CONTRACT LAW IN THE WELFARE STATE: A DEFENSE OF THE UNCONSCIONABILITY DOCTRINE, USURY LAWS, AND RELATED LIMITATIONS ON THE FREEDOM TO CONTRACT

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Abstract

Conventional theories of contract law do not satisfactorily account for laws that restrict contractual freedom, such as usury laws, the unconscionability and related doctrines, and certain bankruptcy laws. Arguments that these laws protect consumers against fraud or that they redistribute wealth founder on a variety of well-known shoals. Indeed, economic theories agree that courts should enforce voluntary contracts, and wealth redistribution should occur through the welfare system. This article argues that this view overlooks distortions produced by the welfare system. The provision of welfare in a free market produces perverse incentives to take excessive credit risks, which both drive up the cost of the welfare system and undermine its goal of poverty reduction. The laws against usurious or unconscionable contracts are desirable because they deter this risky, socially costly behavior. The article also investigates evidence for the argument as a descriptive claim.

It is often claimed that legal rules should be used to redistribute wealth. Examples of such rules might include a tort rule that imposed stricter duties on wealthy actors than on poor actors, or a contract rule that allowed poor debtors to escape burdensome contractual obligations to which they had submitted. Though rarely articulated, the rationale ap-

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pears to be that wealth redistribution is a social good, and so legal rules should be used to promote it.

Such reasoning has inspired an influential critique. The critics, who are usually economists, point out that if rules designed to redistribute wealth are inefficient, they by definition reduce the aggregate wealth of society from the level that would prevail under a system of efficient rules. A switch from an inefficient, redistributive rule to an efficient, nonredistributive rule would create a surplus, and this surplus could be distributed to the poor through taxes and transfers—making many people better off than they would be under the redistributive rule without making anyone else worse off. Critics further argue that the welfare system provides a more equitable way to redistribute wealth than legal rules do, because legal rules redistribute wealth only to people who happen to be injured or people in the class of those likely to be injured in a way that can be redressed by courts—a small and arbitrarily selected portion of the needy population. Accordingly, legal rules should be chosen to maximize efficiency, not to redistribute wealth.

In the area of contract law, the efficiency argument concludes that courts should enforce all voluntary contracts that do not produce negative externalities, regardless of their distributive consequences. If a contract is voluntary, then it presumptively improves the well-being of both parties. If the contract produces no negative externalities, it does not injure any third parties. Such contracts thus make some people better off without making anyone else worse off. As to concerns about redistribution, they are more efficiently addressed through taxes and transfers than through legal rules.[1]

[1] This argument has been made numerous times. See, for example, Charles Fried, Contract as Promise 105–7 (1981); Charles J. Goetz & Robert E. Scott, Enforcing Promises: An Examination of the Basis of Contract, 89 Yale L. J. 1261, 1320–21 (1980); Richard A. Epstein, Unconscionability: A Critical Reappraisal, 18 J. Law & Econ. 293 (1975); Alan Schwartz, A Reexamination of Nonsubstantive Unconscionability, 63 Va. L. Rev. 1053, 1062 (1977); Robert Cooter & Thomas Ulen, Law and Economics 273 (1988); Michael J. Trebilcock, The Limits of Freedom of Contract 97–101 (1993); Louis Kaplow & Steven Shavell, Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income, 23 J. Legal Stud. 667, 674–75 (1994); Daniel T. Ostas, Predicting Unconscionability Decisions: An Economic Model and an Empirical Test, 29 Am. Bus. L. J. 535, 543 n.35 (1991). It is part of the general argument that liability rules should not be used to redistribute wealth, an argument that was first formally made in connection with tort law and has since become very common. See Steven Shavell, A Note on Efficiency vs. Distributional Equity in Legal Rulemaking: Should Distributional Equity Matter Given Optimal Income Taxation? 71 Am. Econ. Rev. 414 (1981); A. Mitchell Polinsky, An Introduction to Law and Economics 119–27 (2d ed. 1989); Richard A. Posner, Economic Analysis of Law 103–4, 447–48 (3d ed. 1986); Steven Shavell, Economic Analysis of Accident Law 296 (1987); Robert C. Ellickson, Order without Law 177 (1991). The influence of these arguments on conventional legal scholarship can be seen in, for example, Jean Braucher, Defining Unfairness: Empathy and Economic Analysis at the Federal Trade Commission, 68 B.U. L. Rev. 349, 381–84 (1988).

This argument runs up against a variety of legal rules that do restrict voluntary contracting and do not appear to be designed to counter the kinds of negative externalities that economists generally recognize. Usury laws restrict the rate of interest to which parties may agree. The unconscionability doctrine limits price terms and other contractual provisions. The penalty doctrine interferes with liquidated damages provisions. The nonwaivable right to discharge in bankruptcy prevents debtors from pledging future assets as collateral. And numerous state statutes and federal regulations prevent debtors from pledging other kinds of assets as collateral and from waiving their rights to certain remedies. These rules, which I call "restrictive contract rules," have generally resisted efforts to rationalize them on economic grounds, and they in fact are criticized on the ground that they interfere with wealth-generating transactions and are inefficient means for redistributing wealth.

This article criticizes this critique of the restrictive contract rules, and it rejects the view that all voluntary contracts should be enforced. The article assumes, with the economists, that the state is committed both to a free market and to the amelioration of poverty, but it also claims that these commitments are in tension. The provision of welfare in a free market produces perverse incentives to take credit risks, which both drive up the cost of the welfare system and undermine its goal of poverty reduction. The argument concludes that restrictive contract doctrines are appropriate means for deterring this socially costly behavior.

Section I presents this "minimum welfare theory" in more detail. Section II contrasts the minimum welfare theory—which I present as a normative theory—with other normative approaches to restrictive contract rules. Section III considers evidence that the minimum welfare theory is also valid as a descriptive theory and contrasts it with other descriptive theories of restrictive contract rules.

I. The Minimum Welfare Theory

I assume that the state has two commitments. First, it is committed to maintaining a free market and accordingly enforces property rights and contracts. Second, the state is committed to reducing poverty, or, more formally, to preventing all citizens from falling below a minimum welfare level. The minimum welfare level is a standard of living, not simply a net worth, and comprises the consumption of shelter, food, medical care, and other "basic necessities." The state maintains the minimum welfare level by transferring cash and other benefits to anyone who falls beneath it.

The simultaneous commitment to enforcement of contracts and to maintenance of a minimum welfare level raises two basic problems of concern to us here. First, it raises the problem of "welfare opportunism." Because loss of income or other assets entitles an individual to payment from the state, the magnitude of the loss suffered by an investor as a result of an investment failure is smaller in a welfare regime than it would be in the case of an identical investment outside of a welfare regime. The riskier the investment, the greater is the expected value of the welfare benefits and the greater is the contribution of welfare to the present value of the investment. As a result, inside a welfare regime actors make riskier investments and more often suffer failure than they would outside a welfare regime. This distortion of behavior in the direction of risk taking, and, in particular, credit risk, drives up the cost of welfare.

Second, the simultaneous commitment to a free market and to poverty reduction raises the problem of "welfare circumvention." Some people are willing to endure a lifestyle the state considers below the minimum welfare level because they have idiosyncratic preferences—they have different views as to what count as the "basic necessities." Others are willing to *risk* enduring a lifestyle below the minimum welfare level for the sake of an attractive, but chancy, investment. Because we assume a free market, people in both groups would be able to exchange their right to receive welfare benefits for cash, and the cash for idiosyncratic goods and risky investments. Although the welfare state restricts the alienation of welfare benefits—in effect, by making them illiquid, discouraging their use for idiosyncratic purposes—a person on welfare or with a low income can, in a free market, reliquidate his benefits. By borrowing against income and assets, he can use the loans to make idiosyncratic purchases of goods that are inconsistent with the minimum welfare level and to make investments that place him at risk of falling below that level.

The welfare opportunism and welfare circumvention problems are closely related. Both arise from the commitment to poverty reduction and the provision of welfare, and both result in, among other distortions, excessive risky borrowing. However, welfare opportunism is foremost a threat to the state's fisc: it increases the number of people to whom the state must pay benefits. In contrast, welfare circumvention is foremost a threat to the commitment to a minimum welfare level: it increases the number of people who fall below the minimum welfare level. Together the problems endanger any program of reducing poverty at reasonable cost.

My argument is that a partial violation of the commitment to the free market is the appropriate response to these problems. Because welfare opportunism and welfare circumvention take the form of high-risk credit activity, the state should enact laws that restrict such activity. Restrictive contract doctrines, such as usury laws, perform this function. By allowing debtors to escape from high-interest credit contracts, they force creditors to withdraw such contracts from the market, denying the debtors the opportunity to obtain high-risk credit in the first place.

Having sketched out the argument, let me elaborate on and qualify some of the points.

A. *The Minimum Welfare Level*

Because "poverty" is a standard of living, not a level of utility, the assumption that the state is committed to poverty reduction implies a minimum welfare level of goods and services.[2] People must not only have access to the "basic necessities," such as food and housing. They must also consume them. By contrast, economists often assume that the state has no commitment other than maximization of aggregate utility, and they support welfare only to the extent that they believe that it maximizes utility. Under this assumption, the minimum welfare theory is not valid. I have no interest in defending the minimum welfare assumption on philosophical or political grounds; however, as I discuss in Section III, poverty reduction more plausibly describes the function of historical and modern welfare systems than utility maximization does.[3]

B. *Welfare Opportunism*

It is useful to model the welfare opportunism problem in order to show precisely how restrictive contract doctrines respond to it. At t_0, X has no wealth and must choose between two investments. For the first investment he must borrow from lender Y a sum of money L at interest rate r_S, for the purpose of obtaining at t_1 a return S with a probability of p. If the investment does not yield S, it yields 0. For the second investment X must borrow L at interest rate r_T, for the purpose of obtaining at t_1 a return T with a probability of q. If the investment does not yield T, it yields 0. Further, X must repay L and interest, $(1 + r_S)L$ or $(1 + r_T)L$,

[2] This assumption is obviously a simplification (compare Nicholas Barr, The Economics of the Welfare State (2d ed. 1993)) but adequate for the purpose of the argument. See Jon Elster, Local Justice: How Institutions Allocate Scarce Resources and Necessary Burdens 236–45 (1992) (describing a "commonsense conception of justice" that includes a minimum welfare level). Note that a defaulter would not qualify for welfare if she is able, by declaring bankruptcy, to preserve sufficient assets and human capital to maintain an ineligible income. The analysis in this section applies only to the poor. Bankruptcy law and the nonpoor will be discussed subsequently.

[3] For simplicity I assume that only the state maintains the minimum welfare level, but clearly families, informal mutual aid societies, and charities do as well. However, they are beyond the scope of this article.

at t_1, if the investment succeeds; X cannot and therefore need not make any repayment if the investment fails.

Now, Y sets r_S or r_T at a level sufficient to compensate her for the risk of nonpayment by X and for the opportunity cost of money (r_m). Thus, $p(1 + r_S)L = (1 + r_m)L$, or $q(1 + r_T)L = (1 + r_m)L$. As we assume that the market rate of interest is 0, $r_S = (1 - p)/p$, or $r_T = (1 - q)/q$.

