Bounded Rationality: A Double-edged Sword in Regulating Standard Form Contracts

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I. Introduction

Behavioral law and economics has grown up rapidly in the legal scholarship for the past twenty years.[1] In contrast to traditional economic analysis of law that generally assumes full rationality of individuals, behavioral law and economics, based on abundant empirical (experimental) evidences of cognitive phycology,[2] explicitly recognizes that humans are only boundedly rational and often make decisions relying more on heuristics than on rigid computation of expected utilities. Arguably, the behavioral approach provides more reliable basis of both positive (i.e., predicting how people would behave under alternative legal systems) and normative (i.e., discussing what sort of law would improve social welfare) analyses of law than the traditional approach.

The law regulating standard form contracts in consumer transactions[3] is among the fields of law in which the behavioral approach seems most promising. It is plausible to presume that many consumers, suffering from bounded rationality, do not read form contract clauses or, even when they read them, can barely estimate what costs and benefits those clauses will have,

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[1] *See generally* Christine Jolls et al., A Behavioral Approach to Law and Economics, 50 STAN. L. REV. 1471(1998); Russell Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051 (2000). These two articles are among the most cited law journal articles since 1995. *See* Russel Korobkin, *What Comes after Victory for Behavioral Law and Economics*, 2011 U. ILL. L. REV. 1653, 1654-55 (2011).

[2] For a comprehensive and highly readable introduction of psychological studies of human behaviors by one of the pioneering scholars of this field, *see* DANIEL KAHNEMAN, THINKING, FAST & SLOW (2011).

[3] Although standard form contracts are widely used in commercial transactions among firms too, I focus on standard form contracts used in consumer transactions. Arguably, the latter type of transactions are more prone to problems caused by bounded rationality and have a larger need for the legal intervention than the former ones.

and make decisions of purchasing goods or services from firms without taking due consideration to those clauses. In his influential article, Russel Korobkin argues that such behaviors of consumers would lead to inefficient standard form contracts, and judicial intervention to them (in particular, invalidating form contract clauses that are proven to be inefficient) would potentially improve efficiency as well as consumers' interests.[4]

In this presentation, I also take a behavioral approach, but from a different perspective from Korobkin's. I try to analyze how the law concerning standard form contracts *is* (rather than should be) developed. It is natural to presume that, like any other individuals, *lawyers*, who are in charge of developing the law as government officials or judges, and *legal scholars,* who advocate for and sometimes participate in the process of the legal reform, also suffer from bounded rationality and make heuristic-oriented decision-making. Therefore, the mechanism of legal development caused (at least in part) by the behaviors of lawyers and legal scholars can be explained using the framework of behavioral economics.

In particular, I try to apply prospect theory[5] to analyze the development of the Japanese law regulating standard form contracts in consumer transactions. The prospect theory predicts that humans' decision-makings are very much influenced by the change from the *reference points*. In short, they dislike the change for worse from the reference points much more than they like change for better from the reference points ("loss aversion"). I argue that, through the legal education they have received, lawyers and legal scholars have a natural tendency to regard *default rules* as reference points. Thus, when they see the firms use standard form contracts limiting the rights of consumers provided by default rules, in order to make profits, they tend to evaluate those firms' conducts as unfair. Such tendency of lawyers and legal scholars will eventually lead to the legal system which basically determines whether to invalidate any form contract clauses by the degree of divergence

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[4] Russel Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi L. Rev. 1203 (2003). Korobkin's analysis, as well as various other economic analyses in the United States on regulation of consumer contracts has recently been introduced in Japan by YASUHITO NISHIUCHI, SHOHISHA KEIYAKU HO NO KEIZAI BUNSEKI [Economic Analysis of Consumer Contract] (2016).

[5] *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979).

of these clauses from relevant default rules. I also discuss how the legal system developed in such a way might fail to improve, or sometimes even worsen, consumers' interests as well as social welfare.[6]

The rest of this article is organized as follows. Part II explains the notion of rationality and standard form contracts that will be made if both parties (firms and consumers) are fully rational. Part III reviews existent literature discussing how inefficient standard form contracts may be made if parties (especially consumers) are boundedly rational and regulating standard form contracts may improve efficiency as well as consumers' interests. Then Part IV discusses on my own hypothesis that boundedly rational regulators and legal scholars regard default rules as reference points, and tries to explain the law regulating standard form contracts in consumer transactions and legal scholarship in Japan with that hypothesis. Part V concludes the analysis.

II. Standard Form Contracts under the Assumption of Rationality

Before examining the case when parties (especially consumers) of standard form contracts are boundedly rational, I first explain the notion of rationality and show what kind of standard form contracts will be made if both parties (firms and consumers) are fully rational. Although this scenario may appear unrealistic, it serves as a good benchmark with which the case when consumers are boundedly rational will be compared.

A. Notion of Rationality

In the standard economic modeling, rational actors make a decision that will maximize their expected utilities.[7] More concretely, when rational actors choose their action from multiple alternatives, they predict an outcome resulting from choosing each alternative and attach a utility to each outcome.

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[6] The possibility that default rules work as default rules has already been recognized by literatures. *See, e.g.,* Russel B. Korobkin, The Status Quo Bias and Contract Default Rules, 83 CORNELL. L. REV. 608 (1998). Existing literatures, however, are mainly interested whether default rules work as reference points for *contracting parties*. In contrast, this article discusses on the possibility that default rules work as reference points for *regulators*.

[7] *See* Korobkin, supra note 4, at 1218.

