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The Morality of Strategic Default

Brent T. White  
The University of Arizona  
James E. Rogers College of Law

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## The Morality of Strategic Default

Brent T. White\*

*Abstract: Responding to those who argue that homeowners who strategically default on their mortgages are immoral and socially irresponsible, this article argues that breaching a mortgage contract is not only morally acceptable, it may be the most responsible course of action when necessary to fulfill more important obligations to one's family.*

As a result of the housing collapse, many Americans have seen their homes lose half their value,<sup>1</sup> owe several hundred thousand dollars more on their homes than their homes are worth<sup>2</sup>, and are unlikely to dig out of their negative equity hole for decades.<sup>3</sup> For these individuals, the American dream of

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\* Associate Professor of Law, University of Arizona, James E. Rogers College of Law.

<sup>1</sup> For example, the median sale price of a Las Vegas home was approximately \$280,000 in 2006 and \$130,000 in early 2010. [www.Zillow.com](http://www.Zillow.com), Las Vegas Home Prices and Home Values, [http://www.zillow.com/local-info/NV-Las-Vegas-home-value/r\\_18959](http://www.zillow.com/local-info/NV-Las-Vegas-home-value/r_18959) (last visited Apr. 13, 2010). In Phoenix, the median sale price was \$245,000 in late 2007 and \$125,000 in early 2010. [www.Zillow.com](http://www.Zillow.com), Phoenix Home Prices and Home Values, [http://www.zillow.com/local-info/AZ-Phoenix-home-value/r\\_40326](http://www.zillow.com/local-info/AZ-Phoenix-home-value/r_40326) (last visited Apr. 13, 2010). In Salinas, CA, the median sale price peaked at over \$600,000 in 2006, but stood at just \$225,000 in early 2010. [www.Zillow.com](http://www.Zillow.com), Salinas Home Prices and Home Values, [http://www.zillow.com/local-info/CA-Salinas-home-value/r\\_54288](http://www.zillow.com/local-info/CA-Salinas-home-value/r_54288) (last visited Apr. 13, 2010).

<sup>2</sup> In the Fourth Quarter of 2009, over 10% of all homeowners with a mortgage owed more than 25% of what their homes were worth. First American Core Logic, Negative Equity Report (Feb. 23, 2010), available at [http://www.loanperformance.com/infocenter/library/Q4\\_2009\\_Negative\\_Equity\\_Final.pdf](http://www.loanperformance.com/infocenter/library/Q4_2009_Negative_Equity_Final.pdf). In Nevada, over half of homeowners were more than 25% underwater, approximately 30% were underwater in Arizona and Florida, and approximately 20% were underwater in California. *Id.* Nationally, the Fourth Quarter 2009 value of all negative equity totaled \$801 billion, with \$660 billion of this concentrated in homes with at least 25% negative equity. *Id.*

<sup>3</sup> For example, assuming a historical appreciation rate of 3.5%, it will take nearly 30 years for an average home purchased for \$600,000 in Salinas during 2006—and now worth roughly one-third of the purchase price—just to regain its 2006 value. See HYE JIN RHO, ET. AL., CHANGING PROSPECTS FOR BUILDING HOME EQUITY 3 (2008), available at [http://www.cepr.net/documents/publications/Changing\\_Prospects\\_for\\_Building\\_Home\\_Equity\\_2008\\_10.pdf](http://www.cepr.net/documents/publications/Changing_Prospects_for_Building_Home_Equity_2008_10.pdf). Moreover, assuming that a Salinas family purchased such a home in 2006 with a 30-year loan at a 6.5% interest rate with a 5% down payment, it would take a little under 20 years for the home's value to appreciate enough to satisfy the concurrent outstanding mortgage debt. By this time, the homeowners would have handed the bank a little under \$600,000 in interest payments, in addition to approximately \$200,000 in payments against the principal. Thus, even without considering additional costs of home ownership or other lost opportunity costs, a family that purchased an average home in Salinas at the market's peak is nearly two decades – and \$800,000 in

homeownership has become a nightmare, and their financial future is dim.