We assume that X and Y face no information costs and that X and Y are neutral with respect to risk. We also assume that investment T is X's privately optimal investment in a nonwelfare regime. Accordingly,

$$qT > pS. \tag{1}$$

Naturally, in the real world it sometimes happens that there is no investment with return T that X could make for which he could borrow money at an affordable rate of interest.

Now, suppose that the transaction occurs in a welfare regime. Then X receives a welfare payment (W) at t_1 only if he has no wealth, that is, if the investment he makes fails. Suppose also that X does not have to use the welfare payment to repay his debt to Y.[4]

Now X's choice reduces to: $p[S - (1 + r_S)L] + (1 - p)W$, and $q[T - (1 + r_T)L] + (1 - q)W$. He will pick the former, if

$$pS > qT - (q - p)W. \tag{2}$$

Thus, X's choice whether to make one investment or the other is influenced by the availability of welfare.

Assuming a continuous range of investment choices, there will always be two investments S and T, such that T would be the optimal investment in the nonwelfare regime, but S is the optimal investment in the welfare regime, and S and T are different investments. Inequality (1) holds, and inequality (2) holds. Because the satisfaction of both inequalities occurs only when $(q - p)W$ exceeds the difference between pS and qT, one may conclude that an investment becomes more socially costly for welfare-related reasons as it becomes riskier relative to alternate investments (high $q - p$) and as welfare payments (W) increase.

For example, suppose that welfare pays \$40 (W) and that X's choice involves an 80 percent (p) chance of converting a \$100 (L) investment into \$180 (S), with a 20 percent ($1 - p$) chance of failure and a 100 percent (q) chance of converting a \$100 (L) investment into \$150 (T). In

[4] This assumption is not essential to the conclusion, and it will be discussed shortly. See note 5 *infra*.

the nonwelfare world X chooses the safe investment: it has an expected return of \$50 (\$150–\$100, where $r_T = 0$), whereas the risky investment has an expected return of \$44 (.8(\$180 − \$125), where $r_S = 0.25$).

However, in the welfare world the return from the risky investment increases to \$52 [.8(\$180 − \$125) + .2(\$40)], whereas the return from the safe investment remains at \$50. The introduction of welfare distorts behavior in the direction of risk taking, because expected welfare benefits increase as risk increases.[5] Note that X would not choose the option of doing nothing. In such a case, where $q = 0$, the expected "return" (the welfare payment) would be \$40.

In order to deter suboptimal risk taking, such as the risky investment in the example, the state must impose a sanction on X or Y or both. To duplicate in the welfare regime the incentives faced in the nonwelfare regime, it is necessary to offset the expected value of receiving welfare, $(q - p)W$, by an equal sum. This sanction, or tax, should be imposed on every credit transaction.

Usury laws might be understood to impose a penalty on transactions where $(q - p)W$ is particularly high.[6] This proposition depends on the premise that $(q - p)W$ is likely to be high when the interest rate charged by the lender is high. Since $r_S = (1 - p)/p$, this is true, holding q and W constant. In the example above, r_S was 25 percent in the welfare world. If the usury ceiling is lower than 25 percent, then Y would refuse to lend the money to X, and X would have to choose the socially preferable investment T instead. Perhaps X could obtain \$100 by borrowing on the black market, but black market interest rates are high, because black market loans are illegal and therefore costly to enforce. A black market interest rate higher than about 27 percent in the example would cause X to choose the safe investment, rather than the risky one.

Consider Figure 1. The curves V_n and V_w represent the value to X of an investment in the nonwelfare and in the welfare regimes, given S, L, and W.[7] Clearly (unless W is large relative to S), V_n and V_w rise as the probability of success increases. The value V_w exceeds V_n for all values

[5] This result holds even if Y can collect X's welfare payments in satisfaction of the debt. If Y had this right, Y would charge a lower interest rate, and the lower interest payments would reduce X's costs by an amount that offsets X's loss of the expected welfare payments. Formally, Y would set r_S such that $p(1 + r_S)L + (1 - p)W = L$, or $r_S = [L - (1 - p)W - pL]/pL$. In the example, $r_S = 0.15$; thus X would obtain .8(180 − 115) = 52.

[6] I consider other possible legal responses to welfare opportunism shortly; see Section ID *infra*.

[7] $V_n = p[S - (1 + r_S)L]$; $V_w = p[S - (1 + r_S)L] + (1 - p)W$. If $r_S = (1 - p)/p$ (as we assume that Y is not entitled to X's welfare payments if X defaults), then $V_n = pS - L$; $V_w = pS - L + (1 - p)W$.

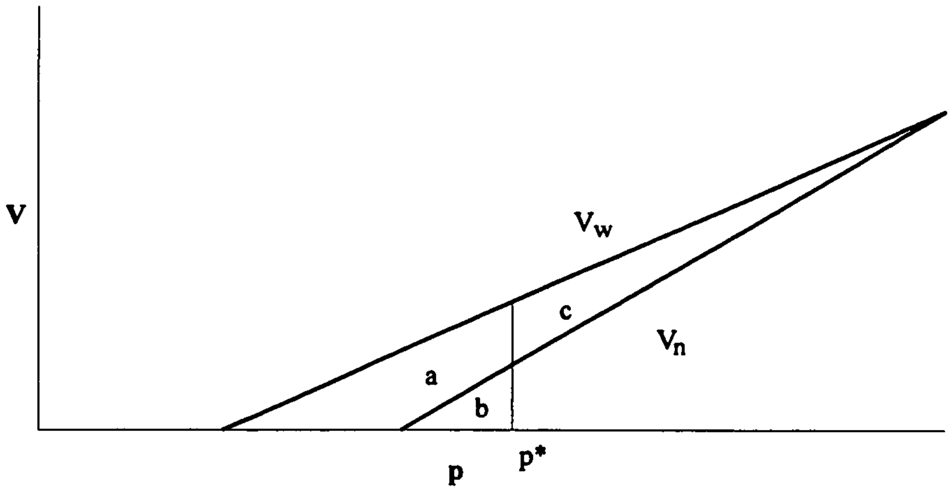

FIGURE 1.—Relative values of investment in welfare and in nonwelfare worlds

of p by $(1 - p)W$. The area between the curves represents the cost of the distortion in the credit market produced by welfare. Figure 1 shows that by sanctioning X and Y in such a way as to reduce V_w by $(1 - p)W$, the state could eliminate the distortion created by the welfare state and duplicate the incentives that would exist in the nonwelfare state.

However, such a sanction would be difficult to administer.[8] Instead, the state could impose an interest-rate ceiling, r^*, where $r^* = (1-p^*)/p^*$, and p^* represents the risk above which the social cost of the investment exceeds its private value to X. The state should set r^* at a point low enough to prevent investments where $V_n < 0$, as these investments are clearly socially costly and would be undertaken only because of the expected welfare benefits. And the state should set r^* somewhat lower in order to deter marginal investments where the losses caused by the distortion in the credit market exceed X's private gain. Under this regime, in which the interest rate ceiling, r^*, would prevent investments at lower than probability p^* in Figure 1, X's incentives would still be distorted by some expected welfare benefits (represented by area c), and X would, in addition, be denied certain private benefits (represented by area b); but his incentives would no longer be distorted by substantial expected welfare benefits (represented by area a).

The roughness with which usury laws thus respond to the distortions in the credit market results from the potential availability of welfare, which, as incorporated into the model, affects every transaction, no mat-

[8] See the discussion of excise taxes in Section ID *infra*.

ter how remote the possibility that the debtor will default and, because of the default, qualify for welfare. A bright-line rule that permits safer and precludes riskier transactions makes a rough cut between low social cost transactions and high social cost transactions, because the riskier transactions produce greater social costs than the safer transactions do.

An objection to the welfare opportunism argument might be that poor people usually use credit to buy goods for consumption, not to make investments. However, because eligibility for most kinds of welfare benefits depends on the value of the applicant's assets as well as on the level of income,[9] in principle a buyer who defaults on a credit obligation and loses all of her furniture under an add-on clause could thereby qualify for welfare benefits. In such a case buyers would be influenced by welfare opportunism. In practice, as we shall see, the level of welfare benefits might not be so sensitive to fluctuations in the value of a person's assets. In this case, the buyer is not influenced by welfare opportunism, but the state's approach creates a new problem, that of welfare circumvention.

C. *Welfare Circumvention*

Suppose the minimum welfare level consists of a private room, a small amount of food per day, clothing, medical care in case of accident, some furniture and appliances, and occasional entertainment. Average person X could purchase these goods and services by spending $600 per month. Suppose that X is employed and earns $600 per month after taxes and that X′ is unemployed and receives welfare benefits worth $600 per month.

Taking the case of X′ first, suppose that the welfare benefits consist entirely of cash payments of $600 per month. The problem from the perspective of a state committed to the minimum welfare level lies in ensuring that X′ uses the money to purchase the basic necessities. Instead X′ might spend his money on drugs or fancy clothes or invest it in long-shot gambles. The state could respond to this danger of idiosyncratic use[10] by making most of the transfers consist of in-kind benefits, such as housing subsidies and food stamps. In the case of X, who might also

[9] See Arthur B. LaFrance, Welfare Law: Structure and Entitlement in a Nutshell 308–17 (1979).

[10] To say that someone is "idiosyncratic" in this context just means that his preferences about how he uses money substantially diverge from the way the state would like him to use the money. An X or X′ who used his monthly $600 to buy the "basic necessities" is not idiosyncratic. The term should be understood broadly, for even a risk-averse person with more mainstream preferences might spend welfare receipts or income on, say, high-risk ventures, in the expectation that wealthy people or private charities will bail him out. See James M. Buchanan, The Samaritan's Dilemma, in Altruism, Morality, and Economic Theory (Edmund S. Phelps ed. 1975).

choose to spend his income idiosyncratically, the state's response is more constrained, but it can nudge X in the right direction by offering to subsidize the basic necessities. Further nudging of X and X′ could consist of taxes and penalties on the attractive "bads," such as drugs and gambling.

A more interesting problem is that X or X′, even after having been nudged away from conventional "bads" such as drugs and gambling, might be willing to use credit in order to increase the quality of goods to be purchased and the return on the investments to be made. Forced to use cash, X′ must buy a cheap television set; but he could buy a fancy one on credit.[11] Forced to use cash, X can invest a few hundred dollars per month in lottery tickets; but by borrowing against his future stream of income, he can invest thousands of dollars up front in a friend's new and untried business. The problem is that the expected source of repayment might dry up: X might lose his job, X′ might be robbed of a month's welfare check. Defaulting on the loan, X or X′ loses all his assets and plunges below the minimum welfare level.

Thus, in its capacity for adding leverage to a person's portfolio, credit poses a threat to the state's ability to enforce the minimum welfare level. Rational and informed but idiosyncratic people who purchase credit, while increasing their utility, also increase the risk of falling below the minimum welfare level. As credit becomes cheaper, more people purchase it, leading to an absolute increase in the number who default and fall below the minimum welfare level. Accordingly, the state has an interest in restricting the availability of credit.

