The Financial Crisis and the Forgotten Law of Contracts

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At the bottom of the financial crisis lie failed contracts. Failed contracts are the stuff of contract law. Yet, to date, most discussions of possible responses to the financial crisis ignore contract law. To the extent contract law makes an appearance, the assumption is usually that the contracts at issue should and will be strictly enforced, so there is not much more to say. Contract law, however, is not dead. Nor is it impotent; it has just been forgotten. This Article explores how courts could use a number of contract doctrines to address perhaps the biggest remaining problem resulting from the financial crisis: the huge number of foreclosures of residential mortgages that have occurred, are occurring, and are expected to continue for some time. Modifications, especially those reducing principal, might have avoided many of these past foreclosures and might prevent ongoing and further foreclosures. Yet despite the fact that such modifications are often in the interests of both homeowner-borrowers and investors in bonds derived from those mortgages, in many cases, they do not happen. The political will for bold legislative action on this problem seems to be lacking. Many solutions to this problem have been proposed, but only a few have been attempted and those have not worked well. A cramped view of contract doctrine may be contributing to this lack of political will. Recognizing the flexibility of contract law may foster a greater willingness to consider creative legislative solutions. After reviewing the conventional contract law approach to the mortgage contract and examining how financial wizardry changed the relevant risks, this Article considers how courts might interpret the contract law doctrines of assignment, modification, restraint of trade, unconscionability, mistake, impracticability, damages, and the objective theory of intent to address the current foreclosure mess.

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I. CONVENTIONAL CONTRACT LAW, MORTGAGE RISKS, AND THE EFFECTS OF THE SECURITIZATION SYSTEM

At the bottom of the financial crisis lie failed contracts. Failed contracts are the stuff of contract law.¹ Yet, to date, most discussions of possible responses to the financial crisis ignore contract law.² Legal

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¹ CURTIS R. REITZ, CASES AND MATERIALS ON CONTRACTS AS BASIC COMMERCIAL LAW, at xxviii (1975).
² An important exception is John Patrick Hunt, Taking Bubbles Seriously in Contract Law, 61 CASE W. RES. L. REV. 681 (2011), which is aimed more broadly at how contract law should deal with bubbles in general. One recent student commentator laments, "The role of the judiciary has been noticeably absent from discussions about solutions to the mortgage crisis." Andrew J. Kazakes, Comment, Protecting Absent Stakeholders in Foreclosure Litigation: The Foreclosure Crisis, Mortgage Modification, and State Court Responses, 43 Loy. L.A. L. REV. 1383, 1386 (2010). Even that commentator, however, does not consider the possibility that courts could use contract law to address the problem. See id.
scholars have generally offered legislative solutions. And proposals for judicial involvement, most notably the settlement state attorneys general and several banks recently concluded for various alleged fraudulent and abusive practices, do not focus on ordinary contract law. Discussions of the crisis tend to say little about contract law, because they simply assume that the contracts at issue should and will be strictly enforced; given that assumption, there is not much more to say. The new formalism, apparently ascendant in the academy, already seems to have prevailed in the public realm despite the greatest economic catastrophe we have seen since the Great Depression.

Contract law, however, is not dead. Nor is it impotent; it has just been forgotten. More precisely, contract law includes a number of flexible doctrines that lawyers and courts with sufficient imagination and boldness could use to address what is perhaps the biggest current problem resulting from the financial crisis: the huge number of past, existing, and potential foreclosures of underwater residential mortgages. Modifications, especially those reducing principal, might have avoided many of these past foreclosures and might prevent future and ongoing foreclosures. Yet, despite the fact that they are often in the interests of both homeowner-borrowers and investors in bonds derived from those mortgages, such modifications are not occurring in a large number of cases. Many solutions to this problem have been proposed, but only a few have been attempted and those have not worked well. A cramped view of contract doctrine may well be contributing to this lack of political will for bold legislative action concerning this problem.

Contract law is no panacea. Court application and enforcement of contract law in individual mortgage cases, or perhaps even class actions, is probably not the best solution to the problem of mass

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5. See, e.g., Neil M. Barofsky, Op-Ed, Where the Bailout Went Wrong, N.Y. Times, Mar. 30, 2011, at A27 (declaring the Home Affordable Modification Program to be “a colossal failure, with far fewer permanent modifications (540,000) than modifications that have failed and been canceled (over 800,000)’’); Michael Powell & Andrew Martin, Foreclosure Aid Fell Short, and Is Fading Away, N.Y. Times, Mar. 30, 2011, at A1.
foreclosures, though it may well be better than what we have tried so far. Nevertheless, cases arising out of the crisis and making their way through the court system are likely to test the assumption of strict contractual enforcement. More important, even if courts do not wind up using contract doctrine in any of the ways I suggest are possible (and these arguments are possibilities; none is a slam dunk), recognizing the flexibility of contract law may foster a greater willingness to consider creative legislative solutions. Thus the common law and legislative action are not only substitutes; they inform each other, as well.

At the very least, the financial crisis raises novel, important, and interesting questions for contract law that scholars ought to be thinking about and debating. This Article aims to begin that discussion. It begins with a review of the conventional contract law approach to the mortgage contract and an examination of how financial wizardry changed the relevant risks. The Article then identifies two broad and interrelated themes arising out of these changes and explores how these themes might play out under a variety of contract doctrines. The first theme, interference with efficient contractual modification, implicates the contract law doctrines of assignment, modification, restraint of trade, and unconscionability. The second theme, exacerbation of and failure to protect against contractual risk, implicates the excuse doctrines of mistake, impracticability, and frustration of purpose. After discussing these themes, I end with a discussion of two famous contract cases in the areas of damages and the objective theory of contracts and show how these cases also provide useful insights into the themes of the financial crisis.

A. The Conventional Contract Law View of Mortgages and Their Risks

Let us begin with the contract at the root of the crisis, the residential home mortgage loan, and consider how conventional contract law understands this contract. Once a lender makes the loan, the lender generally has no further contractual duties to the borrower; only the borrower has duties of performance. The borrower’s primary duties under the note representing the loan contract are to repay the

6. I acknowledge at the outset that mortgages are special kinds of contracts and are governed by many different areas of law, including real property law and a variety of statutes, including the Uniform Commercial Code. See, e.g., U.C.C. §§ 3, 9 (2012). Nevertheless, mortgages involve contracts and are subject to the general law of contracts, unless that law is specifically displaced, for example, by statute.
principal and to pay an agreed rate of interest within the specified repayment period. The first key risk of any loan is the risk that the borrower will not be able to repay it, that is, “default” or “credit risk.” Under the contract, and contract law, the lender bears the default risk, which generally gives the lender a strong incentive to investigate the creditworthiness of the borrower. Lenders also protect against credit risk in a number of other interrelated ways, such as by requiring collateral (for example, in a mortgage contract, the house), charging a higher interest rate, and demanding a larger down payment.

A second risk involved in loans is the risk that changes in market rates of interest could affect the profitability of the deal: “interest rate risk.” In a fixed-rate mortgage, the lender also typically bears the interest rate risk, regardless of whether market interest rates rise or fall. If market interest rates rise, the lender gets a lower return on its money from the mortgage than if it had held onto the money and lent it out later at higher rates. If interest rates fall, mortgage lenders bear the risk because mortgage contracts typically give borrowers the right to make payments early (prepayment right), including the right to pay off the entire loan. Thus borrowers have an incentive to refinance their mortgages when interest rates drop sufficiently, which deprives the lenders of the higher interest payments at the initial rate. Since the 1980s, however, lenders have been able to shift the risk of rising interest rates to borrowers by contracting for adjustable-rate mortgages.

7. Of course, if the borrower’s default is the result of simple unwillingness to pay, as opposed to inability to pay, the borrower remains liable.

8. High interest rates helped lead to the savings and loan crisis. Savings and loan institutions had made many long-term mortgages at relatively low interest rates and so were earning low rates of return on their investments, but had to pay out higher and higher interest to short-term depositors. See, e.g., LAWRENCE J. WHITE, THE S&L DEBACLE 67-68 (1991). The problem was exacerbated by the fact that the Supreme Court of California, in Wellenkamp v. Bank of America, 582 P.2d 970 (Cal. 1978), permitted homeowners to transfer the low-interest mortgages to buyers despite the presence of due-on-sales clauses in the mortgage contracts, as long as the buyer was as creditworthy as the seller. This decision was later preempted by the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 321, 96 Stat. 1469, 1499 (codified as amended at 12 U.S.C. § 1701j-3 (2006)). See also Alex M. Johnson, Jr., Preventing a Return Engagement: Eliminating the Mortgage Purchasers’ Status as a Holder-in-Due-Course: Property Aligning Incentives Among the Parties, 37 PEPP. L. REV. 529, 540-42 (2010) (discussing the holding in Wellenkamp).

9. See, e.g., RESTATEMENT (THIRD) OF PROP.: MORTG. § 6.1 (1997). The Restatement characterizes the rule as a default rule, but for residential home mortgages, many states restrict the ability of lenders to prohibit or charge fees for prepayment of loans. In addition, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) do not accept mortgage loans containing prepayment fee clauses. Lenders can, however, charge “points,” which have similar effects to a prepayment fee. See Dale A. Whitman, Mortage Prepayment Clauses: An Economic and Legal Analysis, 40 UCLA L. REV. 851, 856-57 & n.17 (1993).
for which the interest rate varies with a particular market rate of interest.\textsuperscript{10}

A third risk arises out of the fact that, as noted above, real estate lenders typically take a security interest, known as the mortgage or deed of trust, in the property to protect against the default risk. In other words, the home serves as the collateral for the loan in a mortgage transaction. The risk here is that the value of the collateral could go up or down or, in particular, that the value of the collateral could become higher or lower than the outstanding loan balance. This risk could be termed “collateral” or “equity risk.” In a typical residential mortgage, the lender (as a creditor) is entitled only to the repayment of principal and interest, and the homeowner (as owner) bears the risk of any change in value of the collateral, whether positive or negative. Some further elaboration of this general principle is necessary, however.

Consider first the situation where the value of the collateral rises or is simply larger than the outstanding loan balance. If the homeowner sells the house, the prepayment right enables the homeowner to pay off the loan and keep the remaining increase in value. If the homeowner instead defaults on the loan payments, the homeowner is again entitled to the increase in value above the amount owed on the loan. Several important legal doctrines help insure this result. Courts have long held that the mortgage debtor has an “equity of redemption,” meaning that the debtor has an absolute right (as an owner) to redeem the collateral by making full payment of the underlying debt.\textsuperscript{11} The English High Court of Chancery first recognized the equity of redemption to prevent the immediate expulsion of a landowner who had some prospect of resuming payments within a reasonable time after default.\textsuperscript{12} But courts have understood the equity of redemption to be part of a broader “anticlogging” principle, under which “anything in the mortgage contract which permitted the mortgagee (lender) to retain any interest in the mortgagor’s (borrower’s) property following full payment of the

\textsuperscript{10} Whitman, supra note 9, at 854.

\textsuperscript{11} See, e.g., RESTATEMENT (THIRD) OF PROP.: MORTG. § 3.1(a). The equity of redemption right is mandatory; parties cannot contract out of it. Id. § 3.1(b).

\textsuperscript{12} Vernon v. Bethell, (1762) 28 Eng. Rep. 838 (Ch.); see J. Douglass Poteat, State Legislative Relief for the Mortgage Debtor During the Depression, 5 LAW & CONTEMP. PROBS. 517, 525 (1938). For my purposes, what is important is to note the long-standing willingness of courts to step in and modify mortgage contracts, albeit procedurally rather than substantively, to alleviate hardship on mortgage debtors.
underlying debt was ineffective." Courts recognized that at some point the equity of redemption could be cut off, or foreclosed. Subsequently, most jurisdictions developed the process of "foreclosure by sale," under which the lender who has received a foreclosure decree can have the property sold at a public auction, with the proceeds used to satisfy the debt. The lender must, however, return to the homeowner any surplus, representing the homeowner's equity in the property.

Consider next the situation where the value of the collateral drops. In normal economic times, a drop in the value of a house generally does not reduce that value below the value of the outstanding loan balance. As a result, if the homeowner sells the house, the homeowner can pay off the lender in full but will bear the loss of the drop in home value in a lower amount recovered from the sale. If the value of the house does fall below the value of the outstanding loan (that is, the house is "underwater"), then the homeowner again generally bears the risk, at least in theory. In this scenario, if the homeowner defaults and the lender forecloses and sells the property,

13. Morris G. Shanker, Will Mortgage Law Survive? A Commentary and Critique on Mortgage Law's Birth, Long Life, and Current Proposals for Its Demise, 54 CASE W. RES. L. REV. 69, 75 (2003). Shanker argues that the broader principle has been unjustifiably undermined by RESTATMENT (THIRD) OF PROP.: MORTG. § 3.1(c) ("An agreement in or created contemporaneously with a mortgage that confers on the mortgagee an interest in mortgagor's real estate does not violate this section unless its effectiveness is expressly dependent on mortgagor default.") and developments such as the Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. §§ 3801-3806 (2006), which authorizes "shared appreciation mortgages (SAMS)."

14. See, e.g., RESTATMENT (THIRD) OF PROP.: MORTG. intro. note. The Restatement adds:

It is frankly recognized that these two principles, the right of redemption and the right to surplus, are restrictions on the parties' freedom of contract. They have been justified for hundreds of years by the view that borrowers are often necessitous and incautious, and that they will frequently agree to exceedingly improvident arrangements in order to secure the funds they need.

Id. Before the current crisis, some commentators expressed the concern that if the borrower defaulted despite an increase in the value of the house, then although in theory the borrower would be entitled to the surplus value over the amount owed on the loan, in practice, because the lender would often be the sole bidder at the foreclosure sale, the lender could buy the home at the foreclosure sale for the value of the outstanding debt, but then resell the house at a higher market price, thus capturing the increase in the value of the home. See, e.g., Steven Wechsler, Through the Looking Glass: Foreclosure by Sale as De Facto Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale, 70 CORNELL L. REV. 850, 858 (1985) (providing examples of this behavior). But because most homeowners would probably just sell the house if its market value had risen and pay off the mortgage rather than default, this problem may not be so significant. See Debra Pogrund Stark, Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform, 30 U. MICH. J.L. REFORM 639, 665 (1997) (arguing that instances of lenders' capturing the surplus are relatively rare).
there will be a "deficiency," representing the difference between the outstanding loan balance and the market value of the property realized in the foreclosure sale.\textsuperscript{15} Whether the lender can go after this deficiency depends on whether the loan is "recourse" or "nonrecourse," which is governed by state law. In nonrecourse jurisdictions, the lender's only remedy is to foreclose on the house. In recourse jurisdictions (the majority), the lender may go after other assets of the borrower if there is a deficiency. However, as a practical matter, even in recourse states, lenders rarely go after defaulting borrowers because borrowers rarely have other assets worth the time and expense of pursuing. Moreover, a borrower with other assets would be less likely to default in the first place.\textsuperscript{16} To the extent that the lender does not recover the deficiency, the lender winds up bearing the risk of a drop in the value of the collateral if the borrower defaults. This risk is mitigated somewhat by the fact that borrowers are often deterred from defaulting, even on an underwater mortgage, for a number of reasons, such as a concern about harm to their credit rating or a moral belief in keeping promises. In any case, lenders can protect against this collateral risk by demanding a larger down payment (or, to

\begin{itemize}
  \item \textsuperscript{15} See, e.g., RESTATEMENT (THIRD) OF PROP.: MORTG. §§ 8.2(b), 8.4.
  \item \textsuperscript{16} If the defaulting borrower does have assets worth going after, one important question is how to determine the current value of the property, which in turn determines the deficiency the borrower is obligated to pay. If the size of the deficiency is determined by the bid for the home at a foreclosure sale and if the bidding for that sale is not competitive (as it typically is not because the lender is often the only bidder), the bid value might be significantly less than the fair market value of the property, resulting in a higher deficiency owed by the borrower. This problem was common after the sharp decline in housing prices resulting from the Great Depression. After most courts refused to intervene, many states passed "antideficiency" statutes to address the problem. See Poteat, supra note 12, at 530-31. Poteat remarks:

  It would seem that a court which had set itself a precedent for inventiveness in the creation of the equity of redemption to relieve against the forfeiture of a mortgagor's land would not doubt its authority to deal with the inequities inherent in [the deficiency valuation problem]. But this tradition of the early English Chancellor seems not to have been generally inherited by his contemporary American counterpart.

  \textit{Id.} at 530. Although most courts refused to intervene, J. Douglass Poteat notes that one, the Supreme Court of Wisconsin, was "unwilling to be hemmed in by the inadequacy of old formulas and at the same time [denied its] dependence on legislative authority, [and so broke] through the conventional equity idiom and ... asserted for [itself] an inherent competence to deal with the new demands of this period[, for example, the Great Depression]." \textit{Id.; see} Suring State Bank v. Giese, 246 N.W. 556 (Wis. 1933). After describing this case, Poteat concludes, "Had the courts taken the lead furnished by this decision, it is possible that the many deficiency judgment statutes designed to accomplish the same purpose—and largely by the same procedure—would never have been enacted." Poteat, supra note 12, at 531 (footnote omitted).
\end{itemize}
The greater the down payment, the lower the chance that even if the value of the collateral declines, it will fall below the outstanding amount of the loan.

Fourth, the loan, once made, is often assigned by the loan's "originator" to another entity. Typically the mortgage note expressly permits such assignment. From the viewpoint of conventional contract law, the assignment is irrelevant to the borrowing homeowner. Even absent express permission, contracts are generally assignable, especially when the only contractual obligation of the party contracting with the assignor is to pay money. The justification for this rule is that the paying party (in this case, the borrowing homeowner) should not care who it is paying as long as once the money is paid in full; the paying party gets the full contractual benefits of whatever he was paying for. Putting this in terms of risk, the risk to the borrower from the lender's assignment of the borrower's payment stream to another party ("assignment risk") is zero; thus this fourth type of risk is generally ignored in the typical assigned loan.

Fifth, parties to a loan contract, like parties to other contracts, may want to modify their contract to respond to changing circumstances, though typically the borrower seeks the modification. In the simple mortgage loan context, in which there is a single lender that keeps the mortgage loan whole, if the borrower runs into difficulty making the payments on the loan, the lender and the borrower may voluntarily agree to a variety of modifications of the contract, for example, extension of the time of payment, reduction of the interest rate, or reduction of the principal. Lenders are often willing to enter into modifications, even though they get less under the modification than they would under the original loan, because modifications may increase the likelihood that the homeowner will be able to repay the loan. Lenders could foreclose rather than modify, but foreclosures are costly, both in terms of time and effort, and foreclosure sales often result in lower (distress) sale prices, and so less money for the lender. Whether or not a modification will occur is uncertain. Hence the possibility of modifications, although they are not usually thought of this way, creates yet another form of risk: "modification risk." Under the conventional view, the lender does not bear any modification risk because the lender can always refuse to modify the loan. The borrower bears the risk that the lender will refuse to modify. However, if

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transaction costs associated with modification are low, then the modification risk borne by the borrower is relatively small, because the parties will likely reach some agreement as long as the joint gains from doing a modification exceed the joint gains from foreclosure or other legal remedy.

