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Reforming the Law of Adhesion Contracts: A Judicial Response to the Subprime Mortgage Crisis

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Reforming the Law of Adhesion Contracts: A Judicial Response to the Subprime Mortgage Crisis

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This Article examines the role of standardized contracts of adhesion,[2] in the form of mortgages, installment sale agreements and other contracts for debt that cannot be repaid, in causing the subprime mortgage crisis and the Great Depression. Evidence from the Great Depression, the Savings and Loan Crisis of the 1980s, and the subprime mortgage crisis is canvassed to demonstrate the futility of the government's continued reliance on regulation alone to prevent the recurrence of these disasters, and to show that a reformulation of the law of adhesion contracts is needed. The Article contends that the courts' continued adherence to the theory of presumed assent in all but the most egregious cases is no longer viable given the relationship between adhesion contracts incomprehensible to the average layperson and the major economic disasters that follow in their wake. The Article discusses why the proscriptions offered by scholars are inadequate to resolve this larger economic issue, and proposes a new method for salvaging assent in adhesion contracts while remaining true to the doctrine that assent is based on an objective manifestation of assent through conduct rather than on the subjective intent of the parties.

As many in the media have suggested, the subprime mortgage crisis has plunged our nation into an economic disaster on a scale not seen since the Great Depression.[3] Significant parallels can also be drawn to the Savings and Loan crisis of the 1980s.[4] In each case, periods of great prosperity were followed by crushing losses. Economists, legal scholars, historians and

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[2] Contracts of adhesion are standardized form contracts written with the knowledge that they will not be understood, or even read, by the recipients. They are also presented to the "adherent" as a "take it or leave it" proposition, giving him no alternatives other than complete adherence to the terms presented or outright rejection. E. Allen Farnsworth, Contracts, § 4.26 at 286 (2004). The term, "contract of adhesion" was originally coined as "contrat d'adhésion" by the French jurist, Saleilles, in De la déclaration de volonté § 89, at 229-30 (1901). Edwin Patterson imported the phrase into the United States in *The Delivery of the Life Insurance Policy*, 33 Harv. L. Rev. 198, 222 (1919); *see* Patterson, *The Interpretation and Construction of Contracts*, 64 Colum. L. Rev. 833, 856-57 (1964).

[3] *See* Paul Krugman, *Depression Economics Returns*, N.Y. Times (Nov. 14, 2008); Chris Gay, *Depression Déjà vu,* The Big Money, from Slate (Feb. 2, 2009) (available at http://www.thebigmoney.com/articles/history-lesson/2009/02/02/depression-d-j-vu?page=0,0); Michael Liedtke, *Bank investment plan is more Depression déjà vu*, USA Today (Oct. 14, 2008) (available at http://www.usatoday.com/money/economy/2008-10-14-1490321705_x.htm).

[4] *See* Jack Willoughby*, The Lessons of the Savings-and-Loan Crisis,* Barrons, 3 April 13, 2009, available at *http://online.barrons.com/article/SB123940701204709985.html?page=3;* Barry Meier, *Savings and Loan Crisis May be Guide for Bank Bailout,* N.Y. Times, C1, Sept. 28, 2008.

bankers have all offered explanations for these economic disasters, but their solutions focus on government intervention in the form of monetary and tax policies, the passage of legislation and the formation of administrative agencies.[5] Similarly, legal scholars writing on the subprime loan crisis advocate the adoption of new laws and regulations.[6] But history counsels that relying on statutes and regulations alone will not prevent, and may exacerbate the next financial disaster.

I intend to demonstrate a pattern of regulatory breakdown by briefly reviewing the periods of regulation and deregulation that accompanied the Great Depression of the 1930s, the Savings and Loan crisis of the 1980s, and the present subprime loan debacle. Typically, after a crisis the government rescues major financial institutions at the taxpayer's expense. Besides their cost, these bail-outs create moral hazard by insulating the recipients from the consequences of the risks they have willing assumed. The government then passes laws designed to remedy the perceived causes of the economic crisis. However, when economic prosperity ultimately returns, a pro-business, deregulatory mood inevitably follows. With it, the laws and regulations put in place after the last crash are repealed, amended, or enforced at a minimal level by agencies operating with reduced funding, staffing and support. In addition, the laws designed for the last crisis may not cover newly emerging market conditions and practices of current concern. In an era of deregulation, amendments to update the laws and regulations will often be viewed as unnecessary. For example, when asked about the impact of the unregulated derivates that contributed to the subprime mortgage crisis, the Chairman of the Federal Reserve during this

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[5] *See* Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression (2009); Daniel Gross, Dumb Money: How Our Greatest Financial Minds Bankrupted the Nation (2009); Sandy B. Lewis and William D. Cohan, *The Economy is Still at the Brink*, N.Y. Times, June 7, 2009, at WK 9;George Soros, The Crash of 2008 and What It Means: The New Paradigm for Financial Markets (2008); The Savings and Loan Crisis: Lessons from a Regulatory Failure (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004); Kitty Clavita, Henry N. Pontell, Robert H. Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan Crisis (1997); Martin Mayer, The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry (1990); John Meynard Keynes, The General Theory of Employment, Interest and Money (1936); Charles F. Phillips & J.V. Harland, Government Spending & Economic Recovery (1938); Milton Friedman and Anna Schwartz, A Monetary History of the United States 1867-1960 (1963); Peter Temin, Did Monetary Forces Cause the Great Depression? (1976); Ben Bernanke, Essays on the Great Depression, (2000); The Great Depression Revisited (1981); R.A. Gordon, Economic Instability and Growth: The American Record (1974); Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 (1987); Murray N. Rothbard, America's Great Depression (1972).

[6] *See* Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach For Rating Agency Accountability*, 87 N.C. L. Rev. 1011 (2009); Jonathan Macey, Geoffrey Miller, Maureen O'Hara, Gabriel D. Rosenberg, *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. Corp. L. 789 (2009); Steven J. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 Minn. L. Rev. 373 (2008); David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 Fordham J. Corp. & Fin. L. 709 (2009); Alan M. White, *The Case for Banning Subprime Mortgages*, 77 U. Cin. L. Rev. 617 (2008); Comment, Allison De Tal, *Knowledge is Power: Consumer Education and the Subprime Mortgage Market,* 11 Chap. L. Rev. 633 (2008); Cassandra Jones Harvard, *"Goin' Round in Circles" . . . And Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 Neb. L. Rev. 737 (2008); Comment, Rayth T. Myers, *Foreclosing on the Subprime Loan Crisis: Why Current Regulations Are Flawed and What is Needed to Stop Another Crisis From Occurring*, 87 Or. L. Rev. 311 (2008).

period, Alan Greenspan, remarked that he believed that the market was a sufficient regulator for these new derivatives.[7]

The U.S. government is now repeating this pattern in its response to the subprime mortgage crisis.[8] I suggest that it is time to try a new strategy. Rather than attempting to impose new laws and regulations on powerful and highly-influential business entities, consideration should be given to attacking the issue at its root, by reforming the common law rules of law that apply to contracts of adhesion for credit.[9] It is true that unregulated derivatives were also a significant factor in the subprime loan crisis, but these instruments were all ultimately "derived" from subprime mortgages.[10] These mortgages are the underlying source of today's "toxic assets." Moreover, courts have advantages over legislatures in dealing with adhesion contracts. Courts have greater flexibility in responding quickly to the creativity of those who devise new

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[7] Peter S. Goodman, *The Reckoning: Taking Hard New Look at a Greenspan Legacy*, N.Y. Times, Oct. 9, 2008, available at www.nytimes.com/2008/10/09/business/economy/09greenspan.html (citing Mr. Greenspan's testimony in response to concerns about possible bailouts resulting from unregulated derivatives trading to include the quotes: "Risks in financial markets, including derivatives markets, are being regulated by private parties," and "There is nothing involved in federal regulation per se which makes it superior to market regulation.").

[8] *See infra* Section I(C)(5).

[9] It is widely acknowledged that the non-drafting party will not read, and if he reads, will not understand, contracts of adhesion before he signs them. Writing on the subject in 1960, Karl Llewellyn concluded that boilerplate was so rarely read and agreed to that there should be a conclusive presumption that it had not been read: "The one case in a thousand where the dirty clauses have been read and truly agreed to can, for my money, be discarded both as *de minimus* and to keep that issue from disturbing all the litigation to which it is in fact irrelevant. The common law technique, when the facts run so profusely in a single direction, would be a simple "conclusive presumption" – that boiler-plate has *not* been read." Karl N. Llewellyn, The Common Law Tradition: Deciding Appeals 371 n. 338 (1960). *See* also Restatement (Second) of Contracts § 211 Comment b ("Customers do not in fact ordinarily understand or even read the standard terms"); W. David Slawson, *The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms*, 46 U. Pitt. L. Rev. 21, 27 (1984) ("[B]usinesses know full well that their forms will not generally be read, let alone understood."); Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. Rev. 429, 432-33, 446 (2002) ("Businesses ... know[] that consumers reliably, predictably, and completely fail to read the terms employed in standard-form contracts.... Businesses also can create boilerplate that is difficult to read by using small print, a light font, and all-capital lettering and by burying important terms in the middle of the form."); Jeffrey Davis, *Revamping Consumer-Credit Contract Law*, 68 Va. L. Rev. 1333, 1355 (citing T. Durkin & G. Elliehausen, 1977 Consumer Credit Survey 3-10 (1978), a study showing that borrowers do not read credit disclosures and think they are complicated). Relating specifically to the subprime crisis, Federal Reserve Chairman Ben Bernanke noted, " [T]he . . . rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards and, in some cases, by abusive lending practices and outright fraud. In addition, some households took on mortgage obligations they could not meet, perhaps in some cases because they did not fully understand the terms." Ben Bernanke, Chairman, Federal Reserve, Semiannual Monetary Policy Report to the Congress, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (July 19, 2007), available at http:// www.federalreserve.gov/newevents/testimony/bernanke20070718a.htm.

[10] *See* David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 Fordham J. Corp. & Fin. L. 709, 734-39; (2009); Jonathan Macey, Geoffrey Miller, Maureen O'Hara, Gabriel D. Rosenberg, *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. Corp. L. 789, 799-801 (2009).

deceptive schemes, and are less susceptible to the powerful influence of campaign contributions from regulated entities.[11]

Residential mortgages have been classified as contracts of adhesion because their terms are selected by a professional lender for an unsophisticated borrower who has no choice but to accept them or forego the deal.[12] No remedy for a repeat of the current crisis would be available under the current law of adhesion contracts because the result of a judge's characterization of a mortgage as an adhesion contract is generally that the terms are construed against the drafter,[13] or that their terms are enforced as long as they are not unconscionable,[14] and do not violate public policy.[15] Moreover, adhesion contracts that may influence the boom and bust cycles of the economy are not limited to residential mortgages. They include credit card agreements,[16] auto

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[11] Karl Llewellyn believed that while courts would never completely cure the ills of mass contracting, legislatures were "in the main too slow-moving and too rigid in their moving," given that new fields would constantly be emerging. Karl N. Llewellyn, *The Standardization of Commercial Contracts in English and Continental Law. By O. Prausnitz. London: Sweet & Maxwell 1937*, 52 Harv. L. Rev. 700, 705 (1938-39). For the influence of regulated entities over Congress, *see* Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression 94 (2009)("Legislators who receive big campaign contributions from banks have an incentive to favor weak banking regulation, otherwise those contributions will dwindle.");Eric Lipton and Raymond Hernandez, *A Champion of Wall Street*, N.Y. Times, Dec. 13, 2008 (describing how Democratic Senator Charles E. Schumer embraced financial industry's deregulatory agenda through specific legislative actions while receiving extensive donations for the Democratic Party from Wall Street investment banking firms), and *see infra* notes 292-93, 419.

[12] *See* In re Petroff, 2001 WL 34041797 at *2 (6th Cir. BAP 2001); In re Tudor, 342 B.R. 540, 562 (S.D. Ohio 2005); In re Woodham, 174 B.R. 346, 349 (M.D. Fla. Bankr. 1994); Rau v. Cavenaugh, 500 F. Supp. 204, 207-208 (D.S.D. 1980); Ricker v. United States, 417 F. Supp. 133, 139 (D. Ma. 1976). *But see*, Branco v. Norwest Bank Minnesota, N.A., 381 F. Supp. 2d 1274, 1280-81 (D. Ha. 2005) (noting with approval a state court decision reasoning that mortgages are not contracts of adhesion given the number of mortgage lenders available to borrowers, and holding that the plaintiffs' mortgage was not adhesive).

[13] Bankruptcy courts have often interpreted fee-shifting clauses strictly against the drafter based on a recognition that mortgages are generally, if not always, contracts of adhesion. *See* In re Woodham, 174 B.R. 346, 348-49 (M.D. Fla. Bankr. 1994); In re Romano, 174 B.R. 342, 344-45 (Bankr. M.D. Fla. 1994); In re Barrett, 136 B.R. 387, 393 (Bankr. E.D. Pa. 1992); In re Roberts, 20 B.R. 914, 921 (Bankr. E.D.N.Y. 1982) (fee-shifting terms of form contracts "are to be most strongly construed against the mortgagee").

[14] Branco v. Norwest Bank Minnesota, N.A., 381 F. Supp. 2d 1274, 1280-81 (D. Ha. 2005) (rejecting plaintiffs' claim that arbitration clause in mortgage was unconscionable); Acorn v. Household Internat'l, Inc., 211 F. Supp. 2d 1160, 1168-71 (N.D. Cal. 2002) (denying motion to compel arbitration of plaintiffs' claims of predatory mortgage lending because arbitration riders were unconscionable); Flores v.Transamerica Homefirst, Inc., 93 Cal. App. 4th 846, 113 Cal. Rptr.2d 376 (2001) (holding that arbitration clause in reverse home mortgage was unconscionable); Home Federal Savings & Loan v. Campney, 357 N.W.2d 613, 619-20 (Iowa 1983)(holding that due on sale clause in adhesive residential mortgage was not unconscionable or beyond defendants' reasonable expectations and was therefore enforceable).

[15] In re Petroff, 2001 WL 34041797 at *2 (6th Cir. BAP 2001); In re Tudor, 342 B.R. 540, 562 (S.D. Ohio 2005);

[16] Discover Bank v. Superior Court, 36 Cal 4th 148, 30 Cal. Rptr. 3d 76 (2005); Jones v. Citigroup, Inc., 38 Cal. Rptr. 3d 461 (2006) (credit card agreement was a contract of adhesion but opt-out option in amendment adding

loans and leases, residential leases,[17] cellular phone and internet access contracts,[18] and any other adhesion contracts that impose payment risks and obligations on the consumer that she would not have accepted had she read and understood them.

With few exceptions, most legal commentators support the presumption of enforceability for adhesion contracts, and recommend methods for dealing with especially onerous terms, whether through legislation or modifications of current doctrine.[19] However, none of these prescriptions offer a solution to the inability of consumers to read, understand and potentially reject adhesion contracts for credit that have led to systemic failures of our economic system.

The courts' current approach of enforcing adhesion contracts in all but exceptional cases is inconsistent with the traditional rule that a contract cannot be formed without the offeree's assent to the offer.[20] Courts rely on what commentators agree is fictional assent to overcome this difficulty as a doctrinal matter,[21] but an important question remains. Why have the courts expressed so little concern about doing away with the real thing? Indeed there is virtually no discussion in the cases about why the courts are justified in depriving the American people of

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arbitration clause defeated plaintiff's unconscionability claim); Szetela v. Discover Bank, 97 Cal. App. 4th 1094 (2002); contra, Hutcherson v. Sears Roebuck & Co. 342 Ill. App. 3d 109 (2003); Walther v. Sovereign Bank, 386 Md. 412 (Md. 2005).

17 In re Parker, 269 B.R. 522 (2d Cir. 2001) ("Like mortgages, leases can be adhesion contracts drafted by landlords. The disparity in bargaining power is probably at its height in the instance of low-income tenants, like [debtor] who are desperate to secure housing and cannot afford it on the private market.").

18 Shroyer v. New Cingular Wireless Serv., Inc., 498 F.3d 976 (9th Cir. 2007); Metro-East Center for Conditioning and Health v. Quest Communications Internat'l, Inc., 294 F.3d 924, 927 (7th Cir. 2002); Gatton v. T-Mobile USA, Inc., 152 Cal. App. 4th 571, 61 Cal. Rptr. 3d 344 (2007); Aral v. Earthlink, Inc., 134 Cal. App. 4th 544, 36 Cal. Rptr. 3d 229 (2005).

19 *See infra* Section II(C), discussing, Karl N. Llewellyn, The Common Law Tradition: Deciding Appeals 371 (1960) , Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 632 (1943); Alfred W. Meyer, *Contracts of Adhesion and the Doctrine of Fundamental Breach*, 50 Va. L. Rev. 1178, 1186 (1964); Arthur Allen Leff, *Unconscionability and the Code – The Emperor's New Clause*, 115 U. Pa. L. Rev. 485 (1967); Leff, *Unconscionability and the Crowd – Consumers and the Common Law Tradition*, 31 U. Pitt. L. Rev. 349 (1969-1970); Leff, *Contract as Thing*, 19 Am. U.L. Rev. 131 (1970); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529 (1971); Slawson, *New Approach to Standard Forms*, TRIAL 49 (July-Aug. 1972); Slawson, *Mass Contracts: Lawful Fraud in California*, 48 Cal. L. Rev. 1 (1974); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1251 (1983); Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. Miami L. Rev. 1263, 1265 (1993); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1205-06 (2003);Douglas G. Baird, *The Boilerplate Puzzle*, 104 Mich. L. Rev. 933, 934 (2006).

20 *See* Restatement (Second) of Contracts §§ 17, 22 (1981); E. Allan Farnsworth, Contracts, §3.13 at 143.

21 *See infra* Section II.

their power of assent in the vast majority of contracts they undertake.[22] Perhaps courts believe that the adherents' actual understanding and assent is unnecessary because adhesion contracts are drafted by sophisticated repeat players in their respective businesses. Other courts may have adopted the law and economics view that the forces of competitive markets will protect the adherents from any abuses that may otherwise occur from the use of adhesion contracts.[23] In the case of mortgages and other credit agreements, courts may be relying on the fact that lenders have developed advanced underwriting standards to evaluate the borrower's ability to repay their debt, and have an interest in being repaid that motivates them to engage in "safe and sound" lending practices.

If these assumptions are among the courts' reasons for refusing to grant adherents' the power of actual assent, they should be reexamined in light of the subprime mortgage crisis. The assumption that sophisticated financial entities can be trusted to draft adhesion contracts in the adherent's best interests is of little value in the wake of the global economic catastrophe wrought by the massive sales of complex mortgages to individuals who did not understand them and to whom they were not well suited.[24] Similarly, the assumption that the enlightened self-interest of sophisticated financial institutions will ensure that they enforce reasonable underwriting standards or engage in safe and sound lending practices is difficult to accept when the institutions offering risky mortgages, such as no-documentation loans, prior to the subprime loan crisis included the preeminent national bank, J.P. Morgan Chase, and the nation's largest savings and loan, Washington Mutual.[25]

The theory that market discipline is sufficient to protect the individuals who sign adhesion contracts also fails in light of the recent lending practices in the subprime mortgage market. Repeat players in the market, including the investment banks that issued mortgage-

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[22] *See* W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529, 529 (1971) (estimating that standardized form contracts make up 99% of all contracts).

[23] *See* Richard A. Posner, *The Federal Trade Commission*, 37 U. Chi. L. Rev. 47 (1969); Lucian A. Bebchuk and Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 Mich. L. Rev. 827 (Mar. 2007).

[24] *See* Greg Ip and Jon E. Hilsenrath, *How Credit Got So Easy And Why It's Tightening,* Wall St. J., Aug. 8, 2007 (explaining that when the Federal Reserve held rates down after 2001, lenders offered borrowers with poor credit mortgages with seemingly affordable low introductory rates. One example of these misleading loans were the "2/28" subprime mortgages. The low interest rates on these mortgages rose after the first two years for the remaining 28 years of the mortgage to a rate that was often three percentage points above a prime rate the customer normally paid. Borrowers seldom appreciated how high this rate could be once rates were returned to normal levels.); Mara Der Hovanesian, *Nightmare Mortgages*, Business Week, Sept. 11, 2006 (detailing the sequence of events that led to the sale of option ARMs, which give the borrower several alternatives for payment each month, but add additional amounts to the principal if less than the maximum payment is made, not just as financial planning tools to the wealthy but as "affordability tools to the masses. . .Banks tapped an army of unregulated mortgage brokers to do what needed to be done to keep the money flowing, even if it meant putting dangerous loans in the hands of people who couldn't handle or didn't understand the risk.").

[25] *See* Peter S. Goodman and Gretchen Morgenson, *Saying Yes, WaMu Built Empire on Shaky Loans,* N.Y. Times, Dec. 12, 2008; Denise Trowbridge, *Home lenders lifting threshold: Time of easy credit for buyers ends as foreclosures mount*, The Columbus Dispatch, Aug. 9, 2007.

backed securities and derivatives, the insurance companies that sold credit default swaps, the investors, their financial advisers, the mortgage originators, and the brokers, all failed to sound a warning to end the unsound lending procedures that led to the devaluation of financial assets of such tremendous significance to the economy. Furthermore, if the brilliant minds running Lehman Brothers, Merrill-Lynch, Citigroup, Bank of America, J.P. Morgan Chase, and Washington Mutual were unable to foresee the dangers inherent in the risks they were taking, why are so many Americans now blaming average homeowners for taking excessive risks, especially given how little information, comparatively speaking, they were given? But many do blame them, rather than face up to the fearsome reality that neither bankers operating in a competitive marketplace nor the experts who regulate them have been able to prevent repeated financial fall-outs of a massive scale remedied at taxpayer expense.

One emerging view is that the securitization of mortgages was largely to blame for the market's failure to prevent its participants from engaging in excessive risk-taking. Most loan originators had little reason to maintain underwriting standards when they planned to sell their mortgages shortly after making them, leaving them with little if any exposure.[26] The problem was especially acute in the subprime market, with the securitization of subprime mortgages rising from 50.4 percent in 2001 to 81.2 percent in 2005.[27] Moreover, the history of the housing market gave originators confidence that they could recover their expected return in a foreclosure should the borrower default. This history demonstrated that from 1975 to the third quarter of 2006, the lowest point by which the Office of Federal Housing Enterprise Oversight index of home prices fell was only 5.4 percent.[28] Another explanation for the market failure was that a perverse broker compensation system rewarded brokers for selling borrowers unsuitably risky

[26] *See* David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 Fordham J. Corp. & Fin. L. 709, 734 (2009) ("Since the mortgages were sold, the lender did not retain any liability for nonpayment of the mortgages. There was a disconnect between the people making the lending decision, and the people ultimately bearing the risk of default. This disconnect allowed lenders to make loans seemingly without any consideration of the consequences."); Jonathan Macey, Geoffrey Miller, Maureen O'Hara and Gabriel D. Rosenberg, *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. Corp. L. 789, 801 (2009) ("[B]ecause the originators and brokers did not hold the loans they created, standards and diligence in originating loans were compromised."); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 Fordham L. Rev. 2039, 2045 (2007); Christopher L. Peterson, *Predatory Structured Finance*, 28 Cardozo L. Rev. 2185, 2200-06 (2007). For a critique of this view, *see* Todd J. Zywicki and Joseph D. Adamson, *The Law and Economics of Subprime Lending*, U. Colo. L. Rev. 1, 52-53 (2009).

[27] *See* Todd J. Zywicki and Joseph D. Adamson, *The Law and Economics of Subprime Lending*, U. Colo. L. Rev. 1, 52-53 (2009) ("Wall Street pooled $508 billion worth of subprime mortgages in 2005, up from $56 billion in 2000.")

[28] *See* Martin Neil Baily, Douglas W. Elmendorf, Robert E. Litan, The Great Credit Squeeze: How It Happened, How to Prevent Another (Unpublished Paper) 10 (Economic Studies at Brookings, May 21, 2008) ("M. Baily, Brookings Economics Studies"). This index measures prices for the same dwelling in different markets.

loans. Specifically, broker compensation gave brokers incentives to place borrowers in loans with the highest rates and fees, often in subprime rather than prime loans.[29]

Section I of this article focuses on the role of adhesion contracts in causing the Great Depression and the current subprime mortgage crisis. It also describes how statutes and regulations failed, for similar reasons, to provide an adequate solution for preventing these crises from recurring, in the Great Depression, the Savings and Loan Crisis of the 1980s, and the subprime loan crisis.

Section II explains why current doctrine does not dissuade lenders from engaging in contracting practices that lead to massive failures in the economic system. The section also demonstrates why none of the proposals that legal scholars have offered to remedy particularly egregious cases of overreaching in adhesion contracts will resolve this larger issue.

Section III describes my prescription for reforming the law of adhesion contracts to ameliorate the impact they have as a factor leading to the boom and bust cycles in our economy.

My proposal challenges the orthodox view that the only way to cure massive financial disasters that follow years of deregulation is to enact new laws and regulations. I recommend a change in the common law of adhesion contracts that lie at the heart of at least two of the last three of these crises. The solution I suggest will give a new segment of society a chance to avert financial disasters by giving the recipients of these contracts an opportunity to make an informed decision on the extent of the financial obligations they are willing to assume. Their judgments may often be poor, as were the decisions made by a majority of lenders in the subprime mortgage crisis. However, apart from normative concerns, courts should give adherents the power to make these choices because giving both parties to the contract an opportunity for informed assent will increase the chances that prudent economic decisions will be made.

