What is Interest?

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The Prohibition of Interest, the Expectant Interest and Banking in Halacha

Interest is the rental fee for the use of money. Interest is biblically prohibited. In order to understand this prohibition, this paper looks at difference between the biblical system of law, halacha, and the common law. It follows the subsequent polity that result logically follows from the proscriptions protecting the debtor. Finally, the paper explains how the prohibition is avoided through the use of various legal technicalities in order to keep a bank in compliance with banking regulations.

What is interest?

Interest is not truly rent because borrowed money is no longer the property of the lender, but the property of person holding it. The borrower takes on all the risk for the borrowed money. If he losses it due to factors beyond his control, such as an economic downturn or if it is stolen, he still has to remunerate. The money in his hands belongs to him, whereas the lender gains a right to collect different money. The lender gains a quasi-ownership or encumbrance on the borrower to collect the loan, but does not own the money in the hands of the borrower.

The notion of a rental fee for money cannot be grounded in the property rights of the lender of money in the same way that a lender of an object has a right to the rental fee for the use of that object. When the term of the lease on an object expires, the object is returned to its owner in a somewhat devalued state due to the wear and tear of its use. Its user makes restitution for the use of the object. Interest as an obligation upon a borrower
of money cannot be grounded upon restitution for the use and wear and tear of the money, but grounded upon an agreement in which one party promises interest in consideration for the lender relinquishing his ownership of the funds. The owner of borrowed object remains its owner for the duration of its use, wherever it is. It continues under his ownership when the loan expires. If he demands the object back and the borrower does not return it, the lender can demand payment for the continued use of his property. The lender of money, by contrast, relinquishes ownership immediately. The money is not his wherever it is when the loan expires. If he demands his money back, he is really demanding the property of the borrower.

A lender therefore has to actively fix the amount of compensation for the use of his money setting up the obligation to compensate. His claim for compensation is based on and expectation that he would have profited had he not loaned the principal to the borrower. The owner of the lease of land and utensils, by contrast, does not have to resort to expectations of profit in order to charge rent. He can point directly to his property rights. Even if no price is agreed upon, compensation is rightfully due for the use of that property since it remains the property of the owner.

So understood, interest is a form of taking advantage of a borrower.\(^1\) The lender, who already might have secured his loan with an encumbrance on the property of the borrower, asks the borrower to pay back more than the loan. His demand is grounded on the use the lender might have made with the money.

The United States tax code encourages this kind of extortion. It assumes that one who lends without interest has forgiven something due to him and charges the lender with

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\(^1\) Interest is form of stealing in which the borrower forgives the theft in order to borrow the principal. Babylonian Talmud (R.T.), Tractate Baba Metzia (B.M.) 61a
assignment of income.\textsuperscript{2} This is a mistake. A loan is free in the default. There is no forgiveness of interest. A claim for interest does not arise until it is agreed upon.

Interest is forbidden in \textit{halacha}. By contrast, the common law permits lenders to charge interest. The fact that a loan is no longer the property of the lender is irrelevant to the law. The lender is entitled to his loss of expectations. Furthermore, a party under contract to make a monetary payment by a certain date is charged interest even in absence of terms requiring the payment of interest because of his breach. A loan has a price in the default.

\textbf{The Expectation Interest}

Contracts are legally enforceable promises under the common law. This is most understandable and justified when an opposing party makes expenditures relying upon the promise in a contract. The party making the promise can be thought of as a guarantor to cover the expenses of his opposing party in case of breach. He is expected to compensate for the money spend or lost in reliance of the contract.

The reliance interest in contract law is also found in \textit{halacha}. Indeed, the promise is viewed as a quasi-recipient of the expenditures of his contracting party in reliance of the contract.\textsuperscript{3} As such, he is liable for restitution because it is as if he received the expenditures. This is most easily understood in the case of a party volunteering to become a guarantor on a loan. The act of lending to the borrower is as if the guarantor received the loan. The guarantor makes himself liable for the borrowers debt even though

\textsuperscript{2} U.S.C. §7872
\textsuperscript{3} see B.T. Kiddushin 7a. Just like a guarantor becomes encumbered even though the borrower received the money, not him, a woman becomes married even when she does not receive the ring but it was given to another party upon her request. The reception of the third party is as if the guarantor received the loan and as if the woman received the ring.
he did not receive anything, because the lender accepted the risk of lending and trusted his guarantee of repayment.

Expenditures made in reliance of the contract are not lost when a contract is breached because the party in breach became a guarantor for those expenditures. Common law, however, also allows a party to collect the expectations of profits. It is not obvious that a party in breach should “‘compensate’ the plaintiff by giving him something he never had.”\(^4\) He did cannot be said to cause a loss.

The difficulty in charging interest for late payments or for the use of money when no agreement for interest has been reached between the parties lies in the difficulty in charging for damages to loss of expectations. This problem does not arise in halacha since no damages are assessed for loss of expectations. It is reasonably clear that a party that owes money to another party is encumbered for the principal, but how does he become obligated to compensate for expectations? In the case of a loan, the act of borrowing only obligates the principal. A guarantor can become indebted for the same loan under the fiction that he received the loan; the lender after all suffered a real loss of funds. It is difficult to perceive, on the other hand, how a lending party can expect compensation for funds that he does not yet have.

One may conceive that a party quitting his job for work in perishable goods, or for work in a special event such as a wedding, is liable to compensate for the extra costs of hiring a replacement in lieu of his failure to perform. Such liability is limited to the cost of hiring a replacement however, even if that cost is greater than the value of performance under the original contract. The worker was committed to perform the work

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and the opposing party relied on him passing over the opportunity to hire someone else. The implicit guarantee to compensate for the cost of hiring a replacement in the event of breach, even at a higher price, is not for loss of expectation of gain, but for the job that the worker already owes.

The common law rule of enforcing expectations of promises cannot be founded on reliance, but is a seemingly prophylactic measure found in the modern credit economy.