Two further points should be made. First, to the extent that default on credit causes a loss of wealth sufficient to entitle a person to welfare that she is not already receiving, the problem is one of welfare opportunism, not welfare circumvention. But if the debtor is already on welfare (as in the case of X′), or if the loss of assets does not trigger welfare benefits (as would probably be the case if X forfeited all his furniture as a result of default), the welfare opportunism problem is not implicated.

Second, if the state closely monitored people in order to ensure that they stayed above the minimum welfare level and transferred funds to them the moment they fell below it, again we would have a problem of welfare opportunism, not welfare circumvention. But it would seem impractical to engage in such close monitoring and to channel funds to a person the moment she defaults and forfeits her furniture. More important, if the state were so solicitous, the welfare opportunism problem would become unmanageable. People would constantly spend all their

[11] See, for example, Murphy v. McNamara, 416 A.2d 170 (Conn. 1979).

money on high-risk gambles if any resulting losses would immediately entitle them to further benefits.

D. Restrictive Contract Doctrines

As discussed above, the theoretically precise way to discourage welfare opportunism is to raise the cost of every credit contract by an amount equal to the component of the expected value of the contract attributable to expected welfare benefits. Although calculating this sum would be impractical in any given case, it is likely to be large when a loan is risky and the debtor is poor.

The appropriate way to discourage welfare circumvention is to raise the cost of credit in cases where the borrower is likely to use credit to make purchases or investments inconsistent with maintaining the minimum welfare level. The amount by which the cost of credit should be raised cannot be determined with precision even in theory, because the concept of minimum welfare level cannot be given a precise meaning. But one can say that because poor people (whether or not on welfare) are already close to the minimum welfare level, welfare circumvention is more likely to involve the extension of high-risk loans to the poor than to involve the extension of lower-risk loans to the nonpoor.[12]

In these ways the appropriate responses to welfare opportunism and to welfare circumvention converge on the policy of deterring the extension of high-risk credit to the poor. One approach to this policy is simply the nonenforcement of contracts extending high-risk credit to the poor. In practice, bright-line rules might be used, involving perhaps the establishment of an interest rate ceiling (or ceilings), doctrines designed to prevent circumvention of the ceiling through the use of clever contractual terms, and perhaps loopholes for relatively high-risk loans to the nonpoor and to corporations. Section III argues that this regime of restrictive contract doctrines is roughly what one finds in the law.

The advantage of restrictive contract rules is that they are self-enforcing. Nothing forbids debtors to accept high-risk loans, but because the rules allow them to escape their obligations, creditors would refuse to extend such loans. To be sure, restrictive contract doctrines would not deter inveterate risk takers, spendthrifts, addicts, gamblers, and others drawn toward extreme behavior; they work only at the margin—with respect to ordinary people tempted to use credit to splurge on a fancy

[12] The nonpoor who borrow large amounts of money relative to their assets are prevented from engaging in welfare opportunism and welfare circumvention by the bankruptcy laws, which we discuss shortly.

stereo. Nor do restrictive contract doctrines prevent a poor person who cannot buy a fancy television set on credit from using the money to buy drugs or junk food. Criminal laws, social workers, psychologists, and taxes converge on the extremists, but the fact that neither these measures nor restrictive contract rules eliminate all risky behavior and ensure only healthful and proper behavior is not a refutation of my argument. At some point, risk-suppressing measures become too repressive and unpopular to justify—the English workhouse, which I discuss later, springs to mind—and conflicting norms inhibit total implementation of the minimum welfare theory, properly so.

My approach is analogous to the way insurance companies deal with moral hazard. If insurers could costlessly monitor insureds and charge premiums as a function of care, insureds would act with the optimal amount of care. But because of information costs the insurer must use deductibles, benefits ceilings, penalties, and other devices to reduce the insured's incentive to take risks. The minimum welfare level and constraints on taxation generally (but not always) preclude raising "premiums" (that is, taxes) or denying "coverage" (that is, welfare benefits) to people who are unusually likely to become welfare recipients. But the state can create a kind of deductible by raising the cost of credit. Increasing the cost of credit stimulates individuals to increase their capital-asset ratios: their incentive to engage in risk declines, because they will lose their "equity" should the downside of the risk materialize. The same principle underlies the minimum capital requirements established by bank regulatory agencies: these requirements counter the moral hazard produced by the legal and practical limits on charging actuarially correct premiums for federal deposit insurance.

However, restrictive contract doctrines are not the only means for deterring welfare opportunism and circumvention. There are several other possibilities.

Licensing. By way of comparison, one might imagine a system in which all "poor" people would be required to obtain the approval of a state official before signing any kind of credit contract. The official would approve the contract only if, after examining a statement of the applicant's assets and liabilities, she determines that default would not send the applicant below the minimum welfare level. However, this approach would be cumbersome and expensive, liable to abuse, repressive, difficult to enforce, and otherwise unacceptable.

Administrative Penalties. The state could sanction poor people or, more likely, merchants found to have entered high-risk credit contracts. Because it would be necessary to establish guidelines of acceptable behavior and these guidelines would resemble the restrictive contract doctrines, the only difference between this approach and the approach using restrictive contract doctrines is that the state, rather than the debtor, has the right of action. It would make more sense to give both the state and the debtor a right of action, as is often the case with consumer protection laws.

Excise Taxes. An excise tax on credit, it could be argued, would be an efficient means of deterring the reliance on high-risk credit.[13] The problem with this argument is that the minimum welfare theory would require an excise tax only on high-risk credit to the poor and not on other kinds of credit. It would likely be more difficult for the state to administer an excise tax on high-risk credit extended to the poor than for it to rely on restrictive contract rules.[14] As contract defenses, they are self-enforcing.

II. Other Normative Theories

We can sharpen our analysis by comparing the minimum welfare theory to other normative approaches to restrictive contract rules.

Economic libertarianism, the dominant view of economists and legal economists, directs courts to enforce all contracts that are voluntary and that do not produce negative externalities.[15] In this context, a negative externalities might be the above-market prices produced by a cartel or the injuries produced by a criminal conspiracy. These kinds of negative externalities would justify only narrow contractual restrictions. No economic libertarian has suggested, as I have, that welfare opportunism and welfare circumvention constitute negative externalities, justifying broad contractual restrictions on the extension of credit.[16]

Although authentic libertarians who object to poor relief will not be convinced by the minimum welfare theory, most economists and legal academics concede the importance or unavoidability of poor relief. But they argue that the state should provide it through taxes and transfers,

[13] Compare Robert E. Scott, Rethinking the Regulation of Coercive Creditor Remedies, 89 Colum. L. Rev. 730, 772 (1989).

[14] See Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 249 n.66 (1986).

[15] The phrase "economic libertarianism" might sound oxymoronic (compare Amartya Sen, Choice, Welfare and Measurement 285 ff. (1982)), but the views of libertarians interested in protecting autonomy and economists interested in maximizing wealth converge on support for enforcement of ordinary, voluntary commercial contracts and opposition to restrictive contract rules. A discussion can be found in Trebilcock, *supra* note 1.

[16] However, for arguments somewhat similar to the welfare circumvention argument, compare Susan Rose-Ackerman, Inalienability and the Theory of Property Rights, 85 Colum. L. Rev. 931, 959–61 (1985); Daniel A. Farber, Contract Law and Modern Economic Theory, 78 Nw. U. L. Rev. 303, 335–37 (1983); George J. Wallace, The Uses of Usury: Low Rate Ceilings Reexamined, 56 B.U. L. Rev. 451 (1976).

and not by interfering with voluntary contracts, as such interference is less efficient than taxes and transfers and actually transfers wealth from the poor, not to them.[17]

I do not quarrel with the proposition that contract rules should not be used to redistribute wealth. I quarrel with the argument that this claim implies that contract rules should direct courts to enforce all voluntary contracts. The distortions in credit activity caused by the welfare system mean that such a policy would both encourage socially costly transactions and interfere with the welfare system's goal of poverty reduction.

I should add that some economic libertarians say that the unconscionability doctrine and similar rules can be justified in narrow cases as mechanisms for striking down contracts resulting from bargaining abuse that is not easily identified by conventional contract doctrines.[18] As I discuss below, the use of the unconscionability doctrine in this way is not really to use it as a restrictive contract rule and has no bearing on my argument.

Economic liberalism is a useful tag for the argument that restrictive contract doctrines should be used to strike down contracts resulting from unequal bargaining power.[19] The problem with this view is that courts adjudicating a contract dispute between a single seller and a single buyer are in a poor position to evaluate the seller's market position and impose an appropriate remedy. Cases brought on the basis of antitrust doctrines provide a more suitable opportunity for dealing with monopolistic behavior. Moreover, it is not always true that unequal bargaining power produces contracts different from those produced in a competitive market.[20]

Paternalism holds that restrictive contract doctrines are justified for striking down contracts entered by people against their own interests. It is hard to find defenders of such a position in the academic literature,[21] but there is a widespread feeling among contract law scholars that paternalistic attitudes account for some judges' use of the unconscionability doctrine in certain contract cases.[22] Although it might or might not be desirable sometimes to release a debtor from the consequences of his

[17] See note 1 *supra*.

[18] See Epstein, *supra* note 1.

[19] This view has generally been advanced by courts. See James J. White & Robert S. Summers, Uniform Commercial Code § 4-5 (3d ed. 1988); see, for example, Henningsen v. Bloomfield Motors, Inc., 161 A.2d 69 (1960).

[20] See Trebilcock, *supra* note 1, at 97–101.

[21] For discussions, see Duncan Kennedy, Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power, 41 Md. L. Rev. 563 (1982); Anthony T. Kronman, Paternalism and the Law of Contracts, 92 Yale L. J. 763 (1983).

[22] See Arthur Allen Leff, Unconscionability and the Code—the Emperor's New Clause, 115 U. Penn. L. Rev. 485, 556–58 (1967). See also note 25 *infra*.

poor judgment, it is difficult to say that all or even most poor or not so poor people who accept risky credit do so because they have bad judgment. And yet a paternalistic defense of restrictive contract doctrines would have to make such a claim, because restrictive contract doctrines deter all high-risk credit.

The minimum welfare theory is not in itself paternalistic. The welfare opportunism and welfare circumvention problems are merely logical outgrowths of the assumption that the state is committed to the free market and to the minimum welfare level. The theory is indifferent as to the source of the assumption about poor relief, which could be derived from paternalistic motives (people should be protected against themselves), compassion (poor people should be helped), or entirely self-regarding concerns such as fear that poverty produces disorder.

III. Evidence

Although the minimum welfare theory provides a plausible normative defense of restrictive contract doctrines, its merits as a descriptive theory are more complicated.

Few systematic descriptive theories of restrictive contract doctrines exist in the legal literature, but the various normative arguments about restrictive contract doctrines rest on two competing assumptions about why they exist, which we can dress up as theories. Under what might be called the strong descriptive version of economic libertarianism, what I have been calling restrictive contract rules do not interfere with voluntary contracting. Either they do not really exist, but are used, like conventional contract doctrines, to guard against bargaining defects (as is sometimes claimed about the unconscionability doctrine[23]), or they exist but, because of loopholes and the like, do not exert any influence on behavior (as is sometimes claimed about usury laws).

