Subprime Mortgages and the Case for Broadening the Duty of Good Faith

By Chunlin Leonhard*

Introduction

In the wake of the “most virulent global financial crisis ever” caused by defaults in subprime mortgages and derivative financial products in 2007 and 2008,1 much finger pointing and soul searching have taken place on different fronts. Some point to predatory lending practices and the failure of government regulations.2 Some blame it on irresponsible borrowers who spent money beyond their means in an ill-fated pursuit of the American dream of home ownership.3 Many point their fingers at fraudulent and opportunistic behavior by lenders, investment banks, and investors.4

The subprime mortgage crisis has triggered rethinking of certain cherished free market doctrines such as the presumed efficiency of

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free markets, a theoretical underpinning of contract law. Some staunch defenders of the free market economy have acknowledged that the market does not always regulate itself for the best. The subprime mortgage crisis offers a good opportunity for reflection by contract law scholars as well. What is the role contract law played in this crisis? What can or should contract law do to help avoid the next economic disaster? This Article offers some thoughts on those two questions and hopes to generate a constructive debate on those issues.

This Article argues that contract law played an enabling, albeit hidden, role in the subprime mortgage crisis. Contract law facilitated the subprime mortgage crisis in two ways. First, contract law’s laissez faire paradigm has incentivized contractual parties to pursue their self-interests while failing to provide any constraint on excessive pursuit of self-interests. Second, the current contract law paradigm has also contributed to the subprime mortgage crisis by having nurtured a business culture of everyone for themselves. Contract law’s general tolerance of parties’ single-minded pursuit of self-interest has led to a “moral deficit.” Misaligned incentives without any meaningful constraints and a breakdown of a moral baseline are the primary factors that led to the subprime mortgage crisis.

Contract law’s failure to provide any checks and balances stems from its hands-off approach, built upon unwarranted assumptions of

5. The term “contract law” as used in this Article refers to U.S. contract law.

In his most recent book examining what he calls “the Great Recession,” Professor Joseph Stiglitz, winner of the Nobel Prize in Economics, points out that “markets do not work well on their own” and that the American economy lost the “balance between the role of markets and the role of government.” J OSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY, at xii (2010).

6. Greenspan, who has championed free markets, admitted that he had put too much faith in the self-correcting power of free markets and not enough in the self-destructive power of markets gone amok. EDMUND L. ANDREWS, BUSTED: LIFE INSIDE THE GREAT MORTGAGE MELTDOWN 65 (2009). Judge Richard A. Posner, one of the most influential scholars in the law and economics movement, acknowledged the “need for a more active and intelligent government to keep our model of a capitalist economy from running off the rails,” and that “[t]he movement to deregulate the financial industry went too far by exaggerating the resilience—the self healing powers—of laissez-faire capitalism.” RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF ’08 AND THE DESCENT INTO DEPRESSION, at xii (2009).

7. I am not suggesting here that contract law by itself caused the subprime mortgage crisis. Needless to say, the “perfect storm” resulted from a confluence of multiple factors such as the federal government’s failure to regulate, etc. For a comprehensive examination on the multiple causes of the crisis, see COMM’N ON THE CAUSES OF THE FINAN. & ECON. CRISIS IN THE U.S., THE FINANCIAL CRISIS INQUIRY REPORT (2011) [hereinafter FCIC REPORT].

8. STIGLITZ, supra note 5, at 278.

9. Id. at 84.
rational parties acting on their own behalf and bargaining at arms’
length to maximize their own expected utility.10 Were contract law’s
assumptions correct, one party’s pursuit of their self-interest would
have been tempered by the other party’s equally strong incentive to
pursue their interest. The current contract law paradigm seems to rely
on contractual parties themselves as checks and balances against each
other’s excessive opportunistic behavior. This delicate balance, how-
ever, relies on the accuracy of contract law’s assumptions of rational-
ity, equal bargaining power, and equal access to information.

The subprime mortgage transactions leading up to the subprime
mortgage crisis have demonstrated that those contract law assump-
tions are generally wrong. For example, severe information asymmetry
and unequal bargaining power plagued subprime mortgage transac-
tions.11 Parties with more access to information than borrowers had
deliberately manipulated human decision-making biases, exacerbat-
ing the disparities.12 As a result, parties with more information and
resources dictated the terms of the transactions.13 The other parties to
the subprime mortgage transactions (borrowers) were in no position
to act as a counterbalance against Wall Street. The falsity of contract
law’s assumptions not only raises fairness issues,14 it also results in the
loss of the only built-in checks and balances within contract law.

10. Contract law consists of primarily some default rules, some rules of interpretation
or construction, and a few mandatory rules. Alan Schwartz & Robert E. Scott, Contract
Theory and Limits of Contract Law, 542 YALE L.J. 541, 547–48 (2003); Melvin Aron Eisenberg,
The Limits of Cognition and the Limits of Contracts, 47 STAN. L. REV. 211, 212 (1995). As Profes-
sor Eisenberg pointed out, contract law has already made some concessions (through de-
velopment of common law doctrines and regulations) to acknowledge the fact that
contract law’s essential assumptions do not apply in many situations. Id. at 212–13.

11. See discussion infra Part I.

12. See ZANDI, supra note 3, at 18 (“[M]ortgage borrowers understood little about the
financial obligations they were taking on.”); ANDREWS, supra note 6, at 76–77 (“[M]ortgage
lenders and brokers had steered unsuspecting customers who qualified for traditional
mortgages into far more expensive subprime loans.”).

13. Bar-Gill, supra note 2, at 1122–23 (pointing out that “[t]he imperfectly rational
borrower deals with complexity [of a subprime mortgage contract] by ignoring it” and
noting the various ways lenders used complexity to conceal the true costs and risks of a
loan by taking advantage of the borrowers’ decision-making biases).

14. Courts have adopted various doctrines, such as unconscionability, duress, and ad-
hesion contracts, in an apparent acknowledgement that those assumptions do not apply in
certain situations. Legislatures have attempted to address the fairness concerns by enacting
consumer protection laws and financial regulations.
Without any checks and balances from contract law or elsewhere, Wall Street banks and mortgage brokers took excessive financial risks. They knew they could shift the risks to other contractual parties. They shifted the risks to borrowers at the front end and to investors at the back end. They had no incentive to be diligent because they only had to watch out for their own interests.

In addition to its failure to provide any checks and balances in economic relationships, contract law also facilitated the subprime mortgage crisis, more generally, by fostering an American business

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15. Influenced by the same type of unfettered free-market thinking and “‘captured’ by those they are supposed to regulate,” government regulatory agencies also failed to provide any external constraints on the marketplace. STIGLITZ, supra note 5, at 148–49.

16. Audrey Strauss, Turning a Blind Eye: Wall Street Finance of Predatory Lending, 75 FORDHAM L. REV. 2039, 2048 (2007) (pointing out that “lenders have incentives to cherry-pick their loans and sell the worst ones to investors. And knowing that they can unload the worst loans onto investors, lenders have less reason to underwrite loans carefully.”).

17. ANDREWS, supra note 6, at 40. The fact that many of the financial players did end up being caught up by the risks is another story and topic of much speculation. In his fascinating, well-written and intimate account of how the subprime mortgage affected his own life, New York Times economics reporter Edmund Andrews described “a new gospel of lending” in the subprime mortgage industry: “(1) no borrower is inherently too risky for a loan; (2) riskier borrowers are highly lucrative, as long as you charge a high enough interest rate; (3) you can pass off the risk to someone else.” Id. Some of the big players in the subprime mortgage crisis also got caught up in the frenzy and apparently bought into their own fiction. Id. at 44.

18. Id. at 122 (quoting Bill Ackman, founder of Pershing Squire Capital, as saying that “almost every player in the mortgage boom had been trying to pass the risk on to someone else. Precisely because people at each link in the chain thought they were safe, . . . they were all taking bigger risks and setting the stage for an epic meltdown.”). See also STIGLITZ, supra note 5, at 14.