Finally, if the homeowner defaults on the loan payments, the homeowner is generally in breach of contract, regardless of the reason for default. This is the strict liability feature of contractual liability. Defenses exist under contract law, but they are relatively limited. For example, the borrower bears the risk that general economic circumstances will deteriorate (namely, depression), leading to job loss or other financial hardship for the borrower. The possibility that contract law can allocate or reallocate contractual risk can be conceived as a final form of risk, namely “legal risk.” Predictable contract law is conventionally thought to minimize risk to the contracting parties. Nevertheless, courts will inevitably sacrifice predictability to some degree if they decide that some other risks have gotten out of whack or they suspect some kind of misbehavior on the part of the promisee.

My thesis is that in the period leading up to the current financial crisis, the financial industry reconfigured the traditional structures and altered the relevant risks of the residential mortgage contract so significantly as to call into question the appropriateness of the conventional contract law approach. As a result, courts may, and should, rethink the conventional contract law approach to these contracts by adjusting the legal risk to compensate for the reconfiguration and exacerbation of other risks that occurred. Under the circumstances giving rise to the current crisis, there are sound bases in contract law and theory for doing so.

B. How the Financial Industry Changed the Conventional Relationships and Increased Risk

The short version of the financial industry’s story of its “innovations” in the period leading up to the financial crisis is that the industry figured out ways to reduce mortgage risks to lenders, which lowered the cost of credit and enabled the industry to make homes available to a broader range of homeowners. In particular, lenders became more willing to extend mortgages to those in the “subprime” category who, because of their high credit risk, did not qualify for conventional mortgages backed by the “big three” government-sponsored entities (GSEs): the Federal National Mortgage Association
The reality we have discovered is that the innovations, as they were implemented, actually increased risk, hid the true cost of credit, facilitated a bubble in housing prices, and created a novel way to short the housing market that may have exacerbated the harmful effects of the bubble's bursting. Although the causes of the financial crisis are many, complex, and intertwined, we know enough about what happened to see how the financial innovations impacted the conventional understanding described above.

The primary innovation was the extension of "private-label" securitization into the subprime residential mortgage market. Securitization begins with the pooling of mortgages, or the assignment by the originating lenders (commercial banks or specialized monoline lenders) to a trust (special purpose entity or vehicle) created by a sponsor, also known as an arranger or issuer (often originating banks, but also investment banks and monoline lenders). The trust raises money to buy the mortgages by soliciting investors to buy "residential mortgage-backed securities" (RMBSs), which are bonds entitling the investors to a payment stream from the mortgage pool. In subprime mortgage securitizations, investors purchase securities in different

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18. In 2006, 21% of all mortgages were subprime mortgages. Mark Zandi, Financial Shock 47-48 (updated ed. 2009). Subprime lending grew more than threefold from $190 billion in 2001 to $600 billion in 2006. Adam B. Ashcraft & Til Schuermann, Fed. Reserve Bank of N.Y., Understanding the Securitization of Subprime Mortgage Credit 2 tbl.1 (2008). Alt-A loans, made to borrowers with good credit but with lower underwriting standards, increased more than sixfold from $60 billion in 2001 to $400 billion in 2006. Id.

19. In 2006, 75% of subprime mortgage loans and 91% of Alt-A mortgage loans were securitized, versus 46% and 19% in 2001. Ashcraft & Schuermann, supra note 18, at 2 tbl.1. Securitization had been done previously by the GSEs, but only for "investment grade" mortgages, because the GSEs guaranteed the timely payment of principal and interest and so protected investors against credit risk. See, e.g., Adam J. Levitin, Andrey D. Pavlov & Susan M. Wachter, Securitization: Cause or Remedy of the Financial Crisis? (Georgetown Univ. Law Ctr. Bus. Econ. & Regulatory Policy Working Paper Series, Paper No. 1462895, 2009; Inst. for Law & Econ., Univ. of Pa. Law Sch., Paper No. 09-31, 2009), http://ssrn.com/abstract=1462895. GSEs did not get involved in subprime mortgages until relatively late (2005) and then only by buying top-rated tranches of subprime CDOs. Id. at 10.

20. In 2006, the top ten subprime mortgage originators, representing 60% of the market, were HSBC, New Century Financial, Countrywide, CitiGroup, WMC Mortgage, Fremont, Ameriquest Mortgage, Option One, Wells Fargo, and First Franklin. Ashcraft & Schuermann, supra note 18, at 4 tbl.2.

21. In 2006, the top ten issuers of subprime mortgage-backed securities, representing 63% of the market, were Countrywide, New Century, Option One, Fremont, Washington Mutual, First Franklin, Residential Home Funding Corp, Lehman Brothers, WMC Mortgage, and Ameriquest. Id. at 4 tbl.3.
“tranches,” which correspond to priority levels of payment streams from the aggregated proceeds of all the loans. Investors in the upper-level, highest-rated tranche, which typically represents the vast majority of the investors, get paid first out of the pool and so get the lowest return, corresponding with the lowest level of risk. Investors in the lower-level tranches have a lower priority of payment and so incur a higher level of risk, corresponding with a higher rate of return. Securities from lower-level tranches are themselves often resecuritized by being pooled with similar securities from other mortgage pools. In these resecuritized pools, termed “collateralized debt obligations” (CDOs), investors are also grouped into tranches, again with the vast majority of the highest tranche receiving the highest credit rating. Finally, the trust hires servicers, often affiliated with large commercial banks, to manage the collection and distribution of mortgage payments and to deal with the borrowers in the event of difficulties. Thus, in the world of securitization, it is no longer sufficient to talk about “the lender”; instead, we must distinguish (at the very least) four different parties: the originator, the sponsor (arranger), the investor, and the servicer. How did securitization affect the contractual risks associated with mortgages?

First, lenders who originated mortgages began to care less about credit risk and extended more mortgages to less creditworthy borrowers with less protection for the lenders against default. The immediate reason is that the originators earned fees for closing the mortgages and then assigned them away so that they no longer bore the credit risk. They made money on volume fees paid up front and so acted to maximize the number of loans, leaving the assignees to bear the credit risk.

22. In 2006, the top ten subprime mortgage servicers, representing 54% of the market, were Countrywide, JPMorgan Chase, Citigroup, Option One, Ameriquest, Ocwen Financial Corporation, Wells Fargo, Homecomings Financial, HSBC, and Litton Loan Servicing. Id. at 4 tbl.4. The mortgage servicing industry has undergone substantial consolidation in recent years. By the end of 2008, seventeen firms serviced 88% of all subprime loans, led by Bank of America (which acquired Countrywide), Chase Home Finance, and HSBC, with a combined 42% of the market. Larry Cordell et al., The Incentives of Mortgage Servicers: Myths and Realities, 41 UCC L.J. 347, 357 tbl.4 (2009).

23. From 1999 to 2006, the average loan-to-value ratio of securitized subprime mortgage loans increased from 78.8 to 85.5, meaning that borrowers were putting less money down and taking out larger loans. During the same period, the percentage of securitized subprime mortgage loans for which full documentation of income was provided dropped from 68.7% to 57.7%. ASHCRAFT & SCHEURMANN, supra note 18, at 16 tbl.5. Many of the loans, termed “liar loans,” required no down payment at all and no documentation of income ("stated income"). See, e.g., ZANDI, supra note 18, at 38-39.
Of course, that reason simply raises the question why the borrowers were willing to incur, and the assignees were willing to take on, this additional credit risk. There are basically two, not mutually exclusive, answers. One answer is, essentially, fraud. Any one of the securitization parties, acting alone or in conjunction with one or more of the other parties, may have misled or inadequately informed one or more of the other parties about the credit risks of the borrowers and the degree to which they were protected against these risks. Fraud or similar conduct that originates in the initial loan between the originating lender and the borrower is usually referred to as “predatory lending,” whereas fraud or similar conduct that originates with the borrower has been termed “predatory borrowing.” Even in the absence of fraud in the origination of the loan, fraud and similar conduct could, and apparently did, occur at later stages in the process. Originating lenders made misrepresentations to, or at least insufficiently informed, sponsors or investors about the riskiness of the loans assigned to the securitization pool or about their ability to buy back defective loans, which they promised to do in the “representations and warranties” of their contracts. And sponsors misrepresented or inadequately disclosed in the prospectuses the riskiness to investors of the mortgage loans in the securitization pool. Although direct claims of fraud and similar conduct have to date provided the basis for most of the litigation surrounding the foreclosure crisis, my focus is on the indirect implications of this conduct for contract law treatment of mortgages in cases where fraud in a particular case did not occur or cannot be proved.

The other explanation for the deterioration in residential mortgage lending standards is that the sponsors of, raters of, and investors in mortgage-backed securities thought (erroneously, as it

24. See, e.g., Harold C. Barnett, And Some with a Fountain Pen: Mortgage Fraud, Securitization and the Subprime Bubble, in How They Got Away with It: White-Collar Criminals and the Financial Meltdown 104, 106 (Susan Will, Stephen Handelman & David C. Brotherton eds., 2013) (“[T]he magnitude of fraudulent subprime loans was sufficient to collapse the subprime bubble and initiate the subsequent financial meltdown.”).
25. Ashcraft & Schuermann, supra note 18, app. 2 at 72-74.
27. See, e.g., id.
Securitization of subprime mortgage loans appeared to reduce credit risk by spreading the risk of borrower defaults over a large number of investors. The assumption underlying the securitization regime was that the credit risks of the loans making up the trust were not significantly correlated; that is, the chances of loans in a pool defaulting were thought to be largely independent of each other, like the risks of fires covered by homeowner policies held by an insurance company. This assumption of diversification, which was especially important—and especially problematic—for the resecuritizations of the lower-level tranches of the initial securitizations, led to the belief that the credit risk (and so the cost of credit) for the investors in subprime mortgage pools had dropped significantly. As a result, lenders started to court subprime borrowers more aggressively, which increased the demand for housing. Where possible, builders rapidly put up new homes to meet this demand. In other locations with more inelastic supply, housing prices rose rapidly. The key point is that the financial industry brought into the system a huge amount of additional credit risk that it erroneously thought had been sufficiently diversified.

Another important innovation that affected perceptions of credit risk was the credit default swap (CDS). CDSs are effectively a kind of

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29. Another answer, popular among some politicians and academics, is that the federal government forced banks to relax their credit standards to make housing more available to the poor and minorities. Although the government certainly adopted policies designed to make housing more widely available to these groups, the scope and timing of the expansion of the subprime market make this explanation implausible as the dominant cause of the financial crisis. In any case, certainly the banks in private-label securitizations were not forced by the government to do what they did. See, e.g., FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT, at xv-xxviii (2011), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

30. How much the sponsoring banks actually believed this is a matter of debate. For example, according to journalist Michael Lewis, although the original purpose of mortgage-backed securities was to lower cost of credit and facilitate more loans, the goal eventually became to hide the risk by complicating it. The market was paying Goldman Sachs bond traders to make the market less efficient. With stagnant wages and booming consumption, the cash-strapped American masses had a virtually unlimited demand for loans but an uncertain ability to repay them. All they had going for them, from the point of view of Wall Street financial engineers, was that their financial fates could be misconstrued as uncorrelated.


31. Id. at 8-9, 46-47.


33. LEWIS, supra note 30, at 94.
insurance against loan (bond) defaults. If the bonds are mortgage-backed securities, CDSs also provide a kind of indirect insurance against mortgage defaults and so protection against the credit risk associated with those defaults. Of course, the risk does not go away, but is merely shifted to the party providing the insurance. If the insuring party (CDS seller) can provide efficient diversification, costs associated with credit risks could be reduced, at least in theory. In fact, the same “sponsor banks” that securitized mortgages also eventually securitized CDSs written on credit default obligations (CDOs) (the resecuritisations of lower-tranche, mortgage-backed securities) to create “synthetic CDOs,” again with assertions that the magical diversification powers of securitization made these investments very low risk.\textsuperscript{34}

In reality, however, the use of CDSs in the subprime mortgage market increased risks in a number of ways. Because the CDS sellers, the ultimate bearers of the credit risk of mortgage borrowers, were one step further removed from those borrowers than even the investors in mortgage-backed securities, it was less likely that the CDS sellers would fully understand the credit risks they were undertaking. Moreover, CDSs introduced a new risk into the market: the risk that the insuring parties would not have sufficient assets to pay off on the insurance. This risk, known as “counterparty risk” (really just a kind of credit risk for insurers), was of course thought to be minimal because the bonds being insured were so unlikely to default. As it turned out, however, American International Group (AIG) was the insurer of many of the CDSs in the subprime market, and a government bailout was necessary to enable AIG to make the required insurance payments.\textsuperscript{35}

In addition, CDSs, and the synthetic CDOs created from them, increased risk in the mortgage-backed securities market because they were not limited by the number or value of actual mortgages.\textsuperscript{36} Unlike purchasers of other types of insurance, purchasers of CDSs (the “insureds”) need not have an insurable interest in the bonds they are insuring against and can “insure” for more than the value of the bonds insured against. The asserted justification for these differences from other insurance is that CDSs can be used for beneficial, speculative purposes. Indeed, a number of insightful and determined investors

\textsuperscript{34} Id. at 72-78.
\textsuperscript{35} Id. at 83, 259-60.
\textsuperscript{36} According to Michael Lewis, “The market for ‘synthetics’ removed any constraint on the size of risk associated with subprime mortgage lending.” Id. at 77.
famously used CDSs to short the housing market, which they correctly believed to be overvalued. More infamously, Goldman Sachs and other investment banks allegedly used CDSs to bet against securitizations that they had created. Although some speculative use of CDSs could be justified on efficiency grounds and theoretically could help homeowners by stopping credit bubbles sooner than might otherwise be the case, in the subprime mortgage market, in fact, CDSs helped grow the market and prolong the bubble rather than bring down prices faster. Moreover, once the bubble popped, CDSs amplified the losses incurred and helped spread the economic crisis far beyond the subprime mortgage market. Finally, because it was not thought to be subject to the insurable interest or overinsurance limitations of ordinary insurance, CDSs created incentives on the part of buyers and sellers to overinvest in actions that would make it either more or less likely that the insurance would pay off, investments that are socially wasteful and potentially harmful.

Apart from these effects on credit risk, the second way securitization affected the contractual risks associated with mortgages was to change the nature of interest rate risk. Although fluctuating market interest rates were a main concern of lenders in early mortgage securitizations, they became a much less important factor in subprime mortgage securitizations. The Federal Reserve System adopted a policy of sustained low interest rates, which took care of both the upside and downside interest rate risk problems. In any case, as mentioned above, lenders often protected themselves with adjustable-rate mortgages.

37. See id. (describing several of the key players in the creation of the CDS market that sought to bet against the CDO bubble).
38. See, e.g., Barnett, supra note 24, at 104, 123-25 (discussing Abacus's suit against Goldman Sachs).
39. See, e.g., id. at 124 (arguing that a "synthetic CDO will amplify the impact of default, variously by a factor of three to seven").
40. For this reason, I believe courts should hold CDS contracts unenforceable under contract law as contrary to public policy to the extent they overinsure or involve an uninsurable interest (another forgotten law of contracts). In my view, such claims are not preempted by the Commodity Futures Modernization Act of 2000, H.R. 5660, 106th Cong., 114 Stat. 2763 app. E (2000) (current version at 7 U.S.C. § 27f (2006)).
41. See Lewis, supra note 30, at 7.
42. Some commentators have emphasized that low interest rates helped fuel the housing bubble by spurring the demand for housing, and also helped fuel the demand by investors for mortgage-backed securities because of the attractive returns they provided. Although low interest rates undoubtedly played a role in leading to the crisis, they do not tell the whole story. See, e.g., Levitin, Pavlov & Wachter, supra note 19, at 9. In any case, the particular responses of the financial industry to these low rates were not inevitable.
What became important in the subprime mortgage market was the way contractual interest rates were set. Subprime mortgages generally were hybrids, incorporating both fixed-rate and adjustable-rate features. They used a fixed, initial “teaser” rate that lasted for two or three years, followed by a much higher “reset” adjustable rate based on a fixed markup over a market interest index. To avoid the reset rate, subprime lenders and borrowers depended on refinancing in the wake of expected increases in housing prices as the only way the subprime borrowers had any chance of paying off the loans. In addition, unlike most prime mortgages, most subprime mortgages had penalties for prepayment. That meant that when subprime borrowers sought to refinance, in effect, they could go only to the original lender, who could renegotiate the prepayment penalty along with the mortgage. As a result of an inability to shop around for refinancing, the risk to the subprime borrowers resulting from the reset interest rate increased significantly.

Third, the financial industry mistakenly came to believe that it had reduced collateral risk. As long as the loan pools were sufficiently diversified and housing prices did not generally decline across the board, the fact that some housing prices might drop in some locations was not important to the investors. In fact, as already noted, home prices in many locations had been rising, fueled by increased demand for housing made possible by the greater availability of cheap credit, which in turn was made possible not only by the sustained low interest rates, but also by the securitization myth that credit risk had been substantially diversified away. Unfortunately, the high home prices turned out to be a bubble. When the bubble burst, the artificially inflated housing values disappeared, leaving many borrowing homeowners underwater, that is, holding mortgages for which the outstanding principal debt exceeds the current market value of the home. The key point, however, is that by artificially fueling the demand for housing based on false assumptions and false or misleading statements about credit risk, the financial industry itself


44. Id. at 79-80.

significantly increased collateral risk. Financial institutions kept blowing air into the bubble.