Under the weak descriptive version of economic libertarianism, restrictive contract rules are conceded to exist, but more as atavisms or anoma-

[23] This seems to have been the assumption of earlier commentators; see, for example, M. P. Ellinghaus, In Defense of Unconscionability, 78 Yale L. J. 757 (1969); John A. Spanogle, Jr., Analyzing Unconscionability Problems, 117 U. Penn. L. Rev. 931 (1969). Although in defending the unconscionability doctrine they often would invoke the precedent of usury laws (see, for example, Spanogle, *supra,* at 935), they also would argue that the unconscionability doctrine promoted freedom of contract (see Spanogle, *supra,* at 935–36), and it was thus unclear whether commentators supported the unconscionability doctrine because a reduction in contractual freedom was of minimal concern or because no such reduction would occur. For an argument that the penalty doctrine is not really restrictive but is used to strike down contracts resulting from bargaining abuse, see Samuel A. Rea, Jr., Efficiency Implications of Penalties and Liquidated Damages, 13 J. Legal Stud. 147 (1984).

lies than as rational aspects of the legal system. One might argue that restrictive contract rules are the product of historical inertia or of the pressures of private interests or of error.[24]

Because of space limitations I confine myself to a brief survey of two kinds of evidence: (1) the rules prevailing in modern American law, including evidence about their effect on credit markets; and (2) evidence regarding the historical relationship between poor relief institutions and contract rules.

The question of whether restrictive contract rules exist and have an effect distinguishes the predictions of strong economic libertarianism (no), on the one hand, and weak economic libertarianism and the minimum welfare theory (yes), on the other. The question of whether such rules arose in order to prevent welfare opportunism and circumvention distinguishes the predictions of both forms of economic libertarianism (no) and the minimum welfare theory (yes). To answer the first question, we look at how the rules are used. To answer the second question, we look at evidence about the motives and beliefs of the relevant actors.[25]

A. *The Current Regime*

1. Welfare

The welfare system in the United States is a complicated patchwork of programs, originating at different levels of government—federal, state, and local. The programs often overlap and conflict. Some of them provide benefits to the nonpoor as well as to the poor. Nevertheless, several themes emerge.

First, the welfare programs establish something like a minimum welfare

[24] For interest-group theories about the history of usury laws, see William J. Boyes, In Defense of the Downtrodden: Usury Laws? 39 Pub. Choice 269 (1982) (arguing that conservative states will have strict usury laws because they transfer wealth from the poor to the rich and that liberal states will have weak usury laws); Robert B. Ekelund, Jr., Robert F. Hebert, & Robert D. Tollison, An Economic Model of the Medieval Church: Usury as a Form of Rent Seeking, 5 J. L. Econ. & Org. 307 (1989) (arguing that the Church used usury laws as a device for rent seeking). For an argument that usury laws are relics of a "precommercial morality," see Benjamin Nelson, The Idea of Usury (2d ed. 1969).

[25] For reasons of space I confine discussion of the descriptive analogues to economic liberalism and paternalism to this footnote. Economic liberalism, as a descriptive theory, would predict that restrictive contract doctrines are used to strike down contracts between debtors and cartelized or monopolistic creditors. However, courts never engage in market studies in ordinary debtor-creditor cases, and, although some historical evidence suggests that people often believed that restrictive contract doctrines usefully interfered with monopolistic creditors, there is little evidence that modern creditors have significant market power. Moreover, if courts regulate only nonprice terms, they do not produce an antimonopoly

level. People who lose their jobs and have little savings generally qualify for cash disbursements from the states (known as "general assistance"), including unemployment insurance, and, if they are mothers with children, from the federal government. They may qualify for food stamps, day care, subsidized housing, subsidized utility services, and job training programs; and—in the extreme—they have access to shelters and soup kitchens. The severely disabled qualify for social security benefits; old people, disabled people, mothers on Aid to Families with Dependent Children, and certain other categories of the needy qualify for medical assistance under Medicaid. People otherwise uncovered but who need immediate medical attention benefit from laws which forbid hospital emergency rooms to turn away uninsured patients. The elderly also qualify for social security benefits. And almost everybody benefits from numerous other state and federal insurance schemes, including federal insurance of depository accounts, state insurance against the failure of insurance companies, federal insurance against loss of pensions, and federal disaster relief.[26] Obviously rough and partial, perhaps insufficiently generous (well below, and not to be confused with, the "poverty line")—nonetheless an implicit minimum welfare level emerges from these many programs.

Second, welfare programs typically incorporate restrictions on behavior manifesting welfare opportunism. For example, agencies frequently condition receipt of payments on proof of inability to work, proof of attempts to find work or of prior regular employment (as in the case

effect. See Alan Schwartz & Louis L. Wilde, Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis, 127 U. Penn. L. Rev. 630, 656–58 (1979) (and studies cited therein). Paternalism predicts that judges use restrictive contract doctrines in order to protect the poor against their bad judgment (see notes 21 and 22 *supra* and accompanying text). The vagueness of the concept hinders testability; but, supposing paternalism assumes that all poor people have bad judgment, it implies falsely that judges would interfere with noncredit contracts involving the poor more substantially than they interfere with such contracts generally, unless one believes that the poor are especially ill-equipped to handle credit. Moreover, paternalism regarding the poor does not explain the availability of bankruptcy laws for the nonpoor, unless one extends paternalism to cover even the very wealthy and sophisticated, again only with respect to their credit dealings. These claims may well be true; I expect that they partly explain the motivations of some judges; but they are at any rate less simple and comprehensive than those advanced by the minimum welfare theory.

[26] See the essays collected in Fighting Poverty: What Works and What Doesn't (Sheldon H. Danziger & Daniel H. Weinberg eds. 1986); and in Welfare Reform in America: Perspectives and Prospects (Paul M. Sommers ed. 1982); see also Michael B. Katz, The Undeserving Poor: From the War on Poverty to the War on Welfare (1989); Issues in Insurance 123 ff. (John D. Long ed. 1981); June Axinn & Herman Levin, Social Welfare: A History of the American Response to Need (1975).

of unemployment insurance), or participation in educational programs. Mandatory social security taxes, in theory at least, force people to save who might otherwise spend in anticipation of receiving state-provided retirement benefits. Safety and soundness regulations respond to the incentive to deposit savings in risky banks by inhibiting banks' risk taking. Arguably, the state counters incentives to take physical risks with laws requiring fastened seat belts, motorcycle helmets, and other safety precautions and with laws imposing taxes on cigarettes, alcohol, and other dangerous goods. I do not mean to imply that appropriate steps are always taken in order to counter welfare opportunism. Well-known counterexamples are natural disaster insurance programs, which could but do not force people who build in floodplains to buy private insurance, and Medicaid rules, which could but do not prevent people from qualifying for benefits by transferring assets to family members.[27] Measures taken against welfare opportunism must make concessions to administrative costs and conflicting norms, such as norms against interference with choice.

Third, welfare programs typically recognize the problem of welfare circumvention. Whereas a welfare system designed merely to raise the utility of the poor would consist of cash disbursements,[28] the American welfare system distributes benefits partly in the form of goods and services. Examples include housing and utility subsidies, food stamps, emergency room care, and subsidized clinics. As noted earlier, both the structure of these benefits and restrictive laws—such as laws prohibiting the garnishment of welfare benefits and the sale of food stamps—inhibit conversion of welfare benefits into sums of cash and thus the use of this cash for risky investments or idiosyncratic purchases. Laws prohibiting

[27] See, for example, Katherine Swartz, The Medically Uninsured: Special Focus on Workers 4–5, 9–10 (1989) (evidence indicates that many people decline to buy health insurance because they expect to receive free emergency room services); Louis Kaplow, The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums, 79 Calif. L. Rev. 1485 (1991) (discussing incentive effects of casualty loss and medical expense deductions); Dan R. Anderson & Maurice Weinrobe, Insurance Issues Related to Mortgage Default Risks Associated with Natural Disasters, 53 J. Risk & Ins. 501 (1986) (most persons do not purchase earthquake insurance because they expect to receive government assistance in case of an earthquake); Louis Kaplow, Incentives and Government Relief for Risk, 4 J. Risk & Uncertainty 167 (1991).

[28] Utility-based explanations of in-kind benefits have been offered. One commentator suggests that the state provides in-kind insurance, such as health insurance, because otherwise recipients would decline to buy insurance with cash benefits, even if it would be optimal to do so, in the expectation that wealthy altruists would support them in case of emergency. See Stephen Coate, Altruism, the Samaritan's Dilemma and Government Transfer Policy, Am. Econ. Rev. (in press). Note, however, that by assuming that the altruists find some kinds of deprivation (such as lack of medical care) more intolerable than others, this theory implies that they feel committed to a minimum welfare level of some sort.

or taxing drugs, alcohol, prostitution, and similar highly attractive goods and services discourage the use of cash in a way inconsistent with the minimum welfare level. The purpose of the welfare system is not so much to raise the utility of the poor as to establish a minimum welfare level.[29]

It is important to see how the minimum welfare theory is continuous with so many unremarkable elements of the welfare state. If laws attack the perverse work incentives created by welfare, why should laws not attack the perverse credit incentives created by welfare? If laws discourage the poor from engaging in risky and idiosyncratic behavior, why should laws not discourage them from relying on high-risk credit? Hence the existence of restrictive contract rules.

2. Restrictive Contract Rules

But what are the restrictive contract rules? How do they work? Do they really exist?

Usury Laws. I use the term "usury laws" to refer to the complex hodgepodge of laws that states use to regulate interest rates. States generally set a legal rate of interest as a default rule, a variety of higher civil interest rate ceilings, and a still higher criminal interest rate ceiling. Civil ceilings vary according to the nature of the transaction (money loans, retail installment loans, pledges), the amount of security, the nature of the lender (banks, credit unions, pawnshops, persons), the nature of the borrower (corporations, persons), the size of the loan, and the duration of the loan. The ceilings are often established in different enactments, such as "Small Loan Acts" and "Installment Credit Acts," and are poorly coordinated.[30]

Despite this complexity, it is fair to say that the structure of usury laws manifests a design of deterring the extension of high-risk credit to the poor. The various ceilings are all risk-related: the larger the loan, the longer the loan, the more unrestricted the use of the loan, the less sufficient the security, and the less corporate the borrower, the lower is the applicable ceiling, generally speaking. Indeed, legislatures could reason-

[29] See, for example, Gary Burtless, Public Spending for the Poor: Trends, Prospects, and Economic Limits, in Danziger & Weinberg eds., *supra* note 26, at 24 ("Th[e] allocation of transfers might have occurred because many voters are less concerned about poverty in general than about specific types of deprivation—lack of food, decent housing, and essential medical care"); see also Neil Bruce & Michael Waldman, Transfers in Kind: Why They Can Be Efficient and Nonpaternalistic, 81 Am. Econ. Rev. 1345 (1991). In-kind benefits might also be supported on the paternalistic view that the state knows better what the poor need than the poor do.