If there are more than one (say, N) possible outcomes (O_1, O_2, …, O_N) and it is uncertain which outcome will result from one alternative, then the rational actors predict a probability each of possible outcomes will happen (p_1 for O_1, p_2 for O_2,…, p_N for O_N, where $p_1 + p_{2 + \cdots +} p_N = 1$), and attach a utility to each possible outcome ($U(O_1)$, $U(O_2)$ …, $U(O_N)$). Then they compute an expected utility from the alternative by weigh-averaging these utilities with probabilities:

$$\text{Expected utility from one alternative} = p_1 \times U(O_1) + p_2 \times U(O_2) + \cdots + p_N \times U(O_N).$$

Rational actors compute an expected utility coming from each alternative, and choose the alternative that will produce the largest expected utility.[8]

In modeling decision-making of rational actors, standard economic theory does not set any limit on the actors' cognitive abilities. In other words, it is (implicitly) assumed rational actors have unlimited abilities to compute expected utilities. For example, when a rational consumer chooses to buy some goods from one of different sellers, he or she compares all the attributes of the goods, including prices and other contract terms, and chooses the one that will maximize his or her expected utility.[9]

B. Standard Form Contracts Made by Rational Parties

If we assume that both parties (firms and consumers) of standard form contracts are fully rational, it is easy to see these contracts generally become efficient and improve the interests of both parties.

This point can be illustrated by a simple example.[10] Suppose one seller (Firm) is going to supply some good to a consumer (Consumer) and

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[8] *See* Korobkin & Ulen, supra note 1, at 1062-63.

[9] *See* Korobkin, supra note 4, at 1219.

[10] The analysis in this section is based on Korobkin, supra note 4, at 1209-11. For a more thorough analysis, see Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361 (1991). Also, the analysis in this section is just one application of a theory predicting that contracts made by rational parties will be mutually beneficial. *See* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 293 (2004).

considering which clause it should offer in a standard form contract. One alternative is Liability Clause, in which Firm promises to compensate Consumer for damages if the good causes an accident. The other alternative is Exemption Clause, which exempts Firm from any liability to Consumer.

Liability Clause has its benefits and costs compared with Exemption Clause. Benefits of Liability Clause include preventing an accident by giving Firm an incentive to take precaution, and insuring Consumer against the risk of suffering damages from the accident (as long as Consumer is risk averse and for some reason it is difficult or costly for Consumer to buy insurance him/herself). Costs of Liability Clause, on the other hand, include costs of precaution of Firm induced by the clause and various administrative costs to enforce liability. If Firm and Consumer are both fully rational and can accurately estimate benefits and costs of alternative clauses, they will agree on whichever clause more efficient than the other in order to maximize their own expected utilities. Let me illustrate this point by two cases.

Case1:

Suppose first that Liability Clause gives Consumer benefits worth \$15 and costs \$10 for Firm, compared with Exemption Clause. In other words, Liability Clause is more efficient than Exemption Clause. In this case, Firm will offer Liability Clause and Consumer accepts it.[11] Too see this, suppose that, if Firm offered Exemption Clause, it would offer price \$X.[12] Then Firm will be better off if it offers (a) Liability Clause instead of Exemption Clause and (b) the price that is higher than \$X by the range from \$10 to \$15.[13] Firm will be better off because the price increase (\$10-\$15) will more than compensate the cost increase (\$10). Consumer will also be better off to accept Firm's offer because Liability Clause will give Consumer benefits (\$15) more than the price increase (\$10-15).

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[11] Provided that Consumer evaluates the good higher than the price Firm offers. If not, Consumer will not purchase the good no matter which clause Firm offers. The same is true in Case 2 below.

[12] The specific amount of X is determined by such factors as shapes of supply and demands curves and the market condition (i.e. whether Firm faces the competition or enjoys monopoly) of the goods, which are not specified in this example.

[13] The specific amount of price increase under Liability Clause compared with Exemption Clause is also determined by the market condition. If Firm faces the perfect competition, it will increase the price by \$10, just to compensate the cost increase under Liability Clause. Alternatively, if Firm enjoys monopoly, it will increase the price by \$15 in order to exploit all the benefits of Liability Clause.

Case 2:

Suppose next that Liability Clause gives Consumer benefits worth only $10 and costs $15 for Firm, compared with Exemption Clause. That is, Liability Clause is less efficient than Exemption Clause.[14] In this case, Firm will offer Exemption Clause at the price $X and Consumer will accept it, and both parties will be better off than when Firm offers Liability Clause. If Firm offered Liability Clause instead of Exemption Clause, it would have to increase price by at least $15 to compensate the cost increase, and Consumer would not like such an offer because he or she evaluates Liability Clause only $10, which is less than the price increase.

C. Regulating Standard Form Contracts Will Be No Use

The point of the example in the last section can be generalized. As long as both parties are rational and can accurately estimate costs and benefits of alternative clauses, parties agree on the most efficient clause, that is, the clause producing the largest amount of benefits minus costs, no matter which party enjoys the benefits or bears the costs. If one party bears the costs more than it enjoys benefits, then the party can be compensated by price adjustment (increase or decrease of price, depending on whether the party is a firm or a consumer). Regulating standard form contracts, especially invalidating some "bad" contract clauses in order to "protect" consumers' interests, will be no good in such a situation. If such a regulation invalids a clause (e.g., Exemption Clause in our example) when the clause is inefficient (like in Case 1), the regulation makes no change, since parties do not agree on the clause any way. If, on the other hand, such a regulation invalids a clause when the clause is efficient (like in Case 2), it forces parties to be bound by an inefficient clause (Liability Clause). Such a result is not only inefficient (decreases social welfare) but also is inconsistent with consumers' interests.

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[14] This can happen when (1) administrative costs to enforce liability is high, (2) benefits of giving Firm incentives to take precaution is small (probably because consideration of reputation has already given Firm pretty much incentives to take precaution) and/ or (3) benefits of insuring Consumer against the risk of the damages is small (probably because damage insurances against the kind of the risk the good will cause are easily available to consumers).