“The essence of a credit economy lies in the fact that it tends to eliminate the distinction between present and future (promised) goods. Expectations of future values become, for purposes of trade, present values. In a society in which credit has become a significant and pervasive institution, it is inevitable that the expectancy created by an enforceable promise should be regarded as a kind of property, and breach of the promise as an injury to that property.”

Professors Fuller and Perdue point out that the expectation interest came before the credit economy. They explain that the common law introduced the expectation interest because of “(1) the need for curing and preventing the harms occasioned by reliance, and (2) on the need for facilitating reliance on business agreements.” This is insufficient explanation for the purposes of our inquiry, as expectations are assessed in tort law regardless of reliance and business arrangements. A prophylactic measure cannot justify taking of more than value-for-value in the case of damages for torts. It does not make a borrower unjustifiably enriched by not paying interest. Social policy, utilitarian good, and economic costs do not justify taking money from one and giving it to another.

A suit in tort turns upon consequences of the deed, even distant ones, as long as they were reasonably foreseeable. The loss of expectations are often foreseeable. The concept of the expectation interest in contract law follows because it is the expected

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5 Id. at 59.
6 Id. at 62.
consequence of the promise. A party under contract recovers expenses and loss of expectations as if the words of the bargain were money in his hands. He seeks recovery of property he never possessed but was promised.

The expectation interest, therefore, does not originate in contract law. It stems from tort law. Tort law allows recovery for expected gain including damages caused by a party interfering with business gain. For instance, one who interferes with the sale of merchandise is held liable for the loss of the merchant’s profit. The culpable party caused a loss of profits. Breach of contract is similar to tort damages to expected gain. There is no reasonable distinction between the reliance a party puts in the performance of a contract promising gain and the reliance a party puts in a steady stream of profits.

The common law recognizes the autonomy of a seller and buyer to make choices. A party intentionally invading that self-determination, for instance, not allowing customers to enter a store accepts the risk of loss of the merchant’s profits. By the nature of the interest that the law protects, self-determination, the law preserves the right of a non-contractual party such as routine customers, to reverse that anticipation. However, when a contract is made, the law does not allow a party to continue to exercise that self-determination. What remains is an invasion of the potential gains of the opposite party. Breach of contract is thus treated similar to a third party causing an intentional loss of profit. Although damages for breaching a contract is assessed against the same party that promised performance rather than an independent party preventing a profit, in both cases, there is no compelling reason to rely on one more than the other.

_Halacha_ does not allow tort damages for loss of profit or expectations. It follows that there is no expectation interest for breach of agreements.
The fundamental distinctions between halacha and the common law.

There are three fundamental differences between halacha and the common law, or perhaps, halacha every other legal system. Expectations are not assessed in tort law. Promises per se between parties are not enforceable in contract law. Consent plays no role in criminal law.

Relations and obligations between parties in the common law are regulated by contract and the consequences of their actions. Halacha, by contrast, regulates relations with the concept of kinyan, which effects a change in status of an object or person, and obligations with the concept of the ma’asa, the act of making a change. Kinyan is most often associated with an exchange. It takes place when a party tenders payment for the sale of land, takes a moveable object into his possession, or when a party lifts up an item such as a handkerchief belong to an opposing party to encumber to obligate the terms of an agreement and encumber his property. It impresses upon the parties the finality of their agreement. The lifting up of the handkerchief or some other item can transfer almost anything but cash. It recalls the old common law livery of seisin used to transfer land in which the buyer walked onto the land, picked up the dirt and said specific words in front of the seller. The handkerchief making the kinyan, by contrast, is unrelated to the object sold, is picked up by the current owner who will transfer the property or become encumbered, and is more efficient than awaiting delivery that the modern common law requires for movable goods having no title document.

Conceptually, a kinyan is not a change in relationship as when a contract is made, but a change in the status of the property. This change is effected at the time of the kinyan
before delivery or possession. *Kinyan* makes contracts enforceable, not because the party is forced to comply with his promise, but because the party is encumbered for the value of that which was promised. For example, although a normal employee can quit his job without compensating his employer for any extra expenses involved in hiring new help to finish the day, if the parties make a *kinyan* on the tools of an independent contractor, he is bound to complete his work as if he made a contract under the common law. However, unlike the contract at law that enforces the promise between the parties, the *kinyan* changes the status of the tradesman and his tools. Whereas before he was the owner of all work coming out of his tools, the *kinyan* encumbers his tools so that the work coming out automatically belongs to the employer before delivery.

Partnerships are formed when two parties promise to share profits with one another. They are not held to mere words, but a *kinyan* is made changing their status so that profits coming out of their hands do not belong to the party producing them alone, but to the partners in common. This kind of *kinyan* only works with partners or a group of people in an equal and reciprocal relationship. Otherwise, a person cannot become so encumbered that all his labor belongs to someone else. Without the reciprocal relationship, the *kinyan* borders on servitude requiring a different kind of *kinyan* that has been abolished.

The status of a stolen object is changed through a *kinyan*. A thief makes a *kinyan* of stealing by picking up the object without permission or by dragging it outside, an act of taking it away from the security of the owner into the holdings of the thief. Without the *kinyan*, the object is not stolen and the thief is not liable for the risk of loss of the object. The *kinyan* is a change in the status of the object, not a change in relations between people. If the thief merely prevents the owner from securing his object but does not move

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7 333 Choshet Mishpat 1
the object, it is not stolen and the thief is not responsible for a later loss. He did not make a kinyan to steal.

Many other changes in legal status involve kinyan. Bailment, involving the watching of an object and its responsibility to prevent loss, does not begin until the bailee makes a kinyan on the object. Even a marriage takes effect only with a kinyan. The kinyan of marriage, the giving of the ring or something of value to the bride, creates a change in status of the husband and wife. A wife is a married woman rather than woman under contract with her husband. Contracts are subject to intent and subject to waiver. Third parties, for the most part, are not bound by contracts to which they are not party. The common law has to rely on social policy, a weak footing for the preservation of this venerable institution. By contrast, the kinyan of marriage does not work through a promise changing the relationship between the husband and wife, but through a change in the status of the parties. A third party commits the crime of adultery because of the status of the marriage, the status of the woman being married, which is not subject to consent or waiver of the husband, as in the case of a relationship under contract. The kinyan of divorce restores the original status of the parties.