[30] See generally Barbara A. Curran, Trends in Consumer Credit Legislation (1965); Practising Law Institute, Usury Laws (1982).

ably believe that the poor take on "too much" credit, as the evidence indicates that lower-income consumers are more heavily indebted than middle- and upper-income consumers and that they fall behind on payments more frequently.[31] Unless one believes that the poor are more risk-preferring than the nonpoor, or that they handle credit incompetently—and for neither proposition is there any evidence[32]—this evidence suggests that the welfare system gives the poor an incentive to take on debt, while having minimal effect on the incentives of the nonpoor.[33] However, the data could simply reflect efforts by the temporarily poor to even out consumption over their lives by borrowing.

Evidence also indicates that usury laws reduce the amount of credit extended to low-income persons by a substantial amount, the amount of credit extended to middle-income persons by a small amount, and the amount of credit extended to wealthy persons by a negligible amount.[34] If income is correlated with credit risk, then these results support the claim that usury laws are an effective means for limiting the extension of high-risk credit to the poor.

If usury laws have the function of restricting high-risk credit, then usury ceilings should fluctuate with (and above) the market rate from place to place and over time. As I discuss in the next section, they generally do.

The evidence that usury laws restrict the small loan market contradicts a recurrent criticism of usury laws, namely, that creditors and debtors can evade them by restructuring loan contracts in a way that conceals the element of credit or the size of the interest rate.[35] The critics have pointed to retail installment plans, leases, penalty bonds, expansive secu-

[31] See National Commission on Consumer Finance, Consumer Credit in the United States 19–20 (1972); Mary E. Ryan & E. Scott Maynes, The Excessively Indebted: Who and Why, 3 J. Consumer Aff. 107 (1969).

[32] See Schwartz, *supra* note 1, at 1079–80 (discussing studies); Jan M. Newton, Economic Rationality of the Poor, 36 Hum. Org. 50 (1977).

[33] The reason that the welfare system would have little effect on the incentives of the nonpoor is that the amount of assets and human capital they can protect in bankruptcy exceeds the income level at which they would qualify for welfare. To be sure, there is a chance that a nonpoor person with substantial human capital would, having defaulted on loans, qualify for welfare; he might choose not to work or might suffer an accident that prevented him from working.

[34] See Daniel J. Villegas, The Impact of Usury Ceilings on Consumer Credit, 56 S. Econ. J. 126 (1989), and studies cited therein; see also Orville C. Walker, Jr. & Richard F. Sauter, Consumer Preferences for Alternative Retail Credit Terms: A Concept Test of the Effects of Consumer Legislation, 11 J. Marketing Res. 70 (1974). See generally Note: Usury Legislation—Its Effects on the Economy and a Proposal for Reform, 33 Vand. L. Rev. 199 (1980).

[35] See, for example, National Commission on Consumer Finance, *supra* note 31, at 101.

rity clauses, and many other contractual devices as examples of such evasion.

The problem with this argument is, first, that these circumventions are often uneconomical for small loan contracts; second, that they involve different levels of risk and so may be less risky than a comparable money loan; and third, that they have all anyway been gradually surrounded by legal restrictions, both judge-made and legislature-made, as their meanings and effects have become clear.

To discuss just one, the retail installment contract emerged in England and the United States in the nineteenth century, following the development of markets in durable consumer goods. Usury laws prevented lenders from making money loans to enable consumers to buy these goods, because the risks would have necessitated interest rates in excess of the usury ceilings. So there developed a practice by which the seller would, in effect, lend the goods to the buyer, who would repay the loan in cash installments. Contemporaries understood that these transactions involved interest rates higher than those permitted by usury laws, and the transactions were challenged in court. But the courts generally upheld retail installment contracts, on the ground that usury laws prohibit excessive interest on money loans, not on loans of goods.[36]

At first glance, this reasoning seems specious. It is hard to see the difference between borrowing money from a bank at 20 percent to buy a sewing machine and borrowing from the seller at 20 percent. However, because the sewing machine, as a durable good, is a form of savings, the obligation to pay for a sewing machine poses less of a risk than the obligation to repay a money loan which is not tied to a sewing machine and which thus may be used to buy something with a less durable value than that of a sewing machine.[37]

When England and American states finally enacted limits on the interest that could be charged on retail installment transactions, these limits were usually higher than those imposed on money loans. These laws and others, such as the protection of purchase money security interests in Article 9 of the Uniform Commercial Code and in federal bankruptcy law, reflect the intuition that allowing people to borrow in order to acquire durable goods is not as socially costly as allowing people to borrow money for any purpose they choose. At the same time, in their insistence

[36] See, for example, Hogg v. Ruffner, 66 U.S. 115 (1861).

[37] Note that courts would apply usury laws to a credit sale if the sale was a "sham." See Foreign Commerce v. Tonn, 789 F.2d 221, 226 (3d Cir. 1986) (James Hunter III, J., dissenting). Presumably, a sham occurs when the borrower does not really use the money to buy the goods, as, for example, when the buyer purports to sell to the creditor goods he already owns and purchase them back on credit.

on meaningful, albeit higher, interest-rate ceilings, decision makers appeared to recognize the risk inherent in using credit even to acquire durable goods.

Unconscionability. Retail installment loans were just one kind of the many contracts which lawyers drafted in order to help their clients evade usury laws. In another popular contract the debtor would pledge a note as collateral for a loan with a legal interest rate, but the face value of the note would exceed the amount of the loan, and the parties would expect that the borrower would default, allowing the creditor to keep the note. Legislatures slowly responded to these and similarly imaginative credit contracts by outlawing or restricting them, but in the meantime, courts were often willing to find them unconscionable. This was most common before the middle of the nineteenth century in England and in the United States, and in the last 30 years in the United States, but occurred at the height of the classical theory of contract as well.[38]

Under current law the unconscionability doctrine uncontroversially condemns contracts resulting from somewhat shady bargaining practices which are nonetheless not a violation of statutory or common law rules of duress or fraud ("procedural unconscionability").[39] The doctrine also relatively uncontroversially condemns contracts involving substantial disparities between the contract price and the market price ("substantive unconscionability").[40] Both uses of the doctrine dovetail with the conventional view that courts should strike down involuntary contracts (as, in the latter case, price disparity is strong evidence of bargaining abuse) and conflict with none of the hypotheses.[41]

However, in a number of controversial cases courts have used the unconscionability doctrine to strike down (apparently) voluntary contracts involving (apparently) no price disparity. These cases have several common elements. First, with one exception the court identifies the buyer/debtor as a welfare recipient or as a poor person. Second, the seller/creditor is a retailer of goods, such as home improvements, furni-

[38] See generally P. S. Atiyah, The Rise and Fall of Freedom of Contract 708–13 (1979). But compare Lawrence M. Friedman, A History of American Law 543 (2d ed. 1985).

[39] See White & Summers, *supra* note 19, at 184–89. The unconscionability doctrine appears in U.C.C. § 2-302 and Restatement (Second) of Contracts § 208.

[40] An example is Vom Lehn v. Astor Art Galleries, Ltd., 380 N.Y.S.2d 532 (1976), where a court struck down as unconscionable a sale of jade and jadelike carvings worth $14,750 for $67,000. The buyers in this case were wealthy and sophisticated (although not about art), and, although high-pressure sales tactics were used, the court refused to find fraud or any other bargaining defect. There is nothing new about this rule; see 3 Pomeroy's Equity Jurisprudence § 927 (5th ed. 1941).

[41] See Epstein, *supra* note 1; Lewis A. Kornhauser, Unconscionability in Standard Forms, 64 Calif. L. Rev. 1151, 1180 (1976).

ture, appliances, books. Third, the dispute arises from the buyer's default on a credit obligation. Fourth, the credit obligation involves a high interest rate or draconian security terms. In all such cases but one, the court struck down the contract.

The cases involved buyers defaulting on a promise to pay $2,569 over 5 years for home improvements worth $959,[42] a buyer defaulting on installment payments for a $515 stereo and forfeiting security (household furniture) for which she had paid $1,800,[43] buyers defaulting on a promise to pay $1,146 in installments for a refrigerator-freezer worth $348 (wholesale),[44] buyers defaulting on a promise to pay $280 over 2 years for educational books worth about $110,[45] and a buyer defaulting on a promise to pay $1,268 over one-and-a-half years for a "twenty-five inch Philco console color television set" retailing at $499.[46] In contrast, a court upheld an installment sale of various household goods (bed, chest, dresser, fan) with an aggregate wholesale cost of $234. The cash price was $595, and the installment price was $832 over 2 years.[47] Assuming that the retail price did not contain a hidden interest rate (that is, cash buyers received discounts), the interest rate was probably under 20 percent, much lower than in the other cases.

The cases support the minimum welfare theory to the extent that the difference between the retail cash price and the credit price in the contracts reflected the risk to the seller and thus represented a high interest rate for high-risk credit. The cases support the strong version of economic libertarianism to the extent that the difference between the cash price and the credit price reflected a disparity between market value and price, presumably resulting from fraud, confusion, incompetence, or some other bargaining defect.

The strong economic libertarian might argue that these were really cases of bargaining abuse, pointing to suggestions in most of the cases that the sellers used moderately shady sales tactics or that the buyers

[42] American Home Improvement, Inc. v. MacIver, 201 A.2d 886 (N.H. 1964).

[43] Williams v. Walker-Thomas Furniture Company, 350 F.2d 445 (D.C. Cir. 1965).

[44] Frostifresh Corporation v. Reynoso, 274 N.Y.S.2d 757 (1966). See also Toker v. Perl, 247 A.2d 701 (N.J. 1968), where buyers found themselves contractually bound to pay for a freezer they did not want. The court struck down the contract on the ground that the installment price ($1,093 over 3 years) greatly exceeded the value of the freezer ($300); see also Toker v. Westerman, 274 A.2d 78 (N.J. 1970) (a similar case, except that the freezer was worth $500 and the installment price was $1,229 over 3 years); Jones v. Star Credit Corp., 298 N.Y.S.2d 264 (1969) (similar).

[45] Kugler v. Romain, 279 A.2d 640 (N.J. 1971).

[46] *Murphy, supra* note 11.

[47] Morris v. Capitol Furniture & Appliance Co., 280 A.2d 775 (D.C. 1971).

were poorly educated and ill-informed. However, the courts refused to find procedural unconscionability, holding or implying that any bargaining defects were not sufficient to support rescission.

The strong economic libertarian might also argue that in most of the cases the courts' disapproval of the contracts could not have resulted from the high interest rates, because most of the courts did not calculate present values and thus could not have determined that the interest rates were high. But this point cuts both ways: not having calculated present values, the courts could have not found price disparities either.

Indeed, the courts' laxness in this respect supports the minimum welfare theory. Because the courts not only failed to determine interest rates but also failed to estimate the magnitude of the credit risks faced by the creditors (or to look for a market price of the credit), they could not have known whether a disparity between the market price of the credit and the contract price existed. However, the differences between the cash prices and the credit prices in the contracts were so large as to admit of only two possibilities: either (1) the debtors overpaid for the credit (or the goods) or (2) they paid a high interest rate for very risky credit. That the courts struck down the contracts without deciding between the alternatives supports the minimum welfare theory, because that theory requires rescission in both cases. In contrast, a court wedded to economic libertarianism would have struck down a contract only under the first alternative and thus would have taken the trouble of ensuring that a price disparity existed before striking down any of the contracts in the cases.