III. Standard Form Contracts under the Assumption of Bounded Rationality

As is discussed in the last Part, it is difficult to justify regulations of standard form contracts (especially regulations invalidating form contract clauses apparently disadvantageous to consumers) if parties are fully rational and can accurately estimate costs and benefits of the contracts.[15] Standard economic theory with the assumption of full rationality, however, has been under serious attack because it is not consistent with empirical (experimental) evidences. Behavioral economics, based on abundant experimental evidences of cognitive phycology, explicitly recognizes that humans are only boundedly rational and often make decisions relying more on heuristics than on rigid computation of expected utilities. This Part introduces the theory how humans with bounded rationality make their decisions (only to the extent it is relevant with the theme of this article) and discusses how bounded rationality of consumers may lead them to agreeing on standard form contracts that are inefficient as well as detrimental to their own interests.

A. Decision-making by Humans with Bounded Rationality

According to the knowledge of phycologists, humans have two systems of

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[15] It should be noted, however, that even fully rational parties may inaccurately estimate costs and benefits of contract clauses, since rationality does not mean having perfect information. Even rational consumers may over- or under-estimate benefits or costs because of lack of information, and such misperception can lead the consumers to making inefficient contracts. Indeed, this possibility had been analyzed in economics long before behavioral economics became popular. *See* Micheal A. Spence, *Consumer Misperceptions, Product Failure and Producer Liability*, 44 REV. ECON. STUD. 561 (1977). Contracting problems being discussed in this Part will be understood by some economists (and economically oriented legal scholars) as matters of misperception caused by lack of information, rather than matters of bounded rationality. I prefer understanding the problems in term of bounded rationality, however, since it enables us better to understand how consumers suffer from such misperception and better to predict in which direction such misperception is likely happen (e.g., whether consumers over- or under-estimate the risk of getting involved in accidents) in given circumstances.

thinking in mind. *Sytem 1* operates automatically and quickly, with little or no effort and no sense of self-control. *System 2* allocates attention to effortful mental activities such as complex computations.[16]

When humans have to make some judgement, System 1 operates automatically and suggests an intuitive answer. Though this intuitive thinking operates pretty well, it is prone to errors. System 2 functions to check and controls System1's thinking but, since operation of system 2 requires costly efforts, it sometimes fails to function well and accepts System 1's wrong answer.[17]

A characteristic way of operation of System 1 is, when it faces a hard question, it will (unintentionally) replace the question with a related question that is easier and will answer it. This function is called *substitution* and the easier question that substitutes the original question is called *heuristic question*.[18]

For example, if people want to estimate the frequency of instances of one category, they judge the frequency by the ease with which those instances come to mind. In other words, they replace the original question "how frequent some instances happen?" with the easier heuristic question "how easy those instances come to our mind?" This way of thinking is famously named "availability heuristics."[19] If the objective frequency of those instances and their easiness to come to our minds are diverge, this heuristic can cause serious bias in our judgment. For instance, experimental studies have found people tend to overestimate the frequency of deaths caused by accidents.[20] Since fatal accidents occupy more media coverage than deaths from ordinary causes such as strokes or cancers, they come to people's minds more easily, which make most people believe deaths caused by accidents happen more often than they really do.

B. Standard Form Contracts Made by Boundedly Rational Parties Can be Inefficient

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16 *See* Kahneman, supra note 2, at 20.
17 *See id.* at 43-46.
18 See id. at 97-98.
19 See id at 129; Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability* in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 163-78 (Daniel Kahneman et al., eds, 1982).
20 Kahneman, supra note 2, at 137-38.

If parties of standard form contracts – especially consumers – are only boundedly rational and make heuristic-oriented decisions, it is possible that they agree on form contract clauses that are inefficient as well as detrimental to consumers' interests. This section briefly illustrates this point, following Korobkin's analysis.[21]

As was discussed in section II.B, when fully rational consumers having unlimited cognitive abilities choose to buy some goods from one of different sellers, they compare all the attributes of the goods that will affect their utilities, including prices and other contract terms, and choose one that will maximize their expected utilities. Considering all the attributes of goods to compute expected utilities, however, are beyond abilities of ordinary, boundedly rational consumers. Instead, typical consumers use a simpler method – they replace a hard question with easier one—. They focus on limited number of "salient" attributes that are easily called on their attention, such as price, functionality and physical appearance, and they make purchasing decisions based only on these attributes, without considering other, "non-salient" attributes.[22]

Arguably, many (if not all) matters provided by standard form contracts belong to the category of non-salient attributes. First, in many transactions, form contract clauses are not disclosed to consumers when they make contracts,[23] so consumers simply have no chance to pay attention to them. Second, even when form contract clauses are disclosed to consumers, they are often so long, detailed and written in such tiny points that few (if any) consumers try to read and understand them.[24] Third, even when form terms

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[21] *See* Korobkin, supra note 4, at 1216-44.

[22] *See id.* at 1226-29 (collecting empirical studies supporting the observation described in the text).

[23] Like when consumers buy train tickets or stay at hotel rooms.

[24] When reading form contract clauses is costly, even fully rational consumers would not read them in order to save transaction costs, and such consumers' behaviors could lead to inefficiency of standard form contracts. Indeed, Avery Katz shows in his model of dynamic games with incomplete information, even small costs to read form contract clauses can lead to significant inefficiency through strategic behaviors of firms and consumers. *See* Avery Katz, *Your Terms or Mine? The Duty to Read the Fine Print in Contracts*, 21 RAND J. ECON. 518 (1990). Though elegant as it was, his model's prediction of behaviors of consumers who rationally foresee what firms will offer in form contract clauses and choose their action to maximize their expected utility makes me

are disclosed and consumers read (some of) them, they will not necessarily become "salient" attributes based on which consumers make their purchasing decision. Many of form contract clauses govern matters that will not happen in the ordinary course of transactions, such as whether or to what extent firms are liable to consumers for damages if the purchased goods have caused accidents, or whether disputes between firms and consumers will be solved in the litigation or arbitration. Since those rare events hardly come to consumers' minds (unless similar events have recently been reported sensationally), consumers may well underestimate the risk such events will happen or may even treat the risk is virtually non-existent.[25] In such cases, consumers have no reason to make their purchasing decision based on the form contract clauses that govern those events.

