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Behavior and Contract

Alan M. White†

Introduction

Behavioral law and economics has raised serious questions regarding rational choice theory, an essential underpinning of neoclassical law and economics.¹ Rational choice theory, it seems, does not describe very well how consumers behave or how markets work.² Economists have taken the insights of behavioral scientists in stride, and have begun to acknowledge that real people do not make choices solely to maximize their expected utility as rational choice theory would predict.³ The descriptive project of economics has been greatly enriched by the more complex story that behavioralists are telling.

A rich literature has developed in law and economics as well, incorporating the insights of behavioral scientists in order to reconsider assumptions about the behavior of consumers and firms, and the implication of those assumptions for laws regulating consumer markets, among other things.⁴ Legal

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1. See Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1476 (1998).

2. See, e.g., *id.* at 1476–77 (“[E]ach of the three bounds points to systematic . . . departures from conventional economic models, and thus each of the three bears on generating sound predictions and prescriptions for law.”).

3. See Colin F. Camerer & George Loewenstein, *Behavioral Economics: Past, Present, Future*, in ADVANCES IN BEHAVIORAL ECONOMICS (Colin F. Camerer et al. eds., 2004); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979).

4. See Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004); Shmuel I. Becher, *Behavioral Science and Consumer Standard Form Contracts*, 68 LA. L. REV. 117 (2007); Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided “Reform” of Bankruptcy Law*, 84 TEX. L. REV. 1481 (2006); Matthew A. Edwards, *The Law, Marketing and Behavioral Economics of Consumer Rebates*, 12 STAN. J.L. BUS. & FIN. 362 (2007); Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725 (2005); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707 (2006).

scholars, however, concern themselves not only with describing how people and markets behave, but also with how they ought to behave, and how and to what extent the law should regulate economic behavior.⁵ In this normative aspect, behavioral law and economics has clung stubbornly to goals of efficiency and autonomy.⁶ These goals do not always appear to be well served by the deregulation advocated by adherents of rational choice theory.⁷ Moreover, the triumph of efficiency as a legal norm has led to legal structures and empirically observable market outcomes that have harmed consumers, particularly vulnerable and poor consumers, in ways that are profoundly troubling from the standpoint of normative goals apart from efficiency.⁸

The time has come to rethink the norms to be pursued by consumer contract law. The time has come to replace the monistic value system dominated by wealth-maximizing efficiency with a pluralistic value system that seeks to balance the multiple and sometimes competing goals of equity, justice, autonomy, and efficiency in the law of these markets. Our improved empirical description of consumer contracting behavior needs to be enriched with an improved normative agenda. In particular, the law can and should prevent seller exploitation, exploitation which often consists of sellers understanding and using knowledge about consumer behavior and bounded rationality. For the source of these norms we need to look elsewhere besides efficiency and utilitarianism.

By consumer contract law, I refer to the full range of common law, statutes, uniform laws, and regulations that govern transactions between consumers and firms,⁹ including the law of contract formation and enforcement, the Uniform Commercial Code, the Consumer Credit Protection Act,¹⁰ section 5 of the Federal Trade Commission Act (FTC Act)¹¹ and its state-law equivalents,¹² together with the myriad of statutes regulating

5. Cf. Edwards, *supra* note 4, at 395–421 (describing options for regulating consumer rebates).

6. See Camerer & Loewenstein, *supra* note 3, at 3.

7. See *infra* Part III.A.

8. See *infra* Part II.C.

9. See Charles L. Knapp, *Opting Out or Copping Out? An Argument for Strict Scrutiny of Individual Contracts*, 40 LOY. L.A. L. REV. 95, 120 (2006) (proposing a broader category of “individual contract,” to which most of my discussion would apply).

10. Consumer Credit Protection Act, 15 U.S.C. §§ 1601–93 (2006).

11. Federal Trade Commission Act §5, 15 U.S.C. § 45 (2006).

12. Generically referred to as Unfair and Deceptive Acts and Practices statutes

specific business-to-consumer transactions.¹³ The domain of consumer contracts is a domain of standardized forms drafted by merchants and offered with little if any opportunity for negotiation of terms by the buyers.¹⁴ Behavioral issues are thus fundamentally different from those affecting individually negotiated business-to-business contracts.¹⁵

The efficiency norm has largely triumphed in the past twenty-five years.¹⁶ In the name of efficiency, consumer contract law has turned either to complete nonintervention (i.e. deregulation) or to a focus on fixing market failures, such as using disclosure mandates to ameliorate information asymmetries.¹⁷ The United States has engaged in a vast experiment in deregulation, which has yielded results that can be empirically evaluated.¹⁸ Deregulation of consumer markets, as it turns out, produces significant consumer harm, exploitation, and rent-seeking, and does not necessarily increase consumer welfare.¹⁹

The normative consequences of these insights have yet to be fully elaborated. Scholars who point out the bounded rationality²⁰ of consumer behavior nevertheless cling to the utility

(UDAP) or "Little FTC Acts," these laws have been adopted in all fifty states. See NAT'L CONSUMER LAW CTR., UNFAIR AND DECEPTIVE ACTS AND PRACTICES 1 (6th ed. 2004).

13. See, e.g., Real Estate Settlement Procedures Act, 12 U.S.C. §§ 2601–17 (2006) (regulating disclosures and payment of fees for real estate settlement services); California Rental-Purchase Act, CAL. CIVIL CODE §§ 1812.620–1812.649 (West 1998) (regulating disclosures and remedies in rent-to-own consumer good transactions).

14. See Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1179 (1983); cf. Stewart Macaulay, *Private Legislation and the Duty to Read—Business Run by IBM Machine, the Law of Contracts and Credit Cards*, 19 VAND. L. REV. 1051, 1056 (1966) (comparing certain contracts in business to using "invisible ink").

15. See Russell Korobkin, *Behavioral Economics, Contract Formation, and Contract Law*, in BEHAVIORAL LAW AND ECONOMICS (Cass R. Sunstein ed., 2000) (discussing the impact of "the status quo bias" on negotiated contracts).

16. See Charles L. Knapp, *Taking Contracts Private: The Quiet Revolution in Contract Law*, 71 FORDHAM L. REV. 761, 773–75 (2002); see also *infra* Part II.C.

17. See Jean Braucher, *The Afterlife of Contract*, 90 NW. U. L. REV. 49, 61 (1995) (using Supreme Court decisions on contract issues as a "barometer" and finding a "laissez-faire approach").

18. See *infra* Part I.C.

19. See *infra* Part II.C.

20. Herbert Simon pioneered theories of bounded rationality and "satisficing" to describe the complexity of real human behavior in the marketplace, including the use of mental shortcuts and the practical limitations on gathering and evaluating information. HERBERT A. SIMON, *MODELS OF MAN: SOCIAL AND RATIONAL* 261 (1957); see also Daniel Kahneman, *Maps of Bounded Rationality: Psychology for Behavioral Economics*, 93 AM. ECON. REV. 1449, 1449 (2003).

maximization ideal, and seek legal solutions that will fix the market failure.²¹ In my view, a single-minded focus on designing legal systems to achieve the utilitarian maximization of market-expressed “preferences” ignores both the reality of market functioning and other equally important objectives of the law: promoting equity and preventing exploitation of the economically vulnerable. In other words, not only does the orthodox law and economics approach to consumer contract law fail to achieve its stated efficiency goals, its failure should cause us to question what the law is doing pursuing this impoverished norm of efficiency in the first place. It begs the question by taking its conclusion as its premise. It is based on the following syllogism:

1. Markets are efficient.
2. Regulation of contracts interferes with markets.
3. Regulation is inefficient.
4. Regulation is bad.

While much recent literature explicitly or implicitly challenges premise 1 and conclusions 3 and 4,²² the unstated zero premise is that “efficiency is the goal.” Put another way, the law of contracts must be concerned with efficiency to the exclusion of other norms. Now that the syllogism has broken down, it is time to examine not only premise 1 and the conclusions, but also the zero premise.

I. Rational Choice Theory and Deregulation

A. *The Capture of Legal Culture by Rational Choice Theory*

The legal culture of U.S. consumer contract law for the past quarter century has been captured by the deregulation ideology of law and economics.²³ Judges and lawyers share a common language of consumer autonomy, in which contractual decisions are arrived at by rational choice after careful review of contractual information in a market with sellers vying to provide better products at lower prices.²⁴ Rational choice theory posits that

21. See *infra* notes 233–249 and accompanying text.

22. See, e.g., Bar-Gill, *supra* note 4, at 1376–77 (describing efficiency as a “casualty” in the credit card market and advocating for regulation).

23. See *infra* Part I.C; see also Jon Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 U. PA. L. REV. 129, 142–43 (2003) (“[T]here is no dispute that law and economics has long been, and continues to be, the dominant theoretical paradigm for understanding and assessing law and policy.”).

24. See generally, Jacob Jacoby, *Is it Rational to Assume Consumer Rationality?*

consumers have fixed preferences for goods and services, and that they make choices with limited budgets in order to maximize the fulfillment of their self-interested preferences (i.e., their expected utility).²⁵

In this construct, consumers are depicted as autonomous actors who express their fixed, predetermined preferences by spending their dollars or euros or yuan.²⁶ Sellers are imagined as slaves to their consumer masters, constantly striving to offer the products and services that fulfill the autonomous desires of consumers at the lowest possible price.²⁷ Any legal regulation that interferes with voluntary contracts is depicted in this story as making both consumers and sellers worse off.²⁸ This story that has captured our legal culture is fundamentally false, and does not describe the behavior of consumers and sellers in the real world.

The historical moment when consumer law came to be shaped by rational choice theory occurred in part as a reaction to the equity-based jurisprudence that preceded it.²⁹ In the 1960s and 1970s Congress and the states enacted hundreds of consumer protection laws regulating the process and content of consumer contracts,³⁰ and the American Law Institute proposed nonenforcement of standard form contract terms that were inconsistent with a consumer's "reasonable expectation."³¹ In contrast, the past twenty-five years of consumer legislation have been dominated by deregulation and the vigorous enforcement of consumer form contracts against consumers.³² On the three

Some Consumer Psychological Perspectives on Rational Choice Theory, 6 ROGER WILLIAMS U. L. REV. 81, 98–122 (2000) (identifying Judge Posner as a proponent of rational choice theory and describing the assumptions underlying the theory).

25. AMARTYA KUMAR SEN, RATIONALITY AND FREEDOM 26–33 (2002) (differentiating the various versions of rational choice theory); Jacoby, *supra* note 24, at 87.

26. See Jacoby, *supra* note 24, at 87–88.

27. Cf. Hanson & Yosifon, *supra* note 23, at 161 (“[E]conomists are situationally sensitive in only the narrowest sense—taking into account the way in which price might influence people’s actions based on their willingness to pay . . .”).

28. See *infra* notes 54–57 and accompanying text.

29. See MICHAEL PERTSCHUK, REVOLT AGAINST REGULATION 137 (1982) (“[B]usiness was able to exploit the diffuse public disaffection with government and regulation to legitimize the dismantling of consumer and other regulations that have retained undiminished popular support.”).

30. Edward L. Rubin, *The Code, the Consumer, and the Institutional Structure of the Common Law*, 75 WASH. U. L. Q. 11, 12 (1997).

31. RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. f (1979); Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL’Y REV. 233, 246–47 (2002).

32. See discussion *infra* Part I.C.

occasions when the Supreme Court has decided consumer contract issues, in 1991, 2000, and 2006, it has refused judicial intervention in apparently one-sided form contract terms,³³ assuming that the contracts at issue reflected the voluntary preferences of the consumers, or at least that the law would be best served by pretending that this was so.³⁴

Jon Hanson and David Yosifon described this phenomenon of “maintaining . . . a false, though intuitive, worldview” as one caused by “deep capture.”³⁵ Because powerful corporations benefit collectively from deregulation, it is in their interests to promote the universal and invisible dominance of rational choice theory, which he refers to as “dispositionism,” i.e., the premise that preferences are inherent in consumers’ dispositions and are not the product of situational factors, including manipulation by sellers.³⁶ Business interests actively promoted the teaching and writing that became neoclassical law and economics with generous funding.³⁷ The law and economics dogma has become *de rigueur* in American law schools, albeit the subject of continuing and critical debate.³⁸ The continuing refusal of orthodox economists and legal

33. See *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440 (2006) (holding that the illegality of an allegedly usurious payday loan was for the arbitrator to decide under a mandatory arbitration term); *Green Tree Fin. Corp.—Ala. v. Randolph*, 531 U.S. 79 (2000) (upholding a mandatory arbitration clause in a consumer loan); *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991) (upholding a forum-selection clause in a cruise ship ticket); see also *Norfolk S. Ry. Co. v. Kirby*, 543 U.S. 14, 29 (2004) (noting that contract default rules should achieve efficiency); *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) (rejecting the contract interest rate on a subprime auto loan as the basis for discounting Chapter 13 payments to present value). *But see Till*, 541 U.S. at 491–508 (Scalia, J., dissenting) (arguing that the contract rate should be used based on the assumption that subprime lending markets are competitive and therefore efficient). In *Till*, the plurality disagreed with the assumption about the efficiency of the subprime market, but only because it found that government regulation may distort the consumer credit market, and information problems may prevent consumers from efficiently expressing their preferences and obtaining competitive prices. *Till*, 541 U.S. at 481–82. On a deeper level, both the plurality and dissenting opinions are completely wedded to the tenets of rational choice theory.

