted form as evidence of a form contract. With the spread of word processing, a firm can store a form contract in its computers and print out a new original whenever necessary. The variable terms of the resulting contract may be filled in on the word processor, rather than appearing as handwritten or typed insertions in printed blanks. As a result, preprinted forms may disappear, making it increasingly difficult to tell whether or not a document is a "form" contract.

48. See Moses, *The Evolution and Development of the Oil and Gas Lease*, 2 SW. LEGAL FOUND. INST. OIL & GAS L. 1, 27 (1952).

the above.⁴⁹

In addition to the lack of uniformity regarding which clauses are included, each clause may differ in language from one lease form to the next. Because these differences in clauses and language are not necessarily trivial, a secondary purchaser must be concerned both with which clauses are in any particular form and with the language of those clauses. Outside of California, where a different type of form lease is used,⁵⁰ form leases often are terminated automatically by the failure of the lessee, or its assignee, to pay the exact amount of delay rentals to the right parties, at the right time, by the right method. A failure to meet the technical requirements of the specific language of a given lease form can mean losing an extremely valuable lease.

Because the stakes can be so high, the absence of standardization is costly. Yet standardization has not proceeded past single firms. Exxon has its own standardized forms with minor variants for different states, but there is no industry-wide standard "Texas" lease form. Although industry groups have successfully created standard form joint operating agreements to be used by companies cooperating in the same oil field,⁵¹ no similar standard lease form has been adopted or even proposed.

C. Corporate Securities

Securities markets are the largest and probably the oldest secondary markets for commodity contracts. When corporations or governments sell securities, they are, in essence, entering into contracts with purchasers, as regulated by applicable state and federal law.

Securities issuers create these contracts. Federal and state securities laws allow issuers to choose, for the most part, whether the contracts will be resold in the secondary markets. If a security is registered with the Securities and Exchange Commission, its purchasers generally

49. The bias in favor of the traditional preprinted forms is so strong that many lease forms contain obsolete clauses taken verbatim from their ancestors. One clause, still in common use, entitles the lessor to the free use of any natural gas found on her property for the purpose of cooking or *lighting* (but not heating) in her dwelling, long after the disappearance of gas lights.

50. A major geographical discrepancy further confounds lease form standardization. For obscure reasons, a different "standard" lease form, sometimes labeled a "Revised Form 86," has long been used in California. The California form is two or three times as long as the form used in the rest of the country. The California form covers more topics and covers some topics, particularly surface land use, in more detail. In addition, although until the 1970s the common lessor's royalty in the rest of the country was one-eighth of production, in California the most common royalty was one-sixth of production. These royalty shares were so common that the lease forms often included the customary fraction as one of the preprinted terms.

51. The most successful of these forms may be the Rocky Mountain Joint Operating Agreement, which governs the relationships between lessees in an oil or gas field that is being jointly operated by one lessee on behalf of all others. See ROCKY MOUNTAIN MINERAL LAW FOUND., ROCKY MOUNTAIN JOINT OPERATING AGREEMENT (1984).

may resell it through securities exchanges to any buyers. Securities issued without registration, pursuant to a statutory or regulatory exemption, usually may be sold only to a limited group of investors. Similar distinctions prevail in the securities laws of many states.

The resale market for registered securities dwarfs the initial market for registered securities. In 1986 new public offerings of registered equity securities totalled about 74 billion dollars, compared to total trading on registered stock exchanges of 1.7 trillion dollars.⁵² The same year, the total volume on the New York Stock Exchange (NYSE) alone equalled 1.37 trillion dollars.⁵³ The National Association of Securities Dealers Automated Quotation system (NASDAQ), which is not a registered stock exchange and thus is not included in the first figure, accounted for an additional 378 billion dollars in stock sales.⁵⁴

The corporation issuing registered securities does not know who the eventual owners will be. The issuer creates the "contract," in this case a security, with sales in mind not only to the underwriters or the institutions with which the stock will be placed initially, but also to millions of potential investors. The initial purchasers, of course, buy those securities in part because they know that a further resale market exists. Secondary purchasers, whether individual small investors or massive pension funds, face information costs in shopping for investments. To the extent that an investment contract differs from some standardized model, the investor incurs information costs in determining how the contract differs from the norm.⁵⁵

Some attributes of securities traded in secondary markets are standardized; others are not. The words "common stock," "preferred stock," and "bond" define some aspects of securities. Federal securities laws and regulations "write" into all traded securities additional standard terms, such as reporting requirements and limitations on insider trading. Many of the remaining terms, express or implied, are determined by the issuing corporations, their states of incorporation, or the exchanges on which the shares are listed. Consider the status of standard-

52. 46 SEC MONTHLY STATISTICAL REV., No. 2, at 10, 24-29 tables M-370 to M-376 (1987). The figure for primary public offerings includes offerings of convertible bonds, preferred stock, conventional common stock, limited partnership interests, voting trust certificates, condominium securities, and other equity. *Id.* The overall figures given in the tables include \$100 million in unregistered securities that were issued under Regulation A. *Id.* at 23 table M-350. Although it is not clear whether those unregistered securities are bonds or equity, they are insignificant compared to the \$74 billion in new equity offerings.

53. N.Y. STOCK EXCH., FACT BOOK 1987, at 5 (1987).

54. NAT'L ASS'N OF SEC. DEALERS, NASDAQ FACT BOOK 1988, at 8 (1988).

55. The stockholder faces increased administrative costs as well if ownership of the stock ever requires an independent investigation of the underlying obligations by the stockholder—for example, in the event of a proxy fight or a bankruptcy proceeding.

ization in two such areas: Standardization of state corporation codes and standardization of voting rights for common stock.

