

WHY PARTIES ENTER INTO UNFAIR DEALS: THE RESENTMENT FACTOR

ABSTRACT

Unfair deals, which are prevalent, do not serve the interests of the harmed party to a deal nor society more generally. This article proposes a theory — here coined ‘deal theory’ — to explain ‘dealor’ behaviours and motivations for offering unfair deals. The theory builds on insights offered by relational contract theory, the ultimatum bargaining game and behavioural economics, as well as making its own theoretical claims.

It is here claimed that the dealor makes 3Rs cost benefit calculations — regulation, reputation and resentment costs — before deciding whether or not to offer an unfair deal. A dealor might seek to mitigate these costs by deploying cheat and bully strategies. The policy and legislative challenge is to harness the 3Rs costs to provide disincentives for unfair deals. This article pays particular attention to the resentment cost because its potential effectiveness in constraining unfair behaviour has generally been underestimated.

It is claimed in this article that a heightened understanding of the strong party’s incentives and motivations for offering and performing unfair deals, by using the insights offered by deal theory, can help improve legal, administrative, economic and other measures that can promote the interests of the harmed party and society more generally.

I INTRODUCTION

We are well aware that some deals are inherently unfair. A deal, for instance, might contain unfair terms or be performed in a way that leads to unfair outcomes. In regulating unfair deals attention tends to focus on protecting the weak party from the consequences of the deal. The focus on the consequences for the weak party of unfair deals tends to draw our attention away from considering the reasons why a strong party offers an unfair deal in the first place. Although there is considerable value in taking a morals based approach to the law and policy, doing so tends to draw our attention to the harm done to the ‘victim’ and away from providing adequate attention to the motivations and incentives for the strong party to insist on unfair terms in the first place. A heightened understanding of the strong party’s incentives and motivations for offering and performing unfair deals can help improve the legal, administrative,

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economic and other measures that could be taken to promote the interests of the weak party.

To advance our understanding of why a strong party might impose unfair terms on a weak party — via a contract, or an international treaty, or by some other means — this article makes a number of postulations about the cost-benefit calculations made by the strong party before she proposes an unfair deal.¹ The postulations are collected under a general theory, which is here coined as ‘deal theory’.

The reasons why unfair deals are worthy of attention is because they have a negative impact on the interests of one or both the parties, and are economically and socially sub-optimal. Just as fair deals, for instance, can be said to be optimal in that they maximise the joint welfare of the parties to the deal and maximise social welfare more generally, unfair deals can be said to be sub-optimal and lead to the inefficient allocation of resources. In the international sphere, unfair treaties can provoke the resentment of the weaker party, leading it to perform its treaty obligations grudgingly, if at all. At worst, unfair treaties can promote national resentment, social unrest and poverty in the weak country, and international instability. It makes sense therefore for policy-makers, legislators, regulators and diplomats to promote laws, policies and practices that promote fair deals between parties. Attaining the correct policy settings requires in part a more sophisticated understanding of the incentives and motivations for a strong party to propose and perform unfair deals — which is what deal theory seeks to provide a means for doing.

The account given in this article of deal theory will necessarily be incomplete, in part because its scope is large and evolving. Part II of the article does, however, sketch the theory in outline. For ease of terminology, contracts, international treaties and various other arrangements between parties are referred to as ‘deals’. This term is used because it is broader than the technically defined term ‘contract’, ‘treaty’ or other inter-party arrangement. ‘Deal’ refers, for instance, to pre-contractual offers as well as to contracts themselves and other less formal arrangements between parties. The party offering the deal is referred to as the ‘dealor’, which in the context of this article, is the initiator of the deal offer, and will often (although not necessarily) be the strong party. The other party to the deal is referred to as the ‘dealee’, which in relation to unfair deals is generally (although not necessarily) the weak party. The theory only has relevance where there is party imbalance — that is to say, one party (the dealor) has much greater bargaining power or information than the other party (the dealee).

¹ For a discussion on unfair international treaties see Justin Malbon, ‘TRIPS-plus Treaty Terms: Dealing with Coercion’ in Justin Malbon and Charles Lawson (eds), *Interpreting and Implementing the TRIPS Agreement: Is it fair?* (Edward Elgar, 2008) 159; Frank J Garcia, ‘Is Free Trade “Free?” Is It Even “Trade?” Oppression and Consent in Hemispheric Trade Agreements’ (Research Paper No 117, Boston College Law School, 17 January 2007).

Deal theory, as postulated here, claims that prior to offering a deal, a dealor will make an often crude cost-benefit calculation about the gains to be made from offering an unfair as compared to a fair deal. If the dealor calculates that the financial and other returns of an unfair deal will exceed those that could be expected under a fair deal — at least in the short to immediate term — she will be inclined to offer an unfair deal, and vice versa. She might not be so inclined towards an unfair deal if she calculates that any short or medium term gains will be eroded or obliterated in the medium to longer term by the latent costs of an unfair deal. These latent (and actual) costs on the dealor of an unfair deal are postulated in this article to be ‘3Rs costs’; namely the regulation, reputation and resentment costs to the dealor of offering and entering into an unfair deal. The 3Rs costs are elaborated upon in Part III(C).

In considering whether to offer an unfair deal, a dealor might make a further calculation. If she calculates that an unfair deal could lead to 3Rs costs, the dealor might decide to employ a cheat or bully strategy to mitigate those costs. Under the cheat strategy the dealor calculates that the dealee, and indeed any regulator, will be unaware of the inherent unfairness of the deal, or at least will discover the unfairness when it is too late to be able to inflict 3Rs costs upon the dealor. An alternative that might be available in some circumstances is a bully strategy. Here the dealor believes that offering and engaging in an unfair deal might, for example, provoke the dealee’s resentment (a 3Rs cost), and could give the dealor a bad reputation (another 3Rs cost), but the dealor calculates that this will not inflict any damage upon her because the dealee has no choice but to enter into the deal. This might arise, for instance, where the dealor is a monopolist. These strategies are briefly discussed in Part III(E).

One of the 3Rs costs is the cost to the dealor of the dealee’s resentment. If the dealee believes that she is being treated unfairly under the deal, she will resent it and seek some kind of retribution. The resentful response can be visceral. Indeed, the depth of emotion it can provoke is evident in our vernacular: if a person inflicts an unfair deal on us we say we have been conned, shafted, screwed, played for a sucker, and so on. Imagine, then, the additional armoury available to the legislature or a regulator if it could harness the collective resentment of dealees to a particular type of unfair deal to gain retribution against unfair dealors. This would add to mechanisms for responding to unfair deals beyond the traditional legal measures such as awards for damages, fines, injunctions and other standard legal and regulatory responses to unfair behaviour. This is not to propose over-exuberant dealee vigilantism, rather the proposal is for consideration to be given to broader strategies for reducing the incidence of unfair deals. That is to say, a more sophisticated understanding of the 3Rs costs and the cheat and bully strategies that can be used to mitigate these costs can help improve legislative and regulatory responses for promoting an environment for fair dealing. These propositions are briefly elaborated upon in Parts IV and V.

In some cases the 3Rs costs overlap so that, for instance, a dealee’s resentment may lead her to inflict reputation damage on the dealor — which is to say that there can be an overlapping of, and iteration between, resentment and reputation costs.

In other cases a regulator upon discovering that the dealor has breached a law requiring the dealor, in effect, to behave fairly, might require the dealor to publish an admission of wrongdoing and a public apology. This would enhance regulation and reputation costs.

This article pays particular attention to the resentment cost, in part because of the potential significance of its impact on dealees. The resentment cost is discussed at Part II(C). The discussion relies heavily upon the insights offered by the ultimatum bargaining game, which was first developed by Güth, Schmittberger, and Schwarze.² The game challenges the assumptions of rational choice theory, upon which much of neo-economic theory is based. Under rational choice theory, if I were offered a deal that would leave me, say, \$1 better off than if I did not enter the deal, then I would accept the deal, all other things being equal. The ultimatum bargaining game shows that if I am offered such a deal, but it would leave the dealor considerably better off than me, I might well reject the deal even if I leave myself worse off than if I had accepted the deal. It appears that under some conditions a party will refuse to accept a deal if she believes that the other party will make undue (unfair) gains from the deal.

The observations of the ultimatum bargaining game also suggest that a dealor will often be aware (consciously or otherwise) of the potential risks he or she faces in provoking a dealee's resentment by proposing a deal the dealee will perceive as unfair. Game theory experiments reveal that dealors tend to make proposals close to an equal split of the proceeds of the deal. Experiments also reveal that dealees are prepared to accept proposals that fall some distance short of an equal split. So, for example, under experimental conditions in which a dealor is required to make an offer to the dealee of a share of the stake, dealors tend to offer somewhere between 50–40 per cent. Dealees, on the other hand, tend to reject the offer when the share of the stake drops below 20–30 per cent.³

The insight offered in this article is that the game's experimental results imply that dealees have an unfairness tolerance. That is, assuming a 50–50 per cent split is the optimum point of fairness, and that dealees tend to reject offers below an average 25 per cent share in the stake, the average unfairness tolerance is the proportion between 50 per cent and 25 per cent; which is a 25 per cent unfairness tolerance. The point at which the dealee will reject is described here as the dealee's tipping point, or line of resentment.

The difficulty a dealor faces is accurately assessing where the dealee's line of resentment lies. At what point, for instance, will the dealee assess that the deal on offer is exploitative, and will reject? Worse still, what if the dealee accepts the

² Werner Güth, Rolf Schmittberger and Bernd Schwarze, 'An Experimental Analysis of Ultimatum Bargaining' (1982) 3 *Journal of Economic Behavior and Organization* 367.

³ Kent Greenfield and Peter C Kostant, 'An Experimental Test of Fairness under Agency and Profit-Maximization Constraints (With Notes on Implications for Corporate Governance)' (2003) 71 *George Washington Law Review* 983, 989.

deal, but feels exploited and takes revenge by inflicting ongoing reputation and resentment costs on the dealor? The dealee might enter a deal originally thinking it is fair, and later discover it is not. Or she may feel that she will do herself more harm than good by refusing the deal, but nevertheless seek to punish the dealor for taking unfair advantage of the dealee's weak bargaining position. The dealee will often punish covertly, so as not to raise the ire of the dealor. She may well fear a tit for tat response if the dealor discovers that she is inflicting 3Rs costs.

To avoid crossing the resentment line, the dealor will tend to act conservatively and make an offer that is well short of the resentment line. This explains why the experimental results show that dealors tend to make offers close to the equal split, despite the fact that other experimental data reveals that dealees will often accept offers as low as a 35–25 per cent share. The better the dealor understands the character and values of the dealee, however, the better able the dealor becomes in offering a deal that approaches the tipping point, or line of resentment. If the dealor discovers that the dealee has a high unfairness tolerance, she will be inclined to make an offer that unduly benefits the dealor, relative to theoretical optimum point of fairness. Where an equal split is feasible, this is the theoretical optimum point of fairness. If the dealee is well informed about the deal and has reasonable alternatives to the deal on offer, she will likely have a low unfairness tolerance. Either way, the more the dealor is able to accurately calculate where the dealee's line of resentment lays, the more value the dealor can extract from the deal without risking 3Rs costs. This explains why in large one-off and relational deals the dealor will spend a considerable amount of time and effort getting to know the dealee before making firm proposals to the dealee.

Deal theory makes a number of postulations — or hypotheses — as to why parties enter into 'unfair' deals. This raises the question as to what precisely is meant by the term 'unfair' in this context. This question is examined in Part III.

This article adopts two broad approaches to elucidating deal theory. First, it posits that a dealor will make 3Rs costs calculations, and that she will also weigh up whether she can adopt a cheat or bully strategy to mitigate the 3Rs costs. If after making those calculations the dealor assesses that she will make greater gains from an unfair deal, she will proceed on that basis. Conversely, if she assesses that she will make greater gains from a fair deal, she will proceed on that basis. These are general theoretical postulates, which is to say that it is not claimed that all dealors proceed in this way, merely that in many, if not most, instances this occurs where there are party imbalance preconditions. Some dealors may find that offering an unfair deal is morally repugnant, no matter how much she may gain from an unfair deal even after allowing for the 3Rs costs. However, for analytical purposes we assume that parties act self-interestedly rather than altruistically. The basis for this assumption is outlined in Part III.

