

Strategic Default: The Popularization of a Debate Among Contract Scholars

by Meredith R. Miller

Given the recent, sharp decline in housing prices,¹ an estimated 20% of homeowners with a mortgage are “underwater,”² meaning that these homeowners have borrowed more than their homes are currently worth. Of those underwater homeowners, many can still afford to make their monthly mortgage payments. Given the negative equity in their homes, however, they are faced with the decision whether to carry out a “strategic default.”³

A June 2010 report estimates that roughly 20% of mortgage defaults in the first half of 2009 were strategic.⁴ This has led to innumerable newspaper articles, blog posts, website comments and editorial musings⁵ on the morality of homeowners who can afford to pay but choose, instead, to walk away. This Article centers on the current public discourse about strategic default, which mirrors an ongoing debate among scholars concerning whether the breach of a contract has a moral dimension. The example of strategic default provides a rich avenue to discuss the foundational assumptions and challenges of contract theory, and demonstrates that the public debate would be more aptly focused on systemic reforms rather than individual contracts between borrowers and lenders.

There is a continuing debate among legal scholars regarding competing theoretical justifications for why and how the law enforces contractual obligations. For those that maintain that it is possible to describe and prescribe contract law with a general, unifying theory, the debate is primarily one between promise-based theories and economic theory. This debate between promissory and economic theory reflects a perpetual volley concerning whether contract law should reflect the primacy of morality or efficiency. Given the ubiquity of strategic defaults, this academic debate is now prominently on display in the mainstream public media.

CBS’s *60 minutes* featured a segment that frames the decision facing underwater

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¹ David Streitfield & Javier Hernandez, *Home Prices May Be Nearing a New Dip*, N.Y. TIMES, Nov. 25, 2009, B1, http://www.nytimes.com/2009/11/25/business/economy/25home.html?_r=1&ref=standard_poors_caseshiller_home_price_index (discussing Case-Schiller national index of housing prices, which was 29.1% off from the peak of the market in 2006).

² Scott Lanman, *Bernanke Says Regulators 'Intensely' Reviewing Foreclosures*, BLOOMBERG (Oct. 25, 2010), at <http://www.bloomberg.com/news/2010-10-25/bernanke-says-regulators-are-intensively-reviewing-foreclosure-practices.html> (quoting Federal Reserve Chairman Ben Bernanke); see also David H. Stevens, Assistant Secretary for Housing / Federal Housing Administration Commissioner U.S. Department of Housing and Urban Development, Written Testimony before the Subcommittee on Housing and Community Opportunity U.S. House Committee on Financial Services (Apr. 14, 2010), http://portal.hud.gov/portal/page/portal/HUD/press/speeches_remarks_statements/2010/Speech_04142010.

20% is a nationwide estimate, with some of the harder hit regional markets showing higher estimates. For example, it is estimated that more than 20% of mortgages are underwater in California, Florida and Nevada. “*Underwater Mortgages*” May Not Spell Default: *SF Fed*, ABC NEWS (Oct. 18, 2010), at <http://abcnews.go.com/Business/wireStory?id=11908600> (Reuters).

³ Strategic default describes the situation where a home borrower has the financial ability to continue to pay her mortgage but chooses not to pay and walks away. See Luigi Zingales, *The Menace of Strategic Default*, CITY JOURNAL (Spring 2010), http://www.city-journal.org/2010/20_2_strategic-mortgage-default.html. Zingales notes, “[s]trategic default is hard to define, of course, and presents difficulties for researchers. What exactly does it mean to be able to pay a mortgage? If I default because I’m unwilling to work extra hours to pay my mortgage, is that a strategic default or a necessary one?”

⁴ Posting of Nick Timiraos to WSJ DEVELOPMENTS BLOG, *Study: Nearly One in Five Mortgage Defaults are ‘Strategic’*, <http://blogs.wsj.com/developments/2010/06/28/study-nearly-one-in-five-mortgage-defaults-are-strategic/>

However, given the difficulty in identifying which defaults are strategic, some have suggested that the reports of strategic default are widely exaggerated. See Richard DeKasser, *Rise in ‘Strategic Default’ in Mortgages May Be Exaggerated*, WASH. POST, Aug. 7, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/08/05/AR2010080507381.html>

⁵ See e.g. James B. Stewart, *‘Strategic Defaults’? I Agree With Fannie*, WALL STREET JOURNAL ONLINE, Jun. 30, 2010, <http://online.wsj.com/article/SB10001424052748703374104575336672476924564.html>; Editorial, *Strategic Defaults on Mortgages: The price we pay for the housing folly*, LA TIMES, Jun. 14, 2010, <http://articles.latimes.com/2010/jun/14/opinion/la-ed-default-20100614>; Kenneth R. Harney, *The Nation’s Housing: Walking Away From a Mortgage*, WASH. POST, Nov. 28, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/11/25/AR2009112504186.html>; Liz Pullman Weston, *Are You Foolish to Pay Your Mortgage?*, MSN MONEY, Dec. 9, 2009, <http://articles.moneycentral.msn.com/Banking/HomeFinancing/weston-should-you-walk-away-from-your-home.aspx>.

homeowners who can afford to make their mortgage payments. It contained the following exchange with a couple that was preparing to walk away from their home:

MORLEY SAFER (voiceover): . . . Jane Ellen Schoolick and Danny Keune . . . bought their Phoenix bungalow three years ago for nearly four hundred thousand dollars. The bank now values it at eighty-five thousand. Even though they can afford the mortgage payments, they felt like they were trying to bail out an ocean with a bucket.

JANE ELLEN SCHOOLICK: No logical businessperson would do anything other than walk away. And— so there was a lot of soul searching and I did a lot of crying because I'm in love with this house, and— and every day I would redo the math and think maybe we miss[ed] something. May—you know, this just can't be right.

MORLEY SAFER (voiceover): But it was. The value of their house was dropping anywhere from five to eight thousand dollars a month. So Schoolick and Keune just felt it was time to walk away.

