SUBSTITUTING INVALID CONTRACT TERMS: THEORY AND PRELIMINARY EMPIRICAL FINDINGS

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Abstract

The law often lays down mandatory rules, from which the parties may deviate in favor of one party but not the other. Examples include the invalidation of high liquidated damages, the unenforceability of excessive non-compete clauses in employment contracts, and caps on interest rates in loans. In these cases, the law may substitute the invalid term with a moderate arrangement; with a punitive arrangement that strongly favors the protected party; or with a minimally tolerable arrangement (MTA), which preserves the original term as much as is tolerable.

The article revisits the choice between the various substitutes. Based on theoretical analysis and new empirical studies, it argues that the previous literature, which focused on the incentives the substitute arrangement creates for the drafting of contracts, overlooked two other important incentives. First, the applicable substitute strongly influences customers' inclination to challenge excessive contract terms once a dispute arises. Second, when the invalidation of an excessive term is discretionary, the applicable substitute can affect decision-makers' inclination to invalidate excessive clauses in the first place. Once the two additional incentives are considered, the emerging picture is considerably more complex, and the case for MTAs is weaker.

1. INTRODUCTION

For many decades, the primary means of regulating market transactions has been disclosure duties; but mounting evidence suggests that disclosure duties are largely ineffective (Radin 2013, pp. 219–20; Ben-Shahar and Schneider 2014; Willis 2006; Marotta-Wurgler 2009, p. 341). More recently, considerable attention has been given to *nudges*—"low-cost, choice-preserving, behaviorally informed approaches to regulatory problems" (Sunstein 2014, p. 719)—as a non-intrusive way to influence people's behavior in desirable ways (Thaler and Sunstein 2009; Zamir and Teichman 2018, pp. 177–85); but the efficacy of nudges in the context of markets is doubtful, because suppliers can, and do, counter their impact (Barr, Mullainathan, and Shafir 2009, p. 25; Bubb and Pildes 2014; Willis 2013, pp. 1200–10; Stern 2016). As a result, there is a

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growing interest lately in mandatory regulation of the content of transactions. Examples of such mandatory regulation include usury laws; minimum-wage statutes; statutes that impose liability on construction firms for defects in buildings that they build and sell; and the unenforceability of unconscionable contract terms.

Although the debate about the very need and legitimacy of mandatory regulation of the content of transactions has a long pedigree, relatively little scholarly attention has been given to the design of mandatory rules. With a few exceptions (Kimball and Pfennigstorf 1964; Korobkin 2003, pp. 1247–90), scholars have only recently begun to address questions associated with the design of such rules (Ben-Shahar 2011; Furth-Matzkin 2017; Ben-Shahar and Porat 2019; Zamir and Ayres forthcoming). One of the key questions pertains to the optimal substitutes for unenforceable contractual clauses. In this context, it is useful to distinguish between *bidirectional* and *unidirectional* mandatory rules. When the law lays down a *bidirectional* mandatory rule, it tolerates no deviation; that is, it applies notwithstanding any divergent contractual clause. For example, the rule that a court will not grant specific performance of a contractual obligation to provide personal services is bidirectionally mandatory (Kronman 1978. Pp. 369–76.), as is the denial of insurance coverage for willful acts (Cal. Ins. Code § 533; Fischer 2014). But much more often the law contents itself with *unidirectional* immutability—namely, allowing the parties to deviate from the rule in favor of one party (e.g., the tenant or employee) but not the other (e.g., the landlord or employer) (on the choice between bidirectional and unidirectional mandatory rules, see generally Zamir and Ayres forthcoming). Examples of such minimal standards include the invalidation of unreasonably large liquidated damages (Restatement (Second) of Contracts § 356); standard, statutory insurance policies which may be deviated from in favor of the insureds, but not to their detriment (e.g., California Standard Form Fire Insurance Policy, Cal. Ins. Code § 2070 (2018); Standard Fire Insurance Policy of the State of New York, N.Y. Ins. Law § 3404(f) (Consol. 2010)); and the unenforceability of non-compete clauses in employment contracts that are unreasonably broad in terms of time, area, or line of business (*e.g.*, Fla. Stat. Ann. § 542.335 (2018); La. Rev. Stat. § 23:921 (2017)). In those cases—which are the focus of this article—the question arises as to what arrangement should substitute the invalid term.

In a thought-provoking article, Omri Ben-Shahar (2011, p. 869) has drawn attention to this question, and suggested that there are three possible answers: "(1) the most reasonable term; (2) a punitive term, strongly unfavorable to the overreaching party; and (3) the minimally tolerable term, which preserves the original term as much as is tolerable." For example, when unreasonably large liquidated damages are deemed unenforceable, they may be replaced by an award of damages that the injured party is entitled to under the default remedy rules; by denying the injured party's right to any damages whatsoever; or by awarding her the highest amount of damages that would be considered valid under the liquidated-damages/penalty distinction. We label these three options *Moderate*, *Penalty*, and *Minimally Tolerable Arrangement (*MTA), respectively.

Ben-Shahar demonstrated that the MTA is fairly prevalent (for example, when courts apply the doctrine of partial enforcement of unreasonable terms), and discussed the policy considerations for and against using it from an economic perspective. In a nutshell, he argued that when the issue is one of incentivizing efficient behavior by the parties, the court should implement the most efficient arrangement—which is ordinarily

the most reasonable and moderate as well. In contrast, when the issue is purely distributive—as in the case of the price—there are good reasons to adopt the MTA, which is closest to what the parties would have agreed upon, given the unenforceability of the contractual term. However, as Ben-Shahar acknowledges, there is a serious concern that applying the MTA would incentivize suppliers to use excessive and invalid terms, knowing that many customers will yield to them, and in the worst-case scenario, these would be replaced by the MTA. Hence when the bounds of permissible contracting are readily known yet still violated by the supplier, the supplier should be deterred with administrative and/or contractual sanctions—including a substitute that is more pro-customer than the MTA, or possibly even punitive. Other scholars concur (Drygala 2012, pp. 50–52).

The present Article revisits this theoretical discussion, questions some of its implicit assumptions, and takes first steps to examining them empirically. Thus, in section 2 we argue that according to Ben-Shahar's own criteria, the incidence of MTA should be rather limited. This is because only a small minority of contractual terms are purely distributive, and even in those cases, MTA is usually inappropriate because it creates undesirable incentives for contract drafting.

The Article then describes the results of three empirical studies pertaining to two issues that have not been previously addressed: the impact of the substitutes on customers' inclination to challenge excessive terms once a dispute with the supplier arises; and the substitutes' impact on the judicial inclination to invalidate excessive terms when such invalidation is discretionary. A total of 1,053 people—a representative sample of U.S. population consisting of 500 participants, 325 Israeli legal practitioners (including judges), and 228 Israeli advanced-years law students—took part in these studies.

Thus, section 3 describes the findings of a new vignette study that we conducted to study the incentive effect of the substitutionary arrangement on customers' decision-making once a dispute arises and they are informed about the law. The results indicate that the substitute arrangement may indeed affect customers' inclination to stand up for their rights and challenge excessive terms: they are more likely to challenge such terms under *Penalty* than under MTA, even when the disputed sum of money is the same.

Section 4 challenges the implicit assumption that the enforceability of contractual terms is predetermined and exogenous to the choice of the substitute arrangement. Very often, the annulment of excessive terms is discretionary, and in employing their discretion, judicial decision-makers may be influenced by the content of the substitutionary arrangement. We offer several alternative hypotheses about the possible impact of the substitute arrangement on the inclination to annul excessive terms, and examine these hypotheses through two vignette studies: one using legal practitioners (including judges) as subjects and featuring a within-subjects design, and the other using advanced-years law students and a between-subjects design. Our main finding is that the choice of substitute may indeed affect the inclination to invalidate excessive terms, but that this effect likely varies among decision-makers, depending on their preferred substitute.

The upshot of our more nuanced theoretical analysis and new empirical findings is that the picture is more complex—and the case for MTA substitutes is weaker—than previously realized. Previous analyses have focused on only one of the three *dramatis*

personae involved in the drama (the supplier) while overlooking the other two (the customer and the judge). Our findings suggest that, not only MTAs create undesirable incentives for the drafting of contracts by suppliers (as previously noted), but are also likely to create problematic incentives in terms of customers' inclination to challenge excessive terms and may affect judicial decision-makers' disposition to invalidate them. We readily concede, however, that our empirical findings are preliminary, and further studies are necessary to examine the generality and external validity of our results. More generally, as scholars start systematically to examine the optimal design of mandatory rules (Zamir & Ayres forthcoming), this study should be seen as part of initial steps to study the pertinent considerations empirically (cf. Zamir and Katz forthcoming).

A final comment about the applicability of our analysis is in order. We focus on transactions between commercial sellers of products and providers (or purchasers) of services—including retailers, insurers, lenders, landlords, and employers (collectively labeled "suppliers")—and individual or commercial clients—including consumers, insureds, tenants, borrowers, and employees (collectively labeled "customers"). However, much of the analysis may be relevant to other spheres in which one party controls the drafting of the contract, be they commercial, consumer, or even private.

2. REVISITING THE THEORETICAL ANALYSIS

As previously noted, when the law renders contractual terms—but not the entire contract—unenforceable, the question arises as to which arrangement should substitute the invalid term. Schematically, there are three possible answers to this question: *Penalty*, *Moderate*, and MTA (Ben-Shahar 2011, pp. 876–78). A penalty substitutes the invalid term with an arrangement favoring the party whose interests the law is seeking to protect. For example, if a lender charges an interest rate that exceeds a statutory cap, that clause may be replaced by a zero-percent interest.[1] The primary advantage of this option is that it deters the inclusion of overreaching clauses in contracts. Such deterrence is particularly warranted when suppliers knowingly use unenforceable terms to mislead customers about their legal entitlements. This typically occurs when the drafter of the contract is a repeat player, as in typical consumer and commercial (but not private) contracts. Such a drafter is more likely to know the law and should be incentivized to acquire information about it. A penalty substitute may be used instead of, or in conjunction with, administrative or criminal sanctions for including invalid clauses in a contract (Zamir and Ayres forthcoming; Wilkinson-Ryan forthcoming). However, this option is troubling and arguably unfair when neither party knew, or had reason to know, that the contractual term in question was invalid. While penalty substitutes score high on deterrence, they are the least respectful of the parties' freedom of contract (inasmuch as this freedom is meaningful in contracts where the relevant mandatory rules apply), and they may also incentivize the parties to behave inefficiently when performing their contractual obligations. For example, substituting an excessive

[1] Thus, under California law, for some loans, if an excessive rate is charged "for any reason other than a willful act," the lender forfeits all interest and charges on the loan and may collect only the principal amount; and if any amount is charged willfully in excess of the charges permitted by law, the lender forfeits even the principal. Cal. Fin. Code div. 9 §§ 22751 and 22750, respectively (2018).

liquidated damages clause with no entitlement to any damages for breach of contract would drastically reduce the incentive to keep contractual promises.