34. See, e.g., *Randolph*, 531 U.S. at 90 (“[I]t is undisputed that the parties agreed to arbitrate all claims relating to their contract . . .”).

35. Hanson & Yosifon, *supra* note 23, at 229.

36. *Id.* at 226.

37. Richard Lippitt, *Intellectual Honesty, Industry and Interest Sponsored Professorial Works, and Full Disclosure: Is the Viewpoint Earning the Money, or Is the Money Earning the Viewpoint?*, 47 WAYNE L. REV. 1075, 1088–90 (2001).

38. See Hanson & Yosifon, *supra* note 23, at 140–43; see also David A. Hoffman & Michael P. O’Shea, *Can Law and Economics Be Both Practical and Principled?*, 53 ALA. L. REV. 335, 347–51 (2002) (reviewing the Posner-Dworkin debate); Lewis A. Kornhauser, *On Justifying Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1037 (2000) (defending cost-benefit analysis against critiques).

scholars to acknowledge real world evidence of human behavior has been referred to as “autistic” economics by a small group of dissenting scholars.³⁹ Where the law of consumer contracts is made, in legislatures, regulatory agencies, and courts, the basic assumptions of rational choice theory are rarely if ever challenged, and are now deeply embedded in the making of rules and deciding of cases.⁴⁰

B. Rational Choice Theory as a Norm

While law and economics scholarship sometimes claims to be agnostic as to the normative goals of law, and to offer only tools to evaluate an aspect of legal choices,⁴¹ it has directed attention to utility maximization and cost-benefit analysis.⁴² The law and economics approach directs us to evaluate the efficiency of legal rules.⁴³ Efficiency has a specific definition in this context. The minimalist Pareto formulation of efficiency tells us to favor any outcome that improves at least one consumer or producer’s utility without diminishing the utility of any other person.⁴⁴

The Kaldor-Hicks version of efficiency modifies this formula, to approve any outcome that improves at least one person’s expected utility to such an extent that his or her surplus utility is greater than any loss of utility to others.⁴⁵ In theory, if the winners compensate the losers (by paying money, the yardstick of utility), the winners would still have some excess utility and the losers are no worse off, thus meeting the Pareto efficiency test.⁴⁶ When willingness to pay is used as the proxy for utility, then

39. See THE CRISIS IN ECONOMICS: THE POST-AUTISTIC ECONOMICS MOVEMENT: THE FIRST 600 DAYS 1–9 (Edward Fullbrook ed., 2003). The word “autistic” is used informally and imprecisely in this context to mean inward-looking or oblivious to real-world evidence. Autism sufferers in fact are quite aware of the world around them but suffer from seriously impaired communication that makes it appear to others that they are self-absorbed.

40. See discussion *infra* Part I.C.

41. See A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7–10 (2d ed. 1989); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 15–16 (7th ed. 2007).

42. Daniel A. Farber, *What (If Anything) Can Economics Say About Equity?*, 101 MICH. L. REV. 1791, 1791 (2003) (reviewing LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002)).

43. *Cf. id.* at 1795–96 (outlining different efficiency formulations used “in comparing different states of society”).

44. See Camerer & Loewenstein, *supra* note 3, at 3; Farber, *supra* note 42, at 1795.

45. See JoEllen Lind, *The End of Trial on Damages? Intangible Losses and Comparability Review*, 51 BUFF. L. REV. 251, 318 (2003).

46. See *id.*

efficiency amounts to aggregate wealth maximization.⁴⁷ Unfortunately, Kaldor-Hicks efficiency does not require that the winners *actually* transfer their excess utility to the losers.⁴⁸ Kaldor-Hicks efficiency begins rather rapidly to resemble wealth maximization and utilitarianism, with their well-understood shortcomings as ethical norms.⁴⁹

By giving primacy to consumers' "rational choice," the descriptive project of law and economics has necessarily cast interventionist legal rules as antifreedom and paternalistic.⁵⁰ Thus the agenda subtly shifts, from a positivist program of identifying the laws of markets and how they actually function to promote efficiency (or not), into an effort to delegitimize goals other than efficiency as aims of the law.⁵¹ While there has been considerable discussion in recent law and economics literature about the efficiency norm, its moral justification, and how to accommodate it to the decidedly inefficient preferences of real consumers and real markets,⁵² scholars in this field almost universally remain committed, on a fundamental level, to a utilitarian agenda.⁵³ The limitations of the efficiency norm, and its possible alternatives, are discussed in Part III, below.

Translated to the real world of consumer markets, Kaldor-Hicks efficiency means that the rules should be favored if their

47. Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 119 (1979). There are of course many different versions of efficiency, cost-benefit analysis, and rational choice theory in the academic literature. My focus, however, is on what one might call the popular version that has come to dominate legal discourse of judges, legislators, and regulatory agencies. That version equates efficiency with the maximization of wealth and treats willingness to pay as a cardinal measure of consumer preferences and, therefore, consumer well-being. See Lind, *supra* note 45, at 318.

48. See Lind, *supra* note 45, at 318.

49. *Id.* at 314–19; see also Ronald M. Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191, 194–96 (1980) (challenging the ethics of striving for wealth maximization); discussion *infra* Part III.

50. See Hoffman & O'Shea, *supra* note 38, at 338 ("policies of paternalism").

51. See Jon Hanson & David Yosifon, *The Situational Character: A Critical Realist Perspective on the Human Animal*, 93 GEO. L.J. 1, 159 (2004).

52. See Hoffman & O'Shea, *supra* note 38, at 347–52; Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 968 (2001) ("Welfare economics thus accommodates all factors that are relevant to individuals' well-being and to its distribution.")

53. See, e.g., Eyal Zamir & Barak Medina, *Incorporating Moral Constraints into Economic Analysis* (Sept. 1, 2006) (unpublished manuscript, on file with author), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=931988 (proposing that cost-benefit analysis be used only after reaching certain thresholds dictated by deontological moral norms).

aggregate benefits exceed their aggregate costs.⁵⁴ Conventionally, this means that any voluntary contractual exchange should be permitted.⁵⁵ If both the buyer and seller are willingly exchanging money for goods or services, they must both be better off as a result of the transaction.⁵⁶ Laws and regulations that interfere with the making of contracts, or attempt to prescribe their content (like laws limiting interest rates) are seen as inevitably causing more harm than good, because they prevent voluntary transactions that by hypothesis improve the lot of both the buyer and seller.⁵⁷

But in order to measure costs and benefits, we need a yardstick. This is where rational choice theory, with its assumptions about consumer behavior and preferences, comes in.⁵⁸ In order to measure improvements to an individual consumer's welfare, neoclassical economics observes the consumer's willingness to pay, and the seller's asking price.⁵⁹ If a consumer purchases a service, for example an extended warranty for an automobile, the neoclassical economist assumes that the highest price that the consumer is observed to pay reflects the value of that consumer's innate preference for the peace of mind and protection from risk that the warranty represents.⁶⁰ Likewise, the lowest price at which a seller offers the warranty represents the irreducible cost of providing the warranty plus the seller's desired minimum profit.⁶¹

Rational choice theory requires that: A) a consumer has fixed, predetermined preferences between and among all available

54. See Farber, *supra* note 42, at 1795.

55. See, e.g., Lind, *supra* note 45, at 319–20 (describing a hypothetical car accident, where the one at fault would need to “compensate in a manner that mimics a voluntary market transaction” to remedy the inefficiency).

56. See Lewis A. Kornhauser, *The Resurrection of Contract*, 82 COLUM. L. REV. 184, 188 (1982).

57. See Nathan Oman, *Corporations and Autonomy Theories of Contract: A Critique of the New Lex Mercatoria*, 83 DENV. U. L. REV. 101, 104 (2005) (“[E]fficiency theorists . . . argue that voluntary transactions increase aggregate levels of social welfare and ought to be enforced as a way of increasing wealth and utility.”).

58. See SEN, *supra* note 25, at 27 (summarizing emphasis of rational choice theory).

59. See POSNER, *supra* note 41, at 9.

60. *Id.* at 11.

61. See *id.* (“The economic value of something is how much someone is willing to pay for it or, if he has it already, how much money he demands for parting with it.”); see also Becher, *supra* note 4, at 120 (“[C]ontract law assumes that people know what they want . . .”).

goods and services;⁶² B) the consumer can assign a numerical value, in the form of a price she is willing to pay, to any product and any feature of any product, and; C) the consumer acts at all times to maximize her expected utility, i.e., to fulfill as many preferences as she can given her wealth budget.⁶³ As a normative proposition, rational choice theory holds that the consumer's expression of her preferences through purchasing decisions are the best possible measure of the consumer's well-being.⁶⁴

This yardstick of consumer welfare loses its appeal, however, if the consumer's willingness to pay, e.g., for a warranty, is not fixed, but is instead heavily influenced by situational factors, some of which the seller can control and manipulate.⁶⁵ Moreover, the consumer's willingness to pay in the real world is skewed by a variety of biases and predictable misperceptions that are also well understood by the seller.⁶⁶ If the consumer begins by miscalculating the objective value of the warranty because of the overconfidence bias⁶⁷ or the availability heuristic,⁶⁸ and then has her calculations further influenced by the seller framing the warranty as avoiding loss rather than seeking a gain,⁶⁹ what has

62. Jolls, et al., *supra* note 1, at 1476 (explaining accounting principles of economics).

63. See Willis, *supra* note 4, at 741, 742 (summarizing postulates of neoclassical economics).

64. See Korobkin, *supra* note 15, at 118 (explaining rational choice theory's assumption that parties will act to maximize wealth).

65. E.g., Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251, S254–S259 (Oct. 1986) (examining how descriptive variance influences choice).

66. See, e.g., Willis, *supra* note 4, 754–98 (listing, comprehensively, tactics used against consumers by predatory lenders).

67. Overconfidence bias is the tendency to believe in a higher likelihood of success and a lower likelihood of failure of future projects than is objectively reasonable. See generally Dan Lovallo & Daniel Kahneman, *Delusions of Success: How Optimism Undermines Executives' Decisions*, HARV. BUS. REV., July 2003, at 56, 56 (discussing executives' tendency to overestimate benefits and underestimate costs). Thus, a consumer might believe a warranty is unnecessary because of her belief in her good maintenance practices or general good luck.

68. The availability heuristic is the tendency to measure the probability of unusual events based on personal or personally known experience. See Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCHOL. 207, 208 (1973) ("A person is said to employ the availability heuristic whenever he estimates frequency or probability by the ease with which instances or associations could be brought to mind.").

69. Framing effects result in consumers having different preferences in making the identical choice, depending on how the choice is presented. See generally Tversky & Kahneman, *supra* note 65, at S272. In particular, individuals tend to "prefer" a choice that is framed as avoiding a loss over the same choice when presented as a possible gain. *Id.* at S254, S259; see also McCoy, *supra* note 4, at

happened to our fixed yardstick of consumer welfare?

If behavioral science tells us that a consumer's purchasing decisions do not offer a good yardstick for that consumer's objective welfare, then the goal of maximizing the consumer's freedom to purchase loses its luster. Before turning to the evidence of non-rational consumer market behavior and its implications for the law, it is imperative to understand the extent to which rational choice theory has come to dominate the practice and theory of consumer contract law.

C. *Rational Choice Theory and Its Normative Agenda
Translated into Legal Practice: Legislatures,
Administrative Agencies, and Courts*

Beginning around 1980, Congress progressively preempted most state usury laws,⁷⁰ while contract law in general became less regulated.⁷¹ While the initial deregulation of first mortgage interest rates was partly unintentional,⁷² it was the leading edge of a wave.⁷³ Two United States Supreme Court decisions have resulted in the effective state deregulation of credit card rates and fees.⁷⁴ Initially, the Court permitted national banks to "export" the interest rate laws of their home state to other states in which

730 (illustrating that people make different choices depending on how outcomes are framed).

70. See Cathy Lesser Mansfield, *The Road to "HEL" was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 476 (2000).

71. See Knapp, *supra* note 16, at 767 (comparing the "rules-based" system of the early twentieth century contract law with the later "standards-based" system); *id.* at 774 ("[W]ith privatizing and deregulation the new order of the day, contract law was now to be regarded as just one of many legal spheres in which the free market should be allowed to dominate to the greatest extent possible.").

72. High interest rates in the late 1970s caused market rates for mortgages to temporarily exceed limits in state statutes, and in the case of Arkansas, state constitutional limits. Mansfield, *supra* note 70, at 476. Congress responded with the Depository Institutions Deregulation and Monetary Control Act, preempting state laws limiting the interest rate on first-lien mortgages. Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f-7a (1994). It is unclear whether the members of Congress voting for this provision understood that no higher or more flexible federal interest rate ceiling was going to replace the preempted state laws. See Mansfield, *supra* note 70, at 476 (giving a comprehensive overview of the mortgage market and legislation in the 1970s and 1980s).

