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Regulation of Automatic Renewal Clauses: A Behavioural Law and Economics Approach

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Abstract Many consumer contracts, such as magazine subscriptions, mobile phone contracts, or fitness club subscriptions, are fixed-term contracts containing an automatic renewal clause. This paper provides the rationale of why such contracts are signed and what are the economic and legislative impacts of such clauses. Article seeks to offer a genesis of behavioural and traditional law and economics' arguments to regulate inefficient limitations upon the consumer's authority to terminate. The main findings are as follows: (1) In principle, obscure terms shrouding information on where and how to cancel should be regulated. (2) Formal requirements that impose a heavier burden upon the consumer to terminate (or to switch) than to subscribe with no offsetting economic benefit should be banned. (3) Legislator should intervene in to the formal requirements that increase switching costs imposed upon final consumers. (4) Legislator should intervene in cancellation deadlines that are set very early with no offsetting economic benefit. (5) Regulation mandating sellers to clearly and conspicuously ex ante notify consumers on automatic renewal in writing should be approached with cautiousness. (6) Provisions of Belgium and German law that fix the maximum duration of automatically renewed contracts and convert them into indefinite term contracts should be open to criticism.

Keywords Consumer · Automatic renewal · Behavioural law and economics

The use of fixed-term contracts is widespread within societies and industries. Some examples are magazine subscriptions, mobile phone contracts, contracts for the delivery of electricity, health club subscriptions, software licences, insurance agreements, rental agreements, satellite and cable television contracts, maintenance contracts, and labour contracts. Many of these

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contracts also contain a special automatic renewal clause. Automatic renewal provisions in fixed-term contracts specify that the contract will be automatically renewed for a new term unless the consumer gives notice of his intent to terminate some time prior to the end of the first term, called the cancellation deadline.

Automatic renewal clauses are often accompanied by strict requirements specifying when and how the contract can be terminated. Political decision-makers have paid much attention to the use of automatic renewal clauses in fixed-term contracts. It turns out that some consumers mistakenly forget to cancel the agreement in due time and are subsequently inefficiently bound for a new term. Maynes writes that "consumers [often] cannot find the time to manage effectively consumption that has grown more complex and dynamic (Maynes 1997)." In line with this observation, some legislators like France and the State of Illinois (USA) have introduced a duty of firms to notify consumers in advance that unless the consumer cancels, the contract will automatically renew. Moreover, recent econometric studies also offer evidence that automatic-renewal clauses might increase switching costs and average price and therefore also reduce consumer welfare (Crawford et al. 2011; Farrell and Klemperer 2007). However, despite this growing attention and regulatory intervention the triggering question of whether public authorities shall (and how this shall normatively be done) regulate automatic renewal clauses for reasons of consumer protection remains largely unanswered. This question represents also the focus of our investigation and our article seeks to provide a set of policy recommendations (from "traditional" and from "behavioural" law and economics) on how and when to intervene and identifies several sources of inefficiencies that should be a cause for concern for policymakers in all markets where such clauses are employed.

Employed "traditional" law and economics literature provides merely a few efficiency justifications for such automatically renewable contracts and several reasons why they might severely reduce competition and consequently also social welfare. Namely, "traditional" law and economics analysis suggest that automatic-renewal clauses should be viewed with scepticism since they might reduce consumer choices, increase switching/termination costs (transaction costs), hinder efficient termination, discourage efficient entry, increase average prices, and consequently also significantly reduce consumer welfare.

Provided "behavioural" law and economics investigation reveals that law should facilitate the efficient operation of markets by requiring disclosure of information that minimizes consumer mistakes (i.e., the mandatory disclosure of automatic renewal clauses). The cognitive bias and status quo bias literature generally favours expanding the range of government regulation to include also automatic renewal clauses among business practices that exploit the bias of consumers, or at least some consumers. Moreover, status quo bias generally acts, for example, similarly to transaction costs: It presents a barrier to reallocation when that would be value-enhancing. Some consumers may be cognitively limited in dealing with termination dates of a whole set of consumer contracts containing an automatic renewal clause. Hence, some consumers care more about the costs of commission; they might decide to do nothing even when cancelling would be in their interest. Empirical behavioural studies offer evidence that standard form contract are for example read in full by merely 4 to 5% of consumers (Hillman 2006) and also suggest that disclosure duties are not effective in increasing reading or their understanding of the conditions of the contract (Bakos et al. 2009). However, the extent of the insights of "behavioural" law and economics investigation that might be applied in order to offer normative suggestions to policy makers still remains unclear (Ogus 2000). Faure and Luth (2011) for example point out that the main findings of the behavioural literature are very context-specific and might apply only with respect to particular products or services.

Evidently, both “behavioural” and “traditional” law and economics assessment offer a set of arguments confirming the potential harmful effects of automatic renewal clauses for efficient market competition and for consumer welfare. The analysis calls for more substantive forms of intervention and also confirms/justifies the existing regulatory frameworks in the USA, England, and in The Netherlands strictly regulating automatic renewal provisions, and it also provides a clear path for an immediate statutory reform in those jurisdictions which have not yet regulated such automatic renewal clauses. Moreover, both analyses also suggest that such automatic renewal clauses should not be banned or outlawed completely but instead advocate more cautious approach (grey list) whereas automatic contract renewal provisions must be clearly and conspicuously disclosed. Hence, legislator should regulate the following: (a) obscure terms shrouding information on where and how to cancel, (b) formal requirements that impose a heavier burden upon the consumer to terminate (or to switch) than to subscribe with no offsetting economic benefi, (c) formal requirements that increase switching costs imposed upon final consumers, and (d) cancellation deadlines that are set very early with no offsetting economic benefits. On the other hand, the case of mandating sellers to clearly and conspicuously notify consumers in writing (in a certain reasonable notification period) that unless the consumer cancels the contract, it will automatically renew is generally not so firm. If one opts for such a provision than in order to be effective, additional rules for the advance notice may be required, as for example, a rule that the a written notice to the consumer must be made no less than 30 days and no more than 60 days before the cancellation deadline set by the contract. Furthermore, provisions of Belgium and German law that fix the maximum duration of automatically renewed contracts and convert them into indefinite term contracts should be open to criticism. Namely, such forms of regulatory intervention effectively limit consumer choices and should therefore be treated with great caution according to the “traditional” law and economics approach as well as according to the “behavioural” approach.

However, two caveats should be made. The first caveat is related to the general applicability of the “behavioural” law and economics assumptions in the ex ante stage of conclusion of contracts where consumers might behave differently in relation to whether they conclude contracts via the internet, mobile phone, or in a doorstep selling arrangements. Those different arrangements might indeed trigger different perceptions of cancellation period and, hence, also represents the inherent limitation of our investigation. Formulating general policy conclusions from the behavioural law and economics insights is difficult and this approach is currently still better at listing anomalies without providing an alternative theory (Faure and Luth 2011; Gigerenzer 2005; Mitchell 2002). The second caveat relates to the scientific authority that should be attributed to our findings. Law and economics is strictly speaking not a theory, but rather a method for facilitating discussions on the law. Therefore, the principles we draw from the literature express a personal opinion on what *should* be concluded.

An overview of existing regulatory responses in the European Union, US, Dutch, German, Belgium, and English law to the automatic renewal clause in fixed-term contracts will be given in section 2. Since there must be a minimum level of difference between compared systems to make any comparative enquiry worthwhile and since compared legal systems should at least be at a similar stage of development, English and US law have been chosen to represent common law systems and German law to represent civil law systems. Moreover, three legal systems are so-called “mature” or “parent” legal systems which have been extensively adopted or imitated by others, and hence the choice of comparison appeared to be “value-maximizing.” Further, for reasons of objectivity, scholarly curiosity, and the recent legislative proposals, our paper also provides an economic analysis of the automatic renewal clauses in the law of The Netherlands, Belgium, and the European Union. Another practical reason was involved, namely, the accessibility of legal materials, reports, and comments. The research question is structured as a universal concrete problem and, as such, together with the six chosen legal systems forms our *tertia comparationis*. The regulatory responses address the issue of automatic renewal in fixed-term contracts, not in contracts for an indefinite term. However, automatic renewal is per definition part of a contract for an indefinite duration, i.e., contracts which are automatically renewed until one of the parties decides to terminate it after giving notice of termination. Automatic renewal in indefinite term contracts does not attract the same regulatory response as in fixed-term contracts.[1] The reason for this is that for indefinite term contracts, the contract can generally be terminated at any time whereas under fixed-term contracts consumers need to meet the cancellation deadline in order to terminate the automatic renewal.

In their use of the automatic renewal clause, some consumers make mistakes. They suffer from imperfect information and imperfect rationality and consequently might fail to make choices that maximize their preferences. The question is not whether individuals make mistakes, which they do, but the question is whether these mistakes merit legal intervention and, if so, what type, or regulatory intervention is desirable. We address these questions from two different regulatory frameworks: "traditional" law and economics[2] (section 4) and "behavioural" law and economics[3] (section 5). The outcomes will be used to provide some comments on the existing regulatory responses to automatic renewal clauses (section 6).

Overview of Existing Regulatory Responses to Automatic Renewal Clauses

This section provides a comparative survey of regulatory responses to the automatic renewal clauses in the EU, US, German, Belgium, Dutch, and English law of contracts.

