McGeorge Law Review

Volume 40 | Issue 4 Article 4

1-1-2008

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Recommended Citation
Jeff Sovern, *Coase Theorem and the Power to increase Transaction Costs, The*, 40 McGeorge L. Rev. (2016).
Available at: http://digitalcommons.mcgeorge.edu/mlr/vol40/iss4/4

The Coase Theorem and the Power to Increase Transaction Costs

Jeff Sovern*

The Coase Theorem maintains that in the absence of transaction costs, "regardless of the initial allocation of property rights and choice of remedial protection, the market will determine ultimate allocations of legal entitlements, based on their relative value to different parties."[1] Twenty-eight years after publication of the paper that explained the Coase Theorem, Coase expressed disappointment that his paper had not inspired more study of situations in which contracting parties face positive transaction costs.[2] The purpose of this Article is to explore the consequences under the Coase Theorem in a situation in which parties face positive transaction costs: specifically, when a firm without the initial allocation of a property right can manipulate the transaction costs of consumers who have the initial allocation in asserting their property rights.

A firm wishing to obtain the ultimate entitlement may prefer not to purchase the right but to increase the transaction costs faced by consumers with the initial entitlement in asserting that entitlement. This Article first gives an example of such a situation. It then explores how the power to inflate transaction costs can affect the ultimate allocation of legal entitlements. It concludes that in some cases, the power to manipulate transaction costs will not prevent the party that values the right most highly from ending up with the final allocation of that right, but that in other cases, it will. Indeed, in some circumstances, a consumer contracting with a firm with the power to inflate transaction costs will be better off without the initial allocation of rights. This Article also provides another argument for limiting the power of parties to increase transaction costs.

The sale of financial information presents an example of a situation in which a firm may find it more advantageous to inflate the transaction costs of consumers rather than enter into a contract to buy the entitlement. In 1999,

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1. Francesco Parisi, *Coase Theorem*, *in* NEW PALGRAVE DICTIONARY OF ECONOMICS (L. Blume & S. Durlaufe eds., 2d ed. 2007), *available at* http://ssrn.com/abstract=981282 (on file with the *McGeorge Law Review*). Coase explained his Theorem, though without labeling it a theorem or explicitly stating it, in R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) [hereinafter Coase, *Social Cost*]. In his Nobel Prize acceptance speech, Coase embraced a definition of the Coase Theorem formulated by George Stigler, that "in a regime of zero transaction costs, . . . negotiations between the parties would lead to those arrangements being made which would maximize wealth and this irrespective of the initial assignment of rights." R. H. Coase, *The Institutional Structure of Production*, 82 AM. ECON. REV. 713, 717 (1992). The Theorem has also been stated in other forms. *See, e.g.*, GEORGE J. STIGLER, THE THEORY OF PRICE 120 (4th ed. 1987) ("[U]nder perfect competition private and social costs will be equal."); Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules—A Comment*, 11 J.L. & ECON. 67, 68 (1968) ("[I]f one assumes rationality, no transaction costs, and no legal impediments to bargaining, *all* misallocations of resources would be fully cured in the market by bargains.").

2. R. H. COASE, THE FIRM THE MARKET AND THE LAW 15 (1988).

Congress enacted the Gramm-Leach-Bliley Act (GLBA), which had the effect of allocating to consumers the initial property right in certain information about their financial transactions.[3] Many financial institutions sell this information to others;[4] thus, the Coase Theorem predicts that in a world without transaction costs, if the information was of greater value to financial institutions than to consumers, a market would develop in which financial institutions would purchase from consumers the right to trade in the information.[5] But such a market has not developed. While it is possible that this market has not come into existence because the information is more valuable to consumers than to financial institutions, or because the cost of creating such a market exceeds the gains to be derived thereby, a more plausible explanation for the absence of such a market is that financial institutions have been able to obtain the right to transfer the information without negotiating for it.[6]

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3. Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 U.S.C. and 15 U.S.C.). The relevant provisions are codified at 15 U.S.C. §§ 6801-6827 (2006). Before enactment of the GLBA, it was not clear who had the property right. Some state regulators had brought cases against financial institutions for disclosing customer information to third-party marketers, but those cases did not provide a definitive answer. *See* Minnesota v. Fleet Mortgage Corp., 158 F. Supp. 2d 962 (D. Minn. 2001); Elizabeth K. Brill, *Privacy and Financial Institutions: Current Developments Concerning the Gramm-Leach-Bliley Act of 1999*, 21 ANN. REV. BANKING L. 167, 176 (2002); David W. Roderer, *Tentative Steps Toward Financial Privacy*, 4 N.C. BANKING INST. 209, 210-11 (2000).