A promise to sell or to give something to another party, on the other hand, is not enforceable in halacha. A promise is a mere promise without kinyan because no change has taken place in the object to be sold. A kinyan cannot put the promise to sell into effect. The object either belongs to the first party or the second, but a change has not occurred in an object that is promised to be sold. An object can be encumbered for a future payment of a debt, but not for a future sale, because the debt exists separate from the object.

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8 245 Choshen Mispat 1. A promise to sell is a kinyan of words, not a change in the object.
The reliant interest in _halacha_ does not arise because of a promise of performance as in contract law, but under the laws of _arev_, or guarantor, which also involves a change in status. The _ma’asa_, or act, of lending to a third party is viewed as if the _arev_ received the loan, as mentioned above. Even when someone becomes an _arev_ after the money is lent and a _kinyan_ is needed, he is understood to have assumed the existing debt of the borrower. The _kinyan_ for marriage can work through the law of _arev_, viewing the reception of the ring or object of value by a designated third party as if the bride received it. A party can become an _arev_ for the expenses of burning gasoline for the benefit of a third party riding in an automobile. The third party rightfully should have purchased the gasoline or compensated the driver for the expenses involved in the service. Each second during the act of driving creates a restitutional obligation on the _arev_ as if the gasoline was burnt for his own sake.

Under the laws of _arev_, there is no place for compensating for expectations because the _arev_ is obligated only for a real debt of someone else such as the true recipient of expenses. The act of expenditure for the benefit of a party intrinsically calls for restitution by the recipient and the _arev_ assumes the debt as if he were the recipient. By contrast, with its broad scope not so much as concerned with defining an intrinsic act but with the consequences of an action, the common law and courts of law evaluate the situation from the beginning to the future. Since the promise is enforced, there is an expectancy of gain in the future. The consequence of breach of the promise allows for recovery of that gain.

Courts of chancery have gone even further. They developed equitable conversion out of the promise to sell, so that a home is sold before it is sold, even while that the seller is allowed to remain in the house. The party promising to buy assumes the risk fire
and destruction of the property in most states while the seller of the property is still in possession and still entitled to that possession until exchange of title. See Marion v. Walcott, 68 N.J. 20 (Ch. 1904, buyer assumes risk when contract to buy is signed). It is perplexing that party promising to sell under contract has only promised to sell, has not sold, and equity forces the buyer to assume risk while leaving the owner in possession. Compare to halacha, where buyer tendering monetary payment for personal goods makes a complete kinyan by biblical law, but is barred from that acquisition by the rabbinic courts until delivery as under the common law rule, because of risk of fire while under the possession of the previous owner.

The common law rule awarding damages to future gains is quite different than the enforcement of an agreement promising support or payment. See Unthank v. Rippstein, 386 S.W2d 134 (Tex. 1964, non-testamentary delivery of a handwritten promise of monthly support encumbers an estate). This is also valid in halacha, again, not because the promise is enforced, but because the party becomes encumbered. A party can become encumbered to perform a service, work or even to tax himself according to majority rule. A person can become encumbered so that payment can come from only a particular property. However, the property is not sold, nor is it promised to be sold, as the party may tender payment in cash. The recipient of the encumbrance assumes the risk of fire because he is forced to accept the property as payment, but the still property belongs to the debtor who may tender cask payment of the original amount if the property

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9 B.T. Kesuvos 101b.
10 231 CH. M. 28. There is discussion of whether laws of the community are decided by the majority in the presence of all or by simple majority. 163 Ch. M 1, where majority of the seats of city executive/judicial council are determined by majority vote, while only a minority may be allocated by those paying the majority of taxes. Perhaps this is the balance between one-man, one-vote and money is speech that the Court struggled for in Buckley v. Valeo. 424 U.S. 1 (1976).
increases in value.

A party becoming encumbered to perform an agree service so that he has to compensate for the value of that service if he fails to perform may only become encumbered for the value of the service or of hiring a replacement. If the party sets an amount as compensation unrelated to the value of the service, the promise is not enforceable because the promising party cannot have intend to render himself encumbered himself beyond the value of the service that his opposite party relied upon. The expectancy interest awarding profits unrelated to the value of service an illusion of the common law.

The common law takes a fundamentally different approach to actions in the criminal law. Halacha is grounded in dos and don’ts. Kinyan defines the nature of things and people; ma’asa defines the nature of acts. Homicide and battery are categorically forbidden. Homicide is the ma’asa that kills. Lack of consent is not an element. The common law, by contrast, focuses on causing consequences. Hence the difficulty common legal scholars find in laws banning consensual euthanasia, an act of killing but unaccompanied by the consequence of homicide, the violation of the right to life. Halacha, turning upon the intrinsic nature act, or ma’asa, focuses upon the act. The victim is not free to determine the criminality of the act.

Causal damages for torts are actionable only when they are clear and present at the time of a deed. Future gain is never construed as a loss. Halacha only recognizes a dollar for a dollar. Additionally, not every act that causes present damages is held liable for those damages. Since halacha turns upon the intrinsic nature of the act, a distinction between direct and indirect acts logically follows. All direct and many indirect actions

11 Maimonides 8 S’chiros 13.
that damage the property of another are wrong and forbidden, but not all are give rise to claims for damages. Direct actions give rise to damages because the actor acted to damage property. Difficulty arises in defining actions as acts that intrinsically damage when they only cause damages. For example, throwing a glass vase off a roof is a ma’asa or an act of destroying the vase. Removing a net that might have caught the falling vase, preventing it from breaking, is not a ma’asa of destroying the vase, but indirectly destroys the vase.