19. Many people including Alan Greenspan blame the subprime mortgage crisis on some identified fraudulent practices encouraged by misaligned incentives and lax regulatory policies. DAVID FABER, AND THEN THE ROOF CAVED IN: HOW WALL STREET’S GREED AND STUPIDITY BROUGHT CAPITALISM TO ITS KNEES 51–55 (2009) (pointing out that if just one financial institution imposed the rules, the borrower would find another lender, and the stricter bank would suffer); see also id. at 1 (noting that financial companies rely on trust in order to survive). I do not think that fraud can explain the scope of the subprime mortgage crisis unless we are willing to assume that all of the financial players are fraudulent. I would argue that even though some people did commit fraud, most people involved in the chain of subprime mortgage crisis did not commit fraud, at least not in their minds. Most are guilty of being complacent or lack incentives to be more diligent. After all, according to the conventional thinking, endorsed and backed up by contract law, the borrowers and the investors engaged in these transactions voluntarily and were fully aware of the risks. As Martin Sandbu, The Financial Times economics editorial writer, noted: “Most business people are like most people everywhere: wanting to do the right thing but confused about what the right thing is in a complex world.” Martin Sandbu, Why Aristotle Is the Banker’s Best Friend, FIN. TIMES (London), Jan. 13, 2011, at 9. In my opinion, contract law’s failure to provide any ethical guidelines in economic relationships is in part responsible for the confusion about the “right thing” to do.
culture of everyone for themselves, an economic “survival of the fit-
test” mentality. Presently, contract law gives parties in an economic 
transaction the moral permission to watch out only for themselves.20 
After all, it assumes that the other party can take care of their own 
interests. Contract law’s tacit encouragement of maximizing self-inter-
est has led to what could be called a “moral deficit” in U.S. business 
culture.21

Many scholars have pointed out that contract law’s underlying as-
sumptions do not apply in many situations.22 Current attempts and 
suggestions to fix the inadequacies of the contract law model are pri-
marily focused on curing the defects that prevent people from acting 
as a rational actor would be expected to act.23 Professor White, for 
extample, supported government regulations in consumer contracts 
because of the known decisional biases of consumers and the manipu-
lation of those biases by powerful commercial interests.24 Others sug-
gested new regulations focusing on improving the current disclosure 
regime and adding a federal financial products watchdog.25 Some 
proposed federal legislation requires subprime lenders and brokers to 

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20. See, e.g., John D. McKinnon & Michael R. Crittenden, Panel Rips Wall Street Titan, 
5000752756113586.html. When questioned about Goldman Sachs’s practice of selling 
mortgage securities to investors, then betting that those securities would drop in value, 
Goldman CEO Lloyd Blankfein was quoted as saying, “These are the professional investors 
who want this exposure.” Id. In a New York Times article about the same Goldman Sachs 
practice, another Goldman Sachs spokesman was paraphrased as saying, “clients knew 
Goldman might be betting against mortgages linked to the securities, and that the buyers 
of synthetic mortgage C.D.O.’s were large, sophisticated investors’ . . . .” [I]nvestors could 
have rejected the C.D.O. if they did not like the assets.” Gretchen Morgenson & Louise 
dated December 3, 2007, reported lenders as saying that “they aren’t responsible for 
borrowers who may have been reckless in their real estate investments or their finances, or 
who have own reasons for considering loans with subprime terms.” Rick Brooks & 
online.wsj.com/articles/SB119662974558911055.html.

21. STIGLITZ, supra note 5, at 278 (“The unrelenting pursuit of profits and the eleva-
tion of the pursuit of self-interest may not have created the prosperity that was hoped, but 
they did help create the moral deficit.”); ANDREWS, supra note 6, at xiii (pointing out that 
the crisis “stemmed from deep-seated rot and corroded ethics in our financial system”).

22. See Eisenberg, supra note 10, at 212; Christine Jolls et al., A Behavioral Approach to 
Law and Economics, 50 Stan. L. Rev. 1471 (1998) (advocating a behavioral approach to 
legal analysis that reflects better understanding of human behavior).


24. Id. at 158–61.

25. Bar-Gill, supra note 2, at 1147; ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW 
TODAY’S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT 134 (2008); 
White, supra note 23, at 172–76.
make appropriate loans and to apply assignee liability to any violations by mortgage brokers and lenders. Certain new financial regulations now focus on improving the information disclosure in financial transactions. Finally, Congress enacted sweeping financial regulations in July 2010 and created a federal financial consumer products watchdog as part of the legislation.

This Article argues that contract law is flawed because of its reliance on unwarranted assumptions. Due to the societal importance of economic exchanges, contract law is uniquely positioned to encourage socially desirable conduct. What rules contract law chooses to recognize will likely set the tone for all economic exchanges and define the society itself. As Professor Shiller notes, economic policies can either reinforce or fray the “social fabric—the trust and optimism people feel for each other and for their shared institutions and ways of life.” By choosing the laissez faire approach, contract law is abdicating its responsibility to encourage socially desirable conduct and to discourage undesirable conduct. Maintaining the status quo will


29. Stiglitz, supra note 5, at xix (pointing out that the “universality of the problem [revealed during the subprime mortgage crisis] suggests that there are fundamental flaws in the system”).

30. It is beyond this Article’s scope to engage in a debate about contract law’s role in promoting morality.

31. See generally Francis Fukuyama, Trust: The Social Virtues and the Creation of Prosperity 7 (1995) (asserting that economic activity is a crucial part of social life and shapes society).


33. See Roy Kreitner, Fault at the Contract-Tort Interface, 107 Mich. L. Rev. 1533, 1549 (2009) (stating that contract law is “a mode of social regulation whose rules ought to serve social goals”); see also id., at 1535–36 (surveying the shift in the modernization of contract law from a fault-based regime to a no-fault, privatized regime). See generally Stiglitz, supra note 5, at 38 (discussing “corporate welfare” and tax subsidies to American companies, and noting that “the role of the government is to make the economy more efficient and to help the poor and those who can’t fend for themselves”). Rather than take a strict stance in favor of or against government economic intervention, I have relied on the “nudge” concept developed by Professors Thaler and Sunstein to support my arguments in this Article. Richard H. Thaler & Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth and Happiness 14 (2008). The “nudge” concept refers to any action that policy makers can take to subtly influence people’s choices “in a predictable way without forbid-
lead to a loss of trust and belief in the economic system, with serious consequences for the economy and society as a whole.35

This Article proposes that contract law adopt a more proactive approach by recognizing a broader duty of good faith in economic relationships prior to the formation of a contract (that is, a proactive contract law paradigm). Contract law currently requires that contractual parties act in good faith when performing their contractual duties once a contract has been formed.36 But absent some special relationship between parties, the law has imposed no general pre-contractual duty of good faith.37 A broader duty of good faith in economic relationships is a necessary constraint on opportunistic behavior during the negotiation process before contract formation.38


35. Shiller, supra note 25, at 100–01. One can see evidence of law’s broad impact. For example, well-developed tort law in the United States encourages people to take reasonable precautions to prevent personal injury. Restatement (Second) of Torts § 283 (1965). Anecdotal, the United States is one of the most safety-conscious societies in the world. Notes on file with author; see, e.g., Healthy Homes Initiative, Nat’l Inst. Food & Agric., http://www.csrees.usda.gov/nea/family/in_focus/housing_if_healthyhomes.html (noting “our safety-conscious society”). On the other hand, the United States lags behind most other developed countries in terms of reputation for integrity. Dan Ariely, Predictably Irrational: The Hidden Forces That Shape Our Decisions 214 (2008). Difficult-to-measure qualities and behaviors such as levels of societal corruption, freedom, and honesty are often gauged by such perception indices. See, e.g., Surveys and Indices, Transparency Int’l, http://www.transparency.org/policy_research/surveys_indices/cpi/2010/in_detail (last visited Mar. 13, 2011). The 2009 Transparency International Corruption Perceptions Index shows that the United States has now slipped to number nineteen in the world in terms of the perceived level of public sector corruption. Corruption Perceptions Index 2009, Transparency Int’l, http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table (last visited Mar. 13, 2010). One cannot help but wonder whether this has anything at all to do with the business mentality nurtured by contract law. Stiglitz, supra note 5, at 289 (“[W]e have created an economic system that encourages shortsighted behavior—behavior that is so shortsighted that the costs of the breakdown in trust are never taken into account.”).

36. See discussion infra Part III.A.

37. Id.

38. White, supra note 23, at 136 ("The time has come to replace the monistic value system dominated by wealth-maximizing efficiency with a pluralistic value system that seeks to balance the multiple and sometimes competing goals of equity, justice, autonomy, and efficiency in the law of [the consumer contract] markets."); Steve Ramirez, Toward a More Perfect Capitalism: Legal Infrastructure and the Subprime Mortgage Crisis of 2007–2009, at 15 (draft manuscript) (on file with author).
Current attempts to address the inadequacies of contract law by improving disclosure requirements are insufficient. They do not take into account human decision-making biases and the deliberate manipulation of those biases to the weaker party’s detriment. More disclosures will not effectively deter opportunistic behavior because parties with more resources usually outmaneuver such requirements, as happened widely leading up to the subprime mortgage crisis. Recognizing a duty of good faith as envisioned in this Article would allow a court to apply community standards of reasonable commercial behavior through a reasonable person standard.

Furthermore, by recognizing a duty of good faith in economic relationships, contract law delineates the baseline of acceptable commercial behavior in our society. Currently, contract law holds very low expectations of commercial behavior prior to the formation of a contract. Except for limited situations involving outright fraud, misrepresentation, illegality, incapacity, duress, or unconscionability, contract law tolerates various opportunistic commercial behaviors. Adopting a duty of good faith could rebalance the incentives to foster more positive and mutually beneficial economic relationships.