The second proposition in this article is that dealors can miscalculate their own best interests. That is, they may discount the 3Rs costs by unduly preferencing the short-term gains of an unfair deal over any longer term potential losses. This has

parallels to hyperbolic discounting by consumers. Another countervailing effect is the agency effect. These conditions for miscalculation are outlined in Part V.

The third aspect of this article is essentially normative. Here it is argued that if the legislative or regulatory objective is to promote fair deals, then the insights gained from deal theory can be harnessed to obtain that objective.

Leading on from the examination of unfairness is the claim made in this article that legal systems, in essence, define unacceptable (that is to say, unfair) conduct, and provide a means of redress, sometimes in the form of compensation, for the unfair conduct. Much the same process occurs inside the minds of each of us. We will, for our own purposes, define certain conduct impacting upon us as unacceptable and unfair. We will often seek our own means of retribution — sometimes covertly, other times overtly and symbolically — to make redress for the unfairness. In this way a mini-legal system is operating inside our head — one that identifies the behaviour of others that is unfair and seeks some kind of retribution or compensation for that behaviour. So here we have two systems: the legal system (which is described in this article as the ‘macro-system’) and our personal systems of fairness (described as the ‘micro-system’). The postulation made in Parts III, B and IV is that the macro-system works most effectively if it operates in reasonable harmony with our collective micro-systems of justice. That is to say, generally speaking, the more the macro-system harmonises with our collective micro-systems, the more optimal the macro-system’s performance and effectiveness in enforcing its standards becomes. In other words, the more the macro-system reflects the deeper assessments of fairness by our collective micro-systems, the more effective the macro-system becomes in enforcing its own laws and rules. A further, and related, claim made in this article is that the two systems do not operate independently of each other. The macro-system informs the understandings of fairness of our collective micro-systems, and vice versa.

Resentment can therefore play a role in two contexts: first, in moderating the behaviour of the dealer in relation to a specific deal, and second, as a force to be harnessed by the legislature or a regulator to moderate the behaviour of dealers more generally.

This article, then, attempts some counterbalance to the essentially morals-based focus on the interests of the weak party by directing attention to the incentives for and calculations by the strong party in offering unfair deals. Deal theory, as expounded here, incorporates insights offered by relational contract theory, behavioural economics, and as mentioned, the ultimatum bargaining game, as well as offering insights of its own.

In offering a grand theory (and hopefully not a grandiose theory) in this article, I, the proponent, run the constant danger of mixing descriptive accounts with normative claims. That is to say, a postulate about party behaviour attempts a best fit explanation or theory as to what a party is doing, and why. At times a postulation can double as a proposal about what the party ought to be doing — which

invariably introduces (an often unspoken) moral dimension to what is supposedly a (quasi)-scientific endeavour. The ‘is’ and the ‘ought’ can have a magnetic attraction to each other so strong that it can be hard to tear them apart. That is to say, a descriptive account of what *is* can be coloured by a proponent’s view of what *ought* to be. A forensic examination of the account given in this article is bound to reveal a smudging of the *is* and the *ought*. I have pondered whether at every opportunity I should clearly signal whether a descriptive or normative claim is about to be made. On further reflection I believe that doing so is somewhat futile. The reason is this: although the account given in this article attempts to side-step questions of morality (that is, an essentially normative account), no account of law and justice can, or indeed should, be free of such questions. Normative concerns about the morality of the law should at least be standing there somewhere in the low-lit background. Descriptive accounts of law are necessarily (and should necessarily) be framed within some kind of normative dimension — whether explicitly considered or not. A rigorously ‘scientific’ and apparently value free (descriptive) analysis, on the other hand, is in constant danger of arriving at reasonings that can be meaningless, or at worse truly horrific, if used to comprehend and direct real world practice. That is, to analyse and theorise upon the law in a rigorously value-free way runs the risk of inviting or justifying legal systems that lead to perverse outcomes.⁴ Nevertheless, I will attempt where appropriate to signal whether a descriptive or normative claim is about to be made.

II DEAL THEORY IN OUTLINE

A Introduction

Parties who negotiate and settle fair deals maximise their own joint welfare whilst enhancing overall social welfare,⁵ yet parties often enter into unfair deals. Why is this? The reasons can vary from deal to deal, with a wide range of factors influencing party behaviour. Various psychological, cultural and behavioural factors may come into play, many of which are peculiar to the parties and their specific circumstances. The particularity of many of the factors leading to unfair deals leaves the observer unable to gain useful insights into why parties more generally are inclined to enter unfair deals, and what we should do to avoid unfair

⁴ The standard example of this is a strict value-free positivist account of the law. There are unlikely to be many proponents of this hardcore form of positivism. Nevertheless, it comprehends that the unique characteristic of the law is its capacity to enforce obedience to its edicts. The validity of its edicts is determined solely by asking whether the legislature followed the proper form in enacting laws (ie a majority of legislators voted for the edict). Thus, all edicts (ie laws) that are created using the proper form are necessarily valid, regardless of the fact, for example, that the laws might be arbitrary and might inflict great harm without any apparent justification upon a minority of the citizenship.

⁵ See Alan Schwartz and Robert E Scott, ‘Contract Theory and the Limits of Contract Law’ (2003–04) 113 *Yale Law Journal* 541, 543 who propose that as far as contracts between firms are concerned, ‘contract law should facilitate the efforts of contracting parties to maximize the joint gains (the “contractual surplus”) from transactions’. They claim that contract law should do nothing else.

deals in the future. Human behaviour and motivations are enormously complex rendering attempts at analysing and predicting party behaviour incredibly fraught.

One way of responding to this is to make more generalised and somewhat abstract theoretical claims about party behaviour. Generalised claims can sometimes be more accurate than specific claims. By way of analogy, the generalised claim (or prediction) that average winter temperatures will be lower than average summer temperatures is highly accurate, at least in temperate and polar zones. Despite being a generalised prediction, it is extremely useful. Fashion houses can design and prepare clothing for the next season, sports are played in seasons in which they can be more comfortably played, medicines are manufactured in anticipation of seasonal diseases and holidays are had in the most appropriate season.

Highly specific predictions (for example that next February 21 will be a clear sunny day with a 32 degree maximum temperature) might offer us even more utility, but cannot yet be accurately predicted if the relevant day is some months away. No doubt the capacity to make highly specific long term weather predictions would also be extremely useful, but this is not to deny the accuracy and utility of generalised predictions and claims. Generalised theories are also useful in that they offer a means for laying bare hidden assumptions and potential limitations in existing ways of doing things.⁶ For the purposes of analysis then, the claims made in this article will necessarily be generalised and simplified.

B *The Assumptions*

As a starting point, it will be assumed that dealors generally act self-interestedly rather than altruistically. This is not to suggest that a dealor's self-interested behaviour is necessarily antithetical to the self-interests of both parties. Nor does it necessarily imply unfair or unethical behaviour or outcomes. Being self-interested is not necessarily synonymous with being unduly selfish, as we will see in the discussion in Part III dealing with fairness.

If we assume for the moment that self-interest is a fundamental driver, it allows us to ignore some of the confusing 'noise' of psychological, cultural, behavioural and other drivers that are specific to a particular dealor and dealee, and a particular deal. Some people may in certain circumstances not offer a deal that would extract the greatest gain for them because they are motivated by altruism, generosity or cultural mores. For purposes of analysis, the wider the range of drivers or motivations behind a dealor's deal offer that are taken into consideration, the more complex the analysis becomes and the more difficult it becomes to make useful (generalised) claims about deals. That is, if we allow ourselves to be submerged in a sea of detail and specificity we will be paralysed by the resulting complexities. There would be little chance of gaining insight into party behaviour.

⁶ Kathleen M Carley, 'Computational Organization Science: A New Frontier' (2002) 99 (Supplement 3) *Proceedings of the National Academy of Sciences of the United States of America* 7257, 7257–62, 7267.

For the purposes of deal theory it is also assumed that the self-interested dealor will make calculations about whether to offer a fair or an unfair deal. A dealor, it is posited, calculates before proposing a deal the potential benefits and costs of offering a fair as opposed to an unfair deal. The calculation might be made in a split-second or may be measured and quantified in the dealor's mind over time. That is to say, the calculations might be consciously weighed and measured, or take place in the dark recesses of the sub-conscious mind. It might be a considered calculation, or barely considered at all. For our purposes it is assumed the calculation is made nonetheless. It is assumed, then, that a rather crude cost-benefit analysis is made in which the dealor assesses that if the potential gains to the dealor in offering an unfair deal outweigh the potential costs, an unfair deal should be proposed. These calculations may in some circumstances be prone to error — for example, unduly preferencing short term gains over longer term losses. In any event, if the dealor calculates that the benefits of an unfair deal compared with a fair deal outweigh the costs of an unfair deal, a rational (although not necessarily 'ethical') dealor will pursue the unfair deal. The regulatory challenge, as will be discussed later, is to introduce factors that will weight the cost-benefit analysis in favour of a fair deal.

The term 'unfair' is loaded, and suggests assessments of morality and ethics. That is, it might be said a deal is unfair because it is 'immoral' or 'unethical'. Moral and ethical concerns lie at the heart of a healthy system of law and justice. Deal theory does not suggest any displacement of these concerns. It seeks instead to complement and enhance these concerns, paradoxically enough, by suspending our attention to those moral and ethical concerns. This is because ethical and moral concerns direct our attention almost solely towards the harm done to the weak party and to the remedy that should be provided to her, and distract adequate attention from the reasons and motivations for the strong party to engage in the unfair conduct in the first place. Insights into these reasons and motivations can inform policies and laws to provide disincentives for unfair conduct.

An additional problem with morality and ethics is their relative vagueness and contestability, which invite interminable debates about whether it can truly be said the deal is unfair, and whose moral compass we should use to navigate our way to drawing conclusions on the question. This article bypasses these questions for the moment, not because they lack significance or centrality, but because the article attempts to reduce indeterminacy by removing as much complexity, or 'noise', from our considerations as reasonably possible to enable more generalised claims to be made.

C The 3Rs Costs

This article posits that the self-interested dealor faces a number of potential costs in offering an unfair deal. These potential costs, which beset all deals, are described as the 3Rs costs; regulation, reputation and resentment costs. These are potential and actual costs to the dealor of offering and undertaking an unfair deal; more specifically these are the regulation, reputation and resentment costs of an unfair

deal. A dealer will decide (however fleetingly or carefully considered) to offer a fair deal or an unfair deal to a dealee. In making that decision, she will consciously or subconsciously consider three potential costs of offering an unfair deal, which now will be considered in turn.

1 *Regulation costs*

Regulation costs are the costs of being successfully sued by the dealee, or being pursued by regulatory authorities, and the risk of laws and regulations being made more stringent in the future in response to unfair dealer behaviour. 'Regulation' in this context broadly includes the law of contract and any other laws and regulations that regulate the deal between the dealer and dealee. The regulatory cost of an unfair deal include, for example, any loss sustained from being sued for breach of contract, or from any other civil law action taken by the dealee; or action taken by a regulator in relation to the deal (for example, for breaching competition laws or regulations), and the potential costs of future stricter regulatory oversight.