To compound the stress and anxiety, when they've called their lenders to work out a solution, they've discovered that their lenders won't even talk to them about a loan modification or a short sale as long as they are current on their mortgages.<sup>4</sup>

Out of desperation, some of these underwater homeowners have decided that they would be better off letting go of their homes and have thus intentionally stopped making their mortgage payments.<sup>5</sup> Many have done so with the hope that defaulting on their mortgage will finally bring their lender to the table, but also resigned to the fact that they will likely lose their home.

In a recent article, economist Luigi Zingales suggests that these homeowners are immoral.<sup>6</sup> He also criticizes me, along with Roger Lowenstein of the New York Times, for supposedly contributing to the social menace of "strategic default."<sup>7</sup> Others have joined Zingales in his condemnation of underwater homeowners who strategically default, and of me, for allegedly encouraging them to do so.<sup>8</sup>

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mortgage payments away – from digging out of their negative equity hole.

<sup>4</sup> See Manuel Adelino, Kristopher Gerardi, & Paul Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Federal Reserve Bank of Atlanta, Working Paper 2009-17, Aug. 2009), available at <http://www.frbatlanta.org/invoke.cfm?objectid=149C4D27-5056-9F1212C089648203E1FD&method=display>.

<sup>5</sup> See David Streitfeld, *No Help in Sight, More Homeowners Walk Away*, NEW YORK TIMES, February 2, 2010, <http://www.nytimes.com/2010/02/03/business/03walk.html>. In the third quarter of 2009, 14% of homes were in foreclosure or at least one payment past due. MORTGAGE BANKERS ASSOCIATION, NATIONAL DELINQUENCY SURVEY 2009 3RD QUARTER (Nov. 19, 2009). Studies have estimated the strategic default rate at 17%, 1 EXPERIAN-OLIVER WYMAN MARKET INTELLIGENCE REPORT, UNDERSTANDING STRATEGIC DEFAULT IN MORTGAGES (2009), and 25%, Guiso, Sapienza & Zingales, *supra* note 1, at 2.

<sup>6</sup> Luigi Zingales, *The Menace of Strategic Default*, 20(2) CITY JOURNAL \_\_\_\_\_ (Spring 2010), available at [http://city-journal.org/2010/20\\_2\\_strategic-mortgage-default.html](http://city-journal.org/2010/20_2_strategic-mortgage-default.html).

<sup>7</sup> *Id.* Zingales is referring to Brent T. White, *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis* 4 (forthcoming, Wake Forest L. Rev., Fall 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1494467](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1494467). Strategic default means intentionally stopping mortgage payments, even though one can "afford" to continue making payments. Of course, what it means to be able to "afford" one's payments is contested. For example, if one, faced with limited financial resources, chooses to pay their credit card rather than their mortgage, this might be called a strategic choice to default on one's mortgage instead of one's credit card. The purest strategic default would be a case in which one could easily afford to meet all one's financial obligations but nonetheless decided to stop paying their mortgage because of the home's declining value.

<sup>8</sup> See, e.g. Kenneth R. Harney, *Walking Away from a Mortgage*, WASH. POST, Nov. 28, 2009, available at <http://www.washingtonpost.com/wp->

Before responding, it is important to emphasize that the decision to strategically default on a mortgage involves many complex, localized, and individualized factors.<sup>9</sup> No one should decide to strategically default on their mortgage without sitting down first with a knowledgeable professional to discuss in detail the best course of action.<sup>10</sup> For that reason, I've never advised underwater homeowners as a group to strategically default on their mortgages, and I am not doing so here.

But let's say that an underwater homeowner has actually sat down with a professional to do the calculation and has concluded that defaulting on his mortgage is the only way out of his financial nightmare. Would it be immoral or irresponsible for him to do so?

The argument against homeowners intentionally defaulting their mortgages generally centers on the same three basic points. First, underwater homeowners "promised" to pay their mortgages when they signed the mortgage contract, and it would be immoral to break this promise.<sup>11</sup> Second, foreclosures lead to depreciation of neighborhoods, so underwater homeowners should hang on in order to help preserve their neighbors' property values.<sup>12</sup> And, third, if all underwater homeowners defaulted, the housing market might crash.<sup>13</sup> Homeowners thus have a social obligation to pay their underwater mortgage in order to save the economy.

While all three of these arguments might have some initial appeal, none of them hold water.