Another possibility is to apply the default rule that would govern the transaction in the absence of any contractual arrangement—a *moderate* arrangement (Lawrence 2017, § 1–102:294). Thus, if a contract unconscionably denies the customer's entitlement to any remedy for breach of contract by the supplier, the customer would be entitled to the remedies ordinarily available to the injured party. Such default rules are typically deemed fair and reasonable. They usually reflect the expectations of most parties in the relevant type of contract, and are therefore presumably efficient (Zamir 1997, pp. 1753–55). However, a moderate substitute less effectively deter suppliers, because it assures them that even if the customer exercises her legal rights (which, in many contexts, is not very likely), the supplier's position would be no worse off than in the absence of any clause. Also, if the unenforceable clause is purely distributive—i.e., distributes the contractual surplus between the parties unfairly, but does not create any incentive for their behavior—the efficiency argument in favor of the moderate arrangement arguably disappears (Ben-Shahar 2011, p. 872). Arguably, when it comes to purely distributive terms, there is not even a distributive reason to adopt a penalty or a moderate substitute, because the supplier, who controls the wording of the entire contract, can take advantage of its superior bargaining power elsewhere in the contract—possibly in an inefficient manner (Ben-Shahar 2011, pp. 897–98; Johnson and Lipsitz 2018; for a critique of this argument, see Guttentag 2019, pp. 641–44).

The third possibility is to replace the invalid clause with a *minimally tolerable arrangement* (MTA)—namely a term that would favor the drafter to the greatest extent, and still be deemed enforceable. For example, assume that under the default remedy rules, the supplier would be entitled to $10,000 in damages for the customer's breach; liquidated damages of up to $20,000 would be considered tolerable; and the contract sets a penalty of $30,000 for the customer's breach. According to the present option, the supplier would be entitled to liquidated damages of $20,000. The main advantage of MTAs is that they entail the smallest curtailment of the parties' freedom of contract (Sullivan 2009, pp. 1129, 1158–59; Ben-Shahar 2011, pp. 879–80; Williams 2019, p. 2068). It has also been argued that since MTAs best mimic the parties' agreement given the mandatory rule, they are also the most efficient in the sense that they save the parties the cost of opting out of the default (Ben-Shahar 2011, pp. 872–73, 879). One may, however, question the latter claim, because—contrary to the case of designing default rules—when it comes to the design of substitutes for invalid contractual terms, *ex hypothesi* the cost of drafting has already been incurred (on setting MTAs as default rules, see Ben-Shahar 2009). In any event, the greatest drawback of MTAs are the "perverse incentives" they create for suppliers to include unenforceable terms in contracts (Sullivan 2009, p. 1161), thereby exploiting customers' ignorance of the law, their disinclination to engage in confrontation with suppliers, and so forth (see also section 3 below). Another drawback is that, inasmuch as mandatory rules aim to preclude unfair and inefficient contract clauses (that result from information problems or other traditional or behavioral market failures), MTAs may be less fair and less efficient than moderate substitutes (although, if the parties know best what arrangement would maximize the contractual surplus, while the mandatory rule is inefficient, MTAs are likely to be more efficient than other substitutes). Finally, another limitation of

MTAs is that determining their content may be more challenging for the courts than determining the substance of the moderate or penalty substitutes—especially when the doctrine in question is a vague, value-based standard, such as unconscionability (Ben-Shahar 2011, pp. 883–85; Williams 2019, pp. 2068–70). Aware of this difficulty, suppliers may be tempted to influence the determination of the MTA by strategically using extreme terms that will serve as an anchor in the deliberation about the MTA (Feldman, Schurr, and Teichman 2016, pp. 328–29).[2]

While useful and illuminating, this analysis calls for some comments. First, reality is sometimes more complex than implied by the elegant tripartite taxonomy. It is sometimes unclear whether a given solution should be considered a moderate arrangement or a penalty (or both) (Sullivan 2009, p. 1161). Such is the case when a given trade usage is more favorable to the supplier than the statutory or judge-made default rule. Two pertinent examples are non-compete and arbitration clauses. When a court strikes down an excessive non-compete clause or an unfair arbitration clause, and substitutes them with no restriction on the employee's freedom of occupation, or no compulsory arbitration—are these instances of moderate substitutes (in accordance with the legal default rules), or of penalties (given that reasonable and fair arbitration and non-compete clauses are prevalent in the trade)? (Ben-Shahar 2011, pp. 876–77; for a comparable example, see Drygala 2012, pp. 50–52). To take another example, consider a case where a contract first sets the supplier's liability in broad terms, and then lists a series of exclusions to that liability—some of which are deemed unconscionable. Striking down an exclusionary clause while leaving the broad liability intact may be described as a moderate solution (Ben-Shahar 2011, p. 876), but in reality may be a penalty (if the remaining liability is broader than the default or prevalent arrangement).

The tripartite taxonomy is also schematic in the sense that the three possible substitutes are sometimes nothing more than three dots on a continuum. In the interest-rate example, suppose that in a given type of loan, the prevailing annual rate is 10%, and there is a statutory cap of 20%. When a contract stipulates an annual interest rate of 30%, the penalty substitute can be not only anywhere between 0% to 10%, but actually *lower* than 0%—that is, the statute may exempt the borrower from repaying the principal, or any part thereof (Cal. Fin. Code div. 9 § 22750), and it may impose additional administrative or even criminal sanctions on the lender, including revocation of the lender's license (Small Loans Act, ALA. CODE § 5-18-9). Similarly, in this example the substitute may be set at any rate between 10 and 20%—namely, at an intermediate level between the moderate and minimally tolerable arrangements. Nevertheless, for the purpose of our general and relatively abstract discussion, the tripartite taxonomy is very useful, so we will keep using it.

If we turn to the substantive question, as previously noted, Ben-Shahar has focused on the desirability of MTAs. He concluded that MTAs are the most appropriate substitute when the invalidated clause is purely distributive, but that this conclusion should be qualified when the invalid clause is incorporated in the contract in bad faith, to deter such incorporation (Ben-Shahar 2011, p. 901–04). With regard to the first part of that conclusion, one may wonder what proportion of unenforceable clauses are

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[2] Anchoring denotes people's tendency to estimate values in relation to certain focal values, such that the estimation is drawn towards the anchor (Zamir & Teichman 2018, pp. 79–82).

merely distributive. The main examples of unenforceable clauses Ben-Shahar discusses are arbitration clauses, liquidated damages, non-compete clauses, warranty disclaimers, conditions for recovery of insurance benefits, and prices (including interest rates). However, with the exception of prices and interest rates, all these examples refer to clauses that are not purely, or even primarily, distributive. Arbitration clauses affect the extent to which the customer can effectively obtain a legal remedy against the supplier, so they clearly impact the supplier's behavior throughout the life of the contract (Reuben 2003). Liquidated damages are a poster child of the incentives created by contract remedies—including the promisor's decision whether or not to perform the contract and, consequently, the extent of the promisee's reliance on the expected performance (Goetz and Scott 1977; Schwartz 1990). Non-compete clauses affect the extent to which an employer might be willing to share trade secrets with its employees and the effort that employees put into their work—not to mention their negative externalities in terms of reduced competition (Prescott, Bishara, and Starr 2016, pp. 379–89; Ben-Shahar 2011, pp. 896, 901). Warranties and warranty disclaimers are primarily about incentives, as they affect the investment in production and maintenance of goods, the sharing of information about the goods' qualities and the buyer's needs, the purchase of insurance, and so forth (Zamir 1991, pp. 70–82). Finally, conditions for the recovery of insurance benefits are equally about incentives for the insured, who must meet them in order to recover (and for the insurer, who can rely on their non-fulfillment to avoid paying the insurance benefits) (Cummins and Tennyson 1996, p. 30). We are thus left with the price (including interest rates), which is purely distributive. In fact, according to standard economic analysis, when the impact of a rule is purely distributive, there is presumably no justification for interference in the first place, as standard economic analysis focuses on maximizing overall social utility, rather than its distribution.[3]

Thus, even before considering the second qualification (bad faith inclusion of unenforceable terms in the contract), the case for MTA appears to have a rather limited application. Not only are the great majority of contractual terms not purely distributive, but the inclination to invalidate purely distributive contractual terms is often weaker. Unlike most contractual terms, which tend to be "invisible" (Rakoff 1983), price is often the most salient feature of the contract. Customers are much more likely to know how much they are expected to pay for the goods or services that they buy than the liquidated damages that are to be paid in case of breach; the conditions they must meet in order to recover insurance benefits; or whether or not the contract includes an arbitration clause (and what it means). This is not to say that price terms, which may be

[3] A case in point is price discrimination by monopolies. When a monopoly charges a uniform supra-competitive price, it decreases aggregate social utility, because such pricing eliminates mutually beneficial transactions that would have been made otherwise, thus creating a deadweight loss. However, a monopoly that charges each customer its reservation price maximizes both its profits (by completely appropriating the consumer surplus) and allocative efficiency (by executing all profitable transactions) (Mankiw 2018, pp. 303–08). To be sure, this analysis is rudimentary, and a more sophisticated one would lead to more nuanced conclusions. However, it conveys the basic point that, under the Kaldor-Hicks criterion of efficiency (which is generally employed in economic analysis of law), only aggregate social utility—rather than its distribution—is what ultimately counts (Zamir and Medina 2010, pp. 14–15, 17–18).

complex and obscure (Bar-Gill 2012, pp. 18–21), should not be regulated on the grounds of market failures, fairness, distributive justice, or paternalism—as they sometimes are (Atamer 2017; Zamir and Mendelson 2019, pp. 437–45). However, since most contractual terms are not purely distributive, and purely distributive terms are less likely to be regulated in the first place, it does mean that the case for MTAs has only a rather narrow application.