73. See, e.g., Alternative Mortgage Transactions Parity Act, 12 U.S.C. §§ 3801-3806 (2001) (preempting state regulation of alternative mortgage transactions in the interest of eliminating their discriminatory impact on non-federally chartered creditors).

74. See *Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735 (1996); *Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978).

they did business, under the National Bank Act.⁷⁵ Then the Court broadly defined the payment components that come under the National Bank Act preemption umbrella.⁷⁶ As a result, certain states have removed interest rate and fee restrictions to attract national banks, creating a “race to the bottom” in which other states’ legislators began competing to offer a more attractively deregulated environment.⁷⁷

Similarly, the Federal Trade Commission’s (FTC or Commission) interpretation of its broad consumer protection mandate has evolved dramatically in the past twenty-five years.⁷⁸ Section 5 of the FTC Act calls for the agency to prohibit “unfair and deceptive practices” in the marketplace.⁷⁹ The FTC has shifted its core interpretation of the “unfairness” prong dramatically, adopting economic efficiency as its touchstone with some encouragement from Congress.⁸⁰ In the 1970s, under Chair Michael Pertschuk, the FTC considered regulating television advertising to children as unfair, and sought to take on other commercial practices viewed as harmful to the public welfare or to particular groups of consumers.⁸¹ Congress responded by amending section 5 to circumscribe the concept of unfairness, limiting it to practices that caused measurable economic harm to consumers, and requiring cost-benefit analysis of unfairness regulations.⁸² The cost-benefit amendment implicitly adopts utilitarian efficiency as the norm.⁸³ It requires that FTC

75. See *Marquette*, 439 U.S. at 313 (allowing a national bank to export interest rate rules of its home state to operations in other states).

76. See *Smiley*, 517 U.S. at 740 (holding that late charges were within the National Bank Act’s statutory definition of “interest” and therefore subject to the state law of a national bank’s home state).

77. See Helen A. Garten, *Devolution and Deregulation: The Paradox of Financial Reform*, 14 YALE L. & POL’Y REV. 65, 66 (1996) (explaining that the character of a “dual banking system” leads to state deregulation in order to have a choice between state and national banks).

78. See generally William F. Adkinson, Jr., *Introduction: Federal Trade Commission 90th Anniversary Symposium*, 72 ANTITRUST L. J. 749 (2004) (giving a brief synopsis of articles dealing with a myriad of FTC issues, including the Agency’s evolving history).

79. Federal Trade Commission Act §5, 15 U.S.C. § 45 (2006).

80. Michael Pertschuk, former FTC Chair, gives an entertaining and informative explanation for the FTC’s shift from a focus on overregulation of family values to deregulation and economics. See MICHAEL PERTSCHUK, REVOLT AGAINST REGULATION: THE RISE AND PAUSE OF THE CONSUMER MOVEMENT 69–117 (1982).

81. *Id.* at 69.

82. See 15 U.S.C. § 45(n); see also PERTSCHUK, *supra* note 80, at 73.

83. See 15 U.S.C. § 45(n) (using language such as “consumers” and “substantial injury” to limit the section’s application to issues of quantifiable economic harm).

consumer protection rules achieve Kaldor-Hicks efficiency by maximizing aggregate utility.⁸⁴ To put it another way, Congress has prohibited the FTC from making interpersonal comparisons of utility other than on the basis of willingness to pay.

Since Congress acted, the FTC has rarely issued regulations broadly applicable to contract terms on the basis of unfairness.⁸⁵ The Credit Practices Rule banned as unfair six different consumer contract terms or practices: confessions of judgment, pre-default wage assignments, non-purchase money security interests in household goods, exemption waivers, pyramiding late charges, and failure to provide a mandatory warning notice to cosigners.⁸⁶

The Credit Practices Rule is replete with the language of rational choice theory and utility maximization.⁸⁷ Accordingly, the contract terms that are banned are evaluated solely based on whether the economic savings to the merchants exist and outweigh the dollar cost of the terms to consumers.⁸⁸ Contractual wage assignments, for example, are not condemned as an oppressive use of economic power and leverage to deprive working people of their wages.⁸⁹ They are banned because they do not appear in actual market practice to provide much dollar return to creditors and collectors, and because markets that already ban them in various states were found not to have lost any economic benefit as a result of the bans.⁹⁰

Moreover, since adoption of the Credit Practices Rule, the FTC has retreated even further from any substantive regulation of consumer contract terms, and indeed it is difficult to imagine the present Commission enacting the Credit Practices Rule, even

84. See Lind, *supra* note 45, at 310 (“Kaldor-Hicks . . . involves sacrificing the utility of individuals in order to maximize the wealth of society and treats wealth as the ultimate good.”).

85. See J. Howard Beales, III, *The FTC’s Use of Unfairness Authority: Its Rise, Fall, and Resurrection*, <http://www.ftc.gov/speeches/beales/unfair0603.shtm> (last visited Nov. 6, 2008) (detailing the history of the unfairness doctrine in the FTC).

86. FTC Credit Practices Rule, 16 C.F.R. pt. 444 (2007).

87. See Credit Practice Rule, 49 Fed. Reg. 7740 (Mar. 1, 1984) (to be codified at 16 C.F.R. pt. 444).

88. See *id.* at 7743–44 (defining substantial injury as “economic or monetary” and noting that “violation . . . prevents the forces of supply and demand from maximizing benefits and minimizing costs”).

89. See *generally id.* at 7755–61 (indicating that the Commission looks at both the harm to consumers participating in wage assignment (particularly employment relationships and family welfare) as well as the benefits (most prevalently the borrowing ability of those with bad credit), and that ultimately, it is a weighing of each side, economically, that tips the scales against wage assignment).

90. See *id.* at 7755–61.

couched as it is in its utility maximization rationale.⁹¹ Deborah Platt Majoras, chair of the FTC from 2004 to 2008, equates consumer protection to the promotion of free competition, privacy of consumer information, correction of information problems, and prevention of deception that impair efficient markets, which result in the enhancement of consumer welfare.⁹² Her predecessor, Timothy Muris, who served from 2001 to 2004, was also an emphatic supporter of deregulated markets and their presumed superiority over government regulation.⁹³

In the courts, a similar dominance of rational choice theory is apparent.⁹⁴ To take one example, section 211 of the Restatement (Second) of Contracts, which calls for nonenforcement of standard form contract terms if they are contrary to a consumer's "reasonable expectations,"⁹⁵ has gained little or no traction.⁹⁶ One court described the idea of analyzing adhesion contracts as something other than voluntary agreements based on autonomous preferences as introducing "the serpent of uncertainty in the Eden of contract enforcement."⁹⁷ In upholding the FTC's Credit Practices Rule against a challenge by a credit industry trade association, the D.C. Court of Appeals approved the rationale that "unfair," for purposes of the FTC Act, was the same as not being the result of an efficient market.⁹⁸ Thus, if the FTC finds a market failure, then it may regulate a practice in order to restore the state of affairs that the imaginary competitive market would

91. See, e.g., Deborah Platt Majoras, Chairman, Fed. Trade Comm'n, The FTC's Consumer Protection Agenda: Strategies for the Present and Future, Remarks before American Bar Association Antitrust Section (Jan. 30, 2007), <http://www.ftc.gov/speeches/majoras/070130ABACConsumerProtection.pdf> (calling competition and consumer protection a "complimentary set of tools").

92. See *id.*

93. See Hanson & Yosifon, *supra* note 23, at 239–40 (citing Kenneth W. Clarkson & Timothy J. Muris, *Constraining the Federal Trade Commission: The Case of Occupational Regulation*, 35 U. MIAMI L. REV. 77 (1980)).

94. See, e.g., White & Mansfield, *supra* note 31, at 240 (discussing the negative impact of policies such as "duty-to-read," which ostensibly make consumers and merchants equal bargainers, on those unable to read or understand contract terms).

95. RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. f (1979).

96. The exception has been for cases involving the sale of insurance, and even those decisions appear consistent with rational choice theory and freedom of contract, focusing as they do on the special information problems that insurance contracts present. White & Mansfield, *supra* note 31, at 246–50.

97. *Klos v. Polskie Linie Lotnicze*, 133 F.3d 164, 168 (2d Cir. 1997).

98. *American Financial Services Ass'n v. F.T.C.*, 767 F.2d 957, 976–84 (D.C. Cir. 1985).

have (efficiently) produced.⁹⁹ Similarly, the efforts of merchants to persuade and change consumers' preferences, an activity that according to rational choice theory should be futile, is given protection of a constitutional dimension under the commercial speech doctrine, because such communication is presumed to be informative and promote the efficient fulfillment of consumer preferences.¹⁰⁰

Thus have lawmakers participated in a systematic self-delusion as to the functioning and desirability of deregulated markets. I will now turn to the evidence, both from the behavioral economists' experimental evidence and from real world empirical examples in particular markets, that the rational choice model of consumer markets is fundamentally false.

II. Behavioral Law & Economics: How Consumers and Sellers Really Behave

People simply do not behave in the ways that neoclassical economists assume they do, or ought to.¹⁰¹ In the past ten years, there has been an explosion of legal scholarship drawing on empirical research from economics and the behavioral sciences about consumer and seller economic behavior.¹⁰² This research discredits the utility maximization narrative.¹⁰³ People, it seems, do not approach the marketplace with a series of predetermined preferences, precisely and numerically weighted, seeking like a computer algorithm the package of goods and services that maximizes the fulfillment of their preferences at the lowest cost.¹⁰⁴ Instead, consumer choices result from a wide range of consumer

99. See *id.* (examining "reasonably avoidable" to determine that markets leaving consumers with other than optimal choices were unfair for purposes of the FTC Act).

100. See *Pac. Frontier v. Pleasant Grove City*, 414 F.3d 1221, 1236 (10th Cir. 2005) ("Operating in an economy featuring informed consumers and an efficient allocation of resources clearly benefits both sellers and buyers. Therefore, the injury incurred through the deprivation of commercial speech rights cannot be quantified solely in terms of transaction costs and lost profits to a single market participant.").

101. See *supra* part I.A. (explaining neoclassical economics' assumptions about human behavior).

102. See *supra* note 4.

103. See Camerer & Loewenstein, *supra* note 3, at 6 (commenting on research that determined unavoidable anomalies in utility maximization theory); see also Jacoby, *supra* note 24, at 84 ("Rational Choice Theory is a simplistic theory having little correspondence with the real world of (individual) consumer behavior.").

104. See Jacoby, *supra* note 2425, at 84.

strategies and seller influences.¹⁰⁵ People's preferences are highly contingent on situational factors, such as the framing of choices and the channels by which choices are offered, and are thus readily subject to seller manipulation.¹⁰⁶ Consumers "satisfice," that is, they accept the first products and services offered to them that minimally meet their needs, or are perceived to do so.¹⁰⁷ Real people employ mental short cuts, "heuristics," that sellers can exploit, such as using the initial monthly payment as a proxy for the cost of credit.¹⁰⁸ To describe consumer purchasing in the modern market as an expression of individual autonomy is misleading in the extreme.

Patricia McCoy and Lauren Willis have explored the application of behavioral research to an important current example of consumer exploitation, namely predatory mortgage lending.¹⁰⁹ Professor McCoy identifies a number of consumer behaviors to explain how it is that risky and expensive mortgage products have been so successfully sold to so many American homeowners.¹¹⁰ She argues that predatory lenders use framing effects to present credit choices in ways that obfuscate the risks and overstate the benefits of risky mortgage loans.¹¹¹ They exploit consumers' tendency to use a monthly payment amount as a (misleading) proxy for the price of credit, and characterize bad loans as a means to avoid important losses.¹¹²

Professor Willis offers a comprehensive review of the biases and situational factors that might lead consumers to fall victim to predatory lending, as well as some of the seller behaviors that exploit consumer vulnerability and lead them to enter into

105. See *id.* at 88–90 (listing word-of-mouth, packaging, and retail atmosphere as a few of these competing stimuli).

106. *E.g.* Tversky & Kahneman, *supra* note 65, at S254–S255 (noting that a study of preferences between medical treatments indicated that the framing of statistics affects the type of treatment respondents prefer).

107. Willis, *supra* note 4, at 769.

108. See McCoy, *supra* note 4, at 736 (analyzing the use of heuristics by inexperienced borrowers, which increases their vulnerability to predatory lending).

109. *E.g.*, McCoy, *supra* note 4; Willis, *supra* note 4.

110. See McCoy, *supra* note 4, at 726 (noting that depending on consumers' inexperience, aversion to certain loss, frame of reference, and financial hardships, lenders are able to sell high-risk mortgages to those least capable of appreciating their content).

111. *Id.* at 731 (explaining that because people are typically strongly adverse to loss, predatory lenders frame high-risk loans as large cash gains followed by reasonable payments).