JANE ELLEN SCHOOLICK: I don't think [we're villains]. I--we fulfilled the parts of our contract that we have with the bank. We've let them know what we're doing. It's all legal. It's not anything I've expected I would be doing. And it sure doesn't feel good, but it seems like it's the right thing to do.⁶

In a *New York Times Sunday Magazine* article, Roger Lowenstein supported the decision to walk away. Lowenstein wrote:

Mortgage holders do sign a promissory note, which is a promise to pay. But the contract explicitly details the penalty for nonpayment – surrender of the property. The borrower isn't escaping the consequences; he is suffering them.⁷

However, James B. Stewart, a columnist for *SmartMoney* magazine, expressed a view less sympathetic to the borrowers. In light of the apparent increase in strategic defaults, in June 2010 Fannie Mae announced that it would deny government-backed mortgages for seven years to borrowers who strategically defaulted. In agreeing with Fannie Mae's decision, Stewart wrote: "'strategic default' is too kind a phrase for breaking a promise and breaching a contract."⁸

This popular media coverage has the public debating the ethics of strategic default. For example, a May 31, 2010 article in the *New York Times*, titled "Owners Stop Paying Mortgages, and Stop Fretting,"⁹ lead to a surfeit of both exceedingly supportive and bitterly disapproving reader comments (the article generated over 830 reader comments). Many comments chastised the defaulting homeowners, calling them "deadbeats" and

⁶ *60 Minutes: Mortgages: Walking Away* (CBS broadcast May 9, 2010), <http://www.cbsnews.com/video/watch/?id=6470184n&tag=contentB> ody (transcript on file with author).

NPR's *Morning Edition* recently ran a similar story. Yuki Noguchi, *The Delimma of Walking Away from a Mortgage*, NPR Morning Edition (Oct. 28, 2010), at <http://www.npr.org/templates/story/story.php?storyId=130868236>. The story begins:

To pay or not to pay is the question now facing some homeowners — not because they can't afford their mortgage, but because they don't want to keep paying on a home that's lost value.

But even as they gain popularity, strategic defaults are highly controversial — some might say immoral. About a quarter of American homeowners took out loans that are bigger than their homes are now worth, and some of them say it's simply irrational for them to keep paying the mortgage.

Grace Chen and her husband, Antonis Orphanou, have this debate about their own home. From the outside, there is nothing to flag them as troubled homeowners. They haven't lost their jobs. Their interest rate has stayed the same. They are not counted among the legions headed to foreclosure. In fact, they haven't missed a single mortgage payment.

But they're tempted to.

⁷ Roger Lowenstein, *Walk Away From Your Mortgage!*, NY TIMES SUNDAY MAGAZINE, at 15 (Jan. 7, 2010).

⁸ Stewart, note 5 *supra*.

⁹ David Streitfeld, *Owners Stop Paying Mortgages, and Stop Fretting*, N.Y. TIMES, May 31, 2010, at A1, http://www.nytimes.com/2010/06/01/business/01nopay.html?pagewanted=1&_r=2

"The value of their house was dropping anywhere from five to eight thousand dollars a month."

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“freeloaders” and arguing that they had acted “shamefully.” Other comments supported the homeowners in walking away, denying any moral dimension to strategic default and citing the “free market.”¹⁰

As this conversation takes place in the popular media, the lack of unanimity on the issue falls along the same poles as the academic debate: morality and efficiency. The argument of those that support strategic default reads like a case for efficient breach.¹¹ Many of these commentators argue that the mortgage contract simply presents home borrowers with a choice: pay or surrender the property in foreclosure. If a homeowner is deep underwater, she is better off defaulting and the lender is no worse off relative to the bargain (after all, the lender agreed to foreclosure as a remedy). However, those who argue in favor of strategic default are counteracting a prevailing social norm¹² that it is fundamentally immoral to efficiently breach a contract. Many of the blog comments and even newspaper editorials have reflected a general sense that the homeowners who strategically default are acting contemptibly.

The public discussion further mirrors the academic debate about whether encouraging efficient breach enables the greatest public good or, instead, undermines the very convention of contracting. On the one hand, strategic default serves as an example of how encouragement of breach of contract may lead to a breakdown of confidence in the marketplace and, in turn, could inhibit market activity. On the other, it is difficult to muster sympathy for lenders, whose imprudent loans are a large piece of the systemic problems that gave rise to the collapse of the housing market.

In this debate over strategic default, it is seen that questions of morality are nuanced and contextual. This specific example elucidates the futility of either morality or efficiency as a unifying descriptive or normative theory of contract law. Therefore, instead of focusing on individual contracts, it would be more fruitful to refocus the public debate to appropriate incentives to keep borrowers in their homes¹³ and systemic reforms that would prevent the practices that played a part in devastating outcomes for the housing industry, families and communities.

¹⁰ The true identities and allegiances of the commenters is not known; nevertheless, some of their postings are worth noting because they encapsulate the debate. “amac3” from Illinois commented:

It says a lot about the descent of human character to see that even people who can meet their contractual [sic] debts refuse to do so. They didn’t hate the banks that lent them the money until their spend-as-you-go lifestyle caught up with them. I have nothing against people who suffered health and employment setbacks in this economy and cannot pay. But the ones that simply made a bad decision and now feel everyone is responsible for it are neither to be admired or excused.

“Mike” from Austin also criticized the homeowners for walking away:

This is shameful. As a person who has always been careful with debt, who never used a house as a cash machine, I can’t find much sympathy for these folks. They’re adults, they signed a contract and they sure as heck would have owned up to it if things had gone their way. But now they can say the lenders were “crooks” and use that to justify what amounts to felony theft.

This article seems to be an apology, almost a justification for their behavior. No mention that the rest of us pick up the tab either through higher costs or higher taxes. Perhaps some of the lenders were crooks, but there’s no doubting that these people are essentially stealing. Don’t cover for bad behavior.