Fourth, the private-label securitization system changed the nature of the long-standing practice of assigning mortgages. Instead of mortgages being assigned to other lenders and treated as a whole, mortgages were assigned to a trust in which individual mortgages dissolved into an undifferentiated pool. Securitization made investors relatively indifferent to the performance of any individual mortgage and largely unable to monitor the management of the trust to ensure the maximum value of the pool as a whole. The investors were a large and diverse group “represented” by a trust with a deliberately weak governance structure and a mortgage servicer with authority to make important decisions concerning the individual mortgages in the pool, but lacking a direct financial stake in the mortgages themselves. As Part I.C will show, this combination created risks for homeowner-borrowers that had not existed before because the nature of the assignee had changed.46

Fifth, we are now in the aftermath of the burst housing bubble, and the financial industry having been rescued, one of the main problems is the tremendous number of mortgage loans in distress. The financial crisis has become a foreclosure crisis.47 One key and unique feature of the foreclosure crisis is the concern that many mortgage loans that would be economically efficient to modify are not being modified. A mortgage modification is efficient if the value that could be obtained from modifying the home exceeds the value that can be extracted from foreclosing. In the days before securitization, lenders had a strong incentive to make efficient modifications. In the securitization world, however, the “lender” is no longer a unified decision maker but a dispersed group of investors inadequately represented by servicer “agents.” As will be discussed in detail below, servicers do not have incentives to make efficient mortgage modifications. Moreover, the structure of securitization arrangements created a number of restrictions on modifications. As a result,

46. One set of risks, on which this Article will not focus, concerns the validity of some of the assignments due to “procedural” defects, such as faulty record keeping and the disputed legal status of the Mortgage Electronic Registration System (MERS). See sources cited infra note 73. These are significant concerns, but again separate from the contract law issues I want to raise here.

47. Within twelve months of origination, 4.7% of 2005 vintage mortgages were seriously delinquent or in foreclosure. For 2006 vintage mortgages, the rate increased to 7.8%, and for 2007 vintage mortgages, the rate increased to 10%. LEVENTIS ET AL., supra note 45, at 9.
subprime mortgage securitization imposes modification risks on borrowers that did not exist before.

Finally, although contract law often takes a strict liability approach to obligations, especially in the financial sector, it has always responded to perceived misallocations and nonallocations of risk in contracts. Contract law contains numerous doctrines designed to put liability on the party better able to control, prevent, foresee, protect against, or mitigate risks. As we have seen, the financial industry, in setting up the system of securitizing home mortgages, increased risks in a number of ways. Although the causes of the financial crisis are surely varied and complex, we at least know that at some point the financial industry realized that it had not reduced default risk as much as it originally thought, leading to a drop in prices of mortgage-backed securities, a freeze-up of the secondary loan market, increased defaults on mortgage loans, plunging home prices as lenders flooded the market with a large supply of foreclosed houses, a large number of underwater mortgages, and the effective insolvency of all of our leading financial institutions. The financial crisis then led to a broad economic recession, which, in turn, has led to more defaults on mortgage loans and the current foreclosure crisis. The important point is that the financial crisis was no accident or freak of nature. Many of its causes and consequences are directly traceable to specific actions and omissions of financial institutions that they erroneously believed were reducing, rather than increasing, risk. This fact has important implications under contract law, which will be considered in Part II.

C. Restrictions on Modifications to Securitized Mortgages

John D. Geanakoplos and Susan P. Koniak give the following example of how modifications involving reductions in principal could be efficient (that is, benefit both borrowers and investors):

Think of a couple with a combined income of $75,000. They took out a subprime mortgage for $280,000, but their house has depreciated to a value today of $200,000. They've been paying their mortgage each month, about $25,000 a year at a 9 percent rate including principal and interest. But the interest rate is not the problem. The real problem is that the couple no longer "own" this house in any meaningful sense of the word.

Selling it isn't an option; that would just leave them $80,000 in the hole. After taxes, $80,000 is one and a half years of this couple's

48. See, e.g., FIN. CRISIS INQUIRY COMM'N, supra note 29, at xv-xxvii.
income. And if they sacrifice one and a half years of their working lives, they will still not get a penny when they sell their home.

This couple could rent a comparable home for $10,000 a year, less than half of their current mortgage payments—a sensible cushion to seek in these hard times. Yes, walking away from their home will further weaken their credit rating and disrupt their lives, but pouring good money after bad on a home they do not really own is costlier still.

...Those who accept an interest modification ... are likely to realize at some point that they are essentially “renting” a home and paying more than any renter would. Many of those families will redefault, and see their homes foreclosed.

Bondholders today anticipate making as little as $70,000 on a foreclosed home like that in our example. But consider how much might change simply by writing down the principal from $280,000 to $160,000, 20 percent below the current appraised value of the house. The homeowner might become eligible to refinance the $160,000 loan into a government loan at 5 percent, which would be impossible on the $280,000 mortgage.

Even if the couple couldn’t refinance and still had to pay the original rate of 9 percent, the payments would be reduced to $14,400 a year, considerably less than the $25,000 now owed, and no longer wildly more than renting would cost. And the couple would have $40,000 of equity in the house: a reason to continue to pay, or to spruce up the house and find a buyer. Either way, the original bondholders would have a very good chance of making $160,000, instead of the $70,000 expected now. Everybody wins.49

Yet a number of features of the private-label market for RMBSs combine to significantly restrict mortgage modifications, especially modifications involving reductions in principal, even in cases where such modifications would be efficient.50 Perhaps the most important set of features hindering efficient modifications has to do with the incentives of mortgage servicers, who generally make the decisions

49. Geanakoplos & Koniak, supra note 17.
50. Adam J. Levitin, along with his coauthors, has provided the most detailed analysis of the features of the securitized mortgage market that hinder efficient modifications. See Anna Gelpen & Adam J. Levitin, Rewriting Frankensteins: Workout Prohibitions in Residential Mortgage-Backed Securities, 82 S. CAL. L. REV. 1075, 1087-1102 (2009); Adam J. Levitin & Tara Twomey, Mortgage Servicing, 28 YALE J. ON REG. 1 (2011). For recent empirical evidence that securitization hinders modification, see Sumit Agarwal et al., The Role of Securitization in Mortgage Renegotiation (Fed. Reserve Bank of Chi., Working Paper No. 2011-02, 2011), http://www.chicagofed.org/webpages/publications/working_papers/2011/wp_02.cfm (finding that bank-held loans are 26% to 36% more likely to be renegotiated than comparable securitized mortgages and the modifications of bank-held loans have lower postmodification default rates than modifications of securitized loans).
about whether to foreclose or modify mortgages. Servicers often earn greater profits by foreclosing, rather than modifying, mortgages and by modifying mortgages in ways other than reducing principal that are more likely to result in redefault. On the revenue side, servicers earn a fixed percentage of the outstanding balance of the loan. Although this compensation structure gives servicers some incentive to modify rather than foreclose to keep the revenue stream going, this fixed percentage is relatively small, thus the servicer’s revenues from modification can easily be swamped by modification’s higher costs. “Loss mitigation” activities, such as mortgage modifications, are labor-intensive and costly, as opposed to foreclosure-related activities, which can often be standardized and automated. Moreover, servicers are required to advance payments on delinquent loans to investors, making lengthy modification negotiations even more costly to servicers. Servicers also get reimbursed for expenses incurred in foreclosure (these reimbursements enjoy priority over other claims), but not expenses incurred in modifying a loan. Servicers may also

51. Adam J. Levitin and Tara Twomey argue, “[C]ompensation structure incentivizes servicers to aggressively pursue ancillary fees and to pursue loss mitigation strategies that minimize costs, even if they fail to maximize returns to investors.” Levitin & Twomey, supra note 50, at 37.

52. See Andrew Haughwout, Ebiere Okah & Joseph Tracy, Fed. Reserve Bank of N.Y., Second Chances: Subprime Mortgage Modification and Re-Default 30-31 (2010) (finding that redefault rate declines with the magnitude of the reduction in monthly payments, but declines more when the monthly payments are reduced through principal forgiveness than through interest rate reduction); see also Kazakes, supra note 2, at 1403-06 (discussing mortgage modification as a solution to foreclosure); Levitin & Twomey, supra note 50, at 37-51, 69-81 (describing servicer compensation structure).

53. See Cordell et al., supra note 22, at 360. Earning revenue based on a percentage of the loan balance may give servicers an incentive to modify in ways that result in a higher loan balance, or foreclose quickly if the servicer has fixed capacity and a troubled loan can be replaced with a lucrative, stable one. In addition, “it is more common to gain revenues for foreclosure-related services because these services . . . are easier to do through fee-for-service businesses than services associated with loss mitigation.” Id.

54. One study states the typical rate for subprime mortgages as 50 basis points, or 0.5% of the amount of the loan per year. Thus, for a loan with a yearly balance of $200,000, the servicer would earn $1,000 over the year for servicing the loan. See id.

55. See id. at 358. These costs include the “substantial time to, for example, contact borrowers, collect and verify data, obtain home value estimates, determine whether the borrower has suffered a temporary or permanent setback, coordinate actions with second-lien holders or mortgage insurers, and calculate net present value estimates of loss mitigation alternatives.” Id. at 358-59. These services may require loss mitigation specialists, who servicers claim are in short supply, especially the “full-product,” as opposed to specialty, servicers (large banks) that handle a large percentage of subprime loans. Id. at 359.

56. Id. at 359-60.

57. Levitin & Twomey, supra note 50, at 46-47.
lack incentives to invest in modification staff and technology. Thus, from the servicers’ perspective, the “transaction cost savings from automation and quick foreclosure” will often exceed the net benefits of mortgage modification.

Servicers do not have complete discretion in making decisions about whether to modify mortgages. Servicers of mortgages that are part of private-label securitization trusts have contractual obligations to the trust, and hence the investors, that are governed by Pooling and Servicing Agreements (PSAs). PSAs often require the servicers to act for the benefit of the investors as a whole (for example, by requiring that the servicer engage in loss mitigation on a delinquent loan if the net present value of that action is greater than the net present value of foreclosure), but the PSAs vary widely and often do not provide specific guidance about particular loss mitigation steps. They also generally give considerable discretion to servicers in how they calculate the net present value of different options. And even if servicers breach their contractual obligations to investors by failing to agree to efficient modifications, it may be very difficult for investors to take legal action against the servicers. For example, the PSA might require a certain percentage of investors to agree before a lawsuit can be filed.

Moreover, many PSAs restrict the servicers’ ability to agree to mortgage modifications in a variety of ways. Securitization trusts seek to make approval of modifications difficult for several reasons. The trusts must be passively managed to secure both advantageous tax

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58. Cordell et al., supra note 22, at 359. Reasons given by the authors include the financial constraints of parent companies, a higher recidivism rate for private-label mortgages, and a dim future for subprime mortgages.

59. Levitin & Twomey, supra note 50, at 28-29 (“The system-wide lack of capacity for loss mitigation has been an acute problem in the current mortgage default crisis, and has encouraged use of foreclosure rather than restructuring to handle defaulted loans.”).

60. Cordell et al., supra note 22, at 361-62. Servicers can exercise discretion with respect to such variables as “(1) the house price likely to be obtained in a foreclosure, (2) the discount rate used to discount payments streams under workout options, and (3) the expected recidivism probability.” Id. at 362. GSE securitizations provide more explicit guidance to servicers concerning mortgage modifications. Id. at 361.


62. Cordell et al., supra note 22, at 365 (noting a Credit Suisse study of thirty-one PSAs, of which two did not permit modifications and twelve included “some type of restriction, such as a limit on the percent of mortgages that could be modified or on the minimum mortgage rate that could be charged in a modification that reduced the borrower’s rate”); Gelpen & Levitin, supra note 50, at 1089-91.
treatment and "bankruptcy remoteness" from the sponsoring financial institution. Apart from the preference of the trust organizers to take advantage of legal and accounting rules, the trust as an entity cannot file for or be forced into bankruptcy, where a bankruptcy court might be able to force modifications to the PSA and to the rights of the bondholders that could lead to mortgage modifications. In addition, the Trust Indenture Act of 1939 requires the consent of all bondholders (investors) to any modification that could impair or affect the right to receive principal and interest payments according to the terms of the bond. Although there are no cases applying this statute to RMBSs, even the possibility that the statute would apply may deter some modifications.

In addition, the conflicting interests of the different investor tranches can prevent modifications from being approved. Both lower-level tranches, whose members will not get paid regardless of whether the modification is approved, and higher-level tranches, whose members will get paid regardless of whether the modification is approved, have no incentive to agree to the modification unless they receive compensation from the "fulcrum" tranche, whose members would be better off as a result of the modification. Getting lower-level tranches to approve a modification is made even more difficult to the extent that these tranches are resecuritized into collateralized mortgage obligations (CMOs) or CDOs, because all of those bondholders would also have to approve the modification. Servicers may also fear investor lawsuits if they modify mortgages in ways that are detrimental to some investors, even if the modifications benefit other investors.

63. Levitin & Twomey, supra note 50, at 15. Recent regulations promulgated by the Internal Revenue Service and Securities and Exchanges Commission have, to a large extent, reduced these potential impediments to mortgage modifications. Cordell et al., supra note 22, at 368.
64. Gelpern & Levitin, supra note 50, at 1093-98.
65. Id. at 1091-93.
66. Holders of lower-tranche securities may include the originator institution. Because servicers are often affiliates of these institutions, servicers may have the same weak incentives to modify. Levitin & Twomey, supra note 50, at 45-46.
67. Gelpern & Levitin, supra note 50, at 1098-1100.
68. Id. at 1100-01.
69. Cordell et al., supra note 22, at 365-66; Kazakes, supra note 2, at 1405. Some of this concern has been reduced by a federal safe harbor statute and the absence of such litigation. Kazakes, supra note 2, at 1405-06. Even apart from concern over investor lawsuits, servicers of private-label subprime loans "operate under many different PSAs, with different guidelines and investor preferences for loss mitigation." Cordell et al., supra note 22, at 360.
A different kind of conflict of interest may also inhibit some mortgage modifications in the subprime market. Many subprime borrowers have second liens on their homes. In many cases, borrowers took out the second loan simultaneously with the first loan (in essence, the second loan paid the down payment on the first loan), while in other cases, the borrower took out a "home equity" loan after entering into the first loan. Legal uncertainty exists about whether a senior lienholder can unilaterally modify its loan without losing its priority and becoming subordinate to the junior lienholder. Thus senior lienholders are reluctant to agree to modifications without the consent of junior lienholders. This gives junior lienholders, who would otherwise get nothing in many cases, significant bargaining power to prevent modifications unless the senior lienholders offer sufficient payment to obtain the junior lienholders' consent.

A final feature of the mortgage market that may hinder efficient modifications is the presence of CDSs. Holders of CDSs often include parent institutions of servicers, investors in mortgage-backed securities, and other speculators, but not homeowners. CDS holders get paid the "insurance" money when the "reference bonds" default. In the case of mortgage-backed securities, the bonds default if enough mortgages default. Therefore, CDS holders are at best indifferent to modifications and have an incentive to resist modifications if the insurance payment would exceed payments from performing loans. In cases where parent banks of servicers held the CDSs, that could create a conflict of interest between the servicer and the parent company even if the servicer favored modifications. Although the CDS insurers on the other side of the CDS transaction have a countering incentive to promote modifications to avoid paying out the insurance, those parties may be more diffuse, less knowledgeable, or simply less able to act on their incentive to promote efficient modifications. Moreover, CDS insurers do not have the same incentives and interests as the homeowners in negotiating efficient modifications. The homeowners become mere pawns in a big betting market over which they have no control. That fact should matter for contract law, to which we now turn.

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70. One study estimates that 21% of properties with subprime loans had a junior lien at origin. Cordell et al., supra note 22, at 369, 370 tbl.6.
71. Id. at 369.
72. Id. at 369-71.
II. CONTRACT LAW AND THE CURRENT FORECLOSURE CRISIS

Part I showed that the various parties on the lending side of the subprime mortgage market changed, in important ways, the various risks associated with the mortgage contract. This Part examines how courts might use various contract law doctrines to respond to these shifts in risk. We can divide the discussion of contract doctrine into two general, though overlapping, categories corresponding to the main effects on risk. First, I consider doctrines implicated by the financial industry’s actions that imposed restrictions on, discouraged, and generally raised the cost of efficient modifications, thus affecting assignment, modification, and contractual interest rate risk. These doctrines include assignment, modification, restraint of trade, and unconscionability. Second, I consider doctrines implicated by the financial industry’s actions that exacerbated and failed to protect against collateral risk. Here, I focus on the excuse doctrines: mistake, impracticability, frustration of purpose, and implied conditions. Third, I revisit several of our best-known contract cases and argue that each offers relevant insights into how contract law might address the aftermath of the financial crisis.

A. Interference with Efficient Modifications: Assignment, Modification, and Interest Rate Risk

1. Assignment Doctrine

The process of securitizing mortgages begins with an assignment by the originating lender of its rights to a stream of payments under the mortgage contract. In general, contract rights are assignable unless the parties otherwise agree, and in any case, most mortgage contracts explicitly give the lender the right to assign it. Although the recently settled action by the state attorneys general and private actions by homeowners have raised a number of issues concerning the validity of some assignments of mortgages based on sloppy or incomplete record keeping, my focus here is on the substantive assignment right as opposed to procedural defects in the assignment. Could homeowners challenge these assignments as a matter of substantive contract law, even if the assignments are procedurally valid?

73. See, e.g., U.S. Bank Nat’l Ass’n v. Ibanez, 941 N.E.2d 40, 55 (Mass. 2011) (holding two foreclosure sales invalid because banks had not demonstrated that they were the assignees of the relevant mortgages at the time of the sales); Recent Cases, U.S. Bank National Ass’n v. Ibanez, 941 N.E.2d 40 (Mass. 2011), 125 HARV. L. REV. 827 (2012).
It may be useful to begin by recalling both why contracts were originally nonassignable under the common law and why the rule changed to one of presumed assignability. According to P.S. Atiyah, "It is widely thought that this rule [of nonassignability] originated with the dislike of 'maintenance', that is the process whereby one man would encourage another to bring and maintain some litigation in which he had no genuine interest." The legal prohibition on maintenance has been relaxed over time, in part because people have come to see that the purchase of another's contractual rights to some payment, in fact, gives the purchaser a "genuine interest." But the instinct grounding the prohibition on maintenance is not necessarily unfounded. Many contract disputes that wind up in court, as opposed to settling, do so because there is a change in identity from the original contracting parties, such as a change in management or the death of a contracting party whose estate then acquires the contractual rights or obligations. Assignment may create analogous problems. Suppose, for example, that the party acquiring contractual rights via assignment does so, at least in part, because of a comparative willingness to litigate relative to the transferring party. The acquiring party (assignee) may have no prior relationship with the party (obligor) who contracted with the assignor and no interest in an ongoing relationship with the obligor; thus the assignee may be more willing than the assignor to litigate with the obligor rather than negotiate and settle. As a result, the assignee may be able to extract more from settlement than the assignor would have. Although the obligor may benefit from assignability by getting more advantageous contract terms, it is also possible that the obligor may not fully understand, or satisfactorily be able to protect against, the increased risks of litigation accompanying assignability. The law may have come to the position that the latter concern is not weighty enough to maintain the presumption against assignability, but the concern nonetheless remains.