Many terms of the securities contract are written by the corporation codes of the states in which the issuers have chosen to incorporate. These codes differ significantly and, in spite of efforts to produce model or uniform corporations laws, the states probably will retain different laws. Idaho law standardizes to some extent the securities of all firms incorporated in Idaho, but, apart from federal law, those securities need not conform to any national standard and necessarily differ from securities issued by corporations incorporated in other states. In spite of the differing state corporations codes, a group of issuing companies can standardize their contracts among themselves by choosing the same state of incorporation. Without colluding, corporations could participate in de facto standardization by choosing to incorporate in a state with an unusually large proportion of major publicly listed companies. In fact, forty-three percent of the New York Stock Exchange listed companies have chosen to incorporate in Delaware.⁵⁶

Delaware's predominant position as the state of incorporation for large public corporations has caused debate for the last fifteen years. Some commentators have viewed Delaware's role as the result of a noxious "race to the bottom," in which firms choose to incorporate in the state with the least restrictive corporate laws.⁵⁷ Others have maintained that interstate competition for corporate charters leads to adoption of state corporation laws that maximize the value of companies incorporating in those states; Delaware, these scholars urge, merely has produced the most efficient laws.⁵⁸ As Professor Romano pointed out in an excellent article, neither view can explain convincingly why Delaware has a stranglehold on major company incorporations. Other states could have copied or surpassed the attractive aspects of Delaware's corporations code and undercut Delaware's price.⁵⁹ A few commentators have advanced explanations for Delaware's predominance focusing on market

56. N.Y.S.E. Guide (CCH) ¶ 701.3, at 725-802 (May 27, 1988).

57. The seminal work in this vein is Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). See, e.g., R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976); Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187 (1983); Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545 (1984).

58. Some of the more interesting works taking this view include Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982); Hyman, *The Delaware Controversy—The Legal Debate*, 4 DEL. J. CORP. L. 368 (1979); and Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEG. STUD. 251 (1977). For further discussion, see R. WINTER, *GOVERNMENT AND THE CORPORATION* (1978).

59. Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORGANIZATION 225, 226 (1985).

differentiation by states.⁶⁰ Under this view, Delaware has been the only state to pursue successfully the "big public firm" market niche. Romano's explanation is more complex, and more convincing.

Romano argues that Delaware obtained a large market share by being particularly responsive to the needs of Delaware-chartered corporations. This responsiveness stems from Delaware's entrenched dependence on the corporate chartering "business" for public and private revenue. Delaware retains its market share because corporate attorneys recommend it. Delaware incorporation lowers the cost of providing legal services to clients because it presents a familiar body of law and its judicial interpretation of relevant portions of its corporations code is more complete than states with fewer large corporations. Delaware's advantage is particularly significant at the time a firm decides where to incorporate because, as Romano points out, most major companies change their states of incorporation only in connection with transactions that may lead to litigation.⁶¹

Romano's explanation overlooks a related advantage to companies incorporating in Delaware. Just as corporate lawyers work more efficiently when dealing with Delaware law, so do potential purchasers of the firm's stock. Incorporating in Delaware performs a standardizing function for investors as well as for corporate lawyers. Investors in a corporation probably know and feel more comfortable with Delaware's corporation law than, for example, with Idaho's. Participants in the securities markets know Delaware's corporation law, either by study or by reputation; incorporation in Idaho either might lead a potential investor to spend time and effort examining Idaho's corporate laws or might lower the value the investor places on the security to compensate for the increased risk of dealing with unknown law.⁶²

60. See R. POSNER & K. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* (1980); Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985); Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23 (1983).

61. Romano, *supra* note 59, at 235-42, 273-79 (discussing gaining and retaining market share). An interesting recent article by Professors Macey and Miller expands upon these explanations by pointing out the powerful role of the Delaware corporate bar, acting in self-interest, in assuring corporations that Delaware's corporate law will remain generally congenial to their interests. Macey & Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 *Tex. L. Rev.* 469 (1987).

62. One could argue that "the market" takes into account these factors and the price of the stock automatically adjusts to reflect any substantive difference that Idaho's corporations law makes to an investor. This argument is weak for two reasons. First, any individual investor (other than someone assembling a portfolio that mirrors or encompasses the market) still has to decide whether she believes the security is a "good" investment at a given price. The market quotations do not tell that investor that the stock is worth \$21.75, *i.e.*, \$22.00 per share, less 25 cents for Idaho's corporations law. Second, even if the market adjusts prices to reflect these risks, the market operates only through human beings (or perhaps human-programmed computers). Some person still has to expend time and effort to analyze how Idaho's corporations laws affect the value of

This advantage is closely related to, but distinct from, a claim that Delaware's reputation confers an advantage on firms incorporating in that state. Investors attracted by standardization do not favor Delaware corporations because they know Delaware has a reputation for having "good" corporate laws, but rather because they are familiar with its laws, good or bad. In addition, that the voluntary acts of major public corporations have made Delaware a de facto standard could lead investors to two conclusions: Delaware's laws are acceptable to most public corporations and a Delaware-incorporated firm they invest in will not be at a competitive disadvantage because of its state of incorporation.