This Article proceeds on the assumption that because the consumer has the right to demand that financial institutions not transfer to unaffiliated companies information about his or her transactions, the consumer has the initial allocation of the right. While it is possible to argue that financial institutions have the initial allocation of the right because they may transfer consumer information until the consumer insists that they stop, that does not seem to be consistent with Coase's use of the idea. Coase clearly contemplated that the initial allocation rests with parties who could demand cessation of a practice, or alternatively have the right to engage in the conduct. Thus, in Coase's example of the cattle-raiser whose cattle destroys the crops on the land of a neighboring farmer, Coase explored what impact the imposition of liability would have on the cattle-raiser, even though liability is unlikely to be imposed unless the farmer demands compensation based on the right not to have the crops damaged. Coase, *Social Cost*, *supra* note 1, at 2-6. Similarly, in his discussion of *Sturges v. Bridgman*, 11 Ch. D. 852 (1879), Coase reported that a doctor sued to prevent a confectioner from operating machinery which interfered with the doctor's ability to use a consulting room. *Id* at 8-9. Coase then wrote about the impact of the doctor's victory and on what the consequences would have been if the confectioner had won. *Id.* at 9-10.

4. *See* ACB Privacy Compliance Survey, Nov. 2001, http://files.ots.treas.gov/comments/a45ad121-83d4-48b1-8c14-f5553fafea9a.pdf [hereinafter ACB Survey] (on file with the *McGeorge Law Review*).

5. It seems likely that many consumers would find the information less valuable than many financial institutions and so would be willing to sell their entitlement. While some consumers object to the transfer of information about their transactions, many seem not to. Surveys consistently show that consumers are divided in their view of privacy, with about a quarter strongly in favor of preserving the privacy of their transactions; about a sixth unconcerned with the privacy of their transactions; and the remaining sixty percent willing to share information depending on the circumstances. This can be seen from the survey data collected in Jeff Sovern, *Opting In, Opting Out, or No Options at All: The Fight for Control of Personal Information*, 74 WASH. L. REV. 1033, 1056-64 (1999). Thus, depending on the nature of an offer for the information, somewhere between sixteen and seventy-six percent of consumers should be willing to permit the sale of information.

6. It appears that few consumers have directed their financial institutions not to transfer their information. *See Financial Privacy and Consumer Protection: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 60 (2002) (statement of John C. Dugan, partner, Covington & Burling, on behalf of the Financial Services Coordinating Council) [hereinafter *Financial Privacy Hearing*]

The GLBA requires financial institutions to notify consumers of their practices concerning the sharing of certain consumer information and to allow consumers to opt out from the sharing of that information with non-affiliated companies.[7] Publicly-available information indicates that few consumers have opted out, and so financial institutions seem not to have suffered significant revenue losses from opt-outs.[8] To produce that result, financial institutions have

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("[O]pt-out rates have generally been low, and in nearly all cases under 10 percent."); W.A. Lee, *Opt-Out Notices Give No One a Thrill*, AM. BANKER, July 10, 2001, at 1 ("5% opt-out rate . . . has been circulating as the unofficial industry figure . . . ."); ACB Survey, *supra* note 4 ("Of those institutions that offer their customers the choice to opt-out, the overwhelming majority (60%) report that less than 1% of their customers elected to opt-out."). *Cf.* Randall Akee, *Checkerboards and Coase: Transactions Costs and Efficiency in Land Markets*, INST. FOR THE STUDY OF LAB., at 16 (Nov. 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=947459 (on file with the *McGeorge Law Review*) (study of Palm Springs land market found that "transactions costs can effectively halt bargaining and economic efficiency").

It seems unlikely that the cost of creating the market would exceed the gains from having the market. The transaction costs in creating the market are likely to be small, in light of the fact that financial institutions already communicate their privacy policies at least annually under the GLBA, see 15 U.S.C. § 6803(a) (2006)—and probably communicate with most customers at least monthly—and can easily credit their customers' accounts with any sum agreed to.