Regulation costs are often the least concerning of the 3Rs costs for the dealer. Krawiec claims, for instance, that a growing body of evidence indicates that internal compliance structures do not deter prohibited conduct within firms and may largely serve as window-dressing to provide market legitimacy and reduced legal liability. She concludes, rather pessimistically, that present regulatory structures do not sufficiently deter corporate misconduct and simply lead to a proliferation of costly, and arguably ineffective, internal compliance processes.⁷ Parker and Nielsen are not quite so pessimistic.⁸ Their study of 999 large Australian firms suggests that although business implementation of competition law requirements are partial, symbolic and half-hearted, regulatory enforcement action does improve compliance system implementation.⁹

Although regulation costs might not be considered particularly significant, there are exceptional cases where the costs in fact turn out to be extremely high, at least in the medium to long term. The collapse of Enron led to the jailing of its CEO and federal indictments against its executives for devising complex financial schemes to defraud the company. Gross regulatory breaches leading to sharp regulatory responses were not confined to Enron around the time of its collapse:

The SEC in June 2002 charged WorldCom with massive accounting fraud [the company had wrongly listed over US\$3 billion of its 2001 expenses and US\$797 million of its first quarter 2002 expenses as capital expenses]. In January 2002, Global Crossing filed for Chapter 11 bankruptcy protection, listing assets of 22.4 billion and debts totalling 12.4 billion dollars, the

⁷ Kimberly D Krawiec, 'Cosmetic Compliance and the Failure of Negotiated Governance' (2003) 81 *Washington University Law Quarterly* 487, 487.

⁸ Christine Parker and Vibeke Lehmann Nielsen, 'Do Businesses Take Compliance Systems Seriously? An Empirical Study of the Implementation of Trade Practices Compliance Systems in Australia' (2006) 30 *Melbourne University Law Review* 441.

⁹ *Ibid* 442–4.

fourth largest bankruptcy in US history. The company was accused of employing misleading transactions and accounting methods, which gave the appearance that the company was generating hundreds of millions of dollars in sales and cash revenues that did not actually exist. At Adelphia Communications, the former CEO John Rigas, two of his sons, and two other former executives were charged with conspiracy, securities fraud and wire fraud and with looting the company of hundreds of millions of dollars. At Tyco, tens of millions of dollars in fraudulent bonuses were uncovered, and \$13.5 million dollars in unauthorised loans to key Tyco managers. This was an unprecedented display of accounting fraud, regulatory failure, executive excess and avoidable bankruptcy, with resulting widespread disastrous losses incurred by employees, pension funds and investors.¹⁰

This corporate behaviour led the US Congress in July 2002 to enact the *Sarbanes-Oxley Act*,¹¹ which imposed considerably more regulatory requirements and oversight, the ultimate effectiveness of which is debatable.¹²

These collapses involved the extensive use of unfair deals. Enron, for example, manipulated the Californian energy market to illegally extract profits exceeding US\$500 million during 2000 and 2001.¹³ Extensive use was made of cheat and bully strategies, the apparent success of which only emboldened key players into promoting and entering into larger and nastier unfair deals. A Staff Report of the US Federal Energy Regulatory Commission concluded that Enron had proprietary knowledge of market conditions through its online trading system that was unavailable to other market participants.¹⁴ This enabled it to engage in ‘wash trading’, an illegal stock trading practice where an investor simultaneously buys and sells through different brokers. This gave other players the false impression of market liquidity, causing artificial volatility allowing Enron to take advantage and gain massive profits at the expense of other traders and ultimately the consumers of energy in California.¹⁵ What can be seen here is that the key players within the

¹⁰ Thomas Clarke, ‘Cycles of Crisis and Regulation: the enduring agency and stewardship problems of corporate governance’ (2004) 12 *Corporate Governance* 153, 158.

¹¹ 18 USC §1514A (2002), also known as the ‘Public Company Accounting Reform and Investor Protection Act’ in the US Senate and the ‘Corporate and Auditing Accountability and Responsibility Act’ in the US House of Representatives.

¹² Larry E Ribstein, ‘Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002’ (2002) 28 *Journal of Corporation Law* 1; Ivy Xiyang Zhang, ‘Economic consequences of the Sarbanes-Oxley Act of 2002’ (2007) 44 *Journal of Accounting and Economics* 74.

¹³ Federal Energy Regulatory Commission, United States Congress, *Staff Report, Price Manipulation in Western Markets, Findings at a Glance* (2003) Docket No. PA02-2-000, 1.

¹⁴ *Ibid.*

¹⁵ See Konstantinos Metaxoglou and Aaron Smith, ‘Efficiency of the California Electricity Reserves Market’ (2007) 22 *Journal of Applied Econometrics* 1127, 1130, where they say:

offending corporations miscalculated 3Rs costs, more specifically the regulatory costs, and miscalculated the longer term success of their cheat and bully strategies.

Generally, however, firms that have dealings with consumers, for instance, are unlikely to be too concerned about them suing the firm for breach of contract or for other alleged breaches because of the disproportionate cost and financial risks of litigation to a consumer relative to the firm. There is, therefore, a financial disincentive facing consumers seeking to enforce their legal rights.¹⁶ These effects might be mitigated to some extent if a regulator has standing to sue on the consumer's behalf, or if there is an industry run independent disputes settlements scheme which is of no financial cost to the consumer.

2 Reputation costs

Driving an unfair bargain can also lead to the second 3Rs cost — namely, reputation cost. The dealer may, for example, gain a reputation for being ruthless, underhanded or having a propensity to unduly gain benefits for herself at the expense of the dealee. This might cause the dealee, and other potential dealees to avoid entering into deals with the dealer in the future, or to exercise excessive caution when dealing with the dealer during the course of the deal or in bargaining for future deals.

There is a considerable amount of literature regarding the costs of a firm attaining a bad reputation, and conversely the financial and other benefits of having a good reputation.¹⁷

Among those who took advantage of systematically higher DA [day ahead] prices were Enron traders, by means of their now infamous 'Get Shorty' strategy. Violating market rules and acting as pure speculators, they sold DA at a high price expecting to buy back HA [hour ahead] for a low price, thus gaining the difference. According to taped discussions available from the web site of the Snohomish Public Utility District, Enron traders were so allured by this 'sweet margin' in their buybacks that they did not hesitate to engage into illegitimate business practices, having learned well how to game the market rules. Under the directions of their chief executives, Enron traders repeatedly submitted false information regarding the physical availability of reserve resources that they did not have.

¹⁶ Relying on this bias can backfire, as it did spectacularly so in the 'McLibel' case of *McDonald's Corporation v Steel* [1997] EWHC QB 336 in which McDonald's sued the defendants for libel, presumably thinking this would intimidate the defendants so they would not hand out anti-McDonald's literature. The company won a Pyrrhic victory as a result of the court ordering the defendants to pay damages of £40,000. The case was considered a public relations disaster for the company, and is thought to have cost the company at least £10 million: Mark Oliver, 'McLibel Two Win Legal Aid Case', *The Guardian* (online), 15 February 2005 <<http://www.guardian.co.uk/uk/2005/feb/15/foodanddrink>>.

¹⁷ See, eg, Heski Bar-Isaac, 'Imperfect Competition And Reputational Commitment' (2005) 89 *Economics Letters* (2005) 167; Gary E Bolton, Elena Katok and Axel Ockenfels, 'How Effective are Online Reputation Mechanisms? An Experimental Investigation' (2004) 50 *Management Science* 1587; Ernst Fehr and Klaus M Schmidt, 'A Theory of Fairness, Competition, and Cooperation' (1999) 114 *Quarterly*

From a dealee's perspective, a dealer's reputation turns on questions of how much the dealee can trust the dealer and how careful she needs to be in dealing with the dealer, and how much confidence she can have in any representations the dealer makes about the deal. If the dealee is in a weak bargaining position relative to the dealer, she is highly dependent on the dealer doing the right thing and not unfairly exploiting her strong position. A dealee in a weak position invariably has an informational disadvantage to the dealer about the deal. Again, the dealee is reliant on the dealer not unfairly exploiting this advantage. One factor that can moderate dealer behaviour is fear of the potential reputation damage that can be caused by an unfair deal. It can be posited that dealees, sensing their weaker position, are likely to attach considerable (and possibly exaggerated) significance to any reputation news they receive about a potential dealee. Any good news (ie that the dealee can be trusted and will treat the dealee fairly) will be read by the dealee as highly encouraging and comforting. Bad news will cause financial damage related to the number of potential customers who hear about and believe the bad news.

In some instances a whole marketplace may gain a bad reputation. Akerlof noted some time ago in a famous paper on the market for 'lemons' (the colloquial term for cars that suffer from numerous mechanical and other failings) the problems of a marketplace where there is little trust in the quality of the products on offer.¹⁸ He questioned why second hand cars (in the 1960s) sold for considerably less than new cars, even when the second hand car was relatively new and unused. He speculated that the reason was because potential buyers realised they were at an informational disadvantage to the seller. The seller had the opportunity of using the car for a sufficient period to become aware of whether or not it was a lemon. Because of this potential buyers become suspicious about the car's quality and will therefore only be prepared to pay a relatively low price. Thus, the risk of purchasing a lemon is factored into the price of second hand cars. Because buyers are only prepared to pay relatively low prices, this drives out the quality products (because the market price is so low quality products would sell at a loss), which in turn only confirms the market's reputation for low quality, which can further drive down prices leading to the potential collapse of the market.

One way of overcoming a lemons problem is to establish some kind of reputation system. If the dealer is a stranger to the dealee, about whom she knows very little, she is likely to exercise considerable caution. If, however, there are a series of interactions between the parties, their history of past interactions will inform the dealee about the dealer's trustworthiness.¹⁹ The past dealings raise expectations and assumptions by the parties about their future dealings, and the likely

Journal of Economics 817; Johannes Hörner, 'Reputation and Competition' (2002) 92 *American Economic Review* 644.

¹⁸ George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 *Quarterly Journal of Economics* 488.

¹⁹ Paul Resnick et al, 'Reputation Systems' (2000) 43 *Communications of the ACM* 45, 46.

opportunities for future reciprocity or retaliation if one of the parties misbehaves. Axelrod described these expectations as the ‘shadow of the future’.²⁰

A first dealing with a stranger presents a situation where the parties have no history of past dealings, and therefore no basis for anticipation of future dealings. Here there is a lack of a shadow of the future for constraining present behaviour. We can see from Akerlof’s insights that this serves neither the interests of the dealee nor a fair dealer. The dealee’s information disadvantage may well prompt her to only be prepared to pay a relatively low price for the goods or services on offer because of the perceived risk of buying a lemon. It is therefore in the interests of both parties to establish a reputation system. Resnick et al propose that an effective reputation system requires at least three properties:

- Long-lived entities that inspire an expectation of future interaction;
- Capture and distribution of feedback about current interactions (such information must be visible in the future); and
- Use of feedback to guide trust decisions.²¹

There are a number of studies that confirm that considerable value can be gained for a seller who develops a good reputation, and is trusted by the marketplace.²² To put it categorically, there can be considerable value attained by having a good reputation, and a considerable loss of value if a seller has a bad reputation. It is therefore often in the interests of dealers to develop and maintain a good reputation. That is to say, a bad reputation can be very costly.

3 *Resentment costs*

We turn now to the focus of this article: resentment costs.

There is a burgeoning field of research dealing with resentment. Experimental evidence suggests that parties do not always undertake contract negotiations and performance in a narrowly self-interested way. Instead, parties often act according to their sense of reciprocal fairness. This behaviour is contrary to predictions of rational choice theory.²³

Attention was drawn to reciprocal fairness by the ultimatum bargaining game, which was first developed in 1982 by three German economists, Güth, Schmittberger, and Schwarze.²⁴ The game at its simplest involves two parties, A and B. A is offered a sum of money, say \$100, on the condition that A makes one

²⁰ Robert Axelrod, *The Evolution of Cooperation* (Basic Books, 1984) 126–30.

²¹ Resnick et al, above n 19, 47.

²² Peter W Roberts and Grahame R Dowling, ‘Corporate Reputation And Sustained Superior Financial Performance’ (2002) 23 *Strategic Management Journal* 1077.

²³ Robert E Scott and Paul B Stephan, ‘Self-Enforcing International Agreements and the Limits of Coercion’ (2004) *Wisconsin Law Review* 551, 556.

²⁴ Güth, Schmittberger and Schwarze, above n 2.

offer to B for a share in the stake. B has one opportunity to either accept or reject the offer. B is aware of all these factors. If B accepts, the stake is shared as agreed, if B rejects both parties receive nothing.