112. *Id.* at 736 (explaining the downward spiral inexperienced borrowers are susceptible to, as increasingly unequal borrowing arrangements are entered into in order to stave off immediate debt).

harmful and risky mortgage loans.¹¹³ In addition to the price heuristics, framing effects, and information problems discussed by Professor McCoy, Professor Willis identifies abbreviated reasoning and a focus on salient product features, the affective significance of having one's application for credit approved, and the reliance on intermediaries to avoid decision making stress as other factors enabling predatory lending.¹¹⁴

Likewise, consumers do not ruthlessly take on credit card and other debt based on rational strategies relying on the availability of discharge of debts under the Bankruptcy Code.¹¹⁵ Instead, overconfidence bias, using monthly payments as a proxy for the cost of credit, hyperbolic discount rates, and self-control problems, which are all systematically exploited by purveyors of credit, combine to cause consumers to over-borrow.¹¹⁶

Drawing on the experimental evidence, I propose to apply the insights of behavioral economics to the problem of consumer contract law more generally. I also propose to incorporate empirical evidence regarding actual consumer behavior in the marketplace in order to supplement the insights gained from psychology experiments performed on college students.

A. Consumer Behavioral Biases and Shortcuts

1. Situation Matters: Defaults, Decisional Overload, Framing, and Affective Factors

While rational choice theory posits that consumers have predetermined preferences, and that their behavior will always

113. See generally Willis, *supra* note 4 (analyzing the effect of psychological biases on borrowers, and thereby uncovering serious flaws in approaching home mortgages with the assumption that borrowers act rationally, or even in their own best interests).

114. See *id.* at 766 (noting that borrowers suffer from information overload, which leads to narrowing the scope of comparison to a few key issues). Consumers tend to rely on avoiding negative emotions while seeking positive ones, which also makes them vulnerable to lender manipulation. *Id.* at 769–71. Similarly, loan approval for those who believe themselves to have poor credit can be marketed by lenders either as an affirmation of the borrower's worth or as a warning against attempting to get a better rate. *Id.* at 775. Borrowers rely on lenders to explain the loan process and act in their best interest. *Id.* at 798. This trust offers lenders yet another avenue for borrower exploitation. *Id.*

115. See Block-Lieb & Janger, *supra* note 4, at 1481–82 (critiquing the theory that the rise in bankruptcy is due to deliberate consumer action, which therefore should be curtailed by more stringent bankruptcy laws).

116. See *id.* at 1534–48. “[I]ncreases in the consumer bankruptcy filing rate have . . . been driven by the easy availability and aggressive marketing of (often quite expensive) consumer credit.” *Id.* at 1585.

seek to achieve those fixed preferences to the maximum extent possible,¹¹⁷ behavioral science teaches us that the situation faced by a consumer can determine preferences and choices as much as, or more than, prior preferences.¹¹⁸ One simple illustration is that in making choices, the default choice can often determine the outcome: consumers will make a different choice, i.e., have different “preferences,” depending on which choice is presented as the status quo or default option.¹¹⁹ For example, both New Jersey and Pennsylvania introduced an option for auto insurance consumers to limit their right to sue, in return for lower insurance premiums.¹²⁰ However, the default option in Pennsylvania was to retain the full right to sue, while in New Jersey the default option was the limited right to sue.¹²¹ While 20% of New Jersey drivers opted for the full right to sue, 75% of Pennsylvania drivers did nothing and thereby “opted” for the full right to sue.¹²² Similarly, consumers are more likely to establish bank accounts if employers offer the option of to be paid via direct deposit, as compared to consumers who can only be paid in cash.¹²³

The South African microcredit experiment provides interesting empirical data on the importance of situational and psychological factors in consumer credit decisions.¹²⁴ The lender conducting the experiment agreed to offer microloans (averaging \$150 for four months) to past customers, randomizing the interest rates in the written offer.¹²⁵ Those customers who accepted a loan were assigned randomized interest rates as well, i.e., not necessarily the rate specified in the mailed offer.¹²⁶ The

117. See *supra* Part I.A.

118. See, e.g., Willis, *supra* note 4, at 766 (identifying situational factors which affect choice).

119. See Korobkin, *supra* note 15, at 137 (discussing the “status quo bias” that makes it difficult to determine if parties accept defaults because they are most efficient).

120. See Marianne Bertrand, Sendhil Mullainathan & Eldar Shafir, *Behavioral Economics and Marketing in Aid of Decision Making Among the Poor*, 25 J. PUB. POL’Y & MARKETING 8, 11 (2006).

121. *Id.*

122. *Id.*

123. This practice particularly impacts the poor, who are less likely to have the option of direct deposit, the end result of which is a tendency to pay high fees for after-hours check cashing. *Id.*

124. See Marianne Bertrand, Dean Karlan, Sendhil Mullainathan, Eldar Shafir & Jonathan Zinman, *What’s Psychology Worth? A Field Experiment in the Consumer Credit Market* (Yale Univ. Econ. Growth Ctr., Discussion Paper No. 918, July 2005), available at <http://ssrn.com/abstract=770389>.

125. *Id.* at 7–8.

126. *Id.* at n.17.

experiment had several aims. The economists involved sought evidence of behavior consistent with rational choice theory, in particular adverse selection and moral hazard.¹²⁷ In addition, the lender introduced a number of other variables seeking to identify behavioral factors that would increase consumers' desire to accept the offered loans.¹²⁸ Not surprisingly, the offered interest rate significantly affected the rate at which consumers elected to take the loans ("take-up rate").¹²⁹ More surprisingly, at least to traditional economists, the psychological manipulations affected consumer choices as much as, or more than, simple economic incentives.¹³⁰ The average psychological manipulation increased the loan take-up rate as much as a 0.5% per month reduction in the interest rate.¹³¹

Two striking examples illustrate the effect of psychological factors on consumer choice. First, behavioral scientists have found that decisional conflict can have a paralyzing effect on consumers.¹³² When too many options are presented, the individual will postpone a decision, or elect the status quo, despite the availability of an alternative option on the menu that would improve the individual's welfare or fulfill her preferences.¹³³ In the South African experiment, some loan offers presented a single choice of loan terms, while other offers presented four different

127. *Id.* at 5. Adverse selection is the result of consumers having exclusive knowledge of aspects of their own risk of default, so that consumers with a higher probability of default will accept higher interest rates. See Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249, 262 (1997) (explaining that riskier borrowers know they do not have alternatives that are less expensive than credit cards). A lender offering the higher rate products will attract a disproportionate number of these secretly riskier borrowers. See *id.* Moral hazard is the consumer's endemic preference for defaulting on a contract given the economic incentives presented to her. See Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 401 (1981) (illustrating that a higher interest rate will encourage borrowers to choose the riskier of two alternative projects or behaviors). The evidence for either adverse selection or moral hazard was rather weak, while the impact of some of the psychological manipulations was substantial. See Bertrand et al., *supra* note 124, at 4–5, 17–19; Dean S. Karlan & Jonathan Zinman, *Observing Unobservables: Identifying Information Asymmetries with a Consumer Credit Field Experiment* 6, 27–29 (Yale Univ. Econ. Growth Ctr., Discussion Paper No. 911, May 2005), available at <http://ssrn.com/abstract=725563>.

128. Bertrand et al., *supra* note 124, at 3–5.

129. *Id.* at 16–17.

130. See *id.* at 4–5, 23.

131. *Id.* at 2, 5.

132. See *id.* at 9.

133. See *id.* at 9–10 (citing Eldar Shafir, Itamar Simonson & Amos Tversky, *Reason-Based Choice*, 49 COGNITION 11 (1993)).

combinations of rates and payments.¹³⁴ Reducing the choices to a single offer had the same effect on acceptance of the offer as reducing the interest rate by 2.3% per month.¹³⁵ Second, and even more intriguingly, the inclusion of a photograph of an attractive female rather than a photo of a male increased take-up by male consumers by as much as would a 4.5% reduction in interest rate.¹³⁶ The impact of these manipulations was consistent across income and educational level,¹³⁷ belying the notion that the poor and undereducated are more susceptible to emotional manipulation by sellers.

2. Overconfidence and Risk

Credit and insurance products require consumers to evaluate not only the price and immediate benefits obtained, but also the risks of uncertain future events. In this area, individuals' predictions are clearly biased and inaccurate.¹³⁸ Oren Bar-Gill offers consumers' use of credit cards as a clear example.¹³⁹ Consumers systematically overestimate their ability to repay their credit card balances, and underestimate their future borrowing.¹⁴⁰ As a result, they choose pricing structures as if they will borrow modest amounts and pay their monthly bills in full, or at least on time.¹⁴¹ The credit card industry's pricing, with low annual fees and high interest rates, as well as significant revenues generated from late fees and other default-related charges, exploits consumers' overconfidence in their borrowing and payment habits in a systematic way.¹⁴² Bar-Gill describes this practice as inefficient, and possibly exploitive.¹⁴³ A similar overconfidence

134. *Id.*

135. *Id.* at 17.

136. *Id.* at 19.

137. *Id.* at 26.

138. See *infra* notes 139–144 and accompanying text.

139. See Bar-Gill, *supra* note 4.

140. See *id.* at 1375–76, 1395–1400.

141. See *id.* at 1401–08 (explaining that the most common pricing structures used by credit card issuers appeal to consumers in the short-term since consumers underestimate their risk of accruing debt in the long-term).

142. See *id.* at 1388–95.

143. See *id.* at 1411–16. But see Joshua D. Wright, *Behavioral Law and Economics, Paternalism, and Consumer Contracts: An Empirical Perspective*, 2 N.Y.U. J. L. & LIBERTY 470, 475–82 (2007). Wright relies on industry-sponsored research to contend that behavioral theories are not sufficiently predictive of credit card consumers' choices, because a majority of credit card consumers are observed to make the "rational" (i.e., wealth-maximizing) choice based on the given data. See *id.* On the other hand, he concedes that based on the evidence, consumer behavior

with regard to default risk clearly causes homeowners to take on mortgages with risks of foreclosure that do not maximize their long-term welfare.¹⁴⁴

The problem of consumers' overconfidence is related to the problem of impulse control and conflicting preferences. A consumer can have a long-run preference to keep her debt manageable by paying off credit card balances in full each month, but at the same time prefer in the short-run to make purchases without regard to her eventual ability to pay the resulting bills. If, not surprisingly, the purveyors of credit cater to the consumers' short-run "preference," can it truly be said that the consumers' long-run preferences and the consumers' welfare are thus well-served?

3. Selective Judgment and Saliency

Consumer choices are made based on a limited number of salient product features.¹⁴⁵ Consumers typically consider a maximum of five product features.¹⁴⁶ For example, a consumer shopping for a credit card may consider the annual fee, the interest rate, and a rebate or bonus program offering, such as frequent flyer miles. Credit card provisions regarding remote contingencies, such as what happens if the consumer defaults in payments, or has a dispute requiring litigation, are not salient to consumers.¹⁴⁷ This is both because of the practical limit to the number of features that she can consider,¹⁴⁸ and because of the "availability heuristic," meaning that consumers discount risks that are not easily imagined or connected to a recent personal or

is neither 100% rational nor 100% irrational. *See id.* at 509–10. Wright contends that behavioral economists "assume consistent irrationality," and thereby set up a straw man. *See id.* at n.31. Rather than asserting that consumer behavior is always and predictably non-utilitarian, as Wright implies of behavioralists, behavioral economics is better understood as saying that consumer behavior is not entirely predictable by rational choice theory. What behavioralism loses in predictive certainty, it gains in descriptive depth.

144. *See McCoy, supra* note 4, at 736 (describing homeowners' tendency to overestimate their ability to make all their mortgage payments far into the future based on their ability to make the first payment).

145. *See Russell Korobkin, Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1206, 1225–34 (2003).

146. *See id.* at 1227–29 (describing research involving the number of product attributes that consumers consider in making decisions).

147. *See id.* at 1225–34 (asserting that in a transaction involving a form contract it is unlikely that the consumer will consider the boiler-plate terms of the form contract to be salient).

148. *See id.* at 1226–29, 1291.

familiar experience.¹⁴⁹ Therefore consumers will not generally consider terms such as default interest rate increases or arbitration clauses, and sellers have no reason to offer good versions of these terms.¹⁵⁰ Thus, non-salient contract terms are not likely to be optimized through unregulated market processes.¹⁵¹

Although not articulated in this fashion, the saliency concept has gained some recognition in the law. One example in the law of credit cards is the provision for the consumer's potential liability for charges made by a thief who steals the consumer's card. The Truth in Lending Act (TILA) caps this liability at \$50.¹⁵² Prior to TILA mandating this contract term, card issuers made varying provisions regarding default for unauthorized charges, usually much less favorable to card holders.¹⁵³ When these contractual provisions were left to the free market, the terms developed by sellers were aptly characterized as private legislation, rather than reflecting any consumer choices.¹⁵⁴

The FTC gathered extensive empirical support for the inefficiency of nonsalient terms when it studied, and eventually banned, a variety of onerous merchant remedies in the Credit Practices Rule.¹⁵⁵ The FTC found that provisions for draconian remedies after default, such as assigning consumer wages to the creditor or advance agreement to waiver of exemptions or trial, were not considered by, or bargained for, by consumers.¹⁵⁶

Recently, the Federal Reserve Board conducted extensive consumer focus group testing to redesign the TILA disclosures for credit cards and other open-end credit products.¹⁵⁷ The results with respect to balance computation methods illustrate the saliency problem. Credit card issuers use a variety of different

149. *See id.* at 1232–33.