If form contract clauses are non-salient to consumers, it is straightforward to show the possibility that these clauses will become inefficient and detrimental to consumers. Let us consider again the example in section II.B. In Case 1 of the example, Liability Clause gives Consumer benefits ($15) larger than the costs ($10) born by Firm. If Consumer properly estimates the benefits, he or she prefers Firm's offer of Liability Clause and the price higher by the range from $10 to $15 than the price that would be offered under Exemption Clause ($X). However, if Consumer is boundedly rational and does not think of the risk the good he or she purchases will cause an accident, then Consumer finds no benefit in accepting Liability Clause with the higher price ($X + 10~15), and prefers Exemption Clause with the lower price ($X). In this case, Firm also has no incentive to offer Liability Clause.[26] The end result is Consumer purchases the good under Exemption Clause, which is inefficient as well as inconsistent with Consumer's interest.

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wonder how relevant such an analysis is with reality. Although the end results may not be so different, I prefer modeling of consumers' behaviors with an assumption of bounded rationality as better description of consumer transactions.

[25] See Korobkin, supra note 4, at 1232-33.

[26] If Firm offers Liability Clause, it must offer price higher than $X by at least $10. Then Firm will lose competition against other firms that offer Exemption Clause at the price $X. *See* Korobkin, supra note 4, at 1235-36.Even if Firm enjoys monopoly, offering Liability Clause is not in Firm's interest because fewer consumers will accept such an offer and Firm's profit will be smaller than the case when Firm offers Exemption Clause with the lower price.

C. Regulating Standard Form Contracts Is Not an Easy Task

When standard form contracts are inefficient because of consumers' bounded rationality, it is possible to improve efficiency as well as consumers' interests by regulating standard form contracts. For example, in Case 1 described in section II.B, the law (a statutory regulation or judge-made law) can invalid Exemption Clause and force Firm to offer Liability Clause, which is more efficient and beneficial to consumers. Indeed, Korobkin advocates for regulation of standard form contracts in which courts invalidate form contract clauses that are proven to be both non-salient and inefficient.[27]

Improving the situation by regulating standard form contracts is not always an easy task, however. It is important to note that, even non-salient form contract clauses can be efficient, and if so, invalidating those clauses and replacing them with less efficient clauses would not serve consumers' interests. For example, in Case 2 in section II.B, Exemption Clause is more efficient than Liability Clause.[28] In this case, if the law invalidates Exemption Clause, Firm will offer Liability Clause and the price higher by the range from $10 to $15 than the price it would offer under Exemption Clause. That will not be Consumer's interest, since Liability Clause in Case 2 will give Consumer benefits worth only $10, which is less than the price increase.

To determine whether some contract form clause is inefficient or not is a complicated task, since it requires regulators to estimate costs and benefits the clause will produce. To do this, regulators must compare the situation that will result in the clause in question with another, hypothetical situation that would occur if the law invalidated the clause. For instance, in order to determine efficiency or inefficiency of Exemption Clause, regulators must estimate how much administrative costs of enforcing liability the clause will save, or how much incentives for Firm to take precaution the clause will cut back. Estimating such benefits or costs is not a simple task, no matter which regulatory bodies, administrative offices or courts, will do it.

IV. How Lawyers and Legal Scholars Make Decisions on Regulating Standard

[27] Korobkin, supra note 4, at 1278-90.
[28] When such a situation can happen is discussed in footnote 14, supra.

Form Contracts

Having reviewed existent literature analyzing how problems may arise in standard form contracts when consumers are boundedly rational and how the law should deal with these problems, I would like to move to the question in my interest: How is the law regulating standard form contracts actually being developed?

As was discussed in Part III, though it is possible for the law to improve efficiency as well as consumers' interests by invalidating inefficient form contract clauses, it is not easy for regulators to tell what are inefficient clauses and what are not. It is no wonder such investigation will often face the problem of indeterminacy. Nevertheless, regulators (government officials or courts) in the real world seem to make decisions. There are substantial number of statutes and rules that regulate standard form contracts, and substantial number of courts' decisions that have struck down, or at least limited application of, some form contract terms. Regulators do not hesitate to intervene standard form contracts just because they are not sure of inefficiency of those contracts. To begin with, regulators do not (at least not explicitly) inquire into whether form contract clauses in question are efficient or inefficient before deciding to invalid those clauses.[29] If efficiency does not determine their decision, on what ground regulators decide whether or not to intervene standard form contracts? This Part tries to answer this question, with a help of one theory of behavioral economics – prospect theory.

A. Prospect Theory and Its Implication to Normative Judgement

1. What is Prospect Theory

Prospect theory is a theory advocated by two phycologists who pioneered behavioral economics, Amos Tversky and Daniel Kahneman.[30] Like expected utility theory adopted by standard economics, prospect theory is a descriptive theory predicting how people make their decisions (choices). Prospect theory

[29] Korobkin reports that courts in the United States generally do not inquire into efficiency of form terms before deciding whether those terms should be viewed unconscionable and void. See Korobkin, supra note 4, at 1255 -78 (discussing cases). Japanese courts do not conduct such inquiry, either.

[30] *See* Tversky & Kahneman, supra note 5; Kahneman, supra note 2, Part IV.

is very different from expect utility theory in one respect: it recognizes a special role of states called *reference points*.

According to expect utility theory described in section II.A., when a person makes a choice from alternative actions, he or she predicts what states (outcomes) will result from each of alternative actions, attaches a utility to each of those states, and chooses an action that will result in the largest expected utility. In so doing, the *status quo* – the state in which the actor now stands – has no special meaning. It is only one of those states that can happen and to which the actor attaches a utility. According to prospect theory, in contrast, the status quo is very important. People tend to regard their status quos as reference points, and their judgement about how happy they are is largely determined by the *change* from the reference points.