75. See, e.g., Nanakuli Paving & Rock Co. v. Shell Oil Co., 664 F.2d 772 (9th Cir. 1981) (resolving an interpretive dispute that arose when new management failed to continue a prior unwritten price protection policy); Int'l Telemeter Corp. v. Teleprompter Corp., 592 F.2d 49 (2d Cir. 1979) (resolving a dispute that arose when new management refused to proceed with a negotiated settlement agreement).
76. See, e.g., Hamer v. Sidway, 27 N.E. 256 (N.Y. 1891) (resolving a dispute in which the estate of the promisor resisted a claim by the promisee's assignee even though the deceased promisor had not repudiated the promise).
How is the assignability debate relevant to the financial crisis? Subprime mortgages were assigned from originating lenders to sponsoring banks and ultimately to securitization trusts, which, owing in part to incentives of their servicer-agents, are less likely to modify contracts and, in particular, less likely to modify efficiently by reducing principal. That puts the servicer agents of the assignee trusts in the position of being more likely to “litigate” the contract (or in this case, foreclose on the mortgage) than the assignor-lenders would have been. This modification risk was not the primary reason for the assignment and was not fully understood by the obligor-borrowers. Unwittingly, then, the mortgage securitization system resurrects the concerns with maintenance that motivated the original prohibition on assignments.

Moreover, the key reason that legislatures in England and courts in the United States moved to a presumption of assignability of debt contracts was to protect the “good-faith purchaser,” who acquires contractual rights to payment without knowing of any defects in the loan, and therefore to facilitate the use of debt contracts as a useful substitute for money, that is, as negotiable instruments. Assignees who were good-faith purchasers became “holders in due course,” who are exempt from suits by borrowers claiming defects in formation of the loan. Again, this purpose is far from the purpose of assignability in securitizations. In securitizations, the point of assignment is not to treat the homeowner’s debt obligation itself as a riskless substitute for money. Rather, the point is to take a debt that is known to be risky (in the case of subprime mortgages, extremely risky), reduce that risk by pooling the debt with other mortgages, and create different classes of securities out of the pool based on priority of payment from the money paid into the pool as a whole. That does not mean that assignment for purposes of securitization is necessarily bad or inherently unenforceable. It does, however, mean that the assignment of a mortgage debt does not put the debt in the hands of the kind of good-

77. ATTYAH, supra note 74, at 135.
78. Alex M. Johnson argues, persuasively in my view, that the holder-in-due-course doctrine helped foster the current financial crisis because it gave assignees of subprime mortgages insufficient incentive to monitor the mortgage originations for fraud and other formation defects. See Johnson, supra note 8, at 573-76. He argues further that legislation should abolish the holder-in-due-course doctrine, leaving state courts free to use the unconscionability doctrine to police against formation defects (predatory loans) in securitized mortgages and allow borrowers to go after the assignees. Id. Although my focus here is on modification problems rather than formation problems, and what courts can do under already-existing law, Johnson’s argument has important parallels to the one I am making here.
faith purchaser that motivated the change in the rule on assignability. The assignment in the securitization context is all about reducing the risk of the underlying loan. Thus, applying greater scrutiny to assignments in this context is consistent with the rationale underlying the revision in the rule on assignability.

Not only are the assignments underlying the current financial crisis troubling in light of the historical shift from a presumption of nonassignability to a presumption of assignability of contracts, but they are also troubling in light of the existing law of assignment. Although the Restatement (Second) of the Law of Contracts recognizes a default rule of assignability of contract rights, it deems a contractual right nonassignable if "the substitution of a right of the assignee for the right of the assignor would materially ... increase the burden or risk imposed on [the obligor] by his contract, or materially impair his chance of obtaining return performance, or materially reduce its value to him."79 In the context of securitized mortgages, the borrower is the obligor, the originating lender is the assignor, and the securitization trust is the ultimate assignee, which appoints the servicer as its agent for purposes of enforcing the contract. Under the Restatement provision, then, the question is whether the assignment increases the burden of (or risk to) the borrower, impairs the borrower's chances of obtaining a return performance, or materially reduces the value of the loan to the borrower.

In the case of securitized subprime mortgages, there is an argument that the assignment did "increase the burden of risk imposed on" the borrower or at least "reduce[d] the value" of the borrower's loan to the borrower. The argument is that the ultimate assignees, the securitization trusts, increased what I have called "modification risk": the risk that in the event the borrowers were not able to pay according to the original contract terms, the contracts would not be efficiently modified. In particular, the securitization trusts essentially contracted away the discretion to modify the contract to conflicted agents, the servicers. The ability to have mortgages modified based on the mutual interests of the homeowner and the lender, should circumstances

79. Restatement (Second) of Contracts § 317(2)(a) (1981); cf. U.C.C. § 2-210(2) (2012) ("Except as otherwise provided in Section 9-406, unless otherwise agreed, all rights of either seller or buyer can be assigned except where the assignment would materially change the duty of the other party, or increase materially the burden or risk imposed on him by his contract, or impair materially his chance of obtaining return performance."); Restatement (Third) of Agency § 6.03 cmt. d (2006) (applying similar criteria to determine whether a contract made by an agent on behalf of an undisclosed principal is enforceable by the undisclosed principal against the third party).
warrant, is a benefit of the mortgage contract. That benefit is impaired when the loans are assigned to the securitization trust because of the conflicts of interest resulting from the way the system has been set up. Homeowners did not consent to this material impairment and division of contractual responsibility; in most cases, they had no knowledge of it at all.

It is true that a comment to the Restatement rule recognizes, “When the obligor’s duty is to pay money, a change in the person to whom the payment is to be made is not ordinarily material.” But this just says that the mere assignment of a lender’s right to receive payment from a borrower is generally enforceable. It does not say that there cannot be a material increase in risk or decrease in value in this situation, nor does it attempt to identify what might count as a material change. It is also true that the assignment of a mortgage ordinarily does not substantially increase the burden of repayment under the contract (the payment obligation remains the same) or impair the borrower’s chances of getting the return performance (the loan has already been made). But the assignments of mortgages to securitized pools were no ordinary assignments; they were risk-enhancing assignments.

Another objection to the argument that the assignments of securitized mortgages should not be presumed enforceable under contract law is that the right to modification is not of significant value to the borrower, or that the impairment of this right is not significant. But the current crisis belies this objection. The unexpectedly sharp drop in the value of the collateral (here, housing prices) left many borrowers underwater in their mortgages, and the resulting recession left them unable to make payments. In these unusual circumstances, given the high costs of foreclosure, both lenders and borrowers would in many cases be better off modifying the mortgage loans and, in particular, reducing principal. Many of these efficient modifications are not happening, however, because of the agency costs and other structural obstacles imposed by securitization. Thus a contractual right that, as an economic matter, both the lender and borrower would expect and want to be available is in fact absent or impaired. Although

80. Restatement (Second) of Contracts § 317 cmt. d (emphasis added). The comment goes on to state, “But if the duty is to depend on the personal discretion of one person, substitution of the personal discretion of another is likely to be a material change.” Id.; see also Restatement (Third) of Agency § 6.03 illus. 9 (“T agrees to sell Blackacre in exchange for cash to A, who acts on behalf of P. A’s undisclosed principal. P may require performance from T. The contract made by A requires only the payment of money in exchange for Blackacre.” (emphasis added)).
we can expect financial institutions to modify their contracts in the future to more easily facilitate modification in circumstances such as those in the current crisis, this does not mean that courts cannot apply the default contract rules to remedy existing defective contracts that make both borrowers and investors worse off. The anti-impairment rule of assignment law is the simplest and most direct doctrine that courts could use.81

2. Modification Doctrine

Part II.A.1 argued that assignments that unduly impede modifications are not enforceable under the contract law doctrine of assignment. It did not address the potential remedy a court might impose if it held an assignment unenforceable. It could be that a court would impose a modification or, instead, would undo the assignment and return the contract to the originating lender, which could then lead to a voluntary modification. The remaining sections in this Part consider whether other contract doctrines might provide additional guidance on the substantive contract law rights at issue as well as remedial consequences. A sensible place to start would seem to be the law of contract modifications.

The basic thrust of modern contract law seeks to encourage efficient modifications and to discourage coercive ones. Historically, contract law has focused on the question of whether to enforce modifications to which the contracting parties agreed. The main concern has been that modifications may be coerced, and so need to be policed by courts. The source of this concern is that a contracting party may seek a modification for opportunistic reasons, in particular to take advantage of the vulnerable postcontract position of the other party. In the classic case Alaska Packers’ Ass’n v. Domenico, for example, seamen who had previously contracted to travel to Alaska from San Francisco to fish for salmon at a fixed wage successfully

81. Revised article 9 of the Uniform Commercial Code does not appear to change the rule of assignability discussed here as applied to residential subprime mortgages, even though it applies to the sale of promissory notes accompanying mortgages (but not the mortgage itself). U.C.C. § 9-109(b) & cmt. 7, ex. 1. Article 9, section 406(f), renders “ineffective” any prohibition or restriction on the assignment of an “account,” defined in section 102(a)(2) as a “right to payment of a monetary obligation . . . for [assigned] property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of,” but section 406(h) makes that rule “subject to law other than this article[,] which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.” U.C.C. §§ 9-102(a)(2), -406(f)-(h). The exception in section 406(h) seems to cover residential mortgage obligations. See U.C.C. § 9-406(h).
renegotiated their wages after the boat arrived in Alaskan waters, where procuring substitute fishermen would have been costly. In Alaska Packers and other traditional cases, courts have policed against coerced modifications using the consideration doctrine's "preexisting duty" rule, which makes modifications unenforceable in the absence of new consideration for the modified promise that is above and beyond the preexisting duties of the party seeking the modification. Thus a modified employment contract for a term under which an employer agreed to pay higher wages without any return promise from the employee to take on additional responsibilities in exchange for the higher wages would be unenforceable under the preexisting duty rule for lack of consideration. Aside from doctrinal purity, the justification for the preexisting duty rule is that if the party seeking to enforce the modification has given no new consideration for that modification, the party seeking to challenge the modification is likely to have been coerced into agreeing to it. Modern contract law, however, has moved toward more liberally enforcing modifications, even in the absence of new consideration, if they appear to be a reasonable response to changed economic circumstances rather than simply an opportunistic attempt by one party to coerce the other party into reworking the original deal.

Courts' willingness to enforce modifications can extend even to modifications that violate contractually imposed restrictions on such modifications. The restriction most often discussed in the cases is the "no-oral-modification" clause, which requires any modification to be in writing. The no-oral-modification clause thus imposes a procedural requirement, rather than a substantive one based on the coercive potential of the modification. The purpose of the no-oral-modification clause is primarily to deter fraudulent assertions of consensual oral modifications, which is similar to the purpose of the statute of frauds.

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82. Alaska Packers' Ass'n v. Domenico, 117 F. 99, 101-11 (9th Cir. 1902).
83. See Restatement (Second) of Contracts § 73 ("Performance of a legal duty owed to a promisor which is neither doubtful nor the subject of honest dispute is not consideration; but a similar performance is consideration if it differs from what was required by the duty in a way which reflects more than a pretense of bargain"). In a recent case arising out of the current crisis, a court rejected homeowners' claims that a lender breached an implied contract not to foreclose while the lender was considering a mortgage modification on the ground that the homeowners provided no consideration in exchange for the lender's promise. Kim v. Bank of Am., No. C11-296 MJP, 2011 U.S. Dist. LEXIS 89510 (W.D. Wash. Aug. 11, 2011).
84. Restatement (Second) of Contracts § 89(a); U.C.C. § 2-209(1).
85. In many jurisdictions, the statute of frauds itself applies to mortgage modifications and has been used to reject claims of oral mortgage modifications. See, e.g.,
as well as to protect contracting parties from unauthorized oral promises made by their agents. Under the common law of contracts, courts have often declined to enforce these clauses on the theory that the contracting parties can always modify any contractual restriction on modification. Then-Judge Benjamin N. Cardozo most famously stated: "Those who make a contract may unmake it. The clause which forbids a change may be changed like any other." In determining whether to enforce no-oral-modification clauses, courts do not ignore the purposes underlying these clauses, but rather attempt to distinguish modifications that appear to be fraudulent or a result of unauthorized conduct from those that appear to be legitimate adjustments to changing circumstances. Once again, modern contract law acts to encourage efficient modifications, while at the same time protecting against fabricated ones as opposed to coerced ones.

Some commentators have extrapolated a broader pro-modification principle from the cases declining to enforce no-oral-modification clauses, namely that contractual bans of any kind on modifications are unenforceable. This extrapolation has drawn the


86. U.C.C. article 2 expresses a greater willingness to enforce no-oral-modification clauses, see U.C.C. § 2-209(2), but allows subsequent oral modifications to "operate as a waiver" of the contractual restriction, see U.C.C. § 2-209(4).

87. Justice Oliver Wendell Holmes made a statement similar to then-Judge Cardozo's, though it is less frequently cited. See Bartlett v. Stanchfield, 19 N.E. 549, 550 (Mass. 1889) ("Attempts of parties to tie up by contract their freedom of dealing with each other are futile... There is no right to renounce [the contract] in any way, and by any mode of expression, they saw fit.").


89. RESTATEMENT (SECOND) OF CONTRACTS § 311 cmt. a ("The parties to a contract cannot by agreement preclude themselves from varying their duties to each other by subsequent agreement.").
attention, and criticism, of some law and economics scholars, who argue that contracting parties may have good reasons for agreeing to ban modifications of their contracts. The parties may, for example, want to encourage relationship-specific investments that could be undermined if the other contracting party waits until the investment is made and then demands to renegotiate the deal, knowing that the investing party is stuck. Or the contracting parties may want to prevent the possibility of an unfaithful agent agreeing to a modification of which the agent's principal would not approve. Theorists favoring strict judicial enforcement of "immutable" contracts either tend to ignore, or give less weight to, the likely need for and desirability of efficient postcontract adjustments in response to unexpected changes in circumstances or tend to view court policing of contracts through litigation as excessively costly or insufficiently competent. They tend to prefer maximizing ex ante freedom of contract to preserving ex post freedom of contract. More important for the current situation, the critics have ignored or failed to anticipate the possibility that agency costs might prevent efficient modifications rather than cause inefficient ones.

Although the primary focus of the law and the theory of contract modification has been on whether to enforce modifications (or bans on modifications) to which the parties have agreed, the current financial crisis raises the other side of the question. Many servicers are refusing to agree to efficient modifications with borrowing homeowners, especially those reducing principal, and are instead pursuing costly foreclosure remedies. Thus the question: can contract law ever require parties to enter into modifications that they have not agreed to? The answer seems to be no.

Citing the principle of freedom of contract, courts have declined to require modification if parties do not voluntarily modify their contracts. According to that principle, parties must agree to a modification, just as they must agree to a contract in the first place. In the context of loan modifications, for example, courts have held that

91. See id. at 587, 604.
92. Theorists favoring strict contractual enforcement seem to suffer from a similar failure of imagination with respect to the risk of opportunistic behavior generally. They argue, for example, that strict enforcement deters opportunistic behavior while ignoring or downplaying the risk that strict enforcement can also encourage such behavior. See, e.g., id. at 585-86 (arguing that the plain meaning rule would "reduce strategic behavior").
the failure of a lender to agree to a modification does not violate the contractual duty of good faith, \(^9\) which doctrinally is limited to performance and enforcement as opposed to formation. \(^5\) One court, in a case arising out of the savings and loan crisis in the 1980s, went so far as to hold that the lenders “had an absolute right to bring [a] foreclosure action, whether or not it [was] in their best economic interest.” \(^9\) The court based this holding on provisions of the mortgage contract and stated that nothing in the contract would be construed to “preclude [the] Mortgagee from foreclosing the Mortgage in case of any Event of Default.” \(^9\) In the current crisis, however, neither the original mortgage lender nor the investors in the securitization pools are the primary obstacles to more modifications; rather, it is the servicers who are not acting in the best economic interests of the investors.

If the law is concerned with coercive, fraudulent, or unauthorized modifications, should it not be equally concerned with inefficient or opportunistic failures to modify, at least those resulting from agency costs combined with unanticipated circumstances? In fact, the “rule” against contractual bans on modifications is concerned with inefficient failures to modify. The question is how to enforce that rule. The rule against enforcing contractual-modification bans may simply mean that if both parties agree to a contract that includes such a ban but then later change their minds and agree to a modification, a court will enforce

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94. Rosemont Gardens Funeral Chapel-Cemetery, Inc. v. Trustmark Nat'l Bank, 330 F. Supp. 2d 801, 811 (S.D. Miss. 2004); Resolution Trust Corp. v. Lesal Assocs., No. 91 Civ. 2025 (MBM), 1992 U.S. Dist. LEXIS 6620, at *16-17 (S.D.N.Y. May 6, 1992) (“[T]he implied covenant of good faith and fair dealing is limited to performance under a contract and does not encompass future dealings or negotiations between the parties.... [I]t does not obligate the promisor to make future promises or to renegotiate the contract.”). For cases arising out of the current crisis and espousing the same principle, see generally Wells Fargo Bank v. Riverview East Windsor, No. CV096004927, 2010 Conn. Super. LEXIS 3307 (Dec. 22, 2010); and Bank of America v. Groton Estates, LLC, No. CV096001697, 2010 Conn. Super. LEXIS 1856 (July 13, 2010).

95. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”); id. § 205 cmt. c (noting that the rule “does not deal with good faith in the formation of a contract, including negotiation[.]”). Interestingly, the comment to the rule does not preclude the application of good faith to contractual modifications, though it cites no examples or cases. The comment states, “In cases of negotiation for modification of an existing contractual relationship, the rule stated in this Section may overlap with more specific rules requiring negotiation in good faith.” Id. (citing id. §§ 73, 89).

96. Resolution Trust Corp., 1992 U.S. Dist. LEXIS 6620, at *19 (emphasis added). As the caption of the case reveals, one of the plaintiffs seeking to foreclose was actually the Resolution Trust Corporation acting as conservator for a failed savings and loan, though the court put no weight on the fact that a government entity was a plaintiff. Id. at *3.

97. Id. at *19.
the modification despite the contractual ban. Alternatively, however, the rule could be interpreted to mean that if the contracting parties agree to a ban on modifications, but subsequently one of the parties wants to modify the contract and the other refuses based on a no-modification clause in the contract, a court could impose a duty on the reluctant party to modify or at least bargain in good faith for a modification. To my knowledge, no court has yet taken this approach.