I. Boom and Bust Cycles over Time – Adhesion Contracts and the Failure of Regulation

A. The Great Depression

The decade preceding the Great Depression was marked by high levels of consumer and investor confidence, huge increases in industrial productivity and in the stock market, a booming home construction industry, unprecedented levels of consumer consumption, supported by similarly unprecedented levels of consumer debt, and by a series of pro-business, deregulatory administrations. The market confidence that exemplified the era was expressed well by the popular economist John Moody in 1928, who predicted that economic growth would "continue through many years to come, thus adding steadily to and maintaining a relative plethora of available capital and credit."[30] Based on these and similar prognostications from leading

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[29] *See* Elizabeth Warren, *Making Credit Safer*, Harvard Magazine 4 (May-June 2008) (brokers, who originate more than half of all mortgage loans, can take a fee, called a "yield service premium" from the lender for placing a higher-priced loan, and Fannie Mae estimates that 50 percent of the borrowers who were sold expensive subprime mortgages would have qualified for prime-rate loans).

[30] Jordan A. Schwartz, The Interregnum of Despair: Hoover, Congress and the Depression 4(1970).

economists of the day,[31] and on the soaring stock market, which was followed widely in the popular press, the general view of the economy was upbeat.[32] But wages did not keep pace with production, and only a small percentage of Americans owned sufficient shares to participate in the stock market bonanza of the 1920s.[33] Most Americans were not investors but spenders, and made their purchases on credit under contracts of adhesion such as installment sale contracts and mortgages.[34] Data on average wages, the cost of living, savings rates, and the lending practices surrounding installment sales agreements indicates that the level of consumer debt was the result of unsound lending.[35] Indeed, sophisticated lenders would have known that Americans could not afford the mountain of debt they were assuming to maintain consumption levels sufficient to support the nation's tremendous gains in productivity. Many scholars believe that this debt, and the contraction in consumer spending that inevitably followed, were major factors leading to the Great Depression.[36] As historian, T.H. Watkins, explains:

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[31] Hugh Norton, The Quest for Economic Stability: Roosevelt to Reagan 25 (1977). Norton finds that when doubts were raised as to sustainability of the gains made in the stock market, or the leverage used to finance them, economics professors from Yale, Princeton, Stanford, Michigan and other similarly well-regarded universities were brought forward by industry to support the valuation of the stock market and the level of broker's loans.

[32] Justice Brandeis was one of the few observers who doubted the health of the economy, writing to his brother that, "I can't understand where all the money is coming from. . . We are certainly not earning it as a nation. I think we must be exploiting about 80 percent of Americans, for the benefit of the other 20 percent." Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941, 93 (1994).

[33] *See infra* notes 38-40. Income from dividends rose by 65 percent during the 1920s, and from 1923 to 1929, and dividend payments doubled from $4.6 billion to $9.2 billion, but only two to three million of the country's 120 to 125 million citizens traded on the Exchange during the decade. Lawson, A Commonwealth of Hope 11. In addition, almost 74% of all 1929 dividends went to less than 600,000 shareholders with incomes of over $5,000. Robert S. McElvaine, The Great Depression: America, 1929-1941 44 (1993). *See also* Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 67 (1987) ("The wealthy few also benefited from the enormous growth in capital gains during the stock market boom; not so the bulk of the population.").

[34] *See infra* notes 52, 57, 64-66, 70.

[35] *See infra* pp.13-15.

[36]Peter Temin, *Did Monetary Forces Cause the Great Depression?* 71-72, 83 (1976); Frederick S. Mishkin, *The Household Balance Sheet and the Great Depression*, Journal of Economic History 918-937, XXXVIII (1978); Christina Romer, *The Great Crash and the Onset of the Great Depression*, 597-624, Quarterly Journal of Economics, CV (1990); Martha L. Olney, *Avoiding Default: The Role of Credit in the Consumption of Collapse of 1930*, The Quarterly Journal of Economics, 319 (Feb. 1999); *See also* Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression 30 (2009) ("A credit binge in the 1920s is widely believed to have been a precipitant of the Great Depression."); Dixon Wecter, The Age of the Great Depression: 1929-1941 6 (1948) ("The overexpansion of credit was a prime cause of the disasters that followed 1929. The First World War began a process which reckless financing continued to accelerate. In the background loomed the huge structure of long-term debt in the United States—a public debt, federal state and municipal, of thirty-three billion dollars, and corporate and individuals debts of one hundred billion--which demanded expanding markets and world prosperity for successful carrying."); Broadus Mitchell, Depression Decade From New Era through New Deal, 1929-1941 27-28 (1947) (ascribing as one of the causes of the Great Depression that economic prosperity was "forced" from about

> The surge of installment buying after the war had obscured the essential weakness in the system for a time, but by 1929 even a burgeoning consumerism had not been enough to carry the burden of overproduction. If you were bringing home a hundred dollars a month or less, there were only so many payments you could make for so many toasters or vacuum cleaners or radio sets or automobiles, no matter how tempting they might be, no matter how cunningly an increasingly sophisticated and ubiquitous advertising industry might present them; you either stopped buying, or you defaulted. And people began to stop buying. During the two months before the crash, production declined at an annual rate of 20 percent, wholesale prices at a rate of 7.5 percent, and personal income at a rate of 5 percent – the first major symptoms of the virulence to come.[37]

1. Average Income

During the 1920s, industrial workers' productivity rose by an impressive 40-43 percent, but their income increased by less than 10 percent, with the remaining gains going to increased profits, which rose overall by almost two-thirds.[38] With this increase in corporate profits, the index of speculative gains from the stock market between 1923 and 1929 rose from 100 to a spectacular 410,[39] but the index of wages advanced over the same period from 100 to just 112.[40] To the extent corporate profits were distributed in the form of dividends, these dividends were not widely distributed because relatively few Americans owned stocks.[41] This imbalance in the distribution of the gains from production led to an ever widening gap over the decade between what employees produced and what they were able to consume.[42]

1926, as shown by the growth of consumer credit through installment sales); William E. Leuchtenburg, The Perils of Prosperity 1914-1932 244 (1993) (noting that wages did not keep pace with productivity, so that, "the purchasing power of workers and farmers was not great enough to sustain prosperity. For a while this was partly obscured by the fact that consumers bought goods on installment at a rate faster than their income was expanding, but when the time came that they had to reduce their purchases, the cutback in buying sapped the whole economy.").

[37] T. H. Watkins, The Great Depression: America in the 1930s 46-47 (1993).

[38] Lawson, A Commonwealth of Hope 21. Robert McElvaine reports that in the decade before 1929 output per worker in manufacturing increased by 43 percent, but wages increased only 8 percent. Robert S. McElvaine, The Great Depression: America, 1929-1941 39 (1993). Peter Fearon puts the rise in worker productivity between 1919 and 1929 at 60%. Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 25(1987). From 1928 to 1929, all per capita income rose 28 percent, but that of the lower 93 percent of the non-farm population rose only 6%. The numbers are thrown off by the fact that the per capita income of the top 1% of the non-farm population almost doubled. Anthony J. Badger, The New Deal: The Depression Years, 1933-1940 30 (1989).

[39] Hugh Norton, The Quest for Economic Stability: Roosevelt to Reagan 25 (1977).

[40] Dixon Wecter, A History of American Life: The Age of the Great Depression: 1929-1941 9 (1948).

[41] *See supra*, note 39.

[42] Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 89 (1994); William E. Leuchtenburg, The Perils of Prosperity 1914-1932 244-45 (1993).

A study from the Brookings Institute completed in 1934 revealed that during the 1920s over 70 million people in over 60 percent of the country's families had survived on less than the $2,000 needed to acquire basic necessities.[43] At the time, the average wage was below $1,500 per year.[44] By mid-decade, the average annual income of the country's 5.8 million farm families was only $240 and 54 percent of all farmers earned less than $1,000 a year.[45] With such a large portion of the population making at or below subsistence wages, many families had no savings from which to continue making payments on credit obligations should a job be lost through illness or layoffs.[46]

Unemployment figures were also higher than has been assumed. Although average unemployment rates never rose above 3.7 percent from 1922 to 1929,[47] almost 8 percent of those in the industrial segment of the workforce were unemployed due to technological advances and higher worker productivity.[48] In 1926, the unemployed were estimated at 1.5 million, a number which grew to 1.8 million in 1928.[49]

2. A Boom in Home Construction Leads to Rising Mortgage Debt

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[43] Lawson, A Commonwealth of Hope 21. *See* also Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 67 (1987).

[44] Charles R. Geisst, Wall Street: A History from its Beginnings to the Fall of Enron 154 (2004). According to Bureau of Labor statistics, by 1929, 12 million of the 27 million families who filed income taxes in 1929 earned $1,500 or less, and another 6 million families earned less than $1,000, placing well over half the country's family's in a condition of financial distress. Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 81-82 (1994).

[45] Lawson, A Commonwealth of Hope 22. Peter Fearson puts the estimate of net farm income in 1921 at $521 annually, and at an average of $918 annually between 1926 and 1929. Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 34(1987).

[46] Two thirds of the nation's savings from 1923 to 1929 were made by families with incomes over $10,000 a year, but the 40 percent of the population that made under $1,500 a year spent more than they made. Dixon Wecter, The Age of the Great Depression: 1929-1941 10 (1948). In 1929, 80 percent of America's families made up only 2% of the country's total savings, while the wealthiest 10 percent contributed 86 percent of its savings. Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 67 (1987).

[47] Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 30 (1994).

[48] Lawson, A Commonwealth of Hope 21. *See also* William E. Leuchtenburg, The Perils of Prosperity 1914-1932 193 (1993) ("Corporate profits and dividends far outpaced the rise in wages, and despite the high productivity of the period, there was a disturbing amount of unemployment. At any given time in the 'golden twenties,' from 7 to 12 percent were jobless."). The decade also began with high unemployment, when the postwar recession of 1921 threw five million people out of work. Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 20 (1994).

[49] Dixon Wecter, The Age of the Great Depression: 1929-1941 8-9 (1948).

Another important sector of the investment economy during this period was the boom in construction.[50] At its peak in 1926, the value of new construction accounted for over 60 percent of gross private domestic investment, and 40 percent of all new construction was residential.[51] Given the wage situation, absorbing an increase of this magnitude in new home construction required consumers to assume a corresponding increase in mortgage debt. Accordingly, residential non-farm mortgage debt rose from less than $8 billion in 1919 to $27 billion in 1929.[52] The terms of home mortgages were quite short,[53] but borrowers were usually able to refinance their mortgages as they matured.[54] By the early 1930s, approximately 45 percent of the 10.6 million homes in the country had either first, second or third mortgages.[55] Because many home owners were forced to borrow on a short-term basis, they found their loans difficult to renew after 1929.[56]

3. Easy Credit under Installment Agreements Supports Increased Consumption

Following a sharp recession in 1920, Americans spent the decade leading up to the Great Depression buying a rapidly increasing volume of consumer goods, but at an average wage of forty-eight cents per hour, they had to rely on credit more than ever before.[57] An early

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[50] Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 59-60(1987). Fearon attempts to explain this boom in construction by the one and half million people who were added to the population each year through migration who needed housing, the backlog in demand created during WWI, and the stimulation of rising income and stable building costs.

[51] Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 59(1987).

[52] Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 60(1987).

[53] Barry P. Bosworth, Andrew S. Carron, and Elisabeth H. Rhyne, The Brookings Institution, The Economics of Federal Credit Programs 48-50 (1987) (describing a mortgage market in which down payments of 40 percent were common, loans generally matured in six years or less, and the principal was not amortized, but was paid as a lump sum on the loan). *See also* Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 60 (1987) (many borrowers were forced to accept short-term home mortgages during the home construction boom preceding the 1929 depression); Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 18 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004)(explaining that one of the major banking reforms of the 1930s was the replacement of the standard residential mortgage of the time, the five-year maturity balloon-payment mortgage, with the long-term (20 to 30 year) fixed-rate self-amortizing mortgage).

[54] Catherine England, *Regulatory Regimes and Markets: The Case of Savings and Loans* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 65 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds 2004).

[55] David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 89 (2004).

[56] Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 60 (1987).

[57] Charles R. Geisst, Wall Street: A History from its Beginnings to the Fall of Enron, 154 (2004). *See also* Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 53(1987) ("Consumers were keen to acquire new items; they were even prepared to go into debt to buy automobiles and new homes. The growth in the range of

commentator pointed out the misleading terms of these credit agreements, which became clear in light of Great Depression: "By 1929 felicity on the installment plan had lured its tens of millions. In the harsh light of the Great Depression, such aspects of the system as inflated prices and exorbitant carrying charges, along with misrepresentation of the product, would become all too plain."[58]

Most installment loans were sold by merchants to sales finance companies during the 1920s for a discount soon after they were made, giving the merchants little incentive to inquire into the borrower's ability to make the required payments.[59] Payment was assured through punitive default provisions, where missed installment payments triggered repossession with a total loss of the borrower's equity in the goods.[60] As the head of the Federal Reserve commented in a 1925 observation on the rise of car buying on credit, "people will have an automobile and sacrifice paying their doctor bill, the grocery bill and the clothing bill."[61] As a result, when jobs were lost, cutting consumption was the only viable strategy for households to avoid default.[62] Consumer spending did drop precipitously as unemployment grew, to the extent that the decline in spending is believed to be one of the key factors that turned what may have been a minor recession into the Great Depression.[63]

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products flooding onto the market was extensive and was accompanied by massive advertising campaigns and professional marketing. "); Dixon Wecter, The Age of the Great Depression: 1929-1941, 7 (1948); T. H. Watkins, The Great Depression: America in the 1930s 46-47 (1993).

[58] Dixon Wecter, The Age of the Great Depression: 1929-1941 7 (1948).

[59] Martha L. Olney, Buy Now Pay Later: Advertising, Credit and Consumer Durables in the 1920s 106 (1991). Olney explains that in the 1920s, the bulk of installment credit extended to households was provided by sales finance companies, specialized financial institutions that purchased retail time-sale contracts from sellers. *Id.* The buyer made a down payment to the seller and then signed a form installment sale contract promising to pay the balance, with interest. This form contract was then sold, and assigned, by the seller to the finance company. *Id.* Such retail installment contracts were typically standardized, form documents. *Id.* at 109 n. 16. *See also* sample form installment sale contract from a 1932 sale of a used car., *Id.* at 110, figure 4.2.

[60] Martha L. Olney, Avoiding Default: The Role of Credit in the Consumption of Collapse of 1930, 319, 320, The Quarterly Journal of Economics, Feb. 1999.

[61] Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 46 (1994).

[62] *See* Martha L. Olney, *Avoiding Default: The Role of Credit in the Consumption of Collapse of 1930* 319 The Quarterly Journal of Economics, Feb. 1999.

[63] *See* Martha L. Olney, *Avoiding Default: The Role of Credit in the Consumption of Collapse of 1930* 319 The Quarterly Journal of Economics, Feb. 1999. *See also* Peter Temin, *Did Monetary Forces Cause the Great Depression?* 71-72, 83 (1976); Frederick S. Mishkin, *The Household Balance Sheet and the Great Depression*, Journal of Economic History 918-937, XXXVIII (1978); Christina Romer, *The Great Crash and the Onset of the Great Depression*, 597-624, Quarterly Journal of Economics, CV (1990).

By the end of the decade, almost 15 percent of all retail sales were made on the basis of installment purchase.[64] Outstanding short-term nonmortgage consumer debt, of which credit to purchase durable goods is one component, approximately doubled in the 1920s, from $3.3 billion in 1920 to over $7.6 billion in 1929.[65] Among the most significant of the consumer durables purchased on credit in the years leading up to the Great Depression were automobiles, with sales rising from 1.9 million in 1920 to 4.4 million in 1929.[66] By the end of the 1920s, approximately two-thirds of the nation's families owned an automobile.[67] By 1925, seventy-percent of all car sales, new and used, were made on installment, and competition drove down initial payments to as little as ten percent.[68]

Many farmers went into debt to purchase land when prices were high and later realized that the land would only be profitable if wartime price levels had continued, and that without these prices the land would not produce income levels sufficient to repay the debt.[69] By 1929, farmers, whose per capita income was only one-fifth of the national average, had an accumulated debt $9.8 billion for land and machinery.[70]

With the American consumers' increase in spending on durable goods came a corresponding decrease in savings. From 1898-1916, only 3.7 percent of disposable income was used on average to purchase major durable goods, such as automobiles, furniture and household

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[64] Robert S. McElvaine, The Depression and New Deal: A History in Documents 17 (2000).

[65] Martha L. Olney, Buy Now Pay Later: Advertising, Credit and Consumer Durables in the 1920s, 86 (1991) (durable goods consist of items such as automobiles, furniture, clothing, radios, home improvement, jewelry, phonographs, vacuums, sewing machines, phonographs, and pianos). The number of radios sold went from 100,000 in 1922 to 4.9 million in 1929. William E. Leuchtenburg, The Perils of Prosperity 1914-1932 197 (1993) ("Three out of every four radios were purchased on the installment plan, as were 60 percent of all automobiles and furniture.").

[66] Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 56(1987); Badger, The New Deal: The Depression Years, 1933-1940, 20 (1989).

[67] Badger, The New Deal: The Depression Years, 1933-1940, 20 (1989).

[68] Colin Gordon, New deals, Business, labor, and politics in America, 1920-1935 (1994). *See also* Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 56(1987) (The development of consumer credit was pioneered by General Motors when if founded General Motors Acceptance Corporation in 1919).

[69] Peter Fearon explains that a rise in farm income up to 1919 led to a rapid increase in land values, which were 70% above 1914 levels by 1920, leading in turn to a boom in land speculation. Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 38(1987). Aggregate mortgage debt to support this speculation nearly doubled from 1914 to 1920. Mortgage debt continued to rise after 1920, despite falling property values, because farmers had to substitute long-term mortgages for the short-term debts they had accumulated. As he describes, "The problem for many was that money had been rashly lent, and foolishly borrowed on land which would only be profitable if wartime price levels had prevailed." *Id*. at 40-41.

[70] Anthony J. Badger, The New Deal: The Depression Years, 1933-1940, 14-15 (1989).

appliances, while from 1922 to 1929, 7.2 percent was used for this purpose.[71] At the same time, the share of their disposable income that Americans were saving was nearly cut in half, so that the personal savings rate fell from 6.4 percent to 3.8 percent, a drop of 42 percent.[72] By 1929, almost 80 percent of all households, approximately 21.5 million families, had no savings at all.[73] Meanwhile, banks had shown a willingness to engage in risky lending practices, such as lending for trading on margin and investing in speculative real estate ventures, which left them in a similarly poor position to weather the coming economic storm.[74]

4. Deregulation and Income Distribution

The Republican presidents of the 1920s, Warren G. Harding, Calvin Coolidge, and Herbert Hoover, generally believed that the nation's economic system would produce prosperity and abundance as long as governmental restrictions on business were kept to a minimum.[75] Monetary policy consisted primarily of keeping interest rates low (from 3 to 3.5 percent during the Coolidge years) and maintaining the gold standard, both of which were later seen as contributing factors to the Great Depression.[76]

Another important government policy implemented in the years leading to the Great Depression was a series of tax cuts designed to stimulate investment. Similar to the tax cuts announced by President George Bush on June 7, 2001,[77] Andrew Mellon, the Secretary of the Treasury from 1921 to 1932, defended his policy of reducing taxes on the grounds that the wealthy would use their assets for investment purposes, and these investments would have a "trickle down" effect to the lowest level of society by creating jobs.[78] Mellon's tax cuts were

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[71] Martha L. Olney, Buy Now Pay Later: Advertising, Credit and Consumer Durables in the 1920s, 46 (1991).

[72] *Id.* at 47.

[73] Robert S. McElvaine, The Great Depression: America, 1929-1941 38 (1993).

[74] Badger, The New Deal 68; William E. Leuchtenburg, The Perils of Prosperity 1914-1932 246 (1993) (observing that during the 1920s, "banker-promoters financed speculation and loaded the banks with dubious assets.").

[75] Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 49 (1987); Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941, 53-57 (1994). For example, Coolidge appointed as head of the FTC an attorney for the lumber industry who had denounced the FTC as "an instrument of oppression" to business. Once in office, he promptly issued regulations reducing the agency's surveillance over business practices. Parrish, Anxious Decades 53-54. Similarly, the three largest antitrust cases brought under the Coolidge administration were lost on appeal, and the largest fine it obtained for antitrust violations was $2,000, a sum that was reduced to $50 on appeal, and even then was never collected. Parrish, Anxious Decades 53.

[76] Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 56 (1994).

[77]Nobel –prize winning economist, Joseph E. Stiglitz, has cited these tax cuts, with a special focus on the decrease in the tax on capital gains, as one of the decisions that led to the subprime mortgage crisis. Joseph E. Stiglitz, *Capitalist Fools*, Vanity Fair (Jan. 2009).

[78] Alan Lawson, A Commonwealth of Hope: The New Deal Response to Crisis 10-11, 251 (2006). Lawson compares Mellon's trickle-down tax strategy that preceded the Great Depression with the anti-tax policies of the

certainly followed by increases in stock market investment, and there is no doubt that they benefitted wealthy individuals and corporations. [79] The promised "trickle down" benefits to those lower in the social strata are more difficult to prove.[80] The data tends to support the view that the "1920's were golden . . . only for a privileged section of the American population."[81] According to the Brookings Study, from 1920 to 1929, the per capita income calculated for all Americans rose 9 percent, but per capita income for the top one percent of income recipients rose by 75 percent.[82]

By the end of the 1920s, five percent of the population controlled 90 percent of the wealth.[83] In 1929, the richest tenth of the population received almost 40 percent of the nation's income, before taxes, while the poorest tenth received only 1.8 percent.[84] At that time, when the population of the U.S. was between 120 and 125 million, the 60,000 families in the country who were at the highest end of the economic spectrum had accumulated assets equal to those held by the 25 million families at the bottom.[85] In fact, the distribution of wealth in this country was in such a state after eight years of pursuing Mellon's income tax reduction policies that the vast majority of Americans were left with far too little purchasing power to support the nation's gains

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second Bush administration. From 1921 to 1928, four tax cuts reduced the rate on top incomes from 77 percent to 25 percent, lowered corporate taxes, and repealed the excess profits and gift taxes. *See also* Steve Fraser, Every Man a Speculator: A History of Wall Street in American Life, 379 (2005); Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 18 (1994); Hugh Norton, The Quest for Economic Stability: Roosevelt to Reagan 20 (1977) (noting that Andrew Mellon, as Secretary of the Treasury, believed that high taxes on large incomes would discourage venture capital and thus retard economic development).

[79] It was later discovered that in his eight years as Secretary, Mellon had distributed over $3.5 billion in tax refunds, credits and abatements to wealthy individuals and corporations, including some of his own. Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 55 (1994); John D. Hicks, Republican Ascendancy: 1921-1933 53-54 (1960).

[80] Amity Shlaes attempts to prove Mellon's tax cuts were "good for Henry Ford's worker" based on the claim that after-inflation earning of employees grew 16 percent from 1923 to 1929. Amity Shlaes, The forgotten man: A New History of the Great Depression 38 (2007). Her Bibliographic Notes contain no citations or explanation to support this figure, and it is inconsistent with the numbers provided in the Brookings Institute study and many other documented sources. *See* supra notes 38, 40-45.

[81] I. Bernstein, The Lean Years: A History of the American Worker, 1920-1933 (1960). *See also* F. Stricker, *Affluence for whom? – Another look at prosperity and the working classes in the 1920's*, 24 Labor History (Winter 1983).

[82] Robert S. McElvaine, The Great Depression: America, 1929-1941 38 (1993).

[83] Charles R. Geisst, Wall Street: A History from its Beginnings to the Fall of Enron 154 (2004).

[84] Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 82 (1994).

[85] Lawson, A Commonwealth of Hope 11. *See also* Peter Fearon, War, Prosperity and Depression: The U.S. Economy 1917-45 67 (1987).

in productivity, creating a fundamental instability in the economy.[86] This instability was masked for a time through purchases made with installment credit agreements and mortgages, but the situation was too precarious to survive even a minor recession.

5. Bank Failures and Government Bailouts

From 1922 to 1929, bank failures averaged 691 per year.[87] The seeds of future troubles in the banking industry were sown in these years, based on mismanagement and speculative lending practices. None of these practices were impeded by government enforcement efforts during this anti-regulation era in Washington. As the Louisiana Banking Commissioner put it in an assessment of the bank failures in his state in 1925, "Gross and evil management, poor management, promotion of speculative enterprises, loans without security, too large loans, loans to companies in which officers were interested, were the major causes of bank failure."[88] The banks' speculative lending practices during the 1920s included loans to fund stock market speculation and disastrous real estate investments in southern California and Florida in 1924 and 1925.[89]

As the 1930s began, bank failures became chronic, with 1,345 failures in 1930, 2,298 in 1931 and 1,456 in 1932.[90] In July 1932, President Hoover reluctantly agreed to the demand from Wall Street bankers for relief in the form of loans provided through the Reconstruction Finance Corporation ("RFC"), a new agency created under the Reconstruction Finance Corporation Act.[91] The RFC was funded with $2 billion to lend to banks, insurance companies, building and loan associations, agricultural credit associations, railroads and similar enterprises.[92]

Democrats in the Senate objected to the bill on the grounds that the move would not assist the unemployed, those who needed help most, but the bankers, "the very men who have to

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[86] Anthony J. Badger, The New Deal: The Depression Years, 1933-1940 29 (1989) ("Economists for a long time highlighted the structural weaknesses of the American economy in the 1920s. Because of the maldistribution of income and the flaws of the banking system and the operation of the stock market, there was insufficient demand in the American economy to sustain the great gains made in productivity by American industry and agriculture.").

[87] T. H. Watkins, The Great Depression: America in the 1930s 47 (1993).

[88] T. H. Watkins, The Great Depression: America in the 1930s 47 (1993).

[89] T. H. Watkins, The Great Depression: America in the 1930s 47 (1993). *See also* Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 226-27 (1994). Parrish explains that the Florida real estate boom was supported by sales made through options or binders that permitted buyers to purchase property for as little as 10 percent down with modest monthly payments thereafter. *Id.* at 226. When the crash hit, Miami bank clearings fell from a high of over $1 billion just before the erosion of land prices to $260 million by 1927, and to $143 million a year later. *Id.* at 227.