EU Legislation

The automatic renewal clauses are, after the adoption of a new Directive 2011/83/EU on consumer rights[4] which was published on 22 November 2011, aiming at achieving a real business-to-consumer (B2C) internal market, striking the right balance between a high level of consumer protection and the competitiveness of enterprises, still partially regulated in the Article 3, § 3 of the Directive 93/13/EEC[5] and further on in the Annex to the Directive 93/13/

[1] For employment contracts for an indefinite period of time, legislators have specified minimum notice periods.
[2] We define traditional law and economics as the one which operates in the domain of rational choice theory, where economic agents act as rational, self-interested, wealth maximizing, and risk-averse individuals. Hence, when individuals are confronted with various choices they will choose the option that yields them the most expected welfare. For a synthesis of traditional law and economics see, e.g., Posner 2011, (Korobkin and Ulen 2000), Korobkin 2004; Cooter and Ulen 2011.
[3] "Behavioral" law and economics retains the positive and normative core of law and economics but loosens the behavioural assumptions employed under the "traditional" approach. "Behavioural" law and economics substitute for a strict adherence to rational choice theory a more subtle and context-dependent view of how individuals chose behaviours and actions based largely on empirical studies of behaviour conducted by social scientists. This literature suggests that individuals often make decisions and selected actions based on heuristics, or rules of thumb, rather than on the basis of "rational" calculations of costs and benefits (Korobkin 2004). For a synthesis of "behavioural" law and economics, see Jolls et al. (1998). See also Kahneman and Tversky (1974).
[4] Directive 2011/83/EU OJ L 304/64, 22.11.2011 of the European Parliament and of the Council of 25 October 2011 on consumer rights amending Council Directive 93/13/EEC and Directive 1999/44/EC and repealing Council Directive 85/577/EEC and Directive 97/7/EC. See, however, a proposal for Directive 2008/0196 (COD) according to which all four previously existing EU consumer Directives shall be merged, modernized, and updated.
[5] OJ L 95, 21.4.1993.

EEC in the indicative and non-exhaustive list of the terms which may be regarded as unfair. This Annex lists under its heading (h) as potentially unfair, contract clauses that "automatically extending a contract of fixed duration where the consumer does not indicate otherwise, when the deadline fixed for the consumer to express his desire not to extend the contract is unreasonably early." Such an "automatic renewal" contractual term which has not been individually negotiated shall be according to the Article 3 § 1 of the Directive 93/33/EEC regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer. According to Article 7 of this Directive such unfair terms shall not be enforceable and such a contract shall continue to bind the parties upon those terms only if it is capable of continuing in existence without the unfair terms. This Directive 93/13/EEC justifies the regulation of cancellation deadlines in consumer contracts by reference to fairness concerns. The European Directive points out the possible "unfair" character of the cancellation deadline, but leaves it to the national legislators and to the court's decisions of the member states to implement it.

In addition, the new Directive 2011/83/EU on consumer rights, which despite different initial proposal[6] merely amends existing Directive 93/13/EEC, in Article 5 on information requirements for contracts other than distance or off-premises contracts states that before the consumer is obligated by a contract other than a distance or an off-premises contract, or any corresponding offer, the trader shall provide the consumer in clear and comprehensible manner (if that information is not already apparent from the context) with the information on "the duration of the contract, where applicable, or, if the contract is of indeterminate duration or is to be extended automatically, the conditions for terminating the contract." Obviously, in case that such an information on termination of automatically renewed contracts is not provided appropriately the party is not obliged to perform such a contract. However, provisions of the Directive 2011/83/EU on Consumer Rights will apply to contracts concluded after 13 June 2014 and will replace, also as of 13 June 2014, the current Directive 97/7/EC on the protection of consumers in respect of distance contracts and the current Directive 85/577/EEC to protect consumer in respect of contracts negotiated away from business premises. Directive 1999/44/EC on certain aspects of the sale of consumer goods and associated guarantees as well as previously discussed Directive 93/13/EEC on unfair terms in consumer contracts will remain in force.[7]

England and Australia

Even before English and European legislative regulations came into force, English case law had developed a series of protective mechanisms to review standard contracts. According to the case law, standard terms would only then form part of the contract, if the user had given the other contractual party reasonable opportunity to become acquainted with the terms (reasonable notice test).[8] The first piece of legislation in the United Kingdom was the *Unfair Contract*

[6] On 8 October 2008, the European Commission adopted a proposal for a new Directive on consumer rights (2008/0196 COD) which regulated the automatic renewal clauses in Articles 32 and 35 of the proposed Directive 2008/0196 (COD) and further on in the Annex III to the Directive where the contract terms which are presumed to be unfair were listed. This Annex III listed under its heading (f) as presumably unfair contract terms, which have the object or effect of "automatically renewing a fixed-term contract where the consumer does not indicate otherwise and has to give a long notice to terminate the contract at the end of each renewal period."

[7] Transposition of the new rules into the national laws shall be done by 13 December 2013, and the rules will be applied in all member states at the latest by 13 June 2014.

[8] Parker v. South Eastern Railway Co Ltd. [1877] 2 CPD 416; Thornton v. Shoe Lane Parking Ltd [1971] 2 QB 163.

Terms Act 1977, which is not limited to consumer contracts and which only covers a narrow range of terms.[9] The Directive 93/13/EEC was initially transposed in 1994 via a statutory instrument (Unfair Terms in Consumer Contracts Regulations) resembling the Directive almost word for word. This Unfair Terms in Consumer Contracts Regulations (1999)[10] is enforced by the Unfair Contract Term Unit of the Office of Fair Trading and its director general. In *Bradley Estate Agents Ltd.*[11] one of the consumers lay in an official complaint regarding the automatic renewal clause. Bradley Estate Agents Ltd. provides estate agency services and their agency contract contained an automatic renewal clause under which consumers acknowledge that the sole agency period referred to in one of the previous paragraphs (24 weeks) will last for a minimum period of 24 weeks and that the period of sole agency shall continue, unless and until terminated upon the giving at least 14 days notice in writing (which shall not expire until at least 24 weeks from the date hereof) and at the end of the said 14 days notice period consumer shall be at liberty to instruct another firm. The director general, who has tried the matter, points out that the sole agency term was unnecessarily confusing and likely to be unintelligible to consumers; it comprised a single sentence of eight lines with several parentheses and grammatical sub-clauses. He continues that simple and clear contractual wording was required and that the term needed to be highlighted by the use of italics or by giving a clear explanation in a brochure given to the consumer well before the contract was signed.[12] The clause automatically extended the life of the agreement unless the consumer indicated otherwise, but the consumer was unlikely to be aware of the term. As a result of this decision, the contract term has been re-formulated as follows: “If you want to end the sole agency at the end of that initial period, you must give at least 14 days notice in writing ending at the earliest on the last day of the initial period, which is (). If you do not give us notice at the end of the initial period, then the sole agency will continue after the end of the initial period indefinitely until it is ended either by you giving us notice…”[13]

Similarly, also the new Australian Consumer Law[14] introduces automatic renewal of contracts among terms that are presumed to be unfair (Carter 2010). Section 4(1) (e) of the Australian Consumer Sales Law[15] states that “a term that permits, or has the effect of permitting, one party (but not another party) to renew or not to renew the contract” may be found to be unfair.[16] According to commentators such a clause will unfairly disadvantage the consumer, which may suffer detriment where a contract is not renewed or is automatically renewed without the consumer’s consent (Holly and Svantesson 2010). However, according to Australian Consumer Law[17] such a clause will not be unfair where the automatic renewal of the contract is reasonably necessary and where the automatic renewal does not cause a significant imbalance between the parties (Holly and Svantesson 2010).

[9] Actually, it is designed to control exclusion clauses.
[10] The Directive was initially implemented into English law by the Unfair Terms in Consumer Contracts Regulations 1994 (SI No 1994/3159). The 1994 Regulations came into force on 1 July 1995 but were revoked and replaced by the Unfair Terms in Consumer Contracts Regulations 1999 (SI No 1999/2083).
[11] “Bradley Estate Agents Ltd.”, Unfair Contract Terms, Bulletin No. 3, 1997.
[12] Ibid.
[13] Ibid.
[14] Competition and Consumer Act 2010 - C2011C00003 - Schedule 2 (Australian Consumer Law), Act No. 148 of 2010.
[15] Ibid.
[16] Under section 2 of the Australian Consumer Law states that unfair terms in consumer contracts will be void. And a contract will continue to bind the parties to the contract to the extent that the contract is capable of operating without the undfair term; Ibid.
[17] Ibid.

Germany

Germany has since 1977 already comprehensively regulated the use of unfair contract clauses in the Act Concerning the Regulation of the Law of Standard Business Terms[18] It should be also mentioned that the scope of protected persons is considerably wider than under the Directive 93/13/EEC. Within the framework of the reform of the law of obligations, with the effect from 1 January 2002 the legislator repealed the AGBG and its substantive provisions were integrated into the BGB with minor, mainly drafting changes (BGB § 305–310).[19] The quoted Article 309 § 9 BGB refers to consumer transactions, and the provided list of terms is a black list (terms that are per se invalid) and is strictly applied. Article 309 § 9 BGB hence prohibits longer period of termination than 3 months before the expiry of the contractual relationship and an automatic, tacit lengthening of a contractual relationships. One should also note that, outside §§ 305 et seq. BGB, standard terms may be evaluated by the courts on the basis of good faith (§ 242 BGB), *bonus mores* (§ 138 BGB), and equitable discretion of unilaterally provided contract terms (§ 315 III BGB) which courts initially used for all types of contracts (Markesinis et al. 2006).