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[dyn/content/article/2009/11/25/AR2009112504186.html](http://dyn/content/article/2009/11/25/AR2009112504186.html) (describing the "incendiary core message" of this article with Lewis Ranieri calling me "incredibly irresponsible and misinformed"); Liz Pulliam Weston, *Are You Foolish to Pay Your Mortgage?*, MSN Money, Dec. 9, 2009, <http://articles.moneycentral.msn.com/Banking/HomeFinancing/weston-should-you-walk-away-from-your-home.aspx?page=1> (describing my discussion of walking away as "an assault on our integrity and our character. There's no price tag you can put on that.").

<sup>9</sup> For example, whether strategic default would be a wise choice would depend on such things as the particular laws in one's state, one's immediate need for credit, the cost of renting a similar home, the degree of negative equity, and the prospects for appreciation in one's neighborhood – to name just a few.

<sup>10</sup> Getting good advice, however, is easier said than done. HUD approved counseling agencies, for example, generally warn homeowners against foreclosure, even when it would be in a particular homeowner's best interest. See White, *supra* note 7, at 31-33, n.140, n.141.

<sup>11</sup> Zingales, *supra* note 6; *see also* Guiso, Sapienza & Zingales, *supra* note 1.

<sup>12</sup> See e.g., Liz Pulliam Weston, *supra* note 8 (arguing against strategic default because "more foreclosures would bring more pain to our neighbors, our communities and our economy.")

<sup>13</sup> Zingales, *supra* note 6.

First, a mortgage contract, like all other contracts, is purely a legal document, not a sacred promise.<sup>14</sup>

Think of it this way: when you got your cell phone, you likely signed a contract with your carrier in which you “promised” to pay a set month payment for two years. Let’s say, though, that two months after you sign your contract, the price of cell phone service drops by half – meaning that the same cell phone service you pay \$100 a month for could be had for half of that with another carrier. You decide that you would be financially better off paying the early termination fee of \$300, rather \$100 a month for another 22 months for the same service that you can now get for \$50.

Would it be immoral for you to break your contractual “promise” to pay \$100 for two years, and elect instead to pay the early termination fee? Of course not. The option to breach your “promise” to pay is part of the contract, as is the consequence of breach – a \$300 early termination fee. There is absolutely nothing immoral about exercising your option to breach, and you’d be financially wise to do so.

Though a mortgage contract is more substantial, and involves a home, it is simply a contract, just like a cell phone contract. Like a cell phone contract, a mortgage contract explicitly sets out the consequences of breach.

In other words, the lender has contemplated in advance that the mortgagor might be unable or unwilling to continue making payments on his mortgage at some point and has decided in advance what fair compensation to the lender would be. The lender then wrote that compensation into the contract. Specifically, the lender probably included clauses in the contract providing that the lender may foreclose on the property, keep any payments that have been made, and may opt to pursue a deficiency judgment against the mortgagor, if state law so allows.<sup>15</sup>

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<sup>14</sup> See RESTATEMENT (SECOND) OF CONTRACTS, ch. 16, introductory note (1981) (noting the common law tradition of breach for economic reasons); and Steven Shavell, *Is Breach of Contract Immoral?*, 56 EMORY L.J. 439 (2006)(noting that, “the belief that there is a clear and overarching moral reason to alter contract law to enhance the keeping of contracts appears to be the product of an oversimplified view of moral sentiments and of a related failure to take into account the importance of the incompleteness of contracts.”)

<sup>15</sup> While most states allow deficiency judgments, many states hardest hit by the housing crisis, including Arizona and California, are non-recourse states – meaning that a lender may not pursue a borrower for a deficiency judgment on a purchase money mortgage. See Andra Ghent and Marianna Kudlyak, *Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States 5* (Federal Reserve Bank of Richmond Working Paper No. 09-10, July 10, 2009), available at <http://ssrn.com/abstract=1432437> (listing Alaska, Arizona, California, Iowa, Minnesota, Montana, North Carolina, North Dakota, Washington and Wisconsin as non-recourse states).