Turning to the second qualification, Ben-Shahar rightly points out that MTAs create a strong incentive to insert excessive and unfair terms into the contract. One way to negate this incentive is to impose administrative or criminal sanctions against the inclusion of invalid terms in contracts (Ben-Shahar 2011, pp. 877, 883–84, 902–03; Wilkinson-Ryan forthcoming)—but these are not used very often. Another way to achieve the same goal is to avoid using an MTA whenever the supplier includes an unenforceable term in the contract deliberately and in bad faith (Ben-Shahar 2011, pp. 883, 901–04; Drygala 2012, pp. 51–52). Ben-Shahar points out that identifying such inclusions is easier when the borderline between tolerable and intolerable arrangements is clear; the excessive term is egregious; the supplier is experienced; and the offending term is not prevalent in the relevant trade (Ben-Shahar 2011, 903–04).[4] However, as he implicitly recognizes (Ben-Shahar 2011, p. 904), it is unclear why the appropriate test is one of deliberate or bad-faith behavior. If the inclusion of an unenforceable term in the contract is viewed as a sort of accident that should have been prevented ex ante, the issue is not one of deliberate or bad-faith behavior, but rather of identifying the least cost avoider. Since this is almost invariably the supplier who drafts the contract, MTA appears to be inappropriate in most cases, even for purely distributive contract terms (at least as long as administrative or criminal sanctions for including invalid terms are not commonly imposed).

Thus far, we revisited the question of what arrangements should substitute invalid contract terms within the limits set by the previous literature. The following parts of the Article discuss two elements that are missing from the above analysis: the effect of the substitute on customers' inclination to challenge excessive clauses and its effect on the judicial inclination to invalidate contract clauses.

3. CUSTOMERS' INCENTIVES

3.1. Background and Motivation

As explained above, a key incentive effect of the substitute arrangement pertains to the drafting of contracts by suppliers. Suppliers are most likely to use excessive, unconscionable, and invalid clauses in their contracts under MTA, and least likely to do so under *Penalty*. At the same time, the substitute arrangement is considerably less likely to influence customers' contracting decisions, because very often they are unaware of the contract details and do not know what the law is.

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[4] However, one may question the last of these criteria: the prevalence of a certain term in a given trade does not necessarily indicate good faith, as all suppliers may knowingly use the same unenforceable terms; and the fact that a term is novel may actually indicate that the supplier was unaware of its invalidity.

Another straightforward—yet hitherto overlooked—effect of the substitute arrangement relates to the inclination of customers to challenge potentially (or even definitely) unenforceable terms ex post. While customers hardly ever read standard-form contracts before contracting with suppliers (Bakos, Marotta-Wurgler, and Trossen 2014; Ayres and Schwartz 2014), they are much more likely to do so once a dispute arises (Becher and Unger-Aviram 2010; Furth-Matzkin 2017, pp. 35–40; Furth-Matzkin 2019; Becher and Zarsky 2019). Inasmuch as customers' hold an unshakable belief that unread, unconscionable, and even fraudulently included terms are nevertheless legally binding, they would not try to challenge unenforceable terms (Wilkinson-Ryan 2017; Furth-Matzkin 2019; Furth-Matzkin and Sommers forthcoming; Wilkinson-Ryan forthcoming). However, while at the contracting stage customers are often ignorant of the legal norms governing their transaction, once a dispute arises with the supplier, they may seek professional legal advice, or at least consult with friends or surf the web for legal information (Furth-Matzkin 2017, pp. 35–40). But this is not enough. Even customers who believe that a contractual term that the supplier relies upon is unenforceable may not exercise their rights. Given the characteristic disparities between many suppliers and customers in terms of resources and sophistication; the unpleasantness of confrontation; the monetary and non-monetary costs of litigation; and the indeterminacy of many legal norms, many customers yield to the supplier even if the law is (or is likely to be) on their side (Schmitz 2016; Arbel and Shapira 2019). At that point, the substitute arrangement may have a significant impact on the probability that litigation will ensue, as the decisions of both parties whether to take the matter to court is influenced by the expected remedy or sanction. We focus on the influence of the substitutes on customer's decision to challenge the allegedly invalid term—without which, no litigation, or even dispute, arises.

Consider again the loan example discussed above, where the prevailing annual interest rate is 10% and there is a statutory cap of 20%. Suppose further that a borrower who has taken out a loan of $10,000 for one year, with an annual interest of 30%, faces difficulties repaying it. If she does not challenge the contractual interest rate, she would have to repay $13,000. If she challenges the interest rate and prevails in court, under MTA she would have to pay only $12,000; under *Moderate* only $11,000; and under *Penalty* of 0% interest-rate only $10,000. Other things being equal, borrowers are more likely to exercise their rights if by doing so they are expected to gain (or avoid losing) $3,000 (under *Penalty*), than if they are only expected to gain $2,000 (under *Moderate*), and certainly if they are expected to gain only $1,000 (under MTA). This is all the more true of the borrower's attorney, who is more likely to take the case the higher the expected reward, because his or her fee often depends on the outcome of handling the case. Inasmuch as there is a problem of under-enforcement of customers' rights—and as previously noted, there are good reasons to believe that such a problem does exist, especially in the case of underprivileged and unsophisticated tenants, borrowers, employees, and consumers—this analysis provides a potent argument in favor of *Penalty* (or at least *Moderate*), and against MTA (compare the economic justification for supra-compensatory damages when the probability of enforcement is smaller than one, known as the "multiplier principle." Craswell 2003, pp. 1167–69).

Obviously, the larger the expected gain from challenging an overreaching term, the strongest the incentive to challenging it. However, we hypothesized that the

substitutionary arrangement may influence customers' inclination to challenge excessive terms even when the amount of money or other tangible advantage that are at stake are similar under the three substitutes. Following the above example, let us assume that the prevailing annual interest rate is 10%, the statutory cap is 20%, and the contractual interest is 30%. Now, suppose that one borrower has taken a loan of $10,000 where the substitute is 0% (*Penalty*), another borrower has taken a loan of $15,000 where the substitute is 10% (*Moderate*), and a third borrower—a loan of $30,000 where the substitute is 20% (MTA). For all three borrowers, the gain from successfully challenging the excessive interest is $3,000. Nevertheless, the first borrower may be most inclined to challenge the contractual interest (and the third borrower least inclined to do so), for two reasons.

First, the substitute may have an expressive effect. According to expressive theories of law, the law influences people's behavior not only by imposing duties and conveying rights, but also by expressing attitudes, shaping public perceptions, and sometimes imposing "expressive harms" (Cooter 1998; Anderson and Pildes 2000; McAdams 2015). Arguably, by prescribing a penalty substitute, the law expresses greater condemnation of suppliers' inclusion of excessive terms in their contracts. Such condemnation may increase customers' assessment of their chances to prevail in court or arouse indignation toward suppliers, which consequently will encourage customers to challenge such terms. Conversely, when the law adopts an MTA, it expresses a more lenient attitude toward the inclusion of invalid terms in the contract, which may in turn discourage hesitant customers from challenging them (and *Moderate* might lie somewhere in between).

Another reason is *diminishing sensitivity*, namely, the decreasing impact of any given change on people's perceptions, judgments, and decisions, the further away the change is from the reference point (Zamir and Teichman 2018, pp. 85–86). A familiar manifestation of this phenomenon is that consumers may go out of their way to buy a product for $20 instead of $25, but not do so to buy a product for $495 instead of $500 (Thaler 1980, pp. 50–51). In the above numerical example, while the absolute amount is the same under the three substitutes ($3,000), in the *Penalty* condition this sum constitutes 30% of the principal, in *Moderate* 20%, and in MTA only 10%. Thus, the disputed sum may appear to be largest under *Penalty* and smallest under MTA.[5]

We initially examined this hypothesis in a between-subject pilot study, which was conducted on MTurk—an internet platform that facilitates online surveys and randomized experiments, and is widely used for behavioral studies. We found that even when the disputed sum is the same, customers' inclination to challenge an excessive interest rate, their estimated chances to prevail in court, and their assessment of the extent to which the law denounces excessive interest rates were highest in the *Penalty* condition. There were also strong correlations between participants' answers to the three questions

[5] A counterhypothesis might be that when the perceived stakes are greater, borrowers may assume that it would be *more difficult* to prevail in court, so they would be least inclined to challenge the excessive interest under *Penalty* and most inclined to do so under MTA.

(*Choice*, *Chance*, and *Denounce*). Study 1 aimed to investigate the issue more thoroughly with a representative sample of U.S. adult population.[6]

3.2. Study 1: Customers' Inclination to Challenge Contractual Terms

Study 1 examined customers' inclination to challenge excessive interest rates under the three substitutionary rules in a between-subjects design, where the disputed sum was the same in all three conditions. The vignette referred to an excessive interest rate, because the interest rate appears to be purely distributive, meaning that Ben-Shahar's key insight is directly applicable to it.

Participants. Five-hundred people took part in Study 1—a representative sample of U.S. adult population in terms of age, gender, income, and ethnicity. They were recruited through Toluna, a company specializing in web-based surveys. Their average score on the Ideological Worldview scale was 53.83 (SD=29.47), and average religiosity was 52.02 (SD=34.31).

Design and Procedure. As shown in the Appendix, in the first part of Study 1 participants were initially presented with a brief explanation of the concept of principal and interest in loans; informed that the prevailing annual interest rate for a given type of loan in their jurisdiction is 20%; and advised that according to the law, "excessive and unconscionable" interest rates are void. The vignette went on to say that the courts in their jurisdiction have long struggled with the question of when an interest rate should be considered excessive. With regard to this type of non-bank loans, the courts have usually ruled that an annual interest in excess of 30% is excessive and void, but on occasion they found even higher rates reasonable and valid, and on other occasions lower rates to be excessive and void.

The vignette then described the outcome of a declaration that a given interest rate is excessive and void—which varied between the three conditions: *Penalty* (no interest), *Moderate* (prevailing interest), and MTA (minimally tolerable interest). To ensure that the participants understood the outcome, the initial description was followed by a comprehension question that they had to answer correctly before proceeding with the questionnaire.

Participants were then asked to imagine that they had taken out a loan of the said type in an amount that varied across the three conditions: $5,000 in *Penalty*, $10,000 in *Moderate*, and $20,000 in MTA—with an annual interest rate of 40%. The amount of interest to be paid after one year, in addition to the principal, was also stated—namely, $2,000, $4,000, and $8,000 for *Penalty*, *Moderate*, and MTA, respectively. The vignette further instructed participants to assume that after getting advice about the law, they decided to repay only the principal amount (in *Penalty*), the principal amount plus

[6] To be sure, when customers contemplate whether to challenge an excessive term, they should take into consideration the effect of the substitutionary arrangement on the judge who will decide the case—an issue we directly examine in Studies 2 and 3. In Study 1 we do not directly examine the thought process of customers, but one may assume that at least the more sophisticated customers do take this issue into account.

$2,000 (i.e., 20% of the principal) (in *Moderate*), or the principal amount plus $6,000, namely 30% (in MTA)—which they believed they were legally required to pay. In response, the lender insisted that the participant must pay the remaining balance of $2,000. Table 1 summarizes the numerical details of the three conditions.