But commenter “Jane Smiley” of California did not see any moral failings:

This is how the free market works, folks. There’s no morality involved—you make the best deal you can get away with. Ask Milton Friedman whether there’s something “immoral” about this. Of course not! The market isn’t “moral”, it is required to adjust itself. If we are going to live in a free market, then we citizens can’t be patsies anymore than the bankers and the traders. Is this another step toward criminality? Sure. But why should bankers and traders and politicians be the only criminals?

“Alex” from New York also showed his support for the homeowners who chose to walk away. In part, he wrote:

I support these homeowners wholeheartedly. If banks will not work with troubled, underwater borrowers to modify loans (and they will not), let the borrowers modify the loans on their own terms.

The upside: Money not spent on a mortgage payment can be spent on goods and services that will stimulate local economies, rather than to enhance profits for bank shareholders.

See comments to David Streitfeld, *Owners Stop Paying Mortgages, and Stop Fretting*, N.Y. TIMES, May 31, 2010, at A1, <http://www.nytimes.com/2010/06/01/business/01nopay.html?pagewanted=1&r=2>

¹¹ For a definition of “efficient breach,” see footnotes 21 through 27 and accompanying text.

¹² See footnote 55 and accompanying text.

¹³ See, e.g., Gregory Scott Crespi, *The Trillion Dollar Problem of Underwater Homeowners: Avoiding a New Surge of Foreclosures By Encouraging Principal-Reducing Loan Modifications*, 51 SANTA CLARA L. REV. 153 (2010).

Morality v. Efficiency: Is it Immoral to “Willfully” Breach a Contract?

There is a continuing debate among legal scholars regarding competing theoretical justifications for why and how the law enforces contractual obligations. The debate is primarily one between promise-based theories and economic theory.¹⁴ The promise-based view holds that contracting is an act of promising and the law enforces contracts because there is a moral obligation to keep a promise.¹⁵ Grounded in economic theory, the other prevailing view is that contract law encourages exchanges that are “efficient,” those that maximize individual gains and, in turn, societal wealth.¹⁶

Champions of both of these views have addressed the legal consequences of breaching a contract. One of the challenges for theorists is to explain why conventional contract doctrine does not take into account a breaching party’s motive and whether the breaching party has acted “willfully.” The expectation measure of damages aims to put the non-breaching party in the position she would have been in had the contract been performed.¹⁷ In other words, contract law damages are based upon the non-breaching party’s loss in value that foreseeably arose from the breach of contract.¹⁸ This calculation is purely compensatory and remains unaffected by the culpability of the breaching party.¹⁹ Thus, punitive damages are unavailable and specific performance is rarely awarded, regardless of the reasons for the breach.²⁰ It is largely (if not entirely) irrelevant why the breaching party failed to follow through on her promise. For example, in an apartment lease, it would be irrelevant whether the tenant failed to pay rent because she lost her job or because a better deal arose for another, nearby apartment. The tenant’s motives or reasons for breach simply do not matter.

Law and economics scholars argue that the expectation measure of damages can be explained as encouraging “efficient breach.” An efficient breach occurs when the cost of a party’s performance of the contract “exceeds the benefits to all the parties.”²¹ The theory of efficient breach maintains that “if a party breaches, and is still better off after paying damages to compensate the victim, . . . considered as a unit, the parties are better off because of the breach and the breach makes no party worse off.”²² It is said that “[an efficient breach] induces a result superior to performance, since one party receives the same benefits as performance while the other is able to do even better.”²³

Notably, efficient breach does not provide a doctrinal excuse for a party’s nonperformance of the contract; in other words, efficient breach is not a defense to breach of contract.²⁴ Rather, it is a theory that recognizes why a party might be motivated to breach. The theory appropriates Holmes’ dictum that “[t]he duty to keep a contract. . . means a prediction

¹⁴ Brian Bix, *Contract Rights and Remedies, and the Divergence Between Law and Morality*, 21 *RATIO JURIS* 194, 195-199 (2008) (hereinafter “Bix”). As Professor Bix discusses, reliance-based arguments are often thrown into the mix, but they seem to be derivative of the promissory and efficiency theories. *Id.* at 197-198.

¹⁵ CHARLES FRIED, *CONTACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION*, 16-17 (Harvard University Press 1981).

¹⁶ ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* at 12 (2000). Notably, Steven Feldman ably argues that this is a debate among scholars because the courts have overwhelmingly taken the side of morality over efficiency. Steven W. Feldman, *Autonomy and Accountability in the Law of Contracts: A Response to Professor Shiffrin*, 58 *DRAKE L. REV.* 178, 183-203 (2009).

¹⁷ RESTATEMENT (SECOND) CONTRACTS § 347.

¹⁸ *Id.*

¹⁹ Richard Caswell, *When is a Willful Breach ‘Willful’? The Link Between Definitions and Damages*, 107 *MICH. L. REV.* 1501, 1501 (2009) (“Liability for breach of contract is often described as a form of strict liability, in which the measure of damages is unaffected by the culpability of the breach.”)

²⁰ E. ALLEN FARNSWORTH, *CONTRACTS* § 12.3 (3d ed. 1999); see also Tess Wilkinson-Ryan & Jonathan Baron, *Moral Judgment and Moral Heuristics in Breach of Contract*, 6 *J. EMPIRICAL LEGAL STUD.* 405, 409 (2009) (hereinafter “Wilkinson-Ryan & Baron”).

²¹ Benjamin E. Hermalin, Avery W. Katz & Richard Cravell, Chapter on the Law & Economics of Contracts, in *THE HANDBOOK OF LAW AND ECONOMICS* at 99 (2007).

²² CALAMARI & PERILLO § 14.36, at 620.

²³ Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 *COLUM. L. REV.* 554, 558 (1977).