150. *See id.* at 1234–39.

151. *See id.* at 1243–44.

152. Truth in Lending Act, 15 U.S.C. §1643(a)(1)(B) (2000).

153. *See, e.g.,* Macaulay, *supra* note 14, at 1069–71, 1073–34 (explaining credit card issuers' typical practice of allocating the risk of a lost or stolen credit card to the consumer until the issuer received notification of the loss).

154. *See id.* at 1051–52.

155. *See* Credit Practices Rule; Statement of Basis and Purpose and Regulatory Analysis, 49 Fed. Reg. 7740 (Mar. 1, 1984) (to be codified at 16 C.F.R. pt. 444).

156. *See id.* at 7743–44.

157. *See* Macro Int'l, Inc., *Design and Testing of Effective Truth in Lending Disclosures*, May 16, 2007, available at <http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf>.

methods to calculate the monthly interest charges.¹⁵⁸ Not surprisingly, many issuers have resorted to counterintuitive methods that increase the interest based on a given transaction history.¹⁵⁹ The Federal Reserve attempted to provide explanations of these balance computation methods using various formats and language.¹⁶⁰ None of the attempts were successful; consumers invariably reported that they would disregard this information if it were included in credit card materials.¹⁶¹

Nevertheless, United States legal culture continues, for the most part, to ignore the saliency problem. A comparison of the United States and European approaches to the privacy of consumer information gathered by merchants illustrates the point. The provisions of the Gramm-Leach-Bliley Act (GLB) allow financial institutions to establish any level of information privacy that they choose, so long as the privacy regime is disclosed to consumers, who are presumed to “shop” for contracts based on the competing privacy policies.¹⁶² Significant amounts of evidence suggest that when consumers shop for various financial products, they will consider key price terms, and perhaps benefits like frequent flier miles awards with credit cards, but rarely if ever will the issuer’s privacy policy rise to the level of a salient contract term.¹⁶³ The GLB construct is a classic example of the mythologizing power of rational choice theory. The European Union’s approach, on the other hand, is to establish reasonable default rules for the privacy of consumer information,¹⁶⁴ thus recognizing that the consumer’s preference for privacy is unlikely

158. *See id.* at v.

159. *See id.* at v–vi (explaining the researchers’ attempts to include a useful description of one of the more complicated balance calculation methods called “two-cycle” billing that has the potential for higher interest charges, and their finding that a brief explanation was not sufficient to achieve consumer understanding of the method).

160. *Id.* at v–vi, 27, 31, 34, 39–40.

161. *See id.* at v–vi, 14, 23, 31, 34, 39–40.

162. *See* Gramm-Leach-Bliley Act, 15 U.S.C. §§ 6801–6809 (2000).

163. *See, e.g.*, MARY J. CULNAN, THE CULNAN-MILNE SURVEY ON CONSUMERS & ONLINE PRIVACY NOTICES: SUMMARY OF RESPONSES 6 (Dec. 2001), http://intra.som.umass.edu/georgemilne/pdf_files/culnan-milne.pdf (providing survey data indicating that many consumers rarely read the privacy notices that accompany credit card statements); Korobkin, *supra* note 145, at 1225–34 (presenting evidence that form contract terms are not among the limited number of salient terms that consumers take into consideration when making decisions).

164. *See* Council Directive 95/46, The Protection of Individuals with Regard to the Processing of Personal Data and in the Free Movement of Such Data, 1995 O.J. (L281) (EC).

to be expressed through a market for standardized forms.

4. Mental Shortcuts Affect the Poor Especially—Less Margin for Error

Of particular concern to any theory of justice that gives special consideration to the welfare of the least well-off is the fact that the poor are more likely to be harmed by both their own imperfect decision making and by marketing efforts of sellers that exploit knowledge of consumer behavioral biases.¹⁶⁵ This is not because the biases of the poor are more inaccurate than anyone else's. It is a result of the fact that suboptimal decisions have much greater consequences for the poor.¹⁶⁶ For example, defaults and channel factors often prevent the poor from participating in the financial mainstream, and instead leave them in the fringe banking sector, paying higher fees for less comprehensive banking services.¹⁶⁷

B. Seller Behavior: Obfuscation, Exploitation, and the Agency Problem

Sellers understand very well the extent of consumers' bounded rationality, although they may not describe it in that way. Billions are spent every year on behavioral research by the marketing industry in order to understand consumer biases and heuristics.¹⁶⁸ Armed with this information, marketers engage in various strategies to increase sales by exploiting consumer search costs, obfuscation, identity group marketing, focusing on salient features, identifying with consumers' subjective goals, and other strategies.¹⁶⁹ Seller obfuscation also exploits framing effects, consumer biases, and creates or exacerbates information problems.¹⁷⁰ The examples discussed below illustrate the

165. See Bertrand, Mullainathan & Shafir, *supra* note 120, at 8. For an example of a theory of justice that focuses on the welfare of the least-advantaged members of society, see JOHN RAWLS, *A THEORY OF JUSTICE* (1971).

166. See Bertrand, Mullainathan & Shafir, *supra* note 120, at 8.

167. See *id.* at 11–13.

168. See Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420, 1429 (1999).

169. See, e.g., Glenn Ellison & Sara Fisher Ellison, *Search, Obfuscation, and Price Elasticities on the Internet* (Nat'l Bureau of Econ. Research, Working Paper No. 10570, 2004), available at <http://www.nber.org/papers/w10570> (examining the ways in which Internet retailers use obfuscation to hinder consumers' attempts to perform simple price comparisons); Korobkin, *supra* note 145, at 1234 (“[N]on-salient attributes are subject to inefficiencies driven by the strategic behavior of sellers attempting to increase their profits at the expense of unknowing buyers.”).

170. See, e.g., Bar-Gill, *supra* note 4, at 1375–77, 1388–95 (describing the

possibilities for such seller exploitation.

Payday loans, for example, are described (falsely) as a short-term credit product, exploiting the consumer's optimism bias that predicts an ability to pay the loan in full at the next payday, and discounts the inevitable recurrence of the cash shortage that prompted the loan.¹⁷¹ "Framing," which consists of altering a consumer's preferences by defining the menu from which choices are made,¹⁷² is also used by payday lenders. Payday lenders compare the extremely high Annual Percentage Rate (APR) of a payday loan to the cost of bank overdraft fees if the payday loan is not used (avoiding a loss) rather than, say, the much cheaper alternative of a cash advance on a credit card.

Similarly, a mortgage product that provides for monthly payments of less than the accrued interest, resulting in negative amortization, is sold as a "payment option ARM" mortgage.¹⁷³ The "option" referred to is the consumer's option to pay a larger monthly payment in order to cover the interest, or an even larger payment that will amortize the loan.¹⁷⁴ Of course, these loans are sold based on the initial, negatively amortizing payment, and often borrowers can only afford the lowest payment choice, so that the "option" for marginal borrowers is illusory.¹⁷⁵ Calling these loans "escalating balance" loans or "your payments will go up rapidly" loans would be another way to frame the choice.

While information asymmetries are understood and incorporated in some traditional neoclassical economic models,¹⁷⁶ a

optimism bias and the ways in which lenders exploit it to convince consumers to enter into credit card agreements that are not beneficial to them); McCoy, *supra* note 4, at 729–35 (explaining ways in which predatory lenders frame situations to manipulate loss-averse consumers).

171. See Iain Ramsay, Professor, Osgoode Hall Law School, York University, Keynote Address at Australian Credit at the Crossroads: Consumer Credit Regulation as "The Third Way"? 6–12 (Nov. 8–9, 2004), available at [http://www.consumer.vic.gov.au/CA256902000FE154/Lookup/CAV_SeminarsConferences_National_Credit_2004_November/\\$file/ramsay.pdf](http://www.consumer.vic.gov.au/CA256902000FE154/Lookup/CAV_SeminarsConferences_National_Credit_2004_November/$file/ramsay.pdf) (discussing the limits to consumer rationality, such as optimism bias, and the ways in which payday and other lenders exploit these limitations).

172. See McCoy, *supra* note 4, at 729–32.

173. See Interagency Guidance on Nontraditional Mortgages, 71 Fed. Reg. 58,609, 58,609, 58,613 (Oct. 4, 2006).

174. See *id.* at 58,609.

175. See *id.* at 58,613–14, 58,616 (warning lenders that offering initial rates that are too low increases the risk of "payment shock," in which consumers who only make minimum payments struggle when those payments increase, and requesting lenders to warn borrowers of such risks).

176. See, e.g., Stiglitz & Weiss, *supra* note 127 (examining the ways in which banks' lack of information regarding the riskiness of borrowers leads to excess

behavioral approach recognizes that consumers' misunderstanding of contract information is not just a function of poor disclosure and literacy. Consumers' understanding of contract terms is also affected by systematic biases, and by seller strategies to create and exploit information asymmetry.¹⁷⁷ The information asymmetry that favors sellers of complex financial products is not a mere accident, to be fixed with either mandates for disclosures to consumers or generalized efforts to enhance the financial literacy of the populace. The deeper asymmetry lies in the gulf between the complexity of modern consumer contracts on the one hand, with their fragmented and contingent pricing schemes, deceptive penalty systems, and one-sided remedies, and, on the other hand, the limited ability of the average American to read and use documents and make difficult computations involving compound interest and the like.¹⁷⁸ Put another way, price and product complexity are effective obfuscation strategies that sellers can use to rationally maximize profits. The information problem is not an accident; it is the result of predictable market behaviors. This aspect of market functioning does not maximize consumer welfare, as conceived by neoclassical economics.

In his thorough discussion, Oren Bar-Gill points out the ways in which the credit card industry has exploited consumer biases and self-control problems in designing price structures (annual fees, default-related fees, and so forth) to prices well above marginal cost.¹⁷⁹ The evidence that rational choice theory is not descriptive of the operation of the real world credit card market is plain and robust, as is the evidence that A) behavioral phenomena described based on experiments in the lab find their expression in real behavior in real consumer markets,¹⁸⁰ and B) credit card issuers are systematically able to exploit consumer biases and behaviors.¹⁸¹

While sellers exploit their superior knowledge of behavioral tendencies of consumers, sellers also have their own behavioral problems. Among these are the differences between the motivation of individual retail sales representatives and brokers

demand in credit markets).

177. See sources cited *supra* note 170.

178. See White & Mansfield, *supra* note 31.

179. Bar-Gill, *supra* note 4, at 1388-95.

180. See, e.g., Bertrand et al., *supra* note 124, at 3 (asserting that their study illustrates consumer behaviors that previously had only been documented in lab experiments in a real market setting).

181. See sources cited *supra* note 170.

on the one hand, and the wholesale sellers or lenders on the other.¹⁸² This is the famous agency problem.¹⁸³ Predatory lending has been attributed, at least in part, to the behavior of brokers and intermediaries, who may cause excessively risky credit products to be sold in order to maximize their compensation, and who may be guided by their own biases in steering consumers.¹⁸⁴ For example, they may assume that members of racial minorities are less concerned with price and more concerned with credit approval and convenience.¹⁸⁵ The agency problem and broker biases mean that the forces on both sides of consumer market transactions can result in consumer harm.

C. *The Magnitude of Bounded Rationality and Seller Exploitation in the Real World: Some Examples*

1. Payday Lending

As a result of the deregulation of interest rates at the state and federal levels, the payday loan, a small short-term advance made at triple-digit interest rates, has mushroomed into a major industry in the past fifteen years.¹⁸⁶ The essence of the payday loan product is a deception. Viewed as a payment of, for example, \$45 in order to borrow \$500 for two weeks, such a loan could be seen as a rational alternative for a consumer in certain limited scenarios (such as an emergency non-recurring expense or adequate projected cash flow in the coming pay periods). The lenders know, however, that 90% of payday loans are made to consumers who are not able to repay in the short-term, and instead are forced to “roll over” their loans for months or even years.¹⁸⁷ After five to seven loan renewals the interest begins to exceed the principal, and it is very difficult to argue that such a transaction has increased a consumer’s welfare, even compared to

182. See Christopher L. Peterson, *Preemption, Agency Cost Theory, and Predatory Lending: Are Federal Regulators Biting Off More than They Can Chew?*, 56 AM. U. L. REV. 515, 544 (2007).

183. See *id.* at 544–45.

184. See *id.*

185. See *id.*

186. See Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 855 (2007); Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 110, 111 (2008).