[90] John D. Hicks, Republican Ascendancy: 1921-1933 277 (1960).

[91] Jan. 22, 1932, ch. 8, 47 Stat. 5.

[92] Dixon Wecter, The Age of the Great Depression: 1929-1941 48 (1948).

a large extent brought on the present depression. . . ."[93] Congressman Fiorello La Guardia called it "the millionaires' dole."[94] These concerns were largely realized when the banks and railroads used their RFC loans to repay debts and maintain their credit standing, rather than make investments that would create employment.[95] By the end of 1939, the RFC had disbursed over $10 billion to stimulate the economy, but a large portion of the funds were spent to sustain high executive salaries and pay dividends to stockholders.[96] Between 1929 and 1932, the volume of money paid as salaries to rank and file employees dropped by 40 percent and wages had declined by 60 percent.[97]

As unemployment increased to between 25 and 30 percent, homeowners were no longer able to keep up with their mortgage payments. In 1930, about 150,000 non-farm households lost their property through foreclosure, and in 1931 this figure increased to almost 200,000.[98] By the spring of 1933, half of all home mortgages were technically in default, and foreclosures had reached 1,000 a day.[99] In all, the Great Depression brought the default of 40 percent of the 20 billion in home mortgages.[100]

6. Existing Legal Authority

Before reviewing legislative reforms passed to tackle the Great Depression, it is worth taking a moment to consider that several economic theories hold that the government had the power it needed under existing law to resuscitate the economy without new laws, but misused this power in ways that exacerbated and prolonged the crisis. Current economic theories for the causes of the Great Depression can be roughly divided into four categories; the monetary hypothesis, the nonmonetary/financial hypothesis, the gold standard hypothesis, and the real business cycle hypothesis.[101]

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[93] Jordan A. Schwartz, The Interregnum of Despair, 91 (citing Congressional Record, 72nd Record, 1st Sess. P. 1350).

[94] Dixon Wecter, The Age of the Great Depression: 1929-1941 48 (1948).

[95] Edward Robb Ellis, A Nation in Torment: The Great American Depression of 1929-1939 194 (1970).

[96] Edward Robb Ellis, A Nation in Torment: The Great American Depression of 1929-1939 194-95 (1970).

[97] Dixon Wecter, The Age of the Great Depression: 1929-1941 17 (1948).

[98] Badger, The New Deal 33 (estimating 250,000 foreclosures in 1932); Dixon Wecter, The Age of the Great Depression: 1929-1941 49-50 (1948) (estimating 273,000 foreclosures in 1932).

[99] Badger, The New Deal 33. By 1933, the government estimated that 43 percent of all first mortgages were in default with an average arrearage of fifteen months. Nearly 25 percent of all homeowners with mortgages were in danger of losing their property through foreclosure, and lenders were initiating foreclosures at a rate of 24,000 foreclosures a month. David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 89 (2004).

[100] United States v. Winstar Corp., 518 U.S. 839, 844 (1996).

[101] Randall E. Parker, The Economics of the Great Depression 12 (2007).

Under the monetary hypothesis, principally attributed to the views expressed by Milton Friedman and Anna Schwartz in their 1963 book, *A Monetary History of the United States 1867-1960*, the principal cause of the Great Depression was the Federal Reserve's inept regulatory response to a 35 percent decline in the money supply from August 1929 to March 1933.[102] According to Friedman and Schwartz, the Federal Reserve could have implemented policies throughout the 1929-1933 contraction to increase the money supply.[103] These policies had been explicitly contemplated by the founders of the Federal Reserve System to meet precisely this kind of banking crisis; they had been used successfully in prior years; and they were recommended to the Federal Reserve at the time.[104] Moreover, the failure of one-third of the nation's banks from 1929 to 1933 was a major contributor to the drastic reduction in the money supply, but the Federal Reserve, which was founded in 1913 as the banking system's "lender of last resort," did little to save the failing banks.[105] The contraction in the money supply is also the focus of the gold-standard hypothesis, which focuses on international monetary policy, and claims that one of the principal reasons for the duration of the Great Depression was the government's failure to abandon the gold standard until 1933.[106]

Under the real business cycle theory, advances in technology ("technology shocks") that lead to over-supply and overinvestment are the driving force behind cyclical fluctuations such as the Great Depression.[107] Advocates of this theory believe that government intervention, including many aspects of FDR's New Deal program, will generally have the unintended effect of delaying recovery from economic depressions.[108] Whether or not one adheres to this hypothesis, it does suggest that some skepticism should be applied to the view that regulation is the only proper response to adverse financial conditions.

The nonmonetary/financial hypothesis has been developed by critics of the monetary hypothesis, including Ben Bernanke, Chairman of the Federal Reserve System, during his days

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[102] *Id*. at 13.

[103] *Id.*

[104] *Id.* at 13-14.

[105] Randall E. Parker, The Economics of the Great Depression 13 (2007).

[106] Randall E. Parker, The Economics of the Great Depression 20-21 (2007); Ben S. Bernanke, Governor, Federal Reserve, H. Parker Willis Lecture in Economic Policy, Washington and Lee University, Money, Gold, and the Great Depression (Mar. 2, 2004) (available at http://www.federalreserve.gov/boarddocs/speeches/2004/200403022/default.htm.)

[107] Ben Bernanke, Essays on the Great Depression 255-56 (2000); Bernard C. Beaudreau, Mass Production, The Stock Market Crash and the Great Depression 12-13(1996) .

[108] Harold L. Cole and Lee E. Ohanian, *The Great Depression in the United States From a Neoclassical Perspective*, 23 Federal Reserve Bank of Minneapolis Quarterly Review 6,11 (Winter 1999); Harold L. Cole and Lee E. Ohanian, *How the Government Prolonged the Depression*, Wall St. J. (Feb. 2, 2009).

as an economics professor. [109] Bernanke built on the work of Fisher, who claimed that the dominant forces behind "great" depressions are over-indebtedness and deflation.[110] In what has come to be known as the "credit view," Bernanke's work provided details that further explained Fisher's debt/deflation hypothesis by showing that a major decline in prices leads to a deterioration of bank assets, which results in banks' inability to lend. When financing dries up, consumers lower their spending plans, and aggregate demand declines, contributing to a downward deflationary spiral.[111] The debt deflation theory depends on evidence that there was a substantial build-up of debt before the onset of the Great Depression and that the decline in asset values was at least partially unanticipated when borrowers were incurring the debt.[112] This evidence has now been identified.[113] Under the nonmonetary/financial theory, had consumers not overburdened themselves with debt under contracts of adhesion, at a time when a subsequent decline in assents was at least partially unanticipated, the Great Depression, and for that matter, the subprime mortgage crisis, might not have occurred.

7. Legislative Reforms

This section discusses the economic legislation enacted during the Great Depression that has figured most prominently in the Savings and Loan crisis of the 1980s, and today's subprime mortgage crisis. This legislation dramatically altered the structure and regulation of the nation's banking system and its residential mortgage system.

In July of 1932, Hoover signed the bill for the Federal Home Loan Bank Act (FHLBA),[114] which created twelve regional Federal Home Loan Banks owned by the member institutions. The twelve regional Federal Home Loan Banks (FHLBs) were given $2 billion to be borrowed by savings and loan associations, banks and insurance companies whose credit had been strained by loans to residential and farm owners, thereby increasing liquidity, but not before

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[109] Randall E. Parker, The Economics of the Great Depression 15-16 (2007) (citing Ben Bernanke, *Nonmonetary effects of the financial crisis in the propagation of the Great Depression*, American Economic Review (June 1983)).

[110] Randall E. Parker, The Economics of the Great Depression 16 (2007) (citing Irving Fisher, *The debt-deflation theory of the great depression*, Econometrica (Oct. 1933).

[111] Randall E. Parker, The Economics of the Great Depression 16 (2007) (citing Ben Bernanke, *Nonmonetary effects of the financial crisis in the propagation of the Great Depression*, American Economic Review (June 1983)).

[112] Randall E. Parker, The Economics of the Great Depression 16 (2007) (citing Ben Bernanke, *Nonmonetary effects of the financial crisis in the propagation of the Great Depression*, American Economic Review (June 1983).

[113] Hamilton, J.D., *Was the deflation during the Great Depression anticipated? Evidence from the commodity futures market*, American Economic Review (Mar. 1992); Evans, M. and P. Wachtel *Were price changes during the Great Depression anticipated? Evidence from nominal interest rates"* Journal of Monetary Economics (Oct. 1993); J. Fackler and R. Parker , *Was debt deflation operative during the Great Depression?* Economic Inquiry (Jan. 2005)).

[114] July 22, 1932, ch. 522, 47 Stat. 725, 12 U.S.C. § 1421, et seq. (1933) amended by Section 301 of FIRREA, P.L. 101-73, 103 Stat. 183 (1989).

many home owners had already lost their homes through foreclosure.[115] As Hoover pointed out at the time, "The literally thousands of heart-breaking instances of inability of working people to attain renewal of expiring mortgage on favorable terms, and the consequent loss of their homes, have been one of the tragedies of this depression."[116]

The FHLBA also created the Federal Home Loan Bank Board (FHLBB) to oversee the system.[117] Responsibility for auditing savings and loans was given to the FHLBs, which are wholly owned by the member institutions, and are run by boards a majority of whose directors are elected by member institutions.[118]

As a way of restoring public confidence in the national banking system, the Banking Act of 1933[119] provided national banks with insurance of their deposits up to $2,500.[120] The insurance fund was to be subsidized by the government and the banks, under the supervision of a temporary agency called the Federal Deposit Insurance Corporation (FDIC).[121] The FDIC could be appointed to act as receiver for national banks and for insured state chartered banks according to state law.[122] This legislation prohibited payments of interest on demand deposits to forestall potentially harmful competition among banks and authorized the Federal Reserve Board to set a ceiling on time deposit rates offered by member banks.[123] The portion of the Banking Act of

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[115] John D. Hicks, Republican Ascendancy: 1921-1933 274 (1960); David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 82-86 (2004). Dixon Wecter, The Age of the Great Depression: 1929-1941 49-50 (1948).

[116] David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 82-86 (2004).

[117] Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 17 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[118] Roger C. Kormendi, Victor L. Bernard, S. Craig Pirrong, & Edward A. Snyder, Crisis Resolution in the Thrift Industry: A Mid America Institute Report 15 (1989).

[119] June 16, 1933, ch. 89, 48 Stat. 162, 12 U.S.C.A. §§ 64a. 71a. 197a. 221a, 227, 263, 333-336, 338-39, 348a, 371a-371d, 374a, 375a, 378, 632.

[120] Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 292 (1994); David Mason, From Building and Loans to Bail-Outs: A History of the American Savings and Loan Industry 93 (2004).

[121] Michael Parrish, Anxious Decades: America in Prosperity and Depression 1920-1941 292 (1994).

[122] History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 737 (FDIC Study, Dec. 1987).

[123] History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 737 (FDIC Study, Dec. 1987).

1933 known as the Glass-Steagall Act provided for the separation of commercial banking and investment banking.[124]

The Banking Act of 1935 established the FDIC as a permanent agency of the federal government and inaugurated a permanent federal deposit insurance plan.[125] The Act authorized the FDIC to terminate a bank's insured status if it was found to be engaging in unsafe and unsound lending practices.[126] Premiums were not adjusted to account for risk, but were instead calculated at a flat annual rate of 1/12 of one percent. This percentage was then applied to an assessment base calculated by the six-month average of the difference at the end of each day between the bank's total liabilities for deposits and its total uncollected items.[127]

In 1934, the Federal Housing Act was passed to spur the housing industries by providing federal backing for mortgages.[128] The Act contained four sections: a mortgage insurance program that guaranteed payment home loans (Title I); authorization for a privately-owned tax-exempt federal national mortgage association (FNMA) that would make loans to home buyers and invest in mortgages (Title II); a voluntary deposit insurance program that any building and loan association could join (Title III) and authorization for home improvement loans to comply with federal housing standards (Title IV).[129] The Act created the Federal Housing Authority (later renamed the Federal Housing Administration (FHA)) to administer the programs and make the home improvement loans.[130] Once the FHA began guaranteeing home improvement loans, banks began to recognize the value of consumer loans, and began competing for these loans with finance companies, which had formerly dominated this segment of the market.[131] The FHA was also instrumental in replacing the standard residential mortgage of the time, a five-year maturity

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[124] Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression 270 (2009)

[125] Aug. 23, 1935, ch. 614, 49 Stat. 684; History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 738 (FDIC Study, Dec. 1987).

[126] Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 739 (Dec. 1987).

[127] Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 739 (Dec. 1987).

[128] June 27, 1934, ch. 847, 48 Stat. 1246, 12 U.S.C.A. § 1701 et seq.; David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 91-92 (2004).

[129] David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 91-92 (2004);Charles R. Geisst, Wall Street: A History from its Beginnings to the Fall of Enron 253 (2004).

[130] David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 91-92 (2004); Charles R. Geisst, Wall Street: A History from its Beginnings to the Fall of Enron 253 (2004).

[131] Charles R. Geisst, Wall Street: A History from its Beginnings to the Fall of Enron 253 (2004).

balloon-payment mortgage, with the 20 to 30-year, fixed-rate self-amortizing mortgage.[132] Finally, the Federal Housing Act created the Federal Savings and Loan Insurance Corporation (FSLIC) to provide deposit insurance for savings and loans so they could compete effectively with banks for deposits.[133]

In late 2007, economists advised legislators proposing regulatory reforms in response to the subprime mortgage crisis to draw lessons from a three-year homeowner-relief program enacted during the Great Depression, the Homeowners Loan Act of 1933 ("HOLA").[134] HOLA established an agency called the Homeowners Loan Corporation ("HOLC") to purchase defaulted real estate mortgages from lenders and investors in exchange for bonds, and then refinance the mortgages on more favorable terms.[135] The lenders and investors would have a marketable bond which carried a lower interest rate, but was preferable to a mortgage in default. By the time the legislation expired, HOLC had made 1 million loans, accounting for approximately one-fifth of all mortgages nationwide.[136]

B. The Savings & Loan Crisis

The next banking crisis of comparable scope to the Great Depression occurred in the 1980s, when the number of savings and loans shrank from approximately 4,500 to about 2,400,[137] at an estimated cost to the tax-payers of between $150 and $160 billion.[138] Most

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[132] Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 17 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[133] Catherine England, *Regulatory Regimes and Markets: The Case of Savings and Loans* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 67 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[134] 12 U.S.C. § 1461 (2008). Alex J. Pollock, *A 1930s Loan Rescue Lesson*, The Washington Post, A17, Mar. 14, 2008 (explaining that in 1933, the year HOLA was enacted, about half of mortgage debt was in default, thousands of banks and savings and loans had failed, and the amount of annual mortgage lending had dropped by about 80 percent. This crisis followed a period of good times and easy credit during the 1920s characterized by many interest-only loans, balloon payments, frequent second mortgages, the assumption of rising house prices and confidence in the easy availability of refinancing).

[135] David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 91-92 (2004); Alex J. Pollock, *A 1930s Loan Rescue Lesson*, The Washington Post, A17, Mar. 14, 2008. Pollack reports that qualifying mortgages were limited to 80 percent of the value of the property, on homes with a maximum value of $17,500.

[136] David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 91-92 (2004); Alex J. Pollock, *A 1930s Loan Rescue Lesson*, The Washington Post, A17, Mar. 14, 2008.

[137] Karsten F. Turck, The Crisis of American Savings & Loan Associations: A comprehensive analysis 47 (1998).

[138] Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 17 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004); Catherine England, *Regulatory Regimes and Markets: The Case of Savings and Loans* in The

economists believe that banking regulations adopted in the 1930s to ensure safety and liquidity in the banking system were among the primary causes of the S&L crisis.[139] Other factors included an increased national budget deficit, volatile interest rates, insider fraud, and a collapse in the energy and real estate markets, but a flawed regulatory system is widely believed to have played a central role.[140]

Some economic historians claim that insider fraud and the bubble in the real estate market can be traced to Reagan Administration's policies of deregulating the savings and loan industry prior to the crisis. During President Reagan's eight years in office (1981-1989), the prospective costs of resolving the FSLIC's supervisory cases grew,[141] and abuses at an operational level, including fraud, increased. [142] Regulatory failures also led to flawed examination and supervision, resulting in delays by the mid-1980s in declaring insolvencies.[143]

As in the case of the Great Depression, statutes that were designed to prevent future failures of the banking system were not used properly and exacerbated rather than prevented the S&L crisis of the 1980s, and a period of deregulation in the preceding decade significantly increased its severity. The counter-reaction that occurred during the era of deregulatory fervor that preceded the actual crash was extreme, but contradictory, as it left in place flat-rate federal deposit insurance. This combination of regulation and deregulation was an invitation for excessive risk-taking by the owners of S&Ls and they did not disappoint, filling their balance sheets with junk bonds, speculative real estate and other "toxic assets." In the end, the S&L crisis left us with laws that sanction many of the practices that facilitated the subprime loan crisis – securitization of subprime mortgages, adjustable rate mortgages, and no-money down home

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Savings and Loan Crisis: Lessons from a Regulatory Failure 63 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[139] Catherine England, *Regulatory Regimes and Markets: The Case of Savings and Loans* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 63 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004) (noting that, "For most economists, however, the roots of the savings and loan fiasco lie firmly embedded in the policies pursued by federal and state governments beginning in the 1930s."); Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 17-18 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004); Roger C. Kormendi, Victor L. Bernard, S. Craig Pirrong, & Edward A. Snyder, Crisis Resolution in the Thrift Industry: A Mid America Institute Report 13-14 (1989).

[140] Roger C. Kormendi, Victor L. Bernard, S. Craig Pirrong, & Edward A. Snyder, Crisis Resolution in the Thrift Industry: A Mid America Institute Report 13 (1989).

[141] Arthur W. Leibold, Jr., *Some Hope for the Future, After a Failed National Policy for Thrifts* in James R. Barth, Susanne Trimbath, and Glenn Yago, eds., The Savings and Loan Crisis: Lessons from a Regulatory Failure 41 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[142] The Savings and Loan Crisis: Lessons from a Regulatory Failure 345 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[143] The Savings and Loan Crisis: Lessons from a Regulatory Failure 345 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

mortgages. The reform laws that were enacted after the S&L crisis that could have been used in a positive way to prevent the subprime mortgage crisis were ignored in the climate of deregulation that prevailed in Washington before this latest crisis.

1. The Crisis

The U.S. banking and thrift industry faced a financial crisis in the 1980s of a magnitude not seen since the losses experienced in the Great Depression, when depositors lost $1.4 billion with the closing of 9,755 banks.[144] By 1980, liabilities exceeded the market value of assets for the savings and loan industry as a whole by an estimated $150.5 billion, rendering it insolvent, but no major restructuring of the industry was undertaken until 1989.[145] In 1988, the FSLIC Insurance fund was reported to be at a level of minus $75 billion, and the ratio of losses to all insured deposits rose to 1.48 percent, a level that had not been exceeded since 1933.[146]

Between 1980 and 1994, 1,617 federally insured banks with $302.6 billion in assets were closed or received FDIC financial assistance.[147] During the same period, 1,295 savings and loans with $621 billion in assets were either closed by the FSLIC or the RTC or received FSLIC financial assistance. In total, these failed institutions held 20.5 percent of the assets in the banking system.[148]

2. Regulation and Deregulation

As a result of 1930s-era regulations, savings and loans were restricted to offering fixed-rate long-term residential mortgages that were financed by short-term, federally insured, passbook savings deposits.[149] Savings and loans traditionally earned their income on the spread between the higher long-run interest rates they charged on their mortgage loans and the lower

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[144] Federal Deposit Insurance Corporation, Managing the Crisis: The FDIC and RTC Experience 1980-1994 4 (Aug. 1998).

[145] Catherine England, *Regulatory Regimes and Markets: The Case of Savings and Loans* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 73 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004) citing Edward J. Kane, The Gathering Crisis in Federal Deposit Insurance 102 (1985).

[146] Federal Deposit Insurance Corporation, Managing the Crisis: The FDIC and RTC Experience 1980-1994 4 (Aug. 1998).

[147] Federal Deposit Insurance Corporation , Managing the Crisis: The FDIC and RTC Experience 1980-1994 4 (Aug. 1998).

[148] Federal Deposit Insurance Corporation , Managing the Crisis: The FDIC and RTC Experience 1980-1994 5 (Aug. 1998).

[149] Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 18 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

short-term interest they paid on their deposits.[150] In the two decades after World War II, interest rates were relatively stable, and few savings and loan institutions had difficulty earning adequate returns.[151] When interest rates began to rise in the mid-1960s, savings and loans received relief, beginning in 1966, from the application of Regulation Q, which was promulgated by the Federal Reserve.[152] Regulation Q capped the interest rate that savings and loans could pay for customer deposits, but set the rate that commercial banks could pay even lower, thereby giving savings and loans a competitive advantage.[153] This solution worked relatively well for a time because all the institutions offering federal deposit insurance were covered by Regulation Q's interest rate restrictions.[154] As the 1970s wore on, however, the stability of savings and loans was threatened by a combination of rising interest rates, increased inflation, and alternative sources of investment in high-interest vehicles such as money market accounts and mutual funds offered by non-bank entities like securities firms and insurance companies that were not covered by Regulation Q.[155]

In the early 1970s, several government studies warned of the dangers associated with the existing financial and regulatory structure of the savings and loans and urged reform.[156] Among the recommendations made by the Commissions formed to issue these reports were to permit adjustable rate mortgages (ARMs); to allow savings and loans to diversify their lending into other consumer and commercial fields; and to rescind Regulation Q.[157] These recommendations

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[150] Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 18 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[151] Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 19 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[152] *See* Anchor Sav. Bank, FSB v. U.S., 81 Fed. Cl. 1, 9 (Fed. Cl. 2008).

[153] *Id.* citing Act of Sept. 21, 1966, Pub. L. No. 89-597, 80 Stat. 823 (1966).

[154] Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 19 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[155] *See* Anchor Sav. Bank, FSB v. U.S., 81 Fed. Cl. 1, 10 (Fed. Cl. 2008).

[156] Catherine England, *Regulatory Regimes and Markets: The Case of Savings and Loans* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 64 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004) (describing the Commission on Financial Structure and Regulation, better known as the Hunt Commission, after Chairman Reed Hunt was appointed by President Richard Nixon and issued it report in 1971, and the House of Representative Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions Supervision, Regulation and Insurance also commissioned a study entitled Financial Institutions in the Nation's Economy (known as the FINE Study), completed in 1975, citing Davison, Lee, *Banking Legislation and Regulation* in History of the Eighties—Lessons for the Future, Washington, D.C.: Federal Deposit Insurance Corporation (1997)).

[157] Lawrence J. White, *The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 20 (James R. Barth, Susanne Trimbath, and Glenn

were not implemented for almost a decade. In 1979, Congress gave savings and loans the right to offer ARMs, thereby shifting a significant portion of the interest rate risk to the borrowers.[158] The Depository Institutions Deregulation and Monetary Control Act of 1980[159] eliminated Regulation Q's coverage of thrift and commercial bank deposits, and the Garn-St. Germain Depository Institutions Act of 1982[160] allowed thrifts to invest in a broader variety of assets than the traditional fixed-rate mortgages on one to four family homes.[161] They could now provide 100 percent financing, requiring no down payment; increase their consumer loans, up to 30 percent of their assets; make commercial, corporate and business loans; and invest in nonresidential real estate worth up to 40 percent of their total assets.[162] These statutes also contained provisions giving the FHLBB the authority to lower minimum net-worth requirements.[163]

In 1980, the FHLBB removed the 5 percent limit on brokered deposits, allowing thrifts access to unprecedented amounts of cash.[164] These deposits were placed by brokers who aggregated individual investments, which were then deposited as "jumbo" CDs.[165] Since the maximum insured deposit was $100,000, brokered deposits were packaged as $100,000 CDs, on which investors could command high interest rates.[166] This system was so attractive to everyone involved, the investors, the brokers who received commissions and the thrifts who received

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Yago, eds. 2004); David L. Mason, From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995 206-207 (2004).

158 The Alternative Mortgage Transaction Parity Act, enacted in 1982, 12 U.S.C. § 3801 et seq. Catherine England, *Regulatory Regimes and Markets: The Case of Savings and Loans* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 73 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

159 12 U.S.C. § 1735f-7a.

160 12 U.S.C. § 1701j-3 (2009).

161 Roger C. Kormendi, Victor L. Bernard, S. Craig Pirrong, & Edward A. Snyder, Crisis Resolution in the Thrift Industry: A Mid America Institute Report 14 (1989).

162 Kitty Clavita, Henry N. Pontell, Robert H. Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 12 (1997).

163 R. Dan Brumbaugh, Jr. and Catherine J. Galley, *The Savings and Loan Crisis: Unresolved Policy Issues* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 92 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

164 Kitty Clavita, Henry N. Pontell, Robert H. Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 12 (1997).

165 Kitty Clavita, Henry N. Pontell, Robert H. Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 12 (1997).

166 Kitty Clavita, Henry N. Pontell, Robert H. Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 12 (1997).

funds, that brokered deposits in savings and loans increased 400 percent between 1982 and 1984.[167]

During the early 1980s, regulators issued numerous forbearances that allowed savings and loans to avoid complying with certain rules, and broadened the definition of capital assets to include goodwill so that S&Ls could report higher net worths and avoid increased regulatory oversight.[168] In 1982, the FHLBB also dropped the requirement that shareholders could not own more than 25 percent of the stock in a thrift and that thrifts had to have at least 400 shareholders.[169] With these changes, single investors could start thrifts with noncash assets such as land or real estate.[170]

Economists who favor these changes believe they came too late to be effective, and were undermined by a flawed system of federal deposit insurance.[171] Most commentators on the subject believe that the federal deposit insurance system set up in the Great Depression creates a moral hazard for bankers because they do not have to avoid risk to attract customers or to protect themselves from loss.[172] Bankers can maintain low capital reserves, overvalue assets, and load their balance sheets with "toxic assets," without worrying about an adverse affect on deposits, since depositors have no incentive to shop around for the safest bank.[173] A key defect in the

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[167] Kitty Clavita, Henry N. Pontell, Robert H. Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 12 (1997).