By writing this penalty into the contract, and then signing the contract, the lender has agreed to accept the property, and (in most states) the option to pursue a deficiency judgment, in lieu of payment. Of course, even in states where they can, lenders frequently don't pursue borrowers for deficiency judgments because it's often not economically worthwhile to do so.<sup>16</sup>

Nevertheless, that's the agreement. No one forced the lender to sign that contract.<sup>17</sup> Indeed, they wrote it. And, to be sure, the lender wouldn't hesitate to exercise their right to take a person's house if it was in their financial interest to do so. Concerns of morality or social responsibility wouldn't be part of the equation.<sup>18</sup>

In short, as far as the law is concerned, choosing to exercise the default option in a mortgage contract is no more immoral than choosing to cancel a cell phone contract. The borrower just has to be willing to accept the consequences – which, in the case of a mortgage contract, typically include being subject to foreclosure and, in most states, the risk of a deficiency judgment.

Even though the law doesn't treat breach of a mortgage contract as a moral wrong, it might be argued that one should still keep one's promises.<sup>19</sup> That's a fine belief as far as it goes.

But why treat the promise to pay one's mortgage as any more sacred than any other promise?

We break promises all the time when the consequences of fulfilling them become too great – without being considered immoral for doing so.<sup>20</sup> It's simplistic to suggest that it's always

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<sup>16</sup> See Zingales, *supra* note 6.

<sup>17</sup> Freedom of contract includes the freedom to enter into contracts that others might deem unwise. See RESTATEMENT (SECOND) OF CONTRACTS, ch. 7, introductory note (1981) (“Contract law has traditionally relied in large part on the premise that the parties should be able to make legally enforceable agreements on their own terms, freely arrived at by the process of bargaining.”). For discourses on the freedom of contract, see Samuel Williston, *Freedom of Contract*, 6 CORN. L. Q. 365, 367 (1921); Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553 (1933); Roscoe Pound, *Liberty of Contract*, 18 YALE L. J. 454 (1909).

<sup>18</sup> See Shahien Nasiripour, *JPMorgan Chase Argues Against Mortgage Modifications, Citing Sanctity Of Contracts*, HUFFINGTON POST, April 12, 2010 (reporting that the CEO of JP Morgan testified before Congress that modifying principal balances on underwater mortgages in order to stem foreclosures would be “irresponsible” because modification is not contemplated in the mortgage contract.)

<sup>19</sup> See e.g., Zingales, *supra* note 6; CHARLES FRIED, CONTRACT AS PROMISE (1981); DAVID HUME, A TREATISE OF HUMAN NATURE (1739); IMMANUAL KANT, GROUNDWORK OF THE METAPHYSICS OF MORALS (1785); and Charles Fried, *Philosophy Matters*, 111 HARV. L. REV. 1739 (1998).

<sup>20</sup> For a discussion of obligations toward promises in contract and “moral behavior in contingency,” see Shavell, *supra* note 14, at 443-450 (discussing a theoretical approach where, even if they may form moral

immoral to break a promise. A more accurate description of the social norm is that one should keep one's promises unless one has a compelling enough reason not to.<sup>21</sup> For example, needing to move in order to take care of a seriously ill family member would be a good reason, at least in most people's estimation, for a renter to break a lease agreement. The renter would still have to face the risk that the landlord might pursue him for the remainder of the lease payments, but few would think the renter immoral for taking that risk. Indeed, not only is breaking a promise frequently acceptable, sometimes it's the most moral thing to do.

This is no less true for a mortgage contract.

For many Americans, their home is their primary, and perhaps only, investment.<sup>22</sup> With encouragement from the government and the financial industry, most Americans came to see investing in a home as the primary route to retirement security, and as a means through accumulated equity of sending their children to college.<sup>23</sup> With the housing bust, however, many

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obligations to perform based on the established terms of the contract, parties do not inherently form moral obligations to perform under all possible contingencies).

<sup>21</sup> Consider also the ramifications of a "rule-bound moralist" approach where breach under any and all contingencies is considered immoral regardless of the circumstances. The ultimate effect of such an ideology is not to increase the performances of contractual promises, but to create "a greater deterrent to working out mutually beneficial arrangements." RUSSELL HARDIN, *MORALITY WITHIN THE LIMITS OF REASON* 108 (1988). In other words, were breaking a promise even under extreme contingencies considered immoral, fewer mutually-beneficial promises would be made.