²⁴ Irma S. Russell, *The Broken Promise of Efficient Breach: Sacrificing Certainty for False Efficiency* (2007), http://works.bepress.com/irma_russell/2, at 26, n 116 (discussing efficient breach as theory, not excuse of contractual performance).

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that you must pay damages if you do not keep it, -- and nothing else.”²⁵ Under this view, where a party has assumed obligations pursuant to a contract, that party is presented with a simple choice: perform or pay damages.

Proponents of efficiency theory argue that a party who stands to benefit from the breach after paying damages should breach.²⁶ They contend that, by using an expectation measure of damages, contract doctrine incentivizes efficient breach and is, in turn, welfare maximizing. If contract law allowed for punitive damages or otherwise measured damages in reference to the culpability of the breaching party, many breaches would be inefficient -- it would be rare for a breaching party to be better off after paying the other party’s damages.²⁷

The efficiency theory of contract law has been subject to criticism, including the argument that efficient breach relies upon “a number of simplifying assumptions that do not hold in the real world.”²⁸ It has been argued that, among other things, efficient breach does not account for transaction costs or the limitations on damages that prevent a party from recovering all of her actual losses.²⁹ It has further been argued that efficient breach fails to account for any reputational harm to the breaching party.³⁰ The most disarming opposition to efficiency theory, however, is a fundamental criticism that it fails to take into account any moral dimension of breaching a contract.³¹

The moral view of contract doctrine justifies the law as a means to affirm the sanctity of promises. In *Contract as Promise*, Professor Charles Fried equated contracting with promising. He wrote of the binding nature of promises as a matter of personal autonomy and social norms:

An individual is morally bound to keep his promises because he has intentionally invoked a convention whose function it is to give grounds – moral grounds – for another to expect the promised performance. To renege is to abuse a confidence he was free to invite or not, and which he intentionally did invite.³²

In this connection, some theorists generally condemn contract doctrine’s amorality,³³ and contract theory is, thus, often presented as a polarity between efficiency and morality.³⁴

Increasingly, this polarity has itself been impugned as “artificial” and “unduly simplistic,”³⁵ giving rise to what might be characterized as a more intermediate approach that eschews the rigid poles. For example, Professor Seana Shiffrin argues that “[a]lthough the law should not aim to enforce interpersonal morality as such, the law’s content should be compatible with the conditions necessary for moral agency to flourish.”³⁶ Even in articulating this intermediate view, however, she rejects the efficiency view of contract law.³⁷

²⁵ Oliver Wendell Holmes, *Dedication, The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897); see also RICHARD POSNER, *THE ECONOMIC ANALYSIS OF LAW* 119 (6th ed. 2003) (describing Holmes’ insight as overbroad dictum).

²⁶ CALAMARI & PERILLO § 14.36, at 620.

²⁷ *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289 (7th Cir. 1985) (Posner, J. explains common law rule against punitive damages in contract law in terms of efficiency).

²⁸ Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1085, 1098 (1999-2000).

²⁹ *Id.* at 1098.

³⁰ *Id.* at 1099.

³¹ Bix note 14 *supra*, at 198 (citing Jody S. Kraus, *Reconciling Autonomy and Efficiency in Contract Law: The Vertical Integration Strategy*, PHILOSOPHICAL ISSUES 11: SOCIAL, POLITICAL AND LEGAL PHILOSOPHY), at 420-441 (2001) and STEPHEN A. SMITH, *INTRODUCTION TO CONTRACT THEORY* (Oxford 2004)).

³² Fried note 15 *supra* at 16-17.

³³ Sheana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 710 n.2 (2006-2007) (hereinafter “Shiffrin, Contract and Promise”) (citing Peter Linzer, *On the Amorality of Contract Remedies – Efficacy, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111 (1981); Frank Menetrez, *Consequentialism, Promissory Obligation, and the Theory of Efficient Breach*, 47 UCLA L. REV. 859, 879-80 (2000)).

³⁴ Shiffrin, *Contract and Promise*, note 33 *supra*, at 711; Jeffrey M. Lipshaw, *Objectivity and Subjectivity in Contract Law: A Copernican Response to Professor Shiffrin*, 21 CAN. J. L. & JURISPRUDENCE 399, 400 (2008) (hereinafter “Lipshaw”).

³⁵ Shiffrin, *Contract and Promise*, note 33 *supra*, at 711; Lipshaw note 34 *supra*, at 400.

³⁶ Shiffrin, *Contract and Promise*, note 33 *supra*, at 710; Seanna Shiffrin, *Could Breach of Contract Be Immoral?*, 107 MICH. L. REV. 1551, 1552 (2008-2009) (hereinafter, “Shiffrin, Immoral?”).

³⁷ Barbara H. Fried, *What’s Morality Got to Do With It?*, 120 HARV. L. REV. FORUM 53 (2007) (characterizing Professor Shiffrin’s position as “intermediate”).

Professor Shiffrin writes:

The efficient-breach rationale forwards a justification for a legal doctrine that consists in the claim that barring punitive damages would encourage and facilitate certain breaching behavior. But this behavior is condemned by morality. To the extent that law adopts and embodies this rationale, it thereby embraces and tries to encourage and facilitate immoral behavior.³⁸

Shiffrin does not argue that all breaches are morally wrong; she recognizes that morality requires more than a yes or no answer to the question ‘was there a promise?’ She argues that *some* breaches are morally wrong and the law should recognize immoral breaches with the availability of punitive remedies, “including blame, criticism, recrimination, and avoidance.”³⁹

In response, economic theorists have not necessarily disagreed that *some* breaches of contract may, in certain limited instances, be immoral. For example, Professor Steven Shavell divides the world of contracts into those that specifically provide for a contingency and those that do not.⁴⁰ In the situation where a contract expressly provides for a contingency, then a moral duty to perform is governed by the contract.⁴¹ In the situation, however, where the contract does not speak to the parties’ rights or obligations upon the occurrence of an event, Professor Shavell argues that “the moral duty to perform is governed by what a completely detailed contract addressing the contingency would have stipulated.”⁴²

Professor Shavell provides, among other examples, a contract for snow removal. According to his argument, if the contract expressly requires snow removal even if the clearing equipment is stolen, then the snow remover assumed a moral duty to clear the snow, even if the equipment is stolen. However, in the more common situation where the contract does not provide for this or any number of other possible contingencies, Professor Shavell argues that the snow remover’s moral obligation is defined by what the parties would have hypothetically agreed in a complete contract, which he presumes to be that the snow remover is absolved of his duty if the equipment is stolen.