Just as state corporations codes dictate some terms of the securities contract, stock exchanges require some terms as conditions for listing a security on their exchanges. Each "national securities exchange" or "national securities association" can set, within boundaries, requirements for companies that wish to list their securities with that exchange or association, subject to approval by the Securities and Exchange Commission.⁶³ Through its listing requirements, the NYSE effectively prohibited listed companies from issuing nonvoting common stock or classes of common stock with substantially different voting power from 1926, well before the federal securities acts.⁶⁴ Other exchanges or associations need not follow the NYSE's requirements on voting strength and, in fact, the two most important did not. The American Stock Exchange (Amex) prohibited listed companies from issuing nonvoting common stock, but did not prohibit issuance of classes of common stock with substantially different voting rights.⁶⁵ The National Association of Securities Dealers imposed no limits on the voting rights of the common stock of the thousands of firms it lists through NASDAQ.⁶⁶

All other things being equal, shares listed on the NYSE should have been slightly more valuable than shares listed on the Amex because the NYSE effectively prohibited common stock with different voting powers. Secondary purchasers of the NYSE-listed shares knew, without looking, that all common shares of that firm had equivalent voting rights. Secondary purchasers of Amex-listed shares either had to

a company's stock. Unless the analyst can appropriate the entire value of such information, the market may well underproduce such analysis.

63. See Securities Exchange Act of 1934, § 19(b), 15 U.S.C. § 78s(b) (1982); SEC Rule 19b-4, 17 C.F.R. § 240.19b-4 (1988).

64. N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 313.00 (1984). The history of the so-called "one share, one vote" requirement of the NYSE is traced, in fascinating detail, in Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 688-707 (1986).

65. AM. STOCK EXCH., COMPANY GUIDE, § 124 (1979).

66. See SEC Voting Rights Listing Standards, 52 Fed. Reg. 23,665, 23,666 n.14 (June 24, 1987).

ascertain the share's voting rights or risk a potentially unpleasant surprise.

But all other things are not necessarily equal. Firms listed on the NYSE have shown increasing interest in issuing shares with different voting rights because classes of common stock with differential voting power can serve as antitakeover devices. Amex and NASDAQ provided alternative ways to list the stock without following NYSE's "one share, one vote" rule. Faced with competition from Amex and NASDAQ, the NYSE voted in September 1986 to amend its listing requirements to allow a listed firm to have classes of common stock with different voting rights.⁶⁷ The NYSE submitted the proposed amendment for approval to the Securities and Exchange Commission. Under legislative pressure,⁶⁸ the Commission responded to the NYSE filing by promulgating new Rule 19c-4, a uniform listing requirement governing common stock voting rights on all national securities exchanges or national securities associations.⁶⁹ The new rule bans the issuance of new stock with disparate voting rights that has the effect of disenfranchising existing stockholders.

These market and regulatory changes made the "one share, one vote" provision quite controversial and the subject of much scholarly debate.⁷⁰ While commentators have aired many of the substantive advantages and disadvantages of such rules, no commentator apparently has considered the information cost savings that a standardized provision offers. The information cost savings do not necessarily support a mandatory uniform rule across all securities markets. Companies whose interest in common stock with differential voting powers is sufficiently great to overcome the cost advantages to their secondary purchasers—and hence the price disadvantages to themselves—of standardization should be able to find a market for trading that stock. On the other

67. 18 Sec. Reg. & L. Rep. (BNA) No. 37, at 1389-92 (Sept. 19, 1986).

68. In 1985 identical bills were introduced in both the House of Representatives and the Senate that would have imposed a "one share, one vote" rule on all publicly traded common stock. See H.R. 2783, 99th Cong., 1st Sess. (1985); S. 1314, 99th Cong., 1st Sess. (1985). A similar provision was included in the Tender Offer Reform Act, H.R. 2122, 100th Cong., 1st Sess. (1987), introduced by Congressman John D. Dingell.

69. Final Rule, SEC Voting Rights Listing Standards, 53 Fed. Reg. 26,376 (July 12, 1988). The rule has been challenged in court by the Business Roundtable IRR. 5 CORP. GOVERNANCE BULLETIN 124 (Sept. 10, 1988).

70. See Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CALIF. L. REV. 1671 (1985); Dent, *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725 (1986); Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119 (1987); Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987); Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 1 (1988); Seligman, *supra* note 64; Note, *Dual Class Recapitalization and Shareholder Voting Rights*, 87 COLUM. L. REV. 106 (1987).

hand, the SEC should permit an exchange to refuse to list such stock if a "one share, one vote" requirement is more valuable than the additional listings to be gained from allowing nonstandard common stock.

This Article does not argue that standardization motivated the adoption of federal securities laws, the Delaware corporations code, and the NYSE listing requirements. Delaware did not become a popular state of incorporation by offering a standard corporation code. It gained the added attraction of being the de facto standard after it became a disproportionately popular state of incorporation for substantive reasons probably unrelated to standardization. Similarly, the NYSE instituted its "one share, one vote" rule in 1926 after popular outcry about the "banker control" of publicly traded corporations.⁷¹ The NYSE's goal was not to increase the value of the listed companies by lowering information costs to secondary purchasers, but the increase in value should have been one of the results. The value of standardization, though it may be small in any given case, needs to be remembered and weighed in analyzing securities or any other contract commodity.⁷²

