REFORMING THE LAW OF ADHESION CONTRACTS: A JUDICIAL RESPONSE TO THE SUBPRIME MORTGAGE CRISIS

by
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This Article examines the role of contracts of adhesion[1] in the form of home mortgages and installment sale contracts, as well as in causing the Great Depression and the subprime mortgage crisis. By shifting the focus to these "financial adhesion contracts," this Article suggests that the harm caused by the lack of mutual assent in adhesion contracts consists not simply of one-sided terms, but of terms that impose highly unsuitable economic risks on consumers. When millions of consumers sign such contracts, their collective risk-taking threatens the stability of the entire financial system. The most common cures for the nation's economic ills—market forces, monetary policies, and regulatory controls—are found inadequate to resolve this challenge based on a review of the Great Depression, the savings and loan crisis of the 1980s, and the subprime mortgage crisis. The Article explains why current law and scholarship fail to adequately address the threat posed by financial adhesion contracts and proposes a rule of informed assent for the good of consumers and the economy.

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[1] Contracts of adhesion are standardized form contracts presented by a party with superior bargaining power to the "adherent" as a "take-it-or-leave-it" proposition, giving them no alternatives other than complete adherence to the terms presented or outright rejection. E. ALLEN FARNSWORTH, CONTRACTS § 4.26, at 286 (4th ed. 2004). *See, e.g.*, Kortum-Managhan v. Herbergers NBGL, 204 P.3d 693, 698 (Mont. 2009) ("Contracts of adhesion arise when a party possessing superior bargaining power presents a standardized form of agreement to a party whose choice remains either to accept or reject the contract without the opportunity to negotiate its terms." (quoting Zigrang v. U.S. Bancorp Piper Jaffray, Inc., 123 P.3d 237, 243 (Mont. 2005)). The term, "contract of adhesion" was originally coined as "contrat[] d'adhésion" by the French jurist, Saleilles. RAYMOND SALEILLES, DE LA DÉCLARATION DE VOLONTÉ, art. 133, § 89, at 229 (1901). Edwin Patterson imported the phrase into the United States. Edwin W. Patterson, *The Delivery of a Life-Insurance Policy*, 33 HARV. L. REV. 198, 222 (1919); *see also* Edwin W. Patterson, *The Interpretation and Construction of Contracts*, 64 COLUM. L. REV. 833, 856–57 (1964).

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I. INTRODUCTION

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.[2] Significant parallels have also been drawn to

[2] *See, e.g.*, Paul Krugman, *Depression Economics Returns*, N.Y. TIMES, Nov. 14, 2008, at A33; Chris Gay, *Depression Déjà Vu*, THE BIG MONEY, Feb. 2, 2009, 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.

the savings and loan crisis of the 1980s.[3] In each case, periods of great prosperity were followed by crushing losses. Over time, economists, legal scholars, historians, and bankers have offered a variety of explanations for the causes of each of these economic catastrophes, but their prescriptions for avoiding such catastrophes in the future have all relied on legislative or regulatory intervention in some form, whether through the execution of monetary and taxation policies or the passage of legislation and the formation of administrative agencies.[4] Most commentators who suggest cures for a repeat of the subprime loan crisis also advocate the adoption of new laws and regulations.[5] A few theorists have claimed that markets should be left to regulate themselves and that the laws enacted under the New Deal stand as a warning of how government programs can prolong financial downturns.[6] But neither

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[3] *See* Jack Willoughby, *The Lessons of the Savings-and-Loan Crisis,* BARRONS, Apr. 13, 2009, http://online.barrons.com/article/SB123940701204709985.html?page=3; Barry Meier, *The Bailout Handbook: The Savings and Loan Crisis 19 Years Ago May Be Instructive,* N.Y. TIMES, Sept. 29, 2008, at C1.

[4] *See generally* Ben S. Bernanke, *Preface, in* ESSAYS ON THE GREAT DEPRESSION i (Ben S. Bernanke ed., 2000); KITTY CALAVITA, HENRY N. PONTELL & ROBERT H. TILLMAN, BIG MONEY CRIME: FRAUD AND POLITICS IN THE SAVINGS AND LOAN CRISIS (1997); PETER FEARON, WAR, PROSPERITY AND DEPRESSION: THE U.S. ECONOMY 1917–45 (1987); MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867–1960 (1963); DANIEL GROSS, DUMB MONEY: HOW OUR GREATEST FINANCIAL MINDS BANKRUPTED THE NATION (2009); DAN IMMERGLUCK, FORECLOSED: HIGH-RISK LENDING, DEREGULATION, AND THE UNDERMINING OF AMERICA'S MORTGAGE MARKET (2009); JOHN MEYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY (1964); MARTIN MAYER, THE GREATEST-EVER BANK ROBBERY: THE COLLAPSE OF THE SAVINGS AND LOAN INDUSTRY (1990); RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009) [hereinafter POSNER, A FAILURE OF CAPITALISM]; GEORGE SOROS, THE CRASH OF 2008 AND WHAT IT MEANS: THE NEW PARADIGM FOR FINANCIAL MARKETS (2009); PETER TEMIN, DID MONETARY FORCES CAUSE THE GREAT DEPRESSION? (1976); ROBERT AARON GORDON, ECONOMIC INSTABILITY AND GROWTH: THE AMERICAN RECORD (1974); Sandy B. Lewis & William D. Cohan, *The Economy Is Still at the Brink*, N.Y. TIMES, June 7, 2009, at WK9.

[5] *See generally* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008); Cassandra Jones Havard, *"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); Jonathan Macey et al., *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789 (2009); Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011 (2009); 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); 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); Lauren E. Willis, *Will the Mortgage Market Correct? How Households and Communities Would Fare if Risk Were Priced Well,* 41 CONN. L. REV. 1177 (2009); Allison De Tal, Comment, *Knowledge Is Power: Consumer Education and the Subprime Mortgage Market,* 11 CHAP. L. REV. 633 (2008).

[6] MURRAY N. ROTHBARD, AMERICA'S GREAT DEPRESSION (1972); AMITY SHLAES, THE FORGOTTEN MAN: A NEW HISTORY OF THE GREAT DEPRESSION 7–8 (2007); Harold L. Cole

theory can withstand historical scrutiny. Over the last 80 years, the government has had to rescue the nation's insolvent financial institutions from ruin during the Great Depression, the savings and loan crisis, and the subprime mortgage crisis. In each crisis, government bailouts followed deregulatory regimes when the government failed to exercise its authority to regulate financial institutions under existing laws and regulations. Under these conditions, neither the dormant power of law nor the free and unfettered operation of markets averted the disasters that followed.

In reviewing the periods of regulation and deregulation that accompanied the Great Depression, the savings and loan crisis, and the present subprime loan debacle, a pattern of regulatory breakdown emerges. After each crisis, the government rescued insolvent financial institutions at enormous cost to the taxpayer. By placing the cost of the financial institutions' losing gambles on taxpayers, the government has not only violated the dictates of fairness, but has also created a moral hazard by insulating the bailout recipients from the consequences of the risks they willingly assumed. Rather than discouraging the excessive risk-taking that led to the crisis, the bailouts put the nation's largest financial entities in a "heads I win, tails you lose" position that gives them a rational basis for continuing to engage in problematic conduct. The government has then passed laws designed to remedy the perceived causes of the economic crisis, although the strength of these efforts has depended on the political influence of the regulated entities. When the economy has recovered, a pro-business, deregulatory mood has inevitably followed. With it, the laws and regulations put in place after the prior crash have been repealed, amended, or enforced at a minimal level by agencies operating with reduced funding, staffing, and support. Moreover, the laws that have been enacted to cure the prior crisis often fail to address newly emerging market conditions and practices of current concern. In the eras of deregulation that have coincided with periods of prosperity, political leaders have shown little interest in amendments needed to update financial laws and regulations. When a reporter asked Alan Greenspan, the former Chairman of the Federal Reserve, to address the impact of unregulated over-the-counter derivates on the subprime crisis, he replied that the derivates market was being sufficiently regulated by the market itself.[7] Markets, however, mirror the cyclical pattern of regulatory enforcement.[8]

& Lee E. Ohanian, *How the Government Prolonged the Depression*, WALL ST. J., Feb. 2, 2009, at A17 [hereinafter Cole & Ohanian, *Prolonged the Depression*]; Harold L. Cole & Lee E. Ohanian, *The Great Depression in the United States from a Neoclassical Perspective*, FED. RES. BANK MINNEAPOLIS Q. REV., Winter 1999, at 2, 11 [hereinafter Cole & Ohanian, *Neoclassical Perspective*].

[7] Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A1 (citing Mr. Greenspan's testimony in response to concerns about possible bailouts resulting from unregulated derivatives trading, including the quotes: "Risks in financial markets, including derivatives markets, are being regulated by

The U.S. government has now engaged in bank bailouts and renewed regulatory enforcement efforts as cures for the subprime mortgage crisis.[9] Action by the Federal Reserve and other regulatory agencies is commendable, if ill-timed, and may be necessary to address many of the causes of the crisis, especially on the supply side. These causal factors range from the inability of institutional investors and others in search of relatively safe investment vehicles to obtain respectable returns on Treasuries after the dot-com bust to the conflicts of interest that led the major rating agencies to overstate the quality of mortgage-backed securities. The Federal Reserve's insistence on keeping interest rates low for years after the dot-com bust affected demand as well as supply, but the demand issue should also be addressed by the courts, through the common law that governs adhesion contracts involving future payment obligations, or "financial adhesion contracts." Financial adhesion contracts in the form of subprime mortgages are the underlying source of today's "toxic assets."[10] They are the instruments underlying the mortgage-backed securities and the unregulated over-the-counter derivatives in the form of credit default swaps that destroyed institutions such as Lehman Brothers and AIG.[11]

Focusing on the common law also places the responsibility for creation and enforcement of the law in the hands of the courts, which have institutional advantages over legislatures in dealing with adhesion contracts as the source of financial meltdowns. While courts are not without their deficiencies as fact-finders on policy issues as compared to legislatures and regulatory agencies, and are limited to deciding the cases brought before them, courts have countervailing advantages. These advantages include the ability to respond quickly to newly-developed deceptive schemes implemented through financial adhesion contracts.[12]

private parties," and "There is nothing involved in federal regulation per se which makes it superior to market regulation." *Id.* at A29).

[8] *See* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis,* 41 CONN. L. REV. 963, 1048 (2009) ("[O]bservers have highlighted that market discipline is inherently procyclical, because it is too lax during euphoric 'bubbles' and too extreme during panic-induced 'busts.' In addition, the effectiveness of market discipline is undermined by 'self reinforcing herd and momentum effects,' which cause market participants to follow the herd even when they have doubts about the wisdom of the course the herd is pursuing."); FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 41–42, 45–47 (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf; *see generally* ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2d ed. 2005).

[9] *See infra* Section II.C.4.

[10] *See* Schmudde, *supra* note 5, at 734–39; Macey et al., *supra* note 5, at 799–803.

[11] *See* Schmudde, *supra* note 5, at 734–39.

[12] *See* Alfred W. Meyer, *Contracts of Adhesion and the Doctrine of Fundamental Breach,* 50 VA. L. REV. 1178, 1180 (1964) [hereinafter Meyer, *Contracts of Adhesion*] ("Legislatures still respond slowly, if at all, to consumer interests, and their responses are too rigid to deal adequately with the speed and ingenuity of the commercial draftsman.").

And, the judiciary is better suited to apply the law consistently through the booms and the busts of the economy, since, with the exception of elected judiciaries, they are free from the influence that regulated entities' lobbying efforts and campaign contributions have on their regulators.[13]

Residential mortgages have been classified as contracts of adhesion because their terms are selected by professional lenders for unsophisticated borrowers who have no choice but to accept the lenders' terms or forego purchasing their home.[14] A court's classification of a mortgage as an adhesion contract will not, however, change its treatment of the mortgage as a fully enforceable contract.[15] The only effect of this classification on the court's analysis is that the court may apply the interpretative maxim of *contra proferentem* and interpret the contract strictly against the drafter,[16] or it may consider whether its terms are unconscionable[17] or against public policy[18]—doctrines that may be raised

[13] 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 deceptive practices would constantly be emerging. Karl N. Llewellyn, Book Review, 52 HARV. L. REV. 700, 705 (1939) (reviewing O. PRAUSNITZ, THE STANDARDIZATION OF COMMERCIAL CONTRACTS IN ENGLISH AND CONTINENTAL LAW (1937)). For the influence of regulated entities over Congress, see POSNER, A FAILURE OF CAPITALISM, *supra* note 4, at 94 ("Legislators who receive big campaign contributions from banks have an incentive to favor weak banking regulation, as otherwise those contributions will dwindle."); Eric Lipton & Raymond Hernandez, *A Champion of Wall Street Reaps the Benefits*, N.Y. TIMES, Dec. 14, 2008, at A1 (describing how Democratic Senator Charles E. Schumer embraced the financial industry's deregulatory agenda through specific legislative actions while receiving extensive donations for the Democratic Party from Wall Street investment banking firms); Rakoff, *supra* note 25, at 1208, 1235; *infra* notes 282–83.

[14] *See, e.g.*, *In re* Petroff, No. 00-8085, 2001 WL 34041797, at *2 (B.A.P. 6th Cir. July 25, 2001); *In re* Tudor, 342 B.R. 540, 562–63 (Bankr. S.D. Ohio 2005); *In re* Woodham, 174 B.R. 346, 349 (Bankr. M.D. Fla. 1994); Rau v. Cavenaugh, 500 F. Supp. 204, 207–08 (D.S.D. 1980); Ricker v. United States, 417 F. Supp. 133, 139 (D. Me. 1976). *But cf.* Branco v. Nw. Bank Minn., N.A., 381 F. Supp. 2d 1274, 1280–81 (D. Haw. 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).

[15] *Cf.* Graham v. Scissor-Tail, Inc., 623 P.2d 165, 172 (Cal. 1981); Heller Fin., Inc. v. Midwhey Powder Co., 883 F.2d 1286, 1292 (7th Cir. 1989).

[16] 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. at 348–49; *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").

[17] *See Branco*, 381 F. Supp. 2d at 1280–81 (rejecting plaintiffs' claim that arbitration clause in mortgage was unconscionable); ACORN v. Household Int'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., 113 Cal. Rptr. 2d 376, 382–83 (Cal. Ct. App. 2001) (holding that arbitration clause in reverse home

in defense of the enforcement of any contract. This is not to suggest that the concern is limited to residential mortgages. The impact of installment sale contract debt on the Great Depression demonstrates that any type of consumer adhesion contract that creates long-term financial obligations can have serious repercussions on the economy. These include credit card agreements,[19] car loans and leases, residential leases,[20] phone and Internet access contracts,[21] and any other adhesion contract that imposes payment risks and obligations on the consumer that she would not have accepted had she read and understood them. All of these financial adhesion contracts are enforced despite the lack of informed assent by the recipient, unless he can demonstrate that the term to which he would have objected, had he understood it, is either unconscionable according to applicable commercial standards or is against public policy. Under Corbin's widely-followed standard, contract terms must be "so extreme as to appear unconscionable according to the mores and business practices of the time and place."[22] Unsuitable provisions in financial adhesion contracts will rarely be deemed unconscionable under this standard, since they were commonly used in the subprime lending industry prior to the crisis. The regulators' lax attitude towards even predatory lending practices provides further evidence of the acceptance of these practices during the housing boom. The FBI did not attempt to address the predatory lending practices prevalent during this period, despite the agency's recognition that these practices "often result in the borrower defaulting on his mortgage

mortgage was unconscionable); Home Fed. Sav. & Loan Ass'n v. Campney, 357 N.W.2d 613, 619–20 (Iowa 1984) (holding that due-on-sale clause in adhesive residential mortgage was not unconscionable or beyond defendants' reasonable expectations and was therefore enforceable).

[18] *See In re Petroff*, 2001 WL 34041797, at *2; *In re Tudor*, 342 B.R. at 562.

[19] *See* Kortum-Managhan v. Herbergers NBGL, 204 P.3d 693, 698 (Mont. 2009) (credit card agreement was a contract of adhesion); Discover Bank v. Superior Court, 113 P.3d 1100, 1110 (Cal. 2005); Jones v. Citigroup, Inc., 38 Cal. Rptr. 3d 461, 462 (Cal. Ct. App. 2006) (credit card agreement was a contract of adhesion but opt-out option in amendment adding arbitration clause defeated plaintiff's unconscionability claim); Szetela v. Discover Bank, 118 Cal. Rptr. 2d 862, 864 (Cal Ct. App. 2002); *contra* Hutcherson v. Sears Roebuck & Co., 793 N.E.2d 886, 887–88, 894 (Ill. App. Ct. 2003).

[20] *In re* Parker, 269 B.R. 522, 530 (D. Vt. 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.").

[21] Shroyer v. New Cingular Wireless Servs., Inc., 498 F.3d 976, 978 (9th Cir. 2007); Metro E. Cent. for Conditioning & Health v. Quest Commc'ns Int'l, Inc., 294 F.3d 924, 926 (7th Cir. 2002); Gatton v. T-Mobile USA, Inc., 61 Cal. Rptr. 3d 344, 347 (Cal. Ct. App. 2007); Aral v. Earthlink, Inc., 36 Cal. Rptr. 3d 229, 231 (Cal. Ct. App. 2005).

[22] ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 128, at 188 (1952).

payment and undergoing foreclosure or forced refinancing."[23] Instead, the FBI focused its efforts on what it found was the far greater problem of "Insider Industry Fraud," based on its finding that 80% of all reported losses from mortgage fraud involved the collusion or collaboration of industry insiders.[24]

Current law and scholarship on contracts of adhesion have not addressed the unique problems of financial adhesion contracts, but have focused instead on finding ways to avoid terms that are unduly favorable to the drafting party or are against public policy. Most legal commentators support enforcing adhesion contracts with an exception for unduly onerous terms that are deemed commercially unreasonable, such as certain mandatory arbitration provisions, forum selection clauses, and warranty disclaimers.[25] But solutions designed to strike specific provisions will not address the need to revive mutual assent in financial adhesion contracts which may be unsuitable for some consumers but not others. A "teaser-rate" 2/28 subprime mortgage is unlikely to be deemed unconscionable simply because the rate will increase after the first two years to three points above the prime rate for the remaining 28 years. This mortgage may be perfectly appropriate for the young rake with poor credit who is two years away from receiving access to a trust fund worth a fortune, but could be disastrous for an elderly widow living on a limited

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[23] FEDERAL BUREAU OF INVESTIGATION, FINANCIAL CRIMES REPORT TO THE PUBLIC FISCAL YEAR 2006 21, http://www.fbi.gov/publications/financial/fcs_report2006/publicrpt06.pdf.

[24] *Id.* at 20 ("Based on existing investigations and Mortgage Fraud reporting, 80 percent of all reported fraud losses involve collaboration or collusion by industry insiders.").