*Halacha* therefore cannot bind a party to pay for damages to the expectations of another. The act is defined during its instance of existence and future interests are simply not present. However immediate, they often can be preserved by another act, for example, an immediate restoration of the presently damaged property. Liability is determined by the act of damaging, the act of destroying property, not by the inaction of due care and not by inaction to prevent future damage to the property resulting from a previous action.

The *kinyan* fits in well under the framework of *ma’asa* and defining acts. The *kinyan* is an act that *halacha* creates to effect an immediate result. It is the act of marrying, the act divorce, the act of transfer of ownership or lien, all of which require a *kinyan*; the act of damaging, the act of beating and killing. Thus, the parties to the agreement with proper *kinyan* are held to their words, not because their words lead to a future reliance, which is consequential to their words, but the words were acted upon, creating a lien on the person or property through the *kinyan*.

The common law turns upon consequences of the deed because it is rooted in the state with its goal of common good or the goal of prudent control over social intercourse
rather than with categorical ethics. Promises do not need to become actions in the sense of *kinyan*. People are held to more distant consequences. The expectation interest follows because it is the expected consequence of the promise. There is no need for anything to happen at the time of the promise. The promise can become enforceable later when the promise becomes relied upon. There is no need to define an action. It is the consequence that invites enforcement at law even after a later date.

Battery in the common law is the consequent of intentional touching without consent. Assault is the consequence of intentionally creating fear of immediate harm. It is not the act of touching or creating fear itself that is actionable, but the consequence. If the law is to turn upon the consequences of a deed, rather than the categorical worth of the act, then the will of the victim becomes an essential element in determining lawfulness. Hence, consent is prominent in the common law.

**The Ban on Interest and the Consent of the Governed**

What kind of polity gives rise to a system of law that defines the status of people, things and acts? The answer to this question is remarkably found in *halacha* of debtor and creditor. We compare the basis of sovereignty in America with the commonwealth based upon *halacha* and its laws of interest.

The social contract is not the complete explanation for government in the United States or any other nation of the world. Governments rule by conquest of arms or through the conquest of their law.

Can a government of the people and ruled by its people be said to exercise conquest over the land? Put another way, is there a sovereignty in a democracy? One can argue
that the states and federal government lack ownership over the land, that a majority are
too intangible to conceptually own land in the way a king or single sovereign owns the
land of his country. This, of course, is incorrect.

All acquisitions of land in America originate under an original grant. Heirless
intestate land escheats back to the state rather than to a party in possession. It makes no
difference in the concept of escheat that the state is governed by the many in their
corporate capacity or by a single ruler. In medieval England, the land would escheat to
the lord above the occupant of the land. In colonial America, the land would escheat to
the proprietor, in the case of New Jersey, to Berkeley and Carteret. The title of the
proprietor escheated back to the king. In England, today, land escheats to the Crown and
in New Jersey, land escheats to the State, which replaced the Crown.

In the 1600’s land in Virginia escheated to the Virginia Company. Land in
Massachusetts escheated to the Massachusetts Bay Company. These colonies did not lack
governmental authority and the subsequent the ability to tax as a sovereign because they
were public corporations whose owners bought and sold their shares on the market. The
State of New Jersey today, owned by the people in their corporate capacity, exercises
sovereignty over the land in the state no less than these joint-stock companies.

It is settled law that one who bought land directly from an Indian tribe will not
prevail against another party that bought the same land from the government at a later
date. Only the government can buy from the Indians. Ultimately, title has trace back to
the State. Land acquisition in American, therefore, is not founded upon the natural state
of affairs without a sovereign, but upon the sovereignty of the state through its original
acquisition by conquest.

12 Johnson and Graham's Lessee v. William M'Intosh, 8 Wheaton, 543(1815).
One cannot argue that the United States lacks the traditional sovereign power over the land preventing individuals from entering the country. Congress has plenary, if not absolute power over alien tenure in the country. Although international law bars any county from exiling its own naturally born residents, nations can put their citizens in jail, the practical consequence of which is the prevention of its citizens who have broken the law from returning home.

The power of the purse has historically correlated with political power. Kings were generally limited in their ability to raise revenues, a historic problem in monarchies. As a rule of thumb, nations that have devised legislatures with the ability to tax to meet their needs have thrived. Those who have not, generally had oppressive revolutions, such as the French Revolution, and the Bolshevik Revolution. Certainly parliament can tax in the name of its sovereign, and the New Jersey legislature can tax in the name its sovereign, the people in their corporate capacity who own the land upon which the fee simple of each individual is grounded.

This power of sovereignty over the land did not exist in biblical Israel. The right to the land does not rest with the king, nor does it escheat to the government. It has been found in the writings of Talmudic scholars before Magna Carta, that for this reason, government cannot legislate or tax without the consent of the governed.\(^\text{13}\) People own their land in their own name and not under the tenure of their rulers. The people also hold land in complete equality. From whence did this great rule emerge? Thus rule of pure democracy without a sovereign, not even sovereignty of the people in their corporate capacity, emerged from the laws of interest, from the \textit{halacha} of debtor and creditor. If a person became indebted, he could not be forced to pay interest. If he could not pay back

\(^{13}\text{Or Zarua a contemporary of Richard I of England wrote this in the name of Rabbi Eliezer Mitz.}\)
at all, and his loan was unrecorded, it was forgiven in the seventh year, while a recorded loan encumbered the land. If the lender took the land, it was returned in the year of jubilee. Note carefully. The loss of land has been the source of disenfranchisement, oppression and revolution throughout the ages. A king of Israel and the people in their corporate capacity lacked original acquisition. Since land returned to the debtor in the Jubilee year, not withstanding its sale, it was recognized as inalienable to the population. If land is inalienable, there is no escheat, no original acquisition by a sovereign. Ownership of land was fundamental and spread equally among the population. Government lacked the legislative capacity to rule over the people and their property as a sovereign authority. Authority remained with the people to consent to their own taxation, with leaders and scholars among the people with the consent of the people to legislate, providing a political blessing and bulwark for liberty.