Nevertheless, to the extent that the narrow interpretation of the rule refusing to enforce modification bans represents the current state of the law, as I believe it does, it is worth asking why. One answer is that contract law already handles problems of inefficient or opportunistic failures to modify through other doctrines, including the doctrines of excuse, unconscionability, restraint of trade, and damages. These doctrines all impose, in certain circumstances, judicially enforced "modifications" of the original contract, albeit modifications that courts justify with reference to the implied terms of the contract supplied by contract law itself. Because of these alternative doctrinal outlets, it may be that courts feel less pressure to alter modification law in response to inefficient failures to modify. Perhaps, then, we should expect courts to enforce the judicial ban on contractual-modification bans through other contractual doctrines rather than through modification doctrine. I examine that possibility in Parts II.B and II.C.

Furthermore, courts may be hesitant to specify terms when a large range of possibly reasonable modifications exist. A similar concern underlies the "indefiniteness" doctrine and the courts' resistance to enforcing "agreements to agree." Suppose that the parties draft a contract that contains a provision requiring modifications in specified circumstances but does not detail what the terms of those modifications should be or that states the requirement in very broad or vague language. Would a court necessarily refuse to enforce such a provision? The Restatement provides flexibility for courts to enforce a contractually required, but vaguely specified, duty to modify. And interestingly, in several recent cases arising out of the

98. As noted above, the courts have not yet chosen to use the doctrine of good faith for this purpose.
99. Restatement (Second) of Contracts § 33.
100. Consider, for example, illustration 8 in section 33:
A promises to do a specified piece of work and B promises to pay a price to be thereafter mutually agreed. The provision for future agreement as to price strongly indicates that the parties do not intend to be bound. If they manifest an intent to be bound, the price is a reasonable price at the time for doing the work.
financial crisis, courts have been willing to enforce an indefinite
promise to negotiate a mortgage modification under the doctrine of
promissory estoppel. Given that courts in appropriate cases enforce
indefinite promises, it would be a small step for courts to imply a
"duty to modify" in appropriate circumstances based on the usual
judicial tools for interpreting the presumed intentions of the parties.

Yet there may be another reason courts are reluctant to enforce
the rule against contractual-modification bans by imposing a
modification, or a duty to modify. If parties do not contractually
require modification and do not agree to a modification, then how do
we know whether the party is refusing to modify because of the
restriction on modifications or in spite of it? Courts could address that
concern, however, by taking the position that when they are more
confident that the modification restriction is causing the problem, they
will be more willing to put stronger enforcement teeth into the rule
against enforcing contractual-modification restrictions. In particular, if
the contractual-modification restriction is one that courts cannot easily
remove, the only feasible remedy might be to impose a modification.

This, in my view, is the situation in the current foreclosure crisis.
As already described, many modifications that appear to be efficient

Id. § 33 illus. 8. Although not conclusive, illustration 8 does leave the door open to enforcing
agreements to agree in certain circumstances. Perhaps the circumstances are limited to those
in which some available market can be used to determine the "reasonable price," though the
illustration seems to make the intent of the parties the crucial fact. Note that technically
section 33 would not apply to a contractually mandated modification provision because
section 33 is addressed to uncertainty that makes a contract as a whole unenforceable. In the
case of a contractually mandated modification, there would already be a preexisting,
enforceable contract. Nevertheless, presumably courts would apply a version of the
indefiniteness doctrine to this promise.

(finding that homeowners successfully alleged a promissory estoppel claim by asserting that
the bank holding the mortgage promised to enter into negotiations to modify their loan and
rejecting claims that the promise was unenforceable because it was too indefinite or that it
was simply an agreement to agree); Becker v. 1st Horizon Home Loan Corp., No. 3:10-cv-
that homeowners sufficiently alleged a promissory estoppel claim by asserting that the bank
induced them to default "by giving them the expectation of entering into modification
negotiations in good faith" even though the bank secretly intended to foreclose); Aceves v.
U.S. Bank, 120 Cal. Rptr. 3d 507, 513 (Ct. App. 2011) (allowing plaintiff-homeowner to
proceed under promissory estoppel on claim that the bank promised to negotiate with
homeowner if she forewent filing bankruptcy and finding that the bank's unilateral offer to
modify the loan did not satisfy the bank's duty to negotiate). But see Gulamhussein v. Bank
2011) (rejecting homeowner's promissory estoppel claim based on a promise by the bank
representative that she would qualify for a mortgage modification because there was no
"clear and unambiguous promise").
are not occurring because of a variety of restrictions based on express terms as well as the structure of the securitization system and the incentives of servicers. Thus there are good reasons both to think that the contractual restrictions are deterring efficient modifications and that simply declining to enforce these restrictions will not change the situation.

The financial crisis therefore, at the least, raises interesting questions for contract law's modification doctrine and its general approach to modifications. Another question the cases do not seem to have addressed is what happens if $A$, who has a contract with $B$, enters into a contract with $C$ under which $A$ promises not to modify the contract with $B$. Perhaps a better doctrinal vehicle for discussing this problem is the law of restraint of trade.

3. Restraint of Trade

Contract law has long had a rule that contracts in restraint of trade are unenforceable because they are inconsistent with the ideal of freedom of contract.\(^{102}\) Restraint of trade is a broad term, which, as Justice Louis Brandeis long ago observed, cannot be understood literally, because every contract restrains trade to some degree.\(^{103}\) Contract law has always shared regulation of restraints of trade with other areas of law: originally the criminal law of conspiracy\(^ {104}\) and, more recently and notably, antitrust law. Nevertheless, contract law remains an important regulator of contracts in restraint of trade in two areas: covenants not to compete in employment contracts and covenants not to compete accompanying the sale of a business. Nothing in the contract doctrine of restraint of trade, however, limits the doctrine to those two types of contracts.\(^ {105}\)

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102. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 186(1) ("A promise is unenforceable on grounds of public policy if it is unreasonably in restraint of trade.").

103. Bd. of Trade v. United States, 246 U.S. 231, 238 (1918) ("Every agreement concerning trade ... restrains. To bind, to restrain, is of [its] very essence."); see also RESTATEMENT (SECOND) OF CONTRACTS § 186 cmt. a ("Every promise that relates to business dealings or to a professional or other gainful occupation operates as a restraint in the sense that it restricts the promisor's future activity. Such a promise is not, however, unenforceable unless the restraint that it imposes is unreasonably detrimental to the smooth operation of a freely competitive private economy.").

104. See, e.g., ATTYAH, supra note 74, at 126 ("The policy of the law was to encourage freedom of enterprise, freedom of trade, freedom to work; in so far as a person used this freedom to agree to deprive himself of that freedom, his agreement was not merely ineffective in law, but an offence, a conspiracy.").

105. But cf. RESTATEMENT (SECOND) OF CONTRACTS § 186(2) ("A promise is in restraint of trade if its performance would limit competition in any business or restrict the promisor in the exercise of a gainful occupation."). One can read section 186(2) as an
The types of contracts that courts have traditionally held to be in restraint of trade (cartels, now mostly regulated by antitrust law, and covenants not to compete) share a similar form. In these types of contracts, A makes a contract with B under which B promises not to contract (or not to contract in a certain way) with C. In a cartel arrangement, A also agrees not to contract with C on terms other than those contained in the cartel contract. In an employment covenant not to compete, A is an employer, B is an employee of A, and C is a new employer with whom B would like to contract after ending employment with A. In a covenant not to compete ancillary to the sale of a business, A is the buyer of a business, B is the seller of the business, and C is a potential customer of the business’s products or services with whom B would like to trade after selling the business. In all three examples, the contract in restraint of trade makes the contract between A and B more valuable, but potentially disadvantages C (and B, at least ex post).

The law of restraint of trade has long recognized that contracts in restraint of trade should sometimes be enforced because the added value of the restraint to the contract between A and B may be socially desirable, despite the effect on C, which could even be beneficial rather than harmful. Philosophers and economists have long recognized that some restraints, such as stop signs, paradoxically increase freedom. Thus a partnership agreement has the structural form of a cartel but is an enforceable contract because the social benefits of partnerships outweigh whatever costs they impose on the ability of individual partners to make separate deals with third parties.

exclusive definition of contracts in restraint of trade, or merely a nonexclusive statement of the most common forms of restraints of trade. *Id.* If the former reading is correct, restrictions on modifications of mortgage contracts would not qualify as restraints of trade because they do not “limit competition” in a business or restrict anyone’s employment prospects. Some support for the latter and broader reading, however, can be found in illustration 3 to section 186, which states: “A transfers a tract of land in fee simple to B. As part of the transaction, B promises never to transfer the land. B’s promise is unreasonably in restraint of trade and is unenforceable on grounds of public policy.” *Id.* § 186 illus. 3. A promise not to alienate the property right does not technically fall under the definition of restraint of trade in section 186(2), yet the Restatement writers say it is an unenforceable promise. They do rely on the Restatement of Property, but that leaves open the question of what happens if a promise not to contract with respect to some property right is not covered by the Restatement of Property or the antitrust laws. In any case, of course, the Restatements are not the law, but rather a summary of legal principles offering nonbinding guidance to courts. I have found no cases endorsing or interpreting section 186(2) of the Restatement of Contracts as a limiting definition.

106. See, e.g., ATIYAH, supra note 74, at 127 (arguing that pre-nineteenth-century English courts “wanted to uphold freedom of contract in so far as that encouraged freedom of enterprise, but not in so far as it was used to destroy it”).
parties. Covenants not to compete in employment encourage employers to invest in training their employees and sharing valuable information with them. Covenants not to compete ancillary to the sale of a business enable the seller of a business to sell the “goodwill” of a business along with the physical assets. Nevertheless, even if potential benefits exist, the restraint of trade cannot be broader than necessary to facilitate the legitimate benefits. Partnerships may have market power. Covenants not to compete may extend for a longer-than-reasonable time, to a wider-than-reasonable geographical area, or to a broader-than-reasonable set of goods or services.

A contract between $A$ and $B$ that $B$ will not modify its contract with $C$ has the form of a restraint of trade. In the case of securitized mortgages, $A$ is the securitization trust entity, acting as a pass-through for its investors; $B$ is the servicer who makes the decision whether or not to modify the mortgage; and $C$ is the borrowing homeowner. Although the restrictions on modifications in the contract between $A$ and $B$ may have had social value when drafted in that they protect $A$'s investors against opportunistic modifications by $B$, make the value of investments in $A$ easier to assess, and enable $C$ to get better credit terms, these restrictions are now preventing too many efficient modifications—that is, modifications that make $A$'s investors and $C$ better off—especially those that involve reductions in principal. The purpose of the modification restrictions is not being served by enforcing them due to circumstances unanticipated when the contracts between $A$ and $B$ were drafted; thus the restrictions have become unreasonable restraints of trade whose social harm outweighs the social benefit.

Moreover, $C$ in the mortgage context (the underwater homeowner) is in a worse position than $C$ in the covenant-not-to-compete context (the new employer or new customer of the former business owner) because $C$ cannot contract with a party other than $B$ (the servicer). $C$ (the homeowner) is, in effect, facing a monopolist $B$, albeit a “situational monopolist” created by the mortgage contract rather than the traditional type of monopolist. As noted above, because of the prepayment penalty feature of many subprime loans,
subprime borrowers were effectively tied to their original lenders, on whom they became dependent for the refinancing necessary to keep the mortgage payments flowing as housing prices rose. Although some might argue that homeowner \( C \) will be worse off if the restrictions are not enforced because \( C \) will have worse credit terms on mortgage loans in the future, this is far from clear. The current crisis suggests that homeowners might well be better off with somewhat higher interest rates, greater collateral, or both (which would be less likely to leave the homeowner underwater), combined with the ability to make efficient modifications in the event of changed circumstances.

Even if the restrictions in a contract between \( A \) and \( B \) are unenforceable restraints of trade, that may not help \( C \) (the homeowner) if \( B \) (the servicer), despite the fact that the restrictions are unenforceable, still refuses to contract for a modification with \( C \). In the typical covenant-not-to-compete case, \( B \) wants to contract with \( C \) and \( A \) is trying to use its contract with \( B \) to prevent that. \( C \) cannot force an unwilling \( B \) to contract with \( C \) even though \( B \)'s unwillingness is at least in part due to its unenforceable contract with \( A \). Unlike the typical covenant-not-to-compete case, however, in the securitized mortgage case, \( B \) and \( C \) already have a contract (the mortgage contract), which \( B \) is seeking to enforce in the case of foreclosure. Suppose the contract between \( B \) and \( C \) could be judicially modified so as to eliminate the effect of the restraint of trade on the contract \( B \) seeks to enforce. In covenant-not-to-compete cases, courts sometimes "blue pencil," that is, rewrite or—more aptly for our purposes—modify the contract between \( A \) and \( B \) containing the restraint of trade to make the restraint more reasonable. Nothing in restraint-of-trade law seems to prohibit courts from achieving a similar result by refusing to enforce and instead modifying the existing contract between \( B \) and \( C \). The question is whether a contract, to be in restraint of trade, must itself include the term that creates the restraint of trade (the contract between \( A \) and \( B \)), or whether the contract can merely be one that is affected by (or maybe "infected" by) the restraint of trade contained in another contract (the contract between \( B \) and \( C \)). If these doctrinal constraints make restraint-of-trade law an untenable

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109. See GORTON, supra note 43, at 80 ("It may be that the subprime market is competitive with respect to initial mortgages, but not with respect to refinancing; borrowers are largely tied to their initial lenders. In that case, the original lender can benefit from any home price appreciation." (footnote omitted)).
argument, another possibility is unconscionability, which deals with some of the same issues but with perhaps fewer doctrinal limitations. 4. Unconscionability

A final doctrine courts could use to strike down inefficient restrictions on mortgage modifications, and to impose efficient modifications, is unconscionability. The mortgage contracts at the heart of the current crisis bear a striking similarity to the contract in the most famous unconscionability case, Williams v. Walker-Thomas Furniture Co. Williams involved a challenge to a “cross-collateral” clause that in effect required Williams, the buyer of goods from a furniture store, to post as collateral not just the good immediately purchased but also all previously purchased goods. Both the facts in Williams and the current crisis involve extending credit to subprime debtors through creative financing. Both involve secured lending with collateral whose value significantly drops after the making of the contract. Both involve long-term contractual relationships. Both involve contracts whose enforcement could create significant third-party spillover effects: the harm to Williams’s children in Williams and the harm to neighborhoods and the economy more generally from foreclosures. Perhaps the most important similarity, however, is that in both cases, the contractual problem may have been caused more by an unanticipated rigidity in response to changed circumstances than any inherent procedural defect or per se substantive problem with the overall terms of the deal at the time the contract was made, which is the usual way the Williams case and the doctrine of unconscionability are understood.

Of course, there are important differences as well between Williams and mortgage contracts. First, Williams involved a cross-collateral clause, whereas homeowners post as collateral only the home being purchased with the borrowed money. Second, at the time of her default, the lender in Williams may not have been underwater, in the sense that she owed more money on her contracts than the combined collateral was worth. Thus Williams’s breach might not have been “efficient” in the way that nonperformance by underwater homeowners is. Finally, unlike cases where homes were collateral, in which most homeowners believed that home prices would continue to increase, homeowners in the current crisis may have had reason to believe that home prices would fall.

110. See Restatement (Second) of Contracts § 208 cmt. a (noting that the policy underlying the unconscionability doctrine “overlaps with rules which render particular bargains or terms unenforceable on grounds of public policy”).

111. 350 F.2d 445 (D.C. Cir. 1965).
rise and never fall, in *Williams*, the whole point of the cross-collateral clause was to address the well-recognized problem caused by the immediate drop in the market value of the consumer goods once the consumer takes them home and starts to use them.

Despite these differences, *Williams* is a potentially useful case to consider for the current financial crisis. The *Williams* opinion itself is famously vague about what, exactly, made the cross-collateral clause potentially unconscionable: the court does not in fact hold that the clause was unconscionable, but simply acknowledges that the doctrine exists and is potentially applicable, and remands the case for further findings on the issue. Moreover, the opinion gives precious little information about the circumstances leading to Williams’s default and the store’s subsequent decision to foreclose rather than renegotiate or modify the contract terms. Of course, it could be that Williams’s prospects for repayment had dropped significantly for some reason so that no modification would have been efficient. Another possibility is that although the store would prefer to renegotiate rather than foreclose early in the relationship, when the posted collateral was worth less than the amount of the loan, the store had a greater incentive to foreclose than to renegotiate later in the relationship, when the value of the collateral might have exceeded what Williams owed, at least if Williams was not likely to sue for the extra amount (to which she would be legally entitled).112

These scenarios presume that an efficient modification between Williams and the store was not feasible. Another possibility, however, is that some modification could have been worked out that was economically preferable to “foreclosure” for both parties, in the sense that the amount to be repaid under the modification, discounted by the likelihood of repayment, would have exceeded the value of what the store expected to collect upon exercising its contractual repossession rights under the cross-collateral clause. Most commentators on the case have not focused on the efficient modification possibility. Suppose that the furniture store had promised some third party (for example, one of its own commercial creditors) not to modify its contracts with consumers such as Williams. Or suppose that some new management had come in and changed the previous, flexible policy on modifications to a more rigid one, perhaps because their compensation contracts gave them an incentive to foreclose rather than

112. See, e.g., RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 4.9, at 146 (8th ed. 2011).
modify. Because Williams had, in effect, made specific investments in her reputation as well as pledged collateral with the furniture store, she could not easily go elsewhere and so was vulnerable to a unilateral change in modification policy (that is, an increase in modification risk) by the furniture company. Could such conduct, if proved, have made the cross-collateral clause unconscionable? If so, that is the relevant parallel to the current financial crisis because the homeowners faced a similar situational monopoly as a result of the prepayment penalties they faced, as described in Part II.A.3.

I do not see anything in the Williams opinion that precludes reading the case as a modification-restriction problem, though I readily admit that it is neither the conventional reading of it nor a necessary reading of it. Doctrinally, unconscionability focuses on the time of formation, not the time of performance. Analogous problems at the time of performance, rather than at the time of formation, usually fall under the scope of the doctrine of good faith. Williams, however, could be characterized either as a formation case or as a performance case because it involves a long-term relationship that is really a series of contracts for different goods, tied together by the cross-collateral clause. In any case, the key point is that over time the circumstances might have changed in an unexpected way so that an otherwise efficient modification that might previously have been available to Williams was no longer available. In the mortgage context, the modification restrictions are present from the outset, at least once the mortgages get assigned to the securitization pool, though similar to Williams, refinancings resulted in a series of contracts. Once economic circumstances changed, modifications became more desirable but difficult to achieve because the restrictions exercised a much more pervasive effect than was initially anticipated.