V. ANALYSIS AND POLICY IMPLICATIONS

No major barriers prevent a firm from standardizing its own form contracts. If a firm concludes that it should use one mortgage form, then it will adopt one mortgage form. Between firms, however, standardization is more difficult to achieve. In the three examples discussed, the standardization that did occur resulted either through the efforts of market participants with very large market shares (the FHLMC and the FNMA for residential mortgages; Delaware for corporate charters) or through indirect government regulation (one share, one vote conditions imposed through listing requirements adopted under federal government authority). Lacking those forces, the oil and gas industry has not standardized forms.⁷³

No one can quantify the amount of standardization in contract

71. Seligman, *supra* note 64, at 693-97.

72. The structures of the securities markets and of federal securities regulation provide several opportunities for exploring the extent and limits of secondary purchaser influence in such standardization. Nonregistered, privately placed securities, for which there is no secondary market, are likely to be less standardized than registered securities. Similarly, any one issuer is likely to produce relatively standardized securities (at least within the broad and generally understood classes of securities such as common stock, preferred stock, and various bonds) for the same reasons a retailer standardizes its credit contracts. The single firm faces none of the collective action problems that can make standardization within an industry difficult.

73. A producer or producers with monopoly power can also force standardization, not as a way of exercising market power, but as a way of increasing the value of their product to their many, unconcentrated consumers. Although this seems theoretically possible, I know no plausible examples.

commodities; attempting close comparisons with the amount of standardization of tangible products is foolish. Nevertheless, tangible products, in general, are much more standardized than contract commodities.

The more difficult question is whether the current amount of standardization of contract commodities is the *right* amount. The problem is intractable. Advocates of change tell "just so" stories about market failures that prevent an efficient level of standardization. Advocates of the status quo tell their own stories about markets successfully compensating for those supposed failures in this best of all possible worlds. Perhaps, like the fullness or emptiness of a twelve ounce glass holding six ounces, the answer is more likely to come from the predilections of the observer than from any data. The discrepancy in standardization between contract commodities and tangible goods is striking, but what, if anything, does it mean?

Although I do not know the answer to this question, there is an approach worth trying. The approach begins by identifying the factors that lead to an inefficient use of standardized form contracts compared to standardized tangible goods. Removing or minimizing those barriers would allow participants in the market to adopt voluntary standards only if the standards were to their advantage. The retailers who either did or did not adhere to the proposed forms would draw the short-term utility balance. But the analysis cannot end there. Standardization could have negative effects external to those participants. Standardization might cause a decline in distributional equity (however measured) or a drop in the "dynamic efficiency" of the market through a decline in useful innovation. If we become convinced that a greater amount of standardization would neither cause serious inequity nor inhibit useful innovation, then, as a matter of policy, we should remove the interfering factors and let the market determine the proper level of standardization.

This test is weak. It depends on the assumption that we can be confident that any adverse distributional or dynamic effects of removing barriers to standardization are minimal. If that assumption is true, and the standards are truly voluntary, then they will be adopted only if they are of more value to the participants in the transactions than the nonstandardized forms. If the participants win and no one loses, then the result is Pareto—superior to the previous state of the world. If, on the other hand, the distributional or dynamic costs are significant, then this test makes no attempt to weigh those costs against the gains, probably small, of increased standardization.

This section of the Article explores this analysis. The first subsection discusses four differences between contract commodities and tangi-

ble goods that help to explain why contract commodities are less standardized, and one countervailing factor that suggests standardization might be overused in both fields. The second subsection discusses the possible costs in distributional equity and in innovation of an increase in contract commodity standardization. The final section suggests how further standardization could be encouraged.

A. *Barriers to an Efficient Level of Contract Commodity Standardization*

Four barriers discourage contract commodity standardization more than tangible product standardization: collective action problems, federalism, substantive legal constraints, and lawyers. Bureaucratic inertia also may keep standardization at an inefficient level; it is unclear, however, whether inertia would increase or decrease standardization.

The problems of collective action afflict any attempt at standardization, from weights and measures to computer operating systems to form contracts to the price of crude oil. Although standardization of form contracts may not present the social costs associated with cartels, contract standardizers and cartels share the problems of creating and enforcing agreement. Getting a wide range of people to agree to anything, including a standardized contract form, is expensive, time consuming, and difficult—the more numerous and scattered the parties who must agree, the more expensive the job. One writer gives an example from his own limited efforts to create a widely acceptable mortgage form:

The writer must confess that as counsel for a mortgage banker he has developed a standardized set of mortgage forms for both residential and income property lending which have been approved by more than 30 institutional investors, but it is not a job he would ever again undertake since it involved almost three years of constant work in collaboration with outside counsel and the legal departments of each of the investors. Again, it was a matter of convenience to an institution rather than thinking in terms of making the product saleable in a secondary market. Furthermore, the end product, like all legal documents that emerge from compromises, contains pet clauses of some investors which proved to be nonnegotiable.⁷⁴

Although this collective action problem plagues any kind of standardization, tangible products do have the network of voluntary standards-setting organizations, with their own procedures, traditions, and credibility, to make the job possible. These organizations lower the transactions costs of arriving at a consensus standard and also increase the expectations of the parties to the process that others will adhere to the standard. By contrast, few such voluntary standards-setting organi-

74. Jensen, *Mortgage Standardization: History of Interaction of Economics, Consumerism and Governmental Pressure*, 7 REAL PROP. PROB. & TR. J. 397, 399 n.2 (1972).

zations control contract commodities. The consultation process employed by FHLMC and FNMA in promulgating their standard mortgage forms or the Rocky Mountain Mineral Law Institute's role in suggesting a standard oil and gas operating agreement probably come as close as any example to an ANSI-approved standardization process.⁷⁵

The absence of a structure for standards setting makes adoption of a voluntary standard less likely. A company has little incentive to abandon its own familiar product or form in order to adopt someone else's unless the industry agrees to adopt it as well. The advantages of standardization only come when nearly everyone abides by the standard. Unless producers or consumers expect others to abide by the standard, no one will be the first to move.