How can a nation without the collective capacity over the land actually tax themselves? In other words, does this unique original democracy without a sovereign, fail for lack of capacity to govern? The answer can be found in our previous discussion over reliance and kinyan. A party offering work becomes bound to pay his worker the agreed wages, even without a kinyan. He is personally responsible and his property is automatically encumbered due to the reliance of the worker. Parties entering into yhr reciprocal relationship of a partnership are bound without a kinyan to share profits in accordance with their agreement. The status of the profits, their ownership, is bound by the agreement. The majority in a partnership or in a trade guild can bind the minority as governing their work product.\textsuperscript{14} In the same manner, all people living within a city are

\textsuperscript{14} 176 Choshen Mishpat 3.
bound to one another for their protection and benefit.\textsuperscript{15} Thus a guild can govern or restrict the work product of all. The collective has a claim on the work product and a compulsion against the individual by virtue of their coming together in a society.\textsuperscript{16} This is the origin of the consent of majority, the power to tax and govern without a sovereign. It is the true social contract.

This distinction is great. A nation in which the people in their corporate capacity own the land has the power to tax and legislate over every aspect of property. The government is the original possessor of the land. It has a claim to the individual and his property. The government can seize the property of a taxpayer placing the burden of proof on the individual. The government and its courts can regulate contracts and the relationship between contracting parties. A party collecting damages in court for loss of expectations can keep that money under the laws of the sovereign state. A nation in which the individual owns his land by way of right, the power of the government to tax and legislate derives purely from the consent of the majority. The government has the burden of proof in a case against a taxpayer. The government does not have a \textit{kinyan} over the individual and his property to create legal forms and remedies as exist under the common law. Power of the courts is supreme as the majority and the government cannot violate \textit{halacha}.

\textbf{One-sided interest}

Now we return to the specifics of the laws of interest. There are several ways to set up a loan for profit without fixed interest yet still prohibited by \textit{halacha}. If someone

\begin{footnotesize}
15 163 Choshen Mishpat et. seq.
16 See ft. nt. 10
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leases utensils, he charges rent for their use. Their use has a definite market value so even no price is agreed upon, the market should determine compensation for the rental. Money is not leased. In order to charge for its use, one must enter into fixed agreement. A kinyan is made to encumber the property of the borrower.

If an agreement can be made, say, in which the borrower of money promises to sell land to a lender at a non-discounted price without obligation to actually sell the land, just if he decides to sell it, he will sell it to the lender at a reasonable market price. This agreement does not lack consideration because the terms of the loan provide the option of buying the land when it is put up for sale. If the borrower effectively breaches faith by selling the land to another, the lender may demand the immediate return of the loan. However, no compensation for past or future use of the loan is due. The agreement to sell the land was not an explicit agreement placing restitution value on the loan.

If someone leases machinery, by contrast, the borrower has an implicit duty to compensate for its use. The use of the property of another has an intrinsic value as the owner losses some present value in his property due to depreciation. Even if no price agreed upon, the market determination of the price for rental demands restitution. In order to charge for the use of money, by contrast, an explicit agreement for payment has to be reached.

If a party borrows machinery from a neighbor who typically lends it to him for free, or explicitly lends it to him for free under the condition to sell his neighbor a parcel of land, the agreement to sell the land is not an attempt to fix a value of restitution for the use of the machinery. The use of the machinery is for free. The agreement to sell the land is a condition for its use. If the borrower were to sell the land to a third party, he would
not be required to make compensation for the use the machinery. The secondary agreement to sell the neighbor the land did not create circumstances of rental.

If one borrows money, which does not require compensation for its use, on the same condition that the borrower sells the lender a parcel of land, the agreement, again, did not create a rental agreement for the use of the money. Money does not demand restitution for its use. The lender does not have to explicitly lend the money for free.

Certainly if a party breeches this kind of unenforceable agreement, the lender may demand the return of his property or the repayment of a loan. The borrower is no longer permitted to use a borrowed utensil and would have to compensate for continued use. He would not have to compensate for the use of the money, although is he is not permitted to continue using it. The agreement was a condition for the use of the money, not compensation.

The loan of money under the condition of selling land is called one-sided interest in halahca. It is one-side because the agreement only requires the borrower to sell the land to the lender if he decides to sell the land. He might not ever sell it to anyone. The accepted ruling forbids one-sided interest since it sets a condition for the use of the money. If the seller breeches the agreement and sells to someone else, even though he has not agreed to compensate for the use of the loan, he is no longer permitted to retain the loan. Since the terms require that he comply with the agreement for the continued use of the loan, and if he breaches the agreement, he has to immediately repay the loan, it is interest.

_Heter Iska_

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17 T.B. B.M 63a
Banking is necessary for modern economic intercourse. Concurrent with the rise of banking several hundred years ago, halacha devised a way of lending money under the theory of the heter iska. The word “heter” means “permissible” and “iska” means “investment.” The heter iska originated as a type of business loan. Its use has expanded so that today it is made even for mortgages on houses under the assumption that the value of the property will increase.