For example, suppose one person owns $5 million dollars today. Expected utility theory will predict that this person has the same utility (i.e., is happy to the same extent) no matter whether he or she owned $1 million dollars (in Case 1) or $9 million dollars (in Case 2) yesterday. In contrast, prospect theory will predict – persuasively, in my own judgement –, that the person is much happier today in Case 1 than in Case 2, since his or her situation has changed better in Case 1, while it has changed worse in Case 2, from the reference point (i.e., the wealth s/he owned yesterday).[31]

2. Loss Aversion

Prospect theory maintains, with empirical supports, that people tend to dislike losses (i.e., changes for worse from the reference point) than they like gains (changes for better from the reference point). This propensity is called "loss aversion." Most people decline a gamble in which there is 50% chance of winning $150 and 50% chance of losing $100. For many people, to offset 50% chance of losing $100, the gain must be at least $200. In other words, the "loss aversion rate" is 2.[32] Psychological values people attach to gains and losses from the reference point according to prospect theory can be illustrated in Figure 1 (the reference point is represented by the origin of the graph).

< Insert Figure 1 (in the last page of this article) here>

[31] See Kahneman, supra note 2, at 274-5.
[32] See id., at 283-4.

People's propensity of loss aversion can be seen as a product of System 1 thinking (described in section III.A),[33] and presumably has an evolutionary origin. In most of evolutionary history, our ancestors had survived their lives in which even one wrongful choice could often lead to death directly. In such severe conditions, organisms that treat threats as more urgent than opportunities have a better chance to survive and reproduce.[34]

3. Prospect Theory Also Predicts Humans' Moral Judgment

What is important for our analysis on the regulation of standard form contracts is that prospect theory seems to have a power to predict not only people's day-to-day-life judgements that will affect only their own utilities, but also their *moral* judgements --, that is, how people evaluate other people's conducts as fair or unfair. Generally speaking, people tend to consider it unfair for firms to make profits by imposing losses on their customers or workers relative to *reference transactions* (i.e., transactions functioned as reference points).[35] Such tendency has been well reported in the research (a series of telephone surveys in Canadian metropolitan areas) conducted by Kahneman, Jack Knetsch and Richard Thaler.[36]

In their survey, respondents were asked to judge various actions as acceptable or unfair. One example was as follows:

"A hardware store has been selling snow shovels for $15. The morning after a large snowstorm, the store raises the price to $20. "

Although the store has acted rationally according to standard economic theory (raises its price in response to increase in demand), most respondents (82%) rated its conduct as unfair. They evidently viewed the pre-blizzard price as a reference point and the store's conduct imposing a loss on customers to take advantage of short-time increase in demand as unfair.[37]

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[33] See id., at 281-2.
[34] See id., at 282.
[35] See id., at 305.
[36] Daniel Kahneman et al., *Fairness as a Constraint on Profit Seeking: Entitlements in the Market*, 76 (4) AM. ECON. REV. 728 (1986).
[37] *See* Kahneman et al., supra note 36, at 729; Kahneman, supra note 4, at 305.

Another interesting example was about a store cutting down the wage of its employee.[38] Some respondents were asked to evaluate the case below.

"A small photocopying shop has one employee who has worked in the shop for six months and earns $9 per hour. Business continues to be satisfactory, but a factory in the area has closed and unemployment has increased. Other small shops have now hired reliable workers at $7 an hour to perform jobs similar to those done by the photocopy shop employee. The owner of the photocopying shop reduces the employee's wage to $7."

Most (83%) of the respondents rated the shop-owner's conduct as unfair. Other respondents were shown the same case, except that the last sentence was changed into: "The current employee leaves, and the owner decides to pay a replacement $7 an hour." Now a large majority (73%) of the respondents rated the shop-owner's conduct as acceptable.

The current wage of an employee serves as a reference for evaluating the fairness of the adjustments of that employee's wage, but not for evaluating the fairness of the wage paid to a replacement.[39] These examples may suggest that evaluating fairness relying on reference points (transactions) will tend to protect existing interests, without due consideration into whether a person having such an existing interest really deserves it. Kahneman, Knetsch and Thaler point out:

"It should perhaps be emphasized that the reference transaction provides a basis for fairness judgments because it is normal, not necessarily because it is just. Psychological studies of adaptation suggest that any stable state of affairs tends to become accepted eventually, at least in the sense that alternatives to it no longer readily come to mind."[40]

B. Default Rules as Reference Points

1. Why Lawyers and Legal Scholars Regard Default Rules as Reference Points

Since lawyers, who are engaged in regulation (as government officials

[38] *See* Kahneman et al., supra note 36, at 730.
[39] *See* id.
[40] *See* id., at 730-1.

drafting statutes or establishing rules, or as judges interpreting and sometimes invalidating contracts), and legal scholars, who discuss what are better law and sometimes participate in the legal reform, are also humans, it is natural to assume that their decision-makings are also influenced by heuristics and their normative judgements can be explained by prospect theory at least to some extent. If lawyers and legal scholars make normative judgements about validity of form contract terms – determine whether some form terms should be valid or invalid – as prospect theory predicts, what are reference points they use?

I believe that *default rules* are good candidates of the reference points. Through legal education they took at law schools and/or colleges and through studies to pass bar exams, they made a lot of efforts to memorize default rules and to learn how to interpret them and apply them to particular cases. As a result, they arguably have a natural tendency to regard default rules as reference points, and when they see firms, in order to make profits, include form clauses in consumer contracts that limit rights or expand duties of consumers compared with those provided by default rules, they tend to view such firms' conducts as unfair.

Of course, to regard default rules as reference points does not mean to invalidate automatically any form contract clauses that are different from default rules in any respects. To do so would make all default rules mandatory, which would be inconsistent with a widely accepted view that most rules in contract law are default (discretionary), not mandatory.[41] Rather, lawyers and legal scholars inquire how *far* form contract clauses in question diverge from relevant default rules. If the form contract clauses give consumers by far smaller rights or impose on consumers by far larger duties than rights or duties provided by default rules, they are likely to be viewed as unfair and made invalid. Such an attitude can be illustrated by articles of Consumer Contract Act, the main body of law in Japan regulating consumer contracts (that usually, if not always, take the form of standard form contracts).