Another possible explanation for the lack of a market is that consumers do not care if their information is available or perhaps even want it to be available. But this supposition is belied by the survey evidence described above. *See supra* note 5; *see also* Mike Hatch, *The Privatization of Big Brother: Protecting Sensitive Personal Information from Commercial Interests in the 21st Century*, 27 WM. MITCHELL. L. REV. 1457, 1477-81 (2001). While what people say in surveys does not always correspond with their actions—and indeed it appears many consumers, despite what they say, are willing to sacrifice their privacy if they receive something in exchange—some experiments confirm that at least some consumers value privacy. *See* JANICE TSAI ET AL., THE EFFECT OF ONLINE PRIVACY INFORMATION ON PURCHASING BEHAVIOR: AN EXPERIMENTAL STUDY, at i (June 2007), *available at* http://weis2007.econinfosec.org/papers/57.pdf (on file with the *McGeorge Law Review*) ("[O]nce privacy information is made more salient, some consumers are willing to pay a premium to purchase from more privacy protective websites."). Similarly, many consumers have paid to have their telephone numbers unlisted. *See* Eli M. Noam, *Privacy and Self-Regulation: Markets for Electronic Privacy*, *in* UNITED STATES DEPARTMENT OF COMMERCE, PRIVACY AND SELF-REGULATION IN THE INFORMATION AGE (June 1997), *available at* http://www.ntia.doc.gov/reports/privacy/selfreg1.htm#1B (on file with the *McGeorge Law Review*) (reporting that fifty-five percent of California residents have unlisted numbers).

7. 15 U.S.C. §§ 6802-6803.

8. The fact that some consumers have opted out suggests that consumers differ in their assessment of the relative value of opting out and the transaction costs incurred in doing so.

It may perhaps be argued that consumers have not opted out because they are unwilling to depart from defaults, whatever those defaults may be. This argument finds support in phenomena in other circumstances. For example, different automobile insurance default rules in the neighboring states of New Jersey and Pennsylvania produced different outcomes. *See* Eric J. Johnson et al., *Framing, Probability Distortions, and Insurance Decisions*, *in* CHOICES, VALUES, AND FRAMES 238 (Daniel Kahneman & Amos Tversky eds., 2000). Pennsylvania policies provided that consumers could bring a certain claim, but offered consumers the option to pay lower rates if they would surrender the right to bring the claim. *Id.* New Jersey chose the opposite default—denying consumers the right to assert the claim—but permitted them to pay higher rates if they wanted the right to assert the claim. *Id.* In New Jersey, about seventy-five percent of motorists chose that state's default, while in Pennsylvania approximately eighty percent chose the opposite default. *Id.* Similar psychology may indeed account for the failure of some consumers to opt out of the sale of their financial information. But the situations are not exactly parallel. In the insurance example, consumers received something no matter which choice they made: either lower rates or the right to assert a claim. Accordingly, consumers genuinely uncertain about which was the best choice might have felt that the default implied a recommendation. In contrast, in the privacy context consumers do not receive anything from not opting out, except the time freed by not reading the form and opting out—which is, of course (as discussed more fully below), a transaction cost that the financial apparently increased the transaction costs consumers incur in learning about and exercising their opt-out rights.[9] Thus, some critics have found the notices—in which financial institutions explain to consumers their rights—to be unreadable,[10] while others claim these notices require a college-level education to understand.[11] For example, Capital One's notice provides in part:

> We may share the information described on Page 1 under "information we may collect" with companies in the Capital One family or with business partners such as financial service providers (including credit bureaus, mortgage bankers, securities broker-dealers and insurance agents); nonfinancial companies (including retailers, online and offline

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institution controls to some extent by, for example, making the form more or less readable. In addition, as the automobile insurance example demonstrates, a higher percentage of consumers departed from the defaults in both New Jersey and Pennsylvania, despite receiving some value for staying with the defaults, than in the GLBA situation. Consequently, it appears that the explanation that consumers stay with the default explains, at best, only some failures to opt out.

9. For purposes of this Article, the phrase "transaction costs" is defined broadly. *See, e.g.*, Steven N.S. Cheung, *The Transaction Costs Paradigm: 1998 Presidential Address Western Economic Association*, 36 ECON. INQUIRY 514, 515 (1998) (defining transaction costs as "all the costs which do not exist in a Robinson Crusoe economy"); Richard O. Zerbe Jr. & Howard E. McCurdy, *The Failure of Market Failure*, 18 J. POL'Y ANALYSIS & MGMT. 558, 562 (1999) (defining transaction costs as "the resources necessary to transfer, establish, and maintain property rights" (emphasis omitted)); David Driesen & Shubha Ghosh, *The Functions of Transaction Costs: Rethinking Transaction Cost Minimization in a World of Friction* 31 (Feb. 25, 2003), *available at* http://ssrn.com/abstract=386060 (draft on file with the *McGeorge Law Review*) (defining transaction costs as "the costs of dealing with people").