[168] Roger C. Kormendi, Victor L. Bernard, S. Craig Pirrong, & Edward A. Snyder, Crisis Resolution in the Thrift Industry: A Mid America Institute Report 14 (1989).

[169] Kitty Clavita, Henry N. Pontell, Robert H. Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 12 (1997).

[170] Kitty Clavita, Henry N. Pontell, Robert H. Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 12 (1997).

[171] George G. Kaufman, *What Have We Learned From the Thrift and Banking Crises of the 1980s?* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 8 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004); *see also* Karsten F. Turck, The Crisis of American Savings & Loan Associations: A comprehensive analysis 85-87 (1998).

[172] George G. Kaufman, *What Have We Learned From the Thrift and Banking Crises of the 1980s?* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 8 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004) ("As has been discussed in the academic and profession literature *ad infinitum*, poorly designed insurance systems encourage both excessive moral hazard risk-taking by insured institutions and poor agency behavior by bank regulators (in the form of excessive forbearance).").

[173] *See* Homer Jones, *Banking Reform in the 1930s* in Regulatory Change in an Atmosphere of Crisis: Current Implications of the Roosevelt Years 82-83, 88 (Gary M. Walton, ed. 1979)(expressing reservations about the wisdom of federal insurance of deposits in banks and savings and loan associations on the grounds that it has removed the surveillance by bank customers of the soundness and capital structure of these institutions, which has led to a steady decline in the capital ratio of commercial banks, and noting that uniform rates of assessment give bankers a motive to minimize their capital investments but little motive to properly evaluate the risks of their

design of the insurance system was that the FSLIC created in 1934 to insure savings and loan accounts, [174] charged all savings and loans a flat premium for deposit insurance regardless of the risk inherent in an individual savings and loans' portfolio.[175] Since the FSLIC did not utilize other tools insurers commonly employ to prevent excessive risk taking, such as strict monitoring of the behavior of policyholders, deductibles, and effective limits on coverage, the rational manager of a savings and loan under this system had every incentive to increase the thrift's portfolio risk, especially as the thrift's asset base fell close to the level at which the government was required to cover the thrift's liabilities.[176] As long as their funds are insured, depositors will have no incentive to discipline banks for increased risk-taking by withdrawing their funds. The lack of pressure from depositors also means that there is less pressure on regulators to close banks that have taken on excessive risk on a timely basis when they can no longer meet the depositors' claims in full.[177]

In 1980, Congress increased deposit insurance coverage, from \$40,000 to \$100,000, a response Congress repeated during the subprime mortgage crisis, despite the fact that many commentators believe this decision played a significant role in contributing to the cause and severity of the S&L crisis by reducing depositor concern over the financial health of their insured depositories.[178] The structural incentives in the insurance system to engage in high-risk activities were not counterbalanced by regulatory discipline, but by the steps described above to lift the

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operations, a defect noted by many other economists (citing G.J. Benston, and J.T. Marlin, *Bank examiners' evaluation of credit*, Journal Money, Credit and Banking, 1974, *6*, 23-44; G.P. Dwyer, Jr., *The effects of the banking acts of 1933 and 1935 on capital investment in commercial banking*, Unpublished manuscript, 1978; S. Pelzman, *The costs of competition: an appraisal of the Hunt Commission Report*, Journal Money, Credit and Banking, 1972, *4*, 1001-1004; A.J. Schwartz, *Monetary trends in the U.S. and the U.K., 1878-1970*, Journal of Economic History, 1975, *35*, 138-159.).

[174] The FSLIC was created by Title IV of the National Housing Act in June of 1934. Formerly 12 U.S.C. § 1724, et seq., Repealed by § 407 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, P.L. 101-73, 103 Stat. 183 (1989) (hereinafter "FIRREA") effective August 9, 1989. *See also* § 401(a)(1) that abolished the Federal Savings and Loan Insurance Corporation, effective on the day of enactment of FIRREA.

[175] Roger C. Kormendi, Victor L. Bernard, S. Craig Pirrong, & Edward A. Snyder, Crisis Resolution in the Thrift Industry: A Mid America Institute Report 13 (1989); The Savings and Loan Crisis: Lessons from a Regulatory Failure 345 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[176] Roger C. Kormendi, Victor L. Bernard, S. Craig Pirrong, & Edward A. Snyder, Crisis Resolution in the Thrift Industry: A Mid America Institute Report 13-14 (1989).

[177] George G. Kaufman, *What Have We Learned From the Thrift and Banking Crises of the 1980s?* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 8 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[178] George G. Kaufman, *What Have We Learned From the Thrift and Banking Crises of the 1980s?* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 9 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds., 2004); *see also* Karsten F. Turck, The Crisis of American Savings & Loan Associations: A comprehensive analysis 85-86 ((1998).

restrictions on the thrift industry. Thus, the liberalization of restrictions on thrifts was seen as ill-timed for several reasons. By the time the restrictions were lifted, the interest rate pressures had continued for so long that many thrifts were at or close to insolvency, and therefore had little to lose from engaging in excessive risk-taking. In addition, Congress lessened regulatory oversight just when such oversight was most needed given the increase in flat-rate deposit insurance.[179]

3. The Secondary Mortgage Market

The subprime mortgage crisis has been blamed in large part on the securitization of mortgages, a practice that began with Depression-era laws designed to increase liquidity in the mortgage market. The practice grew in the years leading up to the S&L crisis, with the formation of Ginnie Mae and Freddie Mac, two entities that purchased mortgages for resale in the form of mortgage-backed securities (MBS), and with the development of increasingly complex forms of MBS.[180]

In 1938, Congress created Fannie Mae as a government agency that would purchase mortgages from savings and loans and then sell them to investors in the form of tax-exempt bonds.[181] Congress created the mortgage-backed securities market when it formed two entities, one public and one private, designed to enhance the flow of capital from the investment community to the residential mortgage market.[182] In 1968, Congress reorganized Fannie Mae into two separate corporations, transforming Fannie Mae into a "government sponsored enterprise," (GSE), with the corporate structure of a private entity.[183] The Government National Mortgage Association (GNMA or "Ginnie Mae") was created to take over the special assistance, management and liquidation functions of the old Fannie Mae.[184] Ginnie Mae began issuing

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[179] Roger C. Kormendi, Victor L. Bernard, S. Craig Pirrong, & Edward A. Snyder, Crisis Resolution in the Thrift Industry: A Mid America Institute Report 14 (1989).

[180] David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 Fordham J. Corp. & Fin. L. 709, 736 (2009).

[181] *See* Government Nat. Mortg. Ass'n v. Terry National Housing Act, 608 F.2d 614, 618 (5th Cir. 1979); National Housing Act Amendments of 1938, 52 Stat. 23 (1938), 12 U.S.C. § 1716, tit. III, et seq.; Martin Mayer, The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry 37-38 (1990).

[182] Anchor Sav. Bank, FSB v. U.S., 81 Fed. Cl. 1, 16 (Fed. Cl. 2008).

[183] Calhoun v. Fed. Nat'l Mortg. Ass'n, 823 F.2d 451, 452 (11th Cir. 1987) ("FNMA was reorganized in 1968 to create two separate corporations"), citing 12 U.S.C. § 1717(a)(2); Government Nat. Mortg. Ass'n v. Terry, 608 F.2d 614, 618 (5th Cir. 1979), citing the Housing and Urban Development Act of 1968, 12 U.S.C. §§1716b, 1717(a)(2); Werts v. Federal Nat. Mortg. Ass'n, 48 B.R. 980, 983 (D.C. Pa. 1985) ("In 1968, Congress specifically disassociated F.N.M.A. from its previous ownership and transferred it to private ownership. 2 U.S.Cong. & Admin. News 1968 at 2943-44. F.N.M.A. maintains the capital structure of a privately owned corporation. 12 U.S.C. § 1718….").

[184] Government Nat. Mortg. Ass'n v. Terry, 608 F.2d 614, 619 (5th Cir. 1979) ("HUD retained control over the special assistance functions and the management and liquidation functions by virtue of the Act's transfer of these operations to Ginnie Mae, which was specifically made part of HUD. *See id.* § 1717(a)(2)(A).")

mortgage backed securities comprised of FHA and VA insured mortgages.[185] In 1970, Congress formed a private entity, or GSE, called the Federal Home Loan Mortgage Corporation ("Freddie Mac"), that also issued mortgage backed securities.[186] In 1981, Fannie Mae itself began issuing MBS.[187]

Under legislative underwriting standards, Fannie Mae and Freddie Mac are limited to purchasing and securitizing "conforming mortgages,"[188] leaving open a market for securitization of "non-conforming" mortgages. When Bank of America issued the first so-called "private-label" MBS, it was promptly followed by banks, thrifts, homebuilders, and mortgage-banking companies that specialized in buying mortgages, pooling them, and issuing them as "pass through" securities.[189] This market in non-conforming mortgage securities was facilitated by the passage of the Secondary Mortgage Market Enhancement Act of 1984,[190] which made several changes in existing regulations designed to foster the growth of the private label secondary

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[185] Anchor Sav. Bank, FSB v. U.S., 81 Fed.Cl. 1, 16 (Fed. Cl. 2008) ("Fannie Mae was authorized to purchase "unconventional" mortgages-those insured by the [FHA], and later, the Veterans Administration ("VA")-from local lenders and hold them in portfolio, thereby replenishing the supply of lendable housing capital available to local lenders. In 1972, Fannie Mae began to purchase conventional mortgages, for the first time absorbing mortgage capacity that did not involve FHA or VA insurance.");Washington Federal Sav. and Loan Ass'n v. Federal Home Loan Bank Bd., 526 F. Supp. 343, 353 n.6 (D.C. Ohio 1981) ("[Ginnie Mae] purchases and sells mortgages insured or guaranteed by the Federal Housing Administration (FHA) and the Veterans Administration (VA). It issues GNMA pass-through certificates (Ginnie Maes). A GNMA pass-through certificate is a certificate representing shares in pools of mortgages which are insured by the FHA or VA. The individual pool consists of single-family home mortgages, each having the same interest rate and same approximate maturity. The payments of principal and interest on the mortgages are passed through GNMA to the holder of the certificate. GNMA guarantees the full and timely payment of principal and interest to the certificate holder.").

[186] Anchor Sav. Bank, FSB v. U.S., 81 Fed.Cl. 1, 16 (Fed. Cl.2008).

[187] Anchor Sav. Bank, FSB v. U.S., 81 Fed.Cl. 1, 16 (Fed. Cl. 2008).

[188] For the definition of conforming mortgages that are eligible for purchase by Fannie Mae, *see* 12 U.S.C. § 1717(b)(2) (2008) (loans secured by 1-4-family dwelling units with a principal balance no greater than 80% of the property value at the time of purchase (with limited exceptions). *See* Anchor Sav. Bank, FSB v. U.S., 81 Fed.Cl. 1, 17 (Fed. Cl. 2008) (underwriting standards for a conventional (not a FHA or VA insured mortgage), *conforming mortgage* must not exceed maximums for three categories, including: (1) payment-to-income ratio, measuring a borrower's capacity to make monthly payments; (2) loan-to-value ratio, measuring the amount of the mortgage loan *vis-a-vis* the appraised property value; and (3) loan amount, the maximum amount of which typically increases each year to keep pace with inflation.)

[189] Anchor Sav. Bank, FSB v. U.S., 81 Fed.Cl. 1, 17-18 (Fed. Cl. 2008), citing Kenneth G. Lore & Cameraon L. Cowan, Mortgage-Backed Securities Developments And Trends In The Secondary Mortgage Market 1-2 to 1-3 (2001); Frank J. Fabozzi, The Handbook of Mortgage Securities at 5-6, 31 (5th ed.2001);H. REP. NO. 98-994 at 38, 39 (Statement of Preston Martin, Vice Chairman, Board of Governors of the Fed. Reserve Sys.), *reprinted in* 1984 U.S.C.C.A.N. 2827, 2843.

[190] Pub. L. 98-440, Oct. 3, 1984, 98 Stat. 1689, 15 U.S.C.A. § 77r-1.

mortgage market.[191] These changes included broadening the transactional exemption from security registration requirements of the Securities Act of 1933 for MBS, and preempting state laws that restricted thrift ownership of private-label MBS.[192] The secondary mortgage market responded with rapid growth, and by 1985, trading in home mortgages and related debt had outpaced trading in the stock market, quadrupling to $2 trillion between 1981 and 1986.[193] While the laws permitting the sale of MBS and adjustable rate mortgages facilitated the subprime mortgage crisis of 2007, they also played an important role in mitigating the severity of the S&L crisis.[194] This does not mean, however, that the misuse of MBS could not have been anticipated.

Indeed, several commentators were able to predict the troubles to come based on the state of the law left in place after the S&L crisis. In 1990, Martin Mayer wrote that while the legislation Congress had passed in 1989 would prevent savings and loans from using insured deposits to buy corporate junk bonds, the law, "does little to control their gambling propensities in the mortgage paper market, which probably means that the carousel will come round again and the taxpayer will have to buy many more brass rings."[195] As he predicted, taxpayers have now spent $2.5 trillion to resuscitate the economy after the world's major financial institutions took $396 billion in write-downs on subprime mortgage assets.[196] In addition, two prominent economists published a paper in 1993 entitled, "Looting," that attributed several financial disasters of the 1980s, including the S&L crisis, to a combination of government regulation and government bailouts.[197] In the case of the S&L crisis, they argued that this mix allowed private owners of savings and loans to make loans and investments with federally insured deposits

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[191] Anchor Sav. Bank, FSB v. U.S., 81 Fed.Cl. at 19.

[192] Anchor Sav. Bank, FSB v. U.S., 81 Fed.Cl. at 19.

[193] David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 Fordham J. Corp. & Fin. L. 709, 736 (2009).

[194] As a federal judge observed in a recent decision canvassing the history of the S&L crisis:

> [T]he growth of a secondary mortgage market, where whole mortgages and mortgage-backed securities ('MBS') are sold to both depository institutions and general investors, enabled thrifts to escape the burdens of their fixed-rate mortgage portfolios and recycle capital into new ARM loans. This dynamic secondary market proved to be one of the primary means by which thrifts were able to remedy their maturity gap problems and better respond to interest rate gap problems.

Anchor Sav. Bank, 81 Fed.Cl. at 15.

[195] Martin Mayer, The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry 41 (1990).

[196] David Goldman, "CNN.Money.com's bailout tracker," last updated June 29, 2009; Yalman Onaran, "Subprime Losses Top $396 Billion on Brokers' Writedown Table," Bloomberg.com, last updated June 18, 2008.

[197] George A. Akerlof and Paul M. Romer, *Looting: The Economic Underworld of Bankruptcy for Profit*, 2 Brookings Papers on Economic Activity 1993.

without any concern for the downside risks.[198] When they finished writing the paper, one of the authors, Nobel prize-winner, George Akerlof, reportedly told the other, Paul Romer, an expert on economic growth, that the next candidate for "looting" was in the market for credit derivatives such as collateralized debt obligations.[199]

4. Bailouts and Reregulation

In 1989, the Bush administration and Congress came to the rescue of the savings and loan industry in what was termed, a "bailout."[200] In August of 1989, they enacted the Financial Institution Reform Recovery and Enforcement Act (FIRREA), which authorized an initial tranche of taxpayer funds, raised capital requirements, tightened savings and loans' lending restrictions, and included a ban on holding below investment grade ("junk") bonds.[201] The FHLBB and the FSLIC were abolished.[202] In their place, the Office of Thrift Supervision (OTS) was formed under the supervision of the Treasury Department to regulate and supervise federally and state chartered savings and loan associations.[203] FIRREA also created two new insurance funds to be administered by the FDIC: the Savings Association Fund for savings associations and the Bank Insurance Fund for banks.[204]

The Resolution Trust Corporation was created under FIRREA to continue the liquidation of the insolvent savings and loans associations once the FSLIC fund became insolvent.[205] By the

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[198] George A. Akerlof and Paul M. Romer, *Looting: The Economic Underworld of Bankruptcy for Profit*, 2 Brookings Papers on Economic Activity 1993.

[199] David Leonhardt, *The Looting of America's Coffers*, N.Y. Times, Mar. 11, 2009.

[200] Arthur W. Leibold, Jr., *Some Hope for the Future, After a Failed National Policy for Thrifts* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 42 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[201] Lawrence J. White, *The Savings and Loan Debacle: A Perspective from the Early Twenty-First Century* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 24 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[202] Section 301 of FIRREA; Section 401(a) of FIRREA; Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 743 (Dec. 1987).

[203] Section 301 of FIRREA; § 4 of HOLA, as amended; Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 743 (Dec. 1987).

[204] Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 743 (Dec. 1987).

[205] Section 501 of FIRREA; new § 21A of the Federal Home Loan Bank Act, 12 U.S.C. 1421, et seq.

end of the first of its five years in operation, the RTC had been appointed conservator of 531 thrifts containing $278.3 billion in assets.[206]

Two years later, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[207] Importantly, the FDICIA amended the flat-rate system of deposit insurance premium assessments by basing premiums on the risks that each institution poses to the appropriate insurance fund.[208] In addition, the FDIC was given the authority to deny insurance to any applicant based on the bank's failure to meet certain statutory factors.[209]

The FDICIA also adopted two new provisions to assist troubled depository institutions in a way that would result in the least possible long-term loss to the deposit insurance funds.[210] Under the "least cost test," any assistance the FDIC provides under section 13 of the Act must be necessary to meet the FDIC's obligation to protect the insured deposits in a failed or failing institution and be the least costly to the deposit insurance fund of all possible methods of meeting that obligation (less than liquidation and all other transactions).[211] Federal banking regulators must take "prompt corrective action" under the FDICIA when an insured depository institution falls within one of the three lowest of five specifically enumerated capital categories (well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized).[212] Such prompt corrective actions include increased monitoring, raising additional capital, requiring acceptance of an offer to be acquired, and closure of the institution.[213]

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[206] Federal Deposit Insurance Corporation, Managing the Crisis: The FDIC and RTC Experience 1980-1994 8 (Aug. 1998).

[207] Pub. L. 102-242, Dec. 19, 1991, 105 Stat. 2236, 12 U.S.C. § 1831m, et seq.; Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 744 (Dec. 1987).

[208] Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 746 (Dec. 1987).

[209] Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 746 (Dec. 1987).

[210] Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 745-46 (Dec. 1987).

[211] Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 744-45 (Dec. 1987).

[212] Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 745-46 (Dec. 1987).

[213] Federal Deposit Insurance Corporation, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s 746 (Dec. 1987).

These laws had little effect on regulators' actions regarding bank failures in the years preceding the subprime mortgage crisis. In a study published in 2004 of bank failures from 1995 to 2002, George Kaufman found that regulators had failed to learn the lessons of the S&L crisis under the prompt corrective action and least cost resolution regulations.[214] The failed banks in his study included institutions that concentrated in securitized sub-prime loans, and followed a strategy of holding on to the first dollar loss tranche, widely referred to as the "toxic waste" tranche.[215] Although the regulators were aware of the problem banks for years, they did not act with any sense of urgency when stalled, and did not follow through aggressively on their enforcement actions.[216] This approach led to "higher-cost failures" based in part on parochial concerns of the short-run well-being of the banking industry, and in part on an incentive structure designed to reward regulators for achieving low-cost failures.[217] Based on his 2004 findings, Kaufman asked, "If the regulators cannot deal efficiently and effectively with the current few failures of reasonably small banks, what will they do and how will they act if we ever have a larger number of failures again and particularly of larger banks?"[218]

If the prevailing view of the causes of the S&L crisis is accurate, the regulatory response to the Great Depression not only failed to prevent one of the most costly economic disasters to follow, but actually was instrumental in bringing it about. The question of why regulation may create rather than prevent the difficulties it was designed to redress, in this case bank failures, is beyond the scope of this paper. It is enough to observe that regulations have had this effect, with the Federal Reserve System powers being misused to prolong the Great Depression and the Depression-era regulations contributing significantly to the S&L crisis.

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[214] George G. Kaufman, *What Have We Learned From the Thrift and Banking Crises of the 1980s?* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 3 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[215] George G. Kaufman, *What Have We Learned From the Thrift and Banking Crises of the 1980s?* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 5 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004). These banks were First National Bank of Keystone and Superior Federal Savings. First National Bank of Keystone failed in 1999, with a cost to the FDIC, uninsured depositors and creditors of $800 million, or 75% of its assets, while Superior failed in 2001 with a respective cost of $500 million to $800 million (before a payment by its primary owner) or 20 to 40 percent of its assets. *Id.* at 4.

[216] George G. Kaufman, *What Have We Learned From the Thrift and Banking Crises of the 1980s?* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 6 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[217] George G. Kaufman, *What Have We Learned From the Thrift and Banking Crises of the 1980s?* in The Savings and Loan Crisis: Lessons from a Regulatory Failure 10 (James R. Barth, Susanne Trimbath, and Glenn Yago, eds. 2004).

[218] *Id.*

C. The Subprime Loan Crisis

As with the preceding financial disasters, the subprime loan crisis came on the heels of an era in which the prevailing political philosophy reflected a laissez-faire stance towards regulation. With two devastating financial crises preceding it, there was no shortage of legislation in place designed to prevent a third, and there is ample evidence that the government simply chose not to implement the applicable laws. Nearly every aspect of the mortgage business was subject to extensive laws and regulations.[219] Had regulators exercised their authority under these laws, there is little doubt that the subprime loan crisis would have been prevented, or at the very least mitigated greatly. This crisis did not arise because lawmakers and regulators were powerless to avert it, but because, as with the preceding disasters of similar scope, they were content to let financial institutions operate under minimal supervision during a period of prosperity, and to ignore warning signs that the foundation for this prosperity may not be sound.

The Federal Reserve has long enjoyed broad regulatory control over bank holding companies, member banks and state banks that are members of the Federal Reserve System, but in 1994 Congress gave the agency specific powers to eliminate the abuses engaged in by bank and nonbank subprime lenders. Under the Home Ownership and Equity Protection Act of 1994 (HOEPA), the Federal Reserve was to regulate banks and nonbank lenders to curb unfair, deceptive and predatory lending.[220] Congress directed the Federal Reserve to issue regulations under a mandate of sweepingly descriptive language. The statute authorizes the Federal Reserve to prohibit "acts or practices in connection with mortgages" found to be "unfair, deceptive or designed to evade the provisions of this section," and with mortgage refinancings associated with "abusive lending practices, or that are otherwise not in the interest of the borrower."[221] Despite this mandate to the Federal Reserve, HOEPA had virtually no impact on the growth of subprime

[219] *See* The Home Ownership and Equity Protection Act ("HOEPA"), 15 U.S.C. § 1601 et seq. (enacted in 1994, HOEPA gave the Federal Reserve the authority to regulate high interest rate mortgages);the Truth in Lending Act ("TILA"), 15 U.S.C. § 1001 (1968) (enacted in 1968, TILA requires extensive, and often complex disclosures in consumer credit transactions, including residential mortgages); the Real Estate Settlement Practices Act ("RESPA"), 12 U.S.C. § 2601-17 (1974) (enacted in 1971, RESPA imposes detailed disclosure obligations on lenders in residential mortgage transactions regarding settlement costs, charges and escrow payments scheduled for the first year of the loan); the Equal Credit Opportunity Act, ("ECOA") 15 U.S.C. § 1691 (1991) (enacted in 1991, the ECOA prohibits discrimination against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age, or because an applicant receives income from a public assistance program); the Credit Rating Agency Reform Act of 2006 ("CRARA"), 15 U.S.C. § 78o-7 (2009) (the CRARA requires credit rating agencies, such as the agencies that improperly rated MBS and CDO securities, to register and be regulated by the SEC and to develop rules to prevent conflicts of interest).

[220] 15 U.S.C.A. § 1639(l)(2). The FTC is then empowered to enforce any violation of a regulation promulgated by the Federal Reserve under the section. 15 U.S.C.A. § 1639(m).

[221] 15 U.S.C.A. § 1639(l)(2). HOEPA is incorporated into the Truth in Lending Act as a set of provisions that designate certain mortgages as "high-cost" loans, defined to cover mortgages with rates over 10 percent above rates for Treasury securities with comparable maturities or with fees and points that exceed the greater of 8 percent of the loan or $400. 15 U.S.C. § 1602(aa) (2000). The Federal Reserve has the authority to modify the mortgage trigger by regulation. 15 U.S.C. § 1602(2)(a) (2000).

mortgages, which rose dramatically after its passage.[222]

No action was taken under the 1994 statute by then Chairman of the Federal Reserve, Alan Greenspan, or by his successor Ben Bernanke, who took the helm in early 2006, despite the numerous internal and external warnings concerning predatory lending practices in the subprime lending market. In 2000, the same year HUD and the Treasury issued reports on predatory practices by subprime lenders, Federal Reserve Chairman Alan Greenspan declined the request of Edward Gramlich, the head of the Federal Reserve's Committee on Consumer and Community Affairs from 1997 to 2005, to send examiners into the mortgage-lending affiliates of nationally chartered banks to clean up abusive lending practices in the subprime market.[223] Greenspan later claimed that the terms "unfair" and "deceptive" under HOEPA were unclear, but he did not seek guidance from Congress, or from cases interpreting the TILA or FTC legislation using the same terms.[224] When Bernanke did act, in July of 2008, by issuing proposed regulations concerning subprime lending, he relied on his authority under the 1994 statute,[225] leaving no doubt that he understood that the Federal Reserve had this power all along, and that the statute's terminology posed no obstacle. In announcing these regulations, Bernanke commented that, "Although the high rate of delinquency has a number of causes, it seems clear that unfair or deceptive acts and practices by lenders resulted in the extension of many loans, particularly high-cost loans, that were inappropriate for or misled the borrower."[226]

The Federal Reserve also neglected to exercise authority it was given under legislation that was passed after the S&L crisis to avert future bank failures. Under the "prompt corrective action" provisions of the FDICA, the Federal Reserve is directed by Congress to prevent commercial and investment banks from reaching a point of insolvency at which they are deemed "too big to fail" and must be rescued.[227] Entities that fail to satisfy specified capital levels must raise capital, sell assets, or subject themselves to increased oversight and to a reduction or suspension of dividends.[228] From 2001 to 2008, the Federal Reserve was headed by chairmen who declined to implement statutes designed to prevent abuses in the subprime mortgage market and to avoid bank failures. If, as this evidence demonstrates, post-crisis legislation is only as

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[222] Todd J. Zywicki and Joseph D. Adamson, *The Law and Economics of Subprime Lending*, U. Colo. L. Rev. 1, 20 (2009) ("Originations in the subprime market grew from $65 billion in 1995 to $332 billion in 2003.").