<sup>22</sup> See A. Mechele Dickerson, *The Myth of Home Ownership and Why Home Ownership is not Always a Good Thing*, 84 *Ind. L.J.* 189, 189-192 (2009). In 2004, *Forbes* claimed, "Home ownership rewards most buyers and, barring a severe economic downturn, it's as close as it gets to a 'can't miss' investment." Scott Reeves, *Why Home Ownership Makes Sense*, *Forbes* (July 27, 2004), available at [http://www.forbes.com/2004/07/27/cx\\_sr\\_0727ownership.html](http://www.forbes.com/2004/07/27/cx_sr_0727ownership.html).

<sup>23</sup> See e.g., THE WHITE HOUSE, *HOMEOWNERSHIP: PRESIDENT'S AGENDA TO EXPAND OPPORTUNITIES TO HOMEOWNERSHIP 2007*, available at <http://www.whitehouse.gov/ask/20070906.html> (in which HUD Secretary Alphonso Jackson proclaimed that "owning a home remains the best long-term investment a family can make"); and Scott Reeves, *Why Home Ownership Makes Sense*, *Forbes* (July 27, 2004), available at [http://www.forbes.com/2004/07/27/cx\\_sr\\_0727ownership.html](http://www.forbes.com/2004/07/27/cx_sr_0727ownership.html). ("Home ownership rewards most buyers and, barring a severe economic downturn, it's as close as it gets to a 'can't miss' investment."); and PRESIDENT GEORGE W. BUSH, *A HOME OF YOUR OWN: EXPANDING OPPORTUNITIES FOR ALL AMERICANS* (2002), available at <http://www.whitehouse.gov/infocus/homeownership/homeownership-policy-book-whole.pdf> (extolling the benefits of home ownership, including building wealth and giving families borrowing power to finance important needs). See also Dickerson, *supra* note 24, at 190-91 (discussing the view that a major benefit of homeownership is using accumulated equity to benefit a family's future generations).

Americans' hope of using their homes to support them during retirement, or to pay for their children's college, has vanished.

Moreover, because housing prices were so high during the boom, many Americans were forced to stretch to buy even modest homes – meaning that all or most of their disposable income goes to their mortgage, with little left for savings.<sup>24</sup> This might have worked out for most people if housing prices had continued to increase, or at least stayed stable.

But despite the forecasts of many of the world's top economists,<sup>25</sup> they didn't. As a result of a largely unforeseen housing collapse – which has also been unprecedented in its severity –<sup>26</sup> many underwater homeowners now find themselves pouring all or most of their disposable income into a home that is no longer an investment, but rather a threat to their families' financial security. For many Americans, paying the mortgage means little to no savings for retirement or to send their children to college.

The moral course in such a case may, in fact, be to *stop* paying one's mortgage, even if one can “afford” it according to some arbitrary debt-to-income ratio established by the banking

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<sup>24</sup> See *id.* at 207.

<sup>25</sup> See Michael J. Burry, *I Foresaw the Crisis. Why Didn't the Fed?*, N.Y. Times, Apr. 3, 2010, available at <http://www.nytimes.com/2010/04/04/opinion/04burry.html> (noting that Former Federal Reserve Chairman Alan Greenspan recently proclaimed that no one could have predicted the housing bubble. ‘Everybody missed it,’ he said, ‘academia, the Federal Reserve, all regulators.’”). See also Shahien Nasiripour, *JPMorgan Chase Argues Against Mortgage Modifications, Citing Sanctity Of Contracts*, HUFFINGTON POST, April 12, 2010 (reporting that JP Morgan chairman and chief executive, Jamie Dimon, told a Congressional panel investigating the roots of the financial crisis that JPMorgan Chase did not anticipate home prices falling: “I would say that was probably one of the big misses,” Dimon said. “We stressed almost everything else, but we didn't see home prices going down 40 percent.”). Indeed, even when the housing bubble began to deflate, experts remained optimistic. See Burry at 220, 232 (noting that even when the number of distressed loans began to spike as housing prices began to decline, many predicted that the market would quickly make any necessary corrections) (citing Vikas Bajaj, *Top Lender Sees Mortgage Woes for “Good” Risks*, N.Y. TIMES, July 25, 2007, at A1). HUD Sec. Alphonso Jackson, for example, continued to proclaim in 2007 that “owning a home remains the best long-term investment a family can make” (citing THE WHITE HOUSE, HOMEOWNERSHIP: PRESIDENT’S AGENDA TO EXPAND OPPORTUNITIES TO HOMEOWNERSHIP, available at <http://www.whitehouse.gov/ask/20070906.html>).