To provide a context for discussion, Part I of this Article provides a brief sketch of the transactions in the subprime mortgage crisis to illustrate the role contract law played in the crisis. Studies show that subprime mortgage transactions were plagued by severe information asymmetry and unequal bargaining power. In Part II, this Article sets forth general arguments in support of a broader duty of good faith in economic relationships.

Part III sketches the contours of a broader contractual duty of good faith. Taking a page from U.S. tort law, this Article advocates using the “reasonable person” standard developed within the negligence law framework to assess when the duty of good faith has been breached prior to contract formation. The negligence framework would limit this broader duty of good faith so that the doctrine would

39. See White, supra note 23, at 167–68.
40. ZANDI, supra note 3, at 154–55. Some people have pointed out that the resources of government regulatory agencies are no match for the creativity of the financial industry. Regulators could not keep up with the volume of new, more complicated mortgages being introduced to the borrowers. Id. at 154.
41. See discussion infra Part III.B.
42. See generally MICHAEL SHERMER, THE MIND OF THE MARKET 244 (2008) (advocating that “policies and institutions [should be created] that nudge people in the direction of doing what is good for them, as informed by science and freely chosen by voluntary consent,” and relying on the work of Richard H. Thaler and Cass R. Sunstein).
43. See discussion infra Part I.
not unduly disrupt contractual certainty in regular business transactions. Part IV, the last section of this Article, explores some legitimate concerns about adopting a broader duty of good faith in economic relationships and responds to those concerns.

I. Contract Law’s Role in the Subprime Mortgage Crisis

To understand contract law’s role in the subprime mortgage crisis, the basic structure of the subprime mortgage world must be unpacked. The “perfect financial storm” of the twenty-first century began with individual contracts—loan transactions between lenders or brokers and borrowers. The transactions typically involved a borrower without a good credit score who normally would not qualify for a standard mortgage. These borrowers are commonly known as subprime borrowers. Subprime mortgages mean mortgages provided by lenders to subprime borrowers. The banks, mortgage companies, and brokers involved in the initial loan origination are referred to as originators.

Subprime mortgage contracts at the loan origination stage have some basic characteristics. Professor Bar-Gill found that the subprime mortgage contracts were deliberately designed to appear affordable. The appearance of affordability arose from certain purposefully designed cost-deferral features. Subprime mortgage loan contracts deferred costs by offering small down payments, high loan-to-value ratios ("LTVs"), teaser rates (or "escalating payments"), and prepayment penalties. Because the cost-deferral features preyed upon borrowers’

44. I only offer a brief and somewhat simplified summary of the complicated world of subprime mortgage and its derivative financial products to provide a context for discussion. For a more in-depth examination of the subprime mortgage world, please see Zandi, supra note 3. For an interesting personal account of the subprime mortgage crisis, see Andrews, supra note 6.
47. Because of the profitability of subprime mortgages, some lenders also apparently steered minority borrowers who could have qualified for normal mortgages to subprime mortgages. Andrews, supra note 6 at 190–91.
48. Bar-Gill, supra note 2, at 1089–91, 1090 n.41.
49. See id. at 1108 (“If a borrower cannot afford to make a substantial down payment, then she will take a mortgage with a high LTV.”); Andrews, supra note 6, at 49–50.
50. See Bar-Gill, supra note 2, at 1096, 1120; Zandi, supra note 3, at 30.
51. Bar-Gill, supra note 2, at 1096.
myopia and optimism, borrowers systematically underestimated the true costs associated with the loan due.\textsuperscript{52}

Another feature of the subprime mortgage transactions was their complexity.\textsuperscript{53} The complexity of the subprime mortgage products made it difficult for the buyers to appreciate the risks or even understand the transactions.\textsuperscript{54} These mortgages were full of “booby traps and deceptions.”\textsuperscript{55} As a result, borrowers entered into costly loan contracts that they could not actually afford for very long, resulting in defaults and foreclosures that set off the financial crisis worldwide.

Once the loans were originated, the lenders would sometimes transfer the loans as a pool to a special purpose vehicle (“SPV”), a legal entity set up by the lenders solely for the purpose of receiving those loans.\textsuperscript{56} In some cases, Wall Street investment banks directly bought mortgages from originators.\textsuperscript{57} Then, investment banks working as employees or agents for the SPVs, also referred to as the issuers, would package the loan pool into different tranches of bonds known as mortgage-backed securities (“MBSs”). The big rating agencies, such as Standard & Poor’s and Moody’s Investor Service, would then rate the MBSs based on the risks of each tranche.\textsuperscript{58} The bottom tranche was considered the riskiest and had the lowest rating, while the top tranche was considered the safest and had the highest rating.\textsuperscript{59} This process is known as securitization.\textsuperscript{60}

Once mortgages were packaged into different securities, investment banks offered the MBSs to other investors. At this level, multiple contracts were entered into to sell the MBSs to various investors.\textsuperscript{61}

\textsuperscript{52} Id. at 1120; Jolls et al., supra note 22, at 1541–42. This optimism was often purposefully fostered by the broker. See Faber, supra note 19, at 54.

\textsuperscript{53} Bar-Gill, supra note 2, at 1102–03, 1121–23; ZANDI, supra note 3, at 18. Even former Federal Reserve Chairman Alan Greenspan acknowledged that “some of the exotic new mortgages were so complicated that a person with a Ph.D. in mathematics wouldn’t understand them.” ANDREWS, supra note 6, at 77.

\textsuperscript{54} ZANDI, supra note 3, at 18.

\textsuperscript{55} ANDREWS, supra note 6, at 50.

\textsuperscript{56} Strauss, supra note 16, at 2045.

\textsuperscript{57} Faber, supra note 19, at 66–74 (describing in detail how Wall Street both bought and created the demand for subprime mortgages that fueled the crisis).

\textsuperscript{58} Investors faced the following credit risks: that a borrower would default on their loans, that the borrowers would pay off their loans too early, and that borrowers would sue the SPV for wrongdoings in the loan origination. Strauss, supra note 16, at 2050–54.

\textsuperscript{59} Id. at 2046–48.

\textsuperscript{60} See id. at 2045–48 (describing the securitization process in detail).

\textsuperscript{61} See Jason Cox et al., Why Did the Credit Crisis Spread to Global Markets?, in The E-Book on International Finance and Development (Enrique Carrasco ed., 2010), http://www.uiowa.edu/idlebook/ebook2/contents/part5-II.shtml. Investors here face a different problem from that confronted by the borrowers. All the major financial firms have become
Presumably capable of assessing the risks associated with such securities, investors bought billions of dollars of subprime mortgage backed securities. Lenders thus shifted the risks inherent in subprime mortgages to third-party investors. However, these securities were structured in such a complex manner that a proper risk evaluation was “difficult, if not impossible.” Because these securities—backed by ostensibly secure mortgages—were further blessed by rating agencies as highly safe investments, there was an insatiable demand for

public companies, and many investment funds are managed by managers. The managers (not the investors themselves) made investment decisions. These managers’ fees were based on the trades they did and on the short-term performances. Some scholars have referred to this as an agency problem. Zandi, supra note 3, at 79–87 (pointing out that in 2006, at the peak of the subprime boom, foreign investors owned nearly one-third of all U.S. mortgages); Faber, supra note 19, at 72, 111–19, 165 (detailing a small town called Narvik in Norway, 150 miles inside the Arctic Circle, that bought some American CDOs as an investment without understanding the CDO products).

Arguably, Wall Street would not have been able to create such a demand for esoteric financial products without the AAA ratings provided by rating agencies. The rating agencies, unfortunately, had incentives to issue the high ratings Wall Street wanted because Wall Street paid the agencies’ fees. The rating agencies’ role in this crisis is an example of how resourceful companies or industries can corrupt the system for their own benefit. Andrews, supra note 6, at 147–48 (citing a Wall Street analyst’s research that Wall Street firms corrupted the rating agencies).
them. Investment banks were eager to find additional loans to package and sell. Investment banks did not stop with packaging subprime mortgages into securities. When there weren’t enough MBSs to sell, Wall Street began creating additional financial products derived from MBSs. These derivative financial products were called collateralized debt obligations (“CDO”) and other variations of CDOs. CDOs at their peak were primarily made up of MBSs instead of the loans themselves. Wall Street also created mezzanine CDOs consisting of the bottom (riskiest) tranches that no investor wanted to buy. Once the mezzanine CDOs were magically blessed with the highest ratings by the rating agencies, they were “unloaded on unsuspecting investors the world over.” Wall Street also created additional CDO-derivative products to generate more demand for CDOs and MBSs. Wall Street thus kept its money machine running.

Wall Street firms received handsome fees for their efforts. The hedge fund managers also found it convenient to rely on the rating agencies. They were paid generous salaries, bonuses, and fees for investing someone else’s money. For the brokers and lenders, the more loans they could sell, the better off they were, at least in the short term. The brokers and lenders were paid based on the quantity, not the quality of the loans. The vicious cycle continued until the house of cards fell in 2007.