[25] *See infra* Section III.C, discussing KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 371 (1960) [hereinafter LLEWELLYN, THE COMMON LAW TRADITION]; Douglas G. Baird, *The Boilerplate Puzzle*, 104 MICH. L. REV. 933, 934 (2006); Lee Goldman, *My Way and the Highway: The Law and Economics of Choice of Forum Clauses in Consumer Form Contracts*, 86 NW. U. L. REV. 700 (1992); Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 632 (1943); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1205–07 (2003); Arthur Allen Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485 (1967) [hereinafter Leff, *Code*]; Arthur Allen Leff, *Unconscionability and the Crowd—Consumers and the Common Law Tradition*, 31 U. PITT. L. REV. 349 (1970) [hereinafter Leff, *Crowd*]; Arthur Allen Leff, *Contract as Thing*, 19 AM. U. L. REV. 131, 144 (1970) [hereinafter Leff, *Contract as Thing*]; Meyer, *Contracts of Adhesion*, *supra* note 12, at 1186; Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. MIAMI L. REV. 1263, 1265 (1993); Margaret Jane Radin, *Boilerplate Today: The Rise of Modularity and the Waning of Consent*, 104 MICH. L. REV. 1223, 1225 (2006); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1251 (1983); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529 (1971) [hereinafter Slawson, *Standard Form Contracts*]; W. David Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1 (1974) [hereinafter Slawson, *Mass Contracts*]; W. David Slawson, *New Approach to Standard Forms*, TRIAL, July/Aug. 1972, at 49 [hereinafter Slawson, *New Approach to Standard Forms*].

pension. The fact that there are many more low-income pensioners than trust fund babies, yet millions were sold teaser-rate subprime loans, suggests that not all borrowers were fully cognizant of the risks inherent in their agreements. In the language of contract formation, mutual assent was not achieved.

Under current law, the teaser-rate provision would be enforced for the elderly widow as well as the young rake because the clause itself is not unconscionable when compared to prevailing commercial practices in the industry. When informed assent has been abandoned as a requirement for contract formation, courts have no grounds upon which to refuse enforcement of terms in financial adhesion contracts that pose excessive risks on the recipient given her individual financial circumstances. Since consumers in this country with strained financial resources exponentially outnumber those with ample financial resources, the economy of the nation is placed at risk when the vast majority of consumers enter into contracts that subject them to unacceptable financial risks without their informed consent. Unless you assume that even informed consumers will invariably choose to make self-destructive economic decisions, restoring informed assent to the law of adhesion contracts will promote the stability of the economy, dependent as it is on the individual contracts of the masses. At least some portion of the population of consumers will reject financial contracts that involve risks and obligations beyond what their own circumstances can bear.

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.[26] Bargaining itself is not required as long as the offeree accepts the terms of the drafting party's offer.[27] In most 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 venues left to the consumer for bargaining. When a consumer seeks better terms on a mortgage, he may be presented with a choice among form contracts, but he can never negotiate changes to the terms of the forms. While bargaining may be impossible in today's marketplace, understanding—the only requirement for assent—is not.

Firms that attempt to enforce financial adhesion contracts in court should be required to prove that they reasonably believed that the

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[26] LLEWELLYN, THE COMMON LAW TRADITION, *supra* note 25, at 370 (in boilerplate contracts, specific assent is given to "the few dickered terms"); Richard L. Barnes, *Rediscovering Subjectivity in Contracts: Adhesion and Unconscionability*, 66 LA. L. REV. 123, 187–88 (2005); Korobkin, *supra* note 25, at 1282–84 (contrasting "salient" and "non-salient" terms in consumer adhesion contracts); Rakoff, *supra* note 25, at 1251 (creating a category of "visible" terms, based on terms that adherents generally bargain for or "shop" vs. "invisible" terms).

[27] FARNSWORTH, *supra* note 1, § 2.6, at 55 ("[I]t is not required that the parties actually bargain over the terms of their agreement.").

recipients would understand the contracts before signing or otherwise indicating their assent to the contracts' terms. Even under the objective theory of assent, a manifestation of agreement cannot occur without a manifestation of comprehension. Blind assent, while permissible in Randy Barnett's declarations of obedience by soldiers to their superior officers,[28] should not suffice to create a private law of contract created by corporate legislators. While costs will increase if assent is required, firms already spend considerable resources drafting form adhesion contracts for standardized transactions. What will change is their goal, which currently is to shift risks to the recipients rather than to write simple contracts that the recipients can readily understand. Firms externalize the costs of convincing consumers to accept their one-sided terms by drafting the terms and arranging the transactions so that the terms are no longer salient. Once firms are forced to explain the true costs of these terms to consumers, consumers may reject the terms they find unacceptable, and firms will have to improve them. When consumers are told what the "Rule of 78s" means, for example, they may decide this term is "salient" after all, and make sure it is excluded from their loans.[29] Many prominent scholars today dismiss the efficacy of greater disclosure based on the failure of consumers to read or understand form contracts.[30] But their conclusions are based on current form contracts, which are enforced despite the fact that they are usually incomprehensible to laypeople, are extremely lengthy, contain many non-essential terms, are non-negotiable and are almost identical from

[28] Randy E. Barnett, *Consenting to Form Contracts*, 71 FORDHAM L. REV. 627, 636 (2002).

[29] In *Lanier v. Associates Finance, Inc.*, the lender charged the plaintiff an effective annual interest rate of 31.31% under the Rule of 78s, rather than the 21.59% APR listed in her agreement, when she paid off her ten-year note after only 23 months. 499 N.E.2d 440, 441–42 (Ill. 1986). The court explained that the Rule of 78s, as compared to the "actuarial method . . . does not provide an accurate approximation of unearned finance charges [and] allocates too much of the finance charge to the creditor during the early months of the credit transaction." *Id.* at 442. The court explained the Rule of 78s method with the following example: "In a 12-month loan, . . . the borrower will pay 12/78 of the total finance charge during the first month of the loan, and will pay 11/78 of the total charge during the second month. In each succeeding month of a 12-month loan, the amount of the total finance charge paid is reduced by 1/78 of the total charge, until only 1/78 of the total finance charge remains to be paid during the final month. Since the creditor earns most of the finance charge during the early months of the loan term, the amount of unearned finance charge which the debtor will be entitled to in the event of prepayment rapidly declines." *Id.*

[30] *See generally* Omri Ben-Shahar, *The Myth of the 'Opportunity to Read' in Contract Law*, 5 EUR. REV. CONT. L. 1 (2009); *see also* Bar-Gill & Warren, *supra* note 5, at 12; Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 266 (2002); Yannis Bakos, Florencia Marotta-Wurgler & David R. Trossen, *Does Anyone Read the Fine Print? Testing a Law and Economics Approach to Standard Form Contracts* (New York Univ. Sch. of Law Ctr. for Law, Econ., and Org. Working Paper No. 09-40), *available at* http://ssrn.com/abstract=1443256.

firm to firm within an industry, leaving the consumer with no alternatives. Their conclusions therefore tell us nothing about the efficacy of disclosure if courts enforce contracts depending on whether the drafting party has a reasonable belief that the non-drafting party understands the terms he purportedly agreed to.

Part II examines the part that financial adhesion contracts have played in the Great Depression and the subprime mortgage crisis. The discussion also tracks the failure of competitive markets, regulation, and monetary policies to prevent the Great Depression, the savings and loan crisis, and the subprime loan crisis.

Part III covers current law and scholarship on adhesion contracts, and demonstrates that neither offers a solution adequate to address the dangers posed by financial adhesion.

Part IV describes my prescription for reforming the law of adhesion contracts to ameliorate the impact they have on 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. Since regulation has failed repeatedly, I recommend a change in the common law governing the adhesion contracts that were at the heart of two of the last three catastrophes. The solution I suggest will give consumers the chance to help avert systemic financial disasters by making informed decisions on the extent of the financial obligations they are willing to assume. The judgments of consumers may not always be wise, as was true for the decisions made by many lenders in the subprime mortgage crisis. Despite this risk, courts should give consumers the ability to make informed decisions because it is right as a normative matter, and because giving both contracting parties an opportunity for informed assent will increase the chances that prudent financial decisions affecting the global economy will be made.

II. BOOM AND BUST CYCLES OVER TIME—ADHESION CONTRACTS AND THE FAILURE OF REGULATION

In each period leading up to the three major financial crises studied here, economic prosperity was accompanied by a *laissez-faire* attitude towards regulation. Political leaders demonstrated their hands-off attitude towards major financial institutions by failing to enact or amend legislation to address threats to the nation's financial stability, and by refusing to enforce existing legislation through a variety of techniques, running the gamut from underfunding regulatory agencies to appointing anti-regulation zealots to lead them.

Regulation inevitably comes back into fashion when the "chickens come home to roost," in the form of a sudden wave of insolvencies among financial institutions that the government abandoned to "self-regulation" during the boom years. But the government's enforcement of the curative regulation tends to be short-lived, lasting only so long as the

influence of major financial entities over politicians is outweighed by the influence of average voters hurt by the economic collapse. The following Section outlines the history of regulatory failure during these economic cycles to support the claim that regulatory schemes should not be relied on as the sole remedy, and that a judicial solution should be considered as a supplement to regulation to soften the severity and distress resulting from these cycles.

A. *The Great Depression*

During the decade preceding the Great Depression, as in the years leading up to the subprime mortgage crisis, businesses used financial adhesion contracts in transactions that convinced consumers to assume unprecedented and unsupportable levels of personal debt. And in the Great Depression, as in the subprime mortgage crisis, the Federal Reserve had the regulatory authority to have prevented the crisis had it used its authority wisely.

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 by the popular economist John Moody, who predicted in 1928 that economic growth would "continue through many years to come, thus adding steadily to and maintaining a relative plethora of available capital and credit."[31] Based on these and similar prognostications from leading economists of the day,[32] and on the soaring stock market which was followed widely in the popular press, the general view of the economy was upbeat.[33] But wages did not keep pace with production, and only a small percentage of Americans owned

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[31] JORDAN A. SCHWARZ, THE INTERREGNUM OF DESPAIR: HOOVER, CONGRESS AND THE DEPRESSION 3–4 (1970).

[32] *See* HUGH S. NORTON, THE QUEST FOR ECONOMIC STABILITY: ROOSEVELT TO REAGAN 25 (1977). Norton finds that when doubts were raised as to the 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 brokers' loans.

[33] 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 this . . . money comes 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 E. PARRISH, ANXIOUS DECADES: AMERICA IN PROSPERITY AND DEPRESSION 1920–1941 93 (1992) [hereinafter PARRISH, ANXIOUS DECADES].

sufficient shares to participate in the stock market bonanza of the 1920s.[34]

Most Americans were not investors but spenders, and they made their purchases on credit under contracts of adhesion such as installment sale contracts and mortgages.[35] Data on average wages, the cost of living, savings rates, and the lending practices surrounding installment sales agreements indicate that the level of consumer debt was the result of unsound lending.[36] Many scholars believe that this debt, and the contraction in consumer spending that inevitably followed, were major factors leading to the Great Depression.[37] As historian, T.H. Watkins, explains:

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[34] *See infra* notes 39–41. Income from dividends rose by 65% during the 1920s, and from 1923 to 1929, dividend payments doubled from $4.6 billion to $9.2 billion, but only two to three million of the country's 120 million citizens traded on the Exchange during the decade. ALAN LAWSON, A COMMONWEALTH OF HOPE: THE NEW DEAL RESPONSE TO CRISIS 11, 20 (2006). 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) [hereinafter MCELVAINE, THE GREAT DEPRESSION]. *See also* STEVE FRASER, EVERY MAN A SPECULATOR: A HISTORY OF WALL STREET IN AMERICAN LIFE 391 (2005) (estimating that during the 1920s, "probably 75 percent of the dollar value of all outstanding securities were held by not much more than half a million people."); FEARON, *supra* note 4, at 67 ("The wealthy few also benefited from the enormous growth in capital gains during the stock market boom; not so the bulk of the population.").

[35] *See infra* notes 62–67 and accompanying text.

[36] *See infra* notes 39–71 and accompanying text.

[37] 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 purchases, the cutback in buying sapped the whole economy."); TEMIN, *supra* note 4, at 71–72, 83; 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 individual debts of one hundred billion—which demanded expanding markets and world prosperity for successful carrying."); Frederick S. Mishkin, *The Household Balance Sheet and the Great Depression*, 38 J. ECON. HIST. 918, 919 (1978); Christina D. Romer, *The Great Crash and the Onset of the Great Depression*, 105 Q.J. Econ, 597 (1990); Martha L. Olney, *Avoiding Default: The Role of Credit in the Consumption Collapse of 1930*, 114 Q. J. ECON. 319 (1999) [hereinafter Olney, *Avoiding Default*]; *see also* JOHN D. HICKS, REPUBLICAN ASCENDANCY: 1921–1933 232 (1960) ("[T]he Federal Reserve Board, which might have used its powers to restrain the boom, consistently promoted the inflation of credit that business demanded. This policy contributed not only to the wild speculation in stocks but also to industrial overexpansion, excessive installment buying, and ultimately, of course, to the stock-market collapse."); POSNER, A FAILURE OF CAPITALISM, *supra* note 4, at 30 ("A credit binge in the 1920s is widely believed to have been a precipitant of the Great Depression.").

> 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.[38]

The data revealing the threat to the economy from this combination of unsound lending and overproduction of consumer goods were no secret, but the government did not regulate or even investigate the activities of private lending institutions and businesses that were convincing consumers to take on far more debt than they could afford. The average worker's wages did not reflect the profits from increased productivity, yet consumers supported those profits by purchasing durable goods on credit. If courts had required informed assent of the terms of financial adhesion contracts, consumer debt may not have soared to such heights that it became a major factor in causing the Great Depression.

1. Average Income

During the 1920s, industrial workers' productivity rose by an impressive 40 to 43%, but their income increased by less than 10%, with the remaining gains going to increased profits, which rose overall by almost two-thirds.[39] With this increase in corporate profits, the index of speculative gains from the stock market between 1923 and 1928 rose from 100 to a spectacular 410, but the index of wages advanced over the same period from 100 to just 112.[40] To the extent that corporate profits

[38] T. H. WATKINS, THE GREAT DEPRESSION: AMERICA IN THE 1930S 46–47 (1993). *See also* BROADUS MITCHELL, DEPRESSION DECADE FROM NEW ERA THROUGH NEW DEAL, 1929–1941 27–28 (Henry David et al. eds., Rinehart & Co., Inc. 1955) (1947) ("In various ways, prosperity was forced from about 1926, convenient proof lying in the growth of consumer credit through installment sales.").

[39] LAWSON, *supra* note 34, at 21. Robert McElvaine reports that in the decade before 1929, output per worker in manufacturing increased by 43%, but wages increased only 8%. MCELVAINE, THE GREAT DEPRESSION, *supra* note 34, at 39. Peter Fearon puts the rise in worker productivity between 1919 and 1929 at 60%. FEARON, *supra* note 4, at 25. From 1920 to 1929, all per capita income rose 28%, but that of the lower 93% 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).

[40] WECTER, *supra* note 37, at 9.

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]

A study from the Brookings Institute completed in 1934 revealed that during the 1920s over 70 million people in over 60% of the country's families had survived on less than the $2,000 needed to acquire basic necessities.[43] By mid-decade, the average annual income of the country's 5.8 million farm families was only $240, and 54% of all farmers earned less than $1,000 a year.[44] By 1929, the average wage was below $1,500 per year.[45] With such a large portion of the population earning at or below subsistence wages, many families had no savings from which to continue making payments on credit obligations if a job were lost through illness or dismissal.[46]

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

As in the subprime mortgage crisis, consumers in the years prior to the Great Depression took on excessive mortgage debt based on rosy economic predictions that current market conditions would never end, without appreciating the risks of default and foreclosure. And like borrowers in the subprime mortgage crisis, borrowers in the Great Depression were left with mortgages they could not repay or refinance. The Great Depression, like the subprime crisis, was preceded by a boom in construction supported by mortgage debt.[47] At its peak in 1926, the value of new construction accounted for over 60% of gross private

[41] *See supra* note 34. Stanley K. Schultz & William P. Tishler, American History 102: Civil War to the Present, Crashing Hopes: The Great Depression, http://us.history.wisc.edu/hist102/lectures/lecture18.html.

[42] PARRISH, ANXIOUS DECADES, *supra* note 33 at 89; LEUCHTENBURG, *supra* note 37, at 244–45.

[43] LAWSON, *supra* note 34, at 21. *See* also FEARON, *supra* note 4, at 67.

[44] LAWSON, *supra* note 34, at 22. Peter Fearon puts the estimate of net farm income in 1921 at $517 annually, and at an average of $918 annually between 1926 and 1929. FEARON, *supra* note 4, at 34. *See also* FRASER, *supra* note 34, at 384 ("Three-quarters of American families lived on less than $3,000 a year; 40 percent survived on less than $1,500.").

[45] CHARLES R. GEISST, WALL STREET: A HISTORY 154 (2d ed. 2004). According to Bureau of Labor Statistics, 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 families in a condition of financial hardship. PARRISH, ANXIOUS DECADES, *supra* note 33, at 81–82.

[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% of the population that made under $1,500 a year spent more than they made. WECTER, *supra* note 37, at 10.

[47] FEARON, *supra* note 4, at 59–60. Fearon attributes this boom in construction to the one and one-half million people who were added to the population each year and to migration that increased the need for housing, the backlog in demand created during World War I, and the stimulation of rising income and stable building costs.

domestic investment, and 40% of all new construction was residential.[48] Given the wage situation, 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.[49] The term of a standard home mortgage was five years,[50] but before the crash, borrowers had been able to refinance their mortgages as they matured.[51] By the early 1930s, approximately "45% of the . . . 10.6 million homes in the country had either first, second or third mortgages."[52] Because many homeowners were forced to borrow on a short-term basis, they found their loans difficult to renew after 1929.[53]

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 continued, and that without these prices the land would not produce income sufficient to repay the debt.[54] By 1929, the nation's farmers, whose per capita income was only one-third the national average, had an accumulated debt of $9.8 billion for land and machinery.[55]

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 48 cents per hour, they had to

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[48] *Id.* at 59.

[49] *Id.* at 60.

[50] 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 13, 18 (James R. Barth et al. 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").

[51] Catherine England, *Regulatory Regimes and Markets: The Case of Savings and Loans, in* THE SAVINGS AND LOAN CRISIS: LESSONS FROM A REGULATORY FAILURE 61, 65 (James R. Barth et al. eds., 2004).

[52] DAVID L. MASON, FROM BUILDINGS AND LOANS TO BAIL-OUTS: A HISTORY OF THE AMERICAN SAVINGS AND LOAN INDUSTRY, 1831–1995 89 (2004).

[53] *See* FEARON, *supra* note 4, at 60 (stating that many borrowers were forced to accept short-term home mortgages during the home construction boom preceding the 1929 depression and had difficulty renewing these loans after 1929).

[54] *Id.* at 40–41. 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. *Id.* at 38. 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 which they had accumulated . . . ." *Id.* at 39–40.