10. *See Financial Privacy Hearing*, *supra* note 6, at 62 (statement of Mike Hatch, Minnesota Att'y Gen.) ("The notices are dense and impenetrable."); Rob Blackwell, *FTC Unveils Stepped-Up Privacy Plan*, AM. BANKER, Oct. 5, 2001, at 3 (then-FTC Chair Timothy J. Muris calls GLB privacy notices "barely comprehensible"); Hatch, *supra* note 6, at 1495-97; Mark Hochhauser, *Lost in the Fine Print: Readability of Financial Privacy Notices*, PRIVACY RIGHTS CLEARINGHOUSE, July 2001, http://www.privacyrights.org/ar/GLB-Reading.htm (on file with the *McGeorge Law Review*) ("Consumers will have difficulty reading and understanding the privacy notices . . . ."); *Confusing Privacy Notices Leave Consumers Exposed*, USA TODAY, July 9, 2001, at 13A [hereinafter *Confusing Privacy Notices*] ("[T]he instructions are so confusing, many [consumers] unwittingly threw them away."); John Schwartz, *Privacy Policy Notices Are Called Too Common and Too Confusing*, N.Y. TIMES, May 7, 2001, at A1; ACB Survey, *supra* note 4 ("Of those institutions that reported receiving customer feedback, the majority indicated that their customers did not find the privacy policies useful."). Not all agree. An American Bankers Association telephone survey reported that two-thirds of the consumers who said they had received the notices claimed to have read them. *See* Lee, *supra* note 6. Similarly, a Securities Industry Association survey found that sixty-percent of the people surveyed recalled receiving the notices, two-thirds of those claimed to have read them, and eighty-four percent of those believed they understood them. *In Brief: SIA Survey Finds Privacy Notices Work*, AM. BANKER, Aug. 14, 2001, at 5.

11. *See* Steve Sheng & Lorrie Faith Cranor, *An Evaluation of the Effect of US Financial Privacy Legislation Through the Analysis of Privacy Policies*, 2 J.L. & POL'Y INFO. SOC'Y 943 (2006), *available at* http://www.chariotsfire.com/pub/financial-privacy.v6-sx-lfc.pdf. The GLBA privacy policies do not seem to be a unique response to the need to create privacy policies. Thus, a study of online privacy policies found that only six percent were accessible to those with less than or equal to a high school education and that thirteen percent would require a post-graduate education to understand. Carlos Jensen & Colin Potts, *Privacy Policies as Decision-Making Tools: An Evaluation of Online Privacy Notices*, 6 PROCEEDINGS OF THE SIGCHI CONF. ON HUMAN FACTORS IN COMPUTING SYSTEMS, VIENNA, AUSTRIA 471, 475 (2004). The study also found that some privacy policies used "second-level pages . . . to obscure significant privacy vulnerabilities (disclosure of and opt-out of web-bugs and spy-ware being one example . . .)." *Id.* at 473.

> advertisers, membership list vendors, direct marketers, airlines and publishers); companies that perform marketing services on our behalf, or other financial institutions with which we have joint marketing agreements; and others, such as non-profit organizations and third parties that you direct us to share information about you.[12]

In a speech, Julie Williams, the then-Acting Comptroller of the Currency, explained why financial institutions might wish to inflate the transaction costs consumers incur in opting out:

> [W]hen presented with the prospect of lessening burden and saving costs by providing a streamlined, short form privacy notice containing only certain key information—some in the industry seem to balk. Marketing departments get uneasy because simple and straightforward disclosure of a bank's information sharing policies and an easy means for customers to opt out of that sharing might mean—*that customers will actually understand those policies—and decide to opt out!* The tension here is that shorter, focused consumer disclosures can meaningfully reduce regulatory burden, but, if they are done well, they will also empower consumers to make some decisions that a particular bank may not like.[13]

Rational financial institutions that wish to obtain the right to transfer consumer information should choose the least expensive way of obtaining that right. If it is cheaper for them to obtain the right by inflating consumer transaction costs than by entering into agreements with consumers, they should choose to inflate consumer transaction costs.[14] It appears that they have done just that.[15]

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12. Schwartz, *supra* note 10.