Belgium

Before 1991, Belgium lacked any explicit protection in the field of unfair contract terms. Thus, consumers had to have recourse to principles of general contract law. The Act of 14 July 1991 on Trade Practices and Consumer Protection was the first general Belgium regulation on unfair contract terms. The provisions were enacted in anticipation of the Directive 93/13EEC, directly inspired by its content. This act was amended on several occasions in order to meet the directive's requirements. The reforms expanded the personal and substantive scope and transposed the interpretation rule and transparency requirement of Art. 5 of Directive 93/13 into the TPA. Moreover, the reform changed the effects of unfair clauses. However, Belgium has regulated automatic renewal clauses in the Law of Commercial Practices.[20] The regulation applies only to contracts for the regular delivery of services, like health club subscriptions, telephone and internet contracts, and maintenance contracts. The regulation does not apply to contracts for the regular delivery of goods like gas and electricity or contracts for the hire of movable goods. The rules require that automatic contract renewal provisions be clearly and conspicuously disclosed on the fist page of the contract. In addition, after contracts have been automatically renewed, they can be terminated at any time with a notice period of a maximum of 1 month.

[18] Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen (AGBG).

[19] The new Article 309 § 9 BGB (effective period of long-term obligation relationships), considers as unfair also the automatic renewal clause and provides: "(a) in respect of a contractual relationship which has as its subject matter the regular delivery of goods or the regular effecting of services or work by the user,

(b) a tacit lengthening by, in each case, more than a year of the contractual relationship binding the other contracting party, or

(c) longer period of notice of termination than 3 months before the expiry of the contractual duration provided for initially or extended tacitly and which is to the disadvantage of the other contracting party; this does not apply to contracts for the delivery of things sold as related to each other, for insurance contracts, and for contracts between the proprietors of copyright rights and claims and exploitation companies in the sense of the Act on the exercise of copy rights and related protective rights."

[20] The rules on automatic renewal clauses have been inserted into the Law on Commercial Practices by the Law of 25 April 2007.

The Netherlands

Before 1992, the Dutch Civil Code did not contain any specific provisions on unfair contract terms. Those terms used in consumer contracts were dealt with by the courts by means of the general doctrine. The courts often applied the principle of "good faith" in order to fill in gaps and to nullify unacceptable terms. Yet the new Dutch civil code which came into force on 1 January 1992 contains special provisions on unfair contract terms (Art. 6:231–6:247 BW). The respected black list and the grey list (Art. 6:235, 6:236 BW) relate only to consumer contracts. However, one should note that the new legislative proposal 30,520 aims at regulating automatic renewal clauses in fixed-term contracts. The proposal provides the following rules:

– Contracts can only be automatically renewed for a maximum period of 3 months;
– Formal requirements to cancel may not be more burdensome that formal requirement to subscribe;
– Maximum notice periods of 1 month.

United States of America

In US legislation on enhancing consumer rights throughout their transactions varies widely from one state jurisdiction to another. Today, the need to protect contracting parties has resulted in a plethora of state and federal legislation, supplementing the protections afforded by the common law and the Uniform Commercial Code (Barnett 2012; Farnsworth 2008; Scott and Kraus 2007). An example of an earlier special state legislation to protect consumers is the Illinois Automatic Contract Renewal Act as amended on 19 August 2004 as P.A. 93-0950.[21] The act requires that automatic contract renewal provisions be clearly and conspicuously disclosed. A failure to make an automatic renewal provision in a contract clear and conspicuous renders the automatic renewal provision unenforceable at the election of the party that did not draft the contract. In addition, the business must provide the consumer with notice that the contract will renew unless the consumer cancels the renewal. To that end, Section 10(b) of the amended Act provides that a business that enters into a contract with an initial term of 12 months or more, and that automatically renews for a period of more than 1 month unless the consumer cancels, must notify the consumer in writing of the automatic renewal. Moreover, the following conditions must also be fulfilled:

- The written notice to the consumer must be made no less than 30 days and no more than 60 days before the cancellation deadline set by the contract;
- The notice must be in writing and must clearly and conspicuously disclose that unless the consumer cancels the contract it will automatically renew;
- The notice must be in writing and must clearly and conspicuously disclose where the consumer can obtain details regarding the automatic renewal provision and the cancellation procedure (e.g., a number to contact the business or a reference to the contract provision).[22]

[21] 815 ILCS 601/1 (Illinois Automatic Contract Renewal Act).
[22] Ibid.

Recently, the state of Florida in 2010 passed a new state legislation affecting automatic renewal clauses (House Bill 751) according to which service providers must include a clear and conspicuous clause in the contract specifying the terms of the automatic renewal, as well as give notice (with a notice period between 30 and 60 days prior the automatic renewal) that the contract will be automatically renewed. In the past 4 years, this automatic renewal has become a popular issue and several other states enacted similar automatic renewal legislation.[23]

Economic Rationale of Automatic Renewal Clauses

The use of automatic renewal clauses can easily be analysed using "traditional" law and economics techniques (Posner 2011). The issue is one of minimizing transaction costs and boils down to question whether it is more likely that the parties want to continue the current contract or wish to have a different contract, including no contract at all. Without an automatic renewal clause, parties must incur transaction costs each time they wish to have their continued relationship governed by the current contractual rules. Termination of the contractual relationship is costless, as it requires not renewing the current contract, which is achieved by doing nothing (i.e., automatic termination). This is a form of opt-in mechanism (Table 1). When one uses automatic renewal clauses, the picture is exactly the opposite: Renewing contracts, extending its reign over the contractual relationship, is costless, but the exit costs are positive since transaction costs must be incurred to end the automatic renewal. This is a form of opt-out mechanism (Table 1). Assuming that the costs of termination and renewal are equal among parties, automatic renewal is then efficient when at date t_0 it is more likely that the parties will continue the contract at date t_1. Therefore, when a long-term contract is spot implementable through repeated identical spot or fixed duration contracts, automatic renewal is efficient when it is more likely than not that the agent will be of the same type. In that case, there will be a lot of contracts which are renewed. Forcing the seller and buyer to incur the cost of renewing the contracts would increase the transactions costs of the exchange without a direct benefit.

What are the contract law rules with respect to automatic termination versus automatic renewal? The default contract rule—that is the rule that governs the relationship between contracting parties only if the parties do not explicitly agree to different terms (Ayres and Gertner 1989; Hermalin et al. 2008; Posner 2011; Scott 2003)—is as follows: automatic termination for fixed-term contracts and automatic renewal for contracts for an indefinite term. Hence, contracting parties, to a fixed-term contract, need explicitly to agree on automatic renewal of their contractual relationship. When it is more likely than not that the contract will be renewed, automatic renewal is the optimal choice; when it is more likely than not that the contract will be terminated, automatic termination is efficient. Of course, even under an automatic renewal regime, a minority of customers will terminate the contract. They will do so when that is in their interest, namely, when the transaction costs to cancel are less than the expected gains from terminating. These are the explanations and predictions made from a rational choice perspective. From this perspective, one might argue that there is no need to regulate automatic renewal clauses because they appear to be a rational response to the problem of minimizing transaction costs.[24]

However, there might be an additional phenomenon at stake. Namely, sellers might prefer not to hear from consumers that they do not want to renew the contract because that will

[23] For example, Arkansas, Connecticut, New Mexico, North Carolina, New York, Pennsylvania, Tennessee, and Utah.

[24] Neither are there involved any negative externalities.

Table 1 Opt-out and opt-in mechanisms

	Cancellation costs	Renewal costs
Opt-out: automatic renewal	+	−
Opt-in: automatic termination	−	+

decrease their expected revenues.[25] Accordingly, those sellers would have strong incentives to limit the authority of the consumer to terminate the contract. In other words, firms increase consumer transaction costs because by doing so they increase their revenues. Although such practices reduce the total surplus from an exchange, firms find that acceptable since they maximize their individual gains from the transaction. This discouragement of consumers to terminate a fixed-term contract—which is otherwise automatically renewed—can be done by deliberately inflating transaction costs which the consumer has to incur when he wants to cancel the contract (Sovern 2006). Rational, self-interested, risk-averse, and wealth-maximizing consumer will thus refrain from termination if the transaction costs can be made high enough.[26]

Hence, if a seller can inflate consumer transaction costs to the point where the costs of terminating exceed the benefits derived from termination, a rational consumer will not terminate, and consequently a contract will be renewed.[27] Thus, as "traditional" law and economics suggests, the practice of artificially increased consumer transaction costs might lead to an inefficient allocation of resources, where such contractual terms might be a source of inefficiencies and where accordingly their daily application should be cautiously screened (Sovern 2006).[28] Following subsection, while employing the "traditional" law and economics tools, offers some further substantive insights.

Regulation of Automatic Renewal Clauses Under the "Traditional" Law and Economics Approach

On many occasions, the law and economics analysis of contract law has relaxed the assumption of strong rationality[29] by accounting for information costs (including search costs),

[25] In many contexts, contracting parties have no incentive to increase transaction costs unnecessarily. Conventional economic wisdom even suggests that if people unnecessarily increase the costs incurred by their contracting parties, those parties are likely to find it cheaper to do business with a competitor. Consumer transactions, however, do not always follow this rule, since in some instances business benefits by increasing consumer transaction costs to the detriment of consumers.