To put it another way, if you believe, as some commentators do,[48] that these courts struck down the contracts in the absence of evidence of bargaining abuse or of price disparity, then the cases unambiguously violate strong libertarianism. In contrast, whatever the courts might have thought they were doing,[49] the outcomes of the cases are consistent with the minimum welfare theory.

An important reservation is that these cases are very rare. The cases I have cited are the only ones I have found to have occurred over the last 30 years, and none is recent. However, as I discuss shortly, recent years have seen a surge in the number of clear statutory and regulatory rules that apply interest rate ceilings and security restrictions to contracts

[48] See Jeffrey E. Allen & Robert J. Staaf, The Nexus between Usury, "Time Price," and Unconscionability in Installment Sales, 14 U.C.C. L. J. 219, 226 (1982); Leff, *supra* note 22, at 556–58.

[49] The majority opinions are uninformative, but one dissenting judge appeared to believe that striking down the credit contracts would increase the cost of credit to the poor. See *Williams, supra* note 43, at 450 (John A. Danaher, J., dissenting).

such as the ones in these cases. These rules may have crowded out the vaguer unconscionability doctrine. At any rate, the cases are frequently cited and doctrinally significant.

Bankruptcy Law. Bankruptcy laws prevent lenders from obtaining repayment from the defaulting debtor's future income and from some of the debtor's general assets. Outside of bankruptcy, if a buyer defaults on her obligation to repay a seller for a few pieces of furniture she bought, the seller would be entitled to obtain a judgment lien through judicial process; and if liquidation of the furniture does not satisfy the debt, the seller can go after other assets. However, if the buyer declares bankruptcy, the seller loses some of these powers.

Federal bankruptcy law allows the debtor to exempt from collection her interest in her residence up to $7,500, her interest in her automobile up to $1,200, $4,000 in household furnishings, $500 in jewelry, and $750 in trade-related property, as well as her right to receive social security, unemployment compensation, veterans' benefits, disability benefits, alimony, and pension benefits.[50] States are permitted to opt out of this scheme and substitute their own exemptions, but those that have permit substantial exemptions similar to those granted by federal law.[51]

Because the creditor knows that in a bankruptcy regime a debtor can avoid forfeiture of some of his assets by declaring bankruptcy, the creditor would charge a higher interest rate in a bankruptcy regime than in a nonbankruptcy regime. The debtor might be willing to waive in advance his right to discharge in bankruptcy in order to obtain the lower interest rate. But the law prohibits such a waiver.

In this way bankruptcy law is analogous to the welfare system: it is social insurance for the nonpoor.[52] Bankruptcy law restricts credit and establishes a minimum welfare level. It establishes a minimum welfare level by giving the debtor the right to exempt assets from liquidation

[50] 11 U.S.C. § 522(d).

[51] See 7 Collier on Bankruptcy (15th ed. 1994). For example, Mississippi exempts $30,000 of equity in the debtor's residence and $10,000 in personal property. Oklahoma exempts 160 acres of rural homestead or 1 acre of urban homestead, $4,000 in personal property, poultry and livestock, one gun, and a year's supply of provisions. Stricter states such as Florida, Alabama, and Illinois exempt $5,000–$10,000 in equity and $1,000–$3,000 in personal property.

[52] By "nonpoor," I mean lower- and middle-income persons, as well as wealthy persons. Bankruptcy laws are used by persons at every income level, but mainly by lower- and middle-income persons. See Teresa A. Sullivan, Elizabeth Warren, & Jay Lawrence Westbrook, As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America 63–77 (1989) (bankrupt debtors have incomes about one-third and assets about two-thirds lower than the incomes and assets of average Americans; more than half of bankrupt debtors have incomes between the federal poverty level and the median family income; 14 percent of bankrupt debtors have incomes above the median family income (1981 figures)).

and forbidding him to waive this right; and this nonwaivable right restricts credit by forcing creditors to raise interest rates in order to protect themselves against default, driving marginal borrowers from the market.[53]

Bankruptcy law relies on the fact that a nonpoor person, unlike a poor person, stays above the minimum welfare level even if she becomes insolvent. After bankruptcy law wipes clear her debts, she still has substantial human capital to supplement the goods she is allowed to keep. In contrast, a poor person who becomes insolvent and declares bankruptcy does not have sufficiently valuable goods or human capital to stay above the minimum welfare level. The state must supply welfare benefits, and this subsidy creates the problems of opportunism and circumvention which must be addressed with restrictive contract doctrines.[54]

Laws against Expansive Creditor Remedies. Further contractual provisions designed to facilitate the extension of high-risk credit include wage garnishment, confession of judgment, and expansive security arrangements. These devices interfere with the defaulting debtor's ability to obtain judicial process by enabling the creditor to obtain a remedy against the debtor without first risking an adverse outcome in a court.

The problem is that a debtor who, in effect, waives his right to judicial process in advance cannot easily raise defenses such as usury and unconscionability in order to void a contract.[55] Because expansive creditor remedies defeat the purpose of restrictive contract doctrines, they must be forbidden.

[53] One might criticize this argument on the ground that the right to discharge in bankruptcy is too broad. It would be sufficient to protect from garnishment the cash value of the welfare disbursements for which the bankrupt would qualify. See Jackson, *supra* note 14, at 230–32. See also Stewart E. Sterk, Restraints on Alienation of Human Capital, 79 Va. L. Rev. 383 (1993) (criticizing debtor/creditor laws for exempting human capital from collection). The bankruptcy law *is* rather crude; and the reason for its crudeness is probably, as Sterk points out, that the homestead exemptions which it incorporates evolved at a time when the goods and human capital constituting the minimum welfare level, such as house, land, farming tools, and farming know-how, were fairly uniform. See also John C. Weistart, The Costs of Bankruptcy, 41 Law & Contemp. Probs. 107, 119–21 (No. 4, 1977).

[54] Jackson argues that the nonwaivability of the right to discharge in bankruptcy is justified by perverse incentives to substitute work for leisure that would exist in a nonbankruptcy regime. See Jackson, *supra* note 14, at 243–48. As I noted before, the minimum welfare theory predicts narrower bankruptcy protection than Jackson predicts and than actually exists, and this might support Jackson's theory. But see Sterk, *supra* note 53. However, the minimum welfare theory goes beyond Jackson's by explaining the existence of other kinds of restrictive contract doctrines.

[55] Scott identifies the opportunism problem but dismisses it on the ground that expansive self-help remedies *mitigate* it, rather than aggravate it. He seems to argue that debtors will be deterred from excessive borrowing by such remedies. See Scott, *supra* note 13, at 772 & n.140. But in fact such remedies encourage consumption of credit, because they allow creditors to reduce interest rates. Creditors would either do so to an extent that benefits

Indeed, many of the expansive creditor remedies are illegal. The unconscionability doctrine, as we have seen, has been used to strike down cross-collateral clauses. More recently, federal regulations and state laws against expansive creditor remedies of all kinds have been enacted.[56] Critics attack such restrictions on the ground that they raise creditors' costs, forcing an increase in interest rates and reducing the availability of credit to the poor.[57] The conventional defense of these restrictions is that consumers are often irrational, easily misled, and likely to underestimate long-term risks.[58] But the minimum welfare theory suggests that they, like the other restrictive contract rules, form a coherent response to the problems arising from the state's commitment to a minimum welfare level.[59]

Summary. I have tried to show how the confusing mass of restrictive contract rules arrange themselves in an orderly fashion around the concept of a minimum welfare level. The way that restrictive contract rules cohere with the welfare system casts doubt on the weak economic libertarian's claim that they are relics of history or the products of special interests. Their prevalence, sophistication, and evident influence on actors' behavior contradict the strong version of economic libertarianism.

B. *History*

The purpose of this section is to provide some historical support for the minimum welfare theory as a descriptive theory. I mainly want to continue pummeling the strong and weak versions of economic libertarianism with evidence of the prevalence and importance of restrictive contract rules and to provide suggestive evidence that these rules could have been and perhaps were motivated, in part, by concerns resembling the minimum welfare theory and not so much (or not exclusively) by concerns about bargaining abuse or by the influence of interest groups.

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the debtor more than the expansive remedies harm him or not insist on the expansive remedies in the first place.

[56] See 16 C.F.R. pt. 444, 49 Fed. Reg. 7,740 ff. (1984).

[57] See Scott, *supra* note 13, at 771 ff.; James R. Barth, Joseph J. Cordes, & Anthony M. J. Yezer, Benefits and Costs of Legal Restrictions on Personal Loan Markets, 29 J. Law & Econ. 357 (1986); Alan Schwartz, The Enforceability of Security Interests in Consumer Goods, 26 J. Law & Econ. 117, 154–60 (1983).

[58] See, for example, William C. Whitford & Harold Laufer, The Impact of Denying Self-Help Repossession of Automobiles: A Case Study of the Wisconsin Consumer Act, 1975 Wis. L. Rev. 607, 616.

[59] Stipulated penalties and forfeitures may be used to circumvent usury laws, especially if the debtor and creditor assume that the debtor will "default" on the nominal terms of the contract. Accordingly, the penalty doctrine and rules against forfeitures may be understood as restrictive contract rules. Compare the conventional economic criticisms of the penalty doctrine in Cooter & Ulen, *supra* note 1, at 293–96.

1. Poor Relief

Poor relief—that is, state-directed transfers of wealth from the haves to the have-nots—is an extremely old practice. In England poor relief as a national policy dates as far back as the sixteenth century, when a surge in the number of the poor overwhelmed the resources of localities, leading to massive and disorderly migrations of poor people throughout the countryside. The Elizabethan government enacted the first in a series of Poor Laws, which generally directed localities to raise funds through taxes (or "rates") and distribute them to the indigent. The level of relief varied from place to place, and from time to time, but the Poor Laws did create a kind of decentralized social insurance scheme. High rates and generous distributions also created considerable incentives not to work, not to save, and to migrate from poorer to wealthier localities.