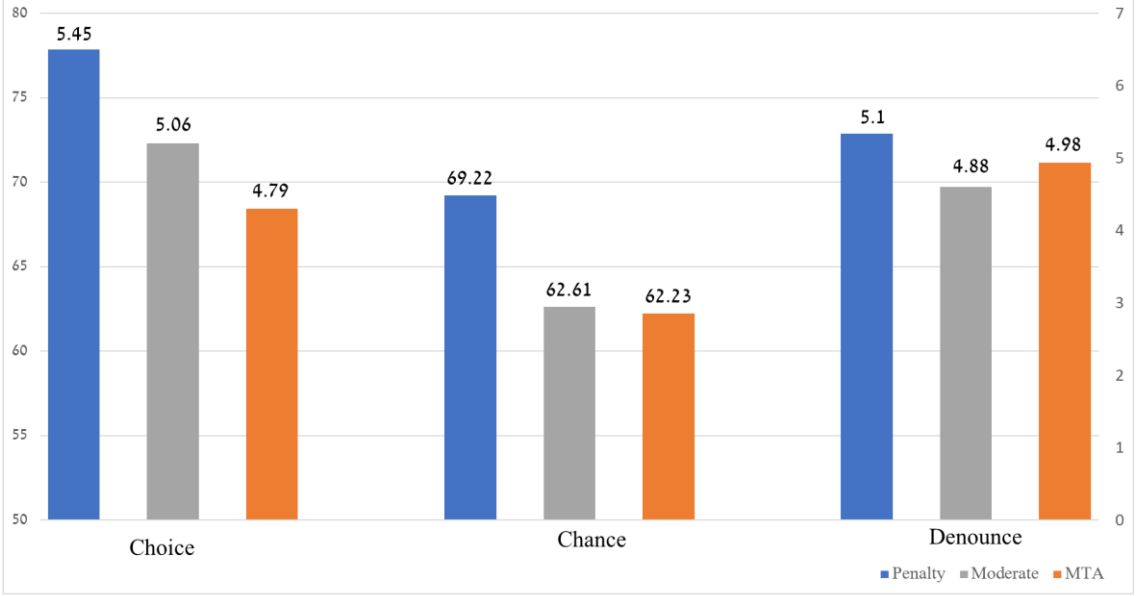
Table 1: Details of Conditions in Study 1

Condition	Principal	Prevailing Interest Rate	Tolerable Interest Rate	Contract Interest Rate	Contract Interest	Amount Demanded	Amount Repaid	Amount in Dispute
Penalty	5,000	20%	30%	40%	2,000	7,000	5,000	2,000
Moderate	10,000	20%	30%	40%	4,000	14,000	12,000	2,000
MTA	20,000	20%	30%	40%	8,000	28,000	26,000	2,000

The participants were told that they can either pay the difference of $2,000 up to the contractual interest rate, or go to court and argue that the contractual interest rate is void, and therefore they must only pay what they already have paid. They were first asked to indicate what they would do on a scale of 1 to 7, where 1 meant that they would definitely pay the difference, and 7 that they would definitely go to court (the *Choice* question). They were then asked to assess the chances that, if they went to court, the court would rule the contractual interest to be excessive and void, on a scale of 0 to 100, where 0 meant that there was no chance, and 100 that it was absolutely certain that the court would so rule (the *Chance* question). Finally, the participants were asked to assess the extent to which the law, as previously described, denounces the charging of excessive interest and treats it as wrong and reprehensible (the *Denounce* question). Participants marked their answers on a scale of 1 to 7, where 1 meant that the law does not denounce excessive interest charges at all, and 7 that it does so very strongly. After completing the first part of the study, the participants were asked to self-rank themselves on the *Ideological Worldview* and *Religiosity* scales.

Results. The outcomes of invalidating the contractual interest rate—*Penalty*, *Moderate*, or MTA—significantly affected the answers to the *Choice* and *Chance* questions, but not the *Denounce* question. Participants' inclination to exercise their rights and their assessments of their chances to win were highest under *Penalty*, and lowest under MTA. Figure 1 presents the mean answers to the *Choice* (on a 1–7 scale), *Chance* (on a 1–100 scale), and *Denounce* (on 1–7 scales) questions. The mean reported likelihood to go to court was 5.45 in *Penalty*, 5.06 in *Moderate*, and 4.79 in MTA. A one-way between-subjects ANOVA yielded significant associations between the scores in *Choice* and the condition ($F(2,497)=5.19$, $p=0.006$). Post hoc comparisons using the Tukey HSD test indicated that participants assessed the likelihood to go to court as significantly higher in the *Penalty* condition than in the MTA condition ($p=0.004$). The difference between *Moderate* and MTA, and between *Penalty* to *Moderate* were not statistically significant.

Figure 1: *Choice*, *Chance*, and *Denounce* in each Condition



Choice represents the likelihood of challenging the interest rate on a 1–7 scale, where 7 is "definitely go to court"); *Chance* – the estimated chance of the court invalidating the interest rate (in percentage); and *Denounce* – the degree to which the law denounces the charging of excessive interest on a 1–7 scale, where 7 means strong denouncement.

The mean estimated chances of the court invalidating the contractual interest rate were 69.22 in *Penalty*, 62.61 in *Moderate*, and 62.23 in MTA. A one-way between-subjects ANOVA yielded significant associations between the scores in *Chance* and the condition ($F(2,497)=4.5$, $p=0.012$). Post hoc comparisons using the Tukey HSD test indicated that in the *Penalty* condition participants assessed their chances of winning the case as significantly higher than under *Moderate* or MTA ($p=0.031$ and $p=0.024$, respectively). The difference between *Moderate* and MTA was not statistically significant. Finally, strong correlations were found between *Chance* and *Denounce* ($r=0.56$, $p<0.001$), between *Chance* and *Choice* ($r=0.55$, $p<0.001$), and between *Denounce* and *Choice* ($r=0.36$, $p<0.001$).[7]

3.3. Discussion

The findings of Study 1 indicate that even when the disputed sum is the same in absolute terms, customers' reported inclination to challenge an excessive interest rate in a loan contract is affected by the applicable substitute arrangement: it is strongest under a penalty substitute and weakest under MTA, with the moderate substitute lying in between. The correlations between the answers to the *Choice*, *Chance*, and *Denounce* questions appear to suggest that the greatest inclination to challenge excessive interest under *Penalty* (and the smallest under MTA) was due to the subjects' higher assessments of their chances to prevail in court, which in turn was due to the perception that the legal condemnation of excessive interest rates is strongest under a penalty. However, the findings do not substantiate this explanation. For one thing, unlike the

[7] No significant associations were found between most of the participants' demographic characteristics and their answers to *Choice*, *Chance*, and *Denounce*. The answers to *Chance* and *Denounce* statistically significantly and positively correlated with the *Ideological Worldview* and the *Religiosity* scales, and the answers to *Denounce* were also statistically significantly and positively correlated with age.

findings of the abovementioned pilot, in Study 1 we did not find an association between the condition and the assessed denunciation. Moreover, the strong correlations found between participants' answers to the *Choice*, *Chance*, and *Denounce* questions do not prove causality between the three. While it is possible that the greater inclination to challenge the excessive interest rate under *Penalty* was due to a more optimistic assessment of obtaining a favorable ruling (which, in turn, was due to a higher assessment of the legal condemnation of such rates in this condition), and/or that the stronger perceived legal condemnation aroused indignation that directly prompted participants to challenge the interest rate, it may also be the case that the answers to the *Chance* and *Denounce* questions were an ex-post rationalization of the decision that participants had made in *Choice* (and other causal connections between the three variables are also conceivable).

The results of Study 1 are consistent with the *diminishing sensitivity* hypothesis. Possibly, the strongest inclination to challenge the excessive interest rate in the *Penalty* condition (and the weakest inclination to do so under MTA) was due to the fact that in *Penalty*, the dispute was over an amount equivalent to 40% of the principal, whereas in the other two conditions it amounted to only 20% (in *Moderate*) or 10% (in MTA) thereof. Importantly, the fact that the proportion between the scope of the dispute and the scope of the transaction is largest under *Penalty* and smallest under MTA is not an artifact of the study's design, but an inherent feature of the substitutes.

Study 1 suggests that, even when one compares between cases with the same stakes, the substitute arrangement may influence customers' inclination to challenge an excessive contractual term—it is likely to be greatest under *Penalty* and smallest under MTA. Inasmuch as it is desirable to encourage customers to challenge unenforceable contract terms, these findings militate against MTA and in favor of *Penalty*.

To be sure, more work is necessary to determine the precise effects of the various substitutes on customers' behavior and their underlying mechanisms, as well as the generality of our findings and their external validity.

4. THE ENDOGENEITY OF UNENFORCEABILITY

4.1. Background and Motivation

Previous studies (Ben-Shahar 2011; Drygala 2012; Wilkinson-Ryan forthcoming) have focused on the impact of the substitute arrangement on suppliers' drafting of contracts. Section 3 broadened this perspective to include the impact of the substitute on customers' inclination to challenge excessive terms once a dispute arises. This section further expands the view by examining the effect of the substitute on the inclination to invalidate excessive contractual clauses, when doing so is discretionary—as when the mandatory norm uses standards such as unconscionability or unreasonableness.

Initially, we had no clear hypothesis about the effect of the substitute arrangement on the inclination to invalidate a high interest rate. In fact, we considered several conflicting hypotheses. One was that participants would be most inclined to invalidate an excessive clause under MTA, because it involves the smallest intervention in the parties' agreement, and is therefore more respectful of the parties' freedom of contract than the other two substitutes. In borderline cases, in particular, when decision-makers hesitate whether to invalidate a contractual term, they might be more willing to do so under MTA, knowing that the outcome of their decision is less consequential than under

Moderate or *Penalty*. This hypothesis is analogous to the idea that people are more inclined to convict a defendant in criminal proceedings if the punishment is less harsh (Tonry 2009; Greenblatt 2008; Guttel and Teichman 2012).

Another possibility was that if participants care primarily about the ex post fairness of the contractual terms, they would be most inclined to invalidate the high interest rate under *Moderate* (the conjecture that people care primality about ex post fairness was based on the results of a separate set of studies, not reported here, where we found that laypersons overwhelmingly preferred *Moderate* substitutes over both *Penalty* and MTA). Such an inclination may stem from viewing the other two alternatives as less desirable, on the grounds that they are either overly punitive (*Penalty*), or overly lenient (MTA) toward the lender. It may also be perceived as a sort of compromise between the two extremes.