Rational choice theory predicts that on the whole parties will choose the alternative that is likely to give them the greatest satisfaction. On that basis we would expect that B will accept any share of the stake offered by A as she will be better off than before she accepted the offer. Rejecting any offer by A would leave B in a worse position than if she had accepted, no matter how small A's offer. We would expect, for example, that if A offered B a \$1 share, she would accept because she would be \$1 better off. Repeated experiments using the ultimatum bargaining game, however, demonstrate that B is likely to reject a \$1 offer (if, say, the stake is \$100), so that both A and B will receive nothing. The evidence shows not only that responders reject small offers, it also shows that proposers, perhaps anticipating rejection, usually offer substantially more than the smallest possible amounts.²⁵

In the first ultimatum game undertaken by Güth et al, proposers made average offers of 36.7 per cent of the stake, while one offer of 30 per cent was rejected.²⁶ The results of subsequent ultimatum game experiments are variable, but on average the minimum amount that responders will accept is between 20–30 per cent of the total stake.²⁷ That is, responders prefer no deal to one they consider to be unfair, despite the fact they would be better off by accepting the unfair deal. Proposers, perhaps anticipating the possibility of rejection of low offers, tend to offer between 40–50 per cent of the stake.²⁸ Taking the position of the proposer, it would appear she is either acting altruistically or she is calculating that her self-interest is best served by not inviting a rejection by the responder. Recall that under the rules of the game the dealee is aware of the amount of the stake, the proposer has only one shot at making an offer for a specified share of the stake, and rejection by the responder will leave her (as well as the responder) with nothing.

As a note of caution, when observing deals taking place in the marketplace more generally we need to be careful about our assessments of how the parties perceive unfairness in relation to a particular deal they are negotiating or performing. For instance, the parties may perceive a deal to be fair (or at least, not unfair) even if, say, the price of the goods or services is substantially higher or lower than the going market price (which can be said to be the optimum fairness point). The parties may depart from the market price (if there is one) to make allowances for the fact

²⁵ Hessel Oosterbeek, Randolph Sloof and Gijs Van De Kuilen, 'Cultural Differences in Ultimatum Game Experiments: Evidence from a Meta-Analysis' (2004) 7 *Experimental Economics* 171, 171.

²⁶ Ibid.

²⁷ Greenfield and Kostant, above n 3, 989; see also Fehr and Schmidt, above n 17, 826, who observe:

When combining the results of a number of research studies, the overall outcome shows that roughly 60–80 per cent of offers fall within the interval 0.4, 0.51, while 3 per cent are below 0.2.

²⁸ Greenfield and Kostant, above n 3, 989.

that one party is bearing a greater risk burden than the other under a particular deal. The offer price might be lower than the market price to promote a long-term business relationship as part of a strategy to increase market share or to induce the other party to move from an existing supplier. Here we can say that the optimum point of fairness for the parties has shifted from the normal (market) optimum point price.

If the above allowance is not made for any shift from the normal market position in the optimum point of fairness for the parties to a particular deal, it can on occasion mislead an observer into believing a deal is unfair because, for instance, the deal price is higher than the average market price. As Schwartz and Scott observe, deal terms that superficially appear to be one-sided are often mistakenly thought to be the product of unequal bargaining power.²⁹ However, as they explain, an apparently one-sided deal is very unlikely to be unfair if during bargaining both parties have a next best option, are both patient negotiators (ie one party is not under pressure to conclude the deal whilst the other is, because of financing or other pressures) and are sophisticated. These elements may well not be in play for unfair contracts.³⁰

The results of the ultimatum game suggest, somewhat paradoxically, that the selfish thing to do is to act altruistically. That is, if we act too greedily we will be punished by the other party, and consequently end up worse off. One strategy used to minimise the chances of negative responses from the other party is for the dealor to use impression management strategies so as to demonstrate to the dealee that the dealor is acting fairly. This is often done by the dealor proposing an equal division of the outcomes. This strategy is particularly prominent when the dealor knows the dealee is aware of the division.³¹

Trivers suggests that although parties gain mutual benefit through reciprocal altruism, there is a constant temptation to receive more than one provides through subtle cheating.³² Some analysts posit that there is a contest between two extreme positions; between ‘fairmen’ who divide everything equally and ‘gamesmen’ who behave selfishly and rationally like proper economic agents.³³ In Thaler’s view, most people are not well described by either extreme view:

Rather, most people prefer more money to less, like to be treated fairly, and like to treat others fairly. To the extent that these objectives are contradictory,

²⁹ Schwartz and Scott, above n 5, 554.

³⁰ Ibid 550.

³¹ Madan M Pillutla and J Keith Murnighan, ‘Being Fair or Appearing Fair: Strategic Behavior In Ultimatum Bargaining’ (1995) 38 *Academy of Management Journal* 1408, 1409.

³² Robert L Trivers, ‘The Evolution of Reciprocal Altruism’ (1971) 46 *Quarterly Review of Biology* 35, 37.

³³ Richard H Thaler, ‘Anomalies: The Ultimatum Game’ (1988) 2 *Journal of Economic Perspectives* 195, 205.

subjects make trade-offs. Behavior also appears to depend greatly on context and other subtle features of the environment.³⁴

The experimental outcomes leave us, however, with a bewildering array of evidence. Some evidence suggests people are concerned about fairness, other evidence indicates that most of us are selfish, and yet other evidence indicates that we usually seek to deal cooperatively.³⁵ Various commentators have attempted to explain the reasons for such apparently contradictory results. One explanation is simply that ‘this is a heterogeneous world where some people exhibit reciprocal fairness and others are selfish’.³⁶ Just as humans are inclined to act fairly, they are also inherently ready to act unjustly and unfairly, or do wrong if they can get away with it.³⁷ Apparently, this behaviour has roots in our biological evolution. Evolutionary psychologists hypothesise that humans have evolved ‘mental algorithms for identifying and punishing defectors’.³⁸ Humans apparently adapted to identify cheaters and to be identified as a non-sucker, that is, someone who is not easily exploited. As a result, there is a tendency to act spitefully when treated unfairly.³⁹ Fehr and Schmidt claim there is an important interaction between a population’s distribution of preferences and its strategic environment.⁴⁰ They conclude that:

there are environments in which the behavior of a minority of purely selfish people forces the majority of fair-minded people to behave in a completely selfish manner, too. ... Likewise, in a simultaneous public good game with punishment, even a small minority of selfish players can trigger the unravelling of cooperation. Yet, we have also shown that a minority of fair-minded players can force a big majority of selfish players to cooperate fully in the public good game with punishment.⁴¹

A significant factor influencing the behaviour of parties in all these environments is their perceptions of whether an outcome of a particular deal is fair. Perceptions appear to be based upon a ‘reference point’ or ‘reference transaction’ from which assessments of fairness are made. If the parties believe that neither is more entitled to the stake than the other, the reference point is typically an even split, assuming an even split is identifiable by the parties.⁴² If both parties believe one is more

³⁴ Ibid.

³⁵ Fehr and Schmidt, above n 17, 817–18.

³⁶ Scott and Stephan, above n 23, 565–6.

³⁷ Pillutla and Murnighan, above n 31, 1408.

³⁸ Francesco Parisi and Nita Ghei, ‘The Role of Reciprocity in International Law’ (2003–4) 36 *Cornell International Law Journal* 93, 105.

³⁹ Owen D Jones, ‘Time-Shifted Rationality and the Law of Law’s Leverage: Behavioral Economics Meets Behavioral Biology’ (2000) 95 *Northwestern University Law Review* 1141, 1182–3.

⁴⁰ Fehr and Schmidt, above n 17, 856.

⁴¹ Ibid.

⁴² Greenfield and Kostant, above n 3, 990.

entitled than the other, the reference point shifts more in favour of that party.⁴³ Evaluations of entitlement in a given situation are ‘the product of complicated social comparison processes’.⁴⁴

The equal split is usually not feasible because most transactions do not involve dividing up the pie, rather they involve exchanging one item (money) for a particular good or service. Many transactions are more complex still. The ultimatum bargaining game, as we have seen, is played out in simplified environment in which the only fairness consideration is the proportion of the split of the money on offer and both parties are fully informed of the total amount at stake. Evidence suggests that fairness concerns may be less pronounced in settings where splitting equally is impossible.⁴⁵

Where the equal split is feasible and no informational asymmetry exists between the parties, the 50–50 per cent split stands as a strong reference point for the parties. For observers and the parties it serves as the optimum point of fairness. For most of us, equal splitting ‘plays an important role in our upbringing and, typically, our first bargaining experiences with siblings and friends are situations where sharing equally is quite common (often enforced by third parties like parents or teachers)’.⁴⁶ In the absence of an equal split reference point, the behaviour of the parties can change dramatically. As Güth and Huck noted:

Comparing the equality game with the inequality games we observed that behavior changed dramatically although the inequality games were generated by only slightly altering a single payoff vector. More precisely, proposers choose significantly more often unfair offers when the exactly equal split is not feasible and responders reject unfair offers less often when all offers imply a payoff advantage for the proposer. ... The general message of these results (which seem in line with a focal-point explanation) is that fairness concerns may be less pronounced in settings where splitting equally is impossible. In reality equal splits are quite often not feasible, e.g., because of different enforceable claims.⁴⁷

In summary, parties generally attempt to be perceived by each other as acting fairly. If an optimum point of fairness (eg the equal split) is ascertainable and known to the parties, they will tend to propose and accept deals that have a closer alignment with the optimum fairness point, than if it is not ascertainable or known to the parties. If the dealee does not know the optimum fairness point, this offers a strong temptation to the dealor to act greedily.

⁴³ Ibid.

⁴⁴ Fehr and Schmidt, above n 17, 822.

⁴⁵ Werner Güth, Steffen Huck and Wieland Müller, ‘The Relevance of Equal Splits in Ultimatum Games’ (2001) 37 *Games and Economic Behavior* 161, 166.

⁴⁶ Ibid 164.

⁴⁷ Ibid 166.

D *The Unfairness Tipping Point*

Commentary on the ultimatum bargaining game outcomes has naturally focused on the fact that it suggests parties act according to their assessments of fairness. This tends to overlook another very interesting insight that the game provides, and that is the degree to which the responder is prepared to tolerate 'unfairness'. If an equal split is feasible, the ultimatum bargaining game suggests that most responders will not reject until the offer falls below 20–30 per cent of the stake, and given that our socialisation would suggest that an equal split is the optimum point of fairness it appears that responders have an unfairness tolerance of between 20–30 per cent.⁴⁸ Proposers on the other hand tend to make offers closer to the equal split. This suggests that they are uncertain as to what the responder's unfairness tolerance (or tipping point) is, so they play conservatively and hence make an offer closer to the equal split.

Negotiations are in reality often not undertaken on an accept or reject basis, nevertheless, there is evidence of dealers punishing dealers for perceived unfair deals in real world circumstances.⁴⁹ Even in the absence of circumstances in which more pronounced assessments can be made of fairness, sensitivity to unfair treatment subsists:

Behaviorally, humans are reciprocators — in most cases reflecting in their own behavior their perceived treatment by others. If nonshareholders believe that management is not acting fairly toward them — that is, if management is withholding 'too much' of the corporate surplus for the shareholders — the other stakeholders will be resentful and will act out their resentment in some way. ... In our experiment, the creation of the agency-maximization duty resulted in a severe drop in the number of deals consummated. ... Even though the duty caused the proposers — our analogue to corporate managers — to act more 'efficiently', *the resentment of the other players created an end result that was inefficient.*⁵⁰

So, a resenter will be unduly harsh in punishing the dealer, even if, as we have seen, the punishment will also hurt the dealee. The term 'punishment' here is not to be taken in the criminal law sense of punishing a person by, for instance, imprisonment or imposing fines and the like. Rather it is meant in a broader sense of harming, or attempting to harm another's interests in some way.

⁴⁸ Greenfield and Kostant, above n 3, 989.

⁴⁹ See Pillutla and Murnighan, above n 31, 1409–10 where they say:

In ultimatum experiments, offers are absolutely final; both parties (who have no history and no expected future) receive nothing if an offer is rejected. The starkness of these interactions necessarily limits their generality, but they provide a basis for clear tests of theoretical predictions and for evaluating whether fairness can explain actions in competitive negotiations.