2. Statutory Provisions Determining Validity of Contract Clauses Based on Default Rules as Reference Points

[41] In Japan, default rules are usually called nin'i-hoki (discretionary rules), which means contracting parties have a discretion to modify those rules by agreements.

According to the Civil Code of Japan, a contracting party who has breached the contract will be liable to the counterparty for damages caused by the breach.[42] In principle, breaching parties must compensate what the counterparties would have gained if contracts were performed, though the principle is subject to the rule of "foreseeability", that is, only damages that were foreseeable to breaching parties should be compensated.[43]

These are basically default rules, so parties have a discretion to modify those rules by agreements, such as to limit the liability to the specified amount (liquidated damages).[44] However, a contract clause that *totally* exempts the firm from liability to consumers arising from breach of the contract is so significantly diverged from the default rules, that Article 8(1)(i) of Consumer Contract Act invalids such a clause.[45]

Also, while limiting liability to the specific amount is not itself prohibited, a contract clause limiting the liability of the firm from breach due to *an intentional act* or *gross negligence* is so significantly diverged from the default rules that Article 8(1)(ii) of Consumer Contract Act invalids such a clause, too.[46] In this respect, it should be noted that Supreme Court of Japan has decided, even in a transaction between firms, a form contract clause limiting liability arising from breach of a contract should not be applicable when the breach was due to an intentional act or gross negligence of the breaching party.[47]

In addition to these and other specific provisions, Consumer Contract Act has a general provision determining validity of a consumer contract by comparing it with a relevant provision of default rules. Article 10 of Consumer Contract Act provides that any consumer contract clause that restricts the

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[42] *See* Minpo (Civil Code), art.415 (cited in Appendix).
[43] *See* Minpo (Civil Code), art.416 (cited in Appendix).
[44] *See* Minpo (Civil Code), art. 419, para.(1) (cited in Appendix).
[45] *See* Shohisha keiyaku ho (Consumer Contract Act) art.8, para.(1), no.(i) (cited in Appendix).
[46] *See* Shohisha keiyaku ho (Consumer Contract Act), art.8, para.(1), no.(ii) (cited in Appendix).
[47] *See* Y.K. Jewelry Yamaya v. KK. Kobe Portopia Hotel, 209 SAIBANSHU MINJI 143 (Sup. Ct., Feb. 23, 2003). It should also be noted that in Japanese law, statutory limitations of liability arising from breach of some types of contracts generally are not applicable when the breach is due to an intentional act or gross negligence (or "reckless act," which is interpreted to have the same meaning as gross negligence). *See, e.g,* Shoho (Commercial Code), art. 581 (liability of land carriers of goods); Kokusai kaijo buppin unso ho (International Carriage of Goods by Sea Act), art. 13-2 (liability of international sea carriers of goods).

rights or expands the duties of consumers more than the application of default provisions in the Civil Code, the Commercial Code and any other laws and regulations, and that unilaterally impairs the interests of consumers in violation of the fundamental principle of good faith, is void.[48] The new Article 548-2 (2) of the Civil Code under deliberation provides the same rule to determine the validity of standard form contracts.[49]

3. Legal Theories Determining Validity of Contract Clauses Based on Default Rules as Reference Points

It should be noted that statutory provisions, as were explained in the last section, that determines validity of contract clauses based on default rules as reference points come from a long tradition of discourse in jurisprudence. In particular, there are legal theories in Germany that argue for "Ordnungsfunktion (ordering function)" or "Leitbildfunktion (leading function)" of default rules.[50] According to these theories, default rules represent the "objective order" set up by the nation, and contracting parties do not have an unlimited freedom to diverge from the objective order even by mutual consents. Rather, to modify default rules, parties must demonstrate a "reason" to justify divergence from those rules. In other words, they must demonstrate why the order given by the nation is not appropriate in a specific circumstance they are in. These theories have had a significant influence on the legal scholarship in Japan, especially in the area of regulation on standard form contracts.[51]

C. Benefits and Costs Using Default Rules as Reference Points

What I have argued in this Part – that judgement by lawyers and legal

[48] See Shohisha keiyakusho (Consumer Contract Act), art.10 (cited in Appendix).
[49] See Draft of the New Civil Code Art. 548-2(2) (cited in Appendix).
[50] Two most influential theorists are Ludwig Raiser and Hans Carl Nipperdey. *See* LUDWIG RAISER, DAS RECHT DER ALLGEMEINEN GESCHÄFTSBEDINGUNGEN, 1935; LUDWIG ENNECCERUS/ HANS CARL NIPPERDEY, ALLGEMEINER TEIL DES BÜRGERLICHEN RECHTS, Halbband 1, 15 Aufl., 1959. For a review of their theories and how much influence they have on the jurisprudence in Japan, *see* Takafumi Matsuda, *Nin'i hoki wo meguru jiritsu to chitsujo (2)* [Autonomy and Order Concerning Default Rules, Part 2], 148 MINSHO HO ZASSHI [Journal of Civil and Commercial Law] 117, 128-44 (2013).
[51] *See* Matsuda, supra note 50, at133 n.127 (citing Japanese articles that introduce and discuss Raiser's theory).

scholars can be explained by prospect theory and that they use default rules as reference points in evaluating form contract terms and determining whether to invalid them – is just a hypothesis at this stage, and much efforts should be needed to collect evidences to show its power to explain the way how the laws regulating standard form contracts have been developed. Even at this stage, however, it is worth considering what benefits and costs legal development in such a way as I hypothesize might have.