Armed with the understanding of the kinyan, and its precision in defining objects rather than relationships, we can redefine the basic debtor-creditor relationship into an investor-trustee relationship so that which ordinarily would be interest is looked upon as profits. We begin the analysis with a basic iska. An investor gives money to an agent to buy a commodity and to sell it for profit. They agree to split the profits. During the time of the iska, the money and the commodity are the property of the investor. Thus, the investor is responsible for the risk of loss of principle or failure of the iska, as long as the agent is not negligent. If the investor gives specific instructions to buy one commodity and the agent acts on his own initiative buying a different commodity, the agent becomes responsible for loss of principal. For example, if the agent is instructed to buy wheat, but instead, buys barley, thinking that to be a better investment, if the price of barley goes down and the investment does not break even, the agent is responsible for the of loss. Although he did not follow instruction, he nonetheless intended to act in the interest of the investor, so we do not assume the agent made a kinyan to steal the money acting on his own initiative. Nonetheless, since the investor specifically ordered him to buy wheat rather than barley, the losses are passed onto the agent. On the other hand, if the price of barley remains stable or goes up and the investment reaps a profit, the investor and agent
split the profit by the terms of the original agreement since the agent invested in the barley for the investor.\(^{18}\)

This rule in the law of agency gives rise to a way of lending money so that the lender is not responsible for risk while he is allowed to take profits. A lender may instruct the borrower to invest in something secure, like bonds that will reap a set income. The lender might demand the market interest rate for its share, perhaps a fraction of a percent lower so that the borrower receives a share for his effort. Once the borrower invests in something else, the borrower assumes all losses just as the agent who bought barley instead of wheat. If he makes a profit on his investment, rather than splitting the profit, the lender receives the agreed market rate on the loan. This is not interest because the money and the investment property is technically the property of the lender. Of course, there is no way of knowing that there was no profit. The lender can assume that the money was properly invested in the blue chip bonds and refuse to believe the borrower that he invested in something else and did not reap a profit. Under this arrangement, the debtor-creditor relationship is set up so that the debtor assumes the risk as if the money as were his own while the creditor retains actual ownership of the money entitling it to the market rate of interest.\(^{19}\)

The more common *heter iska* splits the ownership of the investment, half belonging to the lender and half belonging to the borrower. Thus, only half of the money is a loan, the other half remains the property of the lender as a bailment. There is no switching from the original instructions. The borrower is a trustee over the bailment of the lender. The borrower invests the full amount so that profits and losses are divided between both

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\(^{18}\) B.T. Baba Kama 102b  
\(^{19}\) 292 Choshen Mishpat 7
parties. In this way, the money paid to the lender is not interest, but profit on the one lender’s half share in the venture. Since the borrower is the party actually investing or conducting business on behalf of both shares, he is given a right to take more than the half profits for which he is anyway entitled by virtue of the one half loan. He may take wages instead of a larger share in profits. If the profits were to be split evenly without compensation for the work of the borrower, then interest is paid in his labor for the half belonging to the lender.

This *iska* finds its origins in an ancient livestock deal. An investor gives young sheep or cattle to a shepherd or cattleman. The grown animal is sold and the profits are split, as are the offspring. The lender assumes either the larger share of risk, two-thirds, in order to receive half of the profit and offspring, or half of the risk and only one third of the profit and offspring.\(^{20}\)

This same livestock venture can be done with typical investment.\(^{21}\) For example, X lends Y $100. X retains ownership on $50, while the other $50 belongs to Y as a loan. X is entitled to half of the principal and profits and Y is entitled to half of the principal and profits. If the venture ends with $30 of the principal lost, then the remaining $70 is split so that X receives $35 and Y receives $35 since one half is a loan to Y while the other half remained as the property of X. Since Y is working on behalf of both his half and X’s half, X has to remunerate Y for his labor since he is working on his share presumably because of the favor of the loan to Y. For X, the lender, to avoid benefiting from the loan to Y, X has to either pay Y some wages, or give him a sixth extra of the profits so that profits are divided into thirds, with the borrower receiving two thirds. Alternately, X may

\(^{20}\) B.M. 70b.
\(^{21}\) Id. 104b
accept risk on an extra one sixth so that out of the above $30 loss, X covers $20 and Y covers $10. The $70 is then divided so that Y gets $40 and X gets $30. Y still has to pay back $50 to the lender for his half, so the lender keeps that whole $70 and the borrower owes him $10 from his pocket. The lender absorbs a $20 loss on the whole deal that the borrower does not have to pay back.

This kind arrangement is impossible for banking. Banks cannot accept the risk of their borrowers so that a borrower does not have to pay back the whole loan if he suffers losses. This gave rise to numerous variations making the arrangement more and more like a loan without actually becoming a loan. Lenders draw up contracts on the venture assuming a set amount of profit each year to be split between the lender and borrower. All amounts of profit beyond that amount become the wages of the borrower for his efforts.

An agreement is reached in which the profits going to the lender are limited by the market rate of interest. That assumes that the investment returned double the rate of interest, as profits are to be divided evenly up until that amount. The lender stipulates that he will not believe the borrower that the agreed amount of return was not reached unless he makes an oath in rabbinic court. Few, if any rabbinic courts today allow parties to swear, rendering the burden of proof on the lender unlikely to be met. Indeed, the original agreement further stipulates that in case the borrower declares that not only he did not make sufficient profit, but he lost some of the principal, he is only believe by bringing testimony of the most experienced certified accountant. It becomes impracticable for the borrower to claim that no profits were made. The lender is guaranteed a set payment as if he received interest.
This kind of fiction has been used for home mortgages. The bank and the owner of the home become partners in the property. The property is expected to appreciate in value. The homeowner assumes a set amount of appreciation, which happens to be the market rate for a loan. The homeowner has a high burden if not impossible burden to prove that the home did not appreciate. If the home appreciates more than the agreed interest, the excess belongs to the borrower for his labor in maintaining the property. As the loan progresses and interest payments are made, the homeowner buys back the half owned by the bank with the fixed amount appreciation of the bank’s share and payment of its principal.

The *Heter Iska* and Banking Regulations

The *heter iska* involves two problems for banking regulators. First, banks are not allowed to be partners in business concerns or to invest in business. The Glass-Steagall Act of 1933, 12 USC §24 (Lexis 2011), provides that “nothing herein contained shall authorize the purchase by the [banking] association of any shares of stock of any corporation.” Second, banks are in the business of lending money and collecting fixed interest. They are not equipped for the vicissitudes of lenders claiming non-realization of profits.