⁵⁰ Greenfield and Kostant, above n 3, 1005–6 (emphasis in original).

There are some circumstances in which it is difficult for the dealee, or resenter, to punish the dealor — for example where the dealor is a monopolist, and the dealee has no options other than to deal with the dealor. Fehr and Schmidt believe that the resentful party's capacity to punish is substantially limited in monopoly markets, where the dealees cannot punish the monopolist by destroying some of the surplus and enforcing a more equitable outcome. This suggests to them that fairness plays a smaller role in most markets for goods (which presumably are more likely to be beset by monopolists) than in labour markets. Thus:

in addition to the rejection of low wage offers, workers have some discretion over their work effort. By varying their effort, they can exert a direct impact on the relative material payoff of the employer. Consumers, in contrast, have no similar option available. Therefore, a firm may be reluctant to offer a low wage to workers who are competing for a job if the employed worker has the opportunity to respond to a low wage with low effort.⁵¹

Sometimes a monopolist will not take full advantage of their market power. Empirical evidence suggests that customers have strong feelings about the fairness of a firm's short-run pricing practices, which could explain why some monopoly or oligopoly firms hold their prices below prices they could otherwise gouge as a monopolist or oligopolist.⁵²

Thus, an alternative strategy to extracting the maximum gains from a deal through, say, obtaining gouging prices is to be seen to be acting fairly. Such behaviour is generally rewarded, with the dealee performing her obligations beyond the required standards. Fair behaviour can induce a virtuous cycle.⁵³ There is an increasing body of evidence suggesting that when offered a trust contract

a substantial number of individuals will both pay higher prices and extend higher levels of effort than narrow self-interest would dictate. When offered the same choices plus the possibility of obtaining a monetary sanction if the promisor shirks, the average price offered by buyers and the average effort given by sellers was lower. Without coercive enforcement, reciprocal fairness generates high levels of performance. But once the interaction is backed by coercion, reciprocity declines and overall performance is reduced.⁵⁴

The term 'resentment' suggests the resenter is responding to more than mere non-fair behaviour, but to perceived highly unfair behaviour. In which case, the dealor's behaviour has to be perceived as sufficiently extreme to invoke an extreme response from the dealee. The point at which the dealee will read the dealor's behaviour as being so unfair as to invoke sanctioning or punishing behaviour by the dealee will

⁵¹ Fehr and Schmidt, above n 17, 834.

⁵² See Daniel Kahneman, Jack L Knetsch and Richard Thaler, 'Fairness as a Constraint on Profit Seeking: Entitlements in the Market' (1986) 76 *American Economic Review* 7, 8.

⁵³ Scott and Stephan, above n 23, 577.

⁵⁴ *Ibid* 579.

depend very much on how the dealee assesses where the optimum fairness line is drawn, and how she will assess the point at which the dealer has gone too far and crossed her resentment line. It will also depend on the alternative options open to the dealee. As the dealee has the power to punish it is wise for the dealer to gain a sense of where lies the dealee's line of resentment. The better the dealer knows about the dealee's character and world view the more accurate the dealer's assessment of the dealee's line of resentment, that is to say, the dealee's tipping point.

It can be speculated that the unfairness tolerance will be higher or lower than, say, the 25 per cent average that can be implied from ultimatum bargaining game outcomes depending on market conditions and other factors that lead to greater or lesser degrees of dealee deference. In competitive markets the tolerance might be quite low because the buyer (dealee) has other purchasing options and because she feels affronted by offers that are substantially above the going market price. Of course, rational choice theory would claim that, generally, purchasers will seek to maximise their own utility by shopping for the lowest price. Transaction theory would add a degree of sophistication to this claim by postulating that a person will not seek the lowest price if the search costs for that price exceed the difference between the price on offer and the likely amount of the lowest price. Deal theory does not necessarily seek to contradict these claims. It does, however, offer the additional insight (prompted by the ultimatum bargaining game) that dealees will also be motivated by the desire not to feel exploited. This in part explains the strange behaviour of tourists from high-income countries haggling at excruciating length in marketplaces in low-income countries over the price of a particular good being sold in a village marketplace. Often the price differences being haggled over are trivial to the tourist. The haggling seems to stem more from the tourist's desire not to feel that they are being played for a sucker than from any real interest in gaining the lowest possible price.

There is another possible way of understanding the way that a dealee's resentment tipping point can vary under differing circumstances. Generally, it might be said that we are hierarchical animals. From this it follows that a person who has a lower standing on the hierarchy will yield to a greater or lesser degree to a person at a higher standing. The greater the hierarchical difference, the greater the degree of unfairness tolerance by the person of lower standing. Assume also that our social structures and interactions reward initiative. That is, human progress is to some degree driven by conscious and unconscious rewarding of the initiator. Admittedly, there are situations, particularly in some organisations and businesses, where taking initiative is severely punished (through loss of face, demotion, or dismissal) if the initiative is perceived to have failed. This can, of course, discourage initiative taking. Putting that to one side, and assuming a general position where initiative is rewarded, it is possible that a deal proposer enjoys a privileged position relative to the responder, and is thus accorded a greater degree of unfairness tolerance than would otherwise apply. As an example, if a potential employer makes the first move by offering a specified wage it can be speculated that the potential employee will accept the offer, providing it is not perceived to be too unfair.

The suggestion here is that there is a relationship between the perceived power balance between the parties and the unfairness tolerance of the perceived weaker party. Further claims can be made on the basis of these assumptions. First, the power balance between the parties during the course of a deal relationship can change. Second, each party may perceive their own, and the other party's, bargaining power differently, relative to the other party. Parties may also overestimate or underestimate their own and the other party's relative bargaining power.

The unfairness tolerance of the weaker party is not merely explained by hierarchical deference and initiator reward; the weaker party is also acting in her own self-interest. There is often a cost to the weaker party of punishing the stronger — as she will often also be punishing herself. Take an example of an employee who believes she is being unfairly underpaid and is considering punishing her employer by failing to undertake some of her assigned tasks. Doing this exposes her to the risk of being caught out and the employer firing her. The employee will therefore weigh up the degree to which she is resentful with the risks of being caught and likely extent of any retaliation by the employer.

The dealee's resentment, however, can be costly to the dealer. As an example, an employer who pays her employee a wage well below the market rate may suffer an employee who punishes her by shirking.⁵⁵ The employee may undertake her tasks poorly and become unreliable in the performance of her duties. Similarly, a resentful party to a non-employment contract may well fail to perform her obligations to the standards they would if she were not resentful. The problem the dealer faces is that it is usually difficult to detect whether shirking is actually taking place and the extent of potential losses that are being suffered as a result. Because of the risk of retaliation, dealees rarely announce their unwillingness to perform their promised obligations, instead they 'typically affirm solidarity, protest helplessness in the face of intractable problems, or act in subtle ways that are difficult to evaluate'.⁵⁶

On the basis of insights offered by the ultimatum bargaining game, it can be posited that in the real world a dealer who is sensitive to the risks of being perceived as acting unfairly and consequently being punished by the dealee will, if possible, attempt to assess the dealee's tipping point. The less knowledge the dealer has about the dealee's tipping point, the more conservatively the dealer is required to act to avoid resentment. The more knowledge the dealer has, the closer she can push the deal towards the tipping point. Putting matters more positively, pre-deal negotiations may in part involve the parties getting to know each other better so that they can reach an agreement that both perceive to be fair so that they will be both committed to the full performance of the deals. That is, they may both

⁵⁵ Jedediah Purdy, 'The Promise (And Limits) of Neuroeconomics' (2006) 58 *Alabama Law Review* 1, 26; Mark F Schultz, 'Fear and Norms and Rock & Roll: What Jambands Can Teach Us About Persuading People to Obey Copyright Law' (2006) 21 *Berkeley Technology Law Journal* 651, 656.

⁵⁶ Scott and Stephan, above n 23, 568.

search out how the other is feeling about the proposed deal to ensure there is no resentment.

E *Cheat and Bully Strategies*

Recall that when proposing a deal, the dealor will make a cost-benefit calculation that takes account of the potential costs of offering, and undertaking, a deal that the dealee perceives to be unfair. The potential costs include the 3Rs costs of regulation costs, reputation costs and resentment costs. A dealor may, however, seek to mitigate these costs by using a cheat or bully strategy. In using a cheat strategy, the dealor assesses she can mitigate 3Rs costs because (she calculates) the dealee and the regulator are unlikely to discover the deal is unfair, or if they discover it to be unfair it will be too late for them to inflict 3Rs costs. Using a bully strategy, the dealor calculates that even if the dealee is aware the deal is unfair, the dealee has nowhere else to go. The dealor calculates that the dealee will decide that the unfair deal is better than no deal at all, and that any potential 3Rs costs will not cause any real damage to the dealor. Bully deals might be an available strategy where the dealor is a monopolist.

Taking a marketplace perspective, markets can be described as clean or dirty; and international treaty negotiations can be described as taking place in clean or dirty international settings. A clean marketplace, for instance, is one in which unfair contracts are the exception rather than the rule. Here there is healthy competition, the 3Rs costs play an important role in disciplining dealor behaviour and the environment for cheat and bully strategies do not exist. In a dirty marketplace unfair deals are commonplace. Any disciplinary effect the 3Rs costs might have are mitigated by the widespread use of cheat and bully strategies. Dealors are able to make effective use of cheat strategies, for example, by charging prices in excess of those they could charge in a clean market. In a dirty marketplace, a vast array of tactics are available for cheat strategies. They include obscuring the visibility of competing prices by heavily using advertising and promotional campaigns to draw attention away from the price competitors. Other tactics involve competing with complex pricing systems that render product and price comparison difficult if not impossible. Cheat terms can appear in consumer contracts, which might include hidden fees, excessive penalty clauses, hidden kick-back arrangements with third parties, and so on. Cheat strategies can include neutralising potential reputation costs by using feel-good advertising campaigns and public relations exercises to enhance the dealor's reputation undeservedly. A bully strategy might involve collusion with potential competitors to avoid competing on price or service and product quality.

In the marketplace, perceptions of unfairness play a central role. In a dirty marketplace the unfair dealor engages in a course of conduct through its standard contracts and other mechanisms to hide the unfair characteristics of the deal from the dealee, or simply disregards what the dealee might think about the fairness or otherwise of the deal.

III WHAT IS AN UNFAIR DEAL?

A Introduction

Recall that a central purpose of our analysis is to understand why parties enter into unfair deals. This prompts the question as to what is meant by an unfair deal. Arriving at an answer to this apparently straight forward question is not easy. To begin with, the term has a somewhat chameleon-like quality. At times it refers to a particular dealee's perception of unfairness — and indeed, it also refers to the dealor's perception of what the dealee perceives is unfair. At other times the term 'unfair' has a public meaning — either in the form of the general public perception of unfairness, or in the form of definitions of fairness concepts which are crystallised in laws. In some contexts unfairness is not consciously framed as a moral question — for example, where an innate or visceral response arises from a dealee's perception that she has been screwed by a deal. In other contexts, notions of unfairness are a consciously moral concern. Although these different formulations of unfairness appear to be discrete, in reality these formulations of unfairness bleed into each other. Our innate sense of unfairness, for example, is doubtless informed by moral concerns, whether we are conscious of this or not, and articulated moral concerns about fairness maybe simply narrow self-interest in the guise of higher principle.

Unfairness can be viewed from the perspective of an individual dealee, or from society's perspective. The social perspective may take shape as a generalised conception of unfairness (discoverable, perhaps, by public opinion surveys), or it might be fairness as crystallised by the law. In any event the two general perspectives are not mutually exclusive of each other.

Unfairness can also be viewed internally — from a party's particular perspective, which is to say from a subjective perspective — or externally, from the perspective of an outside observer. When we speak of a cheat strategy to mitigate 3Rs costs regarding an unfair deal, we cannot be speaking of unfairness as perceived by the dealee, because the dealor is deliberately hiding information from the dealee that might provoke her resentment about the deal. So here, unfairness needs to be assessed by an observer external to the deal to assess whether it is unfair. This will require placing a notional dealee in the position of the actual dealee. The notional dealee is taken to be fully informed about the nature and consequences of the deal (that is, the notional dealor is placed in the un-cheat position). If the observer determines that the notional dealee would perceive the deal to be unfair, then it can be said to be unfair. Putting it another way, the deal can be said to be unfair if no rational dealee in the un-cheat position would accept the deal, assuming other reasonable alternatives were available to the dealee.