Conversely, if participants perceive a *Penalty* substitute as signaling a need to strongly deter excessive interest rates, or to help borrowers as much as possible, they might be most inclined to invalidate the interest rate under the *Penalty* condition. This hypothesis draws on the finding that some people are more inclined to convict a defendant in criminal proceedings when the punishment is more severe (Jones, Jones, and Penrod 2015; Zamir, Harlev, and Ritov 2017, pp. 138–41).

Finally, if participants believe that they should not be influenced by the substitute arrangement when determining whether a certain term should be invalidated, they would be equally inclined to invalidate the term in all three substitute conditions. Of course, it is also possible that the impact of the substitute varies across decision-makers, depending on which of the above arguments appeal to them most (compare Jones, Jones, and Penrod 2015).

To gain insight into this issue, we conducted a pilot study on the MTurk platform, with participants from the United States. Using a within-subject design, we first presented the participants with a scenario of lenders who charge excessive interest rate, and asked them to indicate which substitute they would choose as legislators, when the excessive interest rate is void. We then asked them under which substitute they would be most inclined to invalidate the excessive interest rate. We found no statistically significant effect of the substitute arrangement on the *overall* inclination to invalidate the high interest rate. However, there was a strong association between participants' inclination, as judges, to invalidate an excessive interest rate under each of the substitutes, and their preferred substitute as legislators. Among those who answered that the substitute *would* affect their decision as judges, 74.2% were most inclined to invalidate the high interest rate if the substitute was the one they would support as legislators—whatever it was.[8]

[8] The following table summarizes the results:

		Preferred substitute as legislator		
		Penalty	Moderate	MTA
Inclination to invalidate as judge	Penalty	54	11	6
	Moderate	5	69	9
	MTA	8	16	35
	Indifferent	27	18	6

These intriguing results prompted us to study the issue further—this time with legally trained people. Legal training is important in this context, because the decision whether to invalidate a contractual term is ordinarily made by judges. Thus, Study 2 was conducted with legal practitioners, including judges, and Study 3 with advanced-years law students. While Study 2 used a within-subject design, Study 3 employed a between-subject one.

4.2. Study 2: Judicial Inclination to Invalidate Excessive Contract Terms: Within Subjects

Study 2 sought to examine the effect of the substitute arrangement on the subjects' inclination to invalidate overreaching contractual terms, using a sample of Israeli legal practitioners in a within-subjects design.

Participants. A total of 325 legal practitioners took part in this study. They were recruited by invitation to take part in a survey, distributed through the mailing list of Nevo, the leading commercial publisher of legal materials in Israel (academics, as well as non-legal subscribers of the list, such as accountants, were excluded). To encourage participation, two participants were selected at random to win a credit of NIS 500 (~US$ 140) each, for the purchase of books from an academic law publisher. A total of 220 participants were male, 103 were female, and 2 did not indicate gender. Their average age was 46.1 years (SD=12), and their mean professional experience 15.76 years (SD=11.73). On average, the participants in the study devoted 49% of their time to civil litigation (including resolving disputes) (SD=38.02). Among those involved in civil litigation, 196 represented plaintiffs, 204 represented defendants, 12 served as judges, 54 as arbitrators or mediators, 26 as judicial assistants to judges, and 29 as court clerks (participants could mark more than one answer).

Design and Procedure. The study was conducted in Hebrew (see Appendix for an English translation). Participants were initially informed that in many jurisdictions, there are statutes that authorize the courts to declare "excessive and unreasonable" interest rates invalid. It was further explained that, in this context, courts "balance the view that abusive interest rates unfairly enrich lenders and adversely affect borrowers against freedom of contract and the concern that invalidating high interest rates may prevent some borrowers form getting credit in the first place." It was then added that the outcomes of invalidating excessive interest rates vary from one jurisdiction to another, such that the substitutionary arrangement may be "a penalty arrangement" (borrower pays only the principal), "a moderate arrangement" (borrower pays the principal plus the prevailing interest), or "a minimally tolerable arrangement" (borrower pays the principal plus interest at the highest rate that would not be considered excessive and void).

Two presentation orders of the three arrangements were counterbalanced between subjects: *Penalty-Moderate*-MTA or MTA-*Moderate-Penalty*. Following this description, the first question (*Comprehension*) asked participants to assume that "for a given type of loans in a certain jurisdiction, the prevailing annual interest rate is 10%" and that according to the courts' ruling, annual interest exceeding 20% is excessive and void. Based on these assumptions, they were asked to indicate what the outcome of

invalidating an interest rate of 35% would be under each of the three substitutes, on scales of 0 to 35 percent. Participants could not proceed with the questionnaire until they had answered all three questions correctly (the correct answers being *Penalty*: 0%; *Moderate*: 10%; MTA: 20%). The order of the three substitutionary arrangements was the same as in the initial description.

The participants then answered the *Legislator* and *Judge* questions. In the *Legislator* question, they were asked to imagine that they were members of parliament enacting a new statute that would authorize courts to invalidate excessive interest rates. They were asked which of the three outcomes of such invalidation—*Penalty*, *Moderate*, or MTA—they would include in the statute. Again, each participant was presented with the three options in the same order as in the initial description.

In the *Judge* question, participants were asked to imagine that they were serving as a judge in a jurisdiction where courts are authorized to invalidate excessive interest rates. They were asked how their inclination to invalidate high interest rates would be influenced, if at all, by the outcome of such invalidation. In addition to *Penalty*, *Moderate*, and MTA, they had a fourth option—namely, that their inclination to invalidate the high interest rate would be unaffected by the outcome of such invalidation (*Indifferent*). Four variations of the order of the four answers were used: *Penalty*-*Moderate*-MTA-*Indifferent*; MTA-*Moderate*-*Penalty*-*Indifferent*; *Indifferent*-*Penalty*-*Moderate*-MTA; *Indifferent*-MTA-*Moderate*-*Penalty* (for each participant, the order of the three arrangements was the same as in the initial description). The order of the *Legislator* and *Judge* questions was counterbalanced. At the end of the survey, participants were asked to provide demographic details.

Results. The order of presentation of the questions and the three substitutionary arrangements had little effect on the responses.[9] In the *Legislator* question, participants expressed the greatest support for MTA (154 out of 325; 47.4%), followed by *Moderate* (119; 36.6%), and *Penalty* (52; 16%). The differences between MTA and *Penalty*, between MTA and *Moderate* and between *Moderate* and *Penalty* were statistically significant ($\chi^2(1)=50.5$, $p<0.001$; $\chi^2(1)=4.49$, $p=0.034$; and $\chi^2(1)=26.25$, $p<0.001$, respectively).

In response to the *Judge* question, only 60 of the 325 (18.5%) participants indicated that their inclination to invalidate a high interest rate would not be affected by the substitutionary arrangement. Among the large majority of participants who indicated that they would be affected by the substitute (265 of the 325—i.e., 81.5%), 158 (59.6%) were most inclined to invalidate a high interest rate under MTA; 63 (23.7%) were most inclined to do so under *Moderate*; and 44 (16.6%) under Penalty. The differences between MTA and *Penalty*, and between MTA and *Moderate* were statistically

[9] There were two statistically significant effects in this regard: (1) More participants indicated that their inclination to invalidate a high interest rate would not be affected by the substitutionary arrangement when the *Legislator* question was presented first ($\chi^2(1)=5.71$, $p=0.017$); (2) When the *Indifferent* option appeared first in the *Judge* question, relatively more participants preferred *Penalty* over *Moderate* ($\chi^2(2)=7.81$, $p=0.02$). Participants' professional experience did not have significant effect on the *Judge* question. However, a chi square test indicated that participants who had experience in dispute resolution (as judges, arbitrators, mediators, judicial assistants, or court clerks) were less inclined to prefer MTA in *Legislator* than participants who had experience only in civil litigation ($\chi^2(2)=8.19$, $p=0.017$).

significant ($\chi^2(1)=64.34$, $p<0.001$; $\chi^2(1)=40.84$, $p<0.001$, respectively), and the difference between *Penalty* and *Moderate* was marginally statistically significant ($\chi^2(1)=3.37$, $p<0.066$). These results support the first hypothesis presented above, namely that participants would be most inclined to invalidate the excessive interest rate under MTA.

However, this main effect should be interpreted with caution, as there was also a highly statistically significant interaction between the participants' inclination to invalidate an excessive interest rate under each of the substitutes (in *Judge*), and their preferred substitute (in *Legislator*)—as shown in Table 2 ($\chi^2(4)=86.46$, $p<0.001$). Excluding the 60 participants who indicated that their inclination to invalidate a high interest rate would not be affected by the substitute, nearly two thirds (64.9%) were most inclined to invalidate the high interest rate if the substitute arrangement was the one they would support as legislators.[10] To further examine this effect, we ran three additional chi-square tests, such that each test included only two of the possible substitutes (in both the *Legislator* and *Judge* questions): *Penalty* and MTA; *Penalty* and *Moderate*; and *Moderate* and MTA. To determine statistical significance, we used Bonferroni adjusted alpha levels of .017 per test (.05/3). All these tests demonstrated a similar significant pattern where participants were most likely to invalidate the excessive interest rate under the substitute they would support as legislators (*Penalty*-MTA: $\chi^2(1)=40.59$, $p<0.001$; *Penalty-Moderate*: $\chi^2(1)=16.81$, $p<0.001$; *Moderate*-MTA: $\chi^2(1)=48.89$, $p<0.001$).[11]

[10] This interaction effect echoes the interaction effect found in the abovementioned Pilot. See *supra* note 8 and accompanying text.

[11] We also found a significant effect of participants' age on answers to both *Legislator* and *Judge* ($F(2,322)=3.6$; $F(2,262)=4$; $p=0.019$, respectively). Post hoc comparisons using the Tukey HSD test indicated that older participants preferred *Penalty* over MTA in *Legislator* ($p=0.026$), and were more inclined to invalidate the excessive term under *Penalty* than under MTA ($p=0.021$).

Table 2. Results of Study 2: Inclination to invalidate by preferred substitute

		Preferred substitute as legislator		
		Penalty	Moderate	MTA
Greatest inclination to invalidate as judge	Penalty	19	12	13
	Moderate	9	43	11
	MTA	11	37	110
	Indifferent	13	27	20

4.3. Study 3: Judicial Inclination to Invalidate Excessive Contract Terms: Between Subjects

Study 3 sought to examine the effect of the substitute arrangement on people's inclination to invalidate overreaching contractual terms in a between-subjects design. The study was conducted with senior law students. Since it is more difficult to fully comprehend the meaning of the various substitutes in a between-subjects design, we used a more detailed vignette.