13. Julie L. Williams, Acting Comptroller of the Currency, Remarks Before Women in Housing and Finance and the Exchequer Club 6 (Jan. 12, 2005), *available at* http://www.occ.treas.gov/ftp/release/2005-1a.pdf (on file with the *McGeorge Law Review*); *see also Confusing Privacy Notices*, *supra* note 10 (stating that "financial institutions made the notices as confusing as possible" and noting that Wells Fargo's notice was ten pages long).

14. While the belief that financial institutions have deliberately inflated consumer transaction costs is based largely on the types of notices they have produced rather than on, say, internal statements indicating an intent to cause the privacy notices to slip past consumers unnoticed, such internal statements have become available in other contexts. Thus, in *Ting v. AT&T*, 319 F.3d 1126, 1133-34 (9th Cir. 2003), AT&T mailed a consumer services agreement containing an arbitration clause to its customers. The court explained:

> AT&T's market study concluded that most customers "would stop reading and discard the letter" after reading [an initial one-sentence "disclaimer" in its cover letter]. AT&T did not change the substance of the letter as a result of its market research—indeed, internal AT&T documents indicate that the letter was specifically intended to make customers less alert to the details of the [agreement].

Id. at 1134.

15. Conceivably, the desire to retain customer goodwill might restrain financial institutions from inflating consumer transaction costs, but this seems not to have been the case.

In this context—in which the right is worth more to the financial institution than to consumers and financial institutions can obtain the right more cheaply by increasing consumer transaction costs than by purchasing the right—neither the power to inflate transaction costs nor the initial allocation of the right would affect the ultimate allocation of the right. If, contrary to the GLBA, the financial institutions possessed the initial allocation, consumers would not be able to pay financial institutions enough to persuade them to sell the right, and financial institutions would simply retain the right. If, as provided under the GLBA, consumers possess the initial right, financial institutions could obtain the right by inflating the transaction costs consumers face in asserting that right.[16] What does change, however, is the manner in which the financial institutions obtain the right, and that, in turn, has consequences. When financial institutions obtain the right by inflating transaction costs rather than purchasing the right, consumers lose their gains from exchange, and financial institutions obtain something in excess of theirs.

Suppose, by contrast, that the right is more valuable to the consumer than to the financial institution and that the consumer possesses the initial allocation of the right, as provided for by the GLBA. If the financial institution can inflate the consumer's transaction costs to the point that they exceed the right's value to the consumer, the financial institution can still end up with the allocation of the right, simply because the cost to the consumer of asserting her right will exceed the benefits to the consumer of doing so. Theoretically, however, a rational financial institution should not do so if the value of the right to the consumer exceeds the total of the value of the right to the financial institution plus the transaction costs incurred by the parties in entering into an agreement. That is because the financial institution would maximize its profits by agreeing with the consumer not to inflate the consumer's transaction costs in return for a payment from the consumer, and the consumer should be willing to make such a payment because the consumer would be better off paying the financial institution for the right.[17]

An example may help clarify. Suppose the right to sell consumer information is worth one dollar to a financial institution and the right not to have the information sold is worth three dollars to consumers. Absent transaction costs, the Coase Theorem predicts that if the consumer has the initial allocation, the financial institution will not find it worthwhile to purchase the right to use the information from the consumer; in contrast, if the financial institution has the initial allocation, the parties will find it desirable for the bank to sell the right to the consumer for a sum between one and three dollars.

16. This assumes that the costs to the financial institutions of inflating consumer transaction costs are less than the gains to the financial institutions from inflating the costs.

17. To be sure, this payment by the consumer would qualify as a transaction cost, but the consumer would still be better off incurring this transaction cost because the value of the right to the consumer would exceed the transaction cost.

Now suppose that the consumer has the initial allocation, but the financial institution, without materially increasing its own costs, can inflate the consumer's transaction costs in asserting the right to four dollars. In that case, the consumer is likely to forego asserting the right, and the financial institution would be left with the right.[18] But because the right is worth only one dollar to the financial institution, it would be better off not raising the consumer's transaction costs and again bargaining with the consumer for an amount between one and three dollars. The result, then, would be the same as in the situation in which the financial institution did not have the power to inflate transaction costs—the party that values the right most highly would end up with it.

