Transaction costs and the legal mechanics of exchange: the economics of negative options

Avery W. Katz

FTC Conference on Negative Options

January 25, 2007

Normative premises

- Maximizing gains from trade
- Freedom of contract as default institution
- Regulation needed when assumptions of FOK fail
    - No opportunity to contract
    - Uninformed or unsophisticated parties
    - External effects on third parties
    - Including public good aspects of drafting legal forms
    - But not necessarily market power as such

Main conclusions

- Rules of contract formation determine the transaction costs of exchange
  - Influencing what is exchanged
  - And the efficiency and fairness of the transaction
  - E.g., Amazon 1-Click
- Negative options can be efficient if likelihood of acceptance is sufficiently high
  - But can shift bargaining power to the offeror
  - A sophisticated offeror will demand up-front compensation

Economizing on message costs

- Sending and receiving messages are costly, so one message is better than two
- If most offers are rejected, efficient to presume silence is rejection
- But if most are accepted, efficient to presume acceptance
- What's optimal also depends on relative cost of errors
  - Is it costlier to accept an unwanted offer, or to reject a wanted one

The effect on price and quantity

- Offeror takes response cost into account when setting price
  - Price will be lower when a positive response is required
  - And higher when one must respond to reject
  - So the offeree is vulnerable to opportunistic offers
- An informed offeree will thus insist on up-front benefits to enter the arrangement (e.g., Book-of-the-Month Club)
  - Or will rely on offeror's reputational interests
  - E.g., automatic bill payment through ACH debit
- An uniformed offeree will be victimized

Second-best considerations

- Basic intuition: one market distortion might exacerbate or counteract another
- E.g., monopolizing a good with negative external effects
- Negative options marginally increase the quantity traded
  - Thus counteracting the efficiency loss from monopoly pricing
  - If consumers are compensated up-front, the net outcome improves efficiency
  - As with any two-part pricing scheme

Numerical example

- Messages cost \$1, the underlying good has zero marginal cost, consumer WTP ranges uniformly from zero to \$10
- Under standard regime, cost of responding reduces WTP (now from -\$1 to \$9)
  - Seller charges \$4.50, sells 4.5 units, earns \$20.25 gross profit, \$**10.25** net profit
  - Consumers with WTP ranging from \$5.50 to \$10 accept, enjoying surplus of \$**10.125**
  - Total social surplus is **\$20.375**

Numerical example, continued

- With negative option regime, WTP ranges from \$1 to \$11
  - Seller charges \$5.50, sells 5.5 units, earns \$30.25 gross profit, \$**20.25** net profit
  - Consumers with WTP ranging from \$4.50 to \$10 accept, enjoying surplus of \$**9.625**
  - Consumers who don't buy incur **\$4.50** sending rejections
  - Total social surplus is \$20.25 + \$9.625 – \$4.50 = **\$25.375**
- The gain comes from the unit increase in quantity, with average marginal benefit of \$5, over zero MC

Are negative options anticompetitive?

- They do raise rivals' costs of attracting customers
- But if the negative option arrangement is efficient, the differential is justified by real cost savings achieved by the incumbent's prior investment
- So not an entry barrier in the modern understanding
- But it could be anticompetitive
  - If the arrangement is not efficient
  - Or if consumer's nominal switching cost exceeds the real cost of leaving the relationship

Treatment under US contract law

- In general, offeror controls the structure of bargaining
  - With limits to protect offeree, including form-contract requirements
- Restatement of Contracts §69 makes silence acceptance when
  - Offeree takes the benefit of offered services with reasonable opportunity to reject them and reason to know they were offered with expectation of compensation
  - Offeree understands and subjectively intends to accept
  - Offeree exercises dominion over goods (overruled by 39 USC §3009, Mailing of Unordered Merchandise)
  - Because of previous dealings or otherwise, it is reasonable that offeree should notify the offeror if he does not intend to accept

Analysis of contract law doctrine

- Rule sensible overall, as most offers are rejected.
- Interesting question is whether it fits with exceptions
  - First three excepts are motivated by distributional fairness
    - consistent with the leading cases
  - Only the fourth has efficiency overtones: "previous dealings" or otherwise
- So equity a better explanation than efficiency

Compare UCC Article 2

- Article 2 contains several provisions that better track efficiency
  - 2-606 on rejection
  - 2-207 on counteroffers
  - 2-201 on Statute of Frauds.