Participants. A total of 228 advanced-years LL.B. students at the Faculty of Law of the Hebrew University in Jerusalem participated in this study. They were recruited by invitation to take part in a survey distributed by professors of second-year courses (not the authors of this study), or by e-mail messages sent to third- and fourth-year LL.B. students. To encourage participation, sixteen participants were randomly selected to win a prize of NIS 200 each. Forty-six participants who failed the attention question, or provided incoherent answers, were excluded from the analysis.[12] Of the remaining 182 participants, 71 were male, 110 were female, and one did not indicate gender. The average age was 24.82 (SD=2.78). As in Studies 1–3, participants rated themselves on the Ideological Worldview and Religiosity scales. The mean ideological worldview on the 0 (Liberal) to 100 (Conservative) scale was 34.81 (SD=22.58), and the mean religiosity on the 0 (Not at all religious) to 100 (Religious to a great extent) scale was 31.73 (SD=34.6).

Design and Procedure. The study was conducted in Hebrew (see Appendix for an English translation). The participants were initially asked to imagine that they were taking part in drafting a new law that would authorize the courts to invalidate excessive interest rates, especially when lenders exploit borrowers' hardship. The law should stipulate the outcome of invalidating an excessive interest rate, and participants were asked which of three possible outcomes they would choose: *Penalty, Moderate,* or MTA (in that order, or in a reverse one).

The participants were then told that poor people find it difficult to get credit from banks, because the latter are afraid that they would be unable to repay the loan—so poor

[12] By "incoherent answers," we mean that the answer to the *Judicial-Decision* question was at odds with their answer to the *Threshold* question (see Appendix). For example, it is incoherent to indicate that one would not rule in favor of the borrower when the contractual interest rate is 40% (in the former question), but would rule in her favor if the interest rate was, say, 30% (in the latter question).

people are compelled to borrow from other sources. The participants were further told that "in some country," a market for non-bank loans has emerged, aimed at people who have been injured and are filing a tort claim against the injurer.[13] In these cases, the expected damages are used as collateral to ensure that the loan is repaid: if and when damages are received, the money is first used to repay the loan. Lenders examine the prospects of a successful lawsuit in advance, and issue loans only if they assess these prospects to be high, and the anticipated damages as sufficient to repay the loan. Usually, such loans include compound interest that is calculated on a monthly basis. The mechanism of calculating the interest is usually rather complex, such that at least some of the borrowers do not understand the overall cost of the loan they take. Even allowing for the fact that a small portion of the loans are not fully repaid, or not repaid at all (because the sum of damages awarded is too low), the average interest that lenders charge in this type of loans is very high—usually several times higher than the prevailing interest in bank loans.

Participants were then asked to assume that in the said country there is a law that authorizes courts to invalidate excessive interest rates. The outcomes of such invalidation were labeled *Penalty*, *Moderate*, or MTA—varying across the three conditions in a between-subjects design. Next, to confirm the participants' attention and comprehension, they were presented with a comprehension question similar to the one used in Study 2 (see Appendix), which they had to answer correctly before proceeding with the questionnaire.

The questionnaire then described a scenario in which Jane, an old lady who was injured due to medical negligence, has received a loan of $8,000 under the arrangement described above, which was to be repaid if she wins the lawsuit. A year later, the legal proceedings ended, and she won damages of $18,000—one-third of which were used to pay the lawyer's fee and expenses. She then learned that the amount she owed the loan company, including compound interest, was $11,200 (an effective annual interest of 40%). Participants were asked to imagine that they were serving as a judge in a legal dispute between Jane and the loan company, in which Jane argued that the interest rate was excessive, exploiting her hardship. Accordingly, she argued that the contractual interest should be invalidated, and that she should repay a reduced amount, which varied across the three conditions: principal only ($8,000) in the *Penalty* condition; principal plus a reasonable and fair interest (which, she argued, was 15%), in the *Moderate* condition (totaling $9,200); or, in the MTA condition, the principal plus interest at the highest rate that the lender could charge that would not be considered excessive—which she argued was 30% (for a total of $10,400). The company argued that the interest was not excessive, given the high risk that the tort claim would be dismissed and the loan would not be repaid at all.

After reading this description, participants were first asked to indicate whether they would rule in favor of Jane or the loan company (the *Judicial decision* question).

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[13] The description was roughly based on the common practice of *litigants third-party funding* (LTPF), which was recently described in Avraham and Sebok (2019). In LTPF, corporations provide plaintiffs with financial support by lending them money in a nonrecourse loan, where the expected damages are used as collateral. The lenders screen the loan applications and determine the sum of the loan such that they do not bear a significant risk that the loans will not be repaid.

Then—depending on their answer to that question—they were asked whether they would have ruled in favor of Jane had the contractual annual interest been lower (for participants who ruled in favor of Jane) or higher (for those who ruled in favor of the company) (the *Threshold* question). Specifically, they were asked to indicate the lowest interest rate beyond which they would invalidate the contractual interest. The participants then provided demographic details.

Results. The order of presentation of the three substitutionary arrangements had no significant effect on any of the dependent variables.[14] In the *Legislator* question, *Moderate* gained the greatest support: 79 of the 182 (43.4%) participants preferred *Moderate*; 66 (36.3%) preferred *Penalty*; and 37 (20.3%) opted for the MTA ($\chi^2(2)=15.24$, $p<0.001$). The differences between MTA and *Moderate*, and between MTA and *Penalty*, were statistically significant ($\chi^2(1)=15.21$, $p<0.001$; $\chi^2(1)=8.16$, $p=0.004$, respectively)—while the difference between *Moderate* and *Penalty* was not ($\chi^2(1)=1.17$, $p=0.28$).

In the *Judicial decision* question, only 18 of the 182 participants (9.9%) ruled in favor of the loan company. Evidently, from the perspective of Israeli law students, an annual interest of 40% is unacceptable (even though the vignette explicitly referred to "some country," the borrower's name—Jane—is not an Israeli name, and the loan was set in "dollars" rather than in Israeli currency). A two-way ANOVA showed that participants' answers to the *Legislator* question, the condition, and the interaction between the two, all significantly affected the percentage of students who indicated that they would declare the interest rate void ($F(2,173)=6.2$, $p=0.003$; $F(2,173)=5.93$, $p=0.003$; $F(4,173)=2.46$, $p=0.047$, respectively).[15] However, given the small number of participants who were willing to enforce the interest rate, we focus on the more nuanced picture emerging from the answers to the *Threshold* question.

In the *Threshold* question, the mean interest rate above which the students indicated that they would invalidate the interest in the contract between Jane and the loan company was 21.96 (SD=11.93).[16] As shown in Table 3, the interrelations between condition, *Legislator*, and *Threshold* were rather complex. In a two-way ANOVA, both condition and *Legislator* had a statistically significant main effect ($F(2,173)=9.54$,

[14] No significant associations were found between participants' demographic characteristics (gender, age, religiosity and ideological worldview) and their answers to the *Legislator, Judicial decision*, or *Threshold* questions.

[15] The interrelations between condition, *Legislator*, and the percentage of participants who declared the rate void are presented in the following table:

		Preferred substitute as legislator		
		Penalty	Moderate	MTA
Condition	Penalty	100%	80%	50%
	Moderate	100%	100%	92.3%
	MTA	92.6%	88%	87.5%

[16] Interestingly, this mean was lower than the minimally tolerable interest according to Jane's own argument (30%).

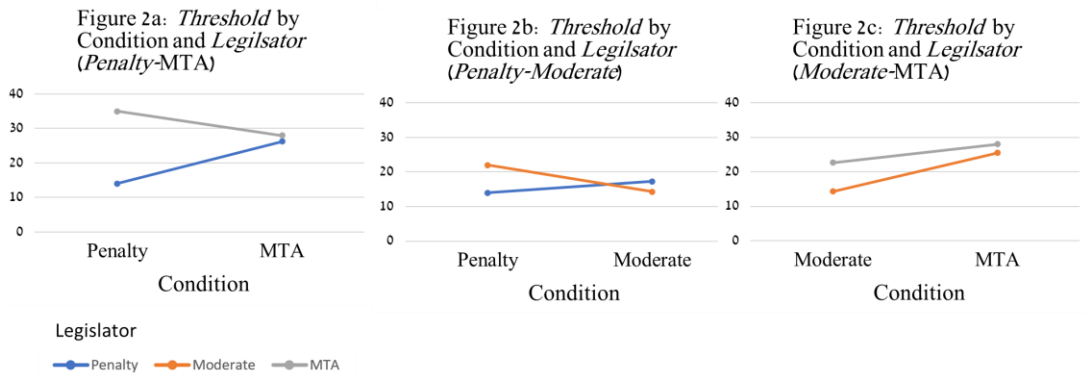
p<0.001; F(2,173)=8.8, *p*<0.001, respectively), but these effects were qualified by a significant interaction effect ((F(4,173)=3.22, *p*=0.014).

Table 3. Results of Study 3: The average of minimal rates at which participants would invalidate the contractual interest

		Preferred substitute as legislator		
		Penalty	Moderate	MTA
Condition	Penalty	14 (7.43)	21.97 (16.02)	35 (15.12)
	Moderate	17.28 (6.67)	14.32 (6.52)	22.62 (11.97)
	MTA	26.28 (8.84)	25.5 (11.08)	28 (10.52)

Standard deviations in parentheses

To better interpret the meaning of these results, we ran three additional two-way ANOVA tests, such that each test comprised only two of the possible substitutes (in both the *Legislator* question and the condition): *Penalty* and MTA; *Penalty* and *Moderate*; and *Moderate* and MTA. As in Study 2, we used Bonferroni adjusted alpha levels of .017 per test (.05/3). An analysis of the *Penalty*-MTA pair revealed a significant main effect of *Legislator*, whereby participants who supported MTA in the abstract were inclined to invalidate a high interest rate at a higher threshold (F(1,61)=17.7, *p*<0.001). This main effect was qualified by a significant interaction effect: on average, participants assigned a lower threshold (that is, were more inclined to invalidate high interest rate) when the substitute arrangement was the one they had supported as legislator (F(1,61)=12.74, *p*=0.001; see Figure 2a). An analysis of the *Penalty-Moderate* pair revealed a marginally significant interaction effect (considering the Bonferroni adjusted alpha), where, again, participants assigned a lower threshold on average when the substitute arrangement was the one they had supported as legislators (F(1,89)=5.58, *p*=0.02; see Figure 2b). Finally, an analysis of the *Moderate*-MTA pair revealed a significant main effect of the condition, whereby under MTA participants were inclined to invalidate the rate at a higher threshold (F(1,74)=12.58, *p*=0.001). A marginally significant effect of *Legislator* was also found (F(1,74)=5.34, *p*=0.02), which once again indicated that participants who had supported MTA as legislators were less inclined to invalidate a high interest rate. No interaction effect was found in this pair (see Figure 2c).