[55] BADGER, *supra* note 39, at 14–15.

rely on credit more than ever before.[56] One commentator suggests an explanation for this self-destructive buying mania by low-income consumers—the misleading terms of these credit agreements—as 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."[57]

During the 1920s, most installment loans were sold by merchants to sales finance companies 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.[58] 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.[59] As a result, when jobs were lost, cutting consumption was the only viable strategy for households to avoid default.[60] 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.[61]

By the end of the decade, almost 15% of all retail sales were made by an installment purchase.[62] Outstanding short-term non-mortgage consumer debt, of which credit to purchase durable goods is one component, more than doubled in the 1920s, from $3.3 billion in 1920

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[56] GEISST, *supra* note 45, at 154. *See also* FEARON, *supra* note 4, at 53 ("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 products flooding onto the market was extensive and was accompanied by massive advertising campaigns and professional marketing."); HICKS, *supra* note 37, at 120 ("Installment buying, always a valuable talking point in sales promotion, increased greatly in volume throughout the 1920's; students of the subject estimated that in the middle 1920's it accounted for sales amounting to nearly $5 billion annually."); WECTER, *supra* note 37, at 7; WATKINS, *supra* note 38, at 46–47.

[57] WECTER, *supra* note 37, at 7.

[58] *See* MARTHA L. OLNEY, BUY NOW, PAY LATER: ADVERTISING, CREDIT AND CONSUMER DURABLES IN THE 1920S 106 (1991) [hereinafter OLNEY, BUY NOW, PAY LATER]. Olney explains that "[i]n the 1920s, the bulk of installment credit extended to households was [provided] by sales finance companies, specialized financial institutions that purchase[d] 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 113. *See also id.* at 110, figure 4.2 (sample form installment sale contract from a 1932 sale of a used car).

[59] Olney, *Avoiding Default*, *supra* note 37, at 320.

[60] *See id.* at 329.

[61] *See id.* at 329–30, 333–34. *See also* TEMIN, *supra* note 4, at 71–72, 83; Mishkin, *supra* note 37, at 932–33; Romer, *supra* note 37.

[62] ROBERT S. MCELVAINE, THE DEPRESSION AND NEW DEAL: A HISTORY IN DOCUMENTS 17 (2000).

to over $7.6 billion in 1929.[63] Among the most significant of the consumer durables purchased on credit in the years leading up to the Great Depression were automobiles, with sales doubling from 1920 to 1929.[64] As the head of the Federal Reserve commented in 1925, "people will have an automobile and sacrifice paying their doctor bill, the grocery bill and the clothing bill."[65] By the end of the 1920s, approximately two-thirds of the nation's families owned an automobile.[66] By 1925, 75% of all car sales, new and used, were made on installment, and down payments of as little as 10% were commonplace.[67]

With American consumers' increase in spending on durable goods came a corresponding decrease in savings. From 1898 to 1916, on average only 3.7% of disposable income was used to purchase major durable goods such as automobiles, furniture, and household appliances, while from 1922 to 1929, 7.2% was used for this purpose.[68] 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% to 3.8%, a drop of 42%.[69] By 1929, almost 80% of all households, approximately 21.5 million families, had no savings at all.[70] 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.[71]

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 as long as governmental

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[63] OLNEY, BUY NOW, PAY LATER, *supra* note 58, at 6–8 (durable goods consist of items such as automobiles, furniture, clothing, radios, home furnishings, jewelry, phonographs, vacuums, sewing machines, and pianos). The number of radios sold went from 100,000 in 1922 to 4.9 million in 1929. LEUCHTENBURG, *supra* note 37, at 197 ("Three out of every four radios were purchased on the installment plan, as were 60 percent of all automobiles and furniture.").

[64] FEARON, *supra* note 4, at 55 (increasing from 1.9 million to 4.4 million); BADGER, *supra* note 39, at 20 (increasing from 1.5 million in 1921 to 4.5 million in 1929).

[65] PARRISH, ANXIOUS DECADES, *supra* note 33, at 46.

[66] BADGER, *supra* note 39, at 20.

[67] COLIN GORDON, NEW DEALS: BUSINESS, LABOR, AND POLITICS IN AMERICA, 1920–1935 43–44 (1994). *See also* FEARON, *supra* note 4, at 56 (noting that the development of consumer credit was pioneered by General Motors when it founded General Motors Acceptance Corporation in 1919).

[68] OLNEY, BUY NOW, PAY LATER, *supra* note 58, at 47.

[69] *Id.*

[70] MCELVAINE, THE GREAT DEPRESSION, *supra* note 34, at 38.

[71] BADGER, *supra* note 39, at 68; LEUCHTENBURG, *supra* note 37, at 246 (observing that during the 1920s, "banker-promoters financed speculation and loaded the banks with dubious assets").

restrictions on business were kept to a minimum.[72] Monetary policy consisted primarily of keeping interest rates low (from 3 to 3.5% during the Coolidge years) and maintaining the gold standard, both of which were later seen as contributing factors to the Great Depression.[73]

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 those who defended the tax cuts announced by President George W. Bush on June 7, 2001,[74] 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, benefiting the lowest level of society by creating jobs.[75] Mellon's tax cuts were certainly followed by increases in stock market investment, and there is no doubt that they benefitted wealthy individuals and corporations.[76] The promised "trickle down" benefits to the less well-off are more difficult to prove.[77] The data tend to support the view that the "twenties were, indeed, golden, but only for a privileged

[72] FEARON, *supra* note 4, at 49; PARRISH, ANXIOUS DECADES, *supra* note 33, at 53–57. 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. *Id.* at 53–54. Similarly, the three largest antitrust cases brought under the Coolidge administration were lost on appeal, and the highest recovery during that period, $2,000, was reduced to $50 on appeal, an amount the administration never collected. *Id.* at 53.

[73] *Id.* at 56–57. *See also* MITCHELL, *supra* note 38, at 27–28.

[74] Nobel Prize-winning economist Joseph E. Stiglitz has cited the passage of 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, at 48, 50–51.

[75] LAWSON, *supra* note 34, at 10–11. Lawson compares Mellon's trickle-down tax strategy that preceded the Great Depression with the anti-tax policies of the second Bush administration. *Id.* at 251. From 1921 to 1928, four tax cuts reduced the rate on top incomes from 77% to 25%, lowered corporate taxes, and repealed the excess profits and gift taxes. Robert R. Keller, *Supply-Side Economic Policies During the Coolidge-Mellon Era*, 16 J. ECON. ISSUES 773, 780 (1982); PARRISH, ANXIOUS DECADES, *supra* note 33, at 18; NORTON, *supra* note 32, at 20 (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").

[76] 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. PARRISH, ANXIOUS DECADES, *supra* note 33, at 54–55; HICKS, *supra* note 37, at 53–54.

[77] Amity Shlaes attempts to prove Mellon's tax cuts were "good for Henry Ford's worker" based on the claim that "after-inflation earnings of employees grew 16% from 1923 to 1929." SHLAES, *supra* note 6, at 38. 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. *Id.* at 396–98. *See supra* notes 43–46.

segment of the American population."[78] According to the Brookings Study, from 1920 to 1929, the per capita disposable income calculated for all Americans rose 9%, but per capita disposable income for the top 1% of income recipients rose by 75%.[79]

By the end of the 1920s, 5% of the population controlled 90% of the wealth.[80] In 1929, the richest tenth of the population received almost 40% of the nation's income, before taxes, while the poorest tenth received only 1.8%.[81] At that time, when the population of the United States 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.[82] 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 in productivity, creating a fundamental instability in the economy.[83] 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 Home Foreclosures*

Following a 20-year period from 1900 to 1920 when bank failures averaged less than 90 per year, failures rose to an average of 691 per year during the period from 1922 to 1929.[84] 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. The Louisiana Banking Commissioner, after an assessment of the bank failures in his state in 1925, put it this way: "[G]ross 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."[85] The banks' speculative lending practices during the 1920s included loans

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[78] IRVING BERNSTEIN, THE LEAN YEARS: A HISTORY OF THE AMERICAN WORKER, 1920–1933 47 (1960). *See also* Frank Stricker, *Affluence for Whom?—Another Look at Prosperity and the Working Classes in the 1920s*, 24 LAB. HIST. 5 (1983).

[79] MCELVAINE, THE GREAT DEPRESSION, *supra* note 34, at 38.

[80] GEISST, *supra* note 45, at 154.

[81] PARRISH, ANXIOUS DECADES, *supra* note 33, at 82.

[82] LAWSON, *supra* note 34, at 11.

[83] BADGER, *supra* note 39, at 29 ("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.").

[84] WATKINS, *supra* note 38, at 47.

[85] *Id.* (alteration in original).

to fund stock market speculation and real estate investments in southern California and Florida in 1924 and 1925.[86]

As unemployment increased to between 25 and 30%, 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.[87] "By the spring of 1933, half of all home mortgages were technically in default; foreclosures had reached 1,000 a day."[88] In all, the Great Depression brought the default of "40 percent of the . . . $20 billion in home mortgages . . . ."[89]

6. Existing Legal Authority

Before reviewing legislative reforms passed to tackle the Great Depression, it should be noted 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 on 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.[90]

Under the monetary hypothesis, principally attributed to the views of Milton Friedman and Anna Schwartz expressed 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% decline in the money supply from August 1929 to March 1933.[91] According to Friedman and Schwartz, the Federal Reserve could have implemented policies throughout the 1929 to 1933 contraction to increase the money supply.[92] 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

[86] *Id. See also* PARRISH, ANXIOUS DECADES, *supra* note 33, at 226–27. 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% 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.

[87] BADGER, *supra* note 39, at 33 (estimating 250,000 foreclosures in 1932); WECTER, *supra* note 37, at 49 (estimating 273,000 foreclosures in 1932).

[88] BADGER, *supra* note 39, at 33. By 1933, "[t]he government estimated that 43 percent of all first mortgages were in default with an average arrearage of fifteen months. . . . [N]early 25 percent of all homeowners with mortgages were in danger of losing their property through foreclosure. In fact, lenders were initiating an average of 24,000 foreclosures per month . . . ." MASON, *supra* note 52, at 89.

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

[90] RANDALL E. PARKER, THE ECONOMICS OF THE GREAT DEPRESSION 12 (2007).

[91] *Id.* at 13.

[92] *Id.*

prior years, and were recommended to the Federal Reserve at the time.[93] 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.[94] 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.[95]

Under the real business cycle theory, advances in technology ("technology shocks") that lead to over-supply and over-investment are the driving force behind cyclical fluctuations such as the Great Depression.[96] Advocates of this theory believe that government intervention, such as elements of FDR's New Deal program, will generally have the unintended effect of delaying recovery from economic depressions.[97] 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 as an economics professor.[98] Bernanke built on the work of Irving Fisher, who claimed that the dominant forces behind "great" depressions are over-indebtedness and deflation.[99] In what has come to be known as the "credit view," Bernanke added to 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.[100] The debt-deflation theory depends on

[93] *Id.* at 13–14.

[94] *Id.* at 13.

[95] *Id.* at 20–21; Ben S. Bernanke, Governor, Federal Reserve Board, Remarks at the H. Parker Willis Lecture in Economic Policy at Washington and Lee University: Money, Gold, and the Great Depression, (Mar. 2, 2004) (transcript *available at* http://www.federalreserve.gov/boarddocs/speeches/2004/200403022/default.htm).

[96] Ben S. Bernanke & Martin Parkinson, *Procyclical Labor Productivity and Competing Theories of the Business Cycle: Some Evidence from Interwar U.S. Manufacturing Industries*, *in* ESSAYS ON THE GREAT DEPRESSION 255, 255–56 (Ben S. Bernanke ed., 2000); *see generally,* BERNARD C. BEAUDREAU, MASS PRODUCTION, THE STOCK MARKET CRASH AND THE GREAT DEPRESSION: THE MACROECONOMICS OF ELECTRIFICATION (1996).

[97] Cole & Ohanian, *Neoclassical Perspective*, *supra* note 6; Cole & Ohanian, *Prolonged the Depression*, *supra* note 6.

[98] PARKER, *supra* note 90, at 15–16 (citing Ben Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257 (1983)).

[99] *Id.* at 16 (citing Irving Fisher, *The Debt-Deflation Theory of Great Depressions*, 1 ECONOMETRICA 337 (1933)).

[100] *Id.* (citing Bernanke, *supra* note 98).

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.[101] This evidence has now been identified.[102] Under the nonmonetary/financial theory, had consumers not overburdened themselves with debt under contracts of adhesion, at a time when a subsequent decline in assets was at least partially unanticipated, the Great Depression, and for that matter, the subprime mortgage crisis, might not have occurred.

7. Legislative Reforms

A number of the laws enacted during the Great Depression have figured 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. The legislation also represents the beginning of a pattern of bank bailouts and regulation in response to breakdowns of the nation's financial system.

As the 1930s began, bank failures became chronic.[103] 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.[104] The Congress provided the RFC with $2 billion to lend to banks, insurance companies, building and loan associations, agricultural credit associations, railroads, and similar enterprises.[105]

Democrats in the Senate objected to the bill to establish the RFC 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 a large extent brought on the present depression . . . ."[106] Congressman Fiorello La Guardia called the RFC "the millionaires' dole."[107] These concerns were largely realized when the banks and railroads used their RFC loans to repay debts and maintain their credit standing, rather than to make

[101] *Id.* (citing Bernanke, *supra* note 98).

[102] *See generally* James D. Hamilton, *Was the Deflation During the Great Depression Anticipated? Evidence from the Commodity Futures Market*, 82 AM. ECON. REV. 157 (1992); Martin Evans & Paul Wachtel, *Were Price Changes During the Great Depression Anticipated? Evidence from Nominal Interest Rates*, 32 J. MONETARY ECON. 1 (1993); James S. Fackler & Randall E. Parker, *Was Debt Deflation Operative During the Great Depression?,* 43 ECON. INQUIRY 67 (2005).

[103] *See* HICKS, *supra* note 37, at 277 (Bank failures totaled 1,345 in 1930, 2,298 in 1931, and 1,456 in 1932).

[104] Reconstruction Finance Corporation Act, ch. 8, 47 Stat. 5 (1932), *repealed by* Reorganization Plan No. 1 of 1957, 71 Stat. 647.

[105] WECTER, *supra* note 37, at 48.

[106] SCHWARZ, *supra* note 31, at 91 (citing 75 CONG. REC. 1350 (1932)).

[107] WECTER, *supra* note 37, at 48; SCHWARZ, *supra* note 31, at 91.

investments that would create employment.[108] 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.[109] Between 1929 and 1932, the volume of money paid as salaries to rank and file employees dropped by 40% and wages had declined by 60%.[110]

In July of 1932, Hoover signed the bill for the Federal Home Loan Bank Act (FHLBA),[111] which created 12 regional Federal Home Loan Banks owned by the member institutions. The 12 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 many homeowners had already lost their homes through foreclosure.[112] As Hoover pointed out at the time, "[t]he literally thousands of heart-breaking instances of inability of working people to attain renewal of expiring mortgages on favorable terms, and the consequent loss of their homes, have been one of the tragedies of this depression."[113]

The FHLBA also created the Federal Home Loan Bank Board (FHLBB) to oversee the system.[114] 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.[115]

As a way of restoring public confidence in the national banking system, the Banking Act of 1933[116] provided national banks with insurance on their deposits up to $2,500.[117] 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).[118] The FDIC could be appointed to act as receiver for national

[108] EDWARD ROBB ELLIS, A NATION IN TORMENT: THE GREAT AMERICAN DEPRESSION 1929–1939 194 (1970).

[109] *Id.* at 194–95.

[110] WECTER, *supra* note 37, at 17.

[111] Federal Home Loan Bank Act (FHLBA), 12 U.S.C. §§ 1421–49 (2006).

[112] HICKS, *supra* note 37, at 274; MASON, *supra* note 52, at 82–86. WECTER, *supra* note 37, at 49–50.

[113] HICKS, *supra* note 37, at 274.

[114] White, *supra* note 50, at 17.

[115] ROGER C. KORMENDI ET AL., CRISIS RESOLUTION IN THE THRIFT INDUSTRY: A MID AMERICA INSTITUTE REPORT 15 (1989).

[116] Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.); *see* 12 U.S.C. §§ 64a, 71a, 197a, 221a, 227, 263, 333–36, 338–39, 348a, 371a–371d, 374a, 375a, 378, 632.

[117] MASON, *supra* note 52, at 93; PARRISH, ANXIOUS DECADES, *supra* note 33, at 292.

[118] PARRISH, ANXIOUS DECADES, *supra* note 33, at 292.

banks and for insured state chartered banks according to state law.[119] The legislation also 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.[120] The portion of the Banking Act of 1933 known as the Glass-Steagall Act provided for the separation of commercial banking and investment banking.[121]

The Banking Act of 1935 established the FDIC as a permanent agency of the federal government and inaugurated a permanent federal deposit insurance plan.[122] 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.[123] Premiums were not adjusted to account for risk, however, but were calculated at a flat annual rate of 1/12 of 1%. 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.[124]

In 1934, the National Housing Act was passed to spur the housing industries by providing federal backing for mortgages.[125] The Act contained four sections: a mortgage insurance program that guaranteed the payment of 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").[126] The Act created the Federal Housing Agency (FHA)—later renamed the Federal Housing Administration—to administer the programs and make the home improvement loans.[127] The FHA was instrumental in replacing the standard residential mortgage of the time, a 5-year maturity balloon-payment mortgage, with a 20- to 30-year, fixed-rate self-amortizing mortgage.[128] Finally, the Federal Housing Act created the Federal Savings and Loan Insurance Corporation (FSLIC) to provide

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[119] FED. DEPOSIT INS. CORP., THE FIRST FIFTY YEARS: A HISTORY OF THE FDIC 1933–1983 49 (1984), *available at* http://www.fdic.gov/bank/analytical/firstfifty/index.html [hereinafter THE FIRST FIFTY YEARS].

[120] *Id.* at 4–5.

[121] POSNER, A FAILURE OF CAPITALISM, *supra* note 4, at 270.

[122] Banking Act of 1935, Pub. L. No. 74-305, 49 Stat. 684; THE FIRST FIFTY YEARS, *supra* note 119, at 51.

[123] *Id.* at 52.

[124] *Id.*

[125] National Housing Act, 12 U.S.C. § 1701 (2006); MASON, *supra* note 52, at 95.

[126] GEISST, *supra* note 45, at 253; MASON, *supra* note 52, at 95.

[127] GEISST, *supra* note 45, at 253; MASON, *supra* note 52, at 95.

[128] White, *supra* note 50, at 18.

deposit insurance for savings and loans so they could compete effectively with banks for deposits.[129]

Congress also enacted a statute during the Great Depression that was specifically designed to provide relief to struggling homeowners, entitled the Home Owners' Loan Act of 1933 (HOLA).[130] Under HOLA, an agency with a three-year mandate called the Homeowners' Loan Corporation (HOLC) was established to purchase defaulted real estate mortgages from lenders and investors in exchange for bonds, and then refinance the mortgages on more favorable terms.[131] The lenders and investors would then 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 one million loans, accounting for approximately one-fifth of all mortgages nationwide.[132]

B. The Savings and Loan Crisis

The regulatory safeguards adopted during the Great Depression to stave off similar threats to the nation's banking system did not avert the savings and loan crisis of the 1980s, when the number of savings and loans shrank from approximately 4,500 to about 2,400,[133] at an estimated cost to taxpayers of between $150 and $160 billion.[134] As in the Great Depression, the savings and loan crisis was preceded by a period when the government opposed regulation and failed to heed the warnings of coming financial troubles. Safety and soundness limitations on the kinds of investments that the savings and loans could make were lifted to assist them in response to changing economic conditions, but deposit insurance was maintained, and even increased.[135] This volatile

[129] England, *supra* note 51, at 67.