Banks traditionally were authorized to do business under a state or national charter that prohibit non-banking activities. “It is well established that a banking corporation cannot be a member of a partnership.” *Hanson v. Birmingham*, 92 F. Supp. 33, 44 (N.D. Iowa 1950). Banks cannot become involved in the business of buying and selling cattle as in the original *iska* of old. *First Nat’l Bank v Stokes* 134 Ark 368 (1918). A bank cannot enter into the first mentioned *iska*, investing for a half-share in the profits from buying
and selling wheat or barley, or cotton for that matter. A bank did so and was found that
the “cotton was obtained by the exercise of an authority not granted them by law. . . .”
not merely the strength of the partnership or business that concerns regulators, they
cannot even “indulge in the commercial business of an electric light company.”
in blue chips is prohibited. “No express power to acquire the stock of another corporation
is conferred upon a national bank.” *California Bank v. Kennedy*, 167 U.S. 362, 366 (U.S.
1897).

That is not the say that banks cannot at times enter into businesses when those
businesses are securities for its debts. A “national bank may take by way of security
property in which it is not authorized to invest, and may become owner of it by
foreclosure or in satisfaction of a debt.” *Merchants' Nat'l Bank v. Wehrmann*, 202 U.S.
295, 299 (U.S. 1906). This even applies to corporations. A bank “might accept accept
stock of another corporation as collateral.” *California Bank v. Kennedy*, 167 U.S. 362,
366-367 (U.S. 1897). The bank can even run the business to minimize its losses. A state
“bank, that to secure a debt contracted to it in its regular course of business, had taken
over the stock of goods, and fixtures of a drug store. . . .” *Snow Hill Banking & Trust Co.
v. D. J. Odum Drug Co.*, 188 N.C. 672, 681 (N.C. 1924). Banks can rent out land
securing a debt. The “bank collecting property on default of a loan can use the property to
minimize its losses incidental to its ownership . . . to lease the property and thus obtain
1916). A national bank, like any bank, can be involved in the “sale of mortgages and

The bank using the *heter iska*, does not merely enter business when a lender defaults, but it becomes an active partner from the start. One might argue, that the borrower might legally dissolve the *heter iska*, and pay no interest, as partnerships are ultra vires to the charter under which the bank operates. In *Merchants' Nat'l Bank v. Wehrmann*, 202 U.S. 295 (U.S. 1906), the Court dissolved such a partnership. Making a distinction between ownership of shares in a corporation and a partnership, Mr. Justice Holmes explained:

“But to take a share by transfer on the books means to become a member of the concern. The person who appears on the books of the corporation as the stockholder is the stockholder as between him and the corporation, and his rights with regard to the corporate property are incident to his position as such. . . . But when a similar transfer is made of a share in a partnership it means that the transferee at once becomes a member of the firm and goes into its business with an unlimited personal liability, in short, does precisely what a national bank has no authority to do. . . . It is not necessary in this case to say that shares like the present could not be accepted as security in any form by a national bank. But such a bank cannot accept an absolute transfer of them to itself.” Id. 300-301

The liability of the owner of stock in a corporation is limited to the value of his investment. The law today continues to reach this distinction between partnerships and stock securities. Not even a state bank can enter into a partnership. The Federal Deposit Insurance Corporation (FDIC) regulations provide an “insured state bank may not directly or indirectly engage as principal in any activity, that is not an equity investment, and is of a type not permissible for a national bank. . . .” 12 CFR 362.3.

The partnership of the *heter iska*, however, is not ultra vires to the bank charter and limits the liability of the bank to the amount of the loan. *Halacha* does not recognize a principal of respondiate superior. The owner of property is not responsible for the actions
of an independent agent using that property. Another problem involved in partnerships is if one partner takes on debt, both partners are liable. If the borrower takes on more debt than the loan, the bank can potentially become liable for half of it. To correct this possibility, the original agreement of the heter iska restricts the liability of the bank to the amount loaned. Depositors in a bank using the heter iska cannot dissolve the agreement and refuse to pay interest as they agree to abide by the principals of halacha and their agreement shielding the bank from liability. Nor might a third party join the bank in a suit against the borrower in a court of law. As far as the third party is concerned, the heter iska indeed is ultra vires, the partnership does not exist, and the bank is a mere lender of funds. Thus, national bank regulations are satisfied. The Comptroller of the Currency can “certify that the bank’s loss exposure is limited as a legal matter and that the bank does not have unlimited liability for the obligations of the enterprise.” 12 CFR 5.36

A second problem arises because banks are in the business of loaning money for a fixed payment. They cannot conduct business if borrowers are allowed to claim that an investment lost value. Banks cannot become involved with customers bringing witnesses that they do not have to pay back half of the loan since it was a bailment that did not see a profit. Regulators have to make sure that the bank remains solvent and strong enough to stay in business.

As a preliminary matter, banks foreclosing on property usually do not recoup their loses. Reclaimed property secured by the loan rarely covers the costs associated with a loan. Foreclosures are estimated to cost lenders an average $50,000 each.22 This is estimated to be “from 30 percent to 60 percent of the outstanding loan balances because

of legal fees, foregone interest, and property expenses.” Only a small percent of banks are able to regain their principal and interest from a borrower who has lost the principal. In this way, the *heter iska* does not make a difference to the bottom line of the bank. If the borrower stops making payments, claiming that he has not made a profit, and meets his burden of proof, the bank might take a loss; but in most of those circumstances, the borrower would have foreclosed under the normal loan paradigm, without the *heter iska*. In the case that the borrower remains solvent and pays the principal, but meets the burden of showing that he did not see a profit so that he does not make the interest payment, the losses of the bank are balanced by an extra security that the *heter iska* provides. A loan made in compliance with *halacha*, as mentioned above, encumbers the borrower and all of his property, not just in rem on the single property as with a home mortgage. In the event of foreclosure, the borrower still has to pay back the losses of the bank. The principal of the loan is secured by all his property making it easier for the bank to recoup its entire principal from other assets. The loss of interest is outweighed by the greater security in recouping the principal. In the end, the bank operating under the *heter iska* is stronger than without it.