<sup>26</sup> See David Anderson & Sarah Hodges, *Credit Crisis Litigation: An Overview of Issues and Outcomes*, 28(6) BANKING AND FIN. SERVICES POL’Y REP. 1 (2009) (“The subprime mortgage crisis . . . has exploded into a global financial crisis more severe than anything seen in the past 70 years.”)

industry.<sup>27</sup> It might be more responsible to put the money saved from giving up one's home and renting instead into a retirement account – so that one is not a financial burden on others in old age – or into a college fund, so that one can give one's children a better chance at life.<sup>28</sup>

In other words, things aren't so black-and-white. And given the unprecedented nature of the housing collapse, it should at least be possible for reasonable people to disagree about the most moral or responsible course of action for seriously underwater homeowners.

I personally believe that one's "promise" to pay the mortgage, such as it is, should sometimes give way to more important obligations to provide for one's family – especially when the lender specifically contemplated the possibility of default in the mortgage contract.

But what about the argument that mortgage default hurts neighborhoods and the economy?<sup>29</sup>

Well, as an initial matter, we don't generally expect individuals to make personal economic decisions for the good of the "generalized other" in a capitalist society.<sup>30</sup> Aside from this fact, however, it's a lot to ask underwater homeowners to prop up neighborhood property values, or the housing market, on their backs – especially if it means sacrificing their ability to send their children to college or save adequately for their own retirement. In my view, it's also an unfair burden.

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<sup>27</sup> See, e.g., Press Release, Making Home Affordable Program, Housing Program Enhancements Offer Additional Options for Struggling Homeowners, (setting 31% of annual income as the "affordability" cut-off)

<sup>28</sup> For a discussion of the philosophical basis of the primary obligation to care for one's children, see, John Eekelaar, *Are Parents Morally Obligated to Care for Their Children?* 11 OXFORD J LEGAL STUDIES 340-353 (1991)

<sup>29</sup> *Supra* notes 12-13.

<sup>30</sup> See, e.g., ALAN WOLFE, WHOSE KEEPER? SOCIAL SCIENCE AND MORAL OBLIGATION 7 (1989) (explaining that, "Society works best, says the economic approach, when there exist a mechanism for enabling people to maximize rationally their self-interest. Yet it is an extremely rare economist who stops at the point of simply asserting the ethical benefits of self-interest; most continue on to make a point about obligations to others as well: because the pursuit of my self-interest contributes to the collective good – economic growth or some form of welfare optimality – my obligation to you is to do what is best for me."); See also ADAM SMITH, WEALTH OF NATIONS, 112 (Penguin Classics 1999) (1776) ("[B]y pursuing his own self-interest [a capitalist] frequently promotes that of the society more effectually than when he really intends to promote it."); *Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council*, 425 U.S. 748, 765 (1976) ("So long as we preserve a predominantly free enterprise economy, the allocation of our resources in large measure will be made through numerous private economic decisions.").

If we are to go down this collective path, however, why is it that only homeowners and not financial institutions are called to sacrifice their own economic well-being for the common good?

As we've clearly seen by now, lenders modify mortgages for underwater homeowners only when it is in the lender's financial interest to do so.<sup>31</sup> From the lender's perspective, modifying a mortgage for a homeowner who is still making payments on time is potentially throwing money away, because the homeowner might still make their payments even without a loan modification.<sup>32</sup> This is why underwater homeowners typically have to default on their mortgage before lenders will even talk to them<sup>33</sup> – and once a homeowner initially defaults, a home is statistically much more likely to end up in foreclosure.<sup>34</sup>

Why take homeowners, and not lenders, to task for putting their own financial interest ahead of the common good?<sup>35</sup>

If lenders were less intransigent and more willing to negotiate, underwater homeowners wouldn't have to walk away from their homes in order to save themselves from financial

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<sup>31</sup> See Jean Braucher, *Fixing the Home Affordable Modification Program to Mitigate the Foreclosure Crisis* (Arizona Legal Studies, Discussion Paper No. 09-37, Dec. 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1518098](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1518098) (“Investors in loans and their servicers should be acting faster if more modifications are in their self-interest, so there is reason to suspect that they are not.”); Manuel Adelino, Kristopher Gerardi, & Paul Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Federal Reserve Bank of Atlanta, Working Paper 2009-17, Aug. 2009), available at <http://www.frbatlanta.org/invoke.cfm?objectid=149C4D27-5056-9F12-12C089648203E1FD&method=display>.