Perhaps the most controversial aspect of Professor Shavell’s claim is that the “hypothetical” complete contract would only require performance by a party (here, the snow remover) when the cost of performance (removing the snow) would be less than the value of the performance to the other party (the land owner). In essence, Shavell’s claim is that the hypothetical complete contract provides for efficient breach and, therefore, supplies the relative moral obligations among the parties.⁴³

To make matters more complex, both Shiffrin and Shavell challenge “morality” as a fixed, unwavering principle. Both of them recognize the possibility that some, but not all, breaches of contract may be immoral. Surrounding each contract is a unique context that can significantly affect the assessment of the morality of a breach.⁴⁴

In these arguments, it is seen that, fundamentally, neither efficiency nor morality can ably explain all of contract law. To the extent these poles are even useful or accurate as justifications for contract doctrine, they are both all right and all wrong. If not all promises are sacrosanct, then the compass of morality does not guide in all cases. Likewise, because the goal of efficiency fails to account for the instances where there is a promise that carries a moral duty to perform, it cannot provide a consistent, universal theory of the law.

The principles of efficiency and morality fail to provide a unifying descriptive or

³⁸ Shiffrin, *Immoral?*, note 36 *supra*, at 1552.

³⁹ Shiffrin, *Immoral?*, note 36 *supra*, at 1551.

⁴⁰ Steven Shavell, *Why Breach of Contract May Not Be Immoral Given the Incompleteness of Contracts*, 107 MICH. L. REV. 1569, 1570 (2009) (hereinafter, “Shavell”).

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.* at 1572.

⁴⁴ Bix note 14 *supra* at 204 (discussing Thomas Scanlon, *Promises and Practices*, 19 PHILOSOPHY AND PUBLIC AFFAIRS 199 (1990)).

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normative explanation for contract law, and the competing justifications have yet to be harmonized.⁴⁵ In recognition of the polarity of the debate (or perhaps in spite of it) more theorists are drawn to a decided pragmatism.⁴⁶

One common strain of this pragmatism is to compartmentalize or sub-categorize areas of contract law or to focus on status-based differences among parties. For instance, Professor Jeffrey Lipshaw notes that theories about contract law often treat business entities and individuals differently.⁴⁷ The moralists have a tendency to limit their justification of contract doctrine to individuals, and the champions of efficiency often limit their theories to sophisticated business entities.⁴⁸ By making these distinctions among actors in the marketplace, these theorists can acknowledge the imbalances of bargaining power that exist in the market and evade counterarguments that their theories are unfair or oversimplified.

More generally, the scholarly competition between efficiency and morality has been framed around what is purported to enable the greatest public good. Economists argue that efficient breach makes the parties to the contract better off and, in turn, efficiently allocates the world's resources and increases the public wealth.⁴⁹ However, it has also been argued that, if the law encourages breach of contract, efficient or otherwise, it will lead to a breakdown of trust in the marketplace and, in turn, could actually inhibit market activity.⁵⁰ Efficient breach, it has been argued, undermines fundamental aims of contract law – predictability and certainty in the marketplace.⁵¹

Even proponents of efficiency theory recognize the social norms at play. They acknowledge that there is a “tension” between the law's lack of concern for the motives of the breaching party and the “felt sense that a wrong has been done when contracts are broken.”⁵² Adding to this discussion, there is also recent consideration of the intuition of those acting in the marketplace. A psychological study by Professors Tess Wilkinson-Ryan and Jonathan Baron suggests that subjects would impose higher damages on a breaching party who willfully breaches a contract, and that moral culpability of the breaching party was a salient factor in assessing damages.⁵³

Another of Professor Wilkinson-Ryan's studies found, however, that moral intuitions about breach of contract are not immutable. The study suggested that people were more likely to breach a contract that contained a liquidated damages clause, presumably because the agreed remedy changed the parties' understanding about the nature and content of the promises made in the contract.⁵⁴ This appears to support Professor Shavell's argument, at least to the extent that expressly stated remedies would define the moral obligations of the parties.

Remarkably, with the current prominence of strategic default, the polarity between morality and efficiency has taken center stage in the popular press, mirroring the ongoing debate among legal scholars.

⁴⁵ Lipshaw note 34 *supra*, at 408 (efficiency and morality will never be harmonized).

⁴⁶ Professor Brian Bix has argued that theories should be “localized to a particular jurisdiction and/or to a particular sub-categories of Contract Law.” Bix note 14 *supra*, at 195; see also Nathan Oman, *Unity and Pluralism in Contract Law*, 103 Mich. L. Rev. 1483 (2004-2005); Lipshaw note 34 *supra*.

⁴⁷ Lipshaw note 34 *supra*, at 400-01. See generally Larry T. Garvin, *Small Business and The False Dichotomies of Contract Law*, 40 Wake Forest L. Rev. 295, 298 (2005) (discussing merchants and consumers as status-based dichotomies in contract law); Meredith R. Miller, *Contract Law, Party Sophistication and the New Formalism*, 75 MISSOURI L. REV. 493 (2010) (discussing theoretical and doctrinal importance of party sophistication).

⁴⁸ *Id.* at 401.

⁴⁹ See Russell note 24 *supra*, at 19-20 (discussing “wealth maximization” as envisioned by economists).

⁵⁰ CALAMARI & PERILLO § 14.36, at 620.