[130] *See* Home Owners' Loan Act, 12 U.S.C. § 1461 (2006). In late 2007, economists advised legislators proposing regulatory reforms in response to the subprime mortgage crisis to draw lessons from HOLA. Alex J. Pollock, *A 1930s Loan Rescue Lesson*, WASH. POST, Mar. 14, 2008, at A17 (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%. 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).

[131] MASON, *supra* note 52, at 91–92; Pollock, *supra* note 130, at A17. Pollock reports that qualifying mortgages were limited to 80% of the value of the property on homes with a maximum value of $17,500.

[132] Pollock, *supra* note 130, at A17.

[133] KARSTEN F. TURCK, THE CRISIS OF AMERICAN SAVINGS & LOAN ASSOCIATIONS: A COMPREHENSIVE ANALYSIS 47 (1998).

[134] White, *supra* note 50, at 17; England, *supra* note 51, at 63.

[135] Most economists believe that the government's failure to amend 1930s era banking laws in an appropriate and timely manner to respond to current financial conditions was the principal cause of the savings and loan crisis. England, *supra* note 51, at 63; White, *supra* note 50, at 17–18; KORMENDI ET AL., *supra* note 115, at 13.

combination of regulation and deregulation was an invitation for the savings and loans to engage in excessive risk-taking. They did not disappoint, filling their balance sheets with junk bonds, speculative real estate and other "toxic assets." In the end, the savings and loan 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 mortgages. Other laws enacted after the savings and loan crisis could have been used to prevent the subprime mortgage crisis, but they 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.[136] 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.[137] Bank regulators echoed the "too big to fail" mantra we hear today, with the Comptroller of the Currency, Todd Conover, asserting in September 1984 that the federal government would not allow any of the nation's 11 largest banks to be liquidated.[138] 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%, a level that had not been exceeded since 1933.[139]

Between 1980 and 1994, 1,617 federally insured banks with $302.6 billion in assets were closed or received FDIC financial assistance.[140] 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% of the assets in the banking system.[141]

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

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[136] FED. DEPOSIT INS. CORP., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 4 (1998), *available at* www.fdic.gov/bank/historical/managing/contents.pdf [hereinafter MANAGING THE CRISIS].

[137] England, *supra* note 51, at 63, 73 (citing EDWARD J. KANE, THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE 102 (1985)).

[138] KANE, *supra* note 137, at 161. Kane comments on the policy of bailing out large insolvent banks as follows: "As long as large deposit institutions and their creditors may count on drawing federal subsidies to extract themselves from what would otherwise be do-or-die situations, the potentially salutary effects of market discipline have little opportunity to make themselves felt." *Id.* at 163.

[139] MANAGING THE CRISIS, *supra* note 136, at 4.

[140] *Id.*

[141] *Id.* at 5.

by short-term, federally insured, passbook savings deposits.[142] The 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 short-term interest they paid on their deposits.[143] In the two decades after World War II, interest rates were relatively stable and few savings and loan institutions had difficulty earning adequate returns.[144] When interest rates began to rise in the mid-1960s, the savings and loans received relief beginning in 1966, as a result of Regulation Q, which was promulgated by the Federal Reserve.[145] Regulation Q capped the interest rate that the 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.[146] This solution worked relatively well for a time because all of the institutions offering federal deposit insurance were covered by Regulation Q's interest rate restrictions.[147] As the 1970s wore on, however, the stability of the savings and loans was threatened by a combination of rising interest rates, increased inflation, and availability of alternative sources of investment in high-interest vehicles such as money market accounts and mutual funds offered by non-bank entities such as securities firms and insurance companies that were not covered by Regulation Q.[148]

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.[149] Among the recommendations made by the Commissions formed to issue these reports were to permit adjustable-rate mortgages (ARMs), to allow the savings and loans to diversify their lending into other consumer and commercial fields, and to rescind Regulation Q.[150] These recommendations 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

[142] White, *supra* note 50, at 18.

[143] *Id.*

[144] *Id.* at 19.

[145] *See* Anchor Sav. Bank, FSB v. United States, 81 Fed. Cl. 1, 10 (2008).

[146] *Id.* (citing Act of Sept. 21, 1966, Pub. L. No. 89-597, 80 Stat. 823 §§ 2, 4 (1966)).

[147] White, *supra* note 50, at 19.

[148] *See Anchor Sav. Bank, FSB*, 81 Fed. Cl. at 10.

[149] England, *supra* note 51, at 64 (describing the Commission on Financial Structure and Regulation, better known as the Hunt Commission, which issued its report in 1971, and the House of Representatives Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, which commissioned a study entitled Financial Institutions in the Nation's Economy (known as the FINE Study), completed in 1975 (citing Lee Davison, *Banking Legislation and Regulation, in* 1 HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE 87, 91–92 (1997))).

[150] White, *supra* note 50, at 20; MASON, *supra* note 52, at 206.

to the borrowers.[151] The Depository Institutions Deregulation and Monetary Control Act[152] eliminated Regulation Q's coverage of thrift and commercial bank deposits, and the Garn-St. Germain Depository Institutions Act[153] "allowed thrifts to invest in a broader variety of assets than the traditional fixed-rate mortgages on one to four family homes."[154] They could now provide 100% financing, requiring no down payment; increase their consumer loans up to a total of 30% of their assets; make commercial, corporate, and business loans; and invest in nonresidential real estate worth up to 40% of their total assets.[155] These statutes also contained provisions giving the FHLBB the authority to lower minimum net-worth requirements.[156]

Economists who favored these changes believe they came too late to be effective, and were undermined by a flawed system of federal deposit insurance.[157] The federal deposit insurance system creates a moral hazard for bankers because they do not have to avoid risk to attract customers or to protect themselves from loss.[158] 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.[159] The

[151] The Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. § 3803 (2006); England, *supra* note 51, at 73.

[152] The Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f-7a (2006).

[153] Garn-St. Germain Depository Institutions Act of 1982, 12 U.S.C. § 1701j-3 (2006).

[154] KORMENDI ET AL., *supra* note 115, at 14.

[155] CALAVITA, PONTELL & TILLMAN, *supra* note 4, at 12.

[156] R. Dan Brumbaugh, Jr. & Catherine J. Galley, *The Savings and Loan Crisis: Unresolved Policy Issues*, *in* THE SAVINGS AND LOAN CRISIS: LESSONS FROM A REGULATORY FAILURE 83, 92 (James R. Barth et al. eds., 2004).

[157] 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 1, 7–8 (James R. Barth et al. eds., 2004); *see also* TURCK, *supra* note 133, at 85–86.

[158] *See* Kaufman, *supra* note 157, at 8 ("As has been discussed in the academic and profession literature *ad infinitum*, poorly designed deposit 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) . . . ."). Insurance also creates a moral hazard for the insurer by changing the insureds' incentives: "the risk that insurance coverage leads insured parties deliberately to pursue risks that in an uninsured state they would not take. For deposit insurers moral hazard is especially difficult because deposit institution managers are better informed than agency personnel about the economic consequences of the risks they take." KANE, *supra* note 137, at 62.

[159] *See* Homer Jones, *Banking Reform in the 1930s*, *in* REGULATORY CHANGE IN AN ATMOSPHERE OF CRISIS: CURRENT IMPLICATIONS OF THE ROOSEVELT YEARS 79, 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

FSLIC, created in 1934 to insure savings and loan accounts,[160] charged all savings and loan institutions a flat premium for deposit insurance regardless of the risk inherent in an individual institution's portfolio.[161] 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.[162] 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.[163]

In 1980, Congress increased deposit insurance coverage from $40,000 to $100,000. During the subprime mortgage crisis, Congress did the same thing, increasing insurance coverage from $100,000 to $225,000 despite the fact that many commentators believe the 1980 decision played a significant role in contributing to the severity of the S&L crisis by reducing depositor concern over the financial health of their insured depositories.[164] The structural incentives in the insurance system to engage in high-risk activities were not counterbalanced by regulatory

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to minimize their capital investments but little motive to properly evaluate the risks of their operations, a defect noted by many other economists (citing George J. Benston & John Tepper Marlin, *Bank Examiners' Evaluation of Credit: An Analysis of the Usefulness of Substandard Loan Data*, 6 J. MONEY, CREDIT & BANKING 23, 23–44 (1974); Gerald P. Dwyer, Jr., *The Effects of the Banking Acts Of 1933 and 1935 on Capital Investment in Commercial Banking*, Unpublished manuscript, 1978; Samuel Peltzman, *The Costs of Competition: An Appraisal of the Hunt Commission Report*, 4 J. MONEY CREDIT & BANKING 1001, 1001–1004 (1972); Anna Jacobson Schwartz, *Monetary Trends in the United States. and the United Kingdom., 1878–1970: Selected Findings*, 35 J. ECON HIST. 138, 138–59 (1975))).

[160] The FSLIC was created by Title IV of the National Housing Act in June of 1934. National Housing Act, 12 U.S.C. § 1725 (1934) (repealed 1989 by the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, § 407, 103 Stat. 183 [hereinafter FIRREA]). *See also* FIRREA § 401(a)(1) (abolishing the Federal Savings and Loan Insurance Corporation).

[161] KORMENDI ET AL., *supra* note 115, at 13; *Causes of the Savings and Loan Crisis*, *in* THE SAVINGS AND LOAN CRISIS: LESSONS FROM A REGULATORY FAILURE 345, 345 (James R. Barth et al. eds., 2004). *See also* KANE, *supra* note 137, at 18 (noting that resistance to the 150 bills introduced to Congress dating back to 1886 for federal guarantees or insurance of bank deposits included views of economists, repeated in a published analysis of federal deposit insurance system adopted in 1933, that "unless insurance assessments were related to the risks taken by individual banks, deposit guarantees eventually would foster looser banking practices rather than sounder ones").

[162] KORMENDI ET AL., *supra* note 115, at 13–14.

[163] Kaufman, *supra* note 157, at 8.

[164] *Id.* at 9–10; TURCK, *supra* note 133, at 85–86.

discipline, but by the steps described above to lift the regulatory restrictions on the thrift industry. Thus, the liberalization of restrictions on thrifts is seen as ill-timed for several reasons. By the time the restrictions were lifted, 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.[165]

During President Reagan's eight years in office, from 1981 to 1989, the prospective costs of resolving the FSLIC's supervisory cases grew,[166] and abuses at an operational level, including fraud, increased.[167] Regulatory failures also led to flawed examination and supervision, resulting in delays by the mid-1980s in declaring insolvencies.[168]

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 savings and loan crisis with the formation of Ginnie Mae and Freddie Mac, two entities that purchased mortgages for resale in the form of mortgage-backed securities, and with the development of increasingly complex forms of mortgage-backed securities.[169]

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.[170] 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.[171] 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.[172] The

[165] KORMENDI ET AL., *supra* note 115, at 14.

[166] 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 31, 41 (James R. Barth et al. eds., 2004).

[167] *Causes of the Savings and Loan Crisis*, *supra* note 161, at 345.

[168] *Id.*

[169] Schmudde, *supra* note 5, at 735–36, n.93.

[170] *See* Gov't Nat'l. Mortgage Ass'n v. Terry, 608 F.2d 614, 618 (5th Cir. 1979); National Housing Act Amendments of 1938, ch. 13, 52 Stat. 8, (codified at 12 U.S.C. § 1716 (2006)); MAYER, *supra* note 4 at 37–38.

[171] Anchor Sav. Bank, FSB v. United States, 81 Fed. Cl. 1, 16 (2008).

[172] Calhoun v. Fed. Nat'l Mortgage 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)); *Terry*, 608 F.2d at 619 (citing the Housing and Urban Development Act of 1968, 12 U.S.C. §§ 1716b, 1717(a)(2)); Werts v. Fed. Nat'l. Mortgage Ass'n, 48 B.R. 980, 983 (E.D. Pa. 1985) ("In 1968, Congress specifically

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.[173] Ginnie Mae began issuing mortgage-backed securities comprised of FHA and Veteran's Administration (VA) insured mortgages.[174] In 1970, Congress formed a private entity, or GSE, called the Federal Home Loan Mortgage Corporation ("Freddie Mac"), that also issued mortgage-backed securities.[175] In 1981, Fannie Mae itself began issuing mortgage-backed securities.[176]

Under legislative underwriting standards, Fannie Mae and Freddie Mac are limited to purchasing and securitizing "conforming mortgages,"[177] leaving open a market for securitization of "non-conforming" mortgages. When Bank of America issued the first so-called "private-label" mortgage-backed securities, it was promptly followed by banks, thrifts, homebuilders, and mortgage-banking companies that specialized in buying mortgages, pooling them, and issuing them as "pass

disassociated F.N.M.A. from its previous ownership and transferred it to private ownership. F.N.M.A. maintains the capital structure of a privately owned corporation. 12 U.S.C. § 1718 . . . ." (citation omitted) (citing 1968 U.S.C.C.A.N. 2873, 2943–44)).

[173] *Terry*, 608 F.2d at 619 ("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." (citing 12 U.S.C. § 1717(a)(2)(A))).

[174] *Anchor Sav. Bank, FSB*, 81 Fed. Cl. at 16 ("Fannie Mae was authorized to purchase 'unconventional' mortgages—those insured by the [FHA], and later, the [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."); Wash. Fed. Sav. & Loan Ass'n v. Fed. Home Loan Bank Bd., 526 F. Supp. 343, 354 n.6 (N.D. 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.").

[175] *Anchor Sav. Bank, FSB*, 81 Fed. Cl. at 16.

[176] *Id.*

[177] For the definition of conforming mortgages that are eligible for purchase by Fannie Mae, see 12 U.S.C. § 1717(b)(2) (Supp. II 2009) (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)); *Anchor Sav. Bank, FSB*, 81 Fed. Cl. at 17 (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.").

through" securities.[178] This market in non-conforming mortgage securities was facilitated by the passage of the Secondary Mortgage Market Enhancement Act of 1984,[179] which made several changes in existing regulations "designed to foster the growth of the private-label secondary mortgage market . . . ."[180] These changes included broadening the transactional exemption from security registration requirements of the Securities Act of 1933 for mortgage-backed securities and preempting state laws that restricted thrift ownership of private-label mortgage-backed securities.[181] 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.[182] While the laws permitting the sale of mortgage-backed securities and adjustable-rate mortgages facilitated the subprime mortgage crisis of 2007, they played an important role in mitigating the severity of the savings and loan crisis.[183] This does not mean, however, that the misuse of mortgage-backed securities could not have been anticipated in the savings and loan reform legislation.

Writing in the aftermath of the savings and loan crisis, several commentators were able to predict troubles to come based on unregulated trading in the secondary mortgage market and the market for credit derivatives. In 1990, Martin Mayer wrote that while the legislation passed by Congress 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."[184] His prediction came true, and taxpayers have now spent $2.2 trillion to resuscitate the economy after the world's major financial institutions took

[178] *Anchor Sav. Bank, FSB*, 81 Fed. Cl. at 17–18 (citing KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE-BACKED SECURITIES: DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET 1–3 (2001)); THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 5–6, 31 (Frank J. Fabozzi ed., 5th ed. 2001); H. Rep. No. 98-994, at 38–39 (1984), *as reprinted in* 1984 U.S.C.C.A.N. 2827, 2843.

[179] Secondary Mortgage Market Enhancement Act of 1984, Pub. L. 98-440, 98 Stat. 1689 (codified as amended in scattered sections of U.S.C.).

[180] *Anchor Sav. Bank, FSB*, 81 Fed. Cl. at 19.

[181] *Id.*

[182] Schmudde, *supra* note 5, at 736.

[183] 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 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, FSB*, 81 Fed. Cl. at 15.

[184] MAYER, *supra* note 4, at 41.

at least $396 billion in write-downs on subprime mortgage assets.[185] A similar predication was made by one of the authors of a paper published in 1993 entitled *Looting: The Economic Underworld of Bankruptcy for Profit*, in which two prominent economists attributed several financial disasters of the 1980s, including the savings and loan crisis, to a combination of government regulation and government bailouts.[186] In the case of the savings and loan crisis, they argued that this mix allowed private owners of savings and loans to make loans and investments with federally insured deposits without any concern for the downside risks.[187] Shortly after finishing the paper, George Akerlof, a Nobel prize-winner, reportedly told his co-author, Paul Romer, an expert on economic growth, that the next candidate for "looting" was already taking shape in the market for credit derivatives.[188]

4. Bailouts and Regulation

In 1989, the Bush administration and Congress came to the rescue of the savings and loan industry in what was referred to at the time as a "bailout."[189] In August 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.[190] The FHLBB and the FSLIC were abolished.[191] 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.[192] FIRREA also created two new insurance funds to be administered by the FDIC: the Savings Association Insurance Fund for savings associations and the Bank Insurance Fund for banks.[193]

[185] David Goldman, *Bailout Tracker: What's Going, What's Coming*, CNNMONEY.COM, Sept. 14, 2009, http://money.cnn.com/2009/09/11/news/economy/bailout_repayment_tracker/index.htm; Yalman Onaran, *Subprime Losses Top $396 Billion on Brokers' Writedowns: Table*, BLOOMBERG.COM, http://www.bloomberg.com/apps/news?pid=20601082&sid=a5GaivCMZu_M.

[186] George A. Akerlof & Paul M. Romer, *Looting: The Economic Underworld of Bankruptcy for Profit*, *in* 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1, 6–7 (William C. Brainard & George L. Perry eds., 1993).

[187] *Id.*

[188] David Leonhardt, *The Looting of America's Coffers*, N.Y. TIMES, Mar. 11, 2009, at B1.

[189] Leibold, *supra* note 166, at 42.

[190] White, *supra* note 50, at 24.

[191] FIRREA, Pub. L. 101-73, § 407, 103 Stat. 183 §§ 301, 401(a) (1989); FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE: AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S 100 (1997), *available at* www.fdic.gov/bank/historical/history/index.html [hereinafter HISTORY OF THE EIGHTIES].

[192] FIRREA § 301; HISTORY OF THE EIGHTIES, *supra* note 191, at 100.

[193] HISTORY OF THE EIGHTIES, *supra* note 191, at 100.

The Resolution Trust Corporation was created under FIRREA to continue the liquidation of the insolvent savings and loan associations once the FSLIC fund became insolvent.[194] By the 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.[195]

Two years later, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[196] 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.[197] 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.[198]

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.[199] 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).[200] 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).[201] Such prompt corrective actions include increased monitoring, raising additional capital, requiring acceptance of an offer to be acquired, and closure of the institution.[202]

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, economist George Kaufman found that regulators had failed to learn the lessons of the savings and loan crisis under the prompt corrective action and least cost resolution regulations.[203] The failed banks in his study included institutions that concentrated in securitized subprime loans, and

[194] FIRREA § 501; Federal Home Loan Bank Act (FHLBA), 12 U.S.C. § 1421 (2006).