<sup>32</sup> Christopher L. Foote, Kristopher S. Gerardi, Lorenz Goette, and Paul S. Willen, *Reducing Foreclosures* 5 (Public Policy Discussion Papers, April 8, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0902.htm> (“Investors also lose money when they modify mortgages for borrowers who would have repaid, anyway, especially if modifications are done *en masse*, as proponents insist they should be.”); see also White, *supra* note 7, at 38-39.

<sup>33</sup> See Edmund L. Andrews, *My Personal Credit Crisis*, N.Y. Times, May 14, 2009, available at <http://www.nytimes.com/2009/05/17/magazine/17foreclosure-t.html?pagewanted=all> (describing the author's efforts to renegotiate his mortgage with his lender, including fact that lender informed him it would not discuss a loan modification until he was late on his payments); and White, *supra* note 7, at 40 (discussing lenders unwillingness negotiate with homeowners current on their payments).

<sup>34</sup> See *October Oversight Report: An Assessment of Foreclosure Mitigation Efforts after Six Months*, Congressional Oversight Panel 25 (October 9, 2009) (reporting that the self-cure rate for homeowners with prime loans who default on their mortgage dropped from an average of 45% between 2000 - 2006 to 6.6% in 2009 – with current self cure rates of 4.3% for Alt-A loans and 5.3% for subprime loans).

<sup>35</sup> See Zingales, *supra* note 6 (criticizing homeowners and not lenders for putting their financial self-interest first).

ruin.<sup>36</sup> And we wouldn't have to worry about the fragile housing market crashing again.

Why speak of morality and social responsibility only when talking about strategic default by homeowners, and not by financial institutions or large corporations?<sup>37</sup>

In the biggest real estate default in history, for example, real estate giant Tishman Speyer Properties strategically defaulted on 4.4 billion dollar in loans on Stuyvesant Town and Peter Cooper Village in New York City after the properties lost 2 billion dollars in value - despite having billions in assets, including Manhattan's Rockefeller Center and the Chrysler Building, that it could have leverage to meet its obligations under the loans.<sup>38</sup> Morgan Stanley did the same on a 1.5 billion dollar mortgage on five buildings in San Francisco, despite raking in record profits last year.<sup>39</sup> Neither was criticized for being immoral.<sup>40</sup> Apparently, what is good for Morgan Stanley or Tishman Speyer is good for the market.

Some have attempted to justify this double standard by arguing that commercial mortgage contracts are somehow fundamentally different than residential mortgage contracts.<sup>41</sup> These commentators suggest that parties to commercial mortgage contracts contemplate the possibility of default in advance and agree on the remedy – typically, surrender of the property. They argue that parties to residential mortgages, on the other hand, contemplate only that the mortgage will be repaid – and thus residential mortgage contracts contain an implicit promise to pay regardless of market conditions that is absent from commercial mortgage contracts.<sup>42</sup>

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<sup>36</sup> See Adelina, Gerardi, and Willen, *supra* note 34, at 3 (claiming that “lenders rarely renegotiate” and noting that only 3% of seriously delinquent mortgages in their study had received “concessionary modifications” in the previous year).

<sup>37</sup> Zingales, *supra* note 6. See also *supra* note 8.