1. Positive Sides of Using Default Rules as Reference Points

One of possible benefits of regulating standard form contracts based on default rules as reference points will be to bring (at least some degree of) certainty or predictability in regulation of standard form contracts. If courts decide whether to invalid form contract clauses in question based on their judgment of efficiency or inefficiency of those clauses, as is proposed by Korobkin,[52] courts must compare estimated benefits and costs arising from those clauses. Such estimation and comparison may well become speculative, and the results of cases will often be difficult to predict. Determining whether to invalidate form clauses based on the degree of divergence from default rules is also speculative, of course, but it will at least give courts some guidelines (i.e., default rules) that are familiar to them than the notion of efficiency. Also, to the extent that attorneys who give advices to parties think in ways similar to judges, the results of cases will be easier to predict.

Another possible benefit is that determining validity of form contract clauses using default rules as reference points may be a convenient rule of thumb (or heuristic, so to speak) that can substitute directly inquiring into inefficiency of those form clauses. To the extent default rules have been developed to strike appropriate balance of interests of parties, they may be fairly efficient rules in many circumstances. If so, form clauses that are significantly diverge from default rules are also likely to be inefficient and should be invalid.

2. Negative Sides of Using Default Rules as Reference Points

Regulating standard form contracts based on default rules as reference

[52] See supra note 27 and accompanying text.

points can be costly, however, if relevant default rules are actually inefficient. Regulators do not necessarily have incentives to establish efficient default rules, and even if they do, they may fail to find what efficient rules are. In addition, even if regulators succeed in establishing default rules that are efficient in most circumstances, these rules may not be efficient for some category of transactions or some category of parties. If some default rule is inefficient, a form contract clause that appears significantly disadvantageous to consumers compared with the default rule may actually be efficient. In this case, invalidating that clause will be not only inefficient but also detrimental to consumers, as was discussed in section III.C.

Of course, the risk of invalidating efficient form contract clauses exists even when regulators determine whether to invalid form contract clauses based on efficiency analysis, since efficiency analysis is difficult and subject to errors, as was discussed in section III.C. As long as regulators (and legal scholars who suggest better regulations to regulators) are concerned with efficiency analysis, however, such errors can be corrected through theoretical and empirical studies that reveal benefits of contract clauses apparently disadvantageous to consumers or costs of relevant default rules. In contrast, if regulators make regulatory decisions (and legal scholars make suggestions to regulators) based on default rules as reference points, they may be satisfied with a belief that they have made a "fair" decision and may not be interested in any theoretical or empirical studies on efficiency of form contract clauses or relevant default rules. In this case, there is little chance for regulatory errors to be corrected.

V. Conclusion

Behavioral approach to law has persuasively demonstrated the possibility that consumers with bounded rationality agree on form contract clauses that are both inefficient and detrimental to their own interests, and that legal intervention to standard form contracts can improve the situation. As was discussed in this article, however, this approach can also identify the possibility that regulators and legal scholars with bounded rationality make their decisions based on default rules as reference points, which may lead to regulatory errors that are difficult to be corrected. In this respect, bounded rationality can be said to be a double-edged sword in regulating standard form

contracts – it clarifies both potentials and riskiness of legal intervention to contract form clauses.

I believe behavioral economics is promising. Though somewhat complicated it is compared with standard economic theory, it stands on more realistic assumptions on human behaviors and enriches both positive and normative analyses of law. I hope the analysis in this article will help readers appreciate the power of behavioral approach to law.

Appendix: Excerpts of Statutes

1. Shohisha keiyaku ho (Consumer Contract Act of Japan)
2. Minpo (Civil Code of Japan)
3. Draft Articles of Minpo (Civil Code) Regarding Standard Form Contracts

1. Shohisha keiyaku ho (Consumer Contract Act of Japan)

Law number: Act No. 61 of 2000

(Definitions)
Article 2
(1)　The term "Consumer" as used in
this Act means an individual (however, the same shall not apply in cases where said individual becomes a party to a contract as
a business enterprise or for the purposes of a business enterprise).
(2)　The term "Business Operator" as used in
this Act (excluding Article 43, paragraph (2), item (ii)) means a
corporation or association, or an individual who becomes a party to
a contract as a business enterprise or for the purposes of
a business enterprise.
(3)　The term "Consumer Contract" as used in
this Act means a contract concluded between a Consumer and a Business Operator.

(Nullity of Clauses which Exempt a Business Operator from Liability for Damages)
Article 8

(1) The following Consumer Contract clauses are void:
(i) Clauses which totally exempt a Business Operator from liability to compensate a Consumer for damages arising from default by the Business Operator;
(ii) Clauses which partially exempt a Business Operator from liability for damages arising from default by the Business Operator (limited to default which arises due to an intentional act or gross negligence on the part of the Business Operator, the Business Operator's representative or employee);
(iii) Clauses which totally exempt a Business Operator from liability for damages to a Consumer which arise from a tort pursuant to the provisions of the Civil Code committed during the Business Operator's performance of a Consumer Contract;
(iv) Clauses which partially exempt a Business Operator from liability for damages to a Consumer arising from a tort (limited to cases in which the same arises due to an intentional act or gross negligence on the part of the Business Operator, the Business Operator's representative or employee) pursuant to the provisions of the Civil Code committed during the Business Operator's performance of a Consumer Contract; and
(v) Where a Consumer Contract is a contract for value, and there exists a latent defect in the subject matter of the Consumer Contract (including where a Consumer Contract is a contract for work, and there exists a defect in the subject matter of a Consumer Contract for work; the same shall apply in the following paragraph): Clauses which totally exclude a Business Operator from liability to compensate a Consumer for damages caused by such defect.

(Nullity of Clauses that Impair the Interests of Consumers Unilaterally)
Article 10
Any Consumer contract clause that restricts the rights or expands the duties of the Consumer more than the application of provisions unrelated to public order in the Civil Code, the Commercial Code (Act No. 48 of 1899) and any other laws and regulations, and that unilaterally impairs the interests of the Consumer,

in violation of the fundamental principle provided
in the second paragraph of Article 1 of the Civil Code, is void.