Theoretically, such a circumstance is possible in the financial information situation. A financial institution, could, for example, make it so difficult for consumers seeking to assert their privacy rights that the value of doing so is outweighed by the transaction costs, while simultaneously offering consumers an arrangement in which, say, for a fee, the bank would complete the required paperwork for the consumer, thus reducing consumer transaction costs to the point where it made sense for consumers to pay the fee.

However realistic such an agreement might be in some contexts, it would not be feasible in the financial information example. Because one of the ways financial institutions inflate consumer transaction costs is by reducing the likelihood that consumers will even notice that they have rights at issue, it is not practical for financial institutions both to inflate consumer transaction costs and to offer to reduce those costs for a fee. Put another way, it is not feasible for financial institutions both to increase consumer transaction costs by reducing the likelihood that consumers will notice that they have a right to opt out, and to draw consumers' attention to that right.[19] Accordingly, financial institutions must choose between obscuring consumer rights, in which case the financial institutions will often retain the right, or not obscuring the rights, in which case it is likely that more consumers will assert the right, though the financial institution could attempt to purchase the right. It appears that financial institutions have, by and large, chosen to obscure consumer rights.

Returning to the example above, the result is that the financial institution will possess the right to use the consumer information—a right worth one dollar—

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18. If the bank could raise the consumer's transaction costs to less than three dollars—that is, the value of the right to the consumer—a rational consumer should still assert her right. The result would be the same as in the situation where the bank lacks the power to inflate consumer transaction costs.

19. This is especially true because the principal way financial institutions increase consumer transaction costs in the consumer information context is by obscuring the notice. Though empirical information is not publicly available, it seems likely that consumers who become aware of their privacy rights do not find it difficult to assert those rights. The GLBA's implementing regulations require financial institutions to provide consumers with "reasonable means" to exercise their opt-out rights. 16 C.F.R. § 313.7(a)(1)(iii) (2009). The regulations specify that financial institutions satisfy that requirement if they: (A) supply a check off box on a form that consumers can return; (B) provide a form that can be sent via email; or (C) provide a toll-free number that consumers can use to opt out. *Id.* § 313.7(a)(2)(ii).

instead of consumers having the higher-valued right, worth three dollars. Thus, the financial institutions' ability to manipulate transaction costs produces an inefficient result. The Coase Theorem presupposes the absence of transaction costs (much less transaction costs deliberately created by one party), and so this result should not be surprising. But it is troubling nonetheless. The consumer has lost all the gains from the exchange.

Now assume once again that instead of giving the initial allocation to consumers, the GLBA had provided it to the financial institutions, so that consumers could prevent the sale of information pertaining to them only by persuading financial institutions to sell them the right. In that situation, the financial institution would have no incentive to inflate the consumer's transaction costs in asserting the right, because the consumer does not possess the initial allocation. Instead, financial institutions should refuse to sell the right if it is more valuable to them than to consumers, and be willing to sell the right if it is more valuable to consumers—exactly what the Coase Theorem predicts. Accordingly, the consumer is better off when the financial institution possesses the initial allocation of the right than when the consumer does, because, in such a case, the financial institution has no incentive to inflate consumer transaction costs and the consumer has the possibility of obtaining the benefits of the exchange, something that is not true when the consumer possesses the initial allocation. In other words, the initial allocation of the property right will sometimes lead to a different final allocation if one party has the power to inflate the other's transaction costs. Table One below illustrates the outcomes in a situation in which the financial institution can inflate consumer transaction costs, and contrasts with Table Two, which illustrates the application of the Coase Theorem in a situation where there are no transaction costs.

TABLE ONE

THE FINAL ALLOCATION WHEN FINANCIAL INSTITUTIONS CAN INFLATE CONSUMER TRANSACTION COSTS

Who Values Right More?	**Who Possesses Initial Allocation?**	
	Financial Institution	Consumer
Financial Institution	Financial Institution	Financial Institution
Consumer	Consumer	Financial Institution

TABLE TWO

THE FINAL ALLOCATION UNDER THE COASE THEOREM
(NO TRANSACTION COSTS)

Who Values Right More?	**Who Possesses Initial Allocation?**	
	Financial Institution	Consumer
Financial Institution	Financial Institution	Financial Institution
Consumer	Consumer	Consumer

The different outcomes are entirely consistent with the Coase Theorem. As Carl J. Dahlman noted, "when there are transaction costs and informational differences between traders, then it may very well matter to whom liabilities and rights are assigned."[20] What is perhaps surprising is that the consumer is sometimes better off when the financial institution, rather than the consumer, has the initial allocation of the right.