<sup>38</sup> See Charles Bagli and Christine Haughney, *Wide Fallout in Failed Deal for Stuyvesant Town*, N.Y. TIMES, Jan. 25, 2010, available at <http://www.nytimes.com/2010/01/26/nyregion/26stuy.html>; and Lingling Wei, *Tishman Faces Office Downturn: Portfolio in Washington in Default; If No Risks, 'Don't Have Any Rewards'*, Wall Street Journal, August 19, 2009, available at <http://online.wsj.com/article/SB125063689346841513.html>

<sup>39</sup> Dan Levy, *Morgan Stanley to Give Up 5 San Francisco Towers Bought at Peak*, BLOOMBERG, Dec. 17, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601206&sid=aLYZhnfoXOSk>. Describing what would be considered a “strategic default” for homeowners, Morgan Stanley officials stated, “This isn't a default or foreclosure situation. We are going to give them the properties to get out of the loan obligation.” *Id.*

<sup>40</sup> Roger Lowenstein, *Walk Away from Your Mortgage*, N.Y. TIMES, Jan. 7, 2010, available at <http://www.nytimes.com/2010/01/10/magazine/10FOB-wwln-t.html>.

<sup>41</sup> Zingales, *supra* note 6.

<sup>42</sup> Zingales, *supra* note 6.

This argument is thin, at best. Residential mortgage contracts, just like commercial mortgage contracts, contemplate the possibility of default and contain an agreed-upon remedy. It is true that sophisticated commercial parties frequently negotiate more favorable terms than the average homeowner, including provisions that sometimes more strictly limit the lender's recourse in the event of default.<sup>43</sup> But this is not a moral difference, and it does not change the fact that both types of contracts contain agreed upon remedies in the event of default. Indeed, if anything, the difference between commercial and residential mortgage contracts cuts in the other direction— and we should be more forgiving of less sophisticated residential borrowers.

But it just can't be the case that it's morally acceptable for financial institutions and large corporations to default on their mortgages, as long as they are willing to bear the contractually-agreed-upon penalty in their contract, but it's not okay for average Americans to do exactly the same thing. There shouldn't be two sets of rules in America.

That said, I would, in fact, favor a world in which all actors – both corporate and individual – acted or were required to act in socially responsible ways. In such a world, institutional lenders – which bear a much greater share of the blame for the housing crisis than the average underwater homeowner – would take responsibility for their actions by writing down at least part of the principal on underwater mortgages.<sup>44</sup>

We shouldn't, however, hold our breath for this to happen. There is no indication that financial institutions are going to start voluntarily writing down mortgages for underwater homeowners,<sup>45</sup>

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<sup>43</sup> Brett Dockwell Kravitz, *Which Price is Right? Valuing Real Estate Purchased in Bulk with Nonrecourse Promissory Notes: Epic Associates v. Commissioner*, 56 Tax Lawyer 301, 301 (Fall 2002) (“Nonrecourse loans are prevalent in the financing of income-producing commercial properties.”).

<sup>44</sup> Along these lines, some scholars have proposed requiring lenders to write down homeowner's negative equity. See e.g., Eric Posner and Luigi Zingales, *The Better, Cheaper Mortgage Fix*, SLATE, Mar. 2, 2009, <http://www.slate.com/id/2212649> (proposing that lenders give underwater homeowners the option of resetting their mortgages to the current value of their houses in exchange for giving the lender 50 percent of the house's future appreciation).

<sup>45</sup> *Banks Resist Plans to Reduce Mortgage Balances*, NEW YORK TIMES BLOG, April 14, 2010, available at: <http://dealbook.blogs.nytimes.com/2010/04/14/banks-resist-plans-to-reduce-mortgage-balances/?src=busln> (reporting that major banks testified before Congress opposing Obama Administration plan that they simply consider principal reductions for underwater homeowners). See also, Adam Zibel, *Banking execs skeptical on mortgage reductions*, Associated Press, April 13, 2010, available at: <http://www.google.com/hostednews/ap/article/ALeqM5gyoZ46fqVwnds84XZfpZHVMrkGCgD9F2A5680>.

nor any indication that Congress will ever pass a law requiring them to do so. Unfortunately, as long as Congress is unwilling to force lenders to write down underwater mortgages, many homeowners will understandably conclude that the most rational choice for them is to let go of their homes.<sup>46</sup>

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<sup>46</sup> See Streitfeld, *No Help in Sight, More Homeowners Walk Away*, NEW YORK TIMES, February 2, 2010, *supra* note 5 (Reporting on the increase in homeowners walking away, and quoting one mortgage broker as explaining, “Everyone has lost hope. They don’t qualify for modifications, and being on the hamster wheel of paying for a property that is not worth it gets so old.”).