The term 'unfairness' is also troublesome because although on the surface it suggests a relatively stable meaning, in reality it rests upon a highly unstable substratum. To begin with a dealee, a dealor, an observer and the law may each hold very different assessments of the fairness of a particular deal. The term

can imply a highly subjective assessment by the parties. As mentioned above, a dealee's response to a perceived unfair deal can be visceral if she thinks she has been exploited. 'Unfairness' is a term that also implies that it is not confined to subjective considerations, and that objective criteria can also apply. In both the subjective and objective states moral considerations can be applied. But 'morality', like 'unfairness', has an unstable meaning. It suggests both purely subjective assessments of morality — that might have little or no bearing on socially defined morality (if there is such a thing) — and a more 'objective', socially or externally defined meaning. The term suggests that it is determined by generally accepted conceptions of appropriate social and personal values.

We will side step a morals-based inquiry for a moment to attempt to avoid indeterminate (and possibly interminable) debates. There is no suggestion here that these questions are not central to considerations about unfairness. Nor is it suggested that questions of morality can or should be considered as being in some way independent of questions about unfairness. Rather, morality is seen to be important, but mysterious. We need therefore to suspend questions of morality for a moment for analytical purposes, and not because it is a side issue. Rather it is the reverse — morality so dominates the unfairness discourse that it obscures from view other operatives upon our sense of fairness and our behavioural responses to perceived unfairness.

B *What is Unfair?*

Our personal sense of fairness (and unfairness) is informed by a limitless range of sources, including our upbringing, friends, associates, parents and school, and by stories, TV shows, the law, and so on. The terms 'fairness' and 'justice' are generally used interchangeably as lay terms. When, for instance, we refer to our 'sense of fairness', we might equally be referring to our 'sense of justice'. The Oxford English dictionary defines 'justice' as having a meaning that includes '3. a. Conformity (of an action or thing) to moral right, or to reason, truth, or fact; rightfulness; fairness; correctness; propriety'.⁵⁷ Justice, as generally understood, therefore comprehends notions of fairness. Justice tends to be thought of as establishing principles and rules that are fair (substantive fairness) and applying them in a procedurally fair way (procedural fairness). Procedural fairness is generally thought of in lay terms as applying principles, rules or policies in a way that treats like cases in a like fashion, and not favouring one person or group over another.

The bounds of any particular aspect of justice or fairness appear at first to be something upon which it is impossible to gain consensus. John Stuart Mill noted in 1863 that not only have

different nations and individuals different notions of justice, but in the mind of one and the same individual, justice is not some one rule, principal, or

⁵⁷ John Simpson and Edmund Weiner (eds), *Oxford English Dictionary* (Clarendon Press, 2nd ed, 1989).

maxim, but many, which do not always coincide in their dictates, and in choosing between which, he is guided either by some extraneous standard or by his own personal predilections.⁵⁸

Henry Sidgwick attempted in the later part of the 19th century to develop a system for understanding the contents of ‘justice’ and found it did not furnish a single definite principle but

a whole swarm of principles, which are unfortunately liable to come into conflict with each other; and of which even those, that, when singly contemplated, have the air of being self-evident truths, do not certainly carry with them any intuitively ascertainable definition of their mutual boundaries and relations.⁵⁹

These observations suggest that notions of justice and fairness are hopelessly relativistic and unascertainable. A further problem with nailing down what we mean by fairness (and justice) is that our assessments of fairness tend to be subject to cognitive biases. As Kaplow and Shavell observe, we tend to favour assessing fairness from an *ex post* perspective. That is, from the perspective of events that have happened, rather than from the more abstract *ex ante* perspective. If, say, a student is expelled from a school, we are prone to assess the fairness of the expulsion from the particularities of the expulsion. We tend not to more rigorously assess its fairness against *ex ante* principles. The problem with this is that *ex post* assessments are more likely to take account of factors that would be considered irrelevant from an *ex ante* perspective, and which would invariably lead to longer term unfair outcomes if applied in the same way to future similar circumstances. According to Kaplow and Shavell:

The *ex post* perspective of many notions of fairness helps explain their broad appeal. When policy analysts or members of the public at large consider what rule seems fair in a given situation, we tend to focus ... on what has actually happened, for that is what we see in the case before us. We do not tend to focus on what did *not* happen (even when that may have been, *ex ante*, a much more likely outcome), and we do not directly observe the *ex-ante* choice situation and how behavior may differ in the future as a consequence of the legal rule that we choose to apply to the situation at hand.⁶⁰

Despite the (apparently hopelessly) relativistic and self-serving nature of notions of fairness, recent research into the ways and circumstances in which people defer to authority suggest that there is more commonality about our assessments of fairness than suggested by Mill and Sidgwick. Tyler and Huo undertook a study of encounters with the police and judges by criminal defendants and others in Los Angeles and Oakland during the turn of the 21st century. The study found that

⁵⁸ John Stuart Mill, *Utilitarianism* (Parker, Son, and Bourn, 1863) 81.

⁵⁹ Henry Sidgwick, *The Methods of Ethics* (MacMillan, 2nd ed, 1877) 326.

⁶⁰ Louis Kaplow and Steven Shavell, *Fairness versus Welfare* (Harvard University Press, 2002) 50.

the subjects of official interactions were more inclined to defer to officials if they perceived them to be acting with procedural justice.⁶¹ The study also found that there was a substantial degree of consistency across ethnic groups of perceptions about the fairness and justice of the conduct of authorities.⁶² This suggests that notions of fairness are not as relativistic and unascertainable as may first seem to be the case.

Other research shows the significance of the relationships between lay perceptions of fairness (including the degree to which authorities and institutions are perceived as acting justly) and perceptions about the legitimacy of those authorities and institutions. Perceived legitimacy impacts upon the degree to which members of society adhere to the rules and directives of authorities and institutions, which in turn impacts upon social and political, social and economic stability. Rothstein writes that in November 1997 he was invited to Moscow to deliver a lecture to Russian academics, politicians, and bureaucrats about the Swedish civil service.⁶³ After his lecture, a Russian tax official asked why it was that Swedes paid their taxes and Russians did not. The Swedish government receives 98 per cent of the taxes that Swedish taxpayers are required to pay, while Russians pay 26 per cent. The reason why Russians do not pay their taxes, it seems, is because, although they want publicly funded services such as health care, education, pensions, defence, and so forth, they correctly assess that most other taxpayers do not pay their taxes, and that even if they did, a significant proportion of the money would go to corrupt officials. It would appear, then, that in Russia trust in the system is in short supply. An effective taxing regime therefore depends upon lay assessments of the fairness of the taxing system, and most significantly the procedural fairness of the conduct of its officials. The system simply fails to effectively operate if there is widespread belief that it does not operate fairly.

Studies of employees show that they are motivated by their evaluations of the legitimacy of corporate rules. If employees experience corporate conduct that they perceive to be procedurally just, they are more likely to be viewed as legitimate and will more likely be obeyed.⁶⁴ As Tyler observes:

Findings consistently suggest that the legitimacy of authorities and institutions is linked to the fairness of the procedures by which they exercise their authority. These findings link legitimacy to the degree to which institutions are 'just' institutions. Hence, the pursuit of public support requires institutions and authorities to adhere to lay principles of justice. The effort to create and maintain legitimacy, in other words, causes institutions to focus on those who are being led, and their conceptions of procedural justice. It is only when the perspectives of everyday members are enshrined

⁶¹ Tom R Tyler and Yuen J Huo, *Trust in the Law* (Russell Sage Foundation, 2002).

⁶² Tom R Tyler, *Why People Obey the Law* (Princeton University Press, 2006) 278.

⁶³ Bo Rothstein, 'Trust, Social Dilemmas, and Collected Memories: On the Rise and Decline of the Swedish Model' (2000) 12 *Journal of Theoretical Politics* 477, 478.

⁶⁴ Tyler, above n 62, 274.

in institutions and in the actions of authorities that widespread legitimacy will exist.⁶⁵

The general perception that an institution is acting fairly can build it reservoirs of support, which can sustain the institution during times of crisis. Studies of community responses to the politically controversial US Supreme Court decision of *Bush v Gore*,⁶⁶ for instance, show that perceptions that the Court generally acts fairly had over time built a reservoir of support for the institution's legitimacy, which played a role in muting public disquiet about the decision.⁶⁷ These observations are consistent with Weber's contention that the most significant of several reasons why authority is obeyed in Western societies is because authority is exercised rationally, and in ways consistent with broad principles of procedural justice.⁶⁸

These studies and theories about lay perceptions of justice and fairness usefully inform our understanding of 'fairness' for the purposes of deal theory. They also highlight the significance of the connection between perceptions of fairness and perceptions of legitimacy. Legitimacy, in turn, explains why institutions within society are or are not able to function effectively within society. Deal theory, however, explores these interactions within the context of transactions, or deals, between parties. It explores how we individually and collectively behave in ways that can regularise the conduct of those in a dominant position (whether as the counterparty to an agreement, or as a dominant actor within an institution or other organisation). It is our resentment of perceived unfair conduct that may lead us to 'punish' the offending conduct, thereby under certain circumstances providing a disincentive for dominant parties to act in perceived unfair ways.

For the purposes of analysis of deal theory, a distinction is made between fairness, non-fairness and unfairness. We each tolerate in our daily lives all kinds of slights and minor injustices, and no doubt are daily authors of the same. We can perhaps describe these tolerated breaches of fairness as acts of 'non-fairness'; acts that we consider not to be fair, but not intolerably so. Actions by others that we consider to be intolerable and deserving of some kind of retribution are to our mind unfair. Unfairness is to our minds categorical, and invites a visceral response — the desire to 'punish' the offending party in some way. We each have ways of privately defining unfair conduct and seeking to punish the offending behaviour.

What might become immediately obvious to the reader is that the process by which we each privately categorise the deeds that are intolerably unfair and deserving of punishment is a microscopic playing out of the essential features of our legal and regulatory system (our justice system). We each carry within our heads a micro-system of justice, which defines and seeks to 'punish' unfair behaviour. The micro-

⁶⁵ Ibid 284.

⁶⁶ *Bush v Gore*, 531 US 98 (2000).

⁶⁷ Tyler, above n 62, 281.

⁶⁸ Max Weber, *Economy and Society* (G Roth and C Wittich eds, University of California Press, 1968) 941–55.

system to some degree or other is informed by and interacts with the macro-system of justice. Deal theory is interested in that interaction.

The interaction between the macro- and micro-systems could be described as an interaction between the public sphere and the private, although that distinction is not altogether helpful. We can speak about the micro-system in either the personal or the collective sense. In the collective sense we are not speaking of my private micro-system, or yours, but all our micro-systems collectively. In this sense the micro-systems as a collective are not within the private sphere — they in some sense are a shadow form of the macro-system, but without its institutions and express rules. It is useful, then, for analysis to distinguish between an individual micro-system and the collective sum of our micro-systems. If we speak of a micro-system in an individual sense, we are talking about the micro-systems of the parties to a particular deal.

It can be said that if a macro-system reflects, to a considerable extent, the values and world view of the collective micro-systems of a society, this indicates that there exists in that society an effective legal system (in terms of society's capacity to enforce unfairness prohibitions and remedies). It also suggests that the society is democratic (in the sense of giving legal effect to the general desire and values of the members of that society). We can describe this as a responsive macro-system. Such a system would not (and in making a normative claim, should not) to some degree or another merely reflect the values and world view of the collected micro-systems; it would (and should) influence them as well. In other words there would be an iterative communication between the two systems.⁶⁹

Perhaps this describes precisely how our political system works, although we cannot be sure. Buried in these descriptions is a normative claim. I am imagining that in a modern democratic society our collective micro-systems are inherently 'fair' and 'just'. I do not imagine that we collectively would desire to use the sheer weight of majority sentiment to inflict 'unfair' outcomes on a minority; but I must admit to that possibility. And given that the micro-systems are influenced by the values, perspectives and rules of the macro-system, it is also possible that a harsh and mean-spirited macro-system could well induce the collective micro-systems to harmonise with its nasty world view.