[195] MANAGING THE CRISIS, *supra* note 136, at 8.

[196] Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242, § 1831m, 105 Stat. 2236; HISTORY OF THE EIGHTIES, *supra* note 191, at 88.

[197] HISTORY OF THE EIGHTIES, *supra* note 191, at 88.

[198] *Id.* at 103.

[199] *Id.* at 75.

[200] *Id.* at 252.

[201] *Id.* at 452, 454.

[202] *Id.* at 454.

[203] Kaufman, *supra* note 157, at 3.

followed a strategy of holding on to the first dollar loss tranche, widely referred to as the "toxic waste" tranche.[204] Although the regulators were aware of the problem banks for years, they did not act with any sense of urgency, were stalled, and did not follow through aggressively on their enforcement actions.[205] This approach led to "higher-cost failures" based in part on parochial concerns about the short-term well-being of the banking industry, and in part on an incentive structure that was not designed to reward regulators for achieving low-cost failures.[206] Based on his 2004 findings, Kaufman asked, "[i]f 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?"[207]

If the prevailing view of the causes of the savings and loan crisis is accurate, the regulatory response to the Great Depression not only failed to prevent one of the most costly economic disasters to follow the Great Depression, 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 savings and loan crisis.

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 crisis, 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.[208] Had regulators exercised their authority under these laws,

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[204] *Id.* at 5. 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% of its assets. *Id.* at 4.

[205] *Id.* at 6.

[206] *Id.* at 10.

[207] *Id.*

[208] *See* Home Ownership and Equity Protection Act of 1994 (HOEPA), 15 U.S.C. §§ 1601–1667f (Supp. 2009) (enacted in 1994, giving the Federal Reserve the authority to regulate high interest rate mortgages); Truth in Lending Act (TILA), 15 U.S.C. §§ 1601–1667f (Supp. 2009) (enacted in 1968, requiring extensive, and often complex disclosures in consumer credit transactions, including residential mortgages); Real Estate Settlement Practices Act of 1974 (RESPA), 12 U.S.C. §§ 2601–2617 (enacted in 1971, imposing detailed disclosure obligations on lenders

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 have been sound.

The Federal Reserve has long enjoyed broad regulatory control over national banks and state banks and trust companies that are members of the Federal Reserve System,[209] but in 1994, Congress gave the agency specific powers to eliminate the abuses engaged in by bank and non-bank subprime lenders. Under the Home Ownership and Equity Protection Act (HOEPA), the Federal Reserve was to regulate banks and nonbank lenders to curb unfair, deceptive, and predatory lending.[210] Congress directed the Federal Reserve to issue regulations under a mandate of sweepingly broad language, providing little support for the agency's claim that it lacked enforcement authority regarding fraudulent lending practices. The statute authorizes the Federal Reserve to prohibit "acts or practices in connection with . . . mortgage loans" 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."[211] Despite this mandate to the Federal Reserve, HOEPA had virtually no impact on the growth of subprime mortgages, which rose dramatically after its passage.[212]

No action was taken under the 1994 statute by then Chairman of the Federal Reserve Alan Greenspan, or by his successor Ben Bernanke, who

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in residential mortgage transactions regarding settlement costs, charges and escrow payments scheduled for the first year of the loan); Equal Credit Opportunity Act (ECOA), 15 U.S.C. §§ 1691–1691f (enacted in 1991, prohibiting 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); Credit Rating Agency Reform Act of 2006 (CRARA), 15 U.S.C. § 78o-7 (2006) (requiring credit rating agencies, such as the agencies that improperly rated mortgage-backed securities and CDO securities, to register and be regulated by the SEC and to develop rules to prevent conflicts of interest).

[209] Federal Reserve Act, 12 U.S.C. § 248 (2006).

[210] 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. *Id.* § 1639(m).

[211] *Id.* § 1639(l)(2). HOEPA is incorporated into TILA as a set of provisions that designate certain mortgages as high-cost loans, defined to cover mortgages with rates over 10% above rates for Treasury securities with comparable maturities or with fees and points that exceed the greater of 8% of the loan or $400. *Id.* § 1602(aa). The Federal Reserve has the authority to modify the mortgage trigger by regulation. *Id.* § 1602(2)(a).

[212] Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 20 (2009) ("Originations in the subprime market grew from $65 billion in 1995 to $332 billion in 2003.").

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.[213] Greenspan later claimed that the terms "unfair" and "deceptive" under HOEPA were unclear,[214] but he did not seek guidance from Congress, or from cases interpreting the FTC legislation using the same terms.[215] When Bernanke did act, in July 2008, by issuing proposed regulations concerning subprime lending, he relied on his authority under the 1994 statute,[216] 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, "[a]lthough 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."[217]

The Federal Reserve also failed to exercise authority it was given under legislation that was passed after the savings and loan crisis to avert future bank failures. Under the "prompt corrective action" provisions of the FDICIA, the Federal Reserve is directed by Congress to prevent commercial and investment banks from reaching a point of insolvency at

[213] Edmund L. Andrews, *Fed and Regulators Shrugged as Subprime Crisis Spread*, N.Y. TIMES, Dec. 18, 2007, at A1.

[214] *Id.*

[215] FTC v. Sperry & Hutchinson Co., 405 U.S. 233, 245 (1972) (holding that under section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45(a)(6), the FTC has the authority to protect consumers from "unfair or deceptive acts or practices" even if these practices do not infringe either the letter or the spirit of the antitrust laws); FTC v. Tashman, 318 F.3d 1273, 1279 (11th Cir. 2003) (recognizing that because "Congress must have realized that this vague and amorphous standard, ['unfair or deceptive practices'], would require more concrete definition[,] Congress gave the FTC broad authority to define by rule specific acts or practices which are unfair or deceptive." (citing 15 U.S.C. § 57a(a)(1)(B)). Congress gave the Federal Reserve similarly broad authority under HOEPA to prohibit "by regulation or order" any "acts or practices" in connection with mortgage loans it found to be "unfair, deceptive, or designed to evade the provisions of this section," and any "refinancing . . . the Board finds to be associated with abusive lending practices or that are otherwise not in the interest of the borrower." 15 U.S.C.A. § 1639(l)(2).

[216] TILA, 15 U.S.C. §§ 1601–1667f (2006). For a detailed review of this regulation, see Schmudde, *supra* note 5, at 756–59.

[217] Steven R. Weisman, *Fed Sets Rules Meant to Stop Deceptive Lending Practices*, N.Y. TIMES, July 15, 2008, at C4.

which they are deemed "too big to fail" and must be rescued.[218] 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.[219] From 2001 to 2008, the Federal Reserve was headed by chairmen who declined to enforce 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 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 mortgage-backed securities were regulated by the Securities and Exchange Commission (SEC), but the SEC's enforcement activities posed no obstacle to the wave of destruction caused by these banks' mortgage-backed securities trading. In fact, the SEC granted a key exemption from regulation in this area that increased the damage caused by mortgage-backed security trading activities.[220] 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 these institutions to make highly-leveraged (12:1 to 30:1 or higher) investments in mortgage-backed securities, over-the-counter credit derivatives, and related instruments.[221] As the head of Goldman Sachs, Henry M. Paulson Jr. attended this meeting and joined in the request to allow highly-leveraged trading in mortgage-backed securities.[222] Two years later, as Treasury secretary, Paulson would direct the transfer of $10 billion in TARP funds to Goldman Sachs based on the firm's mortgage-backed securities losses.[223]

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

[218] Martin Neil Baily, Douglas W. Elmendorf & Robert E. Litan, *The Great Credit Squeeze: How It Happened, How to Prevent Another* 71 (Econ. Studies at Brookings Inst., Discussion Paper, 2008), *available at* http://www.brookings.edu/papers/2008/~/media/Files/rc/papers/2008/0516_credit_squeeze/0516_credit_squeeze.pdf.

[219] *Id.*

[220] *Id.* at 112.

[221] Stephen Labaton, *The Reckoning: Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. TIMES, Oct. 3, 2008, at A1; Stiglitz, *supra* note 74, at 50.

[222] CNNMoney.com, *Bailed Out Banks*, http://money.cnn.com/news/specials/storysupplement/bankbailout; Labaton, *supra* note 221.

[223] *See* Labaton, *supra* note 221. 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 & Don Van Natta, Jr., *Paulson's Calls to Goldman Tested Ethics During Crisis*, N.Y. TIMES, Aug. 9, 2009, at A1.

potentially beyond the scope of existing law—mortgage-backed over-the-counter 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-backed derivatives first emerged,[224] 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.[225] This recommendation took on further weight later that same year when the Federal Reserve had to engineer the bailout of the over one trillion dollar failure of the hedge-fund, Long Term Capital Management, which had engaged in heavy derivates trading.[226] Two years later, Congress exempted over-the-counter derivatives, including mortgage-backed securities derivatives, from the regulation that they had been subject to under the Commodity Exchange Act of 1936.[227] Over-the-counter derivatives, still unregulated, have a current notional value of $680 trillion.[228]

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,[229] 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.[230] At the time the study was conducted, 80% of subprime lending consisted of refinancing loans, rather than loans that enabled borrowers with poor credit to purchase their first home.[231] These subprime refinancing loans increased tenfold from 1993 to 1998.[232] The

[224] Schmudde, *supra* note 5, at 735 n.93.

[225] Manuel Roig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Unheeded Warning Is a Rueful Echo 10 Years On*, WASH. POST, May 26, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009o52502108_pf.html; Stiglitz, *supra* note 74, at 50.

[226] Roig-Franzia, *supra* note 225; Stiglitz, *supra* note 74, at 50.

[227] *See* Commodity Futures Modernization Act of 2000, Pub. L. 106-554, 114 Stat. 2763 (codified in scattered sections of the U.S.C.).

[228] Roig-Franzia, *supra* note 225.

[229] 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, which allowed lenders to offer adjustable-rate mortgages and to use balloon payments. Schmudde, *supra* note 5, at 727–29.

[230] *See Subprime Lending More Likely in Minority and Low-Income Areas*, HUD USER, http://www.huduser.org/periodicals/rrr/rrr_7_2000/0700_1.html.

[231] *Id.*

[232] *Id.*

HUD report also found that African-Americans were being improperly steered into subprime loans regardless of their income level.[233]

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.[234] This Task Force issued a report 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.[235]

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% of all subprime borrowers could have qualified for a far less costly prime loan.[236] 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 per year.[237]

Regulators ignored these warnings until it was too late for corrective action to have any meaningful effect. In March 2007, when regulators finally issued guidance to establish standards on subprime lending, over 30 subprime lenders had already gone out of business.[238] And the Federal Reserve's regulations under HOEPA to control abusive practices by

[233] Subprime loans were five times more likely in black neighborhoods than in white neighborhoods, and homeowners in high-income black neighborhoods were twice as likely as homeowners in low-income white neighborhoods to have subprime loans. *Id.*

[234] *See* U.S. DEP'T OF HOUS. & URBAN DEV., UNEQUAL BURDEN: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING IN AMERICA (2000), http://www.huduser.org/publications/fairhsg/unequal.html.

[235] *See* U.S. DEP'T OF HOUS. & URBAN DEV.-TREASURY NAT'L PREDATORY LENDING TASK FORCE, CURBING PREDATORY HOME MORTGAGE LENDING 116–18 (2000), http://www.huduser.org/publications/hsgfin/curbing.html.

[236] Jennie Kennedy, *The Predatory Lending Trap*, TEX. OBSERVER, Jan. 31, 2002. Freddie Mac found that 35 percent of borrowers in the subprime market could qualify for prime market loans. JAMES H. CARR & LOPA KOLLURI, FINANCIAL SERVICES IN DISTRESSED COMMUNITIES: ISSUES AND ANSWERS 37 (2001).

[237] *See* Sue Kirchhoff, *More U.S. Home Buyers Fall Prey to Predatory Lenders*, USA TODAY, Dec. 6, 2004, *available at* http://www.usatoday.com/money/perfi/housing/2004-12-06-subprime-predatory-lending_x.htm.

[238] Andrews, *supra* note 213, at A32.

subprime lenders were not effective until October 1, 2009, long after the damage had been done.[239]

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 financial adhesion contracts, in the form of mortgages and other credit agreements, for debt they could not afford to repay.[240] According to Federal Reserve data, consumer credit and mortgage debt has risen, as a percentage of disposable income, from 77% in 1990 to 127% in 2007.[241] Studies have shown that between 1991 and 2006, Americans converted their home equity to finance over two trillion in personal consumption.[242] At the same time, savings rates steadily declined, from 9% of disposable income as the average savings rate of U.S. households between 1950 and 1985, down to 0% of disposable income in 2008.[243]

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 rates low through 2004, despite concerns about an inflationary bubble in the housing market.[244] Low mortgage rates made buying a home possible for more Americans, but increased demand also drove up home prices.[245] Sky-rocketing prices made taking on high levels of

[239] *See* Regulation Z, 12 C.F.R. § 226.34 (2008) (codifying that 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* Weisman, *supra* note 217, at C4. 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 were effective on July 30, 2009, two months earlier than the Federal Reserve's final rule. *See* Federal Reserve System Regulation Z, 73 Fed. Reg. 74,989 (Dec. 10, 2008) (codified at 12 C.F.R. § 226.35).

[240] As Joseph Stiglitz has recently observed, "The economy had been sustained by excessive borrowing." Stiglitz, *supra* note 74, at 51.

[241] *The End of the Affair*, ECONOMIST, Nov. 22, 2008, at 39.

[242] *See* Wilmarth, *supra* note 8, at 1010, n.217 (citing Alan Greenspan & James Kennedy, *Sources and Uses of Equity Extracted from Homes*, 24 OXFORD REV. ECON. POL'Y 120, 122, 139 (2008) (finding that three-quarters of the total of $2 trillion in equity extracted from home sales and refinancings for personal consumption made from 1991 to 2001 were made during housing boom of 2001 to 2006)).

[243] *The End of the Affair*, *supra* note 241, at 39, citing as its source the Federal Reserve, U.S. Bureau of Economic Analysis.

[244] Andrews, *supra* note 213, at A1.

[245] POSNER, A FAILURE OF CAPITALISM, *supra* note 4, at 105.

mortgage debt a necessity for an increasing number of home buyers.[246] Conversely, in an environment of rising prices, many lenders offering low "teaser" adjustable-rate loans assured borrowers that in two or three years the prices of their homes would increase sufficiently so that they could refinance their loans at lower rates.[247]

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.[248] In 1994, less than 5% of all mortgages in the U.S. were subprime, but by 2004, subprime loans had grown to 11% of total mortgage originations.[249] In 2005 and 2006, these loans represented 20% of all originations.[250] Meanwhile, mortgages issued from 2004 onwards had increasingly higher 90-day delinquency rates.[251]

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.[252]

3. Rising Mortgage Debt

Between 2000 and 2007, household mortgage debt increased from $4.9 trillion to $10.5 trillion.[253] As of 2007, home mortgage debt represented over 75% of gross domestic product, up from an average of

[246] *See* Macey et al., *supra* note 5, at 800 ("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)*, BLOOMBERG.COM, May 27, 2009, http://www.bloomberg.com/apps/news?pid=20601087&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.

[247] Baily, Elmendorf & Litan, *supra* note 218, at 17.

[248] *Id.* at 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.

[249] *Id.* at 14; Tony Favro, *U.S. Subprime Mortgage Crisis Hurts Individuals and Whole Communities*, CITY MAYORS, Apr. 14, 2007, http://www.citymayors.com/finance/us-subprime.html.

[250] Baily, Elmendorf & Litan, *supra* note 218, at 14.

[251] *Id.* at 15 (a 90-day delinquency means that the mortgage payment is at least 90 days overdue).

[252] *See* U.S. CENSUS BUREAU, MONEY INCOME IN THE UNITED STATES (2001), *available at* http://www.census.gov/prod/2002pubs/p60-218.pdf; U.S. CENSUS BUREAU, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES (2007), *available at* http://www.census.gov/prod/2008pubs/p60-235.pdf (real median household income rose from $42,228 in 2001, or $49,438 in 2007 dollars, to $50,233 in 2007).

[253] *See* Wilmarth, *supra* note 8, at 1009, n.210.

46% during the 1990s.[254] Non-mortgage consumer debt rose from $1.59 billion at the end of 2000 to $2.55 billion by the end of 2007.[255] From 1990 to 2006, mortgage debt increased as a percentage of disposable personal income from 58% to 102%, while non-mortgage debt rose from 87% to 140% during the same period.[256]

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 2007 with the announcement by Bear Sterns that two of their mortgage-backed securities hedge funds, which were valued at $1.5 billion at the end of 2006, were virtually worthless.[257] This announcement, and the rapidly increasing rate of home foreclosures, raised concerns that other financial institutions may also be holding over-valued mortgage-backed securities.[258]

The government bailouts began with Bear Stearns, with the Federal Reserve saving the firm from bankruptcy in March of 2008 by assuming $30 billion in liabilities and arranging a sale to JPMorgan Chase for one-tenth of Bear Stearns's market price.[259] 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.[260] On September 14, 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.[261] Lehman Brothers, another major investment bank that had invested heavily in subprime securities, was forced to file for

[254] Colin Barr, *The $4 Trillion Housing Headache*, CNN MONEY.COM, (May 27, 2009), http://money.cnn.com/2009/05/27/news/mortgage.overhang.fortune/.

[255] *See* Wilmarth, *supra* note 8, at 1009, n.213.

[256] *See id.* at 1010.

[257] Gretchen Morgenson, *Bear Stearns Says Battered Hedge Funds Are Worth Little*, N.Y. TIMES, July 18, 2007, at C2.

[258] 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: The Case for Regulation*, HARVARD MAG., May–June 2008, at 34, 35.

[259] Andrew Ross Sorkin, *JPMorgan Chase Pays Only $2 a Share for Troubled Firm*, N.Y. TIMES, Mar. 17, 2008, at A1.

[260] Charles Duhigg, *As Crisis Grew, A Few Options Shrank to One*, N.Y. TIMES, Sept. 8, 2008, at A1; 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, *supra* note 185 ($84.9 billion of these guarantees have been invested).