187. See URIAH KING, LESLIE PARRISH & OZLEM TANIK, CTR. FOR RESPONSIBLE LENDING, FINANCIAL QUICKSAND: PAYDAY LENDING SINKS BORROWERS IN DEBT WITH \$4.2 BILLION IN PREDATORY FEES EVERY YEAR 6 (2006), http://www.responsiblelending.org/pdfs/rr012-Financial_Quicksand-1106.pdf.

onerous alternatives such as paying overdraft or late fees.¹⁸⁸

The consumer who gets a payday loan is making a completely mistaken, but easily understandable, calculation. She assumes that \$15 or \$20 per \$100 is a small price to pay to meet an immediate expense, discounts the possibility that the same cash shortfall will confront her when the loan becomes due, and believes that she has one of the 10% of loans that do not lead to repeated borrowing. This miscalculation results from the overconfidence bias, and perhaps inappropriate discount rates for the time value of money, but is also actively encouraged by seller obfuscation. The payday lenders, even by naming their product, actively seek to encourage the consumer's mistaken idea that the loan is very short-term and low-cost (i.e., it is a loan "just until payday").

The payday loan also exploits consumers' tendency to create separate mental accounts. One payday borrower, when questioned in a deposition as to why she got a payday loan instead of using a credit card or accepting a new credit card offer, responded that a credit card represented a possibility of accumulating long-term debt that she would never repay, whereas the direct deposit repayment system of the payday loan, in her mind at least, precluded runaway debt.¹⁸⁹ She even acknowledged this as a deliberate device to protect herself against her own self-control problems, just as a dieter might place a lock on the refrigerator.¹⁹⁰

Viewed in the aggregate from a policy standpoint, it is true that a portion, perhaps a third, of the individual consumers who interact with a payday lender use the loan as a truly short-term credit product and are not harmed (and perhaps even benefited).¹⁹¹ Evaluating the product on a cost-benefit basis, however, requires balancing this arguable welfare benefit with the clear harm that results from the combination of consumer overconfidence and seller obfuscation and exploitation, leading two-thirds of consumers stuck in a debt trap, adding interest payments to their chronic cash flow deficit.¹⁹² If we were to consider a consumer who is unable to repay a payday loan in a

188. *See id.* at 4.

189. Deposition of L. Davis at 76, *Turner v. Frascella Enterprises Adv.*, No. 06-101 (Bankr. E.D. Pa. 2006).

190. *Id.*

191. *See KING ET AL.*, *supra* note 187, at 14 app. I (demonstrating that 37% of consumers, accounting for about 10% of loans, took out fewer than 5 payday loans in calendar year 2005).

192. *Id.*

reasonable time as a product failure, the payday loan product could be regarded as having a 60% (by number of consumers) or 90% (by number of loans) failure rate. This is an outcome that would not be tolerated in the case of tangible goods causing physical injuries to consumers.

Thus, even within the utilitarian framework of cost-benefit analysis and aggregation of consumer welfare, the case for banning payday loans, or at least restricting them to their purported intent by limiting repeat borrowing, is compelling. Nevertheless, the mythology of consumer autonomy retains its powerful hold, and commentators continue to caution against excessive regulatory intervention in the face of this obvious exploitation and harm.¹⁹³

2. Price Discrimination, the Auto Market and Auto Financing, and the Black Tax

The deregulation of credit terms has been touted as benefiting previously excluded consumers through the wonders of risk-based pricing.¹⁹⁴ Risk-based pricing refers to the charging of interest rates and fees at a higher rate to consumers perceived as presenting a higher risk (and ultimately, cost) of nonpayment to the lender.¹⁹⁵ Usury laws limiting interest rates are said to prevent risk-based pricing and force creditors to simply deny credit to all but the most creditworthy.¹⁹⁶

Whether the lifting of interest rate ceilings has resulted in the efficient assignment of higher rates to riskier consumer borrowers is not at all clear.¹⁹⁷ What is clear, however, is that in the past decade or so, African-American consumers have systematically paid significantly higher interest rates and fees for both mortgage and automobile credit than their White counterparts.¹⁹⁸ It is equally clear that these higher rates and fees

193. See Mann & Hawkins, *supra* note 186, at 855.

194. Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 HOUSING POLY DEBATE 503, 503 (2004), available at [http://www.mi.vt.edu/data/files/hpd%2015\(3\)/hpd%2015\(3\)_article_white.pdf](http://www.mi.vt.edu/data/files/hpd%2015(3)/hpd%2015(3)_article_white.pdf).

195. *Id.* at 504.

196. See Richard Hynes & Eric Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. & ECON. REV. 168, 180–81 (2002).

197. See generally White, *supra* note 194, at 505 (discussing the principles of the efficiency rationale and providing empirical research to assess its effect).

198. See DEBBIE GRUENSTEIN BOCIAN, KEITH S. ERNST & WEI LI, CTR. FOR RESPONSIBLE LENDING, UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES (2006), http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf; Paul S.

are not directly traceable to higher costs of making loans to minority consumers because of credit risk or any other factor.¹⁹⁹

Auto credit price discrimination has been the subject of several successful class actions.²⁰⁰ The evidence in these cases was particularly straightforward and compelling. Auto loans are commonly sold by auto dealers, who act as agents or brokers for the auto finance lenders such as General Motors Acceptance Corporation (GMAC).²⁰¹ The lender determines an interest rate that it will offer to the consumer, based presumably on objective credit criteria, and informs the dealer.²⁰² The dealer then adds a markup to the par interest rate offered by the finance company and receives a payment from the finance company in return.²⁰³ Prior to the recent litigation, the finance companies allowed the dealers complete discretion in determining the markups.²⁰⁴ The experts retained by the plaintiffs in these suits found consistently that the dealer markups were significantly higher for African-American auto buyers than for Whites.²⁰⁵ Given that the credit risk and other factors were fully reflected in the par rate set by the finance company, it is difficult to see any nonracial explanation for the differential in the dealer markups.²⁰⁶

Racial disparities in the price of credit are also apparent in the subprime mortgage market.²⁰⁷ As a result of changes to the Home Mortgage Disclosure Act (HMDA), lenders now report annually the APR for mortgages priced above a certain threshold,

Calem, Jonathan E. Hershaff & Susan M. Wachter, *Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities*, 15 HOUSING POL'Y DEBATE 603 (2004), available at

[http://www.mi.vt.edu/data/files/hpd%2015\(3\)/hpd%2015\(3\)_article_calem.pdf](http://www.mi.vt.edu/data/files/hpd%2015(3)/hpd%2015(3)_article_calem.pdf);

see also Ian Ayres & Peter Siegelman, *Race and Gender Discrimination in Bargaining for a New Car*, 85 AM. ECON. REV. 304, 312-314, 319 (1995) (reporting survey data showing that auto dealers systematically initiate negotiations for the cash price of autos at higher prices for minority shoppers).

199. GRUNSTEIN BOCIAN ET AL., *supra* note 198, at 3.

200. See generally Nat'l Consumer Law Ctr., Examples of NCLC's Litigation, http://www.nclc.org/issues/cocounseling/examples_litigation.shtml#auto (last visited Oct. 3, 2008) (providing examples of auto credit pricing discrimination class action settlement agreements).

201. See Peterson, *supra* note 182, at 531-33.

202. *Id.*

203. *Id.*

204. *Id.*

205. See *Coleman v. Gen. Motors Acceptance Corp.*, 196 F.R.D. 315, 319-20 (M.D. Tenn. 2000), *rev'd in part*, 296 F.3d 443 (6th Cir. 2002).

206. See *id.* at 320-21.

207. See GRUNSTEIN BOCIAN ET AL., *supra* note 198, at 3-4.

along with demographic and loan data.²⁰⁸ These HMDA reports have been studied carefully by various scholars.²⁰⁹ Despite controlling for credit scores, home values, and other objective criteria, the racial disparities in pricing persist, with minority homeowners paying significantly higher interest rates for mortgage loans than their White counterparts.²¹⁰

To the neoclassical economist, race discrimination in pricing in this form makes no sense. If some sellers of credit are charging higher rates and prices to minority consumers than their risks warrant, other sellers should see the profit opportunity in offering lower rates and prices to the victims of race discrimination. Eventually the sellers charging higher prices would be either driven to lower their prices or forced out of the market.²¹¹ The real world data, however, do not conform to this theoretical model.²¹² Instead, they suggest a complex set of behaviors by consumers and sellers that result in troubling inequities in the unregulated market.²¹³

Although the persistence of race-based pricing is well established empirically, the behavioral reasons for it are less well understood. In its analysis of mortgage price data, the Federal Reserve Board's staff points to the fact that controlling for the identity of the seller significantly reduces the observed racial price disparities.²¹⁴ A number of researchers have suggested that the retail channels for the sale of mortgages, especially subprime mortgages, are segmented in ways that segregate minority homeowners into higher-cost loans.²¹⁵ African-American consumers in particular are more likely to obtain mortgage loans via brokers and less well-regulated outlets, while White borrowers

208. *Id.* at 6–9.

209. *See id.* at 8–9.

210. *See id.* at 3–4; *see also* Calem, et al., *supra* note 198, at 605.

211. *Cf.* GARY S. BECKER, *THE ECONOMICS OF DISCRIMINATION*, 39–49 (2d ed. 1971) (demonstrating how employers' subjective tastes generate discrimination in the labor market); Richard A. Posner, *An Economic Analysis of Sex Discrimination Laws*, 56 U. CHI. L. REV. 1311, 1312 (1989) (discussing the economic effects of sex discrimination in the workplace).

212. *See* Robert B. Avery, Kenneth P. Brevoort & Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, 92 FED. RES. BULL. A123, A162 (2006).

213. *See id.*

214. *See id.* at A158–A159.

215. *See* WILLIAM APGAR, AMAL BENDIMERAD & REN S. ESSENE, HARVARD JOINT CTR. FOR HOUS. STUDIES, *MORTGAGE MARKET CHANNELS AND FAIR LENDING: AN ANALYSIS OF HMDA DATA 4* (2007), http://www.jchs.harvard.edu/publications/finance/mm072_mortgage_market_channels.pdf.

are more likely to borrow from regulated depository institutions, such as banks.²¹⁶ These data suggest a market in which some sellers compete on price, while others appeal to the consumer's desire for easy credit approval, use affinity group marketing, and use other behavioral techniques to avoid price competition.²¹⁷ The perception on the part of retail lenders that minority consumers are more anxious about credit approval than price, and that they pose worse credit risks than objective data would suggest, together with the various perceptions minority consumers may have about mainstream lending institutions, combine to produce racially discriminatory pricing both within and among lenders.²¹⁸ This disturbing and persistent presence of race discrimination in credit pricing is another example of an unregulated market being neither efficient nor fair.

3. Prepayment Penalties in Subprime Mortgages

From 1995 to 2005 the subprime mortgage market exploded in the U.S., growing to roughly 20% of new mortgage originations in 2006.²¹⁹ Subprime mortgages are typically priced at interest rates 2% to 6% higher than conventional and Federal Housing Administration residential mortgages.²²⁰ In addition to the higher rates, subprime mortgages are sold with various other complex price terms that distinguish them from conventional mortgages.²²¹ One such price term is the prepayment penalty.²²² Typically, a subprime mortgage will provide that if the consumer pays more than 20% of the principal prior to the maturity date, a penalty equal to 6 months' interest, 4% to 6% at today's rates, is

216. See *id.* at 27; REN S. ESSENE & WILLIAM APGAR, HARVARD JOINT CTR. FOR HOUS. STUDIES, UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS 28 (2007), http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf.

217. See ESSENE & APGAR, *supra* note 216, at 25–31 (citing a variety of mortgage marketing practices designed to appeal to consumer emotions and biases rather than to compete on price and quality); see also UNITED COMPANIES LENDING CORP., ORIGINATOR ORIENTATION MANUAL 36 (1998) (instructing its employees that their customers are “not interest rate sensitive”).

218. See Avery et al., *supra* note 212, at A162.

219. *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures: Before the S. Comm. on Banking, Housing and Urban Affairs*, 105th Congress 5 (2007) (statement of Douglas Duncan, Senior Vice President of Research and Business Development, Mortgage Bankers Ass'n), available at http://mortgagebankers.org/files/News/InternalResource/48292_Testimony.pdf.

220. See White, *supra* note 194, at 517–519.

221. *Id.* at 514–515.

222. *Id.*

assessed.²²³ In 2001, approximately 80% of subprime mortgages were sold with prepayment penalties.²²⁴ In contrast, fewer than 3% of prime, conventional mortgages were sold with prepayment penalties.²²⁵

Rational choice theory would posit that consumers are “choosing” prepayment penalties in the subprime market because they somehow maximize expected utility. The penalty is only paid in the event that the early prepayment occurs. Therefore, if the consumer receives any benefit, such as a lower interest rate or other savings, the penalty is a rational choice for a consumer who reasonably projects that he will not prepay in the penalty period. An economist might propose the following equation:

$$\text{Prepayment Penalty} = 1 \text{ if } \Delta i > P\$ \times \pi(P)$$

In the above equation, Δi is the present value of the interest rate savings offered in return for the penalty, $P\$$ is the present value of the prepayment penalty, and $\pi(P)$ is the probability of incurring the penalty.