The voluntary standards-setting process for tangible products creates the expectation that others will follow a standard once it has been set. Producers expect other producers to adopt the standard established by the committees. Consumers who were represented in the standards-setting process expect their producers to meet that standard. Without a credible focus for standardization, producers have no incentive to rally around any one product or form. Each wants the others to adopt *its* form as the standard.

Professors Goetz and Scott have noted statements suggesting that a small group of Wall Street law firms may create new standardized forms of covenants, indentures, and other corporate agreements.⁷⁶ This exception may illustrate the rule: these firms are all located in the same part of Manhattan and form a cohesive society. Not surprisingly, the costs of coordinating a standard form are unusually low in this setting. It also may be significant that although no one law firm would reap the full benefits from a new covenant, each firm in the small group of firms involved in this representation would capture some benefit.

De facto standards may emerge as a result of a product's dominance in the market. If, for whatever reason, the IBM personal computer or Delaware corporation law becomes the "market leader," then other firms may conform. But without either a standardization process or a dominant product arising from causes other than standardization, transactions costs, including uncertainty about the actions of other market participants, strongly discourage contract commodity standardization.

The problem of federalism and form contracts is simply that different legal regimes may require different form contracts. For example, the

75. Organizations promoting uniform laws, such as the American Law Institute or the Conference of Commissioners on Uniform State Laws, provide a similar function for state legislation.

76. Goetz & Scott, *supra* note 3, at 304-05.

FNMA and the FHLMC cannot have one form residential mortgage, but must have a form mortgage with riders for each different state. Similarly, the rights and duties that form the securities contract vary among companies incorporated in different states as a result of each chartering state's corporation laws. Firms can mitigate these federalism problems in some circumstances. A firm can choose its state of incorporation, structure a transaction with choice of law problems in mind, or, in some cases, insert an effective choice of law clause. Even when available, none of these solutions is likely to be free of costs.

Similar problems arise with tangible products. For example, Florida and California both can define the characteristics of a legally marketable tangible product and yet use different definitions.⁷⁷ For example, in the aftermath of the two energy crises of the 1970s, states enacted different energy conservation standards for home appliances, which forced industry to produce different refrigerators for different states. Interestingly, industry responded by working with the Natural Resources Defense Council and other environmental groups to convince Congress to pass preemptive federal legislation setting uniform national standards.⁷⁸

Federalism impedes the standardization of contract commodities more than that of tangible products because states regulate the characteristics of these contracts more heavily than they regulate the design of most tangible products. As Professors Goetz and Scott have demonstrated, this regulation involves not only legislative action, but, perhaps more importantly, judicial interpretation.⁷⁹ These contracts are the very stuff of the law and the subjects of millions of state court cases; not surprisingly, the law treats them in more detail than it does the characteristics of tangible products. By doing so, states partially standardize

77. Notable commerce clause cases have resulted from states doing exactly that, apparently in efforts to favor their own producers. For example, in *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132 (1963), Florida growers challenged a California standard that defined ripe (and hence legally marketable) avocados by fat content in a way that always excluded Florida's slightly different variety of avocados. In *Hunt v. Washington State Apple Advertising Commission*, 432 U.S. 333 (1977), North Carolina had adopted legislation banning the use of any grading system for apples sold in North Carolina other than the federal grading system. Washington, which produced 30% of the nation's apples, had long had its own, more stringent, apple grading system. The North Carolina legislation standardizing apple grading thus had the effect of excluding the country's major producer.

78. *See generally* S. REP. NO. 6, 100th Cong., 1st Sess. (1987). Both houses of Congress unanimously passed the legislation on October 15, 1986, at the end of the 99th Congress, only to have it subjected to a pocket veto by President Reagan. An identical bill was introduced at the beginning of the 100th Congress, passed overwhelmingly, signed, and enacted as the National Appliance Energy Conservation Act of 1987, Pub. L. No. 100-12, 101 Stat. 103 (to be codified at 42 U.S.C. § 6201).

79. *See generally* Goetz & Scott, *supra* note 3.

contracts within each state, but the process makes standardization between states more difficult.⁸⁰

Substantive law constrains the adoption of standardized forms for contract commodities in at least two ways. First, courts may consider standardized forms to be "contracts of adhesion" and therefore limit their enforcement. Second, the process of standardizing the forms might violate federal or state antitrust laws.