[261] Andrew Ross Sorkin, *Merrill is Sold: Failing to Find Buyer, Lehman Set to File for Bankruptcy*, N.Y. TIMES, Sept. 15, 2008, at A1; Gretchen Morgenson, *How the Thundering Herd Faltered and Fell*, N.Y. TIMES, Nov. 9, 2008, at BU1; Matthew Karnitschnig, Carrick Mollenkamp & Dan Fitzpatrick, *Bank of America to Buy Merrill*, WALL ST. J., Sept. 15, 2008, at A1.

bankruptcy on September 15, 2008 after the Treasury failed in its efforts to convince Wall Street firms to agree on an industry solution.[262]

After the fall of Lehman Brothers, worried 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.[263] On September 25 2008, Washington Mutual was seized by federal regulators in the largest bank failure in U.S. history.[264] The bank was then sold to JPMorgan Chase for $1.9 billion, with Chase agreeing to absorb $31 billion in losses.[265] 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.[266]

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.[267] After several failed attempts, the administration succeeded in obtaining the passage, in October of 2008, of the Emergency Economic Stabilization Act (EESA).[268] The Act gave the Secretary of the Treasury up to $700 billion to purchase or guarantee "troubled assets" through the Troubled Asset Relief Program (TARP).[269] The 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.[270] By November, stock markets had reached their lowest levels in a decade.[271] By the end of President Bush's administration, the Treasury had distributed $350 billion in TARP funds. Like the banks that received funds from the RFC in the Great Depression, the banks chose to use the

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[262] Eric Dash, *U.S. Gives Banks Urgent Warning to Solve Crisis*, N.Y. TIMES, Sept. 13, 2008, at A1; Sorkin, *supra* note 261, at A1, A19; Joe Nocera & Edmund L. Andrews, *Running a Step Behind as a Crisis Raged*, N.Y. TIMES, Oct. 22, 2008, at A1, A20.

[263] Eric Dash & Andrew Ross Sorkin, *In Largest Bank Failure, U.S. Seizes, Then Sells*, N.Y. TIMES, Sept. 26, 2008, at C8.

[264] *Id.* at A1.

[265] *Id.*; 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.

[266] *Id.*; Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout*, WALL ST. J., Sept. 17, 2008, at A1.

[267] David M. Herszenhorn, *Administration Is Seeking $700 Billion for Wall Street: Bailout Could Set Record*, N.Y. TIMES, Sept. 21, 2008, at A1.

[268] Emergency Economic Stabilization Act of 2008 (EESA), 12 U.S.C.A. §§ 5211, 5212 (West Supp. 2009).

[269] *Id.* § 5211.

[270] Mark Landler, *Stock Markets Rally Worldwide—Biggest Intervention Since '30s*, N.Y. TIMES, Oct. 14, 2008, at A1, A14; CNNMoney.com, *Bailed Out Banks*, http://money.cnn.com/news/specials/storysupplement/bankbailout.

[271] Vikas Bajaj & Jack Healy, *Stocks Drop Sharply and Credit Markets Seize Up*, N.Y. TIMES, Nov. 21, 2008, at A1.

TARP money to fund acquisitions and bolster their balance sheets rather than to increase their lending activities.[272]

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,[273] included the HOPE for Homeowners Act, which was designed to encourage lenders to cooperate in a voluntary FHA refinancing program for homeowners facing foreclosure.[274] But after eight months, the program had assisted only one homeowner in obtaining a more affordable loan.[275] In May of 2009, the Helping Families Save Their Homes Act,[276] amended the HOPE for Homeowners Act by liberalizing some of its restrictions and adding $1,000 incentive payments to loan servicers. 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.[277]

[272] *See* Neil Barofsky, Special Inspector General, Troubled Asset Relief Program, Statement Before the House Committee on Financial Services Subcommittee on Oversight and Investigations (July 22, 2009), http://www.sigtarp.gov/reports.shtml (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 & Ajay Kamalakaran., *Panel Criticises U.S. Treasury Use of TARP Funds*, REUTERS UK, Jan. 9, 2009, http://uk.reuters.com/article/idUKTRE5083OJ20090109 (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); Binyamin Appelbaum, *Bailout Overseer Says Banks Misused TARP Funds*, WASH. POST, July 20, 2009, at A6 (reporting that banks receiving TARP funds used them to make investments, repay debts or buy other banks); *but see* Making Home Affordable Progress Report (May 14, 2009), http://www.treas.gov/press/releases/docs/05142009ProgressReport.pdf (discussing loan modification activities undertaken by various lending institutions).

[273] Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, §§ 1401-1404, 122 Stat. 2654, 2800-10 (codified in scattered sections of 12 U.S.C.A.) (West 2009).

[274] HOPE for Homeowners Program, 12 U.S.C.A. § 1715z-23 (West 2009).

[275] Ranae Merle, *Face-Lift for Foreclosure Prevention*, WASH. 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, http://money.cnn.com/2009/03/25/real_estate/new_hope_plan/index.htm.

[276] Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 202(a), 123 Stat. 1640-41 (to be codified as amended at 12 U.S.C. § 1715z-23 (2009)).

[277] *See Details and Eligibility Requirements of the 'Making Home Affordable' Program*, BOSTON GLOBE, Mar. 4, 2009, http://www.boston.com/news/nation/articles/2009/03/04/details_and_eligibility_requirements_of_the_making_home_affordable_progr

Another section of the 2008 Act is designated as the Secure and Fair Enforcement for Mortgage Licensing Act of 2008.[278] These provisions are exhortative only, providing that the "[s]tates . . . are hereby encouraged to establish a Nationwide Mortgage Licensing System and Registry."[279] 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 subprime crisis.[280] 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.[281]

Campaign finance reform is disturbingly low on the remedial agenda given its importance in creating effective regulatory systems.[282] Only campaign finance reform has a chance of interrupting the pattern that will repeat itself with Congress's 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 were able to secure the defeat of 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.[283] The eight

am/; Making Home Affordable Program, Servicer Performance Report through July 2009, http://www.docstoc.com/docs/22136138/Making-Home-Affordable-Program.

[278] Secure and Fair Enforcement for Mortgage Licensing Act of 2008, 12 U.S.C.A. §§ 5101–5116 (West 2009).

[279] *Id.* § 5101.

[280] 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 & Matthew Haggman, *Borrowers Betrayed: Ex-convicts Active in Mortgage Fraud*, MIAMI HERALD (2008), *available at* http://www.miamiherald.com/static/multimedia/news/mortgage/brokers.html.

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

[282] For a detailed report on the successful efforts of subprime lenders to influence legislators to abandon plans to crack down on reckless lending practices, see Glenn R. Simpson, *Lender Lobbying Blitz Abetted Mortgage Mess,* WALL ST. J., Dec. 31, 2007, at A1.

[283] 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. Interview by Bill Moyers with Senator Dick Durbin and Sara Lawrence-Lightfoot (May 8, 2009), http://www.pbs.org/moyers/journal/05082009/transcript3.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 eight 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

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.[284]

III. EXISTING LAW AND LEGAL THEORY ON CONTRACTS OF ADHESION

Parties who unwittingly sign financial adhesion contracts binding them to debt obligations they cannot afford to repay do not have a mechanism for challenging these contracts under current law, or under the various modifications of the law recommended by scholars.[285] Courts treat contracts of adhesion no differently from contracts that are the product of mutual assent, that is, as fully enforceable absent a valid defense.[286] This position is justified to the extent that two of the defining characteristics of adhesion contracts—the inequality of bargaining power between the parties and the inability of the non-drafting party to bargain over the contract's terms[287]—are not prerequisites to contract formation.[288]

TARP funds), spent $370 million in Washington to fight regulation. Center for Public Integrity, *Who's Behind the Financial Meltdown?*, May 6, 2009, http://www.publicinterity.org/investigations/economic_meltdown. *See also* Stephen Labaton, *Senate Refuses to Let Judges Fix Mortgages in Bankruptcy*, N.Y. TIMES, May 1, 2009, at B3 ("In recent weeks, major banks and bank trade associations worked closely with Senate Republicans to stop the measure.").

[284] Interview with Senator Dick Durbin and Sara Lawrence-Lightfoot, *supra* note 283.

[285] This Article 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 lenders and brokers who misled innocent homeowners into signing unsuitable mortgages. Rather, the point is that regulators failed to prevent the unsound banking practices, predatory lending, and "Insider Industry Fraud" of sophisticated lenders who profited by issuing loans to borrowers who were not qualified to repay them. *See supra* notes 24, 213–39 and accompanying text. As a result, borrowers should be given an opportunity to understand the terms of their loans before they sign them.

[286] *See, e.g.*, Graham v. Scissor-Tail, Inc., 623 P.2d 165, 172 (Cal. 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., Inc. v. Midwhey Powder Co., Inc. 883 F.2d 1286, 1292 (7th Cir. 1989) (finding that there was no reason to treat "adhesion contracts or form contracts differently . . . .").

[287] *See* ACORN v. Household Int'l, Inc., 211 F. Supp. 2d 1160, 1168 (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 only the opportunity to adhere to the contract or reject it." (quoting Armendariz v. Found. Health Psychcare Servs., Inc., 6 P.3d 669, 689 (Cal. 2000))).

[288] FARNSWORTH, *supra* note 1, at 55 (2004) ("[I]t is not required that the parties actually bargain over the terms of their agreement.").

Traditional contract doctrine does, however, require mutual assent to form a contract.[289] Mutual assent ordinarily takes the form of an offer followed by acceptance.[290] Courts purport to determine whether a party has accepted an offer based on an objective interpretation of his words or conduct, rather than on his subjective intent.[291] As Judge Frank put it, the "objectivists transferred from the field of torts that stubborn anti-subjectivist, the 'reasonable man.'"[292] In the context of offer and acceptance, the reasonable person is the party making the offer, as explained by in the famous *Embry v. Hargadine, McKittrick Dry Goods* decision:

> If, whatever a man's real intention may be, he so conducts himself that a reasonable man would believe that he was assenting to the terms proposed by the other party, and that other party upon that belief enters into the contract with him, the man thus conducting himself would be equally bound as if he had intended to agree to the other party's terms.[293]

The reasonable person standard has also been interpreted to include what the offeror knows or should know because of his position and superior knowledge.[294] It is widely recognized that business firms draft and present adhesion contracts with the intention that consumers will not read or understand them to save transaction costs of time,

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[289] RESTATEMENT (SECOND) OF CONTRACTS § 17 (1981).

[290] *Id.* § 22.

[291] The classic formulation of the objective theory is set out in Judge Hand's statement that, "A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent." Hotchkiss v. Nat'l City Bank of N.Y., 200 F. 287, 293 (S.D.N.Y. 1911). *See also* FARNSWORTH, *supra* note 1, § 3.1 at 200–01, § 3.6 at 208, 210; RESTATEMENT (SECOND) OF CONTRACTS §§ 19, 21. Courts routinely state the objective theory as the rule, but often apply a more nuanced approach in an attempt to ascertain the intent of the parties. 1 JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 4.12 at 628–29, 634 (rev. ed. 1993). *See also* Lawrence M. Solan, *Contract as Agreement*, 83 NOTRE DAME L. REV. 353, 354 (2007). If the parties had no shared intent, the court must either hold that no contract was formed or that one party is bound because he knew or had reason to know the intent and understanding of the other, and the other had no reason to know a difference existed. PERILLO § 4.12 at 630. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 20. Meanwhile, adhesion contracts are enforced when the parties have no such common intent even when the drafting party does know of the adherent's intent and understanding. PERILLO, § 4.13 at 636–37.

[292] Ricketts v. Pa. R. Co., 153 F.2d 757, 761 (2d Cir. 1946) (Frank, J., concurring). For a challenge to this view on historical grounds, see Joseph M. Perillo, *The Origins of the Objective Theory of Contract Formation and Interpretation*, 69 FORDHAM L. REV. 427 (2000).

[293] Embry v. Hargadine, McKittrick Dry Goods Co., 105 S.W. 777, 779 (Mo. Ct. App. 1907) (quoting Smith v. Hughes (1871), 6 L.R.Q.B. 597, 607 (Q.B.)).

[294] *See* JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS 24 (6th ed. 2009); Sands v. Sands, 249 A.2d 187, 191 (Md. 1967).

persuasion, and attempted negotiations.[295] And consumers generally have no choice but to sign adhesion contracts with some firm with similar terms for the goods and services they seek.[296] Under these circumstances, a business acting as the "reasonable person" would have no grounds for believing that by signing adhesion contracts its customers have signified their assent to the terms of the contracts, and therefore no grounds for assuming that contracts had been formed under the 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, despite the recognition that the drafters are aware that the signatories do not understand the terms of adhesion contracts and therefore could not agree to them.[297] Second, courts conclude that under the duty to read rule, the adherent is bound by the terms of a contract he has signed despite not having read or understood them.[298] The "duty-to-read" rule was originally based on the "gross negligence" inherent in the act of signing a contract without reading it.[299] Courts enforce adhesion contracts under the duty-to-read rule, however, even though they also acknowledge that the reason these contracts are thought to be indispensible to modern commerce is that the drafters are able to arrange the transactions so that the recipients will not read, understand, or attempt to negotiate the contracts' terms.[300]

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[295] *See infra* note 300.

[296] *See* Arthur Allen Leff, *The Leff Dictionary of Law: A Fragment,* 94 YALE L.J. 1855, 1931 (1985) (indicating that certain form contracts are "used by all members of a particular industry such that a consumer could not acquire certain goods or services at all except on a particular set of terms"); Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429, 446 (2002) ("the terms included in standard-form contracts tend to be uniform within an industry").

[297] FARNSWORTH, *supra* note 1, § 3.6 at 115.

[298] *Id.* § 4.26 at 287; RICHARD A. LORD, 2 WILLISTON ON CONTRACTS § 6:44 (4th ed. 2007). *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); Lawrence v. Muter Co. 171 F.2d 380, 384 (7th Cir. 1948); James Talcott, Inc. v. Fullerton Cotton Mills, Inc., 208 F.2d 81, 83 (5th Cir. 1953).

[299] See the discussion of Morstad v. Atchison, T. & S.F. Ry. Co., 170 P. 886 (N.M. 1918), in Meyerson, *supra* note 25, at 1272. *See also* Welsh v. Kelly-Springfield Tire Co., 12 N.E.2d 254 (Ind. 1938) ("It appears that appellant was a business man of experience. . . . He had the contract in his possession and the fact that he did not read it . . . was clearly the result of his own carelessness and blind folly. Under such circumstances he cannot obtain relief . . . .").

[300] *See* RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. b (1981) ("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

Even when the drafting party's agent has made allegedly fraudulent misrepresentations and omissions to the consumer concerning the terms of the adhesion contract, courts have often held that the consumer is bound to the terms of the contract under the duty-to-read rule.[301] In an Illinois Supreme Court case where the court dismissed a fraud challenge to disclosure of interest calculations consisting solely of the term, "the Rule of 78s", the concurring judge noted the phrase, "conveys nothing to most borrowers, and in fact would not even put them on notice to inquire because it appears entirely innocuous."[302] The majority would have had to agree that the notice was misleading if it suggested the term was "entirely innocuous," as they found that this method of charging interest, "does not provide an accurate approximation of unearned finance charges."[303]

The potential for abuse is exacerbated in cases where the consumer does not 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 a credit card agreement is mailed to the borrower after submitting the application. Yet even here, courts continue to cling to the duty-to-read rule to support the fiction that the consumer has given his assent to

counsel and reviewed 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."); Hillman & Rachlinski, *supra* note 296, at 432–33, 446 ("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."). 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." LLEWELLYN, THE COMMON LAW TRADITION, *supra* note 25, at 371 n.338. *See* also RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. b ("Customers do not in fact ordinarily understand or even read the standard terms."); Jeffrey Davis, *Revamping Consumer-Credit Contract Law*, 68 VA. L. REV. 1333, 1356 (1982) (citing THOMAS A. DURKIN & GREGORY E. ELLIEHAUSEN, 1977 CONSUMER CREDIT SURVEY 3, 7 (1978), a study showing that borrowers do not read credit disclosures and think they are complicated).

[301] *See* Davis v. G.N. Mortgage Corp., 396 F.3d 869, 882 (7th Cir. 2005); Gilliard v. Fulton Fed. Sav. & Loan Ass'n, 356 S.E.2d 734, 735–736 (Ga. Ct. App. 1987); Martinez Tapia v. Banque Indosuez, No. 99-7170, 1999 U.S. App. LEXIS 29260, at *5 (2d Cir. Nov. 3, 1999); Lanier v. Assoc. Fin., Inc., 499 N.E.2d 440, 447–448 (Ill. 1986); Dowagiac Mfg. Co. v. Schroeder, 84 N.W. 14, 14 (Wis. 1900).

[302] *Lanier*, 449 N.E.2d at 449.

[303] *Id.* at 441–42.

the contract terms supplied by the drafting party, sight unseen.[304] Other courts resort to the unconscionability doctrine, finding that a term is unenforceable as procedurally unconscionable if it is not provided to the consumer prior to contracting, an odd solution to a fairly obvious formation issue.[305]

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.[306] Moreover, 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 drafting party gives the non-drafting party a contract that the drafting party does not expect him to understand, since the drafting party itself would not agree to a contract under these circumstances. The drafting party is only acting as a reasonable person in assuming a signature is a sign of acceptance if he drafts a contract that he would expect the recipients of his contract to understand before accepting.

The problem of enforcing contracts without informed assent cannot be avoided by assuming that the adherents willingly assume the risk of submitting to unknown terms.[307] This assumption would only be valid if

[304] In *Brower v. Gateway 2000, Inc.*, the court rejected an adhesion contract defense to enforcement of an ICC arbitration clause under the duty-to-read rule despite uncontested evidence that the elements that the court found made the clause substantively unconscionable, the loser-pays-expenses rule and the $2,000 non-refundable fee, were not disclosed in the contract. 676 N.Y.S.2d 569, 571 (N.Y. App. Div. 1998). As plaintiff's counsel discovered, the only way to obtain the ICC rules containing this information was by contacting the U.S. Council for International Business. *Id.* So the duty to read rule binds the consumer to terms he could not possibly have understood by reading the contract. *See also* Hill v. Gateway 2000, Inc., 105 F.3d 1147, 1150 (7th Cir. 1997); Slawson, *Standard Form Contracts, supra* note 25, at 540.

[305] *See* Trujillo v. Apple Computer, Inc., 578 F. Supp. 2d 979, 992–93 (N.D. Ill. 2008) (damage disclaimer included in warranty was procedurally unconscionable because plaintiff was not given a copy of the contract until after purchase was made); Razor v. Hyundai Motor Am., 854 N.E.2d 607, 623 (Ill. 2006) (arbitration clause was procedurally unconscionable because it was not available until consumer found contract in glove box of car after purchase).

[306] 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, amounts to the exercise of unofficial government of some by others, via private law." Karl N. Llewellyn, *What Price Contract?—An Essay in Perspective,* 40 YALE L. J. 704, 731 (1931) [hereinafter Llewellyn, *What Price*].

[307] Barnett, *supra* note 28, at 636 (Barnett's comparison of the easily avoidable unknown risks of "attach[ing] waxed boards to their feet and propel[ling] themselves

adherents could obtain necessary goods and services without entering into a form contract transaction structured so its recipients would not read or understand its terms. But there is no such choice in today's marketplace, given the universal use of form contracts for consumer transactions. Instead, adherents submit to terms they are not given time to read or understand because they know they have no choice—similar terms will be required no matter which vendor they turn to, and the courts will enforce them. Commercial and legal realities therefore suggest that uninformed assent is anything but voluntary.