[223] Edmund L. Andrews, *Fed Shrugged as Subprime Crisis Spread*, N.Y. Times, Dec. 18, 2007.

[224] *Id.*

[225] Truth in Lending Act, 73 Fed. Reg. 44,522-01, 44,529-31 (July 30, 2008). For details on this regulation, *see* David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 Fordham J. Corp. & Fin. L. 709, 755 (2009).

[226] Steven R. Weisman, *Fed Sets Rules Meant to Stop Deceptive Lending Practices*, N.Y. Times, July 15, 2008.

[227] M. Baily, Brookings Economic Studies 71.

[228] *Id.*

effective as the regulators who implement it, we should not continue to rely solely on regulatory solutions to these repeated financial disasters.

The investment banks that were trading in MBS were regulated by the Securities and Exchange Commission (the "SEC"), but the SEC's enforcement activities posed no obstacle to the wave of destruction caused by these banks' MBS trading. In fact, the SEC granted a key exemption from regulation in this area that actually increased the damage caused by MBS trading activities.[229] In April of 2004, the SEC met with representatives of five of the nation's largest financial institutions and agreed to grant their request for an exemption to the SEC's net capital rule for any bank with assets greater than $5 billion. This exemption allowed them to make highly-leveraged (12:1 to 30:1 or higher) investments in MBS, credit derivatives, and related instruments.[230] As the head of Goldman Sachs, Henry M. Paulson Jr. attended this meeting and joined in the request to allow highly-leveraged trading in MBS.[231] Two years later, as Treasury secretary, Paulson would direct the transfer of $25 billion in TARP funds to Goldman Sachs based on the firm's MBS losses.[232]

By 2000, the nation had a decade's worth of experience with subprime mortgages, but the statutes relevant to the subject had little if any impact on the tide of destruction these mortgages would wreck on the individual and collective fortunes of the country. The one area of the subprime mortgage crisis that may be considered "new" and therefore potentially beyond the scope of existing law – mortgage-backed derivatives – was intentionally exempted from coverage under the Depression-era law that was designed to cover securities of its kind. In 1998, near the end of the decade when mortgage-derivative securities first emerged,[233] Federal Reserve Chairman Alan Greenspan, Treasury Secretary Robert Rubin and his Deputy Lawrence Summers successfully opposed the recommendation made that year by the head of the CFTC, Brooksley Born, who called for the regulation of over-the-counter derivatives.[234] This recommendation took on further weight later that same year when the Federal Reserve had to engineer the bailout of the over trillion dollar failure of the hedge-fund, Long Term Capital Management, which had

[229] M. Baily, Brookings Economic Studies 112.

[230] Stephen Labaton, *The Reckoning: Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. Times, Oct. 3, 2008; Joseph E. Stiglitz, *Capitalist Fools*, Vanity Fair (Jan. 2009).

[231] CNNMoney.com, "Special Report, The bailed out Banks."

[232] *Id.* For a discussion of the concerns regarding the conflicts of interest raised by, among other issues, Paulson's extensive communications with the head of Goldman Sachs in the midst of the crisis, *see*, Gretchen Morgenson and Don Van Natta, Jr., *Paulson's Calls to Goldman Tested Ethics During Crisis*, N.Y. Times, Aug. 9, 2009, A1.

[233] David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 Fordham J. Corp. & Fin. L. 709, 735, n. 93 (2009).

[234] Manuel Moig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Undeeded Warning Is a Rueful Echo 10 Years On*, Washington Post, May 26, 2009; Joseph E. Stiglitz, *Capitalist Fools*, Vanity Fair (Jan. 2009).

engaged in heavy derivates trading.[235] Two years later, Congress exempted derivatives, including MBS derivatives, from regulation under the Commodity Exchange Act of 1936.[236] Over-the-counter derivates, still unregulated, have a current notional value of $680 trillion.[237]

All the laws necessary for lenders to begin offering the high-interest rate, adjustable-rate subprime mortgages at the heart of today's troubles were in force by the mid-eighties,[238] and government officials had ample warnings of their dangers long before the crisis hit in December of 2007. In June of 2000, HUD issued a report entitled, "Unequal Burden: Income and Racial Disparities in Subprime Lending in America," based on a study analyzing one million mortgages reported under the Home Mortgage Disclosure Act.[239] At the time the study was conducted, 80 percent of subprime lending consisted of refinancing loans, rather than on loans that enabled borrowers with poor credit to purchase their first home.[240] These subprime refinancing loans increased tenfold from 1993 to 1998.[241] The HUD report also found that blacks were being improperly steered into subprime loans regardless of their income level.[242]

Based on the HUD report's findings that subprime lenders often engaged in predatory lending practices, a joint HUD-Treasury Task Force on Predatory Lending was formed, with then Treasury Secretary Lawrence Summers as Co-Chair.[243] This Task Force issued a report

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[235] Manuel Moig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Undeeded Warning Is a Rueful Echo 10 Years On*, Washington Post, May 26, 2009; Joseph E. Stiglitz, *Capitalist Fools*, Vanity Fair (Jan. 2009).

[236] *See* Commodities Futures Modernization Act of 2000, 7 U.S.C.A. § 7a-3.

[237] Manuel Moig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Undeeded Warning Is a Rueful Echo 10 Years On*, Washington Post May 26, 2009.

[238] These statutes include the Community Reinvestment Act of 1977, which required that all banking institutions be evaluated to determine if they were adequately meeting the credit needs of their local community, the Depositary Institutions Deregulation and Monetary Control Act ("DIDMCA"), which allowed higher interest rates, and The Alternative Mortgage Transaction Parity Act, enacted in 1982, allowed lenders to offer adjustable rate mortgages and to use balloon payments. David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 Fordham J. Corp. & Fin. L. 709, 728-29 (2009).

[239] *See* Subprime Lending More Likely in Minority and Low-Income Areas RRR (August 2000), http://www.huduser.org/periodicals/rrr/rrr_7_2000/0700_1.html.

[240] *Id.*

[241] *Id.*

[242] Subprime loans were five times more likely in black neighborhoods than white, and homeowners in high-income black neighborhoods were twice as likely as homeowners in low-income white neighborhoods to have subprime loans. Subprime Lending More Likely in Minority and Low-Income Areas RRR (August 2000), http://www.huduser.org/periodicals/rrr/rrr_7_2000/0700_1.html.

[243] *See* Unequal Burden: Income and Racial Disparities in Subprime Lending in America (April 2000, 15 p.), at http://www.huduser.org/publications/fairhsg/unequal.html; (content last updated on 02/22/08).

entitled, "Curbing Predatory Home Mortgage Lending," based on information gathered at five "field forums." This report, issued in August of 2000, proposed a four-point plan to address predatory lending practices. Among the report's recommendations were placing a ban on lending to borrowers without regard to their ability to repay and providing information that was more timely and accurate on loan costs and terms.[244]

The GSEs, Fannie Mae and Freddie Mac, were also issuing their own reports in 2001 that should have raised concerns at the Federal Reserve that subprime loans were being used to implement deceptive practices. Research results issued by Fannie Mae indicated that close to 50 percent of all subprime borrowers could have qualified for a far less costly prime loan.[245] Public interest groups also released findings from studies sounding alarms regarding deceptive practices in the subprime market. For example, the Center for Responsible Lending estimated in a 2001 study that predatory loans cost consumers at least $9.1 billion a year.[246]

Regulators ignored these warnings until it was too late for corrective action to have any meaningful effect. In March of 2007, when regulators finally issued a guidance to establish standards on subprime lending, over 30 subprime lenders had already gone out of business.[247] And the Federal Reserve's regulations under HOEPA to control abusive practices by subprime lenders will not be effective until October 1, 2009, long after the damage has been done.[248] The repeated failure by administrative agencies to enforce regulations until after the boom has bust raises additional questions as to the efficacy of regulatory solutions.

1. Contracts of Adhesion Provide the Credit to Fuel the Economic Recovery

As in the Great Depression, the period of financial prosperity from 2001 to 2007 was largely financed by individuals who signed contracts of adhesion, in the form of mortgages and

[244] *See* Curbing Predatory Home Mortgage Lending 119 (June 2000), available at http://www.huduser.org/publications/hsgfin/curbing.html, (Content last updated on 03/31/05).

[245] Jennie Kennedy, *The Predatory Lending Trap*, Texas Observer, Feb. 1, 2002. Freddie Mac found that 35 percent of borrowers in the subprime market could qualify for prime market loans. *Id.*

[246] Sue Kirchhoff, *More U.S. home buyers fall prey to predatory lenders*, USA Today, available at http://www.usatoday.com/money/perfi/housing/2004-12-06-subprime-predatory-lending_x.htm.

[247] Edmund L. Andrews, *Fed Shrugged as Subprime Crisis Spread*, N.Y.Times, Dec. 18, 2007.

[248] *See* Regulation Z, 12 C.F.R. § 226; 73 Fed. Reg. 44,522 (July 30, 2008) (creditors offering high-cost loans are 1) prohibited from extending credit without regard to a consumer's ability to repay from sources other than the collateral itself; 2) required to verify income and assets used to determine repayment ability; 3) prohibited, with some exceptions, from charging prepayment penalties; and 4) required to set up escrows for taxes and insurance that can be cancelled by borrowers after the first 12 months) ; *see also* Steven R. Weisman, *Fed Sets Rules Meant to Stop Deceptive Lending Practices*, N.Y. Times, July 15, 2008. In an amendment to Regulation Z adopted on December 10, 2008, certain transaction-specific disclosure rules relating to the Mortgage Disclosure Improvement Act of 2008 will be effective two months earlier, on July 30, 2009. *See* 12 C.F.R. Part 226, Fed. Reg. Vol. 73, No. 238, 74989, Dec. 10, 2008.

other credit agreements, for debt they could not afford to repay.[249] According to Federal Reserve data, consumer credit and mortgage debt has risen, as a percentage of disposable income, from 77 percent in 1990 to 127 percent in 2007.[250] Between 2001 and 2006, Americans used refinancing and home equity loans to pull an unprecedented two trillion dollars in equity from their homes.[251] At the same time, savings rates steadily declined, from 9 percent of disposable income as the average savings rate of U.S. households between 1950 and 1985, down to zero percent of disposable income in 2008.[252]

The environment of easy credit that made this volume of credit-backed consumption possible was created by the monetary policies of the Federal Reserve. After the stock market crashed in 2000 as a result of the collapse of the dot-com bubble, the Federal Reserve lowered short-term interest rates to pull the nation out of the recession that followed, and kept them low through 2004, despite concerns about an inflationary bubble in the housing market.[253] The inflationary bubble in the housing market began with the low mortgage rates that followed on the heels of the Federal Reserve's cap on rates. Low mortgage rates made buying a home possible for more Americans, but increased demand also drove up home prices.[254] Sky-rocketing prices made taking on high levels of mortgage debt a necessity for an increasing number of home buyers.[255] Conversely, in an environment of rising prices, lenders offering low "teaser" adjustable rate loans told borrowers that in two or three years the price of their homes would increase sufficiently so that they could re-finance their loan at a lower rate.[256]

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[249] As Joseph Stiglitz has recently observed, "The economy has been sustained by excessive borrowing." Joseph E. Stiglitz, *Capitalist Fools*, Vanity Fair (Jan. 2009).

[250] *The End of the Affair,* The Economist, Nov. 22, 2008, at 39, citing as its source the Federal Reserve, U.S. Bureau of Economic Analysis.

[251] ACORN Fair Housing, Foreclosure Exposure: A Study of Racial and Income Disparities in Home Mortgage Lending in 172 Cities 8 (2007), available at www.research@acorn.org.

[252] *The End of the Affair,* The Economist, Nov. 22, 2008, at 39, citing as its source the Federal Reserve, U.S. Bureau of Economic Analysis.

[253] Edmund L. Andrews, *Fed Shrugged as Subprime Crisis Spread*, N.Y. Times, Dec. 18, 2007.

[254] Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression 105 (2009).

[255] *See* Jonathan Macey, Geoffrey Miller, Maureen O'Hara and Gabriel D. Rosenberg, *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. Corp. L. 789, 800 & n. 58 (2009) ("property prices began to rise on account of increased demand from successful borrowers"). U.S. home prices more than doubled in the early part of the decade before reaching a peak in 2006. Bob Willis, "S&P/Case-Shiller U.S. Home-Price Index Falls 14.4% (Update 4)," available at http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=a4LbdWxjwlu0. Rising home prices are also reflected in the House Price Index published by the Office of Federal Housing Enterprise Oversight (now part of the Federal Housing Finance Agency), which increased every quarter from 1991 through the third quarter of 2007.

[256] M. Baily, Brookings Economic Studies 17.

Once the economy recovered from the 2001 recession, the boom that followed included a huge expansion of mortgage lending, a growing portion of which was in subprime, Alt-A or home equity loans.[257] In 1994, less than five percent of all mortgages in the U.S. were subprime, but by 2004, subprime loans grew to 11 percent of total mortgage originations.[258] In 2005 and 2006, these loans represented 20 percent of all originations.[259] Meanwhile, mortgages issued from 2004 onwards had increasingly higher 90-day delinquency rates.[260]

2. Average Income

The ability of the average borrower to repay his debts, based on his earnings and the cost of living, has not kept pace with the massive increases in the debt he has taken on since the 1990s. The increase in real median household income from 2001 to 2007, adjusted for inflation, amounts to a difference of under $800.[261] Unemployment in the years from 2001 to 2007 ranged from a monthly low of 4.4 percent to a high of 6.3 percent.[262]

3. Rising Mortgage Debt

In 2006 and 2007, home mortgage debt represented over 75 percent of gross domestic product, up from the average of 46 percent during the 1990s.[263] By the end of 2008, home mortgage debt had increased to $10.5 trillion, necessitating a cut of $6.6 trillion to reach the 46 percent of GDP level of the 1990s.[264]

4. Bank Failures Lead to Government Bailouts

Beginning in 2007, banks and financial institutions began reporting massive losses from their holdings of mortgage backed securities and mortgage-related derivates. One of the first signs of trouble came in July of 2007 with the announcement by Bear Sterns that two of their

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[257] M. Baily, Brookings Economic Studies 14. Alt-A loans are made to borrowers who have good credit ratings but do not provide full income and asset documentation. *Id.* at 24.

[258] M. Baily, Brookings Economic Studies 14; Tony Favro, *U.S. subprime mortgage crisis hurts individuals and whole communities*, City Mayors Finance, April 14, 2007.

[259] M. Baily, Brookings Economic Studies 14.

[260] M. Baily, Brookings Economic Studies 15 (A 90-day delinquency means that the mortgage payment is at least ninety days overdue).

[261] *See* U.S. Department of Commerce, U.S. Census Bureau, available at www.ensus.gov/hhes/www/income/income.stats.html (real median household income rose from $42,228 in 2001, or $49,438 in 2007 dollars, to $50,233 in 2007).

[262] U.S. Department of Labor, Bureau of Labor Statistics; available at http://data.bls.gov/PDQ/servlet.

[263] Colin Barr, *The $4 Trillion housing headache*, CNN Money.com (May 27, 2009) available at http://money.cnn.com/2009/05/27/news/mortgage.overhand.fortune/index.htm.

[264] *Id.*

MBS hedge funds, which were valued at $1.5 billion at the end of 2006, were virtually worthless.[265] Given this announcement, and the rapidly increasing rate of home foreclosures, concerns were raised that other financial institutions may also be holding over-valued mortgage-backed securities.[266]

The government bailouts began with Bear Stearns, with the Federal Reserve saving the firm from bankruptcy in March 2008 by assuming $30 billion in liabilities and arranging a sale to JP Morgan Chase for one-tenth of Bear Stearn's market price.[267] This bailout was followed by a rash of bank failures and takeovers in September of 2008. After watching the shares of Fannie Mae and Freddie Mac fall steadily throughout August, federal authorities seized the two GSEs on September 7, 2008 with federal guarantees of $200 billion each.[268] On September 13, 2008, Merrill Lynch, the largest player in the market for mortgage CDOs, sold itself to Bank of America for $50 billion, half its value of $100 billion the previous year.[269] Lehman Brothers, another major investment bank that had invested heavily in subprime securities, was forced to file for bankruptcy on September 15, 2008 after the Treasury failed in its efforts to convince Wall Street firms to come up with an industry solution.[270]

After the fall of Lehman Brothers, depositors began withdrawing their funds from Washington Mutual. Washington Mutual was the nation's largest savings and loan, with $307 billion in assets, many of them comprised of subprime mortgages.[271] On September 24, 2008, Washington Mutual was seized by federal regulators, in the largest bank failure in U.S. history.[272] The bank was then sold to JP Morgan Chase for $1.9 billion, with Chase agreeing to

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[265] Gretchen Morgenson, *Bear Stearns Says Battered Hedge Funds Are Worth Little*, N.Y. Times, July 18, 2007.

[266] In 2006, home foreclosures hit what was then a record-setting 1.3 million, followed by 2.2 million in 2007. Elizabeth Warren, *Making Credit Safer*, Harvard Magazine (May-June 2008).

[267] Andrew Ross Sorkin, *JP Morgan Pays $2 Share for Bear Stearns*, NY Times, Mar. 17, 2008.

[268] Stephen Labaton and Edmund L. Andrews, *In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, N.Y. Times, Sept. 8, 2008; James R. Hagerty, Ruth Simon & Damian Paletta, *U.S. Seizes Mortgage Giants--Government Ousts CEOs of Fannie, Freddie; Promises up to $200 Billion in Capital*, Wall St. J., Sept. 8, 2008, at A1;David Goldman, *CNN.Money.com's bailout tracker*, last updated June 29, 2009 ($84.9 billion of these guarantees have been invested).

[269] Andrew Ross Sorkin, *Lehman files for Bankruptcy, Merrill is Sold*, N.Y. Times, Sept. 14, 2008; Gretchen Morgenson, *How the Thundering Herd Faltered and Fell*, N.Y. Times, Nov.8, 2008; Matthew Karnitschnig, Carrick Mollenkamp & Dan Fitzpatrick, *Bank of America to Buy Merrill*, Wall St. J., Sept. 15, 2008, at A1.

[270] Eric Dash, *U.S. Gives Banks Urgent Warning to Solve Crisis*, N.Y. Times, Sept. 12, 2008; Andrew Ross Sorkin, *Lehman files for Bankruptcy, Merrill is Sold*, N.Y. Times, Sept. 14, 2008; Joe Nocera and Edmund L. Andrews, *The Reckoning: Struggling to Keep Up as the Crisis Raced On*, N.Y. Times, Oct. 22, 2008.

[271] Eric Dash and Andrew Ross Sorkin, *Government Seizes WaMu – Sells Some Assets*, N.Y. Times, Sept. 25, 2008.

[272] *Id.*

absorb $31 billion in losses.[273] Losses experienced by the insurance giant AIG in credit default swaps led to an $85 billion government bailout of the firm on September 15, 2008.[274]

On Sept. 18, 2008, Treasury Secretary Henry M. Paulson Jr. announced a three-page, $700 billion proposal that would allow the government to buy toxic assets from the nation's biggest banks with the goal of restoring confidence in the financial system.[275] After several failed attempts, the administration succeeded in obtaining the passage, in October of 2008, of the Emergency Economic Stabilization Act (EESA).[276] The Act gave the Secretary of the Treasury up to $700 billion to purchase or guarantee "troubled assets" through the Troubled Asset Relief Program or "TARP."[277] Treasury then changed course, announcing a plan to use $250 billion to make equity investments in banks to encourage lending, beginning with an investment of $115 billion in seven of the nation's largest banks on October 28, 2008.[278] By November, stock markets had reached their lowest levels in a decade.[279] By the end of President Bush' administration, the Treasury had distributed $350 billion in TARP funds, but the banks chose to use the money to fund acquisitions and bolster their balance sheets rather than to increase their lending activities.[280]

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[273] Eric Dash and Andrew Ross Sorkin, *Government Seizes WaMu – Sells Some Assets*, N.Y. Times, Sept. 25, 2008; Robin Sidel, David Enrich & Dan Fitzpatrick, *WaMu is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History*, Wall St. J., Sept. 26, 2008, at A1.

[274] Edmund L. Andrews, Michael J. de la Merced and Mary Williams Walsh, *Fed's $85 Billion Loan Rescues Insurer*, N.Y. Times, Sept. 16, 2008; Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout*, Wall St. J., Sept. 17, 2008, at A1.

[275] David M. Herszenhorn, *Administration Is Seeking $700 Billion for Wall Street*, N.Y. Times, Sept. 20, 2008.

[276] 12 U.S.C. §§ 5211, 5212 (2009)

[277] 12 U.S.C. § 5211 (2009).

[278] Mark Landler, *U.S. Investing $250 Billion in Banks*, N.Y. Times, Oct. 13, 2008; CNN.Money.com, *Bailed out Banks*, available at http://money.cnn.com/news/specials/storysupplement/bankbailout.

[279] Vikas Bajaj and Jack Healy, *Stocks Drop Sharply and Credit Markets Seize Up*, N.Y. Times, Nov. 19, 2008.

[280] *See* Neil Barofsky, Special Inspector General for the Troubled Asset Relief Program, Testimony Before the House Committee on Financial Services Subcommittee on Oversight and Investigations, July 22, 2009 (explaining that Treasury did not require recipients to track their use of TARP funds, but that the recipients provided responses to survey letters, indicating that they used TARP funds to avoid a "managed" reduction in their activities, to acquire other institutions, to invest in securities, to pay off debts, to avoid coming to a "standstill" in their lending activities, and to retain as a cushion against future losses); David Lawder, David Alexander and Ajay Kamalakaran, *Panel Criticizes Treasury Use of TARP Funds*, Reuters, Jan. 9, 2009, (Congressional oversight panel report finds that there is no evidence Treasury funds were used to support the housing market and assist homeowners as Congress intended), available at http://uk.reuters.com/article/idUKTRE5083OJ20090109; Binyamin Appelbaum, *Bailout Overseer Says Banks Misused TARP Funds*, July 20, 2009 (reporting that banks receiving TARP funds used them to make investments, repay debts or buy other banks).
http://www.treas.gov/press/releases/docs/05142009ProgressReport.pdf

5. Regulatory Reforms

Washington has reacted to the subprime mortgage crisis with a host of proposed legislative reforms, most of them placing few burdens on the financial institutions most directly responsible for the current state of affairs. The first major reform legislation passed in response to the crisis, the Housing and Economic Recovery Act of 2008,[281] included the HOPE for Homeowners Act, which was designed to encourage lenders to cooperate in a voluntary FHA refinancing program for homeowners facing foreclosure.[282] But after eight months, the program had assisted only one homeowner in obtaining a more affordable loan.[283] In May of 2009, the Helping Families Save Their Homes Act,[284] amended the HOPE for Homeowners Act by liberalizing some of its restrictions and adding $1,000 incentive payments to loan servicers. And in March of 2009, President Obama announced a $75 billion "Making Homes Affordable" program, but by July of 2009 only 235,247 "trial modifications" had begun under the program.[285]

Another section of the 2008 Act is designated as the Secure and Fair Enforcement for Mortgage Licensing Act of 2008.[286] These provisions are exhortative only, providing that the "states are hereby encouraged" to establish a "Nationwide Mortgage Licensing System and Registry."[287] While a uniform licensing system for mortgage brokers may or may not have advantages that outweigh state experimentation and autonomy, uniformity without enforcement is surely pointless, and state licensing regulations were often honored in the breach prior to the

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[281] 12 U.S.C. § 4511 et seq. (2009).

[282] 12 U.S.C.A. § 1715z-23 (2009).

[283] Ranae Merle, *Face-Lift for Foreclosure Prevention*, The Washington Post, May 26, 2009 available at http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502272_pf.html; Les Christie, *HOPE Prevents 1 Foreclosure*, CNNMoney.com, Mar. 25, 2009, available at http://cnnmoney.printthis.clickability.com/pt/cpt?action=cpt&title=HOPE+for+Homeowners+-+not+dead+yet+-+Mar.+25%2C+2009&expire=-1&urlID=34929969&fb=Y&url=http%3A%2F%2Fmoney.cnn.com%2F2009%2F03%2F25%2Freal_estate%2Fnew_hope_plan%2Findex.htm&partnerID=2200.

[284] May 20, 2009, Pub. L. 111-22, 202(a)(4), 123 Stat. 1641, 12 U.S.C.A. § 1715z-23 (2009).

[285] *See Details and eligibility requirements of the 'Making Home Affordable' program*, Boston Globe, Mar. 4, 2009, available at http://www.boston.com/news/nation/articles/2009/03/04/details_and_eligibility_requirements_of_the_making_home_affordable_program?mode=PF; Making Home Affordable, *Servicer Performance Report Through July 2009*, available at http://www.google.com/search?source=ig&hl=en&rlz=1G1GGLQ_ENUS288&q=making+home+affordable+report&aq=f&oq=&aqi=.

[286] 12 U.S.C.A. §§ 5101-5116 (2009).