Subprime mortgages have in fact experienced frequent prepayments, despite the presence of penalties.²²⁶ Something like 50% of subprime mortgages are prepaid in the first 3 years, and 60% or more of those mortgages feature penalties, so that something like 33% of consumers “choosing” loans with penalties end up paying the penalty.²²⁷ These consumers obviously have made the wrong forecast of their own behavior.

The prevalence of prepayment penalties in the subprime market is more easily explained from the perspective of behavioral economics. Information problems certainly play a role,²²⁸ but improved disclosure will not eliminate the psychological factors

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*

227. See Michael D. Calhoun, President, Ctr. For Responsible Lending, Are Legislative Remedies to Limit Predatory Lending Really Remedies?, Address at the Federal Reserve Community Affairs Research Conference 5 (Mar. 29, 2007) (transcript on file with author), available at <http://www.responsiblelending.org/pdfs/remarks-of-michael-calhoun-crl-03-29-2007.pdf>.

228. See JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM'N, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS, ES-7 (2007), <http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf> (finding that two-thirds of consumers surveyed could not determine from disclosure forms that they were subject to a prepayment penalty, and that better disclosures improve consumer awareness).

that allow sellers to sell products with harmful prepayment penalties to subprime borrowers. Overconfidence bias causes consumers to discount the possibility that they will incur the penalty. Saliency means that consumers will focus on more immediate price features, such as the interest rate and the monthly payment, and pay less attention to the prepayment penalty, which is a contingent and future price component. To the extent that the monthly payment itself serves as the proxy for the loan's total cost, the prepayment penalty does not enter into the consumer's calculation at all.

The incidence of incorrectly chosen prepayment penalties is troubling not only because of the direct cost to subprime borrowers of paying the penalties, but also because of two additional consumer welfare harms. Prepayment penalties significantly increase the risk of foreclosure,²²⁹ and fall disproportionately on African-American and Latino consumers.²³⁰

In each of these examples, the degree to which consumer markets deviate from rational choice theory is substantial. In each case, market outcomes are neither efficient nor equitable. The deregulation of consumer credit markets in the name of efficiency has led to a variety of other harms to consumers, including overindebtedness,²³¹ and resulting harms to debtors' health and well-being.²³² In each case, consumer well-being could have been considerably improved with thoughtful restraints on credit offerings in the marketplace.

III. The Normative Conclusions to be Drawn from the Insights of Behavioral Economics

A. *The Normative Conundrum*

Rational choice theory suffers from twin problems: it does not describe the real world accurately, and the efficiency norm it

229. See ROBERTO QUERCIA ET AL., UNIV. OF N. C. AT CHAPEL HILL, THE IMPACT OF PREDATORY LOAN TERMS ON SUBPRIME FORECLOSURES: THE SPECIAL CASE OF PREPAYMENT PENALTIES AND BALLOON PAYMENTS 1 (2005), <http://www.ccc.unc.edu/documents/foreclosurepaper.pdf>.

230. See DEBBIE GRUENSTEIN BOCIAN & RICHARD ZHEI, CTR. FOR RESPONSIBLE LENDING, BORROWERS IN HIGHER MINORITY AREAS MORE LIKELY TO RECEIVE PREPAYMENT PENALTIES ON SUBPRIME LOANS 1 (2005), http://www.responsiblelending.org/pdfs/rr004-PPP_Minority_Neighborhoods-0105.pdf.

231. Block-Lieb & Janger, *supra* note 4, at 1525.

232. Elizabeth Warren, *The Vanishing Middle Class*, in ENDING POVERTY IN AMERICA: HOW TO RESTORE THE AMERICAN DREAM 38 (2007).

imposes excludes consideration of essential concepts of justice. The shortcomings of rational choice theory as a description of real markets call into question its normative underpinnings. For one thing, the behavioral evidence shows that the values of consumer autonomy and utilitarian welfare maximization do not align neatly.²³³ Because of consumers' biases and mental shortcuts, and their exploitation by sellers, deregulation of markets does not maximize consumer welfare.²³⁴ Forced to choose, many legal economists abandon, or at least compromise, the autonomy norm to continue the pursuit of welfare maximization, redefined, via "soft paternalism."²³⁵ Moreover, efficiency and wealth maximization have well-understood defects as norms, particularly if they are to be the sole normative values in a "monistic" value system.²³⁶ Not the least of these problems is the wealth effect, i.e., the fact that in conventional law and economics, the preferences of the rich count for more than those of the poor.²³⁷ A richer approach to consumer contract law would abandon the monistic value system built around utilitarian wealth maximization. In its place, lawmakers and judges need to acknowledge the inevitable, and necessarily indeterminate, competition among values of autonomy, efficiency, welfare maximization, and equity.

Many of the legal economists who are incorporating behavioral research into their work cling to the normative project

233. See Hanson & Kysar, *supra* note 168, at 1425.

234. See *id.*

235. See sources cited *infra* notes 238, 241.

236. For one of the most cited critiques of monistic theories of value, see ELIZABETH ANDERSON, VALUE IN ETHICS AND ECONOMICS 117–40, 163–67 (1993). David A. Hoffman and Michael P. O'Shea summarize the debate concerning efficiency, wealth maximization, and other versions of marketplace. Hoffman & O'Shea, *supra* note 38, at 347–51; see also Lind, *supra* note 45, at 318 (discussing Kaldor-Hicks efficiency in the context of tort compensation).

237. Because economists use willingness to pay, as revealed through market prices, as a proxy for the well-being of consumers, the leap from maximizing welfare (a plausible goal) to maximizing wealth requires disregarding the fact that in the real world, consumers have widely varying wealth and income and, as a result, ability to express their preferences in the market. See Hynes & Posner, *supra* note 196, at 180–82 (examining the positives and negatives of consumer finance laws). In other words, wealth maximization is a form of utilitarianism in which the preferences of the wealthy count for more in the social welfare function. *Id.* This unequally-weighted utilitarianism has obvious moral shortcomings, in any value system that requires that every individual be treated with equal dignity and respect. *Id.* While some law and economics scholars take the wealth effect seriously and advance some theoretical ideas about offsetting adjustments in making law and policy, these adjustments also require moving away from the autonomy of the free market to an oligarchy of enlightened bureaucrats, who are called upon to make some rather difficult utilitarian calculations. *Id.*

of law and economics, and seek to fix the defects that prevent people from acting as the rational utility maximizers that they “should” be.²³⁸ For example, to solve the situation problems, some propose to extend periods of reflection and rights to rescind, remove the emotional burden of the contracting situation, prevent the consumer from employing abbreviated reasoning and being invested in an unwise decision before evaluating all the information, and force the consumer to, hopefully, stop using so many mental shortcuts and be “rational.”²³⁹ To solve the problem of information overload and complex products and services with many non-salient terms that consumers ignore, some propose that courts should enforce these non-salient terms if they are “efficient,” i.e., if the theoretical rational consumer would, acting as a rational chooser, have negotiated them.²⁴⁰ These solutions are sometimes described as “soft paternalism.”²⁴¹

Most legal economists, when confronted with the behavioral evidence that unregulated markets will not achieve wealth maximization, simply propose achieving maximization by other means, such as having judges or regulatory agencies attempt to mimic the efficient operation of the theoretical market.²⁴² This means, of course, that to pursue utilitarian goals, the autonomy value, previously thought to be so neatly aligned with utility maximization, is set aside.²⁴³ The evidence of real world behavior also makes the utilitarian task much more difficult, as we wrestle

238. Ronald Mann, “Contracting” for Credit, 104 MICH. L. REV. 899, 910 (2006) (“The key question is whether consumers on the ground are making choices with sufficient care and rationality to drive the market to a competitive and optimal set of products and prices.”); see also Oren Bar-Gill & Richard Epstein, *Consumer Contracts: Behavioral Economics vs. Neoclassical Economics* (Law and Economics Research Paper Series, Working Paper 07-17, 2007), available at <http://ssrn.com/abstract=982527> (presenting opposing behavioral and neoclassical views of consumer contract law, but both agreeing that legal rules must be designed to maximize aggregate consumer welfare, implicitly via wealth maximization).

239. See, e.g., Willis, *supra* note 4, at 823–24.

240. See Korobkin, *supra* note 15, at 140.

241. See, e.g., Cass Sunstein, *Libertarian Paternalism is Not an Oxymoron* (Univ. of Chicago, John M. Olin Law & Economics Working Paper No. 185, 2d series, 2003), available at <http://ssrn.com/abstract=405940> (advocating “libertarian paternalism”).

242. See Matthew D. Adler & Eric A. Posner, *Implementing Cost-Benefit Analysis when Preferences are Distorted*, in COST-BENEFIT ANALYSIS: LEGAL, ECONOMIC AND PHILOSOPHICAL PERSPECTIVES (Matthew D. Adler & Eric A. Posner eds., 2001); Hoffman & O’Shea, *supra* note 38, at 338–39.

243. See Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for “Asymmetric Paternalism,”* 151 U. PA. L. REV. 1211, 1223 (2003).

with how to measure consumer well-being, since the consumer's own perception of well-being, as expressed through her market choices, turns out to be an imperfect guide.

The desire to adjust the market processes that consumers face to approximate the rational choice theory ideal leaves unstated what the objective of contract and competition law should be. The unstated normative premise is that law should remain faithful to the Kaldor-Hicks efficiency goal,²⁴⁴ sacrificing to some extent the autonomy goal in the process. The new insights of behavioral economics reveal the difficulty of the project, but more fundamentally, the question arises whether the project is worthwhile in the first place. If rational choice theory does not describe how consumers and markets behave, if real people in real markets are subject to exploitation and harm and do not enter the market with fixed preferences to begin with, if indeed their preferences can be manipulated through framing, channel factors, and other informed seller strategies, and if the law is unable to fully empower or force consumers to behave as economists think they should, should we not reconsider the normative goal of consumer contract law?

While there may be merit to tinkering with consumer decision processes and making them less vulnerable to exploitation by sellers, the law also needs to take account of seller exploitation directly, and to recognize that harmful consumer and seller behavior is determined by far more than just information and bias problems. I do not mean to suggest by this that efficiency should be discarded as a goal of the law. The single-minded pursuit of market efficiency need not be replaced with the single-minded pursuit of other goals, such as consumer autonomy, equity, or the prevention of exploitation. The trap into which orthodox law and economics has fallen is the desire for a single, unifying theory and lodestar by which all legal decisions can be measured. The harmful effects of the single-minded pursuit of wealth maximization via deregulation in real world consumer markets are instructive. There will on many occasions be a dialectical tension between and among various values, including efficiency, autonomy, equity, and procedural justice. The point is to recognize this problem, and be explicit about one's normative goals.

244. See Lind, *supra* note 45, at 318.

B. *Proposals to Fix the Market Failures—To What End?*

To begin with, it is clear from the insights of behavioral economics that efficiency and autonomy are not the same thing and are not obviously served by maximum deregulation.²⁴⁵ A new conception of autonomy would mean offering consumers meaningful, and therefore bounded choices, particularly in the realms of complex financial consumer products like credit and insurance. Consumers will consider only salient product terms, will do so with imperfect information, and will make choices that are heavily influenced both by their own biases and by situational factors created by sellers, including the perceived default or status quo option.²⁴⁶

Contract terms involving risks and contingent events, such as loan repayment, are particularly problematic. No amount of information will necessarily overcome the optimism bias, the saliency problem, and the availability heuristic, that is, consumers' tendency to believe that negative outcomes will not happen to them, or will happen only based on their available knowledge of actual instances where risks have materialized.²⁴⁷ Regulation of product safety has long recognized, at least implicitly, that risks affecting consumers' health and physical safety cannot be left to the free market, because of information and behavioral problems, as well as external costs (i.e., harms to third parties caused by consumers willing to buy dangerous products from sellers).²⁴⁸

A variety of proposals can serve to illustrate how a pluralistic value approach to consumer contract law might work. Risky financial products, like subprime mortgage loans, could reasonably be regulated. Certain excessively risky features could be restricted to particular consumers or situations, or banned altogether. Such limitations would not only maximize welfare, but would also promote genuine rather than spurious consumer autonomy. Elizabeth Warren has suggested creation of a

245. For example, the suggestion that enlightened regulators should prevent consumers from making inefficient choices implies that autonomy must be sacrificed to promote efficiency. See, e.g., Cass Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249, 254 (2006).

246. See generally Sunstein, *supra* note 241, at 1195–99 (discussing the rationality, or lack thereof, of consumers' choices).

247. See discussion *supra* Part II.

248. See Elizabeth Warren, *Unsafe at Any Rate*, 5 DEMOCRACY 8, 9 (2007) (“Consumers can enter the market to buy physical products confident that they won’t be tricked into buying exploding toasters and other unreasonably dangerous products.”).