⁵¹ Russell note 24 *supra*, at 4-5, 31-32.

⁵² Shavell note 40 *supra*, at 1570.

⁵³ See generally Wilkinson-Ryan & Baron, note 20 *supra*.

⁵⁴ Tess Wilkinson-Ryan, *Do Liquidated Damages Encourage Efficient Breach? A Psychological Experiment*, 108 MICH. L. REV. 633, 637 (2009-2010).

The Public Debate: Application of Theory to Strategic Default

With strategic default, the generalized public sentiment appears to account for a moral dimension of breach of contract. When it comes to a mortgage contract, social norms favor payment when possible. According to surveys, a decided majority of Americans believe that it is immoral to strategically default on a mortgage.⁵⁵ In a series of incisive articles, Professor Professor Brent T. White, a law professor at the University of Arizona, has gained much attention for his zealous encouragement of underwater homeowners (especially in non-recourse states)⁵⁶ to walk away from their homes. Professor White has challenged the social norms, arguing that homeowners should counteract shame, fear and emotional drivers and default when it is financially rational to do so.⁵⁷

Professor White's argument clearly sides with efficiency and the "perform or pay" position in the poles between efficiency and morality. He writes: "a mortgage contract, like all other contracts, is purely a legal document, not a sacred promise."⁵⁸ He continues to argue that there is "absolutely nothing immoral about exercising your option to breach," especially when it is "financially wise to do so."⁵⁹ In fact, Professor White argues that, in some instances, including strategic default, *the most moral action is to breach the contract.*⁶⁰

It is worth noting that Professor White does *not* argue that the homeowners have not breached the mortgage contract when they walk away. He does *not* argue, and it does not appear that anyone has seriously argued, that there is a conventional doctrinal reason that the homeowners are excused from their obligations – in other words, the traditional defenses of mistake, fraud and impracticability or frustration of purpose are not an appropriate doctrinal fit to excuse the homeowners from paying the loans.⁶¹

Rather, White and others are recognizing that the homeowners are in breach if they walk away, but that they should do so anyway and it is not immoral if they make that choice.

In essence, the encouragement of strategic default reads like a case for efficient breach.⁶² The defaulting homeowner is arguably better off walking away than continuing to repay a loan that far exceeds the value of the home. This is especially true the farther underwater the borrower sinks – that is, the more negative equity in the home, the more incentive there is to walk away.⁶³ Another factor is the time it takes for the lender to foreclose – the longer the delay, the longer the defaulting homeowner can live in the house "rent free," and the

"With strategic default, the generalized public sentiment appears to account for a moral dimension of breach of contract."

⁵⁵ Bob Tedeschi, *Home Owners Walking Away*, N.Y. TIMES, Oct. 25, 2009, at RE11, <http://www.nytimes.com/2009/10/25/realestate/25mort.html>; Zingales, note 3 *supra*; Kiplinger News, *A Third of Americans Have No Qualms About Strategic Default*, KIPLINGER (Sept. 22, 2010), at <http://www.kiplinger.com/news/article.php/a-third-of-americans-have-no-qualms-about-800078057.html>

Though, perhaps the stigma of default is waning. See Jane Hodges, *More see walking on mortgage as a viable plan: 'Strategic default' losing stigma as homes go deeper underwater*, MSNBC.COM (12/20/2010), at http://www.msnbc.msn.com/id/40704053/ns/business-real_estate/

⁵⁶ A "non-recourse" state is a jurisdiction where the lender has no right to pursue the borrower's personal assets if the amount received for the home in foreclosure is insufficient to satisfy the entire outstanding balance on the mortgage. Apparently, 11 states do not allow a lender to pursue deficiency judgments and, in the states that do allow it, lenders rarely pursue the remedy. Zingales, note 3 *supra*.

In the states where there is no statutory bar, and assuming there is no contractual bar, a lender may seek a deficiency judgment (difference between price in foreclosure sale and remaining outstanding balance). In those situations, the incentive for the borrower to walk away is not as strong because of the possibility of having to pay the deficiency. However, if lenders do not usually pursue this recourse, it may be worthwhile for the borrower to walk away and risk such a judgment. In that sense, the efficiency-morality issue is still implicated, but it is certainly more squarely in issue where the lender has no recourse beyond foreclosure.

⁵⁷ Brent T. White, *Underwater and Not Walking Away: Fear, Shame and the Social Management of the Housing Crisis*, 45 WAKE FOREST L. REV. 971 (2010) (hereinafter "Fear, Shame and Social Management"); Brent T. White, *Take this House and Shove it: the Emotional Drivers of Strategic Default*, 63 SMU L. REV. 1279 (2010) (hereinafter "Emotional Drivers"); Brent T. White, *The Morality of Strategic Default*, 58 UCLA L. REV. DISCOURSE 155 (2010) (hereinafter "Morality of Strategic Default").

⁵⁸ White, *Morality of Strategic Default*, note 57, *supra*, at 157 (citing Shavell, *supra*).

⁵⁹ *Id.* at 158.

⁶⁰ *Id.* at 160.

⁶¹ One could, perhaps, credibly argue that, in light of (1) the shifts in the housing market, (2) the role of lenders in causing this shift and (3) the fact that the lenders are in a better position to bear the risk, the doctrine of excuse should be expanded to relieve the homeowners of their obligations under the contracts. For a more general discussion of expansion of the doctrine of excuse, see Melvin A. Eisenberg, *Impossibility, Impracticability, and Frustration*, 1 JOURNAL OF LEGAL ANALYSIS 1 (2009).

⁶² See Posting of Paul Solman to The BUSINESS DESK BLOG, *What Does Justice in the Foreclosure Crisis Look Like?*, PBS NEWS HOUR (11/24/2010), <http://www.pbs.org/newshour/businessdesk/2010/11/what-does-justice-in-the-forec.html> (discussing "efficiency" of walking away).