Courts long have used the doctrine of contracts of adhesion to refuse to enforce provisions in form contracts that they considered unfair to the consumer. In refusing to enforce certain provisions, judges often have based their opinions on the ground that the consumer had no opportunity to bargain over the terms of the contract, but was confronted with a form and was required to "take it or leave it."⁸¹ When an industry adopts standard forms, the consumer has no choice among a variety of "take it or leave it" offers from different firms, thus arguably increasing the form's "adhesive" power.⁸²

Federal antitrust laws also pose a potential substantive limitation to standardization.⁸³ As on other occasions when firms join together, they are able to use the standards-setting process to restrain either themselves or other competitors. While there is little, if any, precedent concerning the application of antitrust laws to contract commodity standardization, plaintiffs long have attacked, with some success, the anticompetitive implications of the standardization of tangible products.⁸⁴

80. Of course, just as appliance makers can overcome state by state differences with preemptive federal law, so can retailers of contract commodities. One example of this strategy may be the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.), which, among other things, preempted state usury laws for certain residential mortgages. Section 501(a)(1) of that Act replaced state usury standards with a national usury standard, providing not only higher rates, but, for a time, a national standard. *Id.* § 501(a)(1), at 161 (codified at 12 U.S.C. § 1735f-7 (1982)). Section 501(b)(2) of the Act, however, allowed states to reimpose individual usury limits on such lines by legislation passed before April 1, 1983. *Id.* § 501(b)(2), at 162 (codified at 12 U.S.C. § 1735f-7 (1982)).

81. See CORBIN ON CONTRACTS §§ 559A-559I (C. Kaufman ed. Supp. 1984); RESTATEMENT SECOND OF CONTRACTS § 211 (1979); Rakoff, *supra* note 3, at 1190-97 (describing the current doctrine).

82. On the other hand, a court might be more likely to enforce a term against a consumer if the term was an industry-wide voluntary standard, set through a process that included consumer representation, than if the retailer had unilaterally promulgated the form contract.

83. State antitrust laws may have the same effect. I ignore them only because their variety makes generalization difficult.

84. See generally D. HEMENWAY, *supra* note 21, at 76-78. The seminal antitrust case, *United States v. Trenton Potteries Co.*, 273 U.S. 392 (1927), dealt with, among other things, an agreement by pottery companies not to sell "seconds"—pottery that fell below certain quality standards. Firms can use standards to prevent themselves from increasing competition, as in *Trenton Potteries*, or firms can prevent competitors using new methods or technologies from invading their market by product standards, as in *American Society of Mechanical Engineers v. Hydrolevel*

In *American Society of Mechanical Engineers (ASME) v. Hydrolevel Corp.*,⁸⁵ for example, the plaintiff successfully alleged that boiler manufacturing companies had used an ASME standard to prevent the plaintiff from competing with an innovative boiler safety feature. In the more recent case of *Indian Head Inc. v. Allied Tube & Conduit Corp.*,⁸⁶ the plaintiff, a manufacturer of a polyvinyl chloride electrical conduit, claimed that a competitor had attempted to prevent the National Fire Protection Association from approving the conduit in the National Electrical Code, a voluntary standard widely incorporated in local building codes. If the competitor had been successful, the plaintiff's conduit could not be used legally in large portions of the country.

Because of this kind of alleged anticompetitive behavior, legislation was introduced in Congress during the 1970s to limit or regulate private standards organizations above and beyond any antitrust constraints.⁸⁷ Although those proposals bore no fruit, potential antitrust liability continued. During the Carter Administration, the Federal Trade Commission asserted its interest in the standardizing process through a rulemaking proceeding. The Commission completed hearings on a proposed rule in 1980, but did not close the proceeding until 1985. It then rejected any regulation partly because of changes in the standards-setting organizations' complaint procedures that resulted from the 1982 *ASME* case:

The Commission's decision was based on a determination that there is inadequate evidence to indicate that anticompetitive practices are sufficiently widespread to justify an industry-wide rule, particularly in light of recent changes in practices of standards developers in response to a Supreme Court decision holding a standards developer responsible for the anticompetitive practices of its members. Rather, the Commission intends to use case-by-case enforcement against specific instances of abuse in the standards development and certification process.⁸⁸

In spite of substantial judicial and administrative litigation, no one knows the limits of federal antitrust liability in this area. One commentator suggests that courts should handle standardization cases under a

Corp., 456 U.S. 556 (1982) or *Indian Head, Inc. v. Allied Tube & Conduit Corp.*, 817 F.2d 938 (2d Cir.), *cert. granted*, 108 S. Ct. 65 (1987).

85. 456 U.S. 556 (1982).

86. 817 F.2d 938 (2d Cir.), *cert. granted*, 108 S. Ct. 65 (1987). The Supreme Court had held that the *Noerr-Pennington* defense to antitrust liability was not available to the defendant to immunize its efforts to influence the National Fire Protection Association even though its National Electric Code was automatically incorporated in many local building codes.

87. R. DIXON, *supra* note 24, at 6.

88. FTC, Notice of Completed Rulemakings, 50 Fed. Reg. 44,971, 44,971-72 (1985); see FTC, Standards and Certification: Notice of Publication of Presiding Officer's Report, 48 Fed. Reg. 25,218 (1983); FTC, Standards and Certification: Availability of Final Staff Report, 48 Fed. Reg. 15,484 (1983); FTC, Standards and Certification: Notice of Proposed Rulemaking, 43 Fed. Reg. 57,269 (1978).

rule of reason analysis, subject to a public welfare defense, but acknowledges that neither part of this recommendation is clearly established in the case law.⁸⁹ Particularly when the standards of legal conduct are not clear, possible antitrust liability discourages standardization of contract commodities.

A final barrier to standardization stems not from economics, federalism, or substantive law, but from the attitudes of lawyers. The lawyers who draft or review contracts and lease forms may not understand or fully share their clients' interests in standardization. To the extent that agency problems keep a company's attorneys from reflecting or expressing the company's interests in standardized contracts, attorneys may underuse such contracts.