[26] Rational consumer will engage in termination until the costs of doing so exceed the transaction's benefit (where the benefit of the termination consists of the difference between the price and the value of the service during renewal period). For a synthesis on rationality, wealth-maximization self-interest and risk-aversion, see Posner (2011).

[27] Although one should note, that this might not work for all consumers with their valuation lower than the price, some consumers might be effectively deterred from terminating the contract due to this high transaction costs. As a result, they will be bound by the contract for an additional term even when the price is higher than their valuation of the contract.

[28] Since P>MB (where P=price, MB=marginal benefits), the consumer could gain by getting out of this transaction and acquiring something for which the price would be equal or below MB. Even more specifically, it causes an inefficient delay in termination by increasing the time period between the moment that the valuation decreases and the effective termination date.

[29] Under the strong version of the rationality assumption, it is assumed that individuals never make mistakes, only buy products they really want for the lowest price, are fully informed about the clauses they sign, have perfect knowledge about their preferences and needs, have stable preferences (perfect willpower), always do what they plan to do, never regret transactions, etc.

decision costs, imperfect information on one's own preferences (e.g., incapacity), and instable preferences (e.g., paternalism-upon-request). In the law and economics literature on the signing-without-reading problem (De Geest 2002; 2011), it is acknowledged that individual consumers are not always informed on the clauses in their contract.[30] When consumers sign contracts without reading or understanding them, the contract drafter possesses more information on the contract than the party who signs it. Signing-without-reading is a form of asymmetric information problem; information is imperfect on the terms (content) of the contract, not on the characteristics of the goods or services purchased (De Geest 2002, 1994). Contract drafters might speculate on the consumer's signing-without-reading and include inefficient terms in the contract. Inefficient terms are those of which the costs are not offset by economic benefits. In the light of the signing-without-reading problem, it is economically justified to regulate contract terms that are inefficient to all contracting parties (De Geest 2002). An example of an inefficient contract term is a clause which makes performance of the contract more costly without any offsetting economic benefit. The fact that no rational party would ever agree with such a clause is indirect evidence of the existence of an information imperfection either because a contracting party rationally signed the contract without reading it or because he is not rational. Because it will often be difficult to prove information problems, it is appropriate not to require evidence on the lack of information in order to invalidate the clause; in this case, direct regulation—in the form of a legal prohibition—is more appropriate. An alternative policy response to the signing-without-reading problem to mandate sellers to clearly and conspicuously disclose contractual deviations from legal default rules (De Geest 2002).

Is regulation of the terms with regard to automatic renewal justified in the light of the analysis of the previous paragraph? This would be the case when the terms that govern the clause are inefficient for all contracting parties, for example when the terms make performance more costly without any offsetting economic benefit. With automatic renewal, the contract does not end automatically; the buyer needs to incur cancellation costs to end the automatic renewal. The intention to end the automatic renewal must be expressed in some way, some time before the contract is automatically renewed, called the cancellation deadline. The contractual terms governing the cancellation might increase costs (without offsetting economic benefits) in different ways.

First, the term concerning the cancellation might lack important information to allow the consumer to cancel. By shrouding the terms of the contract, such as the address, phone number, or e-mail address to which the cancellation order should be sent, consumer transaction costs are increased.[31] Time and effort must be invested by the consumer to find out (if he finds out at all) where to send his intent to terminate the contract. It is clear that the practice of obscuring terms to make it more costly for consumers to cancel has no offsetting benefits.

Second, usually the consumer must fulfil some formalities in cancelling the contract, such as a *written* notice of termination or the requirement that the cancellation order should be sent by registered post. Although more stringent formalities are more costly to fulfil, there is an

[30] For a synthesis, see De Geest and Kovac (2009). See also Polinsky and Shavell (2007).

[31] For example, mail-in rebates that increase the costs consumers must incur to obtain the reduced price instead of simply paying less for the item from the beginning. Consumers must fill out a form, gather proofs of purchase, holding a bottle under boiling water to remove the neck label so that it could be submitted to the manufacturer, etc. The obvious result is that only a handful of consumers obtain the rebate. The term inflated consumer transaction costs was coined by Sovern (2006). Another example concerns opt-in and opt-out approaches to personal privacy. Firms might discourage consumers to opt out of the trade in their personal names by increasing the transaction costs in opting out relative to the costs of opting in, for example, by requiring those who opt out to write the firm without providing a form that the consumer could fill out and return to the company. Firms, for example, also increase the transaction costs to effectively use a guarantee. See also Gabaix and Laibson (2006).

offsetting benefit in terms of a reduction of uncertainty concerning the legal position. The costs of proof of that legal position will be lowered with formal requirements. However, the costs of the formalities might be higher than its benefits. How can we find out whether the costly formalities are an attempt to unnecessarily inflate consumer transaction costs rather than a justified requirement to reduce the costs of proof? The business might require special formal procedures to be followed, such as the requirement to write a letter by registered post to cancel, even though the company permits consumers to express their wishes by telephone on matters on which the company wishes to hear from them, such as when consumers subscribe. It is therefore instructive to compare the formalities required at the formation stage with the formalities required at the cancellation stage. If a tapped phone conversation or an e-mail is sufficient proof of acceptance of the fixed-term contract, why would it not be sufficient proof of the intention to terminate? Formal requirements are therefore a priori undesirable when they impose a heavier burden to cancel than to subscribe.

Finally, the consumer must notify the firm of his intent to terminate some period, e.g., 2 months, before the automatic renewal. Failure to meet the cancellation deadline will result in the automatic renewal of the contract. When cancellation deadlines are set very early, the costs of performing (ie. cancelling) are made more costly than necessary. The costs of performing could even be indefinite when the consumer decides to terminate after the cancellation deadline has passed. Because the intent to terminate must be expressed before the cancellation deadline, this deadline limits the consumer's authority to cancel by shortening the period during which the consumer can cancel. Due to an external shock affecting the value of the contract to the consumer, he might wish to terminate the contract rather than to renew it.

However, when the external shock leading to a reduction in the value of the contract occurs after the deadline for cancellation, the contract will nevertheless be automatically renewed. Assume that the consumer signs a 1-year contract that will be automatically renewed for another year unless the consumer gives written notice of his intent to terminate 3 months prior to the end of the contract. Due to the cancellation deadline, the consumer's authority to cancel is limited in time; in our example, the consumer can only cancel during a period of 9 months. The consumer, who only finds out in the tenth month that the contract renewal is not value-enhancing, will not be able to cancel the contract as the cancellation deadline has passed. He will be bound to the contract for another year although this contract renewal is not efficient. When the probability of a lower valuation for the good or service provided is identically distributed over time, limiting the authority of the consumer effectively increases the expected difference in time between the lower valuation and the effective termination of the contractual relationship, resulting in suboptimal allocation of resources.[32]

Moreover, Crawford et al. (2011) analysed 180,000 consumer contracts in the UK's telephone markets and found that, controlling for the effects of tenure, broadband purchase, price discounts, and self-selection, rollover households switch after their first minimum contract period 34.8% less than comparable customers on standard fixed-term contracts and by 54.8% less than comparable customers of British telecom's fixed-term contracts. Their results imply that automatic-renewal contracts induce switching costs (transaction costs) on the

[32] Furthermore, one may also argue that cancellation deadlines artificially increase the risk for the consumer to be bound to a contract arrangement that he regrets or that might have become inefficient. Under a fixed-term contract, the consumer assumes the risk (for the duration of contract) that changed circumstances cause him to regret the arrangement. The decision to assume voluntarily the risk of uncertain and unforeseeable events is presumably motivated by the corresponding gains that the fixed term agreement offers in terms of fostering investments in transaction-specific assets (Goetz and Scott 1981, pp. 1089–1140). In other words, cancellation deadlines increases the risk of being bound to the contract when valuation is below the price by increasing the consequences when the decrease in valuation occurs after the cancellation deadline has passed.

order of 33% of the monthly price of the average BT fixed-voice telephone service (Crawford et al. 2011).[33] Viard (2007) also points out that reduced switching costs make markets more competitive in US long-distance telephone service. Furthermore, Handel (2013) in his analysis of switching costs and adverse selection in the choice of US health insurance plans found, holding prices fixed, that eliminating switching costs (like costs imposed upon consumers by the automatic renewal of contracts) would improve consumer choices and increase welfare by 10%. Such increased switching costs (consumer transaction costs) may also replace competition period-by-period with competition for consumer's "lifecycle requirements" (Farrell and Klemperer 2007; Klemperer 1987; 1995) which may also imply social welfare losses due to consumers that are either myopic or make mistakes. Alghion and Bolton (1987) also suggest that such increased transaction costs (switching costs) imposed upon consumers by the automatic-renewal clauses may discourage efficient entry by limiting the ability of a potential entrant to attract new consumers. Furthermore, a likely short-run effect of such increased switching (transaction) costs is that these costs also reduce rival's incentives to attract customers by cutting prices or promoting their own products. Farrell and Klemperer (2007) point out that it is likely that higher switching costs actually increase average prices and therefore also reduce consumer welfare significantly.[34] In addition, automatically renewable contract may also introduce exclusive contracts over a portion of seller's customer base, and this consequently reduces the likelihood of either new market entry or the introduction of new services by existing rivals which again reduces welfare (Whinston 2006). These empirical results confirm main outcomes of the "traditional" law and economics analysis and suggest that automatic-renewal clauses should be viewed with scepticism since they might reduce consumer choices, increase switching/ termination costs (transaction costs), hinder efficient termination, discourage efficient entry, increase average prices, and consequently also significantly reduce consumer welfare.