4.4. Discussion

Studies 2 and 3 sought to test the hypothesis that the substitute arrangement may affect judicial inclination to invalidate overreaching contract terms, when such invalidation is discretionary. Before discussing the key findings of the two studies, it is interesting to note, that the relative support for the various substitutes in the abstract (the *Legislator* questions) differed across the two studies. In Study 2, Israeli legal practitioners significantly preferred MTA over both *Penalty* and *Moderate;* whereas in Study 3, Israeli advanced-years law students supported *Moderate* statistically significantly more than MTA (although the difference between *Moderate* and *Penalty* was not statistically significant). In this respect, the students' answers—but not those of the practitioners—comported with those of laypersons from the United States, who (in a separate set of studies, which is not reported here), judged *Moderate* as clearly more desirable than either *Penalty* or MTA.

The fact that (unlike U.S. laypersons and Israeli law students) Israeli legal practitioners were most supportive of MTA, rather than of *Moderate*, may have to do with the latter's familiarity with the pertinent Israeli statute. Under Section 9(a) of the Israeli Fair Credit Law 1993, the courts are instructed *to invalidate or change* any loan contract or a term thereof, which does not comply with the statutory requirements, *to the extent necessary to adapt* [them] *to the statutory requirements*. Section 9(b) adds that the court may adjust the interest rate to the statutory cap or set a lower rate, and give any other order as justice requires. While the statute leaves the court a broad discretion, it implies that MTA is the primary option. Previous studies have established that people tend to believe that the existing state of affairs is justified (Eidelman and Crandall 2012; Zamir and Teichman 2018, p. 50). Thus, one explanation for Israeli legal practitioners' greatest support for MTA in the context of excessive interest rate may be the existing law. Another possibility is that legal practitioners identify with lenders more than U.S. participants and Israeli law students.

With regard to the main findings of Studies 2 and 3, both of them suggest that the substitute arrangement may indeed affect judicial inclination to invalidate high interest rates. It should first be noted that the results of these two studies cannot be directly compared, as they differed from one another in several dimensions. These include the experimental design (within- versus between-subject); the type of loan (generic versus *litigants third-party funding*); the description of the loan (general and abstract versus rich and concrete); the interest rate (not specified versus specified and very high); and the question in response to which the diverging answers were given (*decision* versus *threshold*). One should therefore be extremely cautious in interpreting these results, let alone drawing policy conclusions from them—even in the specific context of excessive interest rate.

While bearing these differences in mind, a key finding of both Study 2 and the pilot that preceded it—which is basically replicated in Study 3—is the association between participants' reported inclination to invalidate the interest rates (in the *Judge* and *Threshold* questions) and their most favored substitute in the abstract (in the *Legislator* question). In Study 2 and in the pilot, participants were clearly more inclined to invalidate excessive rates when the substitute was the one they most preferred. In Study 3, the comparison between *Penalty* and MTA yielded a similar, statistically significant

effect, and the comparison between *Penalty* and *Moderate* yielded a similar marginally significant effect.

The associations between *Legislator* and *Judge* in Study 2, and between *Legislator* and *Threshold* in Study 3, suggest that participants view the three substitutes as qualitatively different from one another. Participants who preferred the MTA (presumably because they were reluctant to intervene in the agreed rate) were naturally less inclined to intervene when the outcome of such invalidation was harsher: *Moderate* or *Penalty*. It is less obvious why participants who (as legislators) preferred *Penalty* or *Moderate* were not more inclined to invalidate high interest rates under MTA (as judges). After all, even if one prefers *Penalty* or *Moderate* in the abstract, in borderline cases, at least, one could feel more comfortable invalidating a contractual interest rate if the outcome of such invalidation is less severe—namely, MTA. With regard to participants who preferred the *Moderate* substitute, one possible answer might be that they prioritize ex post substantive fairness of the contractual terms over considerations of deterrence and freedom of contract, so they were more reluctant to invalidate high interest rates when they deemed the outcome to be less fair (under either *Penalty* or MTA). As for those who preferred the *Penalty* substitute—possibly because they abhor the charging of excessive interest rates—perhaps they were less inclined to implement a law that they find deficient and ineffectual.

A notable difference between Studies 2 and 3 is the main effect of the substitute on the judicial inclination to invalidate the interest rate. While in Study 2, Israeli legal practitioners were most inclined to invalidate the term under MTA, in Study 3, Israeli law students were inclined to invalidate high interest rates at a lower threshold under *Moderate* than under MTA. However, the meaning of this difference is unclear. As previously noted, in Study 2 we found an association between *Legislator* and *Judge*. Thus, the highest inclination to invalidate excessive interest under MTA in Study 2 may stem from the prevalent support for MTA among the Israeli legal practitioners, whereas the low inclination to invalidate excessive interest under MTA among Israeli students (in Study 3) is associated with their greater support for *Moderate* as the appropriate substitute.

In summary, while we would not draw any definitive conclusions about the impact of the substitute arrangement on judicial inclination to invalidate excessive contractual terms based on the findings of Studies 2 and 3, these findings do suggest that the substitute arrangement may indeed have such an effect. Further studies are necessary to advance our understanding of this important issue.

5. CONCLUSION

Mandatory regulation of the content of contracts entails choosing a substitute arrangement in lieu of the invalidated contractual term. Schematically, the three possible substitutes are a pro-customer, penalty arrangement; a moderate arrangement; and a pro-supplier, minimally tolerable arrangement. We have critically examined the arguments offered in support of MTAs, and found that, at best, they can justify such substitutes only in uncommon cases.

Previous studies have focused on the impact of the choice of the substitute arrangement on the drafting of contracts by suppliers. The three empirical studies reported here advance our understanding of this important choice. First, they

demonstrate that customers' reported inclination to challenge excessive terms is the strongest under a penalty substitute—even when the monetary stakes under such a substitute are the same as under the alternative ones. Second, they show that the choice of substitute may affect the judicial inclination to invalidate excessive terms, when such invalidation is discretionary. Specifically, there are indications that people are more inclined to invalidate excessive terms when the substitute is the one they prefer in the abstract

Our findings are preliminary. We examined specific clauses in a particular type of transaction. More studies are needed, therefore, to establish the generality of our findings. Specifically, there is much to be learned about the variables that affect customers' likelihood of challenging exorbitant contract clauses, and about possible differences between consumer and commercial contracts. Moreover, there is a concern about the external validity of these results, as is always the case with vignette studies. For example, we did not examine many factors that are likely to affect customer's inclination to challenge the contract in court and judges' disposition to invalidate excessive terms. Among these are the extent to which the contract term deviates from the reasonable arrangement; the drafting party's awareness of the existence of the mandatory rule; the fairness of the contract as a whole; and the moral value embedded in the mandatory rules. In addition, there may well be a discrepancy between people's reported inclination to challenge excessive interest rate in court and their actual behavior. Future research should therefore use other methods, manipulate additional variables, and examine other populations to study the judgments, decision-making, and behavior of suppliers, customers, legislators, and judges.

On the whole, our theoretical analysis and empirical findings provide a richer account of the choice of substitutes for invalid contract terms. They appear to weaken the case for MTA substitutes. MTA substitutes strengthen the incentive to include invalid terms in contracts; contrary to what one might expect, it is unclear whether they increase judicial inclination to invalidate excessive contractual clauses; and they likely diminish customers' inclination to challenge such clauses.

That said, the multiplicity of relevant considerations and the diversity of situations call for careful examination of all available substitutes, in a bid to adopt the most appropriate one in any given case. Specifically, one should take into account the goals of any mandatory rule and other aspects of its design. For example, the substitute's influence on the judicial inclination to invalidate excessive terms is considerably less important if the law allows the judge little or no discretion whether to invalidate the contractual term. To take another example, the more the law uses other means to deter the incorporation of invalid terms in contracts (such as imposing criminal or administrative sanctions), the less it is imperative to use penalty substitutes to attain that goal.

Finally, the law may leave the choice of the substitute to the judicial decision-makers, thus allowing them to make more nuanced decisions, taking into account the specific characteristics of each case (as is already done in some contexts in some legal

systems).[17] Inasmuch as decision-makers are more willing to invalidate excessive terms when the substitute is the one they are most in favor of (as suggested by the results of Studies 4 and 5), such choice may increase the inclination to invalidate excessive terms, because it would allow decision-maker to replace the invalid term with their favorite substitute.

APPENDIX

Study 1: Vignette and Questions[18]

When borrowers take loans from commercial lenders, they usually repay the principal amount plus an agreed interest. Assume that for a given type of non-bank loans in your jurisdiction, the prevailing annual interest rate is 20%. According to the law, "excessive and unconscionable" interest rates are void and unenforceable. The courts in your jurisdiction have long struggled with the question when should an interest rate be considered excessive. As regards the said type of non-bank loans, the courts have usually ruled that an annual interest exceeding 30% is excessive and void, but sometimes they found even higher rates reasonable and valid, and lower rates excessive and void. Under the law, when a court declares a given interest rate excessive and void, the borrower has to pay [**Penalty**: the principal amount only, without any interest / **Moderate**: the principal amount plus the prevailing interest rate / **Minimally tolerable**: the principal amount plus interest at the highest rate that would still be considered tolerable].

Please read the following statements and mark whether each one of them is correct according to the above description:

When a court declares that a given interest rate is excessive and void, the borrower has to pay the principal amount only, without any interest.	correct	incorrect
When a court declares that a given interest rate is excessive and void, the borrower has to pay the principal amount plus the prevailing interest rate.	correct	incorrect
When a court declares that a given interest rate is excessive and void, the borrower has to pay the principal	correct	incorrect

[17] See the Israeli Fair Credit Law, 1993, cited above. Similarly, according to Section 19(a) of the Israeli Standard-Form Contracts Law, 1982, "[w]here a court, in a proceeding between a supplier and a customer, finds that a condition is unduly disadvantageous, it shall annul it in the contract between them or vary it to the extent necessary to eliminate the undue disadvantage involved."

[18] In all studies, after completing the survey, participants were asked to answer a questionnaire that measured their attitudes to key conflicts in relation to contracts. The responses for this scale were relevant for another study (Katz 2019), and therefore that part of the survey is not cited here.

amount plus interest at the highest rate that would still be considered tolerable.[19]		

Imagine that you needed money and took a loan of the type described above in the amount of [**Penalty**: $5,000 / **Moderate**: $10,000 / **Minimally tolerable**: $20,000], with an annual interest rate of 40%. That is, after one year you had to repay the principal amount plus [**Penalty**: $2,000 / **Moderate**: $4,000 / **Minimally tolerable**: $8,000]. After getting advice about the law, you decided to repay the principal amount [**Penalty**: only / **Moderate**: loan plus $2,000 (20% of the principal amount) / **Minimally tolerable**: loan plus $6,000 (30% of the principal amount)], which you believe you are legally required to pay. In response, the lender insisted that you must pay the remaining difference of $2,000.