The ability of financial institutions to inflate consumer transaction costs is not unique. For example, sellers notoriously make it difficult for consumers to collect on mail-in rebates.[21] Similarly, sellers often obscure contract terms by using small print, unreadable clauses, and lengthy contracts. Online sellers sometimes hide unattractive terms in privacy notices.[22] Some sellers do not provide contract terms until after the consumer has received the item purchased; sellers may, for example, direct consumers to return the item if they are dissatisfied, thus giving consumers a significant incentive to retain the item. Others change contract terms by including drab "bill-stuffers" in an envelope with a more noticeable and seemingly more significant bill, thus reducing the likelihood that the consumer will focus on the change in terms. Forum selection clauses providing for a distant forum, arbitration clauses providing for expensive procedures or barring the use of class actions, or combinations of such devices may increase the cost of dispute resolution to the point where a party is better off foregoing assertion of a claim. Even litigation can involve the inflation of transaction costs, as, for example, when litigants inflict onerous discovery demands on an adversary solely to encourage a more favorable settlement.

How should policy-makers respond to the inflation of consumer transaction costs? Coaseans have sometimes argued that in formulating rules, the government should presume that parties will improve their situation through

20. Carl. J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 158 (1979).

21. This example, and the others described in the text, are discussed more fully in Jeff Sovern, *Toward a New Model of Consumer Protection: The Problem of Inflated Transaction Costs*, 47 WM. & MARY L. REV. 1635 (2006).

22. *See supra* note 11.

bargaining to the extent possible. For example, Elizabeth Hoffman and Mathew L. Spitzer have written that "in choosing a legal rule to govern [certain disputes], a judge or a legislator should start his analysis by presuming that the parties can and will, in general, exhaust the gains from trade through private bargaining."[23] But they add:

> Someone who claims the opposite, that bargaining breakdown will generally occur in some particular setting, must bear the burden of proof. He must point to some phenomenon, such as very high transactions costs, and show how the phenomenon is likely to prevent contracting between the parties. Only if the person who predicts bargaining breakdown makes his case should the judge or legislator act with the presumption of bargaining breakdown.[24]

Situations in which a party can inflate the other's transaction costs present just such a situation, calling for governmental intervention.

Policy-makers have attempted such interventions in the case of financial information by trying to restrain financial institutions from inflating consumer transaction costs. Thus, the GLBA requires that opt-out notices be clear and conspicuous.[25] Regulations implementing the GLBA direct that the notice be "reasonably understandable and designed to call attention to the nature and significance of the information in the notice."[26] The regulations offer further clarification by providing examples: something is "reasonably understandable" if it is presented in "clear concise sentences, paragraphs, and sections"; uses "short explanatory sentences" and "definite, concrete, everyday words"; and avoids "multiple negatives" and legal and business terminology.[27] A writing is "designed to call attention" if it uses plain-language headings and an easy-to-read typeface and type size.[28] But these provisions have been in effect since the first GLBA privacy notices were produced and have not solved the problem.[29]

More recently, regulatory agencies have proposed adoption of a model form that is intended to be more readable.[30] If regulators adopt the form, the GLBA

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23. Elizabeth Hoffman & Mathew L. Spitzer, *Experimental Tests of the Coase Theorem with Large Bargaining Groups*, 15 J. LEGAL STUD. 149, 162 (1986).

24. *Id.* at 162-63.

25. 15 U.S.C. § 6802(b)(1)(A) (2006).

26. 16 C.F.R. § 313.3(b)(1) (2009)

27. *Id.* § 313.3(b)(2)(i).

28. *Id.* § 313.3(b)(2)(ii).

29. *See supra* notes 8-12 and accompanying text.