However, could one out of the cancellation deadlines distillate any offsetting benefits? Can such contract terms ne justified on efficiency grounds? What could be the possible objective of such a requirement? Why is it not sufficient for the consumer to inform the seller, for example, 1 day before the end of the contract of his intention to terminate? The most prominent argument in the economics literature is that exclusive contracts can solve problems of asymmetric information and/or moral hazard (Whinston 2006). For example, a prior notification of the intent to terminate allows the seller to adjust to the changed situation or to refrain from incurring costs in reliance upon the renewal of the contract. Assume that some time prior to the renewal date, the firm starts to incur costs in reliance upon the renewal. If the consumer would terminate unexpectedly, these reliance investments would be wasted. Sports clubs, for example, might have to rent space and materials in advance. In the situation where the firm needs to incur some reliance costs prior to the supply of the service, it makes sense to require that the consumer informs the seller of his intention to terminate before the reliance investments are made. Knowing that the consumer wants to terminate the contract, e.g., 3 months rather than 1 day before the end of the contract will reduce the costs incurred by the firm (sunk investments).[35]

[33] In other words, a rival would have to offer (in perpetuity) a discount on the price of its fixed line voice service of 33% of the price paid in order to overcome the average switching costs imposed on households induced by automatically renewable contracts (Crawford et al. 2011).

[34] In addition.

[35] Further justifications for such inefficiencies from the ex ante perspective, such as screening and investment considerations might exist, but do not hold for the sources of discussed inefficiencies. Namely, screening considerations might justify holding the consumer to the contract he signed for the current period, but do not hold with regard to the renewal which is induced by the time limits to terminate. On economics of screening and self-selection in case of book clubs see Coyte and Ryan (1991). See also Glazer and Hassin (1982) and Liebowitz (1983).

It is, however, easy to see that not all consumer contracts have this characteristic. In many cases, the only adjustment that needs to be made is to register that the service is no longer due to the customer as from a particular date. A prior notification equal to the time that is needed to register the change avoids that services would be delivered when they are no longer due. However, any termination period beyond that period causes an inefficient delay in the termination and burdens the consumer with additional risks. Moreover, any such sunk investments on side of businesses can be more efficiently protected by the use of default option such as severance payments and renegotiation design.[36] Furthermore, such justifications (moral hazard/asymmetric information) are unlikely to be relevant where one is addressing the final customer. Such arguments that automatic renewal clauses may help lower signup costs might be credible, but presumably only for the first term and not on the rolling basis (Crawford et al. 2011). They could indeed decrease marketing costs but simultaneously also increase significantly costs of the competitive process and hence substantially reduce consumer's welfare.

In sum, the "traditional" law and economics literature provides merely a few efficiency justifications for such automatically renewable contracts and several reasons why they might severely reduce competition and consequently also social welfare. An efficiency case can be made to regulate the following:

- Obscure terms shrouding information on where and how to cancel;
- Formal requirements that impose a heavier burden upon the consumer to terminate (or to switch) than to subscribe with no offsetting economic benefit;
- Formal requirements that increase switching costs imposed upon final consumers;
- Cancellation deadlines that are set very early with no offsetting economic benefit.

Regulation of the Automatic Renewal Clause Under a "Behavioural" Law and Economics Approach

The new movement of "behavioural" law and economics builds on the core insights of law-and-economic scholarship but takes seriously the shortcomings of rational choice theory.[37] With the advent of the behavioural approach, the additional regulation of automatic renewal clauses has much political traction today. This section identifies the main principles of the general insights from behavioural law and economics, continues with the specific behavioural analysis of Oren Bar-Gill (2007) on consumer use-pattern mistakes, and tries to compress them into a single set of general "behavioural" principles. For each section in turn, we make a distinction between the positive and the normative analysis.

General Behavioural Approach

A large part of behavioural economics describes ways people sometimes fail to behave in their own best interest due to all sorts of cognitive and emotional impairments (Jolls 2007; Jolls et al. 1998; Korobkin and Ulen 2000; Thaler and Sunstein 2008). A behavioural approach

[36] On default options and sunk investments in an incomplete contracting environment, see Nöldecke and Schmidt (1995) and Aghion et al. (1994).

[37] For a synthesis, see Vandenberghe (2011); Camerer and Talley (2007), and Diamond and Vartiainen (2007). For a review, see (Angner (2012)) and Jolls (2010). See also Camerer et al. (2004) and Jolls et al. (1998).

to contracts analyses how these features of human behaviour affect decision-making in contracting (Sunstein 1997). In accordance with this line of research, we ask what kind of cognitive mistakes may make under an opt-out regime such as automatic renewal as compared to a an opt-in regime such as automatic termination.

Some consumers may be cognitively limited in dealing with termination dates of a whole set of consumer contracts containing an automatic renewal clause. Simon asserts that the mind is a scarce economic resource (Simon 1982).[38] Some consumers may be unable to effectively terminate the automatic renewal when that would be in their interest. In addition, a robust finding in the behavioural-decision research literature has been labelled the status quo bias (Samuelson and Zeckhauser 1988). People are much more likely to stick with existing policies, consumption bundles, and so on than normative theories would predict, even when the costs of switching are very low (Korobkin and Ulen 2000). Some people might have a tendency to do nothing even when taking action to cancel would be in their interest (Brennan 2007). What are the causes of the status quo bias? One potential cause is what is called the omission/commission bias—the tendency to care much more about errors of commission than about errors of omission (Ritov and Baron 2000).[39] Recall that doing nothing (omission) under automatic renewal clauses results in the automatic renewal whereas actively cancelling (commission) leads to termination. Because some consumers care more about the costs of commission, they might decide to do nothing even when cancelling would be in their interest. Another possible source of the status quo bias is procrastination—the tendency to repeatedly delay taking beneficial actions based on a mistaken belief that one will take them in the future (O'Donoghue and Rabin 2000). The status quo bias acts similarly to transaction costs: It presents a barrier to reallocation when that would be value-enhancing (Korobkin and Ulen 2000). There is a potential resource misallocation that may flow from these errors. Here, the mistake is that consumers obtain the goods or services when the value to them is below the price.

Moreover, as discussed in the previous section on "traditional" law and economics literature, a cornerstone of the law and economics approach to standard form contracts is the "informed minority" hypothesis: In competitive markets, a minority of term-conscious buyers is enough to discipline sellers from offering unfavourable boilerplate terms. Yet, Bakos et al. (2009) tracked the internet browsing behaviour of 45,091 households with respect to 66 online software companies to study the extent to which potential buyers access the associated important standard form contract, the end-user licence agreement. He found that only one or two out of every thousand retail software shoppers chooses to access the licence agreement, and those few that do spend too little time, on average, to have read more than a small portion of the licence text (Bakos et al. 2009). Furthermore, Hillman (2006) found that only 4% of participants read e-standard forms, whereas Stark and Choplin 2009 show that only 5% of consumers read the downloaded contract terms and that car rental contracts are read by almost 72% of consumers.

Of course, these cognitive impairments—when they exist—equally apply in the case of an opt-in mechanism under which the contract is automatically terminated and consumers must actively renew it. Some consumers are cognitively limited in dealing with renewal dates of a whole set of consumer contracts and hence will not be able to renew in time when that would

[38] More specifically, attention is a scarce resource.

[39] Their study concerns the role of two biases in hypothetical decisions about vaccinations. One bias is the tendency to favour omissions over commissions, especially when either one might cause harm. The other bias is the tendency to withhold action when missing information about probabilities is salient. They show that this bias is found even when the overall probability of each outcome is clearly constant across the conditions compared (Ritov and Baron 2000, pp. 168–170).

be in their interest. And when the status quo bias applies, some consumers will stick with the automatic termination when active renewal would be in their interest. However, in this case, the sellers will have every incentive to help consumers to overcome their cognitive impairments, where in the former case, the mistakes made are in the seller's interest, as they prefer not to hear that consumers want to cancel their arrangements.

The cognitive bias literature generally favours expanding the range of government regulation to include a wide variety of business practices that exploit the bias of consumers, or at least some consumers (Faure and Luth 2011; Ogus 2000). Such regulation is called paternalistic in kind, because it attempts to protect individuals against their own cognitive and emotional impairments. According to asymmetric paternalism, a policy is asymmetrically paternalistic if it creates large benefits for those people who are boundedly rational while imposing little or no harm on those who are fully rational (Camerer et al. 2003).[40] However, asymmetric paternalism merely provides a metric for evaluating paternalistic policies; it does not provide a justification for paternalistic policies in the first place.[41] The movement is still in search for a normative theory that justifies regulation once cognitive and emotional constraints on consumer's behaviour have been determined (Rischkowsky and Doring 2008). What we do find in the literature are arguments made by the opponents of paternalistic intervention even when the existence of cognitive and emotional impairments is recognized. What are the critical arguments against regulatory responses to protect boundedly rational individuals?