113. According to the Restatement, “If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result.” RESTATEMENT (SECOND) OF CONTRACTS § 208 (emphasis added); accord U.C.C. § 2-302 (2012). However, an accompanying comment (in fact, the comment under which the Restatement writers include the Williams case as illustration 5) states that contract “terms may be unconscionable in some contexts but not in others.” RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. e. Immediately following that, the comment does add, “Overall imbalance and weaknesses in the bargaining process are then important.” Id. But, as I argue in the next paragraph, there are good arguments that weaknesses in the bargaining process did in fact exist in the mortgage-securitization context.

114. RESTATEMENT (SECOND) OF CONTRACTS § 205 (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” (emphasis added)).
In applying unconscionability doctrine, courts often focus on “procedural” unconscionability, that is, weakness in the bargaining process, as well as “substantive” unconscionability, that is, harsh or unfair terms. Many subprime residential borrowers fit the classic procedural unconscionability scenario: they were often ignorant of mortgage terms, including those that affected modification risks, and were certainly not in a position to bargain over such terms.5 More important, the Restatement does not limit procedural unconscionability to these kinds of bargaining process defects. It includes as factors which may contribute to a finding of unconscionability in the bargaining process [a] belief by the stronger party that there is no reasonable probability that the weaker party will fully perform the contract; [and] knowledge of the stronger party that the weaker party will be unable to receive substantial benefits from the contract.6 Both of these factors could describe the originating lenders in the subprime mortgage context. They knew, in many cases, that subprime borrowers were at high risk of defaulting and knew, or should have known, that the contractual restrictions in the securitization contract would make it unlikely that the borrowers could receive the substantial benefits of efficient modifications in the event of adverse circumstances.

There is one more useful way to compare Williams and the current crisis. The traditional economic critique of the Williams case is that finding the cross-collateral clause unconscionable will ultimately harm the Williamses of the world, because the furniture stores of the world will have to find an alternative way to address the risks associated with a high default rate and collateral that rapidly depreciates in value, such as by demanding higher down payments. Eric Posner has argued that this effect might actually be salutary as a means of protecting against moral hazard problems for poor people who live off of social insurance and might otherwise be tempted to buy too many goods, and the “wrong kind” of goods, on credit.7 One could make a similar argument in the mortgage context. John

115. See, e.g., GORTON, supra note 43, at 80 (describing subprime mortgages as a kind of “predatory lending [because] the borrower is attracted to borrow, but may not understand that effectively it is the lender who makes the choice to refinance or not at the end of the first period” (internal quotation marks omitted)); Johnson, supra note 8, at 576-78.
116. RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. d (explaining “[w]eakness in the bargaining process” (emphasis omitted)).
Geanakoplos has developed a theory of the “leverage cycle,” in which creditors inefficiently reduce the amount of collateral they demand (increase leverage) in boom times, which tends to fuel asset bubbles, and then demand an inefficiently high level of collateral in the bust times. Thus interpreting the unconscionability doctrine to limit the ability of lenders to take full advantage of their right to foreclose on the collateral, such as by forcing the lenders to write down principal and accept efficient modifications, could lead lenders to demand higher down payments in future booms, thus blunting to some extent the deleterious effects of the leverage cycle.

Could the modification restrictions make mortgage contracts unconscionable so as to call into play the courts’ equitable powers to rewrite the contracts? Williams, and the unconscionability doctrine itself, are so open-ended that they accommodate such a reading. That could be a sufficient opening for some courageous and creatively inclined court troubled by the current crisis and the apparent unwillingness or inability of state and federal legislatures to address it adequately.

B. The Excuse Doctrine and the Exacerbation of, and Failure To Protect Against, Collateral Risk

So far, I have focused on contractual structures put in place by the financial industry in the assignment and securitization of residential mortgages that interfered with efficient modifications, thus increasing assignment, modification, and contractual interest rate risk. Apart from these risks, however, the financial industry, as discussed in Part I.B, exacerbated and failed to protect against other risks as well, in particular collateral risk. Although the financial industry may not have fully understood its role in increasing these risks, its conduct has potentially opened the door to another set of contract doctrines: the law of contractual excuse.


119. Restatement section 208 states the following with respect to remedies: “Where a term rather than the entire contract is unconscionable, the appropriate remedy is ordinarily to deny effect to the unconscionable term. In such cases as that of an exculpatory term, the effect may be to enlarge the liability of the offending party.” RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. g (emphasis added). Note that the Restatement does not limit the possible remedy to refusing to enforce the offending term if another remedy is necessary to “deny effect” to the term, even if the result of the remedy is to “enlarge the liability of the offending party.” Id.
Any discussion of judicial modification of contracts as a result of unanticipated changed circumstances naturally leads to excuse doctrine. The law of contractual excuse would therefore seem to be the best doctrinal fit for homeowners who turn to courts for relief from underwater mortgages. Yet according to one recent commentator:

[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.\textsuperscript{120}

It is easy to see why no one has tried to make this argument. Contract law has traditionally been understood as a strict liability system, with the availability of excuse severely restricted.\textsuperscript{121} Perhaps in no area are these principles more strictly followed than in debt (loan) and other financial contracts. Even the Great Depression did not lead courts to apply excuse doctrines to relieve contracting parties, including mortgage borrowers.\textsuperscript{122}

Nevertheless, if the purpose of excuse doctrines is to allocate unforeseen risks efficiently when courts have good reason to doubt that the parties have done so themselves, allowing excuse for underwater homeowners seems to fit this purpose quite well. Lenders engaged in conduct that they erroneously thought was reducing risk, when in fact it was exacerbating risk to themselves, to investors, and to homeowners. In effect, lenders succumbed to a classic moral hazard problem, similar to drivers who respond to mandatory seat belt laws, designed to reduce accident risk, by driving faster, thereby increasing accident risk.\textsuperscript{123} Thus lenders are most likely the superior risk

\textsuperscript{120.} Meredith R. Miller, Strategic Default: The Popularization of a Debate Among Contract Scholars, 9 CORNELL REAL EST. REV. 32, 39 (2011).

\textsuperscript{121.} "Contract liability is strict liability. . . . The obligor is therefore liable in damages for breach of contract even if he is without fault and even if circumstances have made the contract more burdensome or less desirable than he had anticipated." \textsc{Restatement (Second) of Contracts} ch. 11, intro. note. I have been critical of the view that contract law is a strict liability system. \textit{See, e.g.,} George M. Cohen, The Fault That Lies Within Our Contract Law, 107 MICH. L. REV. 1445 (2009).


\textsuperscript{123.} Sam Peltzman, The Effects of Automobile Safety Regulation, 83 J. POL. ECON. 677 (1975).
bearers. If contract law is truly at odds with that conclusion, it would be surprising, or at least raise an interesting problem. But is it?

1. Mistake

Contract law allows a party to be excused from some or all of its contractual obligations if that party or both parties made a mistake at the time of contracting. The Restatement defines “mistake” as “a belief that is not in accord with the facts.” It also distinguishes a factual mistake from a “prediction or judgment as to events to occur in the future, even if erroneous.” Courts are generally more willing to grant excuse if both parties are mistaken about the same fact (“mutual” mistake) than if only one party is mistaken (“unilateral” mistake).

In the financial crisis, one way to frame the story of what happened is that subprime borrowers and lenders made a mutual mistake in their assumption that housing prices would continue to rise, or at least would not fall broadly throughout the country. That
assumption was not only crucial, but also unusual. In the words of Gary Gorton, “[N]o other consumer loan has the design feature in which the borrower’s ability to repay is so sensitively linked to appreciation of an underlying asset.”

At first blush, such a mistake does not seem to provide grounds for excuse because it is merely a “prediction” about future housing prices that everyone knew or should have known could fall just like any other prices, as they in fact did. This conclusion merits closer examination, however. One of the important “modern” cases that supports the mistake/prediction distinction is *Leasco Corp. v. Taussig.* In that case, the vice president, Taussig, of a corporate subsidiary, McGeary-Koretsky International (MKI), contracted with the parent corporation, Leasco, to purchase the subsidiary, which was in the civil engineering and consulting business. The purchase price reflected the mutual assumption of the parties that the subsidiary would earn $200,000 in the upcoming year. After entering into the contract, Taussig learned that due to a “design error” in one of the subsidiary’s construction projects, the subsidiary had incurred a “carryback” loss and would earn far less than $200,000 in that year. Taussig sought to be excused from the contract on grounds of mutual mistake, but the court rejected his argument. According to the court:

Both Taussig and Leasco may have hoped, but surely could not have been certain, that MKI would earn $200,000 in fiscal 1971. Neither party intended to allow rescission of the agreement if, as it turned out, one party got a better bargain than had been anticipated. The civil engineering and consulting business is personalized, highly technical, and extremely risky. Neither party could safely assume that the projected earnings would be realized. Both parties had equal access to information indicating that such a projection would be highly unreliable. Indeed, Taussig probably knew more about the business of MKI than anyone else at Leasco since he originally had investigated it,

§ 153(b) (allowing excuse for unilateral mistake if “the other party had reason to know of the mistake or his fault caused the mistake”). Finding that the homeowners were laboring under a mistake of fact as opposed to having made a bad prediction would still be a necessary prerequisite to applying the unilateral mistake theory.

129. GORTON, supra note 43, at 81.

130. 473 F.2d 777 (2d Cir. 1972). Illustration 2 to section 151 is based on the case. See RESTATEMENT (SECOND) OF CONTRACTS § 151 illus. 2 & reporter’s note.

131. In light of my argument here, it is worth noting that in the Restatement (Second) of Contracts illustration based on the case, the problem giving rise to the erroneous valuation of the company is not a design error, but rather “a subsequent economic recession.” RESTATEMENT (SECOND) OF CONTRACTS § 151 illus. 2.
he served as its vice president and he was a liaison executive between Leasco and MKI.132

The decision thus rests on the sensible ground that when two business-savvy parties, with equal access to all relevant information, make a contract involving the sale of a business in an industry known to be volatile, a mutual assumption that the business would be successful cannot be a “fact” for purposes of finding mutual mistake of fact and relieving performance under the contract. The parties must have understood that the business, like any business, could wind up not making as much money as anticipated for any number of reasons, just as it could have wound up making more money than anticipated because some “design innovation” turned out to have unanticipated benefits. Labeling the assumption that the business would make money a prediction, as the Restatement does, is just another way of saying that the parties recognized the general uncertainty about MKI’s earnings and intended that earnings that differed from the anticipated amount would not abrogate the contract; that is, each party “assumed the risk” that the earnings would be higher or lower than originally anticipated.

Moreover, the specific risk that caused the problem in Taussig, although not known at the time of contracting, was at least discoverable at the time by both parties. In any event, as the court notes, if anyone had an informational advantage in the transaction, it was Taussig, who, as an officer of the company he sought to acquire, had access to inside information about the value of the company (thus making him an atypical buyer). Finally, despite Taussig’s claim that the parties had made a mutual mistake, the fact of the matter was that the mistake hurt Taussig but correspondingly benefitted Leasco by the same amount. Thus the court had every reason to be skeptical of Taussig’s claim that he would not have made the deal at all (as opposed to merely at a different price) had the information about MKI been known at the time of contracting. As far as it appears, the contract remained jointly profitable, though the distribution of what economists call the “contractual surplus” was certainly affected by the new information.

The court in the famous Aluminum Co. of America v. Essex Group, Inc. (ALCOA) case133 reached a contrary result to Taussig, allowing ALCOA’s claim of mutual mistake (as well as

132. Taussig, 473 F.2d at 781.
impracticability and frustration) and, importantly for my argument here, unilaterally reforming the price term rather than simply excusing performance. ALCOA and Essex entered into a long-term contract under which ALCOA promised to convert raw alumina supplied by Essex into aluminum at ALCOA's plant and then sell the finished aluminum to Essex, which intended to use it to manufacture aluminum wire. The price that Essex was to pay was partially indexed under a formula crafted with the help of none other than Alan Greenspan, former Chairman of the Board of Governors of the Federal Reserve System. The index included a cap (price ceiling) based on a percentage of the market price of a certain type of aluminum as published in a trade journal, but did not include a minimum guaranteed price (price floor). The index chosen for nonlabor production costs was the Wholesale Price Index for Industrial Commodities (WPI-IC), which ALCOA examined for several years prior to the contract to determine that the index sufficiently tracked its production costs. Unfortunately for ALCOA, in 1973, as a result of increases in oil prices by the Organization of Petroleum Exporting Countries (OPEC) and unanticipated pollution-control costs, the price of electric power (the main nonlabor cost in aluminum conversion) rose much faster than the WPI-IC, and the market price for aluminum rose even faster than production costs. ALCOA projected its losses from performing the contract at $75 million, and so went to court seeking equitable modification of the contract price.

The court found that a mutual mistake existed in that both ALCOA and Essex had incorrectly assumed that the index would work as intended, and that this assumption was “basic” to the contract. The court concluded that the mistake was one of fact existing at the time of contracting, even though the fact that the index would fail to work as expected was neither known nor reasonably knowable at the time. The court rejected the argument that the assumption that the index would work as expected was a mere “naked prediction” and distinguished Taussig on the ground that in ALCOA, the parties had not only recognized the risks posed by their long-term contractual relationship, but had also specifically and carefully written a complex term of the contract to address that risk. The court reasoned that ALCOA had not knowingly assumed the risk that the price index would fail because that risk was unforeseeable.

ALCOA’s reasoning and attempt to distinguish Taussig are troubling. Why should the fact that ALCOA included a price index necessarily mean that the parties “intended” that ALCOA would not
bear the risk if the price index failed to work, to its detriment? Just as Taussig was in a better position than Leasco to have protected himself against the risk that his estimation of MKI’s value was incorrect, ALCOA was arguably in a better position than Essex to protect itself against the risk that its index would fail (for example, by including a price floor in the contract or drafting a better index). The court effectively treated the price index as a defective product that Essex sold and warranted to ALCOA and for which Essex should be strictly liable, when in reality, ALCOA crafted the index to serve its own interests. In fairness to the court, it faced conflicting indications of mutual intent: one based on an inference drawn from the inclusion of a contract term inadequately designed to deal with a risk (pointing toward excuse for ALCOA), and the other based on the general tendency of courts, in the face of uncertain intent, to resort to relative fault considerations (pointing toward liability for ALCOA).

There is another argument that might support the court’s result in ALCOA, though the court does not focus on it in its opinion. As the market price of aluminum rose over the term of the contract, Essex resold millions of pounds of the aluminum it acquired from ALCOA on the open market, rather than using the aluminum internally, at a price greatly exceeding the price Essex paid to ALCOA. The court mentions this fact only to show how far the price index had strayed from market conditions. But if the court is correct that the purpose of the contract was to assure Essex of a long-term supply of aluminum for its own manufacturing operations, similar to a requirements

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134. Whether the inclusion of a price floor would have been cost-effective in light of the information known to the parties at the time of contracting, that is, whether ALCOA was negligent, in the “Hand formula” sense, for failing to include the clause, is subject to debate. See, e.g., Victor P. Goldberg, Price Adjustment in Long-Term Contracts, 1985 Wis. L. REV. 527 (arguing that the price ceiling might have been more valuable to Essex than the price floor was to ALCOA because Essex may have been suspicious of the index and wanted to protect itself against ALCOA’s superior knowledge). The court thought ALCOA had exercised due care in drafting the index. The Restatement takes a somewhat schizophrenic position on the fault of the party claiming mistake. Compare RESTATEMENT (SECOND) OF CONTRACTS § 157 (providing that the fault of the party seeking mistake does not bar excuse unless it amounts to bad faith) and id. § 157 illus. 1 (providing that a “failure to exercise reasonable care in totalling and verifying his figures” does not bar excuse for the party submitting a mistaken bid) with id. § 154(b)-(c) (providing that a court can deny a mistake claim if the party seeking excuse “bears the risk” of the mistake because he “treats his limited knowledge as sufficient” or if the court allocates the risk to him because it is “reasonable” to do so), and id. § 154 illus. 6 (providing that the party submitting a mistaken bid cannot claim excuse if the bid “is the result of [its] mistaken estimate as to the amount of labor required to do the work”).

135. ALCOA, 499 F. Supp. at 59.

136. Id. at 56, 58.
contract, then significant reselling by Essex could be viewed as an opportunistic, bad faith attempt to take advantage of the then-favorable contract price, contrary to what the parties originally contemplated. It is one thing to argue that ALCOA should bear the risk of the flawed index it drafted; it is another to argue that ALCOA should bear the risk that Essex would opportunistically take advantage of ALCOA's miscalculation by taking more aluminum than it needed and reselling it. Understood this way, ALCOA is a case in which the court was willing to interpret the mistake doctrine (and the other excuse doctrines) broadly because Essex's relative fault was more blameworthy than ALCOA's.137

Admittedly, ALCOA is a controversial decision; despite the great uproar (and, in some quarters, hope) when it was first decided, it has rarely been relied on by courts since, either in its expansive view of excuse doctrine or in its assertive approach to remedy.138 Nevertheless, ALCOA has never been overruled and remains available as a usable precedent, though of course it is only a district court opinion from a single jurisdiction. What, then, is the proposition for which the case (at least according to its own reasoning) stands? One way to characterize ALCOA's holding is that when contracting parties rely on a sophisticated, but flawed, financial formula to make a long-term contract, and that formula fails for unforeseeable reasons to track economic conditions in the way that the parties expected, the court may use the mutual mistake doctrine to excuse performance and reformulate the contract terms to better match the underlying contractual assumptions.

Understood that way, ALCOA bears an important resemblance to the current crisis. Similar to ALCOA, the mortgage contracts that led to the financial crisis were based on complex, but flawed, financial models created by investment bankers. The key flaw, as we all now know, was that the models wrongly assumed that housing prices, especially in diverse geographical areas, were not significantly correlated and would behave generally as they had in the past, with the past being defined as post-Great Depression; that is, housing prices would continue to rise over time, or at least not suffer widespread and deep drops. It is true that these models were not specifically written

into the contracts between the homeowner and the originating lender, or even in the contracts between the lender and the securitization entity, in the way that the price index in \textit{ALCOA} was explicitly made part of the contract. Nevertheless, there is no question that financial engineers erroneously relied on these models to create the securitization structures, which, in turn, helped drive the willingness of originating lenders to extend riskier mortgages.