[287] 12 U.S.C.A. § 5101 (2009).

subprime crisis.[288] Finally, the 2008 Act amends TILA to increase its already voluminous disclosure requirements, a well-intentioned but potentially fruitless effort that may add complexity rather than clarity to closing day mortgage paperwork. [289]

Campaign finance reform is disturbingly low on the remedial agenda given its importance in creating effective regulatory systems. Only campaign finance reform has a chance of interrupting the pattern that will repeat itself with Congress' headlong rush to eviscerate the reform legislation it enacts today once the economy recovers, and the politics of deregulation are again in vogue. Even after receiving massive taxpayer-supported bailout payments, financial institutions had the power over legislators necessary to defeat legislation intended to permit homeowners to submit their primary residences for resolution in bankruptcy, just as individuals may currently do for their vacation homes, farms and ranches.[290] The eight million homeowners currently predicted to face foreclosure are no match for the banking industry, according to the bill's sponsor, who described the industry as the "most powerful lobby on Capitol Hill" after failing to overcome the opposition of banking industry lobbyists to the bill's passage.[291]

II. Existing Law and Legal Theory on Contracts of Adhesion

Parties to adhesion contracts who unwittingly sign mortgages, installment sale contracts and other adhesion contracts binding them to debt obligations they cannot afford to repay do not have a mechanism for challenging these contracts under the law as currently applied, or under

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[288] In Florida, the state with the nation's highest rate of mortgage fraud, state regulatory authorities granted broker licenses to thousands of individuals with criminal records from 2000 to 2007. Jack Dolan, Rob Barry and Matthew Haggman, *Borrowers Betrayed: Ex-convicts active in mortgage fraud*, The Miami Herald (2008), available at http://www.miamiherald.com/multimedia/news'/mortgage/brokers.html.

[289] The Mortgage Disclosure Improvement Act of 2008, 15 U.S.C.A. § 1638 (2009), effective July 30, 2009.

[290] In discussing the bill on the PBS program, "Bill Moyer's Journal," its sponsor, Illinois Senator, Richard Durbin, explained that its defeat was a result of strong opposition by the banking industry. Transcript of the Bill Moyers Journal, May 8, 2009, available at http://www.pbs.org/moyers/journal/ transcript1.html . On the floor of the Senate, he argued that having come up with the political will to bail out the banks responsible for the financial crisis, Congress should not fail to provide the modest assistance of bankruptcy relief provided to the well-to-do for vacation homes for the primary residences of the 8 million U.S. homeowners that Moody's predicts will face foreclosure. *Id.* A report issued on May 1, 2009 by the Center for Public Integrity, found that in the last ten years the 25 largest originators of subprime mortgages (entities which were owned or financed by institutions that have received billions in TARP funds), spent $370 million in Washington to fight regulation. Center for Public Integrity, *Who's Behind the Financial Meltdown?* (May 1, 2009), available at http://www.publicinterity.org/investigation/economic_meltdown. *See also* Stephen Labaton, *Senate Refuses to Let Judges Fix Mortgages in Bankruptcy*, N.Y. Times, May 1, 2009 ("In recent weeks, major banks and bank trade associations worked closely with Senate Republicans to stop the measure.").

[291] Transcript of the Bill Moyers Journal, May 8, 2009, available at http://www.pbs.org/moyers/journal/ transcript1.html .

the various modifications recommended by scholars.[292] Under current law, courts treat contracts of adhesion no differently from fully negotiated contracts, that is, as fully enforceable absent a valid defense.[293] This position might be justified on the grounds that certain defining elements of contracts of adhesion – the inequality of bargaining power between the parties and the inability of the non-drafting party to bargain over the contract's terms[294] -- are not prerequisites to contract formation.[295] However, traditional contract doctrine does require mutual assent to form a contract.[296] Mutual assent ordinarily takes the form of an offer followed by acceptance.[297] Courts determine whether a party has accepted an offer based on an objective interpretation of his words or conduct, rather than on his subjective intent.[298] To form a contract, the offeree must accept, and not vary, the terms of the offer.[299] It is widely recognized that adhesion contracts are designed with the intent that the non-drafting party will not understand or even read them,[300] so it is difficult to see how the non-drafting party could have accepted the contract's terms, and therefore how a contract could be formed under traditional offer and acceptance doctrine.

Courts have solved this formation dilemma in two steps. First, they hold that under the objective theory of assent, the non-drafting party's signature constitutes an objective manifestation of his assent, since the act of signing a contract is reasonably interpreted as a sign that the party has accepted the terms of the contract.[301] Second, courts conclude that under the

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[292] This paper will not attempt to resolve the debate over whether the current credit crisis is primarily the fault of greedy homeowners who bought "more house than they could afford" as opposed to overreaching brokers who misled innocent homeowners into signing unsuitable mortgages. Rather, because regulation failed in preventing either phenomena, and the latter was clearly present, as demonstrated by both civil and criminal enforcement efforts, homeowners should have an opportunity to understand their loans before they sign them.

[293] *See e.g.*, Graham v. Scissor-Trail, Inc., 28 Cal 3d 807, 623 P.2d 165, 172 (1981) ("(A) contract of adhesion is fully enforceable . . . unless certain other factors are present which, under the established legal rules . . . operate to render it otherwise.");Heller Fin. v. Midwhey Powder Co., 883 F.2d 1286 (7th Cir. 1989) (finding that there was no reason to treat "adhesion contracts or form contracts differently.").

[294] *See* Acorn v. Household Internat'l, Inc., 211 F. Supp. 2d 1160 (N.D. Cal. 2002) (defining an adhesion contract as a "standardized contract, which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party on the opportunity to adhere to the contract or reject it.").

[295] E. Allen Farnsworth, Contracts, § 2.6 at 55 (2004) ("[I]t is not required that the parties actually bargain over the terms of their agreement.").

[296] Restatement (Second) of Contracts § 17 (1981).

[297] Restatement (Second) of Contracts § 22 (1981).

[298] E. Allan Farnsworth, Contracts §§ 3.3, 3.6, at 110-116 (4th ed. 2004); Restatement (Second) of Contracts §§ 19, 21 (1981).

[299] Restatement (Second) of Contracts §§ 17, 22 (1981); E. Allan Farnsworth, Contracts, §3.13 at 143.

[300] *See supra* note 9.

[301] E. Allan Farnsworth, Contracts, §3.6 at 115.

"duty to read" rule, the adherent is bound by the terms of the contract even if he did not read or understand them.[302] Courts reach this conclusion even though they also recognize that the parties who draft adhesion contracts do so with the intent that the recipient will not read or understand the contract before he signs it, and that this characteristic of adhesion contracts is exactly what is thought to make them indispensible to modern commerce.[303]

In early decisions on the duty to read rule, the main policy rationale the courts relied on was the "gross negligence" of individuals who failed to inform themselves of the contents of the contract before signing it.[304] From this perspective, even fraudulent misrepresentations made by the drafting party's agent concerning the terms of the parties' agreement may not supply a defense to enforcement, since the adherent could have discovered the true terms had he complied with his duty to read the contract, or read and understood the statutorily mandated disclosures.[305]

Placing a duty to read on the non-drafting party regardless of the circumstances may serve values of formalism, such as certainty and efficiency, and if these advantages were significant, might excuse unjust results in isolated cases. But the rule is terribly unfair when applied to contracts of adhesion, not only in a few outlying cases, but as a rule, because the drafting party knows its contract will not be read or understood. For the same reason, the rule violates the objective theory of assent because the drafting party has no reasonable basis for believing that the adherent's signature constitutes evidence that he read or understood the terms of the contract before signing it. As for the policy concerns of the early "duty to read" cases, the non-drafting party has not engaged in "gross negligence" when both parties to the adhesion contract are aware that the contract is not intended to be read or understood before it is signed by the non-drafting party. In a growing number of cases, the consumer does not even have an opportunity to read the form contract before making the purchase. These include "shrink-wrap" transactions, where the detailed terms of sale are inside the product's sealed package, and cases where an insurance policy or credit card agreement is mailed to the buyer after the commitment has been made. Yet even here, courts continue to cling to the "duty to read" rule to support the

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[302] E. Allan Farnsworth, Contracts, §4.26 at 287. *See also* Gaunt v. John Hancock Mutual Life Ins. Co., 160 F.2d 599, 602 (2d Cir. 1947), J. Learned Hand (stating the traditional rule that "a man must indeed read what he signs, and he is charged if he does not . . . "); John D. Calamari, Duty to Read--A Changing Concept, 43 Fordham L. Rev. 341 (1974).

[303] *See* Restatement (Second) of Contracts § 211 Comment b ("A party who makes regular use of a standardized form of agreement does not ordinarily expect his customers to understand or even read the standard terms . One of the purposes of standardization is to eliminate bargaining over details of individual transactions, and that purpose would not be served if a substantial number of customers retained counsel and reviewed the standard terms.").

[304] *See* discussion of Morstade v. Atchinson T. & S.F. Railway Co., 170 P. 886, 890 (N.M. 1918), in Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. Miami L. Rev. 1263 (1993).

[305] *See* Gilliard v. Fulton Federal Savings & Loan, 356 S.E. 2d 734, 735 (Ga. App. 1987); Martinez Tapia v. Banque Indosuez, 1999 U.S. App. LEXIS 29260 (2d Cir. Nov. 3, 1999); Lanier v. Associates Finance, Inc., 499 N.E.2d 440, 447 (Ill. 1986); Dowagiac Mfg. Co. v. Schroeder, 84 N.W. 14,14 (Wis. 1900).

fiction that the consumer has given his assent to the contract terms supplied by the drafting party, sight unseen.[306]

Beginning with Karl Llewellyn, scholars have created special categories for the terms of adhesion contracts that are negotiated, but this distinction is significant to enforcement only to the extent that negotiation of a term signals the adherent's notice and assent to the negotiated term.[307] Bargaining itself is not required as long as the offeree accepts the terms of the drafting party's offer,[308] and in the vast majority of transactions the consumer cannot negotiate any of the terms of the contract, including price. The flea market, garage sale, and car dealership are among the few remaining venues left to the consumer for bargaining. When a consumer seeks better terms on a mortgage or insurance policy he is presented with a choice among form contracts, but the terms of the contracts are not altered to fit his needs. In this sense he has not negotiated the terms of any form contract but has simply been offered a choice of terms selected by the drafting party. Work in the area of adhesion contracts has emphasized the lost power of bargaining over that of assent, which leads to the erroneous conclusion that adhesion contracts must be enforced despite the lack of assent to their terms, since bargaining is impossible.[309] But assent requires only understanding and agreement, which can be achieved even in today's marketplace.

Preservation of the adherent's actual rather than fictional assent to the terms of an adhesion contract is critical because it preserves his option, as offeree, of turning down the offer if its terms are unacceptable. Unless this option is preserved, the contract is simply an embodiment of the will of the drafting party imposed upon the adherent by the courts.[310]

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[306] *See* W. David Slawson, *Standard Form Contracts and Democratic Control of Law-making Power*, 84 Harv. L. Rev. 529, 540-41 (1971); Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569 (1998); Hill v. Gateway 2000, Inc., 105 F.3d 1147, 1149 (7th Cir. 1997).

[307] Karl N. Llewellyn, The Common Law Tradition: Deciding Appeals 371 (1960) (in boilerplate contracts, specific assent is given to "the few dickered terms"); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1251 (1983) (creating a category of "visible" terms, based on terms that adherents generally bargain for or "shop" vs. "invisible" terms); Richard L. Barnes, *Rediscovering Subjectivity in Contracts: Adhesion and Unconscionability*, 66 La. L. Rev. 123, 187 (2005).

[308] E. Allen Farnsworth, Contracts § 2.6 at 55 (2004) ("[I]t is not required that the parties actually bargain over the terms of their agreement.").

[309] *See* Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629 (1943); Leff, *Unconscionability and the Crowd – Consumers and the Common Law Tradition*, 31 U. Pitt. L. Rev. 349 (1969-1970); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529 (1971).

[310] Llewellyn discussed the one-sided nature of non-bargained for standardized contracts as follows: "Law, under the drafting skill of counsel, now turns out a form of contract which resolves all questions in advance in favor of one party to the bargain. It is a form of contract which, in the measure of the importance of the particular deal in the other party's life, amount to the exercise of unofficial government of some by others, via private law." Karl Llewellyn, *What Price Contract? – An Essay in Perspective,* 40 Yale L. J. 704, 731 (1930-1931).

Furthermore, the adherent's option of turning down unacceptable terms cannot be preserved without informed assent, and informed assent requires adherence to the objective theory of assent. The objective theory of assent cannot be satisfied if the adherent has no hope of understanding the terms of the contract, since a reasonable person would not agree to an offer if he did not understand its terms. Such an understanding is impossible if the terms of the contract are intentionally written so that they will be too long and incomprehensible for the offeree to read before signing the contract. The problem cannot be avoided by presuming that the offeree is wise to the game – that he knows that he will be bound by terms he has not read or understood. This presumption would only be valid if the offeree had some choice in the matter. The offeree in today's marketplace has no such choice, given the near universal use of adhesion contracts for consumer transactions. Since he cannot obtain the same goods or services without signing an adhesion contract, he has not exercised assent to the terms of the adhesion contract forced upon him by the marketplace and the courts.

The significance of informed assent in the law of contract is also expressed in the law's provision of remedies for misrepresentation and non-disclosure of material information prior to contract formation.[311] At one extreme, where the offeror misrepresents the nature of the contract itself, in what is known as fraud in the factum, the contract is void on formation grounds, just as it would be under general principles of assent.[312] In the more common cases involving fraud in the inducement, the contract is voidable if the recipient can establish his justifiable reliance on a misrepresentation or omission relating to a material fact relating to the contract.[313] Moreover, conduct (such as signature) that appears to be a manifestation of assent is not effective if it is induced by a misrepresentation or omission of essential terms and the individual giving the apparent assent did not know or have a reasonable opportunity to know the terms.[314] This traditional doctrine is difficult to reconcile with the courts' attitude that an adhesion contract is enforceable despite the recipients' failure to read or understand its terms. Indeed, all a firm needs to do to avoid the law that invalidates contracts because their material terms were not disclosed or misrepresented is to bury these terms in incomprehensible, interminable contracts of adhesion.[315]

A. Unconscionability

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[311] *See* E. Allan Farnsworth, Contracts § 4.18 p. 234 (4th ed. 2004) ("In a system of contract law based on supposedly informed assent, it is in the interest of society as well as of the parties to discourage misleading conduct in the bargaining process. To this end both tort and contract law provide remedies for misrepresentation . . ."); Restatement (Second) of Contracts §§ 161, 162, 163-64, 166 (1981).

[312] *See* E. Allan Farnsworth, Contracts § 4.18 p. 234 (4th ed. 2004).

[313] *Id.* at 237, 240-41.

[314] Restatement (Second) of Contracts §§ 161, 163 (1981).

[315] For cases where the courts have held that the adherent has a duty to read that defeats their claim of fraud or misrepresentation, *see* Gilliard v. Fulton Federal Savings & Loan, 356 S.E. 2d 734, 735 (Ga. App. 1987); Martinez Tapia v. Banque Indosuez, 1999 U.S. App. LEXIS 29260 (2d Cir. Nov. 3, 1999); Lanier v. Associates Finance, Inc., 499 N.E.2d 440, 447 (Ill. 1986); Dowagiac Mfg. Co. v. Schroeder, 84 N.W. 14,14 (Wis. 1900).

Unconscionability is a commonly-used defense courts rely on to deny enforcement to objectionable terms in adhesion contracts. This defense is incorporated in the UCC for sale of goods contracts,[316] and is applied by analogy to non-goods contracts.[317] The concept is not defined in the Code or the Restatement, but each offers guidance suggesting that the doctrine is too narrow to assist borrowers who unknowingly signed contracts for debt they could not repay.[318] Not surprisingly, this standard has led to strikingly unpredictable results when used to excuse parties from their duty to read contracts of adhesion.[319]

Under the unconscionability doctrine, the assent of the adherent to the terms of the adhesion contract is irrelevant; the decision is one of fairness, based on a standard that few litigants can meet. As the court held in applying the unconscionability doctrine to a mortgage case, "No doubt the contracts between the [mortgagors] and the bank were 'adhesion' contracts, but we are not prepared to hold that they were unconscionable in the aspects here in issue . . . Customers who adhere to standardized contractual terms ordinarily 'understand that they are assenting to the terms not read or not understood, subject to such limitations as the law may impose.'"[320] The unanswered question is why the mortgagors should have to agree to terms not read or understood, subject only to the limitations of the unconscionability. Certainly the objective theory of assent does not require this result. If the objective circumstances indicate that the mortgagors were not expected to read or understand the terms before signing the mortgage, how can they be charged with assent to its terms? This view is, if anything, a form of duress,

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[316] UCC § 2-302.

[317] *See* Restatement (Second) of Contracts § 208 (1981); Weaver v. American Oil Co., 257 Ind. 458, 276 N.E.2d 144, 145-48 (holding that clause was unenforceable under the unconscionability doctrine on the grounds that it would have been unconscionable under UCC § 2-302 had it appeared in a sale of goods contract); Zapatha v. Dairy Mart, 408 N.E.2d 1370 (Mass. 1980) (finding the legislative statements of policy on unconscionability "as fairly applicable to all aspects of the franchise agreement . . . by analogy").

[318] The Comments to the Code provide a somewhat circular definition, stating that "the basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract." UCC § 2-3-2, cmt 1. The only insight the Restatement rule provides is the historical standard for unconscionability whereby "a bargain was said to be unconscionable in an action at law if it was 'such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other. . .'" Restatement (Second) of Contracts § 208, Comment b, citing Hume v. United States, 132 U.S. 406 (1889), quoting Earl of Chesterfield v. Janssen, 2 Ves. Sen. 125, 155, 28 Eng. Rep. 82, 100 (Ch. 1750).

[319] *See* John D. Calamari, *Duty to Read - A Changing Concept*, 43 Fordham L. Rev. 346 (1974) (explaining that when exceptions are made to the duty to read, "apparently opposite results are being reached in cases with substantially similar fact patterns"); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1175, 1190-97 (1983) ("The currently applicable law [referring to the presumption of enforceability tempered by the doctrines of unconscionability and public policy] is characterized by a lack of intelligible doctrine and a lack of consistent results.").

[320] Carpenter v. Suffolk Franklin Sav. Bank, 346 N.E.2d 892, 900 (Mass. 1976), quoting Restatement (Second) § 211 cmt. b.

created by doctrine. The need for standardized contracts is a similarly poor excuse, since, as I propose, standardized contracts can be written plainly and presented so that a reasonable person could be expected to read and understand their terms before agreeing to sign them.

Most courts applying the unconscionability doctrine require evidence of defects in the bargaining process, termed "procedural unconscionability" as well as in the outcome, known as "substantive unconscionability."[321] Procedural unconscionability is presumed by some courts if the contract is one of adhesion, since these contracts are defined by the absence of bargaining over their terms,[322] but other courts require evidence that the consumer was unable to find better terms from another source.[323] Substantive unconscionability has defied description, and, like obscenity, is not based on any meaningful standard, but on a subjective determination based on the facts presented.[324]

The prevailing law on adhesion contracts contradicts a fundamental tenet of our judicial system, and one that is essential for the preservation of justice: the concept that legal principles should be applied equally regardless of the status of the parties involved. It seems that it is inconvenient and impractical for the needs of modern-day commerce to grant consumers the right to understand their contractual obligations before they are bound, even major ones such as mortgages, credit card agreements and multi-year service agreements. Consumers are relegated to a new, second-class law of contract. Under this set of rules, what would be treated as a missing term case if the parties were both corporations becomes a case in which one party, the corporation, is entitled to set the terms of the contract, with the goal of shifting as many risks as the law will allow to the consumer. Despite the fact that the consumer will not read, and if he does read, will not understand the contract, the courts will nevertheless impose upon him all the risks, liabilities and obligations provided under the contract by the drafting party. The courts ignore the facts indicating the consumer's lack of assent, based not on equal application of the laws, but solely on the status of the party before them.

B. Reasonable Expectations

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[321] *See e.g.*, Harris v. Green Tree Financial Corp., 183 F.3d 173, 181 (3d Cir. 1999); Rosenberg v. Merrill Lynch, 170 F.3d 1, 17 (1st Cir. 1999); Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308, 322 (6th Cir. 1998); Acorn v. Household Internat'l, Inc., 211 F.Supp.2d 1160, 1168-70 (N.D. Cal. 2002); Discover Bank v. Superior Court, 30 Cal. Rptr. 3d 76, 113 P.3d 1100, 1108-09 (2005); Aral v. Earthlink, Inc., 134 Cal.App. 4th 544, 36 Cal. Rptr. 3d 229, 237-242 (2005); Fontaine v. Industrial Nat'l Bank, 298 A.2d 521, 523 (R.I. 1973). The terms were originally coined by Arthur Leff, who referred to "bargaining naughtiness as 'procedural unconscionability' and to evils in the resulting contract as 'substantive unconscionability.'" Arthur Allen Leff, *Unconscionability and the Code – The Emperor's New Clause*, 115 U. Pa. L. Rev. 485, 487 (1967).

[322] *See* Circuit City Stores v. Adams, 279 F.3d 889, 893 (9th Cir. 2002); Acorn v. Household Internat'l, Inc., 211 F.Supp.2d 1160, 1168 (N.D. Cal. 2002); *but see*, Clark v. DaimlerChrysler Corp., 706 N.W.2d 471, 474-75 (Mich. Ct. App. 2005) (holding that the adhesiveness of the contract was not relevant to the issue of unconscionability).

[323] *See* Pridgen v. Green Tree Fin. Servicing Corp., 88 F. Supp. 2d 655, 658 (S.D. Miss. 2000).

[324] *See e.g.*, Ex Parte Foster, 758 S.2d 516, 520 n.4 (Ala. 1999) (observing that, because there is no "explicit standard" for deciding whether a clause is unconscionable, "each case must be decided on its own facts").

Another major defense to adhesion contracts, the doctrine of reasonable expectations, has been confined to insurance law.[325] Robert Keeton, whose 1970 article was widely influential in the rise of the reasonable expectations doctrine, described the principle as follows: "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy would have negated those expectations."[326] In developing the "reasonable expectations" doctrine, the courts have given insurance contracts the interpretation an insured would reasonably expect, regardless of the insurer's expressed intention.[327]

As embodied in Section 211(3) of the Restatement (Second) of Contracts, the rule is not limited to insurance policies, but applies to all "standardized agreements." The only jurisdiction to have adopted this section of the Restatement, the Supreme Court of Arizona, did so in connection with standardized insurance policies, but noted that the section would also apply to other standardized contracts.[328] One reason for confining the reasonable expectations doctrine to insurance cases was suggested by Eugene Anderson and James Fournier in tracing the doctrine back to the "know thy policyholder" rule.[329] This rule arose from Lord Mansfield's 1780 holding that an insurer is "presumed to be acquainted with the practice of the trade he insures."[330] Being charged with knowledge of the insured's trade, the insurer should also be aware of the insured's insurance needs, or, put differently, his "reasonable expectations" for insurance coverage. And as Anderson and Fournier point out, the "know thy policyholder" doctrine is consistent with the view that the insurer should sell the insured a policy suitable to his needs and consistent with his "reasonable expectations."[331] Since the common law has no comparable "know thy borrower" rule – one that requires lenders to provide borrowers with loans that are suitable to their needs – there are no parallel grounds for applying the "reasonable expectations" doctrine to adhesion contracts involving payment obligations.

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[325] William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 Pepp. L. Rev. 267, 272 (1985-1986).

[326] Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 Harv. L. Rev. 961, 967 (1970).

[327] *See* E. Allan Farnsworth, Contracts § 7.11 (4th ed. 2004), citing Max True Plastering Co. v. United States Fidelity & Guar. Co., 912 P.2d 861 (Okla. 1996).

[328] *See* Darner Motor Sales, Inc. v. Universal Underwriters Ins., 140 Ariz. 383, 682 P.2d 388, 392 n. 8 (1984).

[329] Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholder's Objectively Reasonable Expectations of Insurance Coverage*, 5 Conn. Ins. L.J. 335, 345-46 (1998).

[330] Noble v. Kennoway, 2 Doug. 511, 513 (K.B. 1780). *See also* Buck & Hedrick v. Chesapeake Ins. Co., 26 U.S. (1 Pet.) 151 (1828).

[331] *See* Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholder's Objectively Reasonable Expectations of Insurance Coverage*, 5 Conn. Ins. L.J. 335, 346 (1998).

As applied to insurance policies, the reasonable expectations doctrine has been adopted in over half the states, but its application is far from uniform.[332] Indeed, a consistent theme in the scholarship concerning the doctrine is its lack of consistency and predictability, and the many forms it takes in different jurisdictions.[333] Mark Rahdert has identified four variations on the reasonable expectations rule applied by the courts that purport to follow it, some applying a version of the rule that amounts to no more than the maxim of *contra proferentem,* so that ambiguous clauses are construed against the insurer.[334] As Roger Henderson has observed, the Restatement takes yet another view, switching the vantage point of what the reasonable expectations are under the policy from the policy holder to the insurer.[335]

None of the formulations of the reasonable expectations doctrine hit the mark, however, because they do not offer any method for the adherent to strike terms because his signature did not objectively signify his assent, but only to strike terms the court determines the adherent would not have "reasonably expected." Critics have charged courts with using the reasonable expectations doctrine to engage in wealth-redistribution, to regulate insurance, and to rewrite the parties' contract.[336] The countervailing rationale that leads some courts to disregard these concerns is fairness, given the insureds' coverage needs, but this consideration has provided only slightly greater certainty for analysis than the unconscionability doctrine. A more reliable approach would view the case as one in which the insured had not given his assent to the terms of the policy, including terms that excluded the coverage he reasonably expected, because the policy was written to be unintelligible to the average layperson. Since the contract did not

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[332] *See* Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholder's Objectively Reasonable Expectations of Insurance Coverage*, 5 Conn. Ins. L.J. 335, 356 n.57 (1998) (lists 34 jurisdictions that have adopted the doctrine in various forms): Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. Chi. L. Rev. 1461, 1466 (1989) ("Construing an insurance policy to protect the insured's 'reasonable expectations' means different things to different courts.").