First, even individuals who suffer from both cognitive and emotional impairments can still be regarded as "rational" under weaker versions of that concept. People with these dual limitations still make responsible decisions in their own self-interest, as much of standard economic thought presupposes (Ogus 2000). Why? People learn. They do so because they pay the price for their own error (Epstein 2008; List 2003, 2006). Error leads to frustration whereas rationality leads to an increase in utility. No one could claim that no consumer will fall for the same marketing ploy twice.[42] But people usually learn both from their own errors and from the errors of others—bad new travels fast. People of limited capacities learn to cope with their own limitations and to succeed in spite of them, as they often do (Epstein 2008). On this view of the world, rational conduct does not mean making the one right choice in accordance with some abstract utility function in all states of the world (List 2003, 2006). It means investing in emotional and intellectual controls that allow one to work a bit better than one did before (Epstein 2006). There is a good deal that people, aware of their own limitations, can do to improve their situations (Tor 2008). For those events on which people have little direct knowledge, they need not rely solely on the input from potential transactors on the other side of the market. Often they seek either advice informally from friends or from professionals who know more than they do (Jolls et al. 1998). The crucial issue is whether people who make cognitive errors are aware of their mistakes (Jolls et al. 1998). If consumers are aware of their errors they will do something about it (Epstein 2008). For example, faced with their cognitive limitations on dealing with termination dates of a whole set of consumer contracts containing an automatic renewal clause, consumers might use online management services for subscriptions, such as abon-nee.nl or aboklik.nl. Consumers have private incentives to demand

[40] Policies in response to errors in decision making include default rules, provision or re-framing of information, cooling-off periods, and limiting consumer choices.

[41] Ogus (2000), for example, argues that one should be careful with paternalistic interventions based on cognitive biases, since there may still be welfare maximization notwithstanding the biases and hence there should not be any need for regulatory intervention.

[42] However, under some circumstances like in cases of herd behaviour, specific vulnerability (e.g., Homer Simpson effect) consumers will make such mistakes several times since learning curves do not work always. See, e.g., Laurance et al. (2011).

"paternalistic" help from market parties (Faure and Luth 2011). The availability of "market" protective devices makes it unwise to assume that an additional layer of public regulation will perform any useful protective function (List 2003, 2006). One notable exception where paternalistic intervention by the government might be warranted is linked with the concept of paternalism upon request (Thaler and Sunstein 2008). For psychological reasons, individuals may want to create a pressure system that forces them to do what they want to do (Thaler and Sunstein 2008). Sometimes, only the government can provide such a pressure system because it has a monopoly on using force (wearing seat belts) or because an infringement of property rights is required of those persons who would make it psychologically difficult for others to fulfil their goals (e.g., drugs dealers).

Second, competition among sellers might protect customers who suffer from cognitive limitations. Where information imperfections exist, economic theory has shown that under certain conditions, the market itself will provide solutions (Hadfield et al. 1998). For example, because consumers have imperfect information about the quality of products, the market offers solutions in the form of warranties (Grossman 1981; Milgrom 1981). Will the market also provide solutions for consumers who suffer from cognitive and emotional limitations? If consumers are aware of the problems they have with automatic renewal clauses in fixed-term contracts, some sellers might start to offer contracts that provide for help to manage termination dates. They have an incentive to do so when it will attract more customers and when the cost of providing the service is below the benefits to consumers. However, when automatic renewal is indeed a profitable practice that takes advantage of consumer mistakes, no single seller might have an incentive to offer such a service and the market-based solution is unlikely to emerge (Hadfield et al. 1998). We could also think of the possibility that sellers in a competitive market start to offer contracts in which the costs of mistakes are reduced. One such possibility is a fixed-term contract where the contract can be terminated at any time after automatic renewal. A consumer who mistakenly fails to cancel his fixed-term contract is then not bound for an additional fixed term, but can, for example, cancel the contract by the month. The difficulty, however, with contracts that can be cancelled at any time is strategic, opportunistic behaviour of customers.

Third, not all consumers have the same preferences and not all consumers are equally prone to make cognitive mistakes to the same extent. The group of customers is not homogenous (Korobkin 1998; Korobkin and Ulen 2000). A distinction can be made between inattentive or naïve consumers and sophisticated consumers (Thaler and Sunstein 2008). Particular trade practices which might be costly to customers who make mistakes might be perfectly rational for sophisticated consumers. Prohibiting terms of trade because they are costly to a group of inattentive customers would impose enormous wealth losses because those customers who do benefit from these terms would no longer be able to contract for them (Ogus 2000). It is, for example, not desirable to bring down people who know how to use cancellation deadlines in the effort to help those who are in trouble with the opt-out system (Thaler and Sunstein 2008; Sunstein 2001). However, asymmetric paternalism aims for policies that create large benefits for those people who are boundedly rational while imposing little or no harm on those who are fully rational (Rachlinski 2003). From this perspective, policies that aim at information disclosure are preferable to policies that regulate terms by prohibiting them (Thaler and Sunstein 2008). Information disclosure mandates do not limit the choice in contract terms. Asymmetric paternalism proponents are in favour of information disclosures because it is assumed that information disclosure offers benefits to boundedly rational individuals and they do no harm to sophisticated customers (Thaler and Sunstein 2008). Yet, two additional remarks should be introduced.

Namely, a shortcoming of the asymmetric paternalism metric for evaluating the benefits of paternalistic policies is that is unclear how the benefits are to be assessed against the background of irrational individuals (Rachlinski 2003; Ogus 2000). Behavioural law and economics challenges the core assumptions of rational choice theory, but it lacks an alternative coherent theory of behaviour (Faure and Luth 2011; Gigerenzer 2005; Mitchell 2002). With this shortcoming, no one is quite sure what additional disclosures should be made or has confidence that they could alter behaviours in the right way (Ogus 2000). How are the effects of a legal command to be assessed when rational choice theory is set aside but no alternative overarching theory of behaviour is available? Behavioural law and economics scholars address this critique by stating that "one can analyse the appropriate legal command in any given circumstances without a grand, overarching theory of behaviour so long as one has a due regard for the relevant decision-making capabilities of the actors in that specific setting" (Korobkin and Ulen 2000). Second, while forms of disclosure offer the greatest advantage to the least educated, the costs of regulatory compliance with disclosure mandates are spread across a wider population, meaning that sophisticated consumers are harmed (Ogus 2000). It is very likely that the costs of information disclosure will be shifted to all consumers through slightly higher prices for the goods and services. The ex ante costs of regulation fall on good and bad consumers alike. Moreover, in the presence of cognitive errors information disclosure duties may remain ineffective (Rachlinski 2003).

Finally, one cannot be certain that when government intervention has the effect that people do substitute away from trade practices that may exploit their cognitive errors and that they will take a straight and narrow path instead of some other ruinous choice (Korobkin 2000; Korobkin and Ulen 2000). People who have problems in dealing with automatic renewal are also likely to have problems in dealing with automatic termination. The optimal choice between opt-out or opt-in then boils down to the question under which regime the costs of cognitive errors are the lowest. The costs of mistakenly failing to cancel need to be compared with the cost of mistakenly failing to renew. When the latter types of costs are higher than the former ones, opt-out is the preferred regime. Take the example of health insurance contracts. The risk associated with mistakenly failing to renew the contract under an automatic termination regime is very high. When an accident happens during the period that the individual is uninsured, the losses suffered upon the uninsured will be very high. The losses of mistakenly failing to switch to a more valuable insurance contract with another insurance company under an automatic renewal regime will be much lower. Taking cognitive limitations into account, the better choice in this case from an ex ante perspective is the automatic renewal regime. Regulation that aims at discouraging the use of automatic renewal as being a business practices that exploit the bias of consumers would be very harmful in this case.

In addition, Faure and Luth 2011 call for more substantive control of standard terms as another option for regulatory intervention. Such a substantive control would focus on the content of a contract and remedy the problem of adverse selection and low quality of contractual terms. One possibility of such a substantive control would be an ex ante or ex post administrative control of consumer standard terms (Gillette 2005) and another possibility would be a negotiation between all parties involved who would, supervised by an independent authority, jointly negotiate model standard terms (Collins 2004).[43] However, such an approach

[43] Luth (2010) lists examples of both models. Namely, Israel has experience with pre-approving standard terms and in The Netherlands draft model forms of standard terms are negotiated within the framework of the social economic council where business as well as consumers is represented (Luth 2010).

might be criticized for paternalistic reasons and the desirability of such a substantive intervention may well depend upon specific market and the existence of biases in that particular market (Faure and Luth 2011). Yet, due to the identified biases and heuristics that might impair consumer decision-making and consumer vigilance neither competition nor litigation will induce sellers to draft efficient terms, and this in essence calls for a more substantive control of standard terms in consumer contracts (Faure and Luth 2011).