The First Commerce Bank of Lakewood, New Jersey, is the first bank in the United States to use the *heter iska* for all of its deposits and loans. The document used by the bank includes three pertinent provisions. 1) The borrower agrees to notify the bank within 30 of any lack of assumed profit. 2) He agrees to provide an audit and financial record certified by a five-year member of the American Institute of Certified Public Accountant. 3) The lender shall provide the bank with a notarized signed written

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explanation for the failure to achieve the profits. Every single check made out, every single dollar spent, for the sake the home secured by the loan, has to be made an accounting. He makes an oath verifying his statements to be true. The agreement provides that in lieu of these requirements, the borrower agrees to pay the fixed interest rate. The bank agrees to accept this rate even if the profits are greater than the rate. The lender signs the agreement. The bank then gives the borrower one dollar and acquires a one-half interest in the home. A similar agreement is made between the bank and all its depositors.

How would a claim of not seeing profits play out? In the case of a home mortgage, the borrower buys a house for $100,000. Five years pass and the house is still worth $100,000. The homeowner has the responsibility under the venture to improve the property through his labor to see a profit. He might have hired people to carry out this task. He would have to account for every transaction he made improving or maintaining the property. He would need to bring witnesses for his losses. He would have to swear that he made no profit by renting out the house. What if he brings witnesses that saw the house burn down? The bank requires him to buy insurance, but what if it lapsed? The lapse would be due to his negligence for which he accepted risk. What if he brings witnesses that he was not negligent. The heter iska stipulates that disputes are referred to rabbinic court, which has the authority to restrict acceptance of testimony to two witness meeting difficult requirements. Stringent evidentiary requirements rendering testimony invalid were used thousands of years ago to ensure that few if any people were ever executed for crimes less than homicide, despite the literary impression given the reader of the Bible. Testimony is routinely accepted in normal monetary cases, albeit with a higher
evidentiary standard than the preponderance of the evidence in the common law.

Rabbinic courts still have the authority to invoke stringent requirements invaliding testimony when the parties so stipulate, as in the case of a *heter iska*.

The authority of rabbinic courts is limited today. The rabbinic court cannot force the borrower into its jurisdiction even with the signed document. On the other hand, Jewish people, are prohibited by *halacha* from going to civil court, and have to go to rabbinic court first for adjudication. If the losing party does not make good, the rabbinic court gives the winning party permission to go to civil court. A bank operating in the United States, even with Jewish partners, cannot be expected to go to rabbinic court to bring an action against a borrower. Nor do regulators want to see disputes and claims brought into rabbinic courts, especially to initiate a foreclosure. This problem is solved, as some gentiles are partners in the bank. As long as a gentile has a stake in the bank, he can bring the borrower into civil court on behalf of the bank and all of the partners, since he also is a stakeholder. The bank then becomes as strong a regular bank with the ability to go to court to reclaim its loan or foreclose on a property. If the borrower counter-claims in civil court that he had a *heter iska* and that the loan is only for one half, the bank brings the documents to court showing that the case has to be adjudicated in rabbinic court, which will enforce the testimonial restrictions of swearing and witnesses.

A difficult problem involves the standard loan documentation. Software manufacturers guarantee the validity and legality of their computer programs that produce the standard forms for lending. Few banks want to take the risk of creating a new form and procedure. The First Commerce Bank uses the standard loan forms, but added an extra paragraph. Other banks that have used the *heter iska*, have a *heter iska*
department with the terms of it written on the wall. A borrower signing the loan
documents seeing the *heter iska* is supposedly informed of its terms. Aside from the
problem of the parole evidence rule, regulators often complain that something hanging on
the wall is an improper reliance upon religious law. It is not referred to in any bank
forms. It is hard to conceive that the loan was made under the terms of the heter iska
when it was merely hanging on the wall! By contrast, the First Commerce Bank includes
a reference to the *heter iska* in the written documentation for every loan and deposit
account. The final paragraph at the end of the standard indicates to the borrower that if he
wants to use the *heter iska*, he has that option. The bank director spent about four years
working out the details of the *heter iska*. The document is shown to borrowers upon
request, but copies are not given to the customer to preserve the intellectual property of
the bank.

Finally, how is the bank to determine that a borrower is Jewish and has to make a
*heter iska*? Perhaps he is a Gentile and his wife is Jewish or vice-versa. It is forbidden for
the bank officers who are Jewish to lend money with interest to the borrower. On the
other hand, a bank cannot ask a customer if he or she is Jewish. The additional paragraph
in the documentation leave the discretion with the bank or the borrower to invoke the
*heter iska* ay any time. It does not have to be clarified at the time of the loan. It is always
there. Every borrower is then under two different constructions. The loan documentation
refers to the bank *heter iska* policy. The policy stipulates that the *heter iska* overrides if it
is invoked. Any customer, whether Jewish or Gentile, can invoke the *heter iska*. The
bank for its part cannot and does not have to discriminate. It is understood and it is
enough that if one party is Jewish, even without the knowledge of the bank, it is
automatically invoked in the sense that the bank is not considered lending for actual interest. The bottom line is that all customers take out standard loans under normal terms, but they all have the opportunity to go to rabbinic court to claim that they only own half due to the loss of the principal.

Conclusion

People often conceive of laws proscribing interest as charitable requirements of religion. We have shown that upon close analysis, interest is not justified as a rental fee. The prohibition of interest and other laws relating to debt led to a unique democracy in ancient Israel that does not exist in other countries, fundamentally grounded upon the consent of the governed. The common law, by contrast, with its paradigm of relations and expectations, has normalized the payment of interest in way that is foreign to halacha, and its paradigm of defining objects and acts. The method of analysis used in halacha, has given rise to the heter iska that allows the common law debtor-creditor relationship to be defined as a permissible business investment making modern banking possible.