The state responded with a variety of coercive measures. Tests and punishments were designed to deter the able-bodied from applying for relief. Harsh vagrancy laws were supposed to deter migration. But these measures did not cure the perverse incentives, and 3 centuries of tinkering made things worse than ever. In the nineteenth century the authorities established the workhouse system, which was in some respects an embodiment of the minimum welfare theory. The workhouse provided sufficient food, clothing, and shelter but restricted socializing and family relations, movement, clothing, consumption of alcohol and tobacco, and so on. The purpose was to make the receipt of aid so psychologically devastating and so morally stigmatizing that only the truly needy would request it—thus preventing starvation and homelessness without creating work disincentives. However, the repressiveness of the system came to be seen as intolerable, and it gradually gave way to the familiar social insurance system of the twentieth century.[60]

The history of welfare in the United States followed a similar path. Poor relief commenced as a decentralized, local institution, becoming

[60] See Christopher Hill, Change and Continuity in 17th-Century England 81–102 (1991); 2 C. G. A. Clay, Economic Expansion and Social Change: England, 1500–1700, at 232–33 (1984); John Pound, Poverty and Vagrancy in Tudor England 23–36 (2d ed. 1986); M. A. Crowther, The Workhouse System, 1834–1929, at 14–24 (1981); Atiyah, *supra* note 38, at 525, 623 (contemporaries understood that because poor relief was based on net worth it discouraged saving); E. Lipson, The Age of Mercantilism, vol. 3 in The Economic History of England (2d ed. 1934), at 410 ff.; Karl Polanyi, The Great Transformation (1944); Timothy Besley, Stephen Coate, & Timothy W. Guinnane, Understanding the Workhouse Test: Information and Poor Relief in Nineteenth-Century England (Discussion Paper No. 701, Yale University, Economic Growth Center 1993). For a modern example, see Timothy Besley & Stephen Coate, Workfare versus Welfare: Incentive Arguments for Work Requirements in Poverty-Alleviation Programs, 82 Am. Econ. Rev. 249 (1992) (arguing for and pointing out the historical precedents for screening and deterrence mechanisms in welfare systems).

gradually more centralized as poverty began to be perceived as a problem of the states. Similar fears as in England about work disincentives produced coercive laws requiring tests, conditions, punishments, and migration restrictions. Particularly in the activities of private charities one can see the intimate relationship between relief and discipline.[61] And in the popularity of state homestead exemptions and similar laws—which put a debtor's house, land, tools, farm equipment, and other valuable personal goods beyond the reach of creditors—one can see the appeal of a system that protected individuals against the risk of economic failure without creating disincentives to work or save.[62] Homestead exemptions cost the taxpayer nothing, while preventing borrowers from taking the "undue risks" that made them vulnerable to economic downturns and other misfortunes.[63]

In these and other ways the coerciveness of poor relief and the popularity of homestead exemptions reflected concerns about how the poor used their income (or their poor relief benefits). The problem was that people did not always use their money to buy food and clothes, to pay the rent, and to save against misfortune. They often used their money to buy drink and to gamble and to engage in other mischief, remaining as impoverished as ever and just as likely to commit crimes, join mobs, and burn down the houses of government officials, as they had been before they received any funds.[64] Such worries eventually led to legislation in both countries criminalizing, taxing, and otherwise restricting (as through licenses) such threats to the welfare of the lower classes as drink, gambling, and credit.[65]

We see, then, a historical commitment to poor relief and accompa-

[61] See Michael B. Katz, In the Shadow of the Poorhouse: A Social History of Welfare in America (1986); Walter I. Trattner, From Poor Law to Welfare State: A History of Social Welfare in America (4th ed. 1989). For recent examples of attempts to implement migration restrictions, see Shapiro v. Thompson, 394 U.S. 618 (1968) (striking down a statute that limited welfare benefits to people who met minimum residency requirements); Memorial Hospital v. Maricopa County, 415 U.S. 250 (1974) (striking down a statute that limited free medical care to people who met minimum residency requirements).

[62] See, for example, Paul Goodman, The Emergence of Homestead Exemption in the United States: Accommodation and Resistance to the Market Revolution, 1840–1880, 80 J. Am. Hist. 470 (1993); Peter J. Coleman, Debtors and Creditors in America (1974).

[63] See Charles Warren, Bankruptcy in United States History 95 (1935) (quoting President Buchanan); Goodman, *supra* note 62, at 479.

[64] Atiyah, *supra* note 38; Pound, *supra* note 60; Axinn & Levin, *supra* note 26, at 36–50, 56–62 (quoting 1818 state government document attributing poverty to, among other things, gambling, borrowing, and failure to save).

[65] See Atiyah, *supra* note 38, at 271–72, 560–61 (English authorities subjected drinking to increasingly strict regulation in response to the growing conviction that drinking caused poverty and social disorder).

nying concerns about (1) its creation of work disincentives and (2) its effectiveness at reducing poverty, given people's freedom and inclination to use small incomes or poor relief benefits in "improper" ways. These are, of course, the welfare opportunism and welfare circumvention problems; they were recognized in general terms. Moreover, some evidence suggests that people saw the welfare opportunism and welfare circumvention problems manifesting themselves, among other ways, in excess reliance on credit. Whether restrictive contract laws were actually understood to form a response to these problems is the question to which we now turn.

2. Usury Laws

English law made the charging of any interest a criminal offense until the sixteenth century. The watershed statute of 1571 confined the sanction of criminal punishment to loans at interest rates above 10 percent, while still directing courts not to enforce loans at below 10 percent.[66] This latter rule gradually gave way, and courts were soon enforcing loans at interest rates below the usury ceiling.

The usury ceiling declined over the next 3 centuries, bottoming out at 5 percent in the nineteenth century. This decline probably did not tighten the credit market, as it matched a long-term drop in interest rates, but it obviously did not loosen the market either.[67] To be sure, parties at all times attempted to contract around the usury ceiling, but the courts of equity generally resisted the most obvious attempts at evasion, and the evidence indicates that the usury laws did restrict the small loan market.[68]

In addition to trying to evade usury laws, people tried to get them repealed. Yet even such influential critics as Locke, Bentham, and Blackstone could not convince Parliament to repeal the usury laws.[69] And although their followers finally succeeded in obtaining a repeal of the usury laws in 1854, the courts continued to interfere with high-interest

[66] See Norman Jones, God and the Money Lenders: Usury and Law in Early Modern England 47 ff. (1989); 2 Clay, *supra* note 60, at 232–33; R. H. Tawney, Introduction, in Thomas Wilson, A Discourse upon Usury 165 (R. H. Tawney ed. 1925).

[67] T. S. Ashton, The Industrial Revolution: 1760–1830, at 9 (1948).

[68] See Atiyah, *supra* note 38, at 67, 550; Tawney, *supra* note 66; Hugh H. L. Bellot & R. James Willis, The Law Relating to Unconscionable Bargains with Money-Lenders 35 (1898).

[69] See 4 John Locke, Some Considerations of the Consequences of the Lowering of Interest, and Raising the Value of Money, in the Works of John Locke (1824); 2 William Blackstone, Commentaries on the Laws of England 455–58 (1979); Jeremy Bentham, Defence of Usury (1816). But see Adam Smith, Wealth of Nations 357–59 (1981) (supporting usury laws because they encourage thrift and restrain prodigals and "projectors").

lending, and in 1882 Parliament was already reimposing credit restrictions. Succeeding years saw an increase in the generality and severity of usury and related laws; they soon expressly governed evasive transactions that had once been subject only to the rather vague principles of courts of equity.[70] Thus, during its entire commercial history England's loan market was deregulated for only 28 years.

In the United States, usury ceilings were more volatile than they were in England, but in most states they persisted over the long term. During the colonial era, usury ceilings in Massachusetts, New York, and Pennsylvania varied between 5 percent and 8 percent. In the nineteenth century a few capital-poor states, such as California, had no usury ceilings for substantial periods of time. Most states, however, maintained their usury ceilings throughout the nineteenth century at around 6–10 percent, though penalties for violating them tended to diminish over time, and some states experimented with elimination of the usury ceilings for short periods of time. Between 1900 and the 1930s, most states had usury ceilings ranging around 6–12 percent. By 1965, virtually every state had small loan laws or general usury laws that fixed usury ceilings at between 6 percent and 20 percent.[71] During this entire period—particularly during the nineteenth century—as in England, influential commentators and politicians raised their voices against usury laws, but their attempts to obtain repeal were constantly frustrated.

What caused judges, lawmakers, and other players to resist the arguments of the economists and the economically minded? One clue is that experiments in the nineteenth century with repeal of usury laws in England and some American states were accompanied by a proliferation of loan-sharking and an increase in the number of the poor (if not necessarily a decline in aggregate wealth).[72] Another clue is that popular agitation in favor of usury laws and poor relief would swell when economic down-

[70] Atiyah, *supra* note 38, at 708–13.

[71] See J. B. C. Murray, The History of Usury (1866); James Avery Webb, A Treatise on the Law of Usury (1899); Louis N. Robinson & Rolf Nugent, Regulation of the Small Loan Business (1935); Franklin W. Ryan, Usury and Usury Laws (1924); Curran, *supra* note 30. See also Morton J. Horwitz, The Transformation of American Law, 1780–1860, at 233–34 (1977); Friedman, *supra* note 38, at 544–45; Lawrence M. Friedman, The Usury Laws of Wisconsin: A Study in Legal and Social History, 1963 Wis. L. Rev. 515 (the usury ceiling rose and fell with the business cycle in response to concerns about debtors, who would take on too much debt during the booms and default during the busts).

[72] Atiyah, *supra* note 38, at 551; Friedman, *supra* note 71; Dorothy Johnson Orchard & Geoffrey May, Moneylending in Great Britain 11 (1933). The argument was not always put in this precise manner; usually, commentators spoke of moderating the passions of people under the sway of the moment. But clearly concerns about poverty underlay these arguments. See, for example, Webb, *supra* note 71, at 12–13 (quoting Chancellor Kent).

turns threw large numbers of debtors into default and thrust them from wealth or middle-class comfort or lower-class respectability into poverty. In eighteenth- and nineteenth-century England and nineteenth-century America, many observers understood that defaulters would not have been ruined by an economic bust if they had been discouraged from borrowing in the first place, and some believed that the importance of poverty reduction justified restrictions on borrowing.

This suggests that something like the welfare circumvention theory may have motivated people to support usury laws: people should be forced to forgo "too much" credit in order to prevent them from risking poverty. As to welfare opportunism, it is clear, as I showed earlier, that contemporaries understood the logic behind it. It is not clear, however, that they supported usury laws specifically as a mechanism for deterring the acquisition of credit that was stimulated by the availability of poor relief. Confirmation must await further research.

3. The Problem of Expectant Heirs

An interesting illustration of the welfare circumvention problem and possibly of the welfare opportunism problem is the Chancery's response to the problem of expectant heirs beginning in sixteenth-century England. This problem involved the adult children of the gentry, who felt compelled to maintain a lavish standard of living and would often borrow on their expectancies if their families refused to subsidize their lifestyle. When heirs defaulted, important families lost their future wealth and power to common businessmen. Elizabethans were distressed by the ruin of important families, because they generally regarded these families as a source of stability. Their anxiety surfaced in plays and political debate, in which the prodigal heir losing his expectancy to the usurer was a common theme.[73]

The Chancery responded to this problem by developing equitable doctrines which released heirs from their debts. The chancellors openly grounded their decisions on the premise that allowing heirs to take on debt and to default would undermine the social and political structure of the country: "[It is] the policy of the nation to prevent what was a growing mischief to ancient families, that of seducing an heir apparent from a dependence on his ancestor who probably would have supported him, and, by feeding his extravagancies, tempting him in his father's life-time,

[73] See E. C. Pettet, The Merchant of Venice and the Problem of Usury, 31 Essays and Studies by Members of the English Association 19, 22 (1946); Jones, *supra* note 66, at 45, 172–73; Tawney, *supra* note 66, at 33–36.

to sell the reversion of that estate, which was settled upon him; forasmuch as this tended to the manifest ruin of families.''[74] Lawyers pointed out that the refusal to enforce loans would discourage lenders from extending credit to the people who needed it most. The chancellors understood that the consequence of the doctrine would be an increase in the cost of credit; but ''sales of reversions 'tended to the destruction of heirs sent to town for their education and to the utter ruin of families,' and [the] inability to sell his reversion 'might force an heir to go home and submit to his father or bite on the bridle and indure some hardships, and in the meantime he might grow wiser and be reclaimed.' ''[75] This logic is not that of the economic libertarian. The chancellors evidently would strike down procedurally and substantively fair credit contracts in order to deter potential lenders from extending credit to heirs.