[333] Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured,* 67 Va. L. Rev. 1151, 1197 (1981) ("The courts have not arrived at a systematic understanding of the purposes the principle should serve, and there is no common standard against which to measure the reasonableness of an expectation."); William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 Pepp. L. Rev. 267 (1985-1986); Susan M. Popik and Carol D. Quackenbos, *Reasonable Expectations After Thirty Years: A Failed Doctrine,* 5 Conn. Ins. L.J. 425, 426-28 (1998).

[334] Mark C. Rahdert, *Reasonable Expectations Revisited*, 5 Conn. Ins. L.J. 107 (1998).

[335] Restatement (Second) of Contracts § 211; Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 Ohio L.J. 823, 846-47 (1990). The conclusion the court reaches as to when a layperson has been tricked by "legalese" can actually result in a burden placed on either party, either by finding that the coverage the insured expected is normally provided, so that the insurer should have asked if it was desired, making this information available to the insurer under Section 211, or that the coverage was not normally provided, so that the insured should have asked if it was included, and its interpretation of coverage was not a "reasonable expectation."

[336] *See* William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 Pepp. L. Rev. 267 (1985-1986); Susan M. Popik and Carol D. Quackenbos, *Reasonable Expectations After Thirty Years: A Failed Doctrine,* 5 Conn. Ins. L.J. 425, 426-28 (1998).

represent the terms of the party's agreement, the precise coverage issue would be one on which the parties had not reached agreement. As a missing term case, there would be nothing improper in construing the contract by supplying a term that was consistent with his "reasonable expectations" based on relevant considerations such as representations made to him by the drafting party outside the contract.

C. The Scholars' Proposals

Soon after they were introduced, standardized contracts were eyed with suspicion as tools of potential oppression and unfairness. Critics observed that the drafting party to a standardized contract is usually a more sophisticated repeat-player in the business, is often advised by counsel, and often has greater bargaining power, since the drafting party does not give its agent authority to negotiate the overwhelming majority, if any, of the terms of these agreements, and the market will rarely offer the non-drafting party any alternative terms, even if he were able to understand and compare them.[337] Karl Llewellyn's analysis of the adhesion contracts has been enormously influential, and his prescription is reflected in the doctrines of unconscionability and reasonable expectations.[338] He acknowledged that there was no real assent by the non-drafting parties to the terms of form contracts, but he concluded that the terms should still be enforced based on a theoretical construct called "blanket asset." As he famously explained:

> Instead of thinking about "assent" to boiler-plate clauses, we can recognize that so far as concerns the specific, there is no assent at all. What has in fact been assented to, specifically, are the few dickered terms, and a broad type of transaction, and but one thing more. The one thing more is a blanket assent (not a specific assent) to any not unreasonable or indecent terms the seller may have on his form, which do not alter or eviscerate the reasonable meaning of the dickered terms.[339]

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[337] *See* Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 632 (1943) ("Standard contracts are typically used by enterprises with strong bargaining power. The weaker party, in need of the goods or services, is frequently not in a position to shop around for better terms, either because the author of the standard contract has a monopoly (natural or artificial) or because all competitors use the same clauses."); Victor Goldberg, *Institutional change and the quasi-invisible hand*, 17 J.L. & Econ. 461, 485-86 (1974) (providing economic explanations for why competition among producers does not protect adherents from one-sided terms in adhesion contracts).

[338] The doctrine of unconscionability is reflected in Llewellyn's view that form terms cannot be enforced if they are "manifestly unreasonable and unfair." The doctrine of reasonable expectations embodies Llewellyn's concept that enforcement of boilerplate should be conditioned on satisfaction of the assumption that it does not alter or impair the fair meaning of the dickered terms, although the reasonable expectations doctrine would extend the Llewellyn's concept beyond the express language of the dickered terms to the intent of the parties that could be fairly inferred from those terms. *See* Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 Harv. L. Rev. 961, 967 (1970). Robert Jerry traced the reasonable expectations doctrine back to Llewellyn's writings in *Insurance, Contracts, and the Doctrine of Reasonable Expectations*, 5 Conn. Ins. L. J. 21, 46-51 (1998).

[339] Karl N. Llewellyn, The Common Law Tradition: Deciding Appeals 371 (1960).

According to Llewellyn, a standardized contract creates two contracts; "an arms' length deal, with dickered terms," and another deal whereby the boilerplate is assented to without being read on the assumption that "1) it does not alter or impair the fair meaning of the dickered terms when read alone, and 2) that its terms are neither in the particular nor in the net manifestly unreasonable and unfair."[340] Relying on the one hundred year history of sales law under which any explicit sales transaction creates two contracts, one of sale and one of warranty,[341] he believed that courts should likewise view standardized contracts as containing a contract with bargained-for terms and a collateral contract consisting of boilerplate provisions. Since the consent to the collateral contract is conditional, that contract should not be enforced unless the boilerplate terms do not alter or impair the fair meaning of the bargained-for terms and they are not manifestly unreasonable and unfair, either viewed in isolation or in the aggregate.[342]

Llewellyn's creation of a second contract based on the adherent's "blanket assent" to the drafting party's boilerplate terms is deeply problematic. Most individuals lack the blind faith in the benevolence of business that would lead them to willingly give their "blanket assent" to terms they do not understand. Many quite reasonably believe that businesses use standardized contracts to take advantage of them by placing burdensome terms in the fine-print. The idea that consumers give their blanket assent to the drafting party's terms without reading them because they believe these terms will not be "manifestly unfair or unreasonable," assumes a level of confidence in corporate America that is far higher than most individuals have had since the writings of Upton Sinclair. In this case the simplest explanation is the correct one. Consumers sign contracts of adhesion because they must. A rational individual who was given a choice would not choose to sign an adhesion contract, even under Llewellyn's rules, if he could buy the same goods or services from a vendor under a contract he could read and understand.

Under Llewellyn's proposal, judicial review of adhesion contracts is extremely limited, and does not affect terms that impose risks and obligations on the adherent that he would not have agreed to had he been aware of them at the time of contracting, but which are not "manifestly unreasonable and unfair." An elderly retiree living on a fixed income could argue that she would not have agreed to a teaser rate APR mortgage had she understood that her monthly payment could far exceed her monthly income after the first two years, but the court may well find that the term was not "manifestly unreasonable" in light of the chance that she could refinance given the history of low interest rates and rising real estate prices.

Fredrick Kessler was the next scholar to make a major contribution in the area of standardized contracts. He traced the rise of the standardized contract to "the development of large scale enterprise with its mass production and mass distribution" where terms are

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[340] *Id.*

[341] Llewellyn's reliance on this precedent is a bit tenuous, since the law of warranty he uses to create this "second contract" imposes implied duties on the drafting party in order to protect the non-drafting party, often contrary to the wishes of the drafting party, but non-disclaimable, while boilerplate most often represents duties imposed on the non-drafting party by the drafting party that he is unaware of and may not have agreed to had he read and understood them.

[342] Karl N. Llewellyn, The Common Law Tradition: Deciding Appeals 371 (1960).

formulated by businesses to use with every transaction involving the same product or service.[343] He believed that standardized contracts are frequently contracts of adhesion because the weaker party cannot obtain better terms elsewhere, either because the drafting party has a monopoly, or because all its competitors use the same clauses.[344] Based on a review of insurance cases, Kessler proposed that courts handle standardized contracts by determining what the non-drafting party could legitimately expect in the way of performance from the drafting party through an evaluation of circumstantial evidence, as is done in the field of constructive conditions.[345] His proposal anticipated the reasonable expectation doctrine by suggesting that the disputed terms should be interpreted to protect the expectations of the party with the weaker bargaining position. Courts would maintain the illusion of consent by enforcing adhesion contracts except when specific terms deviated from those generally found in the industry.[346] However, this approach would be of little use to consumers who find themselves victim to abusive practices that are common in an under-regulated market, such as the subprime mortgage market of 2001-2007.

In a 1964 article, Alfred W. Meyer criticized the courts as "neglectfully inept" in remedying adhesion contract abuse, either by claiming that any relief must come from the legislature, or by using "back-door" techniques of interpreting contractual language to mean what it clearly did not mean.[347] He proposed using the doctrine of fundamental breach as a launching pad for the courts to develop a common law for invalidating any clause in an adhesion contract which was inconsistent with the core obligations of the drafting party.[348] As Meyer described his proposal, courts would only strike clauses that seek to immunize the drafting party from liability for breach of a core obligation of the contract.[349] His solution was therefore designed for contracts in which the adherent's performance is concluded by payment and the drafting party's performance is deficient in a way that would constitute a fundamental breach. Meyer's prescription provides no relief for the many adhesion contracts that impose onerous long-term obligations on the adherent, such as home mortgages, credit card agreements, automobile leases, installment sale agreements and long-term service agreements.

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[343] Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 631 (1943).

[344] Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 632 (1943).

[345] Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 637 (1943).

[346] *Id.*

[347] Alfred W. Meyer, *Contracts of Adhesion and the Doctrine of Fundamental Breach*, 50 Va. L. Rev. 1178, 1186 (1964).

[348] Alfred W. Meyer, *Contracts of Adhesion and the Doctrine of Fundamental Breach*, 50 Va. L. Rev. 1178, 1199 (1964).

[349] *Id.*

Arthur Allen Leff made a significant contribution to the literature in the area of adhesion contracts with three articles published in the late 1960s and early 1970s.[350] Critical of the courts' erratic and rudderless application of the then newly-adopted Code section on unconscionability as a method for striking onerous terms of standardized contracts, Leff suggested that legislation, supported by administrative enforcement, was better adapted to police the excesses of adhesion contracts than litigation. Litigation over whether particular clauses were "unconscionable," he believed, simply led to more artful drafting, and would have no effect on broader commercial practices.[351] Government regulation was the preferable remedy in part because Leff conceived of standardized contracts as "things" like the products sold pursuant to them, so that, as with product defects, the government should decide when a manufacturer had gone too far in shifting various risks to the consumer in the contract, and must be satisfied by increasing the product's price to compensate for assuming the risk.[352] Leff recognized that adhesion contracts are rarely read or understood,[353] but advocated their enforcement subject to legislative prohibitions on particular clauses.[354]

Professor W. David Slawson was another scholar who wrote a series of influential articles on adhesion contracts in the 1970s which drew parallels between adhesion contracts and administrative law.[355] Like Llewellyn, Slawson took the position that only a few terms of standardized contracts have the actual assent of the non-drafting party, but that the remaining terms of the contract may be enforced if they pass judicial scrutiny.[356] Slawson attempted to create an "administrative law of contract," likening the delegation of power by the legislature to administrative agencies to implement regulations pursuant to statutes to the delegation of power

[350] Arthur Allen Leff, *Unconscionability and the Code – The Emperor's New Clause*, 115 U. Pa. L. Rev. 485 (1967); Leff, *Unconscionability and the Crowd – Consumers and the Common Law Tradition*, 31 U. Pitt. L. Rev. 349 (1969-1970); Leff, *Contract as Thing*, 19 Am. U.L. Rev. 131 (1970).

[351] Arthur Allen Leff, *Unconscionability and the Crowd – Consumers and the Common Law Tradition*, 31 U. Pitt. L. Rev. 349, 354-357 (1969-1970).

[352] Arthur Allen Leff, *Contract as Thing*, 19 Am. U.L. Rev. 131, 155-56 (1970); Arthur Allen Leff, *Unconscionability and the Crowd – Consumers and the Common Law Tradition*, 31 U. Pitt. L. Rev. 349, 352-53 & n. 18 (1969-1970);

[353] Arthur Allen Leff, *Unconscionability and the Crowd – Consumers and the Common Law Tradition*, 31 U. Pitt. L. Rev. 349 (1969-1970).

[354] Arthur Allen Leff, *Unconscionability and the Crowd – Consumers and the Common Law Tradition*, 31 U. Pitt. L. Rev. 349, 351-52 (1969-1970); Arthur Allen Leff, *Contract as Thing*, 19 Am. U.L. Rev. 131, 155-57 (1970).

[355] *See* W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529 (1971); Slawson, *New Approach to Standard Forms*, TRIAL 49 (July-Aug. 1972); Slawson, *Mass Contracts: Lawful Fraud in California*, 48 Cal. L. Rev. 1 (1974).

[356] W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529, 530 (1971).

by non-drafting parties to drafting parties to draft the terms of standardized contracts.[357] Just as courts review regulations for their fidelity to the legislative intent and the public interest, courts would review the terms in a standardized contract to determine whether they are consistent with the parties' intent and with fairness and the public interest.[358] These latter considerations would be reviewed based on what Slawson called, "non-authoritative standards," that is, "reasons, principles, or considerations possessing no legal authority within the jurisdiction but of greater generality than the law being reviewed and serving to demonstrate that it is in the public interest."[359] In Slawson's system, non-authoritative standards are contrasted with "authoritative" standards such as statutes and binding precedent, and constitute the basis upon which common law principles are formed.[360]

Slawson fails to justify enforcing adhesion contracts absent assent, even under "non-authoritative standards." His argument relies on public stock market transactions in which the market price is accepted without bargaining and no unfairness is inferred, and to the absence of any doctrinal requirement of a bargain for formation purposes.[361] But he is mistaken in believing that the irrelevance of bargaining puts an end to the issue of assent. In his stock market example, the key term for the buyer in the transaction is the price of the stock, and buyer understands that term before he commits to the purchase. Any other information relevant to the value of the stock is available to the buyer in a prospectus, without which the sale cannot be made. To make a convincing analogy, Slawson would have to show that the purchaser had committed to the contract without an understanding of the terms of the agreement, and in such a case unfairness should be inferred because the buyer does not have the ability to reject the contract based on unacceptable terms.

The first scholar who challenged the view that adhesion contracts should be presumptively valid was Todd Rakoff. In his 1984 article, Rakoff claimed that enforcing adhesion contracts without the adherent's assent cannot be justified by economic gains, since competition is insufficient to ensure that distributional effects create a net gain.[362] He also argued that the benefits of standardization could be obtained equally well with terms implied by

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[357] W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529, 533 (1971).

[358] Slawson, *New Approach to Standard Forms*, TRIAL 49, 50 (July-Aug. 1972). Todd Rakoff identified numerous flaws in Slawson's use of administrative law as an analogy to standardized contracts between private parties. Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1212-1214 (1983).

[359] W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529, 533 (1971).

[360] *Id.*

[361] W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529 (1971).

[362] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1220-1229 (1983).

law.[363] Rakoff rejected freedom of contract as a justification for enforcing adhesion contracts, on the grounds that "enforcing boilerplate terms trenches on the freedom of the adhering party" who is "remitted to such justice as the organization on the other side will provide."[364] This view would have led Rakoff to conclude that adhesion contracts should never be enforced, had he not reached the countervailing position that courts should give adhesion contracts deference to "promote firms as instruments conducive to civic freedom."[365] Rakoff claimed that firms do not embody the notion of freedom encompassed in any meaningful conception of freedom of contract, so that the preservation of our democratic society requires that business organizations receive "civic freedoms."[366] The view is an odd one given that Rakoff himself recognizes how well the interests of firms are protected by the courts under the doctrine of freedom of contract in connection with adhesion contracts.[367] As a result, any additional deference would seem unwarranted under Rakoff's own analysis.

Rakoff's compromise solution for the reformulation of the law of adhesion contracts is that the "silent" terms of these contracts, defined as any terms that were not negotiated and would not have been "shopped" by a "customary shopper," should only be enforced if 1) they conform to "background law," since this would be the result if the parties had not reached agreement; or 2) the adherent fails to show "cause."[368] When Rakoff attempts to define how adherents would prove "cause," the concept appears to differ little from the unconscionability and reasonable expectations doctrines.[369]

Michael Meyerson has attempted the "reunification" of contract law by demonstrating that enforcement of adhesion contracts conflicts with the objective theory of assent.[370] As he explains, "Because the drafters of these contracts know not only that their forms will not be read, but also that it is reasonable for consumers to sign them unstudied, a reasonable drafter should have no illusion that there has been true assent to these terms."[371] Meyerson's solution is for

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[363] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1230-35 (1983).

[364] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1235-36, 1237-38 (1983).

[365] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1240 (1983).

[366] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1239-42 (1983).

[367] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1235-36, 1237-38 (1983).

[368] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1242-43, 1251-54 (1983).

[369] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1262-83 (1983).

[370] Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. Miami L. Rev. 1263, 1265 (1993).

[371] Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. Miami L. Rev. 1263, 1265 (1993).

courts to engage in a fact-intensive review, incorporating seven "critical questions."[372] He advises the courts to examine which terms a seller would reasonably expect were known and understood by the consumer; which terms were actually negotiated and explained; the purposes for which the goods or services were being acquired; the legitimate purposes for which subordinate clauses were included; the content of communications between the consumer and the seller's agent; the effect of advertisements; and the topics that were beyond the scope of the consumer's contemplation.[373] If reunifying the law of contract were the goal, however, Meyerson's prescriptive analysis should have been limited to whether the offeree had engaged in any conduct that would objectively convey assent to the term at issue. Meyerson's approach goes far beyond this question, and would enforce adhesion contracts unless a particular factor establishes an exception to the duty to read rule. [374] As such, the seven considerations betray his initial claim by enforcing terms in adhesion contracts even when there was no objective evidence of assent.

Scholars who agree with Meyerson's conclusion that the adherent's signature does not indicate his assent to the terms of the adhesion contract have offered a variety of remedial proposals. Edith R. Warkentine advocates replacing the unconscionability doctrine with a three-part test that would apply to terms that "unduly favor" the drafter or deprive the adherent of a right or remedy he would have had without the term.[375] Her recommendation would not cover situations where the contested term does not deprive the adherent of a pre-existing right or remedy, and does not "unduly favor" the drafter, but is simply a term the adherent would not have agreed to had he read and understood it. Wayne Barnes proposes adoption of the reasonable expectations rule, as formulated in Section 211(3) of the Restatement Second, beyond

[372] Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. Miami L. Rev. 1263, 1265-66 (1993).

[373] Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. Miami L. Rev. 1263, 1266, 1326 (1993).

[374] Meyerson's factors assume the continued vitality of the presumption of validity for adhesion contracts because each is an exception to enforcement and none, besides actual notice, require objective evidence of the adherent's consent beyond signature. Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. Miami L. Rev. 1263, 1302-14 (1993). His factors are drawn from current law, where they constitute exceptions to the duty to read rule, but once the duty to read is reformed, there should be no need for exceptions. Under his plan, the court should consider the purpose of the contract because a term in an adhesion contract would not be enforced if it defeated the purpose of the contract. *Id.* at 1302-106. But without some evidence of assent beyond the adherent's signature, the term should not be enforced even if it is perfectly consistent with the purpose of the contract, and an inquiry into the purpose of the contract will tell the court nothing with respect to the critical question of the adherent's assent.

[375] Edith R. Warkentine, *Beyond Unconscionability: The Case For Using "Knowing Assent" As The Basis For Analyzing Unbargained-For Terms In Standard Form Contracts*, 31 Seattle L. Rev. 469, 473 (2007) (the three-part test would require the drafter to show that 1) the unbargained for term was conspicuous; 2) the importance of the term was explained so the adherent understood its significance; and 3) the adherent separately manifested its assent to the term).

the insurance law context.[376] This proposal falls short because the Restatement rule will only cover cases where the borrower can establish fraud-like intent: that the lender knew or should have known that the risks or obligations it imposed would not have been acceptable to this particular borrower.[377] Borrowers who deal with on-line mortgage brokers, brokers and lenders who conduct minimal due diligence and credit card companies that accept applications by mail or through the Internet would almost never be able to satisfy this standard. Finally, Donald King takes the most extreme view, recommending that courts should only enforce the terms which are discussed and agreed upon, using gap-fillers to govern the remaining issues.[378] This proposal resolves the assent issue, but does not offer any method other than a verbal discussion between the adherent and the drafting party's agent of any term of an adhesion contract that may become the subject of dispute. In addition, the outcome of contract disputes would tend to rest on a credibility contest between the parties' witnesses.

Another group of scholars, primarily those from the school of law and economics, find the concern over assent misplaced, and believe that contracts of adhesion are unobjectionable because the market will ensure that their terms are economically efficient. Following Leff's "Contract as Thing" scholarship, Douglas Baird has argued that the consumer's lack of choice as to the boilerplate terms in adhesion contracts is no different, and no more problematic, than his lack of choice as to unknown features in mass-produced goods.[379] Since the remedy for the sale of defective products was the enactment of warranty laws, he claims that the appropriate remedy for abusive terms in standardized contracts of adhesion is to pass legislation to ban such clauses, as they come to light, such as the cross-collateralization clauses in the famous unconscionability case, *William v. Walker-Thomas Furniture*.[380]

Baird also claims that scholars' continued concern about the lost right of assent in adhesion contracts is antiquated and obsolete,[381] but the collapse of contracts into products analysis does not support his thesis. Baird makes this error because he fails to test his claim with

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[376] Wayne R. Barnes, *Toward A Fairer Model of Consumer Assent to Standard Form Contracts: In Defense of Restatement Subsection 211(3)*, 82 Wash. L. Rev. 227 (2007).

[377] Section 211(3) provides that, "Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement." Restatement (Second) of Contracts § 211 (3) (1981).

[378] Donald B. King, *Standard Form Contracts: A Call for Reality,* 44 St. Louis U.L.J. 909, 916 (2000).

[379] Douglas G. Baird, *The Boilerplate Puzzle*, 104 Mich. L. Rev. 933, 934 (2006). As Margaret Jane Radin has observed, the collapse of the contract-product distinction has become prominent in contract theory involving economic analysis, and dates back to articles written in the 1970s by Arthur Leff (Arthur Allen Leff, *Contract as Thing*, 19 Am. U. L. Rev. 131, 144-51, 155 (1970)) and Lewis A. Kornhauser (Lewis A. Kornhauser, *Unconscionability in Standard Forms*, 64 Cal. L. Rev. 1151 (1976)). Margaret Jane Radin, *Boilerplate Today: The Rise of Modularity and the Waning of Consent*, 104 Mich. L. Rev. 1223, 1229 (2006).

[380] 350 F.2d 445 (D.C. Cir. 1965); Douglas G. Baird, *The Boilerplate Puzzle*, 104 Mich. L. Rev. 933, 943 (2006).

[381] Douglas G. Baird, *The Boilerplate Puzzle*, 104 Mich. L. Rev. 933, 951-52 (2006).

a rather obvious hypothetical: If the terms in adhesion contracts have become indistinguishable from unknown product attributes, why do they operate as affirmative contract rights in favor of the drafting party in adhesion contracts but only as potential defenses when presented as undisclosed product attributes? Adhesion contracts give the drafting party the right to bring an action for damages against the non-drafting party based on the multitude of risk-shifting clauses it may choose to include in the contract, but a product that is sold with a latent defect or limitation provides the seller with no more than a possible defense to the buyer's action. In this way, the adhesion contract gives the seller any rights he drafts into the contract in a way that the non-disclosure of product attributes does not. It will not do to simply declare that destroying the buyer's right to assent to these terms is irrelevant, since the correspondence between the product and the contract cases that supposedly supports the argument has given way.

In any event, since Baird is not interested in assent or rights, he relies on the markets and the legislature as outside forces that will protect adherents from abuses committed by the drafters of contracts of adhesion. This view ignores the historical failures of markets and legislation to protect adherents, and deprives the individual of the choice to enter contracts tailored to his own needs, regardless of the views of the legislature, a body that often fails to act in time to prevent society from ruinous loss.

Other law and economics scholars claim that reputational concerns[382] and comparison shopping prevent firms from overreaching when they draft adhesion contracts.[383] No evidence is presented to support either theory, and neither seems remotely plausible. The idea that reputational concerns prevent major commercial firms from drafting one-sided terms in adhesion contracts is undermined by the fact that consumers have no reliable source of data on how often particular firms have enforced particularly onerous or confusing clauses in their adhesion contracts, or under what circumstances. Similarly, the comparison shopping theory relies on a multitude of counter-factual assumptions. To adopt this theory, one must assume that a meaningful number of consumers not only read and comprehend the terms of adhesion contracts, which are designed so that this does not occur, but that they compare adhesion contracts from competitors offering the same products or services and base their decision on differences between these terms.[384] One must further assume that the reasons for the purchasing decisions of these informed consumers are conveyed to the companies with offending provisions and that

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[382] Lucian A. Bebchuk and Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 Mich. L. Rev. 827 (Mar. 2007). Posner and Bebchuk also argue that the purpose of one-sided terms in adhesion agreements is to act as a shield in the event the adherent attempts to take opportunistic advantage of the firm. *Id.* at 833. But if the terms of adhesion contracts are only being enforced in exceptional cases, they are not needed to calculate risks, one of the key rationalizations for these non-negotiable, standardized agreements. Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 631-32 (1943).

[383] George L. Priest, *A Theory of the Consumer Warranty,* 90 Yale L.J. 1297, 1347 (1981).

[384] Compare Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. Miami L. Rev. 1263, 1270-1271 (1993) ("Despite wishful commentary to the contrary, there is no evidence that a small cadre of type-A consumers ferrets out the most beneficial subordinate contract terms, permitting the market to protect the vast majority of consumers.").

these companies conclude that the loss of business outweighs the benefits derived from their use. In such a world, the market might eliminate the use of inefficient terms.