2. Civil Code in Japan

Law number: Act No. 89 of 1896
Amendment : Act No. 78 of 2006

(Fundamental Principles)
Article 1
(2) The exercise of rights and performance of duties must be done in good faith.

(Damages due to Default)
Article 415
If an obligor fails to perform consistent with the purpose of its obligation, the obligee shall be entitled to demand damages arising from such failure. The same shall apply in cases it has become impossible to perform due to reasons attributable to the obligor.

(Scope of Damages)
Article 416
(1) The purpose of the demand for the damages for failure to perform an obligation shall be to demand the compensation for damages which would ordinarily arise from such failure.
(2) The obligee may also demand the compensation for damages which arise from any special circumstances if the party did foresee, or should have foreseen, such circumstances.

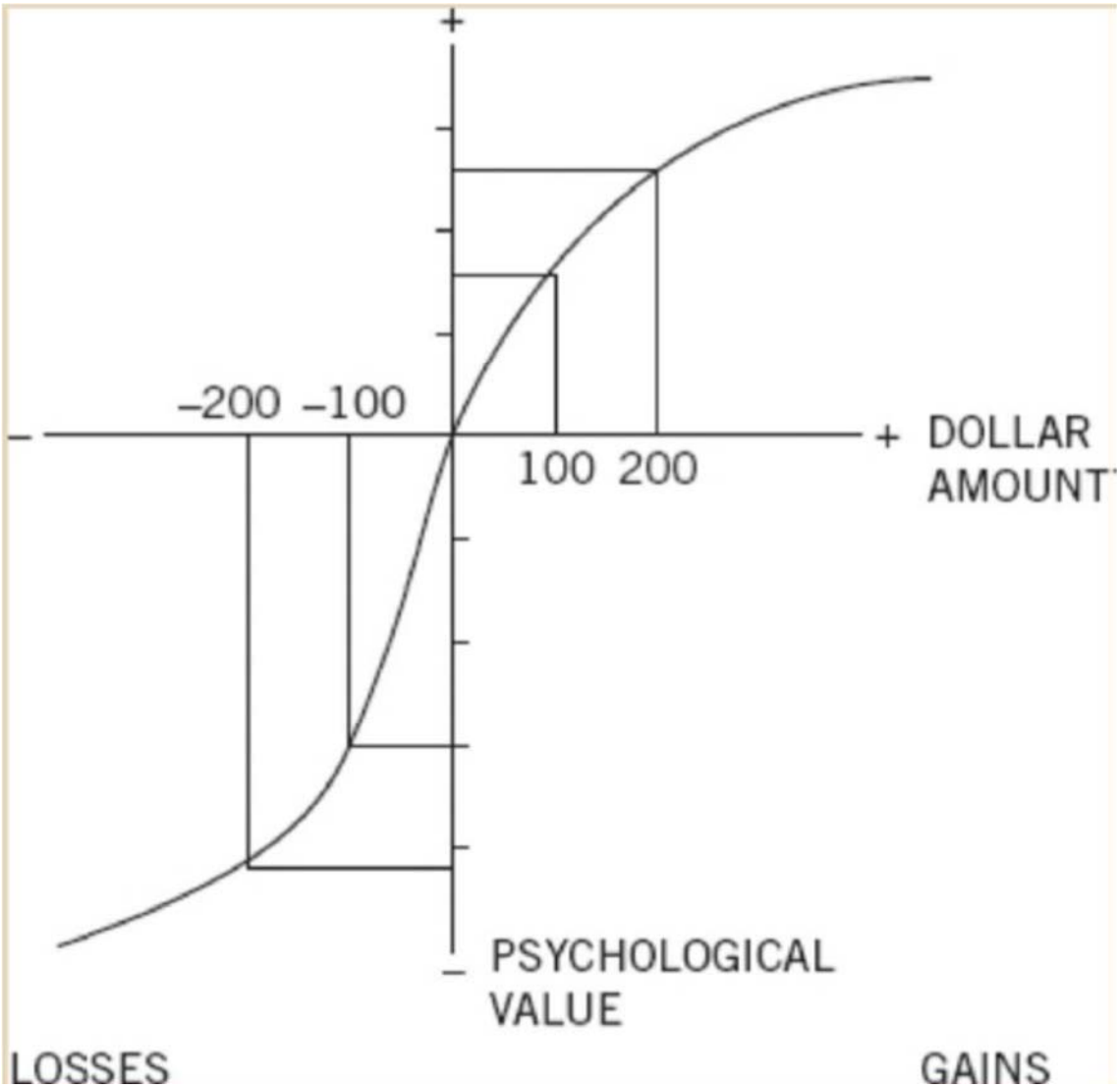
(Liquidated Damages)
Article 420
(1) The parties may agree on the amount of the liquidated damages with respect to the failure to perform the obligation.
In such case, the court may not increase or decrease the amount thereof.
(3) Any penalty is presumed to constitute liquidated damages.

3. New Articles of Minpo (Civil Code) of Japan regarding Standard Form Transaction Agreements (under Deliberation)

(Agreement Based on Standard Clauses)
Article 548-2
(2) Notwithstanding the preceding paragraph, the other party will not be deemed (under the provisions of the preceding paragraph) to have agreed to a contract term that restricts its rights, or places an obligation upon it, if, in light of the aspects and the actual circumstances of the standard transaction as well as socially accepted ideas with regards to standard transactions, the term is deemed unilaterally detrimental to the interests of the other party, in contravention of the basic principles set forth in Article 1, paragraph

Note:
English translations of articles of the Consumer Contract Act and the Civil Code are based on Japanese Law Translation Database System operated by Ministry of Justice of Japan(http://www.japaneselawtranslation.go.jp/?re=02), while English translation of new Article 548-2 was made by David Litt.

Figure 1: Psychological of values of gains and losses according to prospect theory



Source: Kahneman, supra note 2, Chap.26.