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66. Faber, supra note 19, at 66–74.
67. Andrews, supra note 6, at 112–18.
68. Faber, supra note 19, at 98–101.
69. Id. at 100.
70. Id. at 102.
71. Id. at 102 (quoting Ann Rutledge, a former analyst at Moody’s who rated structured products).
72. For a detailed explanation of the various CDO products, please see Faber, supra note 19, at 103–09.
73. Id. at 102.
74. Zandi, supra note 3, at 42.
75. Andrews, supra note 6, at 145; Faber, supra note 19, at 127–30.
76. Andrews, supra note 6, at 145; Faber, supra note 19, at 130–33 (pointing out that thirty years ago, most of the firms on Wall Street were partnerships while now all the major financial firms are public companies).
77. Zandi, supra note 3, at 95.
78. Faber, supra note 19, at 66–74, 163 (describing Wall Street’s role in creating the subprime mortgage frenzy because of its willingness to buy the mortgages from originators which in turn incentivized the originators to push the loan products to borrowers).
79. Can one argue that securitization is the culprit? I would disagree. Securitization is a legitimate tool to connect the mortgage markets with the capital markets. Securitization by itself allows the shifting of the risks to investors who are compensated for their willing-
II. A Duty of Good Faith in Economic Relationships

This Article advocates that contract law adopt a broader duty of good faith in economic relationships prior to the formation of a contract. This position raises some immediate questions. One question is how to design a rule that would discourage opportunistic commercial behavior without dampening parties’ creativity and innovation. How can contract law calibrate the incentives so that the parties are motivated to look for mutually beneficial opportunities that may also benefit the society as a whole?80 What factors should the courts use to assess when a breach has occurred? In pre-contract formation cases, where should the courts draw the line between acceptable commercial behavior pre-contract formation and a breach of the duty of good faith? What limitations should be in place to prevent undue interference in parties’ freedom to contract?

This section first discusses briefly the current status of the duty of good faith in contract law. Courts and legislatures have recognized a narrow duty of good faith in contractual relationships. Absent any special relationship between parties, courts and legislatures have generally imposed the duty only in contract performance or enforcement after a contract has been formed.81 This section then discusses a potential standard to apply when assessing whether a party breaches a duty of good faith prior to contract formation. Lastly, this section advocates applying the “reasonable person” standard borrowed from tort law.

A. Current Status of the Duty of Good Faith in U.S. Contract Law

The concept of good faith is well recognized in contract law.82 Courts currently impose a duty of good faith on parties performing the terms of a contract after its formation.83 The doctrine generally

80. Professors Schwartz and Scott suggest that businesses are motivated to maximize joint gain in a contractual relationship. See Schwartz & Scott, supra note 10, at 553–54. This position assumes that all the firms have equal access to information and equal bargaining power; however, not all firms do. A clear example in the business-to-business context is the disparity in bargaining power between Walmart and its suppliers. The same concerns exist in business-to-consumer contexts.


83. Id. at 313–14.
requires a party vested with discretion under the terms of the contract to exercise the discretion in good faith.\footnote{Id.} Courts have struggled with a precise definition of the doctrine of good faith.\footnote{Id. at 312–13.} The doctrine has been primarily defined by what it does—for example, to exclude different forms of bad faith, to limit contractual parties’ discretion, to prevent a party from reneging on performing under the contract, or to protect parties’ reasonable expectations.\footnote{Id. at 313 (and the articles cited therein).} The Uniform Commercial Code (“UCC”) defines “good faith” as “honesty in fact” and “fair dealing.”\footnote{“Good faith, except as otherwise provided in Article 5, means honesty in fact and the observance of reasonable commercial standards of fair dealing.” U.C.C. § 1-201 (2008).}

The doctrine’s history in the United States illustrates its controversial nature even in its current narrow scope. Courts had generally resisted recognizing the doctrine prior to the adoption of the UCC in the 1950s.\footnote{Leonhard, supra note 82, at 311–12.} When the UCC incorporated the doctrine of good faith, the drafters pointed out that the UCC does not recognize an independent cause of action for failure to perform or enforce it in good faith, except in relation to a specific duty or obligation under the contract.\footnote{Id. at 314.} The refusal to recognize a separate cause of action reflects the scholars’ concern about the doctrine’s capacity to interfere with the parties’ private bargains.\footnote{Luigi Russi, Can Good Faith Performance Be Unfair? An Economic Framework for Understanding the Problem, 29 Whittier L. Rev. 565, 572 (2008).} Despite the controversies surrounding the doctrine, it is worthwhile to examine whether the doctrine of good faith can or should be the vehicle to improve the current contract law paradigm.

**B. Breaching the Duty of Good Faith in Economic Relationships**

If a duty of good faith is imposed prior to contract formation, what standard should the court use to assess when the duty has been breached? In post-contract formation cases, there is a well-developed body of case law regarding when a breach of the duty of good faith occurs.\footnote{For a detailed discussion on the doctrine, please see Harold Dubroff, The Implied Covenant of Good Faith in Contract Interpretation and Gap Filling: Revising a Revered Relic, 80 St. John’s L. Rev. 559 (2006).} In cases involving claims prior to contract formation, we can borrow a page from tort law. Courts have had extensive experience in weighing multiple public interest and policy concerns in assessing
whether a duty of care has been breached in tort law. Negligence law requires a party to conform its conduct to that of "a reasonable man under like circumstances."92 The words 'reasonable man' denote a person exercising those qualities of attention, knowledge, intelligence, and judgment which society requires of its members for the protection of their own interests and the interests of others.93 The reasonable person standard is objective and external and reflects a "standard of conduct demanded by the community for the protection of others against unreasonable risk."94 The standard is flexible because it allows the fact finder to consider the particular circumstances of the case while providing a formula whereby a uniform standard may be fashioned and maintained.95

Applying community standards through the "reasonable person" would impose some reasonable limits on a pre-contract duty of good faith. In economic transactions, the reasonable person standard would sanction commercial behavior that a reasonable person would consider acceptable. For example, in cases where parties have equal bargaining power and access to information, a reasonable person standard would not result in liability for one party if the other party suffers an economic loss and claims breach. On the other hand, if one party has little or no bargaining power and no access to information, the stronger party would be required to behave like a reasonable person in the community in a similar situation to avoid a breach. In the case of subprime mortgage transactions, lenders and/or originators would have breached the duty if it was shown that the mortgage products were designed to deliberately mislead and confuse the borrowers.

In addition to the limits placed by the reasonable person standard, defenses to a negligence action, such as consent and contributory negligence, will also shield a party from being exposed to liability despite commercially reasonable behavior. For example, the defense of consent can be potentially asserted against a breach of duty of good faith where the defendant can sustain its burden of proving that the plaintiff effectively consented to the economic exchange.96 Allowing consent as an affirmative defense removes the presumption of voluntary consent by plaintiff in a breach of contract action currently indulged by contract law.

92. Restatement (Second) of Torts § 283 (1965).
93. Id. § 283 cmt. b.
94. Id. § 283 cmt. c.
95. Id.
96. Restatement (Second) of Torts § 892B (1979).
Once a breach is found, what damages should plaintiffs be entitled to? This Article suggests that a party that breached its duty of good faith should be liable for all damages permissible under tort law. For instance, some courts have allowed tort damages for breach of the duty of good faith in insurance transactions. Scholars have pointed out that contract law’s compensatory damages approach does not do enough to deter wrongful conduct. Allowing tort recovery would have more of a deterrent effect and would provide the necessary checks and balances against excessive opportunistic behavior.

III. In Support of a Broad Duty of Good Faith in Economic Relationships

Why should contract law adopt a broader duty of good faith in economic relationships? Contract law plays a significant role in the welfare of society because it governs economic relationships. Leaving the contract mechanism to the whims of the parties fails to take into consideration the societal interests in economic relationships. A broader duty of good faith in economic relationships, with appropriate limiting principles, will help provide some external checks and balances against excessive opportunistic behavior.

This section will set forth a few arguments in support of recognizing a broader duty of good faith in economic relationships. I draw heavily on behavioral research that shows that even under the best of circumstances people suffer from decision-making biases. Part A explores the implications of those behavioral findings, and Part B highlights social changes that exacerbate the problems of relying on certain assumptions.

99. See generally Fukuyama, supra note 31, at 6–7 (espousing the need for economic relationships that create rather than destroy wealth).
100. See Kreitner, supra note 33, at 1547 (stating that the focus on individual exchange will not capture all the social stakes).
A. Behavioral Studies Show that Underlying Assumptions of Contract Law Are Generally Wrong

Recognizing a broad duty of good faith in economic relationships is necessary because the underlying assumptions relied upon to justify the current passive approach are generally wrong, as demonstrated by behavioral findings by a group of scholars over the recent decades. The current contract law paradigm, heavily influenced by the rational choice model of free market economy, assumes that people have equal access to information and equal bargaining power. These assumptions are appealing because they are consistent with cherished values of individual autonomy and freedom of contract.