The remedies for misrepresentation, non-disclosure, and unilateral mistake prior to formation also demonstrate that assent in the law of contract means informed assent, not blind assent.[308] At one extreme, where the offeror misrepresents the nature of the contract itself (*fraud in the factum*), the contract is void on formation grounds, just as it would be under general principles of assent.[309] 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 regarding the contract.[310] Conduct, such as a 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.[311] This traditional doctrine is difficult to reconcile with the courts' position that an adhesion contract is enforceable despite the adherent's failure to read or understand its terms. Indeed, all a drafter needs to do to avoid the law of misrepresentation and omission is to bury the oppressive terms in incomprehensible, interminable contracts of adhesion.[312]

The contract doctrine of misrepresentation is not limited to misstatements made with fraudulent intent, and therefore cannot be distinguished as an importation of tort principles designed to punish wrongdoing. Even innocent misrepresentations will prevent formation of a contract by undermining the validity of assent given by the party who

down . . . mountains" and the unknown risks of entering into a form contract is singularly insensitive to consumer realities).

[308] *See* FARNSWORTH, *supra* note 1, § 4.18 at 234 ("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 §§ 161–64, 166 (1981).

[309] *See* FARNSWORTH, *supra* note 1, § 4.18 at 234.

[310] *Id.* at 240.

[311] RESTATEMENT (SECOND) OF CONTRACTS §§ 161, 163.

[312] For cases where the courts have held that the adherent has a duty to read that defeats their claim of fraud or misrepresentation, see Martinez Tapia v. Banque Indosuez, No. 99-7170, 1999 U.S. App. LEXIS 29260, at *5 (2d Cir. Nov. 3, 1999); Gilliard v. Fulton Fed. Sav. & Loan Ass'n, 356 S.E.2d 734, 735–736 (Ga. Ct. App. 1987); Lanier v. Assoc. Fin., Inc., 499 N.E.2d 440, 447 (Ill. 1986); Dowagiac Mfg. Co. v. Schroeder, 84 N.W. 14, 14 (Wis. 1900).

was misled if the misrepresentation is material.[313] The law gives a remedy for even innocent misrepresentations of material terms based on lack of assent, but rejects claims of fraudulent misrepresentation made by parties to adhesion contracts that are admittedly entered into without informed consent. An innocent statement made by sellers that a home was free of termites would give grounds for rescission under the law of misrepresentation, but a fraudulent statement concerning the calculation of interest under a form loan would not.

The law of unilateral mistake is also based on the premise that assent means informed assent, at least to the basic assumptions made by the mistaken party. In the *Restatement (Second) of Contracts* formulation, an injured party may void a contract if he made a mistake when contracting concerning a basic assumption on which he made the contract—as long as he does not bear the risk of the mistake—and the result will either be unconscionable, or the other side should have known of the mistake, or was at fault in causing the mistake.[314] If assent did not require that the offeree have an understanding of at least the most significant terms of the contract, from the offeree's perspective, the offeree's mistake as to those terms would not give him the option to avoid the contract. A contractor who submits a mistaken bid is relieved from his contract under the law of unilateral mistake,[315] but an adherent is bound by the boilerplate in his contract regardless of how mistaken he later claims to have been as to its terms.

These conflicts in the law raise the issue of materiality in the context of the subprime mortgage crisis. That is, would the borrowers be able to prove that their assent was induced by a misrepresentation, omission of a material fact, or unilateral mistake, and that they did not know or have a reasonable opportunity to know the fact because it was disclosed in a fashion unintelligible to a layman? With the benefit of hindsight, the most likely candidate for such a fact would be summed up as "affordability." If the borrower asked the lender or broker the question, "Will I be able to make the monthly payments?" and received an affirmative answer when the borrower could not afford the monthly payments based on his disclosed income and debt levels, the facts would appear to satisfy the Restatement standard that "[a] misrepresentation is material if it would be likely to induce a reasonable person to manifest his assent, or if the maker knows that it would be likely to induce the recipient to do so."[316] An omission would be equivalent to a misrepresentation if the lender or broker knew the borrower was operating under a mistake as to a "basic assumption" on which the

[313] RESTATEMENT (SECOND) OF CONTRACTS §§ 162(2), 163, 164(1).

[314] *Id.* § 153.

[315] *See, e.g.*, Boise Junior Coll. Dist. v. Mattefs Constr. Co., 450 P.2d 604, 605 (Idaho 1969); Elsinore Union Elementary Sch. Dist. v. Kastorff, 353 P.2d 713, 714 (Cal. 1960).

[316] RESTATEMENT (SECOND) OF CONTRACTS § 162(2).

borrower was making the contract,[317] a standard that should be met by affordability.

But is it possible to prove that borrowers would have rejected unaffordable loans if they had understood them? Taking one of the starkest examples of deception first, Freddie Mac and Fannie Mae have estimated that from 35% to 50% of subprime borrowers would have qualified for far less expensive prime mortgages.[318] And a study conducted for the Wall Street Journal showed that from 2000 to 2006, 55% of subprime mortgage borrowers had credit scores that would have qualified them for lower-cost prime mortgages.[319] It seems reasonable to assume that this group would have rejected the subprime loans had they been aware of the facts. For those still unconvinced, Elizabeth Warren and Amelia Warren Tyagi have shown that had a household obtained a $100,000, 30-year prime loan, rather than a 20% subprime loan for the same amount (using 2003 data), their savings of $370,000 would enable them to "put two children through college, purchase half a dozen new cars, *and* put enough aside for a comfortable retirement."[320]

The complexity of mortgage loans makes it difficult for consumers to understand and compare their terms, despite the obvious importance of their ability to comprehend the contract governing what is, for most consumers, their most valuable asset and their largest debt. Oren Bar-Gill and Elizabeth Warren have collected numerous studies and analyses documenting the high prevalence of consumer error in the mortgage market, including in the market for subprime mortgages.[321] And lenders are not blameless in the matter of consumers' confusion. A recent article by Patricia McCoy discusses practices used by subprime lenders to reduce consumers' ability to shop for lower interest rates.[322]

Analysis of social science data and mortgage disclosures has established that home mortgage borrowers are often deceived into assuming excessive risk.[323] Empirical data collected by the Federal

[317] *Id.* § 161(b).

[318] CARR & KOLLURI, *supra* note 236, at 31, 37.

[319] Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J., Dec. 3, 2007, at A1 (citing a study by First American Loan Performance).

[320] ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE 134 (2003); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 729 (2006).

[321] Bar-Gill & Warren, *supra* note 5, at 38–39.

[322] *Id.* at 40 (citing Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123, 123 (2007)).

[323] William N. Eskridge, Jr., *One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psycholigical Dynamics of the Home Sale and Loan Transaction*, 70 VA. L. REV. 1083, 1111 (1984) (Based on what psychological decision-making theory reveals about influences that distort consumer choice, the fact that disclosures are made after the consumer had chosen a lender, and are often inaccurate or too complex to be understood, and segmentation of markets, "home mortgagors frequently are deceived, pay excessive mortgage-related charges, or

Reserve Board indicates that a majority of Americans are risk averse when it comes to their finances.[324] Borrowers who are risk averse prefer the safety of fixed-rate mortgages.[325] And many risk averse borrowers may not have understood whether they had a fixed-rate or an adjustable-rate mortgage (ARM). In a 2007 national poll of home mortgage holders, over one-third did not know whether they had a fixed mortgage or an ARM, and of the remaining respondents, only 6% thought they had an ARM.[326] Since industry data puts the figure at 25%, the results suggest that about three-quarters of those with ARMs do not understand that their payments could increase.[327]

The assumption that borrowers would have accepted the risk of adjustable-rate subprime mortgages had they understood them is also highly dependent on the circumstances of the borrower. At one end of the spectrum, it seems unlikely that a low-income borrower with a large family to support who understood his mortgage would have agreed to a "teaser-rate" negative amortization loan. These loans were offered by brokers who promised low monthly rates but failed to explain that the rates were fixed for as little as one day, that rates could reach up to 10% thereafter, that they reset as frequently as every month, or that each payment made below their maximum "option" would increase the principal.[328] Similarly, an elderly pensioner acting on full information

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assume excessive risk."); Willis, *supra* note 5, at 1234–55, (agreeing that borrowers "look for a loan with a monthly payment they can afford," and "ask themselves, 'can I afford it?,'" but citing behavior studies to support the claim that the demand side is inadequate to ensure efficient mortgage terms because borrowers fail to account fully for the risk of foreclosure).

[324] Brahima Coulibaly & Geng Li, *Choice of Mortgage Contracts: Evidence from the Survey of Consumer Finances* 13 (Fin. & Econ. Discussion Series, Working Paper, 2007-50, Aug. 30, 2007), http://www.federalreserve.gov/PUBS/FEDS/2007/200750/200750pap.pdf. Based on sample selection procedures taken from nationwide household survey data collected by the Federal Reserve Board in 1995, 1998, 2001, and 2004, the study found that about 60% of the households were risk averse. *Id.* at 12–13.

[325] *Id.* at 13 ("Borrowers who are more risk averse, have risky income or are less likely to move in the near term tend to prefer FRMs [fixed rate mortgages]."). *See also* John Y. Campbell & Joao F. Cocco, *Household Risk Management and Optimal Mortgage Choice* 3 (Harvard Inst. Econ. Research, Discussion Paper No. 1946, 2002), *available at* http://www.economics.harvard.edu/pub/hier/2002/HIER1946.pdf ("We find that households with large houses relative to their income, volatile labor income, or high risk aversion are particularly adversely affected by the income risk of an ARM and are more likely to prefer an FRM.").

[326] Willis, *supra* note 5, at 1241–42.

[327] *Id.* at 1242.

[328] *See* Center for Responsible Lending, *Facts About "Toxic Mortgages"—Payment Option ARMS*, Nov. 5, 2007, http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/po-arms-toxic.pdf; Press Release, Illinois Attorney General Lisa Madigan, Madigan Continues Fight Against Mortgage Foreclosure Crisis (Nov. 26, 2007), *available at* http://www.illinoisattorneygeneral.gov/pressroom/2007_11/20071126.html; John W. Schoen, *Mortgage Woes Could be 'Tip of the Iceberg': Fraud, Abusive Lending Crushes*

would not trade a mortgage with low-fixed payments for a mortgage with monthly payments that would significantly exceed his total monthly income once the rates reset.[329] A younger employed borrower, confident in his prospects of a pay increase through a promotion or job relocation, and in his ability to move in with his family or friends in the worst case scenario, may have understood that his monthly payments could exceed his ability to pay when rates reset on his ARM mortgage, and gambled on rising home prices and his ability to refinance before then. But the fact that some borrowers would have accepted this risk does not prove that the subprime borrowers whose debt-to-income ratio could not sustain even a modest increase in their monthly payment would have accepted the risk of foreclosure had they been aware that it existed.

A. *Unconscionability*

Unconscionability is the doctrine courts use most often to strike overly one-sided terms in adhesion contracts. The defense is incorporated in the Uniform Commercial Code (U.C.C.) for sale of goods contracts,[330] and is applied by analogy to non-goods contracts.[331] In the classic definition from *Williams v. Walker-Thomas Furniture Co.*, unconscionability includes, "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party."[332] Under Corbin's influential test for evaluating the reasonableness of the contract's terms, the terms must be "so extreme as to appear unconscionable according to the mores and business practices of the time and place."[333] The definition in the comments to section 2-302 of the U.C.C. is similar: "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."[334]

Dreams for Millions of Homeowners, MSNBC, Apr. 10, 2007, http://www.msnbc.msn.com/id/17929461/ns/business-mortgage_mess/.

[329] *See* Ellen E. Schultz, *Older Borrowers, Out in the Cold*, WALL ST. J., Apr. 14, 2009, at D1. (reporting that many elderly borrowers were misled into purchasing such mortgages).

[330] U.C.C. § 2-302 (2002).

[331] *See* RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981); Weaver v. Am. Oil Co., 276 N.E.2d 144, 145–46 (Ind. 1971) (holding that clause was unenforceable under the unconscionability doctrine on the grounds that it would have been unconscionable under section 2-302 of the U.C.C. had it appeared in a sale of goods contract); Zapatha v. Dairy Mart, Inc., 408 N.E.2d 1370, 1375 (Mass. 1980) (finding the legislative statements of policy on unconscionability "as fairly applicable to all aspects of the franchise agreement . . . by analogy.").

[332] 350 F.2d 445, 449 (D.C. Cir. 1965).

[333] *Id.* at 450 (quoting CORBIN, *supra* note 22, § 128, at 188).

[334] U.C.C. § 2-302, cmt. 1. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 208, cmt. b (citing the following historical standard for unconscionability: "[A] bargain

While the *Williams* definition speaks of an "absence of meaningful choice" as the first element of an unconscionability defense, the decision was a rare occasion when the courts have admitted that consumers do not assent to the terms of adhesion contracts and an example of the futility of such admissions. According to the court's circular logic, if a consumer signs a "commercially unreasonable" contract without understanding its terms, he has not manifested any objective signs of assent, an exception has arisen to the duty-to-read rule, and the court must review the contract to determine whether its terms are unconscionable:

> Ordinarily, one who signs an agreement without full knowledge of its terms might be held to assume the risk that he has entered a one-sided bargain. But when a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no knowledge of its terms, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms. In such a case the usual rule that the terms of the agreement are not to be questioned should be abandoned and the court should consider whether the terms of the contract are so unfair that enforcement should be withheld.[335]

Since the court goes on to adopt the "commercial" test of reasonableness for its unconscionability review, it is unclear how terms could be "commercially unreasonable" for purposes of suspending the duty-to-read rule and still be enforceable. Thus, once the determination is made that the consumer's lack of consent is a concern, because the contract is commercially unreasonable, no further analysis of unconscionability would be required despite the duty-to-read rule. Assent only matters in contracts deemed unconscionable as commercially unreasonable, so it is unclear whether lack of assent, which is no more prevalent in unconscionable adhesion contracts than in any other adhesion contracts (how could it be when consumers do not read or understand them?), is truly a separate element. But in the context of financial adhesion contracts, like the cross-collateralization clauses in *Williams*, the commercial reasonableness test is fatal to an unconscionability challenge, since clauses commonly used by industry are often extremely harmful to low-income consumers.

Commenting on the application of Corbin's test in *Williams*, Arthur Leff noted that the cross-collateralization clauses the court found suspect were valid in all but one of the 37 states that had statutes curtailing retail installment sales.[336] Likewise, the complex mortgage products that gave rise to the subprime mortgage crisis would not appear "so extreme as to

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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 . . . .'") (quoting Hume v. United States, 132 U.S. 406 (1889)).

[335] *Williams*, 350 F.2d at 449–450 (footnotes omitted).

[336] Leff, *Code*, *supra* note 25, at 554–55.

appear unconscionable according to the mores and business practices" of the booming real estate market in which they flourished.[337]

In *Carpenter v. Suffolk Franklin Savings Bank*, a case where the borrowers attempted to strike terms of a mortgage as unconscionable, the court disregarded their lack of assent on the grounds that the terms were not unreasonable:

> 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.'[338]

But the standard of commercial reasonableness will not remedy the harm inherent in financial adhesion contracts. Complex financial instruments may be sold to sophisticated parties represented by counsel without violating business norms, but the law does not distinguish the sale of the same instruments to unrepresented individuals for whom they may be highly unsuitable. The court's approach leaves unanswered the question of why borrowers should have to agree to terms the drafters know will not be understood, subject only to the limitations of the unconscionability doctrine. Certainly the objective theory of assent does not require this result. If the objective circumstances indicate that the lender could not have expected borrowers to understand the material terms of the mortgage before signing it, how can the borrowers be charged with assent? This view is, if anything, a form of duress created by doctrine. The need for standardized contracts is a similarly poor excuse, since the burden should be on the party seeking to avoid the costs of obtaining assent to write and present these contracts so that the intended recipients could understand them before giving their assent.

B. Reasonable Expectations

Another major defense to adhesion contracts, the doctrine of reasonable expectations, has been confined to insurance law.[339] 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 provisions would have

[337] *Id.* at 554 (quoting *Williams*, 350 F.2d at 450).

[338] 346 N.E.2d 892, 900 (Mass. 1976) (quoting RESTATEMENT (SECOND) OF CONTRACTS § 237 cmt. b (Tentative Drafts Nos. 1–7, 1973)) (citation omitted). Professor Rakoff, one of the most critical analysts of adhesion contracts, finds that this case "reaches the right result" as an application of trade custom within an industry that was not unreasonable. Rakoff, *supra* note 25, at 1280–81.

[339] William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267, 272 (1986).

negated those expectations."[340] 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.[341] As applied to insurance policies, the reasonable expectations doctrine has been adopted in over one-half the states, but its application is far from uniform.[342] 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.[343] 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,* where ambiguous clauses are construed against the insurer.[344] 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 policyholder to the insurer.[345]

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." Wayne Barnes has recommended that courts

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[340] Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970).

[341] *See* FARNSWORTH, *supra* note 1, § 7.11 at 461 (citing Max True Plastering Co. v. U.S. Fid. & Guar. Co., 912 P.2d 861, 863–65 (Okla. 1996)).

[342] *See* Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholders' Objectively Reasonable Expectations of Insurance Coverage*, 5 CONN. INS. L.J. 335, 353–56 n.57 (1998) (listing 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.").

[343] 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."); Mayhew, *supra* note 339, at 277; Susan M. Popik & Carol D. Quackenbos, *Reasonable Expectations After Thirty Years: A Failed Doctrine,* 5 CONN. INS. L.J. 425, 426–28 (1998).

[344] Mark C. Rahdert, *Reasonable Expectations Revisited*, 5 CONN. INS. L.J. 107, 111–16 (1998).

[345] *See* RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (1981); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 846–47 (1990). The conclusion that 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." *Id.*

adopt section 211(3),[346] a course only a few jurisdictions have followed in the 30 years since its publication.[347] One reason courts may hesitate to extend the reasonable expectations doctrine beyond insurance cases was suggested by Eugene Anderson and James Fournier in tracing the doctrine back to the "know thy policyholder" rule.[348] 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 . . . ."[349] Being charged with knowledge of this 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 the insured's needs and consistent with his "reasonable expectations."[350] 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.

Even if the Restatement rule were adopted, it would only cover cases where the consumer could establish that the lender knew or should have known that the consumer would not have accepted the risks or obligations imposed by the agreement.[351] Consumers who deal with on-line mortgage brokers, brokers and lenders who conduct minimal due diligence, or credit card companies that accept applications by mail or over the Internet may not be able to meet this standard.

None of the formulations of the reasonable expectations doctrine hit the mark, however, because they do not offer any method for the

[346] 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, 232 (2007). *See also* Wayne Barnes, *The Objective Theory of Contracts*, 76 U. CIN. L. REV. 1119, 1155–57 (2008) (advocating adoption of section 211(3) to form contracts on the grounds that merchants should not be able to take advantage of consumers' failure to read form contracts by including terms they know consumers would object to, and noting that, "[t]his practice, countenanced for the better part of a century by traditional contract law and arguments of business necessity, is completely antithetical to the paradigm of knowing, mutual, and voluntary assent to contract terms.").