A Specific Behavioural Approach: Use-Pattern Mistakes

Oren Bar-Gill (2007) draws attention to a less-studies category of consumer mistakes: use-pattern mistakes. He argues that use-pattern mistakes are prevalent. But more importantly, according to him, sellers respond strategically to such mistakes by redesigning their products, contracts, and pricing mechanisms. In his view, many observed outcomes in numerous consumer markets can be explained as market reactions to consumer misperceptions, especially misperceptions about product use.[44] Continuing along the lines set out by the analysis made by Bar-Gill (2007), sellers have a strong incentive to include an automatic renewal clause in case consumers misperceive their future use of the cancellation option. More specifically, at the contract signing stage consumers may overestimate the likelihood of cancelling or alternatively, underestimate the likelihood of contract renewal. Bar-Gill classifies this kind of misperception as a use-pattern mistake (Bar-Gill 2007). The consumer is mistaken not about a product attribute but rather about her future behaviour—about the probability that she will cancel the contract when that would be in her interest. The perceived cancellation rate is higher than the actual cancellation rate. When the actual cancellation rate is below the perceived cancellation rate, there will be too many contracts with automatic renewal clauses. In addition, sellers deliberately increase or inflate the transaction costs associated with cancellation—by imposing onerous requirement on consumers who wish to cancel the agreements. The increased transaction costs reduce the actual cancellation level. According to Bar-Gill (2007), a lower cancellation rate is attractive to sellers only if it increases consumer mistakes, i.e., only if the degree of overestimation of the cancellation rate is inversely related to the actual cancellation rate. He states that the prevalence of such tactics that increase the cost of cancellation is evidence of such an inverse correlation.[45]

It is worth looking for a moment at the methodological approach of the Bar-Gill analysis (Bar-Gill 2007). He does not look into the causes of consumer mistakes or misperceptions, but instead takes mistakes as given and focuses on market responses to mistakes. In essence, he shows how particular price and product designs are welfare-reducing for consumers under the assumption that consumers make use-pattern mistakes. In addition, he implicitly claims that particular price and product designs would not exist or continue to exist but for the existence of use-pattern mistakes. Hence, the conclusion is drawn that automatic renewal clauses are welfare-reducing for consumers who overestimate the future use of their cancellation option relative to the actual cancellation rate, for then too many contracts with

[44] Also the decision reached by many sellers to adopt on opt-out rather than an opt-in mechanism is arguably an example of product design in response to consumer misperceptions (Bar-Gill 2007, pp. 27).

[45] In addition, Hanson and Kysar (1999) show that endowment effect results in consumer's over-valuation of his contract and as a results steers him to keep the good instead of returning it as he thought he would do. Due to this endowment effect, consumers will also tend to stay with the provider of services that they already contracted with, despite the fact that competitors offer better options (Brennan 2007).

automatic renewal clauses will be adopted.[46] In addition, because sellers could also offer contracts with an opt-in mechanism,[47] the persistence of opt-out contracts is presumed to be evidence of a strategic response to consumer misperception. Also, the persistence of tactics to increase the transaction costs of cancelling is presumed to be evidence that consumers misperceive use-patterns.

The findings of Bar-Gill (2007) have been from the viewpoint of the rational choice framework criticized, notably by Richard Epstein (Bar-Gill and Epstein 2007).[48] The latter one argues that many of the design features that Bar-Gill (2007) explains as strategic responses to consumer misperception can be explained within a mistake-free, rational choice framework. However, Bar-Gill responds to this critique by saying that the design features he describes serve merely as indicators of persistent consumer mistakes, not as conclusive proof that mistakes exist (Bar-Gill 2007, pp. 3-4). Accordingly, design evidence must be considered in combination with other economic data before a market failure conclusion can be drawn.

From normative perspective, Bar-Gill argues that the welfare costs of use-pattern mistakes are often exacerbated as sellers redesign their products, contracts, and prices in response to the these mistakes (Bar-Gill 2007). Due to observed heuristics and biases consumer decision-making might be suboptimal, misleading them to enter into contracts that do not maximize their utility and hence also do not maximize social welfare (Faure and Luth 2011). Therefore, the law plays an important role in facilitating the efficient operation of markets by requiring disclosure of information that minimizes consumer mistakes.[49] And when the problem is use-pattern mistakes, the cure must be use-pattern disclosure individual use-pattern information where possible, average-use information otherwise (Bar-Gill 2007).

Use information on the cancellation option is unlikely to be of any help to consumers who misperceive their future use of the cancellation option. Assume that a rule would be introduced that obliges sellers to give information on actual cancellation rates in order to correct consumer misperceptions. Subsequently, the seller informs new subscribers that "last year, only 3% of the subscribers cancelled their contract." This type of information will not correct consumer misperceptions because it does not give information on the reasons for the low cancellation rate. The consumer might think cancellation rates were so low because most of the customers were happy to continue the contract. Misperceptions could only be corrected when the seller would give information on the percentage of customers who mistakenly forgot to cancel. However, also sellers are not able to tell how many customers are inefficiently bound for a new term. This would require a survey among customers.

Comments on Existing Regulatory Responses to the Automatic Renewal Clause

Are the regulatory responses of the assessed legal systems in line with the "traditional" and "behavioural" law and economics recommendations? In section 2, it has been shown that EU, US, English, German, Dutch, and Belgium legislators have responded in different ways to regulate the automatic renewal clauses. How can these responses be understood in the light of the foregoing analysis? In following sections, we briefly

[46] "Too many" from an efficiency point of view.

[47] Moreover, service could end without a phone call after the introductory period. A consumer who wishes to continue receiving the service could be required to make the call (Bar-Gill 2007, pp. 27–29).

[48] Epstein argues that many of the design features that Bar-Gill explains as strategic responses to consumer misperception can be explained within a mistake-free, rational choice framework (Bar-Gill and Epstein 2007, pp. 7–17).

[49] Epstein resists this regulatory impulse (Bar-Gill and Epstein 2007).

comment on (parts of) regulatory responses that are justified from a "traditional" law and economics approach to regulation. In the following sections, we also briefly discuss additional forms (parts of) of regulation of which the underlying motivation comes from the "behavioural" law and economics' approach.

Prohibition of Cancellation Deadlines Set Too Early

Under the English, US, German, Belgium, Dutch law, and under the EU directive on Unfair Consumer Terms in Consumer Contracts,[50] a presumption of unfairness exists for contract clauses that automatically extend a contract of fixed duration where the consumer does not indicate otherwise, when the deadline fixed for the consumer to express his desire not to extend the contract is unreasonably early. This form of regulatory intervention is justified under the "traditional" law and economics regulatory framework because it concerns an efficient term that makes performance of the contract more costly than necessary. Cancellation deadlines which are set too early, inefficiently limit the authority of the consumer to cancel and increase switching costs which may in turn lead to excessive prevention costs, increased uncertainty, and an inefficient allocation of resources.

Formal Requirements to Cancel May Not Be More Burdensome than Requirements to Subscribe

The Dutch legislative proposal correctly prohibits sellers to require more burdensome requirements for cancelling than for subscribing. This particular rule is justified under the "traditional" law and economics approach because excessively burdensome formal requirements increase the costs of performing without any offsetting economic benefit. General prohibition of such formal requirements is economically justified and may also decrease switching (transaction) costs and consequently might increase consumer choices, induce efficient termination, encourage efficient entry, decrease average prices, and consequently also increase consumer welfare.

Duty to Clearly and Conspicuously Disclose the Terms of Automatic Renewal

Under the new EU Directive 2011/83/EU on consumer rights,[51] under English, German, Belgian laws, and the rules of the State of Illinois (USA),[52] sellers must clearly and conspicuously disclose the terms of the automatic renewal clause. This disclosure duty is justified in the light of the signing-without-reading or signing-without-understanding problem. Consumers do not read or understand terms that are part of the small print. Reading is costly. Therefore, rules that oblige sellers to draft contracts in a clear way reduce reading costs and are efficiency-enhancing. Moreover, such a duty is also accordance with other recommendations from both "traditional" and "behavioural" law and economics analysis since it may also decrease terminating and switching (transaction) costs, might increase consumer choices, induce efficient termination, encourage efficient entry, decrease average prices, and consequently also increase consumer welfare.

[50] Directive 93/13/EEC.

[51] Directive 2011/83/EU OJ L 304/64, 22.11.2011 of the European Parliament and of the Council of 25 October 2011.

[52] 815 ILCS 601 (Illinois Automatic Contract Renewal Act).

Duty to Notify the Consumer in Advance

In some countries, like France[53] and the state of Illinois[54] in the USA, the automatic renewal of fixed-term contracts is not effective unless the seller has notified consumers in advance of the possibility to cancel the contract. The argument underlying this form of regulatory intervention is that consumers are cognitively limited in dealing with termination dates of a whole set of consumer contracts. Therefore, this form of regulation has a paternalistic background. For example, in the wake of the French legislation, it has been said that a French household has on average 25 service contracts and subscriptions. Under such circumstances they might forget the cancellation date. Maynes (1997) has written about how "consumers [often] cannot find the time to manage effectively consumption that has grown more complex and dynamic."[55] Inattentive consumers might benefit from being notified in advance. The question is whether legislators should mandate a notification by firms.

Economic theory predicts that sellers would voluntarily offer to notify consumers when consumers are aware of their cognitive limitations and are willing to pay for being notified. Even when sellers themselves are not willing to make this offer, external market parties will step in and sell this service to consumers. From this perspective, there is no need for regulatory intervention. Moreover, introduction of such a rule might jeopardize any contractual remedy a service provider may have with respect to a customer's early termination of a contract.[56] When the government nevertheless mandates sellers to notify, there will be no longer a demand for "external" notification services. This would be a problem when external parties can offer the service at lower costs than sellers themselves. However, because sellers themselves possess the necessary information on termination dates as a by-product of subscriptions, we can reasonably assume that they can provide the service at lower costs than the external parties. This is true when we consider the notification service in isolation. But the external parties usually offer a package of services: notification of termination dates as well as information on cheap alternative offers at that time. When the notification service is part of package of services offered by the external party, it is less obvious that notification by external parties is more costly than notification by the sellers themselves.