More important, the case for applying the \textit{ALCOA} principle is stronger in the current financial crisis context than it was in the \textit{ALCOA} case itself, as well as in \textit{Taussig}. First, like \textit{Taussig}, \textit{ALCOA} involved two sophisticated contracting parties, amply situated to protect themselves against risks, negotiating a nonstandardized contract. In the residential mortgage context, mortgage contracts are highly standardized, and though some homeowners might be knowledgeable about the housing market and the securitization system, most are not, nor are they in a bargaining position that would enable them to negotiate specific contractual protections against remote risks such as the potential decline in the value of their home or restrictions on modifications. Second, in \textit{ALCOA}, the party who created the flawed index, \textit{ALCOA}, was the party who was hurt by it and then sought excuse. In the residential mortgage context, the homeowners who had nothing to do with creating the flawed financial models would be seeking excuse.\textsuperscript{139}

Third, in contrast to both \textit{ALCOA} and \textit{Taussig}, the subprime mortgage context was not one involving a change in risk that benefitted one contracting party while hurting the other. Both subprime borrowers and investors in securitized mortgages, the ultimate beneficiaries on the lending side of the transaction, would have been better off had there been no mistake. If the assumption that home prices would continue to rise had been correct, both borrowers and investors would have been better off under the existing loans. And if the borrowers and investors had realized that they were mistaken about home prices, the mortgage loans would most likely not have been made, at least apart from the possibility of fraud on the part of originating lenders and the financial institutions structuring the securitizations.

\textsuperscript{139} It is true that the originating lenders may not have created the flawed models either (though some originators were, or were owned by or otherwise affiliated with, large financial institutions), but the mortgage passed through the hands of parties who did, and the originating lenders certainly understood why the parties to whom they were assigning mortgages were so willing to buy them up.
Finally, although ALCOA devised a faulty index, ALCOA had nothing to do with the reason the index ultimately failed. ALCOA did not contribute in any meaningful way to the rising price of oil or pollution control. By contrast, the financial industry’s erroneous belief in the accuracy of its own models led to a huge increase in the securitization of subprime mortgages, which helped lead to the bursting of the housing bubble that rendered the financial models inaccurate.

2. Impracticability and Frustration of Purpose

At first glance, underwater homeowners do not seem to fit comfortably under the doctrines of impracticability and frustration of purpose. Paying parties generally cannot claim that their performance is impracticable simply because payment becomes more difficult for them. Because a homeowner-borrower’s only obligation under a mortgage is to pay money, impracticability thus seems unavailable. The doctrine of frustration of purpose developed in part to provide some grounds for excusing paying parties based on an unanticipated reduction in the value of what they contracted to buy. But the doctrine of frustration generally requires that the main purpose of the contract be frustrated by some external event. A borrowing homeowner gets the house she contracted for as long as she pays back the loan and the contractually agreed interest. Her purpose is not frustrated; only her ability to pay is. That seems inadequate to support any frustration of purpose claim.

But, once again, this doctrinal picture is incomplete. Start with the doctrine of “impracticability,” as described in the Restatement. Section 261 states:

Where, after a contract is made, a party’s performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.

It may be useful at the outset to note that several issues that are often crucial in impracticability cases would not likely be key issues were homeowners to raise impracticability claims. First, although


section 261 does not use the term "unforeseeable," all courts and commentators agree that at the very least, for excuse to be granted, the "event" must be "unexpected" by the promisor seeking excuse.\textsuperscript{142} The dominant contemporary view is that most people in the financial industry did not foresee the crisis. Whether or not they did, there cannot be any plausible argument that homeowners did. Second, many cases imply, from contract terms, an allocation of risk of even unforeseeable events. The paradigmatic case is a fixed-price contract, which courts uniformly deem to allocate the risk of market price shifts. In the context of subprime mortgages, however, we have seen that the contract does not, as a practical matter, allocate to one party or the other in all cases the analogous risk of declines in home values below the outstanding mortgage debt, that is, collateral risk. If the homeowner pays off the mortgage and then sells the house, the homeowner bears the risk of declining home value. If the homeowner defaults and the lender forecloses and sells the house, the lender bears that risk. In a recourse jurisdiction, the lender could go after the borrower for the deficiency, but that will not do the lender much good in the subprime case, where the homeowner has few other assets. Thus the argument that the homeowner cannot claim excuse for impracticability because the homeowner has contractually agreed to bear the risk of house-price declines in all cases is not fully consistent with the economic reality of the contract.

But was the financial crisis an event whose nonoccurrence was a "basic assumption" on which the mortgage contracts were made and that made the performance of the contract by homeowner-borrowers impracticable? The Restatement suggests not. In the comments, it states, "The continuation of existing market conditions and of the financial situation of the parties are \textit{ordinarily} not such assumptions, so that mere market shifts or financial inability do not \textit{usually} effect discharge under the rule stated in this Section."\textsuperscript{143} Yet the Restatement leaves some wiggle room immediately following. The next sentence

\textsuperscript{142} Id. § 261 cmt. a.

\textsuperscript{143} Id. § 261 cmt. b (emphasis added); \textit{see also} id. § 261 cmt. e ("This Section recognizes that if the performance remains practicable and it is merely beyond the party's capacity to render it, he is ordinarily not discharged, [because] a party generally assumes the risk of his own inability to perform his duty. Even if a party contracts to render a performance that \textit{depends on some act by a third party}, he is not ordinarily discharged because of a failure by that party because this is also a risk that is commonly understood to be on the obligor." (emphasis added)). Note that the Restatement puts the risk on an obligor who depends on some act by a third party, but does not address what happens when the obligor depends on some act (or some nonact) by the obligee.
of the same comment states, "In borderline cases this [basic assumption] criterion is sufficiently flexible to take account of factors that bear on a just allocation of risk." 144

One such factor might be that thinking of the "risk" in the financial crisis as simply the risk of falling house prices is misleading because, as discussed above, there are a number of risks associated with the subprime mortgage contract, of which the decline in collateral value is only one. Section 261 does not talk in terms of risk, but in terms of an event. If the relevant event, broadly defined, is the financial crisis, then that event involved the realization of multiple risks. Thus not only did the financial crisis lead to declining home prices, but it also led to an economic downturn and high unemployment, making it difficult for many homeowners to make their loan payments. Moreover, the crisis led to not just a decline in home prices, but to such a sharp decline that many homes wound up underwater, with the market value of the homes dropping below the outstanding amount of the mortgage loan. Finally, as I have been emphasizing, the crisis also led to an increased risk that restrictions imposed as part of the securitization process would impede or prevent mortgage modifications, even if they were in the interests of both homeowners and investors. At the very least, these risks were not expressly allocated to the homeowners in their mortgage contracts. And homeowners could not have been expected to anticipate this confluence of risks to the extent that finding that the contracts impliedly assigned the risk to them would make sense.

Not only was the financial crisis an event that resulted in the realization of a number of risks besides "market shifts" and "financial inability," but the realization of all the relevant risks was not a mere accident or completely random event. Rather, the financial crisis can be at least significantly linked to the conduct of the lenders, who are the parties insisting on full enforcement of mortgage contracts (the obligees in Restatement parlance). Would that be enough to overcome the usual presumption that general financial downturns and specific individual financial hardships, which focus on only a limited aspect of the event, are not sufficient to establish impracticability?

144. Id. § 261 cmt. b. The ALCOA case, which as discussed above found for ALCOA on its claim of mutual mistake, took advantage of the doctrinal flexibility and also found that performance had become impracticable because the nonoccurrence of the failure of the price index was a basic assumption on which the contract was made, and ALCOA did not assume the risk of deviation beyond the reasonable limits of risk.
Section 261 makes no mention of the relevance of the obligee's conduct in bringing about the event. The text of section 261 refers only to the absence of fault on the part of the party claiming excuse, the "obligor." Comment d to section 261 explains what happens if some or all of the relevant risks are at least to some extent within the control of the obligee. It states:

Events that come within the rule stated in this Section are generally due either to "acts of God" or to acts of third parties. If the event that prevents the obligor's performance is caused by the obligee, it will ordinarily amount to a breach by the latter and the situation will be governed by the rules stated in Chapter 10 [Performance and Non-Performance], without regard to this Section.\(^\text{145}\)

The comment seems to say that as long as the obligee's conduct constitutes a breach, there is no reason for the obligor to seek excuse under the impracticability doctrine; rather, the obligor should just seek damages or another remedy for the obligee's breach, which in any case would, if material, relieve the obligor from further obligation to perform.\(^\text{146}\) What if, however, the risks are within the control of the obligee, but the obligee's exacerbation of those risks does not constitute a breach? Could the doctrine of impracticability still apply? Neither section 261 nor its comment precludes the possibility.

In the mortgage context, the financial institutions behind the subprime mortgage market expansion not only had control over, but also exacerbated, the risks identified above. They established a system of securitization, resecuritization, and CDSs that ultimately destabilized the economy and contributed to a nationwide and global recession, as well as massive defaults on mortgages. They made it more likely that mortgages would end up underwater by lowering required down payments, which increased leverage and helped fuel the unsustainable housing price bubble. And they created a massive agency problem by putting inadequately monitored and controlled servicers, with weak incentives and authority to respond to the crisis by making efficient modifications, in charge of modifications. None of these actions would be a breach of the original mortgage contract between the homeowner and the originating lender. The financial crisis thus presents an opportunity for a court to find an exception to the general rule that financial hardship and market instability are not grounds for excuse.

\(^{145}\) Id. § 261 cmt. d (emphasis added).

\(^{146}\) Id. § 237.
Even if courts were to accept this possibility, however, several important interpretive questions remain. One is a question of how strong a causal connection courts should require between the conduct of the obligee in a particular contract and the event and its constituent risks. If, for example, courts apply the same standard of causation that would apply in, say, a tort suit seeking damages, it might be that few homeowners would be able to take advantage of the excuse doctrine. A second question is how strictly courts would interpret the requirement that an obligor claiming impracticability must show that his performance has become impracticable. Although the causal link is probably strongest for the increased risks to homeowners due to restrictions on mortgage modifications, mortgage modifications are not, technically speaking, performance under the original contract.

This might be where the doctrine of frustration comes in. According to section 265 of the Restatement:

Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary.\(^{147}\)

As already noted, if the homeowner's principal purpose in obtaining the mortgage is obtaining a place to live, then that purpose is not frustrated. If, however, the homeowner's purpose is broadened somewhat, then there might be room for a frustration argument. First, a typical person who buys a home and takes out a mortgage is not simply looking for a place to live; she is looking to be an owner. Nor is the typical home buyer primarily interested in speculating on the value of the house in the way an investor speculates by buying stock. By putting so many homes seriously underwater, the financial crisis has arguably frustrated the purpose of homeownership by making the underwater homeowners effectively no different, and in fact worse off, than renters.

Second, just as the fact that the obligee caused or exacerbated the relevant risk should matter for impracticability, so it should also matter for frustration. Lenders encouraged potential homeowners to buy ever-more-expensive homes and to view these homes as an investment and a way to achieve the American Dream, courtesy of ever-increasing home prices. For many subprime mortgage borrowers, the assumption

\(^{147}\) Id. § 265.
of rising prices was such a basic assumption of the deal that in the absence of such an assumption, the transaction would, in the words of one of the comments to section 265, "make little [economic] sense." Moreover, the inability of many of these homeowners to enter into efficient modifications also substantially frustrates their principal purpose of home ownership, and the nonoccurrence of structures that would hinder such modifications is arguably a basic assumption of the mortgage contract. Finally, the financial crisis substantially frustrated the ability of many homeowners to make their payments. Although generally a paying party's inability to pay is not grounds for triggering the frustration doctrine, the fact that the conduct of lenders exacerbated the risks that helped lead to the financial crisis could be viewed as enough to overcome the usual presumption.

If either the impracticability or frustration of purpose doctrine applies, one of the important features of these doctrines, at least as represented in the Restatement, is their flexibility with respect to remedy. Section 272(2) states that in case of excuse for impracticability or frustration of purpose, "the court may grant relief on such terms as justice requires." As noted above, ALCOA, which granted excuse to ALCOA under the doctrines of impracticability and frustration as well as mutual mistake, relied on this section to craft a

148. Id. § 265 cmt. a (stating that to satisfy the requirement that a "principal purpose" of the contract be frustrated, the contractual purpose "must be so completely the basis of the contract that, as both parties understand, without it the transaction would make little sense").

149. In one recent case arising out of the current crisis, the court considered and rejected a frustration of purpose claim by the borrower. See Vision Bank v. Luke, No. 5:10cv45/RS-MD, 2010 U.S. Dist. LEXIS 64243 (N.D. Fla. June 29, 2010). In that case, the bank made a loan of around $1 million to finance the purchase of a residential lot by two developers who were also managing members in an LLC, which executed the mortgage. When the value of the lot dropped by half six years into the mortgage, the bank opted to sue the developers rather than foreclose. The LLC contracted to sell the property at the reduced market value and offered to use the net proceeds of the sale to partially pay the loan if the bank would provide a complete satisfaction of the mortgage in exchange for the partial payment, thus writing off principal. The bank refused to allow partial payment to satisfy the mortgage. The court rejected the LLC's frustration of purpose claim for three reasons: (1) the purpose of the mortgage was not frustrated, (2) a decline in property values is not enough to support a frustration claim because that would just allow a borrower to withdraw from a bad bargain, and (3) the event was foreseeable and could have been provided for in the contract. The court was likely influenced by the fact that the borrowers were developers rather than residential homeowners. Moreover, although the court did not focus on this fact, it is noteworthy that the mortgage was apparently not securitized but held by the bank that originated it. As a result, the structural obstacles to efficient modification, on which this Article has focused, were not present.

150. Restatement (Second) of Contracts § 272(2); see also id. § 272 cmt. c ("The question . . . is whether the court can salvage a part of the agreement that is still executory on both sides . . . by supplying a term which is reasonable in the circumstances.").
judicial modification. Although that approach by the court was controversial and has not been followed by other courts (it was not even followed by the parties, which settled and renegotiated the deal for themselves), it remains a possibility in an appropriate case. A situation in which restrictions on modifications cannot easily be undone by homeowners and investors, and so hinder private modification solutions, could be viewed as such a case.

3. Constructive Conditions

Apart from the doctrines of impracticability and frustration, it may be useful to recall one more forgotten doctrine of contracts that serves similar purposes. The doctrine of impracticability began in England as an application of the law of implied (now called constructive) conditions, which are conditions read into a contract by a court. The doctrine of constructive conditions is still recognized by the Restatement, but its domain has narrowed as other, more specific doctrines, such as impracticability, have taken over the doctrinal space. To the extent that the doctrines of impracticability and frustration are narrowly interpreted, however, a creative court could resort to the constructive conditions doctrine, which lacks some of the doctrinal restraints of the excuse doctrines, to achieve a similar result. Specifically, the court could impose a condition on the homeowner-borrower's duty to pay that the lender not engage in conduct that exacerbates either the risk of inability to pay or the risk of inability to modify mortgages.

One area the Restatement leaves for the constructive conditions doctrine is a situation "where an obligor's duty cannot be performed without some act by the obligee, and the court supplies a term making that act a condition of the obligor's duty." Important, the comment goes on to say that even if the obligee's failure to act (or, presumably, affirmative contrary act) is not a breach by the obligee, a court could still deem the doing of the act a necessary condition on the obligor's duty if the obligee's failure unduly interferes with the obligor's performance. Thus, in the context of an underwater mortgage, even

152. RESTATEMENT (SECOND) OF CONTRACTS § 226 ("An event may be made a condition ... by a term supplied by the court."). See generally Edwin W. Patterson, Constructive Conditions in Contracts, 42 COLUM. L. REV. 903 (1942).
153. RESTATEMENT (SECOND) OF CONTRACTS § 226 cmt. c.
154. Id. (noting that although "[i]n most such situations, the obligee's own obligation of good faith and fair dealing imposes on him a duty to do the act, so that a material failure to perform that duty would, in any case, have the same effect as the non-occurrence of a
if a lender has no duty to avoid conduct that risks reducing the value of
the collateral, and the servicer has no duty to agree to a modification,
the failure to modify when a modification would be in the best
interests of the homeowner and the investors could be construed as the
nonoccurrence of a condition on the borrower’s duty to pay, at least the
duty to pay more than what would be due under a reasonable
modification. The question is whether, to be a condition, the obligee’s
conduct must be such as to prevent or at least interfere with the
obligor’s performance under the original contract, which a restriction
on modification of course would not do. My point is simply that the
Restatement allows for the possibility that a court could impose a
constructive condition that the obligee not engage in conduct that
unexpectedly and substantially reduces the overall value of the contract
to the obligor. Given the circumstances of the financial crisis, a court
would have a sound basis for using the doctrine in this way.

4. Superior Risk Bearer

The fact that a doctrine can be interpreted in a particular way
does not, of course, mean that it should be. In fact, the economic
theory of excuse doctrines supports the flexible doctrinal reading I
have argued for here. Economic analysis has identified three aspects
of efficient risk allocation: risk prevention, risk spreading (risk
bearing), and risk mitigation. I have already considered risk
prevention to some extent in discussing the excuse doctrines above.
Generally, risk prevention is a minor concern in discussions of
impracticability, or else the focus is on potential risk prevention by the
obligee claiming excuse. If in fact, however, the obligee is in a better
position than the obligor to take cost-effective precautions that would
reduce a given risk (as opposed to full prevention), economic analysis
would support excusing the obligor’s performance. There is no
question that subprime lenders could have taken a number of steps to
reduce the risk that a large number of homeowners would find
themselves underwater in their mortgages and unable to obtain a
modification of those mortgages even if the benefits of those
modifications exceeded their costs. They could have maintained,
rather than lowered, credit standards. They could have required larger
down payments, rather than allowed smaller down payments. They
could have been more skeptical in questioning the assumptions

condition,” it is possible for a court to find a constructive condition even in “situations where
no duty to do the act is imposed” (citation omitted)).
underlying their pricing models or in relying on the ratings of agencies. They could have structured securitizations to facilitate efficient modifications.

Various objections could be raised against the argument that the lenders were in a better position than homeowners to take precautions against the relevant risks. Some might argue that low interest rates, lax regulation, and competitive pressures "forced" the lenders to take the steps they did. This objection is not a satisfactory response to the question: Which of two contracting parties is best positioned to bear a risk not expressly allocated in the contract? From an economic perspective, the point of legal liability (and legal rules generally) is to change incentives, and so to affect future behavior in the face of competing pressures to act otherwise.

Others would argue that homeowners share an equal or greater portion of the blame for participating in the speculative bubble by buying homes more valuable than they could afford solely in the hope that prices would continue to rise. This objection recognizes that homeowners and lenders entered into many loan transactions with the joint expectation that they were gambling on home prices continuing to rise. Homeowners could certainly have refrained from buying the most expensive homes they could get financing for or could have, on their own, made higher down payments. Nevertheless, as between homeowners and the originating lenders, it seems hard to dispute that the lenders were better situated to assess and control the relevant risks.