Law school does not prepare lawyers to view themselves as product designers. Attorneys are trained to think about the legal consequences of the documents they design and, under the prevailing view of legal ethics, to advance their clients' interests as far as the client wishes—which usually is assumed to be as far as possible. As a result, attorneys draft documents with legal frills not included in the standard industry form. One could ascribe overdrafting to an attorney's wish to justify his fees, but more than fees may be involved. Instead, overdrafting may reflect lawyers' attempts to justify their worth by meeting professional norms of craftsmanship. "Good lawyers" think they can improve any document. Standard forms may be no exception.⁹⁰

No harm may result if the client closely controls his lawyer. The client, perhaps more aware of the advantages of using the standard form, can listen to the lawyer's suggestions, weigh the specific legal advantages against the benefits of standardization, and accept or reject the lawyer's draft. The clients for whom contract commodities are drafted may be more knowledgeable and legally sophisticated than the average client, but it still may prove difficult for them to assert themselves against the lawyer's mystique. Agency problems between attorney and client are still possible.

Finally, firms have agency problems close to home. A firm's officers or employees may make the firm behave in ways that advance their personal interests rather than the interests of the firm. These agency

89. Goldenberg, *Standards, Public Welfare Defenses, and the Antitrust Laws*, 42 *BUS. LAW.* 629, 638-39, 643-46 (1987).

90. An alternative, more cynical explanation is that lawyers seek marketing advantages through product differentiation. The attorney increases the value of his services to a client by tying that client to an unusual, nonstandard form. Another attorney would have to spend some time and effort studying the form to be able to advise the client and thus would be at a disadvantage in trying to gain that client's business. Of course, neither explanation is inconsistent with an attorney trying to have her form chosen as the standard for a new document. *See supra* text accompanying notes 75-77.

problems might affect a firm's decision to standardize, although the direction of the effect is unclear.

Employees may prefer standardized contracts because the forms make their jobs easier, whether or not standardizing benefits the firm. A firm possibly could profit by spending time and effort to analyze separate forms, but its employees may not want to spend the time and effort required to realize that benefit. Alternatively, risk averse employees may prefer standardized forms because standardized forms shield employees from blame. Employees might conclude that they would not be blamed for buying or using the industry standard even if it eventually causes their firm problems. This reaction could affect not only form contracts, but also all kinds of standardized products, from bolts to IBM-compatible computers.

Of course, when speculating about how self-interest affects behavior, it is easy to hypothesize exactly opposite effects. One could guess just as easily that employees would underuse form contracts in order to justify an overly large purchasing department and build their own empire. The ultimate significance of this agency problem is hard to determine, but its possible implications should not be ignored.

B. External Costs of Increased Contract Commodity Standardization

Direct, perceptible gains and losses to the parties from standardizing contracts should be reflected in the value of those contracts to the retailers. Changes in distribution and changes in future efficiency are effects of standardization that may not affect retailers directly.

The effects of greater standardization on distributional equity are unclear. An industry-wide voluntary standard, instituted largely for the convenience of retailers and secondary purchasers, might work against consumers—home buyers, oil and gas lessors, securities investors, or others. That possibility already exists to an equally strong degree in industries in which each firm has its own standard form. As the literature on adhesive contracts suggests, few consumers negotiate the “legal terms” of contracts. The price may be negotiable; with rare exceptions, the “boilerplate” terms of the form are not.

Consumers or their representatives currently have no role in drafting form contracts. Under a system of standardization similar to the system for tangible products or similar to the process used by FHLMC and FNMA to draft their uniform mortgages, consumer representatives would participate in drafting the contracts. In the case of the FHLMC and FNMA mortgage forms, consumer representatives played an impor-

tant role in drafting the form.⁹¹ Increased standardization through such a procedure could not leave consumers worse off than the present non-system; it ought to improve their positions.⁹²

The effect of an industry-wide standard on innovation in contract forms is more difficult to determine. Even if the standardization of forms leads to a more efficient economy today, the result could be disastrous if mandatory standard forms were frozen into place, to govern what might be a very different future.

Even voluntary standardization discourages some innovation. A firm should adopt a voluntary standard form contract only if its benefits from the use of form outweigh the costs. The firm should apply the same analysis in deciding whether to depart from the voluntary standard in favor of an innovation. If voluntary standards exist, some innovations that would have been adopted in the absence of standardization will not be adopted. Whether or not a standard exists, a firm that adopts an innovation in forms faces costs in printing, in retraining its staff, and in educating its consumers or secondary purchasers about a new form. If there is an industry-wide standard, then the firm faces another cost; it loses the premium in the secondary market for standardization. This discouragement of innovation is not necessarily a problem. Using the older form as a standard would be preferable to using either the old form or the new form without a standard, but it would be worse than having the innovative form as a new standard.

The solution to the problem of innovation is to make the "new improved" form the new standard. When the standards-setting process remains in place, firms can propose changes to the old standard form, enabling them to change forms while keeping the benefits of standardization. This solution is not perfect because changing standards would not be costless.

First, the industry would face the additional cost of another standards-setting process. Second, as Professors Goetz and Scott argue in the context of state-required implied contract terms, the existence of one standard can make it more difficult to innovate successfully, as market participants and courts persist in putting the new language in the old pigeonholes.⁹³ Third, once the new standard is adopted, some of the benefits of standardization are lost. Information and administration

91. See generally Jensen, *supra* note 74.

92. The question remains who will receive the benefits of standardization: the consumer, the retailer, or the secondary purchaser. No a priori answer seems possible. Those benefits could be reflected in a lower price to the consumer, in a higher price from the secondary purchaser to the retailer, in greater profits for the secondary purchaser, or in any combination of the three. The incidence of the benefits should vary with the structure of the relevant markets.