Does the regulatory intervention in the form of a notification duty satisfy the criterion of asymmetric paternalism? Does it benefit inattentive consumers without harming sophisticated consumers? First, we need to analyse whether inattentive consumers benefit from the service. The primary beneficiary of the rule is the cognitively limited consumer who actually wishes to cancel the agreement. The problem is that not all cognitively limited consumers effectively want to cancel the agreement. Some of them want continuance of the contract. Sellers do not have information on who wants to cancel and who does not. Subsequently, notification will be sent to all customers indiscriminately. For those consumers who want contract continuance, the costs of notification are wasted. One could argue against this argument that the administrative costs of notification are so low that even if a notification does no good, it will do no harm

[53] Loi no 2005-67 du 28 janvier 2005 tendant a conforter la confiance et la protection du consommateur: art. L. 136 1. – Le professionnel prestataire de services informe le consommateur par écrit, au plus tôt trois mois a au plus tard un mois avant le terme de la période autorisant le rejet de la reconduction, de la possibilité de ne pas réconduir le contrat qu'il a conclu avec une clause de reconduction tacite.

Lorsque cette information ne lui a pas été adressée conformément aux dispositions du premier alinéa, le consommateur peut mettre gratuitement un terme au contrat, a tout moment a compter de la date de reconduction.

[54] See supra section 2.6.

[55] This is because consumers must spread their attention "thinly across thousands of transactions and the management of hundreds of possessions (Maynes 1997, pp. 163–165).

[56] See, e.g., Ovitz v. Bloomberg L.P., No. 38, N.Y. March 7, 2012.

either. But even if we assume that the costs of warning are very low per individual case, the costs for the society as a whole are substantial.[57] In assessing the benefits of the notification duty, one needs to compare the benefits to cognitively limited consumers who actually wish to cancel and the costs to those who want contract continuance.

Furthermore, problems arise in assessing the effectiveness of the notification duty when the beneficiaries are assumed to be boundedly rational. Will a notification duty effectively reduce the amount of mistakes made by cognitively biased consumers? Maybe the advance notice will get lost in the administration of the administratively weak consumer. Therefore, to be effective, additional rules for the advance notice may be required. Illinois, for example, has correctly introduced the rule that the written notice to the consumer must be made no less than 30 days and no more than 60 days before the cancellation deadline set by the contract. What about the potential harm to sophisticated consumers? Sophisticated consumers might not need to be notified, but the added costs of a notification duty will be spread among all consumers alike. Sophisticated consumers will pay for a service they might not want or need. This problem might, in theory, be overcome by a notification duty upon request. Under such a rule, sellers are required to offer the service only to those consumers who have expressed this desire at the contract formation stage. In that way, only the consumers who need or want the notification service would pay for it.

The drafters of the Dutch proposal reject this type of intervention on the ground that the sellers would set the price of the notification service so high as to discourage consumers to demand it. Implicit in the drafter's argument is the assumption that the notification service is not an attribute on which sellers compete. Economic theory, however, predicts that in competitive markets, all goods and services sell at marginal costs. Hence, consumers would buy from those sellers who provide the notification service at the lowest price.

Maximum Duration of Automatically Renewed Contracts and Conversion into Indefinite Term Contracts

Under Belgian law, automatically renewed contracts can be terminated at any time with a notice period of maximum 1 month. Under the Dutch legislative proposal, fixed-term contracts cannot automatically renew for more than 3 months. Under German law, fixed-term contracts cannot automatically renew for more than 1 year. All this forms of regulatory intervention effectively limit consumer choices and should therefore be treated with great caution according to the "traditional" law and economics approach as well as according to the "behavioural" approach. Under the regulatory framework of "traditional" law and economics, such prohibitions are only economically justified when particular contracts terms are inefficient to all contracting parties. It is only economically justified to prohibit terms that no rational party would ever accept. For example, with respect to the Dutch proposal, the relevant question is whether it would ever be in the mutual interest of a rational consumer and seller to agree to a contract that automatically renews for more than 3 months. If the answer is yes, it is not economically justified to prohibit contracts with automatic renewal for more than 3 months.

Under the behavioural law and economics approach, the aim is to protect boundedly rational consumers, preferably through disclosure mandates, but if necessary, through regulation of contract terms. Limitations on the duration of automatically renewed contracts protect consumers who mistakenly forget to cancel the fixed-term contract by reducing the costs of their error. For example, under the Dutch proposal, a consumer who mistakenly forgets to

[57] The costs to society of a warning duty are the following: number of annual contract per family $*$ the number of families $*$ the costs per notification.

cancel a 1-year fixed-term contract will not be bound for another year, but maximally for a period of 3 months. The protection of consumers against their errors comes at a cost, notably the disappearance of mutually beneficial contractual practices. One could argue that the limits on the duration of automatically renewed contracts do not prohibit parties to agree to successive contracts of a fixed duration; they only prohibit successive fixed-term contracts of a particular duration that are the result of automatic renewal. It implies that if parties want a succession of fixed-term contracts, the consumer has to actively renew the contracts after the expiration of each term (i.e., regime of automatic termination). All consumers, who want continuance, need to incur costs to renew their contracts. This is a more costly regime than automatic renewal when—at the contract formation stage—it is more likely than not that consumers will renew the contract. But the major concern for behavioural theorists should be that cognitively limited consumers are prone to make errors of mistakenly failing to renew, errors that might be much more costly than errors of mistakenly failing to terminate. Under the behavioural approach, legal commands in any given circumstance must be analysed with due regard for the relevant decision-making capabilities of the actors in that specific setting (Korobkin and Ulen 2000). It makes sense to exclude particular types of contracts, like health insurance, from automatic renewal regulation, as is the case in most countries.

Conclusion

Question of if and how shall public authorities regulate automatic renewal clauses for reasons of consumer protection have recently drawn the attention of many legislators. The earlier regulatory responses that prohibit terms that make cancellation unnecessarily costly for consumers, like the EC directive on Unfair Contract Terms, are economically justified in the light of the signing-without-reading problem. The traditional law and economics approach recognizes this problem and supports regulatory responses to address the inefficiencies that it might create.

Employed "traditional" law and economics literature provides several significant reasons why they might severely reduce competition and consequently also social welfare. Namely, "traditional" law and economics analysis and suggest that automatic-renewal clauses should be viewed with scepticism since they might reduce consumer choices, increase switching/ termination costs (transaction costs), hinder efficient termination, discourage efficient entry, increase average prices, and consequently also significantly reduce consumer welfare.

The behavioural literature calls for a cautious introduction of a governmental regulation (Faure and Luth 2011) on automatic renewal to cope with cognitive or emotional impairments of consumers. Particular types of regulation like the duty to notify consumers in advance of an upcoming automatic renewal and rules that reduce the costs of mistakenly failing to cancel are examples of regulatory responses that are introduced for paternalistic reasons. Provided "behavioural" law and economics investigation reveals that law should facilitate the efficient operation of markets by requiring disclosure of information that minimizes consumer mistakes (i.e., the mandatory disclosure of automatic renewal clauses). The cognitive bias and status quo bias literature offers several arguments for governmental regulation to include also automatic renewal clauses among business practices that exploit the bias of consumers, or at least some consumers. Moreover, status quo bias generally acts, for example, similarly to transaction costs: It presents a barrier to reallocation when that would be value-enhancing. Some consumers may be cognitively limited in dealing with termination dates of a whole set of consumer contracts containing an automatic renewal clause. Hence, some consumers care more about the costs of commission; they might decide to do nothing even when cancelling would be in their interest.

Evidently, both “behavioural” and “traditional” law and economics assessment offer a set of arguments confirming the potential harmful effects of automatic renewal clauses for efficient market competition and for consumer welfare. The analysis also provides arguments in support of the existing regulatory frameworks in USA, England, and in The Netherlands regulating automatic renewal provisions and it also provides a clear path for an immediate statutory reform in those jurisdictions which have not yet regulated such automatic renewal clauses. Moreover, both analyses also suggest that such automatic renewal clauses should not be banned or outlawed entirely but instead advocate more cautious approach (grey list) whereas automatic contract renewal provisions must be clearly and conspicuously disclosed. Provided analysis also offers a set of following recommendations to the policy makers, where a legislator might (a) introduce a mandatory prohibition of cancellation deadlines set too early and should regulate the obscure terms shrouding information on where and how to cancel, (b) regulate formal requirements that impose a heavier burden upon the consumer to terminate (or to switch) than to subscribe with no offsetting economic benefit, (c) regulate formal requirements that increase switching costs imposed upon final consumers, and finally (d) regulate cancellation deadlines that are set very early with no offsetting economic benefit. On the other hand, the case of mandating sellers to clearly and conspicuously notify consumers in writing (in a certain reasonable notification period) that unless the consumer cancels the contract it will automatically renew is not so firm and should hence not be introduced unconditionally as a mandatory rule. If one opts for such a rule than in order to be effective, additional rules for the advance notice may be required, as for example, a rule that the written notice to the consumer must be made no less than 30 days and no more than 60 days before the cancellation deadline set by the contract. Furthermore, provisions of Belgium and German law that fix the maximum duration of automatically renewed contracts and convert them into indefinite term contracts should be open to criticism. Namely, such forms of regulatory intervention effectively limit consumer choices and should therefore be treated with great caution according to the “traditional” law and economics approach as well as according to the “behavioural” approach.

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