Assume that, at this point, you have two options. One option is to pay the difference of $2,000 up to the contractual interest rate of 40%. The other option is to go to court and argue that the contractual interest rate is void and therefore you only have to pay [**Penalty**: the principal amount, without any interest / **Moderate**: an interest rate of 20%, as you did / **Minimally tolerable**: an interest rate of 30%, as you did].

On a scale of 1 to 7 (where 1 means that you will definitely pay the difference and 7 that you will definitely go to court), what will you do?

What are, in your opinion, the chances that, if you would avoid paying the difference and go to court, the court would accept your argument that the contractual interest rate is excessive and void? Please mark your assessment on a scale of 0 to 100, where 0 means that there is no chance that your argument would be accepted and 100 means that there is absolute certainty that it would.

To what extent does the law, as described above, denounce the charging of excessive interest and treat it as wrong and reprehensible? Please mark your answer on a 1–7 scale, where 1 means that the law does not denounce the charging of excessive interest at all, and 7 means that it very strongly denounces it.

STUDY 2: VIGNETTE AND QUESTIONS

In many legal systems, there are laws that authorize the court to rule that an excessive and unreasonable interest rate is invalid. When courts employ their authority in this matter, they balance between the position that excessive and unreasonable interest enriches the lenders and harms the borrowers unfairly, and freedom of contract and the concern that invalidating high interest rates might deny borrowers the opportunity of getting credit in the first place.
The outcomes of a judicial determination that a given interest is excessive and void vary from one legal system to another. In general, there are three arrangements, each of

[19] The order of the three questions was randomized. Participants could only proceed with the questionnaire when they had answered all three questions correctly.

which is adopted in some legal systems. Specifically, when a court rules that an interest rate is excessive and void, the outcome of such ruling is one of the following:

a. **A "penalty" arrangement:** the borrower has to pay only the principal and is exempt from paying any interest.

b. **A "moderate" arrangement**: the borrower has to pay the principal plus the prevailing interest rate in loans of the same type.

c. **A "minimally tolerable arrangement"**: the borrower has to pay the principal plus interest at the highest rate that would still not be considered excessive and void.

[Comprehension] To ensure that the above description is clear, we would be grateful if you could answer the following question. Assume that for a given type of loans in a certain country, the prevailing annual interest rate is 10%. According to the ruling of the courts in that country, an annual interest exceeding 20% is excessive and void. Imagine that in a lawsuit filed a lender against a borrower, the court held that the contract interest of 35% is excessive and void. What interest would the borrower have to pay under each of the statutory arrangements described above, following the court's decision? Please mark the correct answer

- Under **the "penalty" arrangement** the borrower should pay an interest of: (0% … 35%).
- Under **a "moderate" arrangement** the borrower should pay an interest of: (0% … 35%).
- Under **a minimally tolerable arrangement** the borrower should pay an interest of: (0% … 35%).[20]

[Legislator] Now, imagine that you are a member of a parliament that enacts a new statute that would authorize the courts to invalidate excessive interest rates. What outcome of such invalidation would you include in the statute? Please mark one of the following options:

a. **A "penalty" arrangement:** the borrower has to pay only the principal and is exempt from paying any interest.

b. **A "moderate" arrangement**: the borrower has to pay the principal plus the prevailing interest rate in loans of the same type.

c. **A "minimally tolerable arrangement"**: the borrower has to pay the principal plus interest at the highest rate that would still not be considered excessive and void.

[Judge] Imagine that you are serving as a judge in a country where courts are authorized to invalidate excessive interest rates in loans. How would your inclination to

[20] The above three questions were presented in two different sequences (1, 2, 3, or 3, 2, 1) in this and in the following questions—with each subject seeing the same order throughout. Respondents could only proceed to the next question after answering all parts of the Comprehension question correctly.

invalidate a high interest rate be affected, if at all, by the outcome of such invalidation? Please mark one of the following options:

__ My inclination to invalidate high interest rates would be strongest under the "penalty" arrangement.

__ My inclination to invalidate high interest rates would be strongest under the "moderate" arrangement.

__ My inclination to invalidate high interest rates would be strongest under the minimally tolerable arrangement.

__ My inclination to invalidate high interest rates would not be affected by the outcome of such invalidation.[21]

Study 3: Vignettes and Questions

[Legislator] Imagine that you are taking part in drafting a new law that will authorize the courts to invalidate excessive interest rates, especially when lenders exploit borrowers' hardship. The law should stipulate the outcome of invalidating an excessive interest rate. Which of the following three outcomes would you choose?

__ **Penalty**: The borrower should only repay the principal, with no interest, to deter lenders from charging excessive interest rates.

__ **Moderate**: The borrower should repay the principal plus the prevailing interest in loans of the same type, so that the interest is reasonable and fair.

__ **Minimally tolerable**. The borrower should repay the principal plus the highest interest rate that would still be considered tolerable (as opposed to excessive and void), so as not to infringe upon freedom of contract and the market for loans.[22]

Poor people find it difficult to get credit from banks, because banks are afraid that they may not be able to repay the loan, so they are compelled to borrow money from other sources. Assume that in some country, a market for non-bank loans has emerged for people who have been injured in an accident and are filing a tort claim against the injurer. In these cases, the damages that the borrower is expected to get from the lawsuit are used as a sort of collateral to ensure that the loan is repaid: if and when damages are received, the money is first used to repay the loan. The practice is that lenders examine the prospects of the claim in advance, and issue loans only if they estimate these prospects to be high, and that the amount of damages would be enough to repay the loan. Usually, such loans include monthly interest, and a compound interest calculated on a monthly basis. The mechanism of calculating the interest is usually rather

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[21] Four orders—1, 2, 3, 4 / 3, 2, 1, 4 / 4, 1, 2, 3 / 4, 3, 2, 1—were used. The order of options 1 to 3 was the same as in *Comprehension*. The order of *Judge* and *Legislator* was also counterbalanced. After answering these questions, participants were asked to answer another question and to provide demographic details, as well as details about their professional experience.

[22] Participants were randomly assigned to one of two orders of presentation of the three options: *Penalty*-*Moderate*-Tolerable, or Tolerable-*Moderate*-*Penalty*.

complex, such that at least some of the borrowers do not understand the overall cost of the loan they are taking. Even after taking into account that a small portion of the loans are not fully repaid, or not repaid at all (because the sum of damages awarded is too low), the average interest that lenders charge for this type of loans is very high. Usually, borrowers pay an effective interest that is several times higher than the prevailing interest in bank loans to private individuals.
Assume further, that in the said country there is a law that authorizes courts to invalidate excessive interest rates. According to that legislation, when a court invalidates an excessive interest rate, the borrower should repay the principal [**Penalty**: with no interest (the *Penalty* outcome) / **Moderate**: plus interest that is reasonable and fair in the circumstances (the *Moderate* outcome) / **Minimally tolerable:** plus interest at the highest rate that the lender could charge and still not be considered excessive (the *Tolerable* outcome)].

[**Comprehension-1**] Please read the following statements and, in each case, mark whether it is correct or incorrect:

In the country described above, when a court invalidates excessive interest, the borrower must repay the principal amount with no interest.	correct	incorrect
In the country described above, when a court invalidates excessive interest, the borrower must repay the principal amount plus interest that is fair and reasonable in the circumstances.	correct	incorrect
In the country described above, when a court invalidates excessive interest, the borrower must repay the principal amount plus interest at the highest rate that the lender could charge that would still not be considered excessive.[23]	correct	incorrect

[**Judicial Decision**] Assume that Jane, an old lady who was injured due to medical negligence, has received a loan of $8,000 under the arrangement described above, which will be repaid if she wins her lawsuit. After a year from receiving the loan, the legal proceedings ended, and she won damages of $18,000. One-third of this sum was paid to the lawyer for his fee and expenses. It then transpired that the sum she should pay in repayment of the loan, including compound interest, is $11,200 (i.e., an effective annual interest of 40%). Imagine that you are serving as a judge in the legal dispute between Jane and the loan company. Jane argues that this is an excessive interest rate that was set while taking advantage of her hardship. Therefore, it should be invalidated and she should repay the principal [**Penalty**: with no interest, that is only $8,000 / **Moderate**: plus interest that is reasonable and fair in the circumstances, which she claims is 15%, that is only $9,200 / **Minimally tolerable:** plus interest at the highest

[23] The order of the three questions was randomized. Participants could only proceed with the questionnaire when they answered all three questions correctly.

rate that the lender could charge and still not be considered excessive, which she claims is 30%, that is only $10,400]. The company argues that the interest is not excessive given the high risk it undertook that the claim would be dismissed and the loan would not be repaid at all. How would you decide the case?

__ I would rule in favor of Jane and invalidate the contractual interest of 40%, so that Jane would have to repay the loan [**Penalty**: with no interest / **Moderate**: plus interest that is reasonable and fair in the circumstances / **Minimally tolerable:** plus interest at the highest rate that the lender could charge and still not be considered excessive].

__ I would rule in favor of the loan company, so that Jane would have to repay the loan according to the contract.

[**Threshold**] [a follow-up question whose wording depended on whether the participant ruled in favor of Jane or the company]:
Would you rule in favor of Jane and invalidate the contractual interest, so that Jane would have to repay the loan [**Penalty**: with no interest / **Moderate**: plus interest that is reasonable and fair in the circumstances / **Minimally tolerable:** plus interest at the highest rate that the lender could charge and still not be considered excessive], had the contractual annual interest been [**in favor of Jane:** lower / **in favor of the company:** higher]? Please indicate the lowest interest rate beyond which you would invalidate the contractual interest: ___ percent per year.

[**Comprehension-2**] Assume that, in the country described in the previous questions, the reasonable and fair interest in a given type of loans is 15% per annum, and the courts have ruled that interest rates above 30% are excessive and therefore void. According to the law of that country (which you have applied in the previous questions), if a contract sets an annual interest of 45%, the outcome of invalidating the contractual interest is:

__ that the borrower must repay the principal, with no interest.

__ that the borrower must repay the principal, plus the reasonable and fair interest of 15%.

__ that the borrower must repay the principal, plus interest at the highest rate that the lender could charge and would still not be invalidated as being excessive—namely, 30%.

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