

Blog Post

Ruthless, or Just Rational?

Posted on **August 9, 2010** by Linda R. Stahl

Today, *The Line* welcomes guest blogger Linda Stahl. Linda is a partner in our litigation practice. Using her experience in litigating issues affecting CMBS trusts and loan servicers, she will periodically share her insightful perspectives to *The Line*.

“[A]ny homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator—and one who is not honoring his obligation.”

Henry M. Paulson, Jr., Former Treasury Secretary

“The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfillment has gone by, and therefore free to break his contract if he chooses.”

Oliver Wendell Holmes, Jr., *The Common Law*

While strategic defaults have been big news in recent months—with attendant hand-wringing by mortgage lenders and the Obama Administration alike—the notion that someone might “ruthlessly” breach a contract in pursuit of his own economic interest is as old as the law of contracts itself. Indeed the law is structured to permit, if not encourage, this result. Since as early as the 17th century, courts have limited the remedy for breach of contract to economic damages proximately caused by the breach. *Why* a party breached—whether for ill motive or good—provides no basis for additional recovery; you can’t recover punitive damages. In this sense, it has often been observed that the law of contracts is “amoral.” And with good reason.

Sometimes, a breach of contract results in a net gain to everyone involved. This would be the case where, for example, I agree to lease you office space at \$10 a square foot, but before you move in, another renter offers me \$15 instead. If you could find equivalent office space for \$12 a square foot, then it makes sense for me to breach, because even if I pay you damages in the amount of your costs, I’m still \$3 a square foot ahead of the game. You are no worse off; I am better off; and my new tenant is happy. On a macro level, the real estate went to its highest and best use (if you believe the market speaks accurately on this score).

So is society better off when a borrower walks an upside-down mortgage? Certainly the borrower is, as he is free from paying more for his house than it’s worth. It may also hasten the market adjustments necessary at the end of a bubble and bring price into alignment with value. Still, the perception remains that rational economic actors behaving in their own self interest (the very essence of Adam Smith’s invisible hand) are “ruthless.”

But why? It could be that the equity arms of investment banks or lenders, some of whom have themselves engaged in opportunistic defaults or surrendered properties to get out from under unfavorable loans (e.g., Morgan Stanley affiliates walking the debt on its Crescent properties, followed by surrender of five San Francisco office buildings), don’t like being on the receiving end of the breach. At least not on this scale coming from historically reliable citizens. Perhaps it’s because homeowners, whose loans are often nonrecourse because lenders either can’t or won’t sue for any deficiency between the loan balance and the sale price, do not bear the full costs of breach. Or is it that the principle of amoral contracts no longer—or should no longer—stand?

My thoughts on that issue next time . . .