93. Goetz & Scott, *supra* note 3, at 290-91.

costs increase as secondary purchasers are forced to determine whether a given contract is in the old or the new standard form.

The existence of standards for some kinds of products poses even greater barriers to innovation. Many tangible good standards are what Professor Hemenway defined as "interchangeability standards." For example, a standard format for laying out the letters on a typewriter keyboard involves an enormous investment in human capital; even if changing typing technology made the old keyboard inefficient, the standard could not be changed without retraining millions of typists.⁹⁴ Fortunately, form contracts generally are what Hemenway termed "single product standards"⁹⁵ and thus can be changed without major retraining or replacement of complementary equipment. If the form contract would involve an interchangeability standard, even voluntary standardization should proceed warily because of the potential barriers to innovation.

C. *Encouraging Contract Commodity Standardization*

Based on the analysis above, the costs of contract standardization to distributional equity and discouraging innovation seem small. If these costs are small, what can be done to encourage efficient contract commodity standardization? Promoting voluntary standards-setting organizations similar to those found for tangible goods offers the best solution. Administrative actions, like those taken by Hoover's Commerce Department concerning tangible products, or legislation could encourage industries to form organizations to discuss standardizing their contract forms. Any encouragement should have two conditions: standards-setting organizations must include consumer representatives and proposed standards must be voluntary.

Consumer representation may reduce the bargaining imbalance and possible overreaching in current form contracts. Currently, each firm produces its own form contract without opportunity for comments by consumer organizations. Promoting forums in which many firms' forms can be affected simultaneously should increase both the likelihood and the effectiveness of participation by consumer groups.

Requiring standards to be voluntary should limit their costs. If the

94. For a fascinating history of keyboards and an analysis of the continuing power of the inefficient "QWERTY" keyboard compared to the much more efficient Dvorak alternative, see David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332 (1985), and David, *Understanding the Economics of QWERTY: The Necessity of History*, in ECONOMIC HISTORY AND THE MODERN ECONOMIST 30 (W. Parker ed. 1986). The limited recent economic literature on standardization has focused on barriers to innovation caused by interchangeability standards or "network externalities." See *supra* note 21.

95. See generally HEMENWAY, *supra* note 21.

standard is not efficient, then firms in the industry will ignore it. If a standard operates poorly in a specific case, then an individual firm will use a different form in that situation. If the market now has the efficient, "correct" amount of standardization, then the voluntary standards either will not be created or, if created, will be ignored. Unless the voluntary standards stifle innovation, society will have lost only the time involved in the standards-setting process.

Promoting standards-setting organizations, similar to those used for tangible products, would decrease many of the barriers to standardizing form contracts. Organizations could go far to limit the collective action problems firms face by both lowering the transactions costs in writing standards and increasing the probabilities that the agreed upon standards would be adopted. Industry concerns about contract enforceability or antitrust liability might be ameliorated by encouraging an open process with consumer representation. Standards also would decrease the barriers posed by firms' lawyers by focusing attention on the process of standardizing. Only the problems of federalism would remain untouched, and even state legislatures might be persuaded by voluntary standards to move toward national uniformity.

As long as barriers to standardization keep form contracts underused, there are gains to be achieved, gains in working hours and lives no longer devoted to reading, analyzing, and rereading endless variations on a theme. But how much time and money is unclear; the magnitude of the possible benefits may not justify much effort in light of the possible costs. Although one cannot predict the benefits of such a change with accuracy, the difference between the standardization of tangible goods and contract commodities is so striking and the probable costs are so low that careful encouragement of voluntary standard form contracts makes sense.

VI. CONCLUSION

[A] consumer contract of adhesion *looks* like a classic bargained contract. A consumer contract is *not* a thing, at least not the way cars, cows and couches are things, and no rhetoric is going to convince anyone for long that it is. Thus the real hope of an exercise like this is necessarily more modest than any total sensory transformation. It can aspire at most temporarily to smash the semantic box in which our current thinking is locked.⁹⁶

By conceptualizing form contracts as commodities, this Article has tried to create a theoretical framework for thinking about their prevalence. Although the framework does implicate public policy, it probably is most useful as a guide to empirical work into the standardization of

96. Leff, *supra* note 2, at 157.

legal documents.

But why bother? Concern with the style of the fine print in legal documents may appear to be true formalism, but the real issue is law-making power. An enforceable contract becomes the law between the parties, displacing whatever more general statutory or common law. The laws of residential mortgages may vary from state to state, but for eighty percent of recent mortgagors, the relevant law came not from their state's courts or legislatures, but from the FNMA and the FHLMC. Pressures from such secondary purchasers create a realm of law that is neither public law nor truly individual private law.

Law school education, teaching, and often research focuses on law books—the cases, statutes and regulations. But as teachers and scholars of law, our real concern is not—or should not be—the books or the models they contain, but the world they attempt to describe or control. In many respects, the world does not follow the model the law prescribes.⁹⁷ This Article attempts to foster a better understanding of the pressures that lead to standard forms, and thus a better understanding of the roles of private entities in making law—*not* the law of the codes, the reports, and the hornbooks, but the law of some corners of the real world.

97. See, e.g., Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 STAN. L. REV. 623 (1986); Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).