The simplicity and elegance of those assumptions diminishes, however, when one realizes that the real world is very different from the world assumed by contract law. That the contract law paradigm is based on unwarranted assumptions is well established. For the last several decades, behavioral economists have demonstrated that people are more complicated and far less rational than the standard

102. I do not mean to suggest that the rationality assumption fails in all cases. Part of the difficulty with contract law is that the word “contract” fails to capture the complexities of commercial relationships encompassed by the word. On one end of the spectrum of contractual relationships there are multiple-year complex relationships in areas dealing with natural resources such as oil exploration, and on the other end, there are single-item sales transactions. Between the two extremes lie many variations of economic relationships. In some situations, contractual parties may have equal bargaining power and equal access to information. However, the adoption of a broader duty of good faith applying the “reasonable person” standard would not disrupt those types of contractual relationships that are consistent with the current contract law paradigm.

103. The predominant conception of the rational choice microeconomic theory is that people act rationally to maximize their own expected utility. See Russell Korobkin & Thomas S. Ulen, Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics, 88 CALIF. L. REV. 1051, 1052 (2000), for a detailed discussion of the various conceptions of the rational choice theory. This theory assumes that decision makers conduct a cost/benefit analysis of competing options and choose the option that would maximize their expected utility. Id. at 1063.


105. It is true that every rule of general applicability has certain exceptions. That some assumptions can be wrong sometimes does not necessary undermine the validity of that particular general principle which relied on those assumptions. However, there comes a time when the underlying assumptions are so wrong and to such a large extent that the general principle can no longer be justified. That moment has arrived for contract law.


economic theory assumes. Behavioral economists have observed deviations from the rationality assumption regardless of its definition.

Interestingly, the challenge to contract law in the twenty-first century is the mere fact that human beings are all too human. Behavioral economists have demonstrated that the human decision-making process can be illogical. People are notoriously incapable of estimating future costs. They tend to be overly optimistic, myopic, and place too little weight on the future costs and benefits and too much weight on the short-term costs and benefits. Individuals also tend to misjudge the likelihood or probability of a future event. They rely on the short cut of a small sample of present events as indicative of future events while ignoring other evidence, such as prior occurrences and the quality of the sample. These biases lead to systematic underestimation of future risks.

The human tendency to rely on shortcuts to make decisions often leads to predictable mistakes. For example, when making a decision, human beings tend to overemphasize information that is salient or available to them (referred to as the saliency effect). These known biases make it possible to predict people’s irrationality. Studies have shown that people’s choices are often affected by how the choices were presented to them (referred to as the framing effect). Professor Eisenberg recognized the strong pull of the framing effect and its potential to be manipulated.

The finding that people are “predictably irrational” has significant implications. It means that people’s decision making can be

109. See Jolls et al., supra note 22, at 1488. Professors Jolls et al. pointed out that there could be five different definitions of rationality. It could mean that the person’s behavior: (1) conforms to the expected utility theory; (2) is responsive to cost and benefit incentives; (3) is internally consistent; (4) promotes his or her own welfare; or (5) is effective in achieving his or her own goal. Id.
110. Bar-Gill, supra note 2, at 1118–21.
111. Eisenberg, supra note 10, at 216–18, 222 (referring to subconscious brain activity).
112. Id. at 222.
113. Id. at 223.
114. Id. at 221.
115. Id. at 220–21.
116. Ariely, supra note 35, at xx (offering an interesting in-depth examination of the human decision-making process and the biases that affect it).
117. Eisenberg, supra note 10, at 218–19.
118. Id. at 220.
manipulated. Manipulation of those biases was exactly what happened during the subprime mortgage transactions.120

During the subprime mortgage transactions, the lenders manipulated those with less information through deliberate contract design.121 Subprime loan products with cost-deferral features exploited people’s inherent biases of optimism and myopia. The borrowers focused on short-term benefits and underestimated future risks. Borrowers’ decision-making biases were further exacerbated by lenders’ eager assurances not to worry about the future high rates because borrowers could refinance in a short time.122 Lenders and brokers led the borrowers further astray with deceptively appealing solicitations.123 The manipulation rendered contract law’s assumption of voluntary choice and equal access to information largely illusory.124

To sum up, behavioral research shows that the underlying assumptions of the passive contract law model are generally wrong because of human decision-making flaws. That those flaws are being actively exploited creates an urgent need to reevaluate contract law’s passive approach.125 The current widespread information asymmetry and unequal bargaining power prove that contract law has no built-in checks and balances to prevent excessive opportunistic behavior in economic relationships. A more proactive contract law paradigm is needed to provide some necessary constraints.126

121. See Faber, supra note 19, at 51–52 (stating that a lack of regulation enabled unscrupulous practices, such as not verifying income); White, supra note 23, at 158–60 (pointing out that the marketing industry spends billions of dollars on behavioral research to devise marketing strategies which can increase sales).
122. Faber, supra note 19, at 54.
123. Id. at 45. For a detailed discussion of how lenders exploited these decisional biases in consumer contract contexts, see White, supra note 23, and the articles cited therein.
124. Information asymmetry can be caused by multiple factors. It could be due to a lack of access to relevant information, the inability to understand relevant information because of its difficulty, and/or the deliberate manipulation of human decision-making biases. The information asymmetry during the subprime mortgage transactions is caused by all of the above factors. That is also the reason why merely improving disclosure, which goes to the issue of access to information only, is insufficient.
125. See generally Jolls et al., supra note 22, at 1522 (exploring ways law can best be structured to achieve specific ends, such as deterring socially undesirable behavior).
126. See id. (advocating a behavioral approach to legal analysis that reflects a better understanding of human behavior).
B. Social Changes in the Twenty-First Century Support Recognizing a Broader Duty of Good Faith

Social changes also support imposing a broader duty of good faith in economic relationships—a more proactive contract law paradigm.127 Because modern technologies increase access to the global marketplace, the last few decades have seen unprecedented growth and consolidation of financial power.128 Such concentration of economic power, combined with a better understanding of human beings and human decision-making processes, has created powerful commercial forces singularly focused on profit making.129 These commercial entities have devoted considerable resources to manipulate consumer behavior more than ever before.130 The resulting information asymmetry leads to even greater inequality in bargaining power between the parties.

Because of the consolidation of financial resources and information advantages in the hands of relatively few powerful companies, the laissez faire approach of the current contract law is no longer appropriate.131 As Professor Stiglitz pointed out, powerful entities will try to take advantage of their positions to benefit themselves.132 The Wall Street firms behind the subprime mortgage crisis created the demand for mortgages by developing exotic mortgage-backed financial products for sale to investors.133 They manipulated the rating agencies to bless those products with the top ratings.134 The top ratings ensured a continuous flow of buyers for those financial products because of access to global money.135 Wall Street’s financial power not only gave it

127. Ronald K.L. Collins, Foreword, in Grant Gilmore, The Death of Contract, at vii, xix (2d ed. 1995). Great contract law scholars view “rules of law not as mystical absolutes but as tentative approximations subject to change as the conditions which called them forth themselves changed.” Id. (quoting Grant Gilmore, Review: Justice Joseph Story and the Rise of the Supreme Court, 39 U. Chi. L. Rev. 244, 244–45 (1971)).
128. STIGLITZ, supra note 5, at 205.
129. See discussion supra Part I.
130. See Steven D. Levitt & Stephen J. Durner, Freakonomics 64–69 (2005) (discussing how real estate agents use their information advantage to manipulate home prices); Jolls et al., supra note 22, at 1519 (stating that public and private parties can take advantage of certain behavioral tendencies “to promote their selfish . . . goals”).
131. STIGLITZ, supra note 5, at 207 (“The old rules, whether they worked well in the past, are not the right rules for the twenty first century.”).
132. Id. at 175–76 (endorsing the need for a Financial Products Safety Commission).
133. Faber, supra note 19, at 66–74.
134. Lewis, supra note 4, at 72–77.
an information advantage but also the wherewithal to corrupt the system itself.\textsuperscript{136}

If contract law remains as is, parties with more resources and information advantages can count on the court system to maintain their advantages.\textsuperscript{137} Contract law is, in effect, aiding and abetting the exploitation of those who are disempowered by the rich and contributing to the perception that the system is rigged in favor of the rich.\textsuperscript{138} If contract law continues to turn a blind eye to the inequality, it will only exacerbate the gap between the rich and the poor.\textsuperscript{139}

An interesting inconsistency pervades American society: Americans are generally suspicious of big government and concentrated political power,\textsuperscript{140} yet they tolerate elites who maximize and consolidate their wealth.\textsuperscript{141} The Founding Fathers drafted the Constitution with the explicit purpose of restricting governmental power.\textsuperscript{142} The Constitution sets forth a system of checks and balances by creating three separate but equal branches of the government so as to prevent the concentration of political power in any one branch.\textsuperscript{143} However,
American society appears to tolerate the concentration of economic wealth, and indeed, encourages it by adopting a laissez faire approach in economic policies. Yet, concentrated economic power can also lead to corruption and result in serious consequences for the society. As Professor Ramirez recently proposed, “the power of growth-retarding elites must be constrained through law in order to secure maximum macroeconomic growth.”