We will assume for a moment that the collective micro-systems are essentially egalitarian. From this it follows that a deal can be said to be unfair without having regard to the social or economic status of the parties. So a deal could be said to be unfair regardless of whether the dealee is rich or poor, or from the upper class or the lower class. This starting assumption needs to be relaxed somewhat to accommodate the proposition put in this article that unfairness tolerances can vary as a result of the perceived or actual power relationship between the parties.

⁶⁹ In a dictatorship, in which the macro-system is unresponsive, the macro-system would be used to influence or force the collective micro-systems to conform to its views of fairness. The macro-system would, to a substantially reduced degree, be influenced by the perceptions of fairness of the collective micro-systems.

A poor person believing she is in a weak bargaining position may tolerate a greater degree of non-fairness before she resents the deal. Thus, for analytical purposes at least, the optimum point of fairness in a deal is determined from an egalitarian perspective. From these propositions, the normative claim can be made that a society that seeks to be egalitarian will or should seek to narrow the unfairness tolerances of deals that take place within that society.

There is another more pragmatic aspect to the ideal of harmonising the macro- and micro-systems. Two of the 3Rs costs, namely reputation and resentment, can inflict serious damage upon a dealer if the audience for the reputation claims is sufficiently large and the resentment response is sufficiently severe. If a regulator were to harmonise its remedial system with the collective micro-systems to trigger a retaliatory response against an unfair dealer, this may well prove more effective in moderating future dealer behaviour than by merely relying on the standard tools for enforcement such as using penalties or entitling parties to sue for compensation. Some regulators do in fact enlist two of the 3Rs, namely the reputation and resentment costs to moderate dealer behaviour. As an example, the regulator who requires a dealer who has breached the law by misrepresenting the virtues of a product to publish a public apology and correct the claims made about the product. Here the regulator is effectively inviting each of our micro-systems to treat the dealer warily or boycott the dealer.

*C Macro and Micro Perceptions of Fairness as a Moderator of
Selfish and Selfless Behaviour*

Yet another function of the relationship (ideally) between the macro- and micro-systems is to regulate or moderate the moments, and degrees to which, we act or should act either selfishly or selflessly. As a society we benefit from each of our members acting at times either selfishly and selflessly (that is to say, cooperatively). A society that is overly selfish, it can be supposed, becomes mean-spirited, corrupt and brutal. A society that is overly selfless, on the other hand, can be claimed to be one that loiters aimlessly; becalmed upon a windless sea. It lacks direction, vitality and, ironically, cohesion. A selfless society (or group) will however tend to act in a highly cooperative way when it is seriously threatened or suffering privations. Here a high degree of cooperation is required for survival.

Organised selfishness (a process that includes the marketplace), on the other hand, requires a level of cohesiveness amongst self-interested players to function even in good times. That is, 'beneficial' selfishness usually requires a degree of organisation (and paradoxically, cooperation) that may be lacking in a totally selfless society. An overly selfless society operates well below its economic potential, leaving its members more financially impoverished than needs be. In an overly selfish society, on the other hand, the selfish prevail and the selfless are effectively enslaved, to the detriment of the society as a whole.

Ideally, therefore a society needs its members to act to appropriate degrees both selfishly and selflessly. Arguably, a switching or moderating system is needed to

ensure the proper interplay of these general behaviours. The claim here is that our micro and macro characterisations of ‘unfairness’ play a critical role in the operation of that moderating system. The point at which unfairness occurs may well mark the point at which selfish behaviour becomes destructive, or at least counterproductive. So, an ideal society relies upon the effective operation of an unfairness moderator — which, when it works well, helps maintain equilibrium between overall selfish and selfless behaviours. We can see here how central our internalisation of a sense of fairness is in ensuring that we personally are not taken undue advantage of by the selfish behaviour of others, and to ensuring the overall functioning of a well functioning society.

The social benefit that can be gained by selfish behaviour was identified some time ago by Adam Smith. His famous insight is that a society of members pursuing their self-interest magically (as though there was an invisible hand guiding society) leads to the overall benefit of society. As he said, it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.⁷⁰ The insight Smith offered is, of course, highly generalised as this magical process does not always work; markets are manipulated, some members of society are excluded from the marketplace or enter on seriously disadvantaged terms, and so on.

John Rawls also offers insights into how selfish behaviour can notionally be attuned to deliver social benefit. He proposes that it is possible to imagine the design of a fair society by placing imagined players in the ‘original position’. Here the players stand behind a veil of ignorance where they design a set of rules for governing an imagined future society. After designing the rules the players enter the society. However, when designing the rules they are unaware of which position they will enter and what status they will hold in the new society. It is therefore in their self-interest to design the rules as fairly and non-discriminatory as possible. The Rawlsian game operates rather like the rule at a birthday party which requires that the child who divides up the cake will take the last remaining portion. In this way self-interest is harnessed so as to attain the general good. It is therefore in the best interests (the selfish interests) of those in the original position to design a society as fair and equal as possible because when they enter the world they have designed they may well end up in the least advantageous position.

Rawls’ (moral) pre-supposition is that society should be egalitarian — which is to say, self-consciously cooperative. What is interesting is the apparently paradoxical

⁷⁰ See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations, the Glasgow Edition of the Works and Correspondence of Adam Smith* (Wogan, Gilbert and Hodges, 6th ed, 1801) 15. A fuller context for the quote is as follows:

But man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and shew them that it is for their own advantage to do for him what he requires of them ... It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk of them of our own necessities but of their advantages.

operation of the original position, which harnesses self-interest in the original position to attain an egalitarian society. And in other ways, Smith's invisible hand paradoxically utilises individual self-interest to enhance the economic and social benefits for society more generally.

Returning to the meaning of unfairness, Rawls' perspective on how we come to specify what are fair terms and cooperation is interesting. He asks:

Are they specified by an authority distinct from the persons cooperating, say, by God's law? Or are these terms recognized by everyone as fair by reference to a moral order of values, say, by rational intuition, or by reference to what some have viewed as 'natural law'? Or are they settled by agreement reached by free and equal citizens engaged in cooperation, and made in view of what they regard as their reciprocal advantage, or good?⁷¹

Rawls responds by saying the best answer is the last; that is where there is an agreement between citizens themselves reached under conditions that will set rules that are fair for all — these conditions exist in the 'original position' posited by Rawls.⁷²

There is in the accounts of Smith and Rawls a distinct air of artificiality. In Smith's marketplace the participants are well informed, are of equal means and have equal access to the marketplace. In Rawls' original position the imagined players are free, equal, moral (at a basic level, at least) and rational. Under deal theory, by contrast, the players are hierarchical, constrained by bounded rationality and their 'morality' is largely confined to questions about whether they intuitively consider the deal to be unfair or not. The players in deal theory, for the purposes of analysis, are artificial, but nevertheless are closer in nature to real world players than many other theories permit. Another difference is that under the Rawlsian and Smithsonian systems the outcomes are ultimately fair, whereas under deal theory the possibility of an unfair deal is ever present.

D Analysing Unfairness

Unfairness, for present purposes, can be analysed from the perspective of a particular deal. It can also be seen from a marketplace, or other sub-societal or societal, perspective. A more particularised analysis might pay particular regard to the micro-systems of the parties to a particular deal. A more contextualised analysis, on the other hand, will attempt to assess the unfairness boundaries as set within the collective minds of the players in the marketplace more generally. Under either form of analysis, unfairness is established by the parties to a deal (or the players in the marketplace), rather than solely by systems or institutions external to the parties themselves. That is, unfairness is not primarily established by the

⁷¹ John Rawls, *Justice as Fairness: A Restatement* (Erin Kelly ed, Belknap Press, 2001) 14–15.

⁷² *Ibid* 15.

operation of the law, regulations or externally devised moral or ethical standards. For the purposes of analysis, the micro-system fairness boundaries may well be influenced by external standards, laws and regulations, but are not imposed by them — as we will see in the discussion about folk-law, in the next section.

Superficially, it might be claimed that macro-system fairness standards are more discoverable than micro-system standards because macro-system standards can be found in written laws and regulations and the like, whereas micro-system standards exist within our heads. This claim, however, over-assumes the tangibility of the external standards; that is, their discoverability merely as words on pages or on computer screens. There is endless debate, for example, about the objective meaning of the words in statutes and constitutions. The claim about the more discoverable nature of the macro-system also underestimates the capacity of parties to a deal to be able to make relatively accurate estimates of each other's fairness standards (assuming each has a reasonable knowledge about the other, and there are not distorting factors at play, such as agency problems and hyperbolic discounting).⁷³ It also underestimates our capacity to interrogate the ways in which our micro-systems define unfairness. We can make generalised assessments and speculations about the workings of our micro-systems of justice, use our intuition to estimate the general standards of fairness held by the majority of players in a marketplace, or divine these standards by using qualitative or quantitative research methodologies.⁷⁴ We can also use the ultimatum bargaining game, as we have seen in the discussion above, and also apply behavioural studies, and other forms of social science methodologies to gain insights into the operation of micro-systems.

IV THE FOLK-LAW

The ways in which our individual and collective micro-systems interact with the macro-system — and more specifically the law — is interesting. As mentioned, in setting the optimum point of fairness and our unfairness tipping point for a deal, our micro-systems will have formed a (sometimes hazy) conception of fairness that is in part influenced by, but not determined by, our understanding of what the law says. This understanding is invariably informed by what we might each gather

⁷³ See below Part VI.

⁷⁴ Macaulay suggests the following approach by lawyers for aligning the law with the true intentions of parties to a contract:

Assuming that cost barriers permit, lawyers may be able to show judges what would be fair in a particular commercial context. The judges and the lawyers involved might never define 'fair' in a precise fashion that would satisfy a critic or offer answers to judges and lawyers in future cases. Nonetheless, all involved might accept that the results seemed to fall within an intuited zone of fairness. This process, however, might be very costly because it could require an exploration of the full commercial context. Of course, there is a risk that the judges might get it wrong, and cost barriers to proving the full context of a transaction would likely increase that risk. However, there is no reason to presume that the process always will be unduly costly or judges will always get it wrong.

Stewart Macaulay, 'The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules' (2003) 66 *Modern Law Review* 44, 67.

from TV shows, newspaper reports, stories told by our friends and so forth. All these sources influence our own framing of values, and help us form our imagining of what the law says. The law as we collectively and individually imagine what it says is in essence folkloric — or folk-*law*-ic. Folk-law as we individually and collectively imagine it informs our micro-systemic formulation of unfairness.

The macro- and micro-systems interact in another way. As mentioned, each of our micro-systems has an impressive capacity to punish perceived unfair conduct. The offender's (dealer's) reputation can be trashed, and the hurt party can underperform her obligations or act in various ways to covertly sabotage the interests of the 'offender'. Sometimes, however, this might not be enough, and the harmed party will seek to enlist the agency of the macro-system to gain appropriate retribution for the other party's unfair behaviour. We each imagine (or at least hope), it can be said, that we can call upon the aid of the macro-system (the law) if we are subjected to relatively serious acts of unfairness. We believe and hope that it has defined unfairness in approximately the same way we have, and that the macro-system will parcel out punishments or provide us remedies on our behalf and provide a means for us to demand compensation.⁷⁵

The folk-law is hazy in outline and is carried in the minds of every citizen. It is the real law as imagined — and the imagined law is a mix of what each citizen thinks the law says and what she would like it to say. The imagined law may at times be harsher and at other times more forgiving than the real law. The folk-law also reflects (at a deep and unarticulated level) each citizen's sense of fairness. Rawls would possibly equate folk-law with what he describes as a 'public conception of justice'.⁷⁶ As he sees it, a modern democratic society is based on the idea of citizens as free and equal persons, and the idea of a well ordered society. In his view, the public political culture of a democratic society and its conception of itself as a system of social cooperation are essential to its functioning. And an essential organising idea of social cooperation is the idea of fair terms of cooperation, which in turn specify 'an idea of reciprocity, or mutuality'.⁷⁷ He adds that: 'The idea of cooperation also includes the idea of each participant's rational advantage, or good. The idea of rational advantage specifies what it is that those engaged in cooperation are seeking to advance from the standpoint of their own good.'⁷⁸

Folk-law is more egocentric than Rawls' public conception of justice. Under Rawls' system there is a shared public view of rational advantage or good. Folk-law, on the other hand, is in the mind of each person. Folk-law, however, is subject to many and varied influences, including by what people believe the real law claims to be unfair. It is the real law as we imagine it to be — that is, as we think it is and as we would like it to be.