As the cases evolved chancellors put less emphasis on the necessity of maintaining the power of the ruling class and more emphasis on the foolishness, weakness of will, and credulity that one might attribute to the expectant heirs. The transition from the rhetoric of class to the rhetoric of process, however, expanded the applicability of the equitable doctrine. In a 1754 Chancery case, in which the court rescinded a sailor's assignment of his right to receive prize money at a future date, the court reasoned that sailors belong to ''a race of men, loose and unthinking'' and should be considered ''at least in as favourable a light as a young heir.''[76] By appealing more to the vulnerability of the heirs in the later expectant heir cases and less to the interests of ancient families, the Chancery extended the meaning of the equitable doctrine in a way that made it applicable to the elderly and the poor, who seemed as vulnerable to the chill of the market as sailors and expectant heirs.[77]

Although the equitable doctrine was thus somewhat muddled, con-

[74] John P. Dawson, Economic Duress—an Essay in Perspective, 45 Mich. L. Rev. 253, 268 n.37 (1947), quoting Cole v. Gibbons, 3 P. Williams 290, 293 (1734). See also Jones, *supra* note 66, at 69–70.

[75] See Dawson, *supra* note 74, at 270 n.42, quoting Twisleton v. Griffith, 1 P. Williams 310 (1716). For similar arguments by a sixteenth-century commentator, see Wilson, *supra* note 66, at 369 (arguing that credit encourages profligacy and that people should live more moderately). The high level of economic sophistication of commentators on usury in seventeenth-century England is evident in William D. Grammp, The Controversy over Usury in the Seventeenth Century, 10 J. Eur. Econ. Hist. 671 (1981).

[76] Dawson, *supra* note 74, at 273 n.55, quoting How v. Weldon and Edwards, 2 Vesey Senior 516, 518 (1754).

[77] *Id.* at 272–74; Bellot & Willis, *supra* note 68, at 45–55. See also William M. McGovern, Jr., Forfeiture, Inequality of Bargaining Power, and the Availability of Credit: An Historical Perspective, 74 Nw. U. L. Rev. 141 (1979) (discussing history of doctrines restricting creditors' remedies); Atiyah, *supra* note 38, at 147–48, 171–77.

taining as it did concerns both about process and about substance, it influenced American courts in the nineteenth and twentieth centuries.[78] Dawson suggests that American courts insisted on more evidence of procedural abuse than British courts did, but it appears that well into the nineteenth century American courts were striking down high-risk credit contracts in the same way that the British courts of equity did.[79]

The expectant heir problem can be understood as a special case of the welfare circumvention problem, the problem of how to force people to behave "responsibly": to work, save, support their families; not to gamble, speculate, drink. The obvious solution was to encourage the former activities and discourage the latter. As excessive and risky borrowing was part of typically "irresponsible" behavior, restrictive contract rules were a sensible response.

The expectant heir problem is also a possible illustration of the problem of welfare opportunism. Although the state did not have to foot the bill for the extravagances of the expectant heir, the family did. If the chancellors believed that heirs acted extravagantly because the heirs expected their families to rescue them from their debts, and if the chancellors wanted to protect the families from this behavior, then they recognized the problem of welfare opportunism and attempted to solve it, in the manner directed by the minimum welfare theory, by refusing to enforce the loans. As the chancellors and the suffering parents of the prodigals very likely traveled in the same social circles, this conjecture is not far-fetched.

4. The Appropriateness of Usury Laws as Welfare Doctrines

As noted in Section I, usury laws might appear to be crudely overinclusive responses to the problems of welfare opportunism and welfare circumvention. Ceilings on interest rates not only deter the extension of high-risk credit to poor people; they also deter the extension of high-risk credit to rich people (other than heirs), and they might also, in some cases, deter the extension of even relatively low-risk credit to poor people. Could such clumsy tools really have had historical importance?

With respect to the first objection, throughout American, English, and European history, usury laws, though nominally applicable to all lenders and borrowers, always have had a greater impact on the small loan market from which poor people borrow than on the credit relations of busi-

[78] See Dawson, *supra* note 74, at 274; William E. Nelson, Americanization of the Common Law 142 (1975) (discussing nineteenth-century cases in which the Supreme Judicial Court of Massachusetts refused to enforce sales of expected inheritances on the ground that permitting such sales would encourage idleness); Pomeroy, *supra* note 40, § 953.

[79] Dawson, *supra* note 74, at 278–79.

nesses and other sophisticated investors. Even in the Middle Ages and the early modern period, when in many countries all interest charging was prohibited, authorities permitted a variety of circumventions by relatively wealthy businessmen and merchants. For example, in a contract known as a *census,* lenders could extend credit at interest by purchasing the right to a portion of the annual return on a property, and an interest rate could be built into this portion of the return. In a *societas,* a kind of partnership, lenders would advance money and receive in return a share of profits sufficiently large to reflect an interest payment. The bills of exchange used in foreign trade generally reflected in their price structure usurious interest rates.[80] In contrast, the usury laws were enforced most strictly and vigorously with respect to transactions between ordinary people.[81] This practice of mixing bright-line rules and discrete exceptions prevails today.

With respect to the second objection, one should recognize that authorities did not enforce usury laws crudely or thoughtlessly even against the poor. Authorities and observers understood that credit could reduce poverty, so long as the poor did not borrow so much as to put themselves under substantial risk of default. What was needed were charitable organizations which would both advance credit and monitor the debtors' activities in order to ensure that they did not accept too much. Such organizations sprang up in Italy in the fifteenth century and rapidly spread throughout Europe.[82] Their importance for aiding the poor overwhelmed theological reservations about the charging of interest.

5. Summary

The historical evidence provides little support for strong economic libertarianism. The evidence suggests that during various historical periods contemporaries believed that usury laws restricted credit markets and that during these periods the laws did in fact restrict credit markets—or, at least, the markets in small loans.

The historical evidence also provides little support for weak economic libertarianism. Usury laws inflamed too much passion, produced too much debate, played a role in too much legislative activity, to have been

[80] See Tawney, *supra* note 66.

[81] As Tawney says, with reference to England: "Among the peasants and small masters who composed the mass of the population in medieval England, borrowing and lending were common, and it was with reference to their petty transactions, not to the world of high finance, that the traditional attitude toward the money-lender had been crystallized." See R. H. Tawney, Religion and the Rise of Capitalism 39 (1962). See also *id.* at 46–47.

[82] See John T. Noonan, Jr., The Scholastic Analysis of Usury 295 (1957).

merely relics of an earlier era and not to have been intimately tied to contemporary policy. Indeed, they played too important a role to have plausibly been the excreta of interest-group politics. Which interest group should get credit for the usury policies of the medieval Church, early modern England, and Arkansas in the 1970s? Clearly, the relaxation of the prohibition against interest charging starting at the end of the Middle Ages reflected the growing importance of credit in commercializing economies,[83] but the persistence into the modern era of the taboo against high rates of interest on loans to the poor reflected the continuity of social problems from old economy to new.

I do not want to simplify. People have found vindication of their opposition to usury laws in a variety of sources, including Old Testament injunctions against the charging of interest, New Testament exhortations about love and charity, Aristotle's metaphysics of money, the writings of the early Church fathers and the scholastics, agrarian traditions of mutual aid, vague notions of economic exploitation, suspicions about what would now be called monopolistic behavior, paternalistic attitudes about the judgment of the poor, anti-Semitic and xenophobic prejudices, fears about social instability, personal or political gain, and fanciful propositions founded on basic economic error.[84] However, it is doubtful that many of these reasons can account for the fantastic survival of usury laws despite almost incessant controversy over hundreds of years and in many different countries. This survival suggests that they respond to some basic social problem, and, though a more thorough and systematic examination of evidence is wanted, a plausible hypothesis is that this problem has been that of poverty.

IV. Conclusion

The hypothesis of this article is that usury laws, the unconscionability doctrine, and similar laws restricting freedom of contract are best understood as legal mechanisms for restricting the extension of credit to high-risk borrowers, particularly the poor, and that this policy is broadly consistent with the goal of maintaining a welfare system within a free market. I make the normative claim that those who endorse the policy of poverty reduction through the welfare system should support restrictive contract laws. And I make the more tentative descriptive claim that restrictive contract laws in fact serve the function of countering distortions produced

[83] *Id.;* Tawney, *supra* note 81; Tawney, *supra* note 66, at 119; see also Hill, *supra* note 60, at 81–102.

[84] See Tawney, *supra* note 66; Tawney, *supra* note 81; Jones, *supra* note 66.

by the welfare system and have sometimes been roughly understood to serve this purpose.

A collateral purpose of this article has been to show how a coherent and plausible theory of contract law can be salvaged from the dispute between economic and libertarian contract theorists, on the one hand, and their critics, on the other. The economic libertarian theory, despite its defects, does powerfully justify important elements of contract law, such as the doctrinal bias in favor of policing bargaining abuse and against evaluating terms. But, ingenious attempts notwithstanding, the view cannot explain the numerous restrictive contract doctrines.

On the other side, many commentators have insisted on a more complicated view of contract law. It is both true and proper, they argue, that contract rules not only ensure fair bargaining but redistribute wealth,[85] enforce norms of substantive fairness,[86] protect dignity,[87] and promote other social goals.[88] In reflecting so many norms, contract law is continuous with the rest of law; it has no peculiar structure or overriding purpose such as the maximization of wealth or the protection of autonomy; indeed, perhaps it is incoherent.[89]

I want to suggest to the contrary that contract law does have a structure, but not precisely a libertarian one. The tension between the process-based rules that promote contracting and the rules that restrict contracting dissolves, once one sees that the former dominate transactions involving the nonpoor and the latter come into play mostly in transactions involving the poor. In insisting against the critics that contract law has a structure, but against the libertarians that the social welfare scheme affects contract doctrine, the minimum welfare theory exhibits neither the plenitude of the critics' theories nor the parsimony of the libertarians'. But it provides a more coherent account than either of the role of contract law in the welfare state.

[85] On this possibility, see Kennedy, *supra* note 21; Anthony T. Kronman, Contract Law and Distributive Justice, 89 Yale L. J. 472 (1980).

[86] See James Gordley, Equality in Exchange, 69 Calif. L. Rev. 1587 (1981).

[87] See, for example, Rose-Ackerman, *supra* note 16; Kronman, *supra* note 21.

[88] See, for example, Ian R. Macneil, Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law, 72 Nw. U. L. Rev. 854 (1978).

[89] Compare Duncan Kennedy, Form and Substance in Private Law Adjudication, 89 Harv. L. Rev. 1685 (1976); Roberto Mangabeira Unger, The Critical Legal Studies Movement 60–80 (1986).