The incentive to pursue self-interest may have been what people needed in the late nineteenth century when classic contract law began to take its shape. Strong incentives were necessary to kick-start this country’s economy. However, the twenty-first century provides a very different social context. The subprime mortgage crisis has shown us the dark side of the unbridled pursuit of self-interests.

C. The Current Contract Law Paradigm Undermines Its Goal of Efficiency

It is generally accepted that one goal of contract law is to promote economic efficiency. The current contract law paradigm is said to promote wealth maximization because it assumes that if both parties to an agreement are willing to enter into the contract, they must both be made better off as a result. Regardless of the defini-

144. See Joseph E. Stiglitz, Of the 1%, by the 1%, for the 1%, VANITY FAIR, May 2011, available at http://www.vanityfair.com/society/features/2011/05/top-one-percent-201105 (noting that the top one percent of Americans control forty percent of national wealth and that “key executive-branch policymakers on trade and economic policy also come from the top 1 percent”); Hart, supra note 137, at 216–17 (discussing the ways that the presumption of contract validity immunizes coercive elements from being effectively challenged, thereby providing insight into one mechanism by which wealth is concentrated).

145. See Ramirez, supra note 38, at 2.

146. Id. at 11.

147. STIGLITZ, supra note 5, at 207.

148. Some scholars have challenged contract law’s focus on efficiency maximization only. See, e.g., White, supra note 23. Professor Kar also challenged the principle of efficiency maximization because of its failure to “respect the separateness of persons, and . . . what is special about our distinctive relationships with one another” and its exclusion of “considerations of justice and fairness from the relevant legal calculus.” Robin Bradley Kar, Contract Law and the Second-Person Standpoint: Why Efficiency Maximization Principles Can Neither Explain Nor Justify the Expectation Damages Remedy, 40 Loy. L.A. L. Rev. 977, 980 (2007). See also Schwartz & Scott, supra note 10, at 545 (advocating that contract law should only concern itself with the efficiency goal in business-to-business contracts).

149. Schwartz and Scott argue that the only normative goal of contract law in firm to firm contracts (referred to as Category I contracts) is to facilitate their efforts to maximize the gains for both parties. Schwartz & Scott, supra note 10, at 544, 549. They argue that the negative externalities that might potentially be generated by these contracts such as environmental pollution or price fixing can be regulated by environmental laws and anti-trust laws. They concluded that contract law for a modern economy should be “little more than
tion of efficiency, contract law apparently assumes that the best way to promote efficiency is to allow private parties to arrange their own affairs.\footnote{150}{See Eisenberg, supra note 10, at 212.}

Discussions of efficiency in the contract law context have not differentiated between efficiency for one party to the contract, efficiency for both parties to the contract, or efficiency to society as a whole. Perhaps, there are some implicit assumptions that efficiency for the individual parties coincides with efficiency for the society as a whole. This Article will refer to these efficiencies as individual efficiency, microefficiency, and macroefficiency, respectively. Although one can envision a situation where all three efficiencies coincide, they do not necessarily all exist in every case.

The subprime mortgage crisis demonstrates that the current laissez faire contract law paradigm undermines its goal of efficiency, both at the microefficiency level (between individual parties) and at the macroefficiency level (for the society as a whole).\footnote{151}{For purposes of this discussion, this Article does not challenge contract law’s adherence to the normative goal of efficiency. It is beyond the scope of this Article to examine in depth the various definitions of efficiency. Some scholars have questioned whether efficiency should be the only normative goal of contract law. There are advocates on both sides of the fence. Compare White, supra note 23, at 136 (arguing that the normative goal of contract law should be a balancing of competing interests of efficiency and fairness in the consumer contract context), with Schwartz & Scott, supra note 10, at 545 (arguing that contract law should only concern itself with efficiency).} The contract law paradigm failed to promote microefficiency because subprime mortgage transactions solely benefitted the parties with more resources and more access to information. The transactions were thus only “individually efficient” for Wall Street firms.\footnote{152}{Zandi, supra note 3, at 42; FCIC Report, supra note 7, at 8 (describing a term coined during the subprime mortgage boom—IBGYBG, or “I’ll be gone, you’ll be gone”—that referred to deals that brought in big fees to bankers while pushing larger losses to the future and to third parties).} Extensive evidence shows that many subprime borrowers entered into loan transactions not because the deals were good for them, but because borrowers’ decisional biases were manipulated by lenders.\footnote{153}{See discussion supra Part III.A.} Without equal access to information, one can hardly argue that the parties can allocate the resources efficiently at the micro level.\footnote{154}{Id.}
The near collapse of the financial system and the ramifications thereof demonstrated that subprime mortgage transactions failed to promote macroefficiency.\textsuperscript{155} The subprime mortgage crisis brought down some venerable financial firms such as Bear Stearns and Lehman Brothers.\textsuperscript{156} A massive government bailout was necessary to prop up the financial and insurance industries.\textsuperscript{157} Thousands of people lost their jobs and their homes.\textsuperscript{158} Incredible amounts of wealth were wiped out in a very short span. Trillions of dollars in wealth (between the losses on the stock market and real estate) was lost in about two years.\textsuperscript{159} Andrews blamed the United States for sending the global economy into “its worst downturn in decades.”\textsuperscript{160} The subprime mortgage crisis generated hundreds of lawsuits amongst multiple parties.\textsuperscript{161} The consequences of the massive government bailout are still unknown.\textsuperscript{162} The social costs of job and home loss, the trauma to the nation’s psyche, lost trust, and other collateral damage are immeasurable.

By inducing borrowers to enter subprime mortgage contracts whose risks and terms they largely misunderstood, lenders took advantage of their resource, informational, and legal positions. Despite pro-

\textsuperscript{155} FCIC Report, supra note 7, at xv, 8. To the extent one narrowly defines efficiency only in terms of wealth maximization at the individual efficiency level, one could argue that the contract law’s laissez faire approach promoted efficiency at the individual level in some cases because some individuals and companies were able to arguably maximize wealth for themselves. Lewis, supra note 4, at 256. However, this view of the efficiency goal is very problematic because the individual wealth maximization was at the expense of the society as a whole.

\textsuperscript{156} Id. at xvi, xxi.

\textsuperscript{157} Prins, supra note 46, at 4–5, 10.

\textsuperscript{158} FCIC Report, supra note 7, at xv (pointing out that as of the printing time of the report, “there are more than 26 million Americans who are out of work, cannot find full-time work, or have given up looking for work. About four million families have lost their homes to foreclosure and another four and a half million have slipped into the foreclosure process or are seriously behind on their mortgage payments.”).

\textsuperscript{159} Id.

\textsuperscript{160} Andrews, supra note 6, at x–xi.

\textsuperscript{161} Jonathan C. Dickey, Subprime Related Securities Litigation: Where Do We Go From Here?, (PLI-Corp. Law & Practice Course Handbook Series No. 14433, 2008).

\textsuperscript{162} Preliminarily, the investments in the auto and financial industries appear to be yielding returns, though not enough to pay back the bailouts. See, e.g., Rachelle Younglai & Andrew Hay, AIG’s Financial Condition Improving: U.S. Watchdog, Reuters (Jan. 20, 2011, 4:58 p.m.), http://www.reuters.com/article/idUSTRE70J79320110120; Josh Mitchell & Sharon Terlep, U.S. Unlikely to Recoup GM Bailout, Panel Says, WALL ST. J., Jan. 13, 2011, at B4. FCIC Report, supra note 7, at xvi (pointing out that “the impacts of this crisis are likely to be felt for a generation. And the nation faces no easy path to renewed economic strength.”).
viding banks with individual gains, the micro-
inefficient contracts en masse created a very inefficient macroeconomic situation. The divergence of efficiencies supports a need for a more proactive paradigm.163

D. Contract Law’s Tolerance of Unbridled Pursuit of Self Interest Has Led to a Moral Erosion of Business Culture

Contract law has nurtured a business environment where one only needs to focus on maximizing one’s own profits.164 In her article *Divergence of Contract and Promise*, Professor Shiffrin pointed out that contract law’s remedial doctrines encouraged breaches of promises, a departure from the moral rule that promises should be kept.165 She argued that contract law should be fashioned to allow people to live consistently with their moral beliefs.166 The subprime mortgage crisis shows that contract law’s laissez faire approach failed to promote the “moral being” and made it harder for an otherwise decent human being to behave reasonably in the face of great incentives to profit.167

The subprime mortgage crisis offers an example of moral corrosion due to the inconsistency of contract law with moral norms applicable to the same behavior. Contract law facilitated unfettered greed by giving parties in contractual relationships legal and moral permission to maximize their own profits without regard for any other party’s wellbeing; after all, the other party is presumed to know how to watch out for his or her own interests.168 In Andrews’s words, the sub-

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163. Where the contractual parties actually have equal access to information and equal bargaining power, one can understand that the transaction may create efficiencies because the parties would not have entered into this transaction unless they believed that it was good for them.