⁶³ Nick Timaraos, *How Far Underwater Do Borrowers Sink Before Walking Away?*, WSJ DEVELOPMENTS BLOG, Jun. 28, 2010, <http://blogs.wsj.com/developments/2010/06/28/how-far-underwater-do-borrowers-sink-before-walking-away/>

“The right to foreclose is a remedy to which the parties agreed...”

more incentive there is to strategically default and save money for the eventual eviction.⁶⁴ Interestingly, one of the frequent concerns about strategic default is the effect it will have on a home borrower’s credit rating.⁶⁵ Once the factor of a home borrower’s credit rating is added to the decision whether to default, the calculation becomes more complex. In some cases, a factor against strategic default is stated as more than just the consideration of borrower’s credit rating; it even extends to concern about whether friends and family will harbor resentment as they continue to pay their own obligations.⁶⁶ Indeed, to the extent that an injury to the home borrower’s credit rating and relationships is a reputational harm, the public discourse imitates the argument that efficient breach theory relies upon simplifying assumptions.

Nevertheless, in making the case for strategic default, one could further argue that the bank is no worse off relative to what it bargained for – after all, the lender expressly agreed to take on the risk of getting stuck with the home instead of getting repaid on the loan. The right to foreclose is a remedy to which the parties agreed.⁶⁷

Indeed, applying Professor Shavell’s argument that breach of contract is not necessarily immoral, it would seem that the mortgage contract expressly provides for what should happen in the event of a default by the home borrower: foreclosure. Therefore, the moral obligations of the parties are expressed in the contract and, as long as the home borrower allows the foreclosure process to proceed, the home borrower has met her moral obligation. The foreclosure absolves the borrower of any moral obligation to continue to pay – because the bargain expressly frames the parties’ rights and, therefore, moral obligations. Incidentally, because the mortgage contract contains a specified remedy, it squares with the view of the subjects in Professor Wilkinson-Ryan’s study, which found that an agreed remedy changed their understanding about the nature and content of the promises made in the contract.⁶⁸

Notwithstanding this finding, many of the blog comments and even newspaper editorials⁶⁹ have reflected a public sense that the homeowners who strategically defaulted are acting “shamefully.”⁷⁰ Professor White has identified and attempted to refute the following three points which are generally stated as the premise for the argument that strategic default is immoral: (1) the homeowners promised to pay their mortgages and it is immoral to break a promise, (2) foreclosures depreciate neighborhoods and negatively affect neighbors’ property values and (3) if all underwater homeowners defaulted, the housing market might crash.⁷¹ In arguing that strategic default is moral, Professor White directly challenges all three points and, in so doing, invites further discussion of the theoretical underpinnings of contract doctrine and the efficiency versus morality debate.

⁶⁴ One article advises:

In fact, a strategic default can take a year or longer, depending on state laws and how quickly the lender might be able to sell the repossessed home.

Delays surrounding the foreclosure process mean homeowners often can stay in the home for up to two years before being evicted. In some cases, owners may be able to sock away as much as \$30,000 or \$40,000, Maddux [CEO of YouWalkAway.Com] says.

Marci Geffner, *3 options for unloading house in tough times*, STANDARD-EXAMINER (Nov. 11, 2010), at <http://www.standard.net/topics/business/2010/11/11/3-options-unloading-house-tough-times>

Indeed, amidst allegations of technical flaws in mortgage and foreclosure documents, Bank of America self-imposed a moratorium on foreclosure sales, leading one commentator to quip that this made strategic default look even more attractive. Felix Salmon, *Strategic default just got a lot more attractive*, REUTERS (FELIX SALMON BLOG) (Oct. 8, 2010), at <http://blogs.reuters.com/felix-salmon/2010/10/08/strategic-default-just-got-a-lot-more-attractive/>

⁶⁵ Tedeschi note 55 *supra* (“A foreclosure will drop the borrower’s credit score by at least 100 points, and will remain on a credit report for seven years.”); see also Robert Celasch, *Wait for the market to rebound, or cut your losses?* SACRAMENTO BUSINESS JOURNAL (Oct. 14, 2010), at <http://www.bizjournals.com/sacramento/stories/2010/10/18/focus1.html?b=1287374400%255E4093841> (foreclosure will lower credit rating 140-150 points).

⁶⁶ Amy Fontinelle, *Strategic Default: Should You Do it?*, SF GATE (PROVIDED BY INVESTOPEDIA), (Nov. 11, 2010), at <http://www.sfgate.com/cgi-bin/article.cgi?f=/g/a/2010/11/11/investopedia48377.DTL> (“Choosing strategic default also has social implications. Friends, family members, neighbors and other people who know about your decision may judge you negatively. They may see your behavior as irresponsible and/or immoral. People who are struggling to do everything in their power to keep their homes may resent you.”)

⁶⁷ The lender’s miscalculation was, of course, the assumption that such a sharp decline in housing prices was very unlikely to occur and that very few, if any, homeowners would ever purposefully default.

⁶⁸ Tess Wilkinson-Ryan, *Do Liquidated Damages Encourage Efficient Breach?* *A Psychological Experiment*, note 54.

⁶⁹ See note 5, *supra*.

⁷⁰ See note 10, *supra*.

⁷¹ See generally White, *Morality of Strategic Default*, note 58, *supra*.

The first of these points, that breaking a promise is immoral, very directly implicates the more general, scholarly discussion about whether breach of contract has a moral dimension. In response, White has essentially invoked some of the complexities of the debate among contract scholars. He argues that the social norm about keeping promises is not absolute but rather that “one should keep one’s promises unless one has a compelling enough reason not to.”⁷² In other words, morality is not a ‘yes or no’ question. The context of the housing crisis and the specifics of the written loan documents play a role in the assessment of what is ethical. Here, specific to the housing crisis, those who support strategic default point to the general unwillingness of lenders to renegotiate the loans and the widespread sense that many of the loans were imprudent, even predatory.⁷³

Professor White’s second and third points address the general concern that strategic defaults are not good for the economy at large and implicate the question about which justification of contract doctrine favors the greater public good.