⁷⁵ Punishment here is not limited to punishment in the criminal law sense. It includes compensation or damages for breaches of agreements, and for torts.

⁷⁶ Rawls, above n 71, 5.

⁷⁷ Ibid 6.

⁷⁸ Ibid.

In terms of a particular deal, if the dealee (and possibly the dealer) imagines that the law says that a particular behaviour regarding the deal is impermissible (whether or not the law *actually* states that) then this imagined standard assists with establishing an observable optimum point of fairness for the deal, as well as influencing the dealee's perceptions of unfairness regarding the deal and her unfairness tipping point. This line will often be a hazy, contingent and shifting. But if the dealer crosses the line, she risks retribution by the dealee.

The ultimate aims of society should not necessarily be to engineer the folk-law and the real law into lock-step conformity; there can be a creative and dynamic engagement between the two. Each can moderate and inspire the other. If, however, there is constant disharmony and miscommunication between two systems, this would suggest an unproductive relationship, and possibly indicate the existence of a dysfunctional or autocratic society. The challenge for lawmakers and regulators is to gain relative synchronicity between the two systems.⁷⁹ This is not simply a task of ensuring the players fully understand and internalise the (legal and regulatory) rules of the game, but to also ensure the laws and regulations make sense to the parties and reflect their deeper sense of fair play. Likewise, the real law would need to reflect to some reasonable degree the aspirations of fairness and justice of the holders of the folk-law.

In an ideal case, the relationship between the two systems, including the agency role of the macro-system for our individual micro-system, does not amount to a social contract in which we trade our birthright freedoms with the state in return for the state protecting and defending us. Rather, it is a joint enterprise in which both the micro- (individual and collective) and macro-systems operate to constrain unfair behaviour.

V DEALOR MISCALCULATIONS OF HER OWN SELF-INTEREST

For completeness, we can turn briefly to the ways in which deal theory can provide insights into the ways in which the dealer can miscalculate her own self-interest by pursuing an unfair deal. As has been said, a dealer will either fleetingly, or in a more considered fashion, decide whether to propose a fair or unfair deal, and whether the 3Rs costs of an unfair deal could be mitigated by a cheat or bully strategy. We assume for the purposes of analysis that the parties to a deal will be acting self-interestedly and not altruistically. Dealers, it is suggested, are prone to

⁷⁹ The problems that arise if the macro-system does not align with the micro-system can be illustrated by the following commentary by Macaulay regarding contract law:

We might decide that there is a high cost in legitimacy if the legal system comes to symbolise that contract rests on manipulations of forms and courts reject the substance of the real deal of the parties. At the very least, if our courts allow those who draft written contracts to impose terms inconsistent with expectations and the implicit dimensions of contract, we can expect reformers to demand that the law police those bits of private legislation that masquerade as contracts so that they are fair.

Macaulay, above n 74, 79.

making a number of miscalculations about their self-interest in relation to assessing 3Rs costs.

As mentioned, the more unfamiliar a dealor is about the dealee's world view and value set, the greater her risks of miscalculating the dealee's line of resentment. In addition, a dealor is prone to cognitive biases and behavioural effects that may lead to miscalculations. As an example, it would seem likely that she might be as equally liable to engage in the types of hyperbolic discounting assessments that consumers have been found to make when engaging in longer-term transactions, such as borrowing to buy a car or a house, or entering a pension scheme. It appears from a number of studies that humans have a tendency to place less weight on the future than on the present, so that we in effect discount future payoffs (this is the hyperbolic discounting effect).⁸⁰ As an illustration, people tend to prefer one apple today than two apples tomorrow.⁸¹ On this basis it can be extrapolated that a dealor in proposing an unfair deal is likely to preference the short-term benefits the deal will deliver and discount the longer-term 3Rs. This may well explain in part the behaviour of the key Enron players. It is possible that they heavily discounted any likely future 3Rs costs, or simply assumed that the cheat and bully strategy they were using would be fully effective, forever.

In any event, the regulatory challenge is to work out ways of overcoming the effects of any hyperbolic discounting.

A dealor might also miscalculate because of agency effects. An 'agent' could be the dealor's employee. Adverse agency effects might arise where the agent's self-interest does not properly align with the dealor's self-interest. The agent might aggressively pursue an unfair deal on the dealor's behalf, realising that the dealor will probably suffer 3Rs costs eventually. The agent might, despite this realisation, pursue the deal because she will be rewarded by receiving staff bonuses for closing a deal, or will receive peer approval by her work colleagues, or will simply not care what impact an unfair deal will have on her employer (possibly because she resents the way she is treated by the employer and seeks to punish him).

⁸⁰ Partha Dasgupta and Eric Maskin, 'Uncertainty and Hyperbolic Discounting' (2005) 95 *American Economic Review* 1290.

⁸¹ See Ariel Rubinstein, 'Economics And Psychology? The Case of Hyperbolic Discounting' (2003) 44 *International Economic Review* 1207, 1209, who cites Thaler's experiments reported in Richard Thaler, 'Some Empirical Evidence on Dynamic Inconsistency' (1981) 8 *Economic Letters* 201. Rubinstein is dubious of claims that research data supports the hyperbolic discounting theory, he nevertheless offers a succinct description of the theory at 1209:

Ainslie and Haslam (1992) report that 'a majority of subjects say they would prefer to have a prize of a \$100 certified check available immediately over a \$200 certified check that could not be cashed before 2 years; the same people do not prefer a \$100 certified check that could be cashed in 6 years to a \$200 certified check that could be cashed in 8 years'. Findings of this type have been replicated with choices involving a wide range of goods (eg, real cash, hypothetical cash, food, and access to video games) and a wide range of subject populations. Most importantly, the results seem to be confirmed by our intuition.

VI CONCLUSION

Deal theory, as proposed in this article offers an additional and alternative way of considering unfair or wrongful behaviour regarding 'deals'. Deals include contracting, negotiating and entering international treaties, as well as other forms of transactional behaviour between individuals, firms, agencies and national governments. Laws, policies and (to a lesser degree) analysis tend to consider unfairness and wrong-doing from the perspective of the harmed party, and the harm caused to them. In contract law, for instance, actions for breach of contract or concerning vitiating of consent are focused on whether the plaintiff has suffered injury and the nature, cause and extent of the injury. In considering vitiating factors, the focus is on any suppression or interference with the plaintiff's freely informed consent to the agreement. Of course, it is completely appropriate for the law to take this course. Deal theory, however, views transactions from the perspective of the initiator of a deal, and why she offers an unfair deal in the first place. Understanding the motivations and calculations made by the dealor can inform the development of public policy to lessen the incidence of unfair deals.

An unfair deal is often the result of vitiating factors. That is to say, a deal is unfair if (to some reasonably substantial degree) a fully informed dealee would consider it to be against her interests to accept the deal, assuming she had other reasonable alternative deals available to her that could be costlessly identified and negotiated. Unfair deals, in neo-classical economic theory terms, are sub-optimal and lead to the misallocation of economic resources. The costs of an unfair deal are not confined to the economy, it may also cause loss to the dealor from 'punishments' inflicted by the dealor in the form of one or more 3Rs costs. An employee believing she is being underpaid, for instance, may underperform her employment duties, causing losses that exceed the savings gained by underpayment.

The downside of unfair deals goes beyond the general economic and the individual dealor costs. Political and legal systems that tolerate the prevalence of unfair deals may suffer a lack of public support and legitimacy. This can impact upon social and economic stability. It is therefore in the interests of good governance and a well functioning society for there to be a rule making and enforcement environment that hardens the conditions for unfair deals to thrive. Developing the appropriate rules and policies to create those conditions requires deeper insight into the motivations for dealors to offer and enter into unfair deals.

For the purposes of analysis, it is posited that in general the person initiating a deal will make a rather crude cost-benefit analysis about offering an unfair deal. The costs, rationally understood and calculated, include the 3Rs costs of regulation, reputation and resentment. This article focused on the last of these three costs. A dealor, aware of the potential costs of an unfair deal, may seek to mitigate them by using a cheat or bully strategy. The cheat strategy attempts to hide the unfair aspects of the deal from the dealee. Under a bully strategy, the dealor is indifferent to the dealee's reaction to the unfair deal, and indeed seeks to reinforce the message

to the dealee that she has no other option but to accept the unfair terms and that any punishing behaviour will rebound upon her, causing her substantial loss.

How, then, can a particular deal be said to be unfair? An assessment can be made from the perspective of the parties to a particular deal or from the perspective of a notional well informed and disinterested observer. In making the assessment it cannot be assumed, for instance, that, just because a deal departs from the prices and terms of other similar deals in the marketplace, it is necessarily unfair. There maybe trade-offs taking place that render the deal fair. For example concessions may exist so as to encourage a longer term relationship between the parties. Also, deal theory posits that unfairness is conduct that is likely to invoke a serious negative reaction from the dealee — namely, the desire to punish by inflicting 3Rs costs on the dealer in response to the perceived unfairness of the deal. A dealee will tolerate some measure of ‘non-fairness’ for various reasons explained in this article. However, the dealee has a tipping point, or line of resentment, beyond which otherwise tolerated non-fairness becomes intolerable unfairness. It is at this point that the dealee is prepared to punish, even if doing so will, to some degree, harm her own self-interest.

Assessments made by a dealee about the unfairness of a deal are informed by fairness benchmarks. Under the conditions of the ultimatum bargaining game where both parties are aware of the amount of the stake, the optimum point of fairness is a 50–50 per cent split. In real life, however, these conditions rarely apply. Unfairness is therefore generally measured against a variety of factors including those which, it is thought, the law proclaims to be actionable. Misleading and deceptive conduct provides an example. Parties to contracts are usually not lawyers, or informed in any detailed way about the content of the law, and so for them assessments are made against what they think the law says. In this case, assessments are made against a folk-lawric standard. The folk-law is not a fantasy or simply the product of a self-serving imagination, rather it reflects to some degree an intuitive sense of fairness and justice. The content of folk-law is informed by the real law, and in a good society, the real law is informed by the folk-law’s intuitive sense of fairness.

A dealee’s desire to punish a dealer by imposing one or more 3Rs costs is triggered by a sense that an injustice or act of unfairness has been inflicted upon the dealee. Her desire to punish — because the dealer has played her for a sucker etc — can be quite visceral. It therefore makes sense, in a policy and legal setting, to harness the dealee’s desire and means for inflicting sanctions upon the dealer so as to promote fair dealings between parties. This might involve imposing transparency measures so that dealees can easily become fully informed of the nature of a deal, thereby reducing the opportunity for cheat strategies.

In conclusion, unfair deals are not good for the dealee, or society more generally. Hence our individual and collective aversion to such deals, and our instinctive desire to moderate dealer behaviour by punishing detected incidences of unfair conduct by inflicting 3Rs costs on the dealer. We have both a personal interest

in reducing and eliminating the possibility that we will be the victims of an unfair deal, and a social interest in the establishment of formal (macro-system) mechanisms, enhanced by the power of informal (micro-system) mechanisms, for discouraging the incidence of unfair deals. Healthy macro- and micro-systems have a mutual interest to rid society of unfair deals. Corrupt macro-systems may be less interested.

The challenge for legislators and regulators is to gain a more elaborated understanding of the motives and incentives for unfair deals, and to devise mechanisms to remove those incentives.