164. This is consistent with the individualistic culture and the free-market economy of this society. Contract law has elevated those values to new heights by cheering on the pursuit of individual self-interests and protecting those self-interests when necessary.


166. *Id.* at 717–18. Professor Shiffrin’s article focused on contract law’s apparent departure from the moral rule that “breach of promise is wrong,” *id.* at 724, with respect to its remedial doctrines. My quarrel with contract law is the theoretical underpinnings for the contract law paradigm itself. The contractual remedial doctrines’ tolerance of breach (viewed by Professor Shiffrin as a departure from the moral rule) reflects certain unwarranted assumptions underlying contract law theory.

167. *Id.* at 740–41.

168. Professor Shiffrin expressed “a further worry about a legal regime that introduces divergent norms that apply to agents simultaneously alongside moral norms—namely, whether moral individuals can participate in both cultures without running the risk that their participation will corrode the habits and expectations associated with moral practice.” *Id.* at 740.
prime mortgage crisis is “a debacle that stemmed from deep-seated rot and corroded ethics in our financial systems.”


Trust is an important ingredient for the success of a modern society. Francis Fukuyama, in his book, Trust: The Social Virtues and the Creation of Prosperity, argued convincingly that a high degree of social trust is critical to the success of a modern society. Positive economic relationships create public good such as fostering trust in the marketplace. Trust lowers transaction costs in a society by facilitating transactions. When people trust each other, it reduces the “number of contingencies that must be considered when ‘doing a deal.’” On the other hand, when trust does not exist, economic crises such as the subprime mortgage crisis occur: the crisis began when investors lost faith in their bankers and the banks refused to trust each other.

Structural changes can influence the level of social trust. The subprime mortgage crisis came about partly because of misaligned incentives. Over the past few decades, behavioral economists have concluded that incentives matter. Contract law should help align incentives to encourage people to behave in a socially responsible manner. Requiring that people exercise good faith in economic transactions helps improve social trust by providing some external constraints on people’s opportunistic behavior. A broader duty of good faith may “nudge” people in the right direction for the benefit of the society as a whole.

169. Andrews, supra note 6, at xiii.
171. FUKUYAMA, supra note 31. I do not intend to suggest that the duty of good faith is a panacea for all the ills that plague the free market economy. I believe that it would nurture a different mindset more conducive for the growth of the society as a whole.
172. Kreitner, supra note 33, at 1548.
173. Shermer, supra note 42, at 177–79.
174. Id. at 177–78 (quoting Paul Zak, a professor of economics at Claremont Graduate University).
175. See Faber, supra note 19, at 1, 10.
177. See, e.g., Levitt & Durner, supra note 130, at 16–17.
178. See id.
179. See generally Thaler & Sunstein, supra note 33. I borrowed the “nudge” concept from Professors Thaler and Sunstein.
Studies show that people will engage in opportunistic behavior if there are no external constraints.\textsuperscript{180} However, if people are reminded of some moral standards, they will try to refrain from opportunistic behavior. In a series of experiments on cheating, there were significant differences between the groups that could recall the Ten Commandments\textsuperscript{181} and students who signed an honor code,\textsuperscript{182} for example, and those that did not. Both the Ten Commandments and the honor code in those experiments served as reminders of a certain moral standard. A contract law paradigm incorporating a duty of good faith can provide the same necessary reminder and “nudge” people in the right direction.\textsuperscript{183} Contract law’s recognition of a duty of good faith serves as an authoritative pronouncement of what the law expects from people when they engage in economic transactions with others. People are likely to cooperate when an authority instructs them to do so.\textsuperscript{184}

Requiring people to abide by a certain standard when engaging in economic transactions is also consistent with people’s innate sense of fairness. Although human beings are motivated by self-interest, behavioral economists have demonstrated that humans have a strong sense of fairness.\textsuperscript{185} People are socially oriented.\textsuperscript{186} Evolution has taught human beings that cooperation and altruism are more conducive for survival.\textsuperscript{187} Experiments have shown that people are willing to act against their financial interests for the sake of fairness.\textsuperscript{188} Shermer refers to this as an “Evolutionary Stable Strategy”: fairness evolved as a strategy for maintaining social harmony in small groups.\textsuperscript{189}

Over the long run, imposing a duty of good faith will help foster more positive, trusting economic relationships for the benefit of the society as a whole. On one hand, it places some external constraints and serves as a reminder of the standard they have to abide by in economic relationships. On the other, its existence brings out the best in people—people’s sense of fairness.

\textsuperscript{180} ARIELY, supra note 35, at 222.
\textsuperscript{181} Id. at 208–09.
\textsuperscript{182} Id. at 212.
\textsuperscript{183} See THALER & SUNSTEIN, supra note 33, at 6.
\textsuperscript{185} See SHERMER, supra note 42, at 176; Jolls et al., supra note 22, at 1495–96.
\textsuperscript{186} SHERMER, supra note 42, at 125.
\textsuperscript{187} Id.
\textsuperscript{188} Jolls et al., supra note 22, at 1492, 1545.
\textsuperscript{189} SHERMER, supra note 42, at 126.
IV. Potential Concerns About Imposing a Broader Duty of Good Faith in Economic Relationships

This section addresses some of the potential concerns regarding expanding the duty of good faith to the pre-contract formation stage. Potential arguments against adopting a broad duty of good faith will likely include the usual charge that the doctrine is paternalistic. The doctrine’s apparent defiance of a precise definition further fuels the concern about paternalism. Some courts and scholars fear that the lack of a precise definition may potentially give the courts a license to override the parties’ private agreement.

Another possible objection is that the doctrine interjects a third party into the private contracting process. It has the potential to interfere with individual autonomy and freedom of contract, two related and fundamental principles of contract law. It creates uncertainty in the contracting process. This section addresses those arguments and offers some responses.


One objection to a broader duty of good faith (one that has been articulated against the current doctrine even with its narrow scope) is that the doctrine seemingly offends the two bedrock principles of contract law—individual autonomy and freedom of contract. Contracts are intended to be a tool for private parties to define their respective obligations to each other. Imposing a broader duty of good faith interjects the courts (and hence the government) into the contracting process. Critics would argue that this doctrine is overly paternalistic.

A duty of good faith delineates the standard of acceptable economic behavior prior to the formation of a contract. Accordingly, a broad duty of good faith requires the involvement of the government as a third-party enforcement mechanism to oversee the contracting process. To that extent, imposing a broad duty of good faith does limit individual autonomy and freedom of contract.

190. See Thomas A. Diamond & Howard Foss, Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery, 47 HASTINGS L.J. 585, 590 (1996), and the literature cited therein. Professors Diamond and Foss provided a comprehensive summary of the various attempts to define the doctrine of good faith and fair dealing. Id.


192. White, supra note 23, at 177.
However, as explained above, cumulative evidence shows that the underlying assumptions of the current passive contract law model are simply wrong most of the time. Because the current contract law rests on faulty assumptions, it has no built-in checks and balances. Government intervention provides an external check against excessive opportunistic behavior in economic relationships. The government represents a necessary counterbalance against powerful market forces.

Advocates for unregulated markets also operate on the assumption that people have equal bargaining power and equal access to information. The subprime mortgage crisis shows that the marketplace, skewed by severe information asymmetry and unequal bargaining power, merely offers the illusion of freedom and autonomy. Seemingly “free” choices are influenced by manipulation of those with more resources and information. Because the underlying assumptions warranting the application of the principles of freedom of contract and individual autonomy are wrong, the argument against paternalistic intervention lacks merit.

Concerns regarding paternalism are further outweighed by the potential damage to the perception of fairness and legitimacy in contract law. The current laissez faire approach permits stronger parties to resort to the coercive power of the government via the courts to enforce contracts they are able to obtain as a result of their superior bargaining power. This further solidifies the perception that the system is rigged in favor of the rich. To maintain its legitimacy, the system must treat all members of society fairly. Thus, it is necessary to place some constraints on market activities, even though they may limit individual autonomy and freedom of contract.