In the world as it is, however, neither reputation nor comparison shopping will ensure a self-regulating market in the terms contained in adhesion contracts, as the subprime mortgage crisis has rather conclusively demonstrated. In the highly competitive market for subprime mortgages, market forces did not prevent subprime lenders from engaging in predatory practices on an unprecedented scale.[385] Karl Llewellyn noted this phenomena in the 1930s, writing that, "In general, however, the tendency when standardized contracts are used has seemed even in such highly competitive spheres as installment sales, residence leases, investments, and commercial banking to be rather the borrowing and accumulation of seller-protective instead of customer-protective clauses. A *fortiori* when, as in the labor field, competitive pressure on the bargain-drafter weakens."[386]

Picking up on Llewellyn's point forty years later, Victor Goldberg wrote a paper agreeing with Llewellyn that competition does not protect consumers from "seller-protective" clauses.[387] Goldberg's reasons for this market failure include the high costs to consumers of acquiring and comparing information on contract terms other than price, and the fact that any producer-friendly terms that increase profits will attract new entrants to the industry until excess profits are bid away.[388] Goldberg preferred a regulatory solution to litigation,[389] citing the risk and expense of litigation, but he did not address any of the difficulties inherent in relying on regulatory solutions to abusive contracts.[390]

Russell Korobkin has also provided a theory of market failure to explain why sellers have a profit incentive to place inefficient terms in form contracts, based on behavior studies relating to limitations in our decision-making capabilities when presented with complex information.[391] For example, explaining each provision in an adhesion contract to the consumer would not

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[385] Cathy Lesser Mansfield, *The Road to Subprime "HEL" was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 512-14, 556-61 (2000) (describing the abusive provisions contained in subprime mortgage loans).

[386] Karl N. Llewellyn, *What Price Contract? – An Essay in Perspective,* 40 Yale L.J. 704, 734 (1930-1931).

[387] Victor Goldberg, *Institutional change and the quasi-invisible hand*, 17 J.L. & Econ. 461 (1974).

[388] Victor Goldberg, *Institutional change and the quasi-invisible hand*, 17 J.L. & Econ. 461, 485-86, (1974). Posner takes the position that in a competitive environment standardized form contracts will not pose a problem. Richard A. Posner, *The Federal Trade Commission*, 37 U. Chi. L. Rev. 47 (1969).

[389] Government would either provide consumers with a "faithful agent" by setting default terms, mandatory terms, and prohibited terms, or would create an agency to bargain directly with firms over the terms of standard contracts. Victor Goldberg, *Institutional change and the quasi-invisible hand*, 17 J.L. & Econ. 461, 488-89 (1974).

[390] Victor Goldberg, *Institutional change and the quasi-invisible hand*, 17 J.L. & Econ. 461, 488 (1974).

[391] Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1205-06 (2003).

improve efficiency,[392] according to Korobkin, because consumers are boundedly rational decision-makers who may be able to process as few as five "salient" terms.[393] He recommended that the problem of inefficient terms in adhesion contracts should be addressed by enacting mandatory contract terms and by modifying the doctrine of unconscionability to incorporate an economic analysis of the efficiency of their terms.[394]

Korobkin's solution is to turn these decisions over to those better qualified – legislators and judges – who will enact and enforce economically efficient contract terms. The contention that legislators can be relied upon to protect individuals from the abuses of adhesion contracts is a weak one, as the historical account above has shown. And Korobkin's suggestions for modifying the doctrine of unconscionability to incorporate an analysis of economic efficiency would not address the issue of assent. He recommends that the consumer bear the burden of proof to show that the contested term is "non-salient" to a substantial number of buyers in the relevant market as one element of unconscionability. [395] A consumer would not be able to prove that the interest rate terms of a mortgage or credit card is "non-salient," but she may still have been misled by failing to read or understand the fine print in the adhesion contract she signed.

In addition to the substantive shortcomings of this approach, it also poses significant procedural difficulties. The consumer must demonstrate that the benefits of the non-salient term to "the seller in the form of savings in production, distribution, and sales costs [do not] exceed the value of an alternative term to potential buyers." [396] This analysis will require either direct evidence in the form of economic studies and projections, or "reliance on more general theoretical principles familiar to all law-and-economics scholars."[397] As a result, this prescription ratchets the task of challenging a contract of adhesion up to the level of antitrust litigation, complete with the requisite staff of economists.

III. A Proposed Judicial Solution – Standardized Contracts That Warrant A Presumption Of Assent By Signature

The problem of adhesion contracts is not simply one of harmonizing doctrine, or even of reviving the autonomy of the individual in contract, but of empowering everyday citizens, using

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[392] Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1246-47 (Fall. 2003).

[393] A "salient" attribute is one that "buyers consider." Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1205, 1227-28 (Fall. 2003).

[394] Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1205-06 (2003).

[395] Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1283-84 (Fall. 2003).

[396] *Id.*

[397] Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1284 (Fall. 2003)

their common sense, to stave off the worst of the excesses committed by sophisticated creditors who draft adhesion contracts that lead to financial ruin on a global scale. Our society is left out of balance, as courts have effected a transfer of power from individuals to corporations by permitting the organizations that draft adhesion contracts to impose their own their terms on the adherents without their consent, in what has quite reasonably been considered private law-making.[398] Kessler predicted this move when he wrote that standardized contracts could be used as instruments to create a "new feudal order," consistent with the law's return from contract to status.[399] He was wrong in supposing that firms must exert monopoly power to achieve this result;[400] all they needed was for courts to enforce terms that are too long and complex to be read or understood by the average individual.

Scholars have wrestled for decades over whether what is needed to reform the law of adhesion contracts is a new set of legal rules or a return to fundamental principles of contract law. I suggest a modification of existing rules that remains true to fundamental legal principles while recognizing present-day commercial realities. In an excellent analogy, Alan White and Cathy Lesser Mansfield compare the history of the adoption of the Battle of the Forms rule to the problem of assent in adhesion contracts.[401] While perhaps not the Code's finest achievement, this rule nevertheless revised the common law rules of offer and acceptance to acknowledge the formation of contracts through the exchange of forms without affecting the power of assent as to material terms for contracts between merchants, and without affecting the power of assent as to any terms for consumers.[402] The objective theory of assent and the duty to read rule should likewise be revised to enforce today's contracts of adhesion without affecting the consumers' power of assent to their terms.

An analysis of adhesion contracts that preserves the formational requirement that the adherent assent to its terms and is consistent with the objective theory of assent should focus on whether the adherent has engaged in conduct that would reasonably be construed to convey her assent to the terms of the contract. This conduct may or may not be the adherent's act of signing the contract. Signature will not provide evidence of assent if the adhesion contract was written

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[398] Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 640 (1943) (noting that freedom of contract allows businesses using contracts of adhesion "to legislate in a substantially authoritarian manner without using the appearance of authoritarian forms"); Larry Bates, *Administrative Regulation of Terms in Form Contracts: A Comparative Analysis of Consumer Protection*, Emory Int'l L. Rev. (2002) ("Thus, when the law enforces the terms of the contract supplied by the seller, in effect it is allowing the seller to reshape the law to its advantage but without the popular participation we normally associate with legislation in a liberal state.")

[399] Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 640-41 (1943).

[400] *Id.* at 640.

[401] UCC § 2-207; Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract*, 13 Stan. L. & Pol'y Rev. 233, 266 (2002).

[402] Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract*, 13 Stan. L. & Pol'y Rev. 233, 266 (2002).

and presented in accordance with commonly followed business practices, which are universally recognized to deny the adherent the opportunity to read and understand the contract's terms.[403] These practices must be changed so that they produce adhesion contracts capable of establishing assent through the adherent's signature. Each transaction should be examined by the courts to determine whether the adherent's signature of the contract actually constituted objective evidence of assent and gave rise to a duty to read. If this new doctrine were adopted, the use of the term "adhesion contract" would be replaced with the term "standardized contract" similar to the usage adopted in Section 211 of the Restatement Second. Form contracts that did not pass the test would fail for lack of assent, and the matter would be handled as a missing term case, assuming there was no question of indefiniteness or intention to form a contract.

While the test is an objective one, objectivity does not imply that the test can be applied blindly without regard to the nature and context of each transaction. While the question is simple, answering it should not be. Under the revised duty to read, in keeping with the objective theory of assent, courts will ask one fundamental question: Given the nature and surrounding circumstances of this transaction, would a reasonable person have read and understood the contract before signing it?

If the answer to this question is no, whether because the adhesion contract is made up of the usual incomprehensible legalese, the contract consists of 30 pages of minute type for a $25 transaction, or the language was not made available to the adherent before signature, the drafting party may introduce evidence that the adherent nevertheless received notice of the disputed term, perhaps through the drafting party's agent, or her attorney at a real estate closing. If the drafting party has no evidence of this kind, the court will be presented with a missing term case, where the parties have not reached agreement on the disputed term. In such a case, the court must engage in contract construction, and may apply a gap-filler term using what Rakoff calls "background law."[404]

One aspect of the analysis will be the "readability" of the contract – the subject of the largely unsuccessful "Plain English" movement of the 1970s.[405] If a person realizes after reading the first few lines of a contract that he cannot understand a word, it is unreasonable to expect him to continue the futile exercise of reading the contract in its entirety. A court applying a duty to read rule modified to reflect the commercial realities of the situation would not conclude that a reasonable person is bound by the terms of contract that is incomprehensible to him. And under the objective theory of assent, the adherent's signature of an unintelligible contract would not signify assent because it is unreasonable to conclude that the adherent agreed to terms he did not understand. Similarly, disclosures must not overwhelm, or they become their own form of

[403] *See supra* note 9.

[404] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1242-43(1983).

[405] This movement resulted in the passage of numerous state statutes requiring "easy to read" consumer contracts and insurance policies. *See, e.g.*, Conn. Gen. Stat. Ann. § 42-152 (West 2007) (consumer contracts "shall be written in plain language"); N.Y. Gen. Oblig. Law § 5-702 (Consol. Supp. 2005) (consumer contracts must be written "in a clear and coherent manner using words with common and every day meanings"); 73 Pa. Cons. Stat. Ann. § 2205 (West Supp. 2008) (consumer contracts "shall be ... easy to read and understand").

boilerplate. The Truth in Lending Act is a case in point. Disclosures under TILA are incomprehensible to most consumers, and have had no effect on the competitiveness of the market.[406]

A related issue is length.[407] The permissible length of an adhesion contract may vary according to the importance of its subject matter. When an Internet sale transaction involves a small dollar amount and a one-time payment, the consumer's electronic signature to five-pages of boilerplate, displayed in a 1x1 inch box, may not constitute objective evidence of assent. Under these circumstances, it would not be reasonable to expect consumers to spend the time and effort to read such extensive boilerplate, none of which is essential to the sale or intended for their benefit, for such a minor transaction.

The setting in which the individual is expected to read the contract should also be considered. If the drafting party does not give the adherent the time or opportunity to read the form contract before signing it, the drafting party cannot argue that the adherent has assented to its terms. In an increasing number of transactions, such as insurance contracts, credit card agreements, and "shrink-wrap" agreements, the drafting party does not supply the adherent with the terms of the transaction until after it has been consummated. In the Orwellian world of contract law to which consumers are now subject, the contract formed by acceptance of an offer is not formed until the adherent has assented, by silence (almost never sufficient to constitute assent under Section 69 of the Restatement Second of Contracts) to the drafting party's terms which are contained in product packaging accessible only after the adherent has performed his own contractual obligations in full by paying the purchase price.[408]

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[406] Jeffrey Davis, *Revamping Consumer-Credit Contract Law*, 68 Va. L. Rev. 1333, 1345 (citing studies showing that TILA has had no market impact, explaining why the bill to simplify TILA disclosures will have no impact, and stating that, "The resulting (TILA) disclosure statement is nearly incomprehensible to the average consumer; the information essential to making good credit-use decisions lies buried under mounds of superfluous data."); Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract*, 13 Stan. L. & Pol'y Rev. 233, 234 (2002) (collecting supporting data, including literacy research to show that many U.S. citizens cannot understand federally mandated disclosure information, and stating that, "Among, or in addition to, the long agreements they sign, consumers are provided with legally mandated disclosure forms that are supposed to make clear the essential terms of the deal (such as cash price, cost of credit, and quantity), but the utility of these disclosures is also widely questioned.").

[407] Literacy surveys and readability studies confirm this common sense intuition. *See* Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract*, 13 Stan. L. & Pol'y Rev. 233, 264 (2002) ("In addition, the number and length of contract and disclosure documents would have to be greatly reduced if a reasonable percentage of the consuming public is to use them."). *See also* Elizabeth Warren, Making Credit Safer, Harvard Magazine (May-June 2008) (explaining that one of the reasons consumers have become mired in high-cost debt is that "disclosure has become a way to obfuscate rather than to inform," and noting that, "by the early 2000s, [the typical credit-card contract] had grown to more than 30 pages of incomprehensible text.").

[408] *See* Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569 (1998). *See also Hill v. Gateway 2000, Inc.,* 105 F.3d 1147, 1149 (7th Cir. 1997). *See* ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1451 (7th Cir. 1996) ; Lozano v. AT&T Wireless, 216 F. Supp. 2d 1071, 1073 & n.1 (C.D. Cal. 2002); I.Lan Sys., Inc. v. Netscout Serv. Level Corp., 183 F. Supp. 2d 328 (D. Mass. 2002); Bischoff v. DirecTV, Inc., 180 F. Supp. 2d 1097, 1103-06 (C.D. Cal. 2002);

Until the culture has adapted to the new law, notice of the significance of reading the contract will be another factor. Apathy and indifference will be difficult obstacles to overcome. Like the many Americans who no longer vote, many consumers have come to believe that their views do not count; that there is no point in attempting to read form contracts because the corporations that draft these contracts will always prevail in the end. Firms will have to address this issue in their contracts and through their agents by emphasizing the importance of reading form contracts and motivating consumers to do so.[409] Motivating consumers to read form contracts can be achieved in various ways, such as through warnings that the contract contains terms relating to the consumers' duties and obligations under the contract, as well as restrictions on the consumers' rights and remedies against the company.

In appropriate cases, the drafting party should be permitted to introduce evidence that the adherent was given actual notice of the disputed term by the drafting party's agent, the adherent's attorney or other agent, in promotional materials or by other means. Complex credit transactions like mortgages, where the parties meet in person for the execution of the contract, give the drafting party an opportunity to have its agents explain the key clauses to the adherents to obtain their assent. The drafting party should also be able to show that an adherent had a heightened level of sophistication, placing his capacity to read and understand above the "reasonable person." These mechanisms will hinder the ability of real estate speculators to avoid their credit obligations. As with cases involving disclosures in the sale of securities, the actual knowledge of the buyer/adherent is critical. Accordingly, if a real estate speculator attempts to avoid enforcement of a complex mortgage presented at a closing where he was not represented by counsel, the mortgagee may attempt to establish his assent by presenting evidence such as other, similar mortgages the mortgagor has entered into, educational materials he has studied on the subject and the purposes of his loan.

The purpose for the contract may also be helpful in identifying adherents who had an actual understanding of the risks disclosed in the agreement, regardless of whether a reasonable person acting in the circumstances would have read and understood the contract before signing it. If an elderly gentleman living on a fixed pension challenges a teaser rate ARM mortgage he used to refinance his home, and his monthly loan payments and minimum living expenses will exceed his monthly income if the interest rate increases by even 2 percent, it is unlikely he is attempting to avoid risks he willingly accepted. On the other hand, an individual who obtained the same teaser rate ARM loan in order to purchase his fifth home in two years, for no money down, with the intention of selling the home for a profit before the interest rate cap expired would be unlikely to convince the factfinder that he was misled concerning the terms of his mortgage.

Westendorf v. Gateway 2000, Inc., 41 U.C.C. Rep. Serv. 2d (CBC) 1110 (Del. Ch. 2000); M.A. Mortenson Co. v. Timberline Software Corp., 998 P.2d 305, 313 (Wash. 2000).

[409] *See* Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 Va. L. Rev. 1387, 1460 (1983) ("Whether a consumer reads a particular contract may depend on whether the consumer perceives the expected gain from reading to exceed the cost.").

In cases where a consumer has been given an opportunity to read a clearly written standardized contract but has nevertheless misunderstood a disputed term, courts should apply the existing doctrine of unilateral mistake as the appropriate interpretive tool. Under Section 20 of the Restatement Second, if the drafting party knew or had reason to know of the meaning attached to a particular term by the consumer, and the consumer does not know or have reason to know of the meaning the drafting party gave to the term, the consumer's meaning should prevail.[410]

This analysis best reflects the reality of the parties' dealings. Much as firms would like to eliminate the discretion and authority of their sales agents, in most cases their agents must still convince potential customers to buy the goods or services they sell, or at least advise them on the characteristics and distinguishing features of the various goods or services offered. Sales talk inevitably involves some description of the goods or services, which may or may not be consistent with the terms of the written agreement. Internet "clickwrap" transactions differ only in that the "sales talk" never deviates from the script. The consumer still relies on terms disclosed in the information provided about the product or service that is presented to assist them in making their choice, and will scroll through the boilerplate without reading it before entering "I agree" as necessary to finalize the purchase.

Some may object to this proposal on the grounds that every clause contained in standardized form contracts is critical, and that the language they contain is as clear as possible given the subject matter. Rakoff addressed the first point. He observed that there is no legal necessity for enforcing the multitude of terms contained in standardized form contracts, since courts enforce contracts as long as the parties intend to be bound and specify a few core business terms.[411] The UCC provides a host of gap-fillers for such situations. If the parties intend to enter a contract but reach no agreement as to price, the price will be a "reasonable price" at the time of delivery.[412] Similarly, a contract is enforceable even though the parties have not agreed upon terms as to specific quantities,[413] the place for delivery,[414] the time for shipment, delivery, or successive performances,[415] a description of performance,[416] the time and place of payment or delivery, the quality of the goods, or any particular warranties.[417] When courts show themselves able and willing to enforce the most skeletal of contracts, they should not enforce the byzantine minutiae of most standardized adhesion contracts drafted by businesses when the consumers'

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[410] Restatement (Second) of Contracts § 20(2) (1981).

[411] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1181 (1983).

[412] UCC § 2-305.

[413] UCC § 2-306.

[414] UCC § 2-308.

[415] UCC § 2-309.

[416] UCC § 2-311.

[417] UCC § 2-201, Comment 1.

assent is a legal fiction. Moreover, as Rakoff also observed, courts can supply missing terms based on existing law, so there is nothing in the concept of mass distribution or the needs of standardization that requires that the drafting party's terms must prevail.[418]

As to whether the complexity of the subject matter of standardized form contracts makes it impossible to draft them in language comprehensible to a lay person, that objection is addressed by statutes enacted in several states requiring that insurance policies, among the most obtuse of all instruments devised by the legal profession, be written in clear and understandable language.[419] Most states also require group insurers to provide a certificate to insureds that explains the coverages provided under the master policy, including any significant conditions, exclusions or exceptions.[420] When the certificate varies with the master policy, the insurer will be bound by the more permissive provisions outlined in the certificate, on the grounds that the insured will normally have access to and rely on the certificate.[421]

Another objection may be that efforts to limit the enforcement of adhesion contracts to intelligible contracts, like disclosure, will not cure the market failure that results in one-sided terms because consumers are not rational decisionmakers. Consumers are "boundedly rational decisionmakers," confounding the assumption of rational behavior ("expected utility theory") key to the economic theory of form contracts that expects these contracts to be self-regulating in a free market system.[422] They cannot be relied upon to engage in "fully non-selective and

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[418] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 111208, 1235 (1983).

[419] *See* Scott B. Krider, *Comment, The Reconstruction of Insurance Contracts Under the Doctrine of Reasonable Expectations*, 18 J. Marshall L. Rev. 174 n. 104 (1984-1985). Krider argued that the reasonable expectations doctrine could be abandoned in insurance cases if these statutes mandating "easy to read" policies were more widely adopted. *Id.* at 173-76. He conceded that the administrative agencies tasked by most states to regulate the content of insurance policies were understaffed and overworked, and that the regulation of policy forms had historically been a low priority, and suggested that developing consumer interest groups would motivate these agencies. *Id.* at 175. Anderson and Fornier's paper strongly suggests that the influence of the insurance industry may make it enormously difficult for even the most well-organized consumer interest groups to have an impact on regulators. Eugene R. Anderson and James J. Fournier, *Why Courts Enforce Insurance Policyholders' Objectively Reasonable Expectations of Insurance Coverage*, 5 Conn. Ins. L.J. 335 (1998). *See also* Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured,* 67 Va. L. Rev. 1151, 1190 (1981) (recommending judicial as well as regulatory controls in part because "the industry has tended to dominate the regulators.")

[420] W. Meyer, *Life and Health Insurance Law* § 19:14 (1972).

[421] Romano v. New England Mut. Life Ins., 178 W.Va. 523, 362 S.E.2d 334, 338-39 (1987); Lecher v. General American Life Ins. Co., 55 Haw. 624, 525 P.2d 1114 (1974); Bellamy v. Pacific Mut. Life Ins. Co., 651 S.W.2d 490 (Mo.1983); Evans v. Lincoln Income Life Ins. Co., 585 P.2d 407 (Okla.1978), Hayes Truck Lines, Inc. v. Investors Ins. Corp., 269 Or. 565, 525 P.2d 1289 (1974).

[422] Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1218-19 (2003).

compensatory decisions" using "weighted-added strategy" as the free market theory assumes, but fall short by ignoring information they must consider for the market to self-regulate.[423]

Mankind's failure to live up to a theoretical construct of rational behavior that was created to support the theory that the market is self-regulating establishes a flaw in the theory, not an argument for enforcing adhesion contracts despite the lack of assent by the adherents. Even if it were possible, my goal is not to foist economically efficient contracts on unwilling adherents, but to return dignity, independence and individuality to an imperfect humanity, regardless of how feeble its decision-making facilities may be. It is the group-think of experts, after all, that brought us to such a pass.

Others have expressed concerns that statutorily mandated disclosures are inadequate when it comes to adhesion contracts involving credit obligations because the vast majority of Americans are functionally illiterate, and cannot understand the most basic financial concepts contained in most credit disclosures.[424] Alan White and Cathy Lesser Mansfield cite findings of a 1992 Department of Education literacy study and readability research as evidence that the duty to read should be abandoned for standardized form contracts involving credit and that legislation should be adopted to protect consumers in this area.[425] But they also note that while the Federal Trade Commission has had authority under the FTC Act to prohibit terms in credit contracts deemed "unfair and deceptive," the agency has not issued a substantive consumer contract regulation under the Act since 1984.[426] This record does not bode well for a policy of regulatory controls. And their claim that even with simplified disclosures, there will always be consumers for whom no explanation is sufficient proves too much.[427] The doctrine of incapacity deals with such cases, and the terms consumers must know to protect themselves in credit transactions are not so complex that they cannot be explained to those with the capacity to contract. Even if consumers are not well-equipped to protect themselves if they are provided with credit agreements that were written to be understood rather than to obfuscate, they deserve an opportunity to prove they can outperform the dismal record set by Congress, the regulatory agencies, the courts, the free market and the lenders, brokers and other providers of credit to whom their well-being has for so long been entrusted.

Any dire predictions that commerce as we know it will come to a standstill if individuals are given contracts they can be expected to read and understand should be laid to rest by the healthy profits of the insurance industry, which continues to prosper despite the courts' use of the

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[423] Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1222, 1225 (2003).

[424] Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract*, 13 Stan. L. & Pol'y Rev. 233, 234 (2002)

[425] Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract*, 13 Stan. L. & Pol'y Rev. 233, 235-40, 265-66 (2002).

[426] Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract*, 13 Stan. L. & Pol'y Rev. 233, 258-59 (2002).

[427] Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract*, 13 Stan. L. & Pol'y Rev. 233, 264 (2002).

reasonable expectations rule for several decades to overturn standardized terms in their policies.[428] Perhaps this is due in part to the fact that many insurance companies fail to enforce their own exceptions in any standardized manner,[429] a fact that some commentators claim is true regarding standardized contracts generally.[430]

[428] Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract*, 13 Stan. L. & Pol'y Rev. 233, 263 (2002) ("The special treatment of insurance contracts, including the application of section 211 of the *Second Restatement* to insurance agreements, does not seem to have brought the insurance industry to a grinding halt.").

[429] Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholder's Objectively Reasonable Expectations of Insurance Coverage*, 5 Conn. Ins. L.J. 335, 345-46 (1998).

[430] Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 Mich. L. Rev. 827, 833 (2006).

Conclusion

Adhesion contracts imposing credit obligations on consumers that they cannot afford to repay have had a devastating impact on the economy in two of the greatest financial disasters our nation has experienced. Market discipline and regulation have proven inadequate solutions in the past, yet the government continues to rely on them. Courts have left adherents to their own devices based on an excessive and misguided devotion to the principle of freedom of contract, striking down only the most egregious clauses in adhesion contracts under the doctrine of unconscionability. Why businesses should be able to enforce form contracts knowing that consumers will not read or understand them has never been adequately accounted for by the courts or by legal scholars who defend this practice.

Under my proposal, courts would only enforce adhesion contracts if, given the nature and surrounding circumstances of the transaction, a reasonable person would have read and understood the contract before signing it. Businesses would have to accept that when they draft standardized contracts for consumers, they must write contracts that an average consumer could be expected to read and understand before execution. When it is clear from the face of a standardized contract and the nature of the transaction that it was not reasonable to expect that consumers would read or understand the contract before signing it, there is no legitimate basis for enforcing the contract under the objective theory of assent or the duty to read doctrine. While a business could introduce evidence to show that a consumer did assent to a contested term of a complicated contract of adhesion, through an admission or other means, such terms would not be automatically enforced.

Statutes may be passed to forbid especially egregious types of mortgages, mortgage terms, burdensome credit card provisions or other forms of overreaching in credit agreements. Although highly unlikely, it is possible that during the boom years that precede the busts, these statutes may also be maintained and enforced by well-staffed and funded administrative agencies. But statutes and regulations still cannot keep pace with the misleading and fraudulent practices of lenders and brokers, or the suitability issues dealt with only by the most scrupulous lenders and the most well-informed borrowers. Adding a judicial remedy to legislative and regulatory solutions offers stability as well as flexibility. Like regulation, enforcement will not be perfect, and abuses will continue. But giving consumers the ability to challenge their adhesion contracts in court will provide a warning to those drafting these contracts that the courts will stand behind consumers who are unwilling to blindly accept the risks of reckless credit practices that so often send the nation into financial ruin.