30. *See* DEP'T OF THE TREASURY ET AL., INTERAGENCY PROPOSAL FOR MODEL PRIVACY FORM UNDER THE GRAMM-LEACH-BLILEY ACT (Mar. 21, 2007), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070321a1.pdf (on file with the *McGeorge Law Review*). The proposal was submitted on behalf of the following agencies: Office of the Comptroller of the Currency (Department of the Treasury), Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision (Department of the Treasury), National Credit Union Administration, Federal Trade Commission, Commodity Futures Trading

provides that financial institutions that use it would be deemed in compliance with the statute.[31] It is not clear whether this will provide sufficient incentive for financial institutions to use the form and risk forgoing the revenue stream from selling consumer information. Indeed, if it is true that financial institutions prefer that consumers not opt out of the sale of information pertaining to them, financial institutions might eschew use of a model form, in favor of less readable and noticeable forms that the financial institutions believe satisfy the statutory mandate.[32]

The fact that attempts to restrain financial institutions from inflating consumer transaction costs in connection with financial information have not succeeded does not mean that such attempts cannot succeed. Perhaps policy-makers have not been specific enough—or have left financial institutions too much discretion—and some tinkering with the regulations would produce a better result. But a preferable approach would be to adopt explicitly a norm against the inflation of consumer transaction costs and use that norm in evaluating attempts by financial institutions to comply with the disclosure regulations. The implementation of such a norm and what it might look like have been addressed elsewhere.[33] Ideally, if parties responded to such a norm by not inflating consumer transaction costs, they could engage in Coasean bargaining and reach an efficient result, thus negating the need for further government intervention.

It has long been recognized that transaction costs function as grit in the machinery of transactions. This Article has argued that giving financial institutions an incentive to toss more grit into the machinery by increasing transaction costs can produce an inefficient result by preventing parties from reaching the highest-valued uses of items and information. Coase began his famous article by stating that "[t]his paper is concerned with those actions of business firms which have harmful effects on others,"[34] and proceeded to show that sometimes those harmful effects are worth incurring. Unfortunately, when financial institutions have the power to inflate consumer transaction costs, the

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Commission, and Securities and Exchange Commission. *Id.* at 1-2.

31. 15 U.S.C. § 6803(e)(4) (2006).

32. The risks for a financial institution found to have violated the GLBA's privacy provisions are unclear, but probably not significant. Consumers do not have a private right of action for violations of the GLBA. *See, e.g.*, Borninski v. Williamson, No. 3:02-CV-1014, 2004 WL 433746, at *3 (N.D. Tex. Mar. 4, 2004) (listing other cases that have held the same). Perhaps a violation of the GLBA would give rise to a negligence per se claim, *see* Anthony E. White, Comment, *The Recognition of a Negligence Cause of Action for Victims of Identity Theft: Someone Stole My Identity, Now Who Is Going to Pay for It?*, 88 MARQ. L. REV. 847 (2005), or a claim under a state's unfair or deceptive acts or practices statute. *But see* Smith v. Chase Manhattan Bank, 741 N.Y.S.2d 100, 100-01 (N.Y. App. Div. 2002) (dismissing plaintiffs' UDAP claim against a bank for disclosing financial information to third parties in violation of its written confidentiality commitment on the ground that the complaint failed to allege actual injury and explaining that "the 'harm' at the heart of this purported class action, is that class members were merely offered products and services which they were free to decline" and that "[t]his does not qualify as actual harm"). The GLBA is enforced by various financial institution regulators, *see* 15 U.S.C. § 6805, but it remains unclear how vigorously they will enforce the GLBA.

33. *See* Sovern, *supra* note 21.

34. Coase, *Social Cost*, *supra* note 1, at 1.

harmful effects are not always offset by benefits worth incurring. In Frank J. Tipler's words, "a general and quite useful moral principle is suggested [by] the Coase Theorem itself: *Thou shalt not increase human transaction costs*[.] Or better, *Thou shalt act to reduce transaction costs for others*."[35] Unfortunately, this "moral principle," in common with many others, is not always followed.

35. Frank J. Tipler, *The Value/Fact Distinction: Coase's Theorem Unifies Normative and Positive Economics* (Soc. Sci. Res. Network Jan. 2007), *available at* http://ssrn.com/abstract=959855 (on file with the *McGeorge Law Review*); *see also* Dahlman, *supra* note 20, at 160 ("[T]he Coase analysis implies one of two corrective measures: (i) find out if there is a feasible way to decrease the costs of transacting between market agents through government action, or (ii) *if* that is not possible, the analysis would suggest employing taxes, legislative action, standards, prohibitions, agencies, or whatever else can be thought of that will achieve the allocation of resources we have already decided is preferred."). *But see* David Gilo & Ariel Porat, *The Unconventional Uses of Transaction Costs*, *in* BOILERPLATE: THE FOUNDATION OF MARKET CONTRACTS 66 (Omri Ben-Shahar ed., 2007) (listing arguably beneficial uses of transaction costs).