In the wake of the financial crisis, even staunch supporters of the free-market economy recognize that government regulations can play

193. See discussion supra Part III.A.
194. See discussion supra Part III.B.
195. White, supra note 23, at 177 (pointing out that paternalism is a false bogeyman); Jolls et al., supra note 22, at 1541 (explaining that bounded rationality calls into question the anti-paternalism of the standard economic theory).
196. Eisenberg, supra note 10, at 230 (“Since the premise does not apply, neither should the principle itself.”).
197. Hart, supra note 137, at 216.
199. ARIELY, supra note 35, at 48.
a role in the market. Government intervention is necessary so that every member of society can enjoy their rights effectively. Courts and legislators have recognized the necessity of government intervention in economic relationships in a variety of instances. They have attempted to bring the duty of good faith into economic relationships prior to contract formation by relying on quasi-contractual theories to impose liability. They have also imposed a duty of disclosure during contract negotiations in numerous situations involving special relationships. Additionally, as Professor Gilmore noted, the duty of good faith is the unifying principle behind the doctrines of fraud, duress, and unconscionability.

The concept of good faith also justifies government involvement in non-contract contexts, such as tortious interference with contractual relationships, consumer fraud regulations, and disclosure regulations of the banking and financial industries. Colorado imposed a duty of good faith and fair dealing on all mortgage brokers in the state. The fairness norms form the basis for many laws including those prohibiting usurious lending, price gouging, and ticket scalping. Federal regulation is well accepted in certain situations where

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200. See, e.g., ANDREWS, supra note 6, at 65 (recounting Alan Greenspan’s 2008 testimony before the House Committee on Oversight and Government Reform).

201. Kreitner, supra note 33, at 1542. U.S. tort law embodies the concept that each person has the freedom of action as long as it does not interfere with others’ freedom. Id. at 1538.

202. For example, doctrines such as promissory estoppel and unjust enrichment operate to impose liability on one party in an economic relationship even though there is no enforceable contract between the parties. King v. Trs. of Bos. Univ., 647 N.E.2d 1196 (Mass. 1995); Credit Bureau Enters., Inc. v. Pelo, 608 N.W.2d 20 (Iowa 2000).

203. Palmieri, supra note 97, at 120 (discussing in-depth various situations where courts have imposed a duty to disclose during contract negotiations).

204. GILMORE, supra note 127, at 84–85, 85 n.195; Eisenberg, supra note 10, at 212.


206. See S. 07-216, 66th Gen. Assemb., Reg. Sess. (Colo. 2007) (“A mortgage broker shall have a duty of good faith and fair dealing in all communications and transactions with a borrower. Such duty includes, but is not limited to: (a) The duty to not recommend or induce the borrower to enter into a transaction that does not have a reasonable, tangible net benefit to the borrower, considering all of the circumstances, including the terms of a loan, the cost of a loan, and the borrower’s circumstances . . . .”). In December 2007, Senate Bill 2452, the “Home Ownership Preservation and Protection Act of 2007,” sought to impose a duty to “act with reasonable skill, care, and diligence” on lenders. S. 2452, 110th Cong. § 129B (2007), available at http://www.govtrack.us/congress/billtext.xpd?bill =S110-2452. Senate Bill 2452 did not become law, however. Id.

207. Jolls et al., supra note 22, at 1511, 1516.
there is information asymmetry. For example, the U.S. government has legislated extensively on food and drugs.

Thus, in various instances, government intervention is neither inconsistent with individual autonomy and freedom of contract, nor unfamiliar in the realm of private contracts. Rather than a vestige of paternalism, regulation often helps markets fulfill their promise to provide fair terms to all comers, regardless of their institutional or individual status.

B. Broader Duty of Good Faith and Contractual Certainty

The good faith doctrine’s vagueness also causes concern that it may allow the courts to inject an amorphous moral standard in contractual relationships. The vagueness and ambiguity might disrupt contractual certainty and interfere with the parties’ risk allocation. The sophistication of U.S. courts and the examples set by civil law countries allay these concerns.

It is true that a contract law paradigm recognizing a broad duty of good faith in economic relationships is not as neat and predictable as the current contract law model. However, courts have been applying the duty of good faith, albeit in a narrower scope, for many years. There is no evidence that they routinely overuse or abuse the doctrine in application. Moreover, courts have been dealing with rules that require nuanced analysis such as the reasonableness standard in the context of tort law. There is no reason to believe that courts and juries are not up to the task here.

In any event, the concern about certainty is outweighed by concerns about fairness to all. Without judicial remedies, weaker parties in economic relationships are at the mercy of stronger parties whose only objective is to pursue their own self-interests. The certainty fostered by the current contract law model comes at the expense of fairness. The only certainty guaranteed by the passive approach currently employed is that the party with more resources and more access to information will come out ahead. Professor Stiglitz has suggested that the government should enact policies to prevent exploitation of this

208. Stiglitz, supra note 5, at 175.
209. Id. For example, under the Food, Drug, and Cosmetic Act, 21 U.S.C. § 301, 331 (2006), the federal government through the Food and Drug Administration has the extensive authority to regulate various aspects of food and drug products. See e.g., 21 C.F.R. §§ 1.20–1.24, 1.90–1.101 (2011).
nature. The benefit of imposing an expanded duty of good faith is that it will encourage more reasonable behavior, minimize commercial bullying, and ultimately promote fairness.

Some countries following the civil law system have apparently recognized a more expansive duty of good faith. The fact that those civil law countries have functioning commercial systems despite having adopted a broader duty of good faith belies an automatic rejection of the doctrine. It would be interesting to examine the scope of the duty of good faith as applied in the civil law system and the limiting principles, if any, on the doctrine to prevent unnecessary disruption of private agreements.

One could argue that in light of the doctrine’s propensity to interfere with certainty and predictability, it may be better to let the government regulate specific industries on a case-by-case basis rather than overhaul the contract law paradigm itself. After all, the financial industry already undergoes heavy regulation. The subprime mortgage crisis, however, reveals the fact that financial regulations were not sufficient to curb the excess. In addition, the existence of the financial regulations does not mean that contract law should excuse itself from the process. Contract law applies to all economic exchanges. The same unfettered incentive that led to the subprime mortgage crisis could rear its ugly head in other economic relationships as well.

Conclusion

The subprime mortgage crisis has brought to the forefront a systemic flaw of contract law. It has demonstrated that the system relied on unwarranted assumptions which effectively eliminated the only built-in checks and balances. The lack of equal access to information and resources leaves the weaker party to the contract at the mercy of the advantaged party. Without any actual bargaining in the process,

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212. Stiglitz, supra note 5, at 204.
214. Unfortunately, such an analysis is beyond the scope of this Article.
215. A detailed examination of the financial regulations is beyond the scope of this Article. There are clearly regulatory failures in the case of subprime mortgages. See FCIC Report, supra note 7, at 279. It is also too early to assess the impact of the recent financial reforms.
contract law’s laissez faire approach fails to provide any checks and balances against excessive opportunistic behavior.

The severe informational asymmetry is exacerbated by manipulation of human decision-making biases identified by behavioral economists over the past few decades. Powerful commercial interests devote substantial resources to manipulating people’s decision making. What is more, modern society has seen an unprecedented concentration of financial power due to new technology and access to the global marketplace. The U.S. financial industry exemplifies such concentration of financial power. Because of their resources, Wall Street firms were able to manipulate the system for their own benefit. All of these developments vitiate the passive approach of contract law.

Despite the concerns surrounding a broader duty of good faith in economic relationships, recognizing such a duty would provide a better balance between competing interests of individual autonomy and freedom of contract, efficiency, and fairness. It may offer some counterbalance against excessively opportunistic commercial behavior in economic relationships. It could further create an incentive for parties to work together for the benefit of both parties and society as a result. In addition, adopting a broader duty of good faith will elevate the baseline standard of acceptable economic behavior. This principle recognizes that because we live in an interconnected modern society where the entire society benefits when all of us, including the weakest members, are protected.217

Could an expanded duty of good faith have prevented the subprime mortgage crisis?218 To begin, a broader duty of good faith would have fostered a vastly different business culture. A business culture honoring honesty in fact and commercial reasonableness, for ex-


218. The FCIC report concluded that the financial crisis was avoidable. See FCIC REPORT, supra note 7, at xvii.

The sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves. More than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe.

Id. at xviii.
ample, might have prevented the vicious cycle from forming in the first place. Had there been a broader duty of good faith, the loan originators would not have sold mortgages to borrowers that the originators knew did not have the financial resources to repay the loan, since they would not be able to successfully sue the borrower to recoup the money lent. Wall Street firms would not have created all of those esoteric derivative financial products just so that they could sell them to other investors and earn handsome fees for themselves in the process, since they might have been forced to exchange the money they received from the purchasers for the now-worthless paper. A duty of good faith in economic relationships could have been the proverbial flapping of butterfly wings which altered the course of history and helped avoid a financial hurricane of the magnitude that struck our world. Perhaps adopting an expanded duty of good faith now will prevent another similar crisis in the future.