Financial Services Product Safety Commission, which would regulate the safety of financial products marketed to consumers, particularly credit cards.²⁴⁹ Such a commission could concern itself not only with measuring the welfare benefits and harms of various products, and the channels by which they are sold to consumers, but the equity effects as well, including the impact of credit products on wealth accumulation and distribution.²⁵⁰

Apart from concerns of autonomy, the law also must take account of the exploitation of consumers in general and of the poor and minority groups in particular. The payday lending example offers a compelling instance of seller exploitation of consumer information and behavior problems whose harmful effects fall particularly hard on low-income working people.²⁵¹ The racial disparities in auto and subprime credit pricing also offer persistent and disturbing evidence that the unregulated market further disadvantages the disadvantaged.²⁵²

Prior proposals to rethink consumer law in light of behavioral research tend to fall into four categories. The first category is firmly grounded in rational choice theory. It consists of proposals to attack the information and bias problems by giving consumers better, more useful and timely disclosures.²⁵³ Second are proposals to regulate the contracting situation, for example with periods of reflection.²⁵⁴ Third are proposals to regulate contract terms directly, as in the example of the Financial Services Product Safety Commission idea. These proposals may retain the efficiency goal, while recognizing the unregulated market's ability to achieve it, or they may explicitly or implicitly promote other values.²⁵⁵ Fourth are proposals to allow courts to refuse enforcement of contracts, or modify their terms.²⁵⁶ These proposals also can be based on notions of efficiency, as in the case of Professor Korobkin's suggestion that courts fix non-salient terms to mimic the outcome of an imaginary efficient market.²⁵⁷ But nonenforcement can also be grounded in recognition of the

249. *Id.* at 8.

250. *See id.*

251. *See* Mann & Hawkins, *supra* note 186, at 884; Peterson, *supra* note 182, at 1126.

252. *See* GRUENSTEIN BOCIAN ET AL., *supra* note 198; Ayres & Siegelman, *supra* note 198, at 312–14, 319; Calem et al., *supra* note 198.

253. *See infra* notes 259–260 and accompanying text.

254. *See infra* notes 278–279 and accompanying text.

255. *See infra* notes 281–282 and accompanying text.

256. *See infra* note 283 and accompanying text.

257. *See* Korobkin, *supra* note 15, at 137–42.

competing demands of fairness, autonomy, and efficiency.

Included in the first, information-fixing category, are proposals to simply increase disclosures. One example is Oren Bar-Gill's proposal to debias credit card consumers by disclosing to them the risks of credit overextension.²⁵⁸ He suggests that consumers be informed, presumably in the written disclosure package they already receive, of the risk that the consumer may be underestimating their future borrowing, using statistics of past borrower behavior.²⁵⁹ The consumer could also receive individual notice as their balance increases of the potential long-term consequences.²⁶⁰ While the intention may be laudable, research shows that debiasing is very difficult, and that even when consumers are told about their behavioral biases they may not correct them substantially.²⁶¹ When impulse control is involved, the disclosure may just be consumer abuse, telling them what they already know, but are not able to prevent, as with warning labels on high-calorie foods.²⁶²

Another information fix involves some substantive contract regulation. If consumer choice is rendered less effective or ineffective because of the complexity and multiplicity of product features, then regulation should aim to reduce complexity. For example, mortgage lenders could be forced to simplify their pricing structures, putting all the cost of credit into an interest rate and a single fee.²⁶³ This has been the aim of mortgage reform proposals by the Department of Housing and Urban Development for years.²⁶⁴ A related information fix is to require sellers and lenders to provide readily accessible price information via an information clearinghouse on the internet, or a centralized bidding system.²⁶⁵ None of the information fixes, of course, will overcome the selectivity and saliency problems.

The next category includes proposals which would make regulatory improvements to the contracting situation. Among

258. See Bar-Gill, *supra* note 4, at 1378, 1417–20.

259. See *id.*

260. *Id.* at 1419.

261. See Jolls et al., *supra* note 1, at 1542.

262. See *id.*

263. Willis, *supra* note 4, at 821.

264. *E.g.*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, JOINT REPORT TO THE CONGRESS CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT (1998), <http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf>.

265. Willis, *supra* note 4, at 825.

these are proposals to provide consumers with assistance from an expert.²⁶⁶ For example, mortgage borrowers might be required or strongly encouraged to review proposed transactions with a trusted advisor, such as an attorney or housing counselor.²⁶⁷ An independent advisor could not only overcome some information and bias problems, but could also counteract the psychological manipulations of the broker or seller, such as identity group marketing or selling approval rather than price.²⁶⁸

The neutral counselor idea is being tried as this article is being written. The Illinois legislature has adopted a law requiring homeowners perceived as being vulnerable to predatory lending to have an in-person meeting with a counselor prior to entering into certain mortgage loans.²⁶⁹ Originally the state regulator was required to designate zip codes considered especially vulnerable to predatory lending.²⁷⁰ This requirement raised a hue and cry when the designated zip codes were all primarily African-American neighborhoods in Cook County (Chicago).²⁷¹ New regulations have been proposed that will direct counseling only for homeowners being offered loans with nonstandard features, such as interest-only, stated income or reduced income documentation, an adjustable rate, or a prepayment penalty.²⁷² The opposition by lenders has invoked the rational choice theory language of autonomy in efforts to persuade consumers that it is the legislator, rather than predatory lenders, who are victimizing minority homeowners by imposing paternalistic requirements on their access to credit.²⁷³

266. ESSENE & APGAR, *supra* note 216, at 35–38.

267. *Id.* Another variant proposed is a second opinion hotline, providing contract review by experts via telephone rather than in person. *Id.* at 36–38.

268. *See id.* at 38.

269. *See generally* 765 ILL. COMP. STAT. ANN. 77/70 (West 2008) (delineating the Predatory lending database pilot program). The Illinois legislation has raised tremendous opposition from the real estate and lending industry, as well as community groups, who fear that the delays and costs resulting from mandatory counseling will make mortgage lending and home buying and selling more difficult. *See Course Required for Some Home Hunters*, CHI. SUN-TIMES, Mar. 22, 2007, at 54; *see also* Lisa K. Bates & Shannon Van Zandt, *Illinois' New Approach to Regulating Predatory Lending: Unintended Consequences of Borrower Triggers & Spatial Targeting* (Univ. of Illinois Spatial Policy Analysis Research Consortium, Working Paper No. 2007-02, 2007), available at http://www.ace.uiuc.edu/Reap/SPARC/2007-02_BatesVanzandt.pdf (discussing Illinois' approach to regulating predatory lending).

270. *See Course Required for Some Home Hunters*, *supra* note 269, at 54.

271. *See id.*

272. *See id.*

273. *See id.*; *see also* Amy Merrick, *Borrowing Trouble: Illinois Tries New Tack*

The suitability proposal first put forth by Patricia McCoy and Kathleen Engel²⁷⁴ is intriguing because it addresses the contracting situation (allowing the consumer to rely on the advice of a credit broker to choose appropriate contract terms) and also allows for nonenforcement after the fact, if a court finds a transaction to have been unsuitable.²⁷⁵ The proposal, analogizing from the existing duties imposed on investment brokers, is to require mortgage brokers and sellers to offer only loan transactions that are suitable for the borrower, i.e., that provide an appropriate benefit at an appropriate price with an appropriate level of risk.²⁷⁶ Although the measure of suitability may be a simple utilitarian cost-benefit analysis, it could also take account of consumer biases and misperceptions of the objective benefits and harms of a proposed transaction.²⁷⁷

The law can also alter the contracting situation by removing urgency and requiring reflection by the consumer. These measures address, to some extent, affective load, decisional overload, and premature commitment. In this category are measures to allow the consumer time after contracting to cancel the agreement,²⁷⁸ or to provide mandatory disclosures far in advance of the time for contracting.²⁷⁹

The law can take advantage of the status quo or default option bias, by creating safe or preferred default products and contract terms. This can be done by regulations defining “standard” products in each market. Also in this category is Oren Bar-Gill’s proposal to impose certain price structures on unsolicited credit card offers.²⁸⁰ To the extent that consumers are more likely to sign credit card applications that arrive in the mailbox than they are to seek out the best available card offerings through independent research, this approach regulates the default (or inertia) option and restricts the domain of “choice” to contracts that are actively sought by consumers rather than passively accepted.

Against Predatory Loans, WALL ST. J., Aug. 21, 2007, at A10 (summarizing opposition to the Illinois legislation).

274. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1317–66 (2002).

275. *Id.* at 1337–39.

276. *See id.* at 1343.

277. *See id.* at 1317–66.

278. The Truth in Lending Act imposes a three-day cancellation right in all residential mortgage refinancing transactions. 15 U.S.C. § 1635(a) (2000).

279. Willis, *supra* note 4, at 823–24.

280. Bar-Gill, *supra* note 4, at 1373.

The third approach to consumer protection is to regulate contract terms directly, mandating, limiting, or prohibiting terms including prices. The European Union's directive on unfair contract terms relies on a combination of direct regulation and after-the-fact nonenforcement by courts to protect consumers from terms regarded as abusive.²⁸¹ The FTC's Credit Practices Rule is another example of simply prohibiting terms that cannot be viewed as benefiting consumers in the vast majority of situations.²⁸² In addition to relying on agencies with expertise and the empirical research to evaluate potential restrictions or bans, consumer protection law could rely on negotiated rulemaking, where stakeholders and their representatives (industry and consumer advocates) could develop blacklists of contract terms, or model contracts and pricing structures.

The fourth approach is regulating the outcome of consumer contracts after the fact, typically by judicial decision. This category obviously includes unconscionability and unfair and deceptive practice litigation. It could also include the application of strict liability doctrine to products that endanger consumer's financial well-being as well as those that endanger health and safety, a variant of the Financial Services Product Safety Commission. Consumer contracts can and should be rewritten when shown to have violated antidiscrimination laws, as in the case of the fair lending claims against automobile finance companies.²⁸³

The traditional law and economics response to many of these proposals is that they are paternalistic, and defeat the important norm of consumer autonomy. If the law is to take account of the real evidence that consumers in the unregulated market are exploited and their welfare is often harmed, the full range of these interventions needs to be seriously considered. The precautionary principle that the market is to be preferred to regulation unless the regulation can be shown to a certainty to improve aggregate welfare is simply an expression of the discredited rational choice theory of consumer markets, and of the exclusive pursuit of efficiency without regard for other values.

281. Council Directive 93/13, 1993 O.J. (L 95) 29–34 (EC).

282. 16 C.F.R. § 444.2 (2007).

283. See generally Examples of Nat'l Consumer Law Ctr. Litigation, *supra* note 200 (providing examples of auto credit pricing discrimination class action settlement agreements).

Conclusion

Behavioral science shows us that setting boundaries for the range of seller choices and controlling the situation in which consumers choose makes real choice possible. Consider, for example, a deregulated regime in which information overload, seller obfuscation, a "decision" process where consumers have no real information on contract terms until after they are emotionally committed to a decision, and where the terms offered are so complex that numerous non-salient and clearly harmful terms are regularly included in services purchased. This describes today's high-cost mortgage and credit card markets. Then consider an alternative, regulated marketplace, where products are sufficiently standardized by legal rules to reduce the domain of choices to a manageable number, where terms that no reasonable consumer would "prefer" are excluded *ex ante* by legal rules, and where sellers are prevented in various ways from creating stress and truncated reasoning by manipulating the time and place of the consumer's contractual choice making. Does the second scenario reduce the consumer's autonomy? Is the law's refusal to set boundaries in the first scenario not "paternalistic?" Paternalism is a false bogeyman. Consumer's choices will be framed either by sellers or by legal rules. Allowing consumers the freedom and autonomy to be manipulated and exploited does not promote autonomy.

Equally important is the need to make equity and prevention of exploitation an explicit norm in consumer contract law. Knowing as we now do that exploitation is real, that sellers can successfully and consistently impose harmful terms on consumers, particularly vulnerable consumers, legal intervention need not slavishly justify itself on grounds of repairing the broken market in an endless chase after the chimera of efficiency or an impossible-to-measure maximization of well-being. A new normative paradigm for regulating consumer markets might combine utilitarianism that looks at sufficiency rather than maximization,²⁸⁴ with robust values of autonomy and equity. If banning unfair terms to protect the poor results in a greater dollar loss to affluent consumers than the savings achieved for the poor,

284. In other words, a social welfare analysis that measures the extent to which basic needs of all members of a society are met rather than simply summing up the entire society's consumption. See MAHBUB UL HAQ, REFLECTIONS ON HUMAN DEVELOPMENT 24-66 (1995); Paul Streeten, *Basic Needs: Some Unsettled Questions*, 12 WORLD DEV. 973, 973 (1984).

so be it. So long as lawmakers and judges are explicit and transparent about the norms they are pursuing, there is no reason that in the battle of competing goals, efficiency should always come out the winner.²⁸⁵ While utilitarianism and cost-benefit analysis must continue to inform legal choices, they ought not to dictate them.

285. See Jeremy Waldron, *Criticizing the Economic Analysis of Law*, 99 *YALE L.J.* 1441, 1460 (1990) (reviewing JULES J. COLEMAN, *MARKETS, MORALS, AND THE LAW* (1988)) ("What is unpalatable about [economic analysis of law] is not its concern with efficiency, but its obsession with it to the exclusion of everything else.").