Moreover, excuse doctrine could take into account homeowner behavior in a number of ways. For example, courts could limit excuse to situations involving residential homeowners with respect to mortgages on their primary residence that have become underwater and for which the homeowners cannot now make the payments but could reasonably be expected to continue to make payments if the loan principal were reduced. Courts could also refuse to allow excuse if there are second liens on the home. Many homeowners, in addition to

155. In the most recent edition of his treatise, Judge Richard Posner makes both of these arguments, though in the context of broadly assessing blame for the crisis, rather than in the specific context of considering whether lenders or homeowners are the superior risk bearers. POSNER supra note 112, § 15.14, at 619 (arguing that criticism of bankers for "failing to anticipate and prevent the financial collapse" is "misplaced" because "a bank that fails to maximize profits is in danger of quickly losing its principal assets to its more daring competitors"); id. § 15.14, at 620 (arguing that many homeowners took a "gamble" in buying more valuable houses than they could reasonably afford, and that this gamble was not necessarily irrational, though "it is an open question how many [homeowners] had their eyes open").
their mortgages, took out home equity loans for purposes other than buying the house. If courts imposed such limitations, many homeowners would not be able to make a successful excuse argument, though of course they might be able to make some of the other arguments I consider here, as well as arguments based on fraud or statutory violations.

The second aspect of the superior-risk-bearer analysis, efficient risk bearing, also points in favor of allowing some kind of excuse for homeowners. Although many have noted the difficulty in determining the “least-cost” insurer in many cases, in the case of private-label securitized mortgages, the market itself seems to have provided an answer. The securitization system and its offshoots (like CDSs) created, in effect, a giant insurance system for pooling mortgage default risks for lenders, albeit one that proved to be insufficiently funded and inadequately diversified. No comparable private mortgage insurance market for the benefit of homeowners has developed, most likely because of the heterogeneity of homeowners and the moral hazard problems associated with that insurance. Moreover, it is more difficult for homeowners than for lenders to hedge against the risk that home values will decrease. Of course, the securitization system did not spread risks as much as the financial industry thought, but that does not detract from the conclusion that, as between lenders and homeowners, the lenders were most likely in a better position to insure against the relevant risks.

The third branch of the superior-risk-bearer analysis, the least-cost mitigator, links excuse doctrine with the doctrines discussed in Part II.A. Excuse doctrines make economic sense when the obligee is in a better position than the obligor to obtain cost-effective substitute

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157. A market for private mortgage insurance for the benefit of lenders does exist. Traditionally, lenders have required homeowners to buy mortgage insurance if their down payment is less than 20%. In the subprime market, originating lenders did not insist that the homeowners purchase private mortgage insurance, because the originating lenders assigned the mortgages away into securitization pools and so bore no default risk.

158. See Posner, supra note 112, § 4.5, at 132 ("[I]t's difficult to buy insurance against the risk of being the victim of a breach of contract, because...[there is too much heterogeneity among contracts [and] a party insured against the consequences of a breach would have less incentive to make the contract a success.").

159. The focus on mitigation as a key feature of impracticability doctrine comes from Victor P. Goldberg, Impossibility and Related Excuses, 144 J. INSTITUTIONAL & THEORETICAL ECON. 100 (1988).
performance after the risk occurs. This may be the case where the obligee places some subjective (idiosyncratic) value on the obligor’s performance. Thus, for example, under the facts of the famous case of *Taylor v. Caldwell*, in which a theater successfully sought excuse from a contract with a performer after a fire, 160 once the fire burns down the theater, we might want to excuse the theater in order to encourage the performer to find the best substitute to showcase her talents to avoid the possibility that she would make exaggerated claims of loss in suing the theater for breach. The least-cost mitigator idea also helps explain courts’ reluctance to allow excuse for paying parties in the event of economic depression or personal financial hardship. Because money is fungible, paying parties will often have choices about which creditors they pay and how much. Too readily allowing excuse for paying parties could lead to exaggerated claims of hardship, and claims that performance of the original contract is no longer efficient in the sense of being jointly profitable.

Although homeowners are paying parties, their situation is meaningfully different from that of other buyers. If a home is currently underwater, the market value of the home provides objective evidence that the mortgage transaction, as originally structured, has become uneconomical. Homeowners have an incentive to walk away from underwater homes, as many have done. Insisting that the homeowner must continue to pay in these circumstances is like insisting that a business continue to pour money into a losing investment, a classic example of the sunk-cost fallacy. As discussed in the previous Part, however, if the homeowner could afford to make payments as long as the loan principal were reduced so that the modified contract were once again jointly profitable, but the financial industry put structures in place that prevented that outcome from occurring, then there is a justification for legal intervention. In this context, one could view the reduction of principal as an efficient mitigation act. Thus, if excuse doctrine can be interpreted to facilitate efficient mortgage modifications, economic analysis would support that interpretation. 161 Although modification is not usually thought of as an act of mitigation, which generally involves a unilateral act by one party rather than a revision of contract terms, in this situation,

substituting a new mortgage rather than a new debtor may be the most efficient ex post response. But for the modification restrictions imposed by the financial industry, these mitigation acts would be occurring. The fact that lenders have disabled themselves from making these modifications should not change the conclusion that they are in the best position to do so for purposes of determining the superior risk bearer and the application of contractual excuse doctrines.

C. Other Doctrinal Analogies

1. Damages Doctrine and Peevyhouse

So far, I have discussed a variety of contract doctrines that could be interpreted to allow some defense for the defaulting homeowner. As in many contract cases, however, the crucial question could be the remedy—in this case, whether courts could impose modifications. I have already referenced several doctrines that could allow the necessary remedial flexibility. In this Part, I consider another possible route: the doctrine of contract damages. Mortgage foreclosure is merely a contractual remedy for breach by the homeowner. Many contract doctrines impose limits on remedies that would otherwise be available, often for reasons that have to do as much with fault or risk-shifting as with claimed measurement difficulties. In the context of mortgages, as already noted, the equity of redemption is a judicially created limitation on the foreclosure remedy. Doctrinal limitations on damages could be viewed as essentially forced judicial modifications of contracts. Thinking about how these limitations could be relevant to the foreclosure crisis might allay some concerns about judicial remaking of contracts.

To begin to think about how the law of contract damages could apply to mortgages, consider another famous case that involves real estate, but otherwise seems far removed from the mortgage foreclosure problem, at first glance. The case is Peevyhouse v. Garland Coal & Mining Co. In Peevyhouse, a farm couple contracted with a coal company to allow the coal company to engage in strip mining on the farmers’ land on condition that the coal company promise to restore the land after it was done mining. After mining for some period, the coal company decided not to do the promised restoration work because

the cost of doing so turned out to be higher and the value of the coal lower than the company had originally anticipated. The farmers sued, but the court limited the farmers’ recovery to the diminution in the market value of the farmers’ property, a small amount, rather than allow the farmers to recover the cost of completing the restoration work, a significantly larger amount.

Although many, including me, have criticized the *Peevyhouse* case, it is fairly representative of one of the most important themes in the law of contract remedies: the law’s reluctance to protect alleged idiosyncratic value, or at least a reluctance to presume it exists. What the farmers lost from not getting the higher cost-of-completion remedy was their idiosyncratic value in the land, that is, the value to them above and beyond the market value, or the value a hypothetical, next-highest bidder would place on the land. In this regard, *Peevyhouse* is really not much different from a host of other limitations on contractual remedies, such as restrictions on specific performance, the penalty doctrine limitation on liquidated damages, the foreseeability limitation, and the certainty limitation.

Most of these doctrines have the greatest force in cases where the breaching party, as opposed to the paying party, is the one who has promised to perform some service or provide some good. The concept of idiosyncratic value seems inapplicable to cases involving breaches by the party whose obligation is to pay, which of course is the situation when a homeowner defaults on his mortgage. Generally, the party to whom money is owed has no idiosyncratic value in that money.
Nevertheless, there is a parallel to the idiosyncratic-loss problem in the case of foreclosure of an underwater mortgage. If the homeowner cannot afford to pay, but could afford to pay if the mortgage principal were written down to the current market value, what is the loss to the lender of a court’s denying the lender the right to foreclose and requiring the lender to accept a modification lowering principal payments? In the event that the homeowner winds up paying off the loan at the lower amount, the lender gets at least the benefit it would have gotten if it had foreclosed, sold the house, and given a new mortgage to the buyer of the foreclosed property (by assumption, the lender could not pursue the original homeowner for the deficiency). If, on the other hand, the original homeowner defaults again after the modification, the lender would still get the house and be able to sell it at the market price, assuming that price does not continue to fall. The point is that the original amount the lender would have gotten had the homeowner been able to make the payments on the original loan is now lost in any case. Whatever the lender might lose above and beyond that amount from not being able to foreclose now could be characterized as idiosyncratic, and therefore presumptively unenforceable, loss.

Thus the defaulting homeowner can be analogized to the defaulting coal company in *Peevyhouse*. The farmers effectively made a loan of their land (as opposed to their money) to the coal company, which promised to pay them back not only in royalties from the coal, but also in restored land. The coal company essentially defaulted on this loan by not doing the restoration work. In both cases, the nonperformance by the breaching party could be viewed as efficient in the sense that the cost of full performance of the original contract exceeds the benefit. The damages remedy in *Peevyhouse* can then be understood as a judicial modification of the loan contract, allowing the coal company to stop mining the coal and pay a small amount in damages (analogous to a reduction in loan principal) as a result of the unexpectedly high cost of performing the original restoration promise under the contract.

Moreover, as with *ALCOA*, the case for applying the *Peevyhouse* principle to defaulting homeowners is arguably stronger than in *Peevyhouse* itself. What makes *Peevyhouse* controversial is either the suspicion that the coal company “borrower” knew about the potential problems with restoration initially or early on in the performance of the contract, and yet kept going, or the view that the coal company was the superior risk bearer because it was in a better position to calculate
the net benefits of the coal extraction and restoration work. Defaulting homeowner-borrowers, by contrast, were in a worse position than the originating lenders either to know about the problems with the securitization system or to do anything about them (other than not borrow).

2. The Objective Theory of Contracts and Lucy

I end my discussion of contract doctrine where such discussions often begin: contract formation and the objective theory of contractual intent. According to the objective theory, courts judge a contracting party's intention by a reasonable understanding of his words and conduct, even if that reasonable understanding conflicts with his subjective intention. As with other doctrines considered so far, the objective theory does not seem to be relevant to the financial crisis. What evidence is there that lenders or borrowers subjectively intended something different from the words they used or the way they acted?

We can see the connection between the objective theory and the financial crisis by reexamining perhaps the best-known objective theory case, Lucy v. Zehmer,170 which just happens to be a real estate transaction. Lucy wanted to buy Zehmer's farm, but Zehmer was reluctant to sell, having previously refused several offers by Lucy. One night shortly before Christmas in 1952, Lucy entered Zehmer's restaurant and, after some drinking by and discussion between the men, Lucy offered to buy the farm for $50,000, an apparently fair price. Lucy got Zehmer and his wife to write out and sign, on the back of a restaurant check, a promise to sell the farm to Lucy for $50,000 and to hand over the writing to Lucy. Zehmer subsequently reneged, claiming, "[T]he writing sought to be enforced was prepared as a bluff or dare to force Lucy to admit that he did not have $50,000; that the whole matter was a joke."171

The Supreme Court of Appeals of Virginia held that there was an enforceable contract and awarded specific performance to Lucy. The court found Zehmer's argument to be "unusual, if not bizarre" and held that under the objective theory, whether or not Zehmer was joking was irrelevant.172 The court found that the writing, as well as Zehmer's conduct, manifested an intent to enter into a "serious business

170. 84 S.E.2d 516 (Va. 1954).
171. Id. at 520.
172. Id.
transaction” and that Lucy both actually and reasonably believed that Zehmer was serious.173

In my view, it is the court’s opinion and use of the objective theory of contract that is “unusual, if not bizarre,” though I agree with the result in the case for reasons other than those stressed by the court. Objective evidence not focused on by the court, but arguably relevant to the case, as well as to the financial crisis, supports Zehmer’s argument that the transaction was not serious. Zehmer not only subjectively believed (incorrectly, as it turned out) that Lucy did not have $50,000, but he also expressed this doubt to Lucy (according to Lucy’s own testimony, Zehmer “seemed to doubt that Lucy could raise $50,000”).174 Yet Zehmer agreed to the deal. Why? In a “serious business transaction” for real estate, what reasonable seller would agree to sell property on credit for a significant sum (as $50,000 was in 1952) without checking the creditworthiness of the buyer, conditioning the deal on the buyer’s securing a mortgage from a reputable bank (which would then have an incentive to check the buyer’s creditworthiness), or himself taking a security interest in the property? Zehmer, however, said nothing about collateral for his effective loan to Lucy, despite the fact that he expressly voiced concern about Lucy’s ability to pay and the contractual “instrument” is silent on the subject.175

Perhaps the reason Zehmer did not say anything about collateral is that the parties did not contemplate a credit transaction. Zehmer’s testimony indicated that he had in mind a pure cash transaction. Lucy apparently treated the transaction that way, writing to Zehmer almost two weeks after their meeting to say that he was “ready to pay the purchase price in cash” without any reference to borrowing the money.176 But if that were the parties’ intention, it is notable that nothing in the writing signed by Zehmer required, or even mentioned, a cash transaction. Nor did the testimony cited by the court state that a cash transaction was required. Zehmer’s testimony focused on the fact that Lucy did not have $50,000 in cash on him the night of the meeting. In its opinion, the court’s only reference to whether the parties contemplated a cash or credit transaction was in response to Lucy’s testimony: “[I]f there was any jesting it was about paying

173. Id. at 521.
174. Id. at 518.
175. Id. at 517.
176. Id. at 518.
The court’s response: “The contract and the evidence show that he was not expected to pay the money that night.” Regardless, if the parties contemplated that Lucy would pay with his own cash, then that makes the deal even stranger because Zehmer, whether in the contract or otherwise, took no steps to protect against the risk of Lucy’s inability to pay by, for example, conditioning the deal on payment in full by a certain date. If Lucy had shown up with a $10,000 check two weeks later, claiming he would pay the rest of the money “in due time,” would the court have let Zehmer back out?

Zehmer, of course, could have been acting stupidly or irrationally (he did, implausibly, try to claim he was too drunk to know what he was doing), and one could argue that if that were the case, he got what he deserved, with the objective theory serving to punish his stupidity or irrationality. I think that story is unlikely, however, as did the court.

Instead, I think it more likely that Zehmer acted as he did because he sincerely believed that Lucy did not have the money, and Lucy knew it. Zehmer likely viewed the matter more as a bluff or dare rather than a joke, in that Zehmer thought Lucy would be forced to concede that he did not have the money, and then Zehmer could go around town boasting to friends and neighbors of how he had bested Lucy. The serious business transaction was, in reality, a high-stakes poker game. Zehmer bet the farm, and he lost the bet. Lucy in fact did have the money, because he had secret financing—an ace in the hole. His brother was willing to put up half of the money and take a half-interest in the land (so the brother was a co-owner, not a creditor).

If Zehmer deserved to lose, it was not because his subjective intent (joking) was inconsistent with his objective conduct (serious business transaction, as indicated by the writing and the surrounding circumstances), but because both his subjective intent and objective conduct were consistent, and wrongful. Zehmer had no subjective intention of entering into a serious business transaction for the sale of the farm. And he agreed to a “transaction” whose very terms, by omitting any protection against nonpayment by Lucy of a substantial sum of money, confirm Zehmer’s lack of seriousness. But Zehmer also intended to take advantage of what he perceived to be Lucy’s impecuniousness, via the social device of contract. Unfortunately for

177. Id. at 521-22.
178. Id. at 522.
179. Somewhat surprisingly, the court in its opinion identifies the “bluff or dare” argument but says nothing about it, focusing on the “joke” interpretation.
Zehmer, Lucy turned the tables on him. Zehmer's conduct and words matched his subjective intention; he just guessed wrong.

Yes, one could blame Lucy for strategically withholding key information from Zehmer. But on the other hand, he was not doing so in a way that financially harmed Zehmer and was only retaliating against Zehmer's unreasonable attempt to take advantage of him. Moreover, Lucy did really want the farm and was willing and able to pay what was apparently a fair price for it. What he tricked Zehmer out of was whatever idiosyncratic value Zehmer placed on the farm above and beyond its fair market value. Thus the case to some extent demonstrates the same court skepticism about idiosyncratic value and reluctance to protect it that we see in *Peevyhouse* and other contract law cases (though the fact that the court awards Lucy specific performance, thereby protecting Lucy's subjective value in the property, cuts against that theme).

On this reading, *Lucy* provides an interesting parallel to the financial crisis. In both situations, an apparently serious real estate transaction is actually based on unrealistic assumptions about the buying (borrowing) party's ability to pay. In both situations, the selling (lending) party wrongly believed that it would not be hurt by writing a contract that did not sufficiently protect against the borrower's inability to pay. The difference is that in the financial crisis, the financial industry in fact wanted originating lenders to make the loans because the industry thought securitization and rising home prices would protect against the risk that the borrowers would not repay, whereas Zehmer believed that Lucy would never want to go through with the transaction once he confessed to not having the money. Thus, in *Lucy*, it is the seller who is seeking to escape from the contract, whereas in the financial crisis, it is the buyer (borrower) who seeks contractual relief. But just as the court in *Lucy* (at least implicitly) recognized that Zehmer, as the seller and person best able to control the structure of the transaction, should bear the responsibility for not protecting against the relevant risk and instead trying to take advantage of the situation, so courts should also view lenders in the financial crisis as better situated to bear the contractual risks they exacerbated and failed to protect against, where their objective conduct and subjective beliefs were consistent and wrong.

III. CONCLUSION

The financial crisis was not simply the result of the failure of innovative strategies to reduce the risks associated with mortgage
contracts. Financial institutions created a complex system of contracts that put in place obstacles to efficient modification, exacerbated risks in ways that homeowners did not know about and had no ability to control, and failed to take ordinary precautions against foreseeable risks. Contract law has always been concerned not merely with the avoidance or shifting of risk, but also with the protection against, or exacerbation of, risk. Many contract doctrines can be understood as designed to put the burden on the party best positioned to control risk. This is the essential insight of the law and economics approach to contract law. I have argued that homeowners could make use of a number of these doctrines to convince courts to help them escape from underwater mortgages and impose efficient modifications that servicers are currently unable or unwilling to negotiate. In particular, the doctrines of assignment and excuse seem to be potentially powerful vehicles for achieving this goal. The severe consequences of the greatest financial catastrophe since the Great Depression call for legal innovation to match and remedy the disastrous financial innovation bequeathed to us by the financial industry. This is no time to forget the possibilities of contract law.