The efficiency theorists would likely argue that strategic default makes sense not only for the borrower and lender but it also, in turn, efficiently allocates the world’s resources and increases the public wealth. This was basically an argument made by one of the anonymous *New York Times* website comments that supported strategic default: “The upside: Money not spent on a mortgage payment can be spent on goods and services that will stimulate local economies.”⁷⁴

Even so, with the example of strategic default, one can also see the argument that, if the law encourages breach of contract, efficient or otherwise, it may lead to a breakdown of confidence in the marketplace and, in turn, could actually inhibit market activity. The housing crisis precipitated a credit crisis, making it difficult to obtain financing in all facets of the economy, including for small businesses and potential homebuyers.⁷⁵ Even after receiving billions in taxpayer bailouts, banks tightened lending practices, nearly paralyzing the entire economy. The banks were “worried” they would not get repaid; what occurred was a breakdown of confidence.⁷⁶ In fact, then Treasury Secretary Henry Paulson commented on the bank bailouts: “Our purpose is to increase confidence in our banks and increase the confidence of banks...”⁷⁷

This point brings the conversation back to Professor Charles Fried’s observation that reneging on a promise (which he equates with the making of a contract) is an “abuse of confidence.”⁷⁸ If nobody felt obligated to follow through with contractual obligations, the convention of contracting would collapse. This appears to explain the social norms around keeping promises and the moral intuition that breaching a contract is wrong. In fact, Luigi Zingales, a professor of finance and entrepreneurship, has commented that “[u]ndermining the social norm that people should pay their mortgages, as Lowenstein and White do, is . . . a very bad idea. You might just as well say that when a theater is going up in flames, it’s ‘rational’ to trample other people in rushing to the exits.”⁷⁹

Professor Zingales’ argument is based on the devastating, domino effect that foreclosures have on communities and the property values of the neighboring homes.⁸⁰ The frequent response to his argument is an intuitive and appealing one that presents a double standard: lenders and big corporations default all the time when it is in their financial interest to do so, why can’t homeowners?⁸¹ Remarkably, this apparent double standard presents an

⁷² *Id.* at 159.

⁷³ See generally White, *Fear, Shame and the Social Management*, note 58, *supra*.

⁷⁴ See note 10, *supra*.

⁷⁵ See generally *Anatomy of a Meltdown*, WASH. POST, <http://www.washingtonpost.com/wp-srv/business/creditchrisis/>

⁷⁶ Frank Langfitt, *Despite Cash Injection, Banks Cautious on Lending*, NPR, ALL THINGS CONSIDERED, Oct. 20, 2008, <http://www.npr.org/templates/story/story.php?storyId=95913064>.

⁷⁷ *Id.*

⁷⁸ Fried note 15 *supra*, at 16-17.

⁷⁹ Zingales note 3 *supra*.

⁸⁰ *Id.* (result of mass strategic defaults “put[s] the entire system at risk”).

⁸¹ White, *Morality of Strategic Default*, note 57 *supra*, at 163 (discussing Tishman Speyer default in loans on Stuyvesant Town); Lowenstein

interesting challenge to the frequent presumption of scholars that business and personal contracts should be theorized separately.⁸² It also points to how the futility of a unifying theory of contract doctrine leads to the law's pragmatism, which can, however, potentially lead to its very incoherence.

Conclusion

The current, public discourse about strategic default provides a rich example of the competing theoretical views of contract law and illustrates the failure of either morality or efficiency as a unifying descriptive or normative theory. With the failure of a unifying theory, these theoretical poles form the basis for the parties' competing arguments. The lenders (and even the government)⁸³ are attempting to stave off mass foreclosures by shaming the borrowers for reneging on the promise to repay the loans. On the other hand, the defaulting homeowners (and those encouraging them) argue that there is nothing immoral about breaching a mortgage contract. The parties' respective arguments demonstrate that the question whether a breach of contract is immoral is more sophisticated than simply asking if someone reneged on a promise.

To the extent that the debate has been framed as one of individual morality, perhaps the response of contract doctrine should be an amendment of the current doctrine of excuse, so that the homeowners are not technically in breach of contract in the first place. This would force contract law to address whether the homeowners or lenders should bear the risk of the systemic failures that lead to the crisis. As it stands, however, contract law and theory are not equipped to provide any clarity to the public discourse, which is too often inaptly framed as a question of individual morality.

In truth, the debate about strategic default may not be one for contract doctrine but, rather, a question about which housing policies and lending practices enable the greatest public good. Because the concerns about strategic default – neighborhood depreciation and market collapse – are systemic, the solutions should be driven by those concerns. Rather than shame individual borrowers who decide to walk away, and place upon their conscience the burdens of depreciated neighborhoods and market failures, a more meaningful public discourse would instead focus on appropriate incentives for them to stay in their homes and systemic reforms to avoid this situation in the future. After all, the reason the individual morality of these homeowners is in a position to be challenged is a perfect storm that was occasioned in large measure by widespread, imprudent lending practices, and the morality of those practices may also be called into question.

“...the debate about strategic default may not be one for contract doctrine but, rather, a question about which housing policies and lending practices enable the greatest public good.”

note 7 *supra*.

Jon Stewart's *The Daily Show* pointed to this double standard when it “reported” on the Mortgage Bankers Association's own strategic default on its office space. See THE DAILY SHOW (Oct. 7, 2010), at <http://www.thedailyshow.com/watch/thu-october-7-2010/mortgage-bankers-association-strategic-default>

⁸² See note 47 *supra* and accompanying text.

⁸³ White, *Shame Fear and the Social Management*, note 57 *supra*; see also Fannie Mae, News Release (6/23/2010), at <http://www.fanniemae.com/newsreleases/2010/5071.jhtml> (for seven years, Fannie Mae will not give government-backed loans to borrowers who strategically default).