[347] Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 396–97 & n.8 (Ariz. 1984) (adopting section 211(3) in an insurance case). *See also* Zigrang v. U.S. Bancorp Piper Jaffray, Inc., 123 P.3d 237, 240 (Mont. 2005) (extending reasonable expectations doctrine beyond the insurance context without citing the *Restatement (Second) of Contracts*).

[348] Anderson & Fournier, *supra* note 342, at 345–46.

[349] Noble v. Kennoway, (1780) 99 Eng. Rep. 326, 327 (K.B.). *See also* Buck v. Chesapeake Ins. Co., 26 U.S. (1 Pet.) 151, 160 (1828).

[350] *See* Anderson & Fournier, *supra* note 342, at 346.

[351] 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).

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.[352] The countervailing rationale that leads some courts to disregard these concerns is fairness, given the insured's 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 represent the terms of the parties' 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 the insured's "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, advised by counsel, and 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.[353] Karl Llewellyn's analysis of adhesion contracts has been enormously influential, and his prescription is reflected in the doctrines of unconscionability and reasonable expectations.[354] He

[352] *See* Mayhew, *supra* note 339, at 286–87; Popik & Quackenbos, *supra* note 343, at 428–29.

[353] *See* Kessler, *supra* note 25, at 632 ("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 P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J.L. & ECON. 461, 485–86 (1974) [hereinafter Goldberg, *Institutional Change*] (providing economic explanations for why competition among producers does not protect adherents from one-sided terms in adhesion contracts).

[354] 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

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 the broad type of the transaction, and but one thing more. That 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.[355]

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."[356] Relying on the hundred-year history of sales law under which any explicit sales transaction creates two contracts, one of sale and one of warranty,[357] 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 or unfair, either viewed in isolation or in the aggregate.[358]

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

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not alter or impair the fair meaning of the dickered terms, although the reasonable expectations doctrine would extend 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* Keeton, *supra* note 340, at 967. Robert H. Jerry II traced the reasonable expectations doctrine back to Llewellyn's writings. Robert H. Jerry, II, *Insurance, Contract, and the Doctrine of Reasonable Expectations*, 5 CONN. INS. L.J. 21, 46–51 (1998).

[355] LLEWELLYN, THE COMMON LAW TRADITION, *supra* note 25, at 370.

[356] *Id.* at 370–71.

[357] 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.

[358] LLEWELLYN, THE COMMON LAW TRADITION, *supra* note 25, at 371.

businesses use standardized contracts to take advantage of them by placing burdensome terms in the fine-print. 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 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 prevailing business practices.

Following Llewellyn, Fredrick Kessler was the next scholar to make a major contribution in the area of standardized contracts. Kessler traced the rise of the standardized contract to "[t]he development of large scale enterprise with its mass production and mass distribution" where terms are formulated by businesses to use with every transaction involving the same product or service.[359] 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.[360] 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.[361] 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.[362] This approach would be of little use, however, 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 to 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

[359] Kessler, *supra* note 25, at 631.
[360] *Id.* at 632.
[361] *Id.* at 637.
[362] *Id.*

"back-door" techniques of interpreting contractual language to mean what it clearly did not mean.[363] 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.[364] 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.[365] 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.

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.[366] Critical of the courts' erratic application of the then newly-adopted U.C.C. 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.[367] 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 addressed by increasing the product's price to compensate for assuming the risk.[368] Leff recognized that adhesion contracts are rarely read or understood,[369] but advocated their enforcement subject to legislative prohibitions on particular clauses.[370]

Professor W. David Slawson is another scholar who wrote a series of articles on adhesion contracts in the 1970s that drew parallels between

[363] Meyer, *Contracts of Adhesion*, *supra* note 12, at 1186.
[364] *Id.* at 1199.
[365] *Id.* at 1198–99.
[366] Leff, *Code*, *supra* note 25; Leff, *Crowd*, *supra* note 25; Leff, *Contract as Thing*, *supra* note 25.
[367] Leff, *Crowd*, *supra* note 25, at 354–57.
[368] Leff, *Contract as Thing*, *supra* note 25, at 155–56; Leff, *Crowd* , *supra* note 25, at 352–53 & n.18.
[369] Leff, *Crowd*, *supra* note 25, at 349.
[370] *Id.* at 351–53; Leff, *Contract as Thing*, *supra* note 25, 155–56.

adhesion contracts and administrative law.[371] In a highly influential 1971 article, Slawson begins with the premise that "the standard form is not a contract," because consumers either have no opportunity to read their terms in "rolling contracts" cases or, giving home mortgages as an example, "no one but a lawyer or an unusually intelligent layman could hope to comprehend the full significance of their terms."[372] Slawson finds that this form of private law-making lacks legitimacy, comparing it to the state of our democracy if "we would receive incomprehensible ballots six to eight pages long in the mail some weeks after we had voted informing us, if we cared to pay for the assistance of a lawyer to read them, for whom our votes had been cast."[373] But Slawson nevertheless concludes that form contracts lacking in assent are indispensible to modern commerce.[374] His solution is two-fold. First, forms should only be enforced as contracts to the extent the parties can reasonably be expected to understand their terms.[375] As he explains, "Quick contracts are then necessarily simple, and the issuers of standard forms are required in every situation to make the contents of their forms reasonably understood by the recipient or the forms will not be considered contracts."[376] Forms which are not contracts because consent is lacking may still be enforced if they can be justified under what he 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 . . . ."[377] 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.[378]

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

[371] *See* Slawson, *Standard Form Contracts*, *supra* note 25; Slawson, *New Approach to Standard Forms*, *supra* note 25; Slawson, *Mass Contracts*, *supra* note 25.

[372] Slawson, *Standard Form Contracts*, *supra* note 25, at 541.

[373] *Id.*

[374] *Id.*

[375] *Id.* at 566 ("Most contracts today are made quickly, often without thought as to any but their major terms, and many contracts are made without one party having any real alternative but to accept the terms which the other party sets. The first condition is adequately taken into account if we restore the principle that a contract includes only those terms which *both* parties can reasonably be expected to understand.").

[376] *Id.*

[377] *Id.* at 533. Todd Rakoff identified numerous flaws in Slawson's use of administrative law as an analogy to standardized contracts between private parties. Rakoff, *supra* note 25, at 1212–14.

[378] Slawson, *Standard Form Contracts*, *supra* note 25, at 533.

doctrinal requirement of a bargain for formation purposes.[379] 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 the buyer understands that term before he commits to the purchase. Any other information material 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.

Todd Rakoff was the first to challenge the view that adhesion contracts should be presumptively valid. 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.[380] He also noted that the uniformity achieved through enforcing the drafter's terms in standardized contracts could be provided by the gap-filler terms of "background" law.[381] 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."[382] This view would have led Rakoff to conclude that adhesion contracts are unenforceable for lack of mutual assent, had he not concluded that courts should give adhesion contracts deference to "promote firms as instruments conducive to civic freedom . . . ."[383] The view is an odd one given that Rakoff recognized how well the interests of firms are protected by the courts in connection with adhesion contracts.[384] 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,"[385] should only be enforced if 1) they conform to "background law," since this would be the result if the parties had not

[379] *Id.* at 552–54.
[380] Rakoff, *supra* note 25, at 1220–29.
[381] *Id.* at 1230–35.
[382] *Id.* at 1235–38.
[383] *Id.* at 1240.
[384] *Id.* at 1235–38.
[385] *Id.* at 1251–52.

reached agreement; or 2) the drafting party can show "cause."[386] Rakoff does not define "cause," but his analysis of how invisible terms would be evaluated supports common commercial practices without regard to the needs of the individual in a way that would not be helpful in dealing with financial adhesion contracts.[387]

Michael Meyerson has attempted the "reunification" of contract law by demonstrating that enforcement of adhesion contracts conflicts with the objective theory of assent.[388] As he explains, "[b]ecause 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."[389] Meyerson's solution is for courts to engage in a fact-intensive review, incorporating seven "critical questions."[390] 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 effects of advertisements; and the topics that were beyond the scope of the consumer's contemplation.[391] 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.[392] As such, the seven considerations betray his

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[386] *Id.* at 1242–43 ("The rule should thus be that to justify enforcement of any form term, to the extent that it deviates from background law, cause must be shown.").

[387] Rakoff's proposals for determining when to sustain adhesion contracts include estimating "the degree to which a form term was included for its direct commercial utility and the degree to which it was designed merely to gain power over the over party," and adopting trade practice "whenever it is sufficiently sound to be enforced as background law, but not otherwise." *Id.* at 1263, 1282–83.

[388] Meyerson, *supra* note 25, at 1265.

[389] *Id.*

[390] *Id.* at 1265–66.

[391] *Id.* at 1266.

[392] 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. *Id.* at 1302–14. 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 1302–06. 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

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.[393] 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. 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.[394] 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. Under King's solution, the outcome of contract disputes would also 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.[395] 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,

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the purpose of the contract will tell the court nothing with respect to the critical question of the adherent's assent.

[393] 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 U. L. REV. 469, 473 (2008) (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).

[394] Donald B. King, *Standard Form Contracts: A Call for Reality,* 44 ST. LOUIS U. L.J. 909, 915–16 (2000).

[395] Baird, *supra* note 25, at 934. 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 (Leff, *Contract as Thing*, *supra* note 25, at 144–51) and Lewis A. Kornhauser (Lewis A. Kornhauser, Comment, *Unconscionability in Standard Forms*, 64 CAL. L. REV. 1151, 1168 (1976)). Radin, *supra* note 25, at 1229.

such as the cross-collateralization clauses in the famous unconscionability case, *William v. Walker-Thomas Furniture Co.*[396]

Baird also claims that scholars' continued concern about the lost right of assent in adhesion contracts is antiquated and obsolete,[397] 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 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.

Since Baird is not interested in assent or rights, he relies on the markets and the legislature as external 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 them of the choice to enter contracts tailored to their own needs, regardless of the views of the legislature, a body that often fails to act in time to protect the individual or society from ruinous losses.

Other law and economics scholars contend that reputational concerns and comparison shopping by an "informed minority" prevent firms from including one-sided terms in adhesion contracts[398]—a claim that would doubtless come as quite a shock to the lawyers who actually

[396] 350 F.2d 445 (D.C. Cir. 1965); Baird, *supra* note 25, at 941–42.

[397] Baird, *supra* note 25, at 951–52.

[398] *See* Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827 (2006). 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. Clayton P. Gillette, *Pre-Approved Contracts for Internet Commerce*, 42 HOUS. L. REV. 975, 977 (2005); Kessler, *supra* note 25, at 631–32; George L. Priest, *A Theory of the Consumer Product Warranty,* 90 YALE L.J. 1297, 1347 (1981); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 659–62 (1979). *But see* R. Ted Cruz and Jeffrey Hinck, *Not My Brother's Keeper: The Inability of an Informed Minority to Correct for Imperfect Information*, 47 HASTINGS L.J. 635, 636 (1996).

draft these agreements.[399] A new study has challenged the "informed minority" theory based on evidence collected in the market for software end user license agreements.[400] The study tracked visits of 45,091 households to 66 software companies over a month, and found that only one to two in a thousand shoppers (between 0.05% and 0.22%) accessed the software license for even a second, which is several orders of magnitude shorter than required by economists' models to sustain "informed minority equilibrium."[401] Beyond the proven failure of consumers to read form contracts, the "informed minority" theory depends on the faulty assumptions that an informed minority understands the terms of adhesion contracts and is able to purchase the same goods or services from competitors that offer better terms.[402] Similarly, companies will not remove one-sided terms from their adhesion contracts based on a concern for their reputation unless these terms become known to the buying public.[403] The software license study found that consumers were not becoming informed about the terms of the software licenses by consulting other online sources,[404] suggesting that there is no general reputational effect of unread adhesion contract

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[399] A study of the terms of 647 online end user license agreements shows that while they do not converge on the legal minimum, almost all of them are more restrictive than the otherwise applicable default rules. Florencia Marotta-Wurgler, *Competition and the Quality of Standard Form Contracts: The Case of Software License Agreements*, 5 J. EMPIRICAL LEGAL STUD. 447, 450, 463 (2008); Florencia Marotta-Wurgler, *What's in a Standard Form Contract? An Empirical Analysis of Software License Agreement*, 4 J. EMPIRICAL LEGAL STUD. 677, 679, 703, 706 (2007).

[400] Bakos, Marotta-Wurgler & Trossen, *supra* note 30.

[401] *Id.* at 3, 36–37. The authors also estimated that the marginal cost of providing maintenance and support, a term favoring the buyer, and concluded that sellers would find it more cost-effective to lose up to one to two times the 0.2% of "informed buyers" rather than provide the term, even assuming all these buyers would be lost absent the term. *Id.* at 4.

[402] *See* Richard L. Hasen, Comment, *Efficiency Under Informational Asymmetry: The Effect of Framing on Legal Rules*, 38 UCLA L. REV. 391, 430–31 (1990); *see also* Meyerson, *supra* note 25, at 1270–71 ("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." (footnotes omitted)); Cruz & Hinck, *supra* note 398 (claiming that the informed minority theory relies on faulty assumptions). Empirical research on the subject indicates that competitors supply comparable terms. *See* Slawson, *Standard Form Contracts, supra* note 25, at 531 ("When such a contingency arises [the contingency covered by a form contract] the buyer will not usually be in a position to compare the form he bought with others he might have bought instead. Most buyers probably believe (correctly) that the forms they could have bought from a competing seller would have been just as bad anyway.").

[403] *See* Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 243–44 (1995). ("[C]ompetition will not have this effect unless a significant number of form takers participate in this search. Typically that will not occur, because most form takers will find it irrational to engage in search and deliberation on any given form.").

[404] Bakos, Marotta-Wurgler & Trossen, *supra* note 30, at 34.

terms. Finally, sellers may find it more profitable to cater to the clear majority who are unaware of the onerous boilerplate rather than eliminate it on behalf of a phantom minority, especially when their competitors can undercut them by not following suit.[405]

Neither reputation nor comparison shopping by an informed minority will ensure economically efficient terms in adhesion contracts. In the highly competitive market for subprime mortgages, market forces did not prevent subprime lenders from engaging in unsound lending practices on an unprecedented scale.[406] As Karl Llewellyn observed in the 1930s:

> 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.[407]

Picking up Llewellyn's point 40 years later, Victor Goldberg wrote a paper agreeing with Llewellyn that competition does not protect consumers from "seller-protective" clauses.[408] Goldberg's reasons given 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 into the industry until excess profits are bid away.[409] Goldberg preferred a regulatory solution to litigation,[410] citing the risk and expense

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[405] *See* Victor P. Goldberg, *The "Battle of the Forms": Fairness, Efficiency, and the Best-Shot Rule*, 76 OR. L. REV. 155, 165 (1997) ("Others will presume that the random buyer they run into will not have read the form and that, by stacking the deck, the seller can perhaps gain more from the nonreaders than it loses to the readers."); Slawson, *Standard Form Contracts*, *supra* note 25, at 531 ("An unfair form will not deter sales because the seller can easily arrange his sales so that few if any buyers will read his forms, whatever their terms, and he risks nothing because the law will treat his forms as contracts anyway. . . . An unfair form thus normally constitutes a costless benefit which a seller refuses at his peril. If he fails to take advantage of it, his competitors will."); Eisenberg, *supra* note 403, at 244 (describing the "market-for-lemons phenomenon" that results in low-quality terms in form contracts in competitive markets).

[406] 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).

[407] Llewellyn, *What Price*, *supra* note 306, at 734.

[408] Goldberg, *Institutional Change*, *supra* note 353.

[409] *Id.* at 485–86. 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, 62 (1969).

[410] Government would either provide consumers with a "faithful agent" by setting default terms, mandatory terms, and prohibited terms, or would create an agency to

of litigation, but he did not address any of the difficulties inherent in relying on regulatory solutions to abusive contracts.[411]

Indeed, if courts are relying on the law and economics view that competitive market forces will protect consumers' interests even if they do not read or understand the adhesion contracts they sign,[412] the courts should reconsider their faith in economic prognostications like these in light of recent events.[413] The idea that inefficient form contract terms will be eliminated by the market cannot be sustained in the wake of the global economic catastrophe wrought by the massive sales of complex mortgages to individuals who did not understand them and could not afford them.[414] 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 insupportable when the institutions offering no-documentation, interest-only mortgages prior to the subprime loan crisis included one of the country's oldest national banks, JPMorgan Chase, and the nation's largest savings and loan, Washington Mutual.[415]

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bargain directly with firms over the terms of standard contracts. Goldberg, *Institutional Change*, *supra* note 353, at 488–89.

[411] *Id.*

[412] *See* Bebchuk & Posner, *supra* note 398, at 830; Posner, *supra* note 409, at 62.

[413] *See* Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES MAG., Sept. 6, 2009, at 36.

[414] *See* Greg Ip & Jon E. Hilsenrath, *How Credit Got So Easy and Why It's Tightening*, WALL ST. J., Aug. 7, 2007, at A1, A8 (explaining that when the Federal Reserve held rates down after 2001, lenders offered mortgages to borrowers with poor credit at seemingly affordable low introductory rates. Some examples 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*, BUS. WK., Sept. 11, 2006, at 70, 71–73. (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 for the wealthy but as affordability tools for 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."). As Federal Reserve Chairman Ben Bernanke remarked, "[The] 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 S. Bernanke, Chairman, Fed. Reserve Board, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (July 19, 2007), http://www.federalreserve.gov/newsevents/testimony/bernanke20070718a.htm.

[415] *See* JPMORGAN CHASE & CO., THE HISTORY OF JPMORGAN CHASE & CO.: 200 YEARS OF LEADERSHIP IN BANKING 1, *available at* http://www.jpmorgan.com/cm/BlobServer?blobtable=Document&blobcol=urlblob&blobkey=name&blobheader=application/pdf&blobwhere=jpmc/about/history/shorthistory.pdf; Eric Dash & Andrew

Repeat players in the market—including the investment banks that issued mortgage-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 respond appropriately to the risks of unsound lending that led to the devaluation of financial assets on such a massive scale. If the highly-trained financiers running Lehman Brothers, Merrill Lynch, Citigroup, Bank of America, JPMorgan 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 the borrowers. Perhaps they would rather blame the homeowners than face the fearsome reality that neither bankers operating in a competitive marketplace nor the experts who regulate them have been able to prevent repeated financial fallouts on a massive scale remedied at taxpayer expense.

One explanation for the market failure that led to the latest crisis focuses on the securitization of mortgages. Most loan originators had little reason to maintain underwriting standards when they planned to sell these mortgages shortly after making them, leaving them with little if any exposure.[416] The problem was especially acute in the subprime market, with the securitization of subprime mortgages rising from 50.4% of originations in 2001 to 81.2% in 2005.[417] 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 the Office of Federal Housing Enterprise Oversight index of home

Ross Sorkin, *Government Seizes WaMu and Sells Some Assets*, N.Y. TIMES, Sept. 25, 2008, *available at* http://www.nytimes.com/2008/09/26/business/26wamu.html; Peter S. Goodman & Gretchen Morgenson, *Saying Yes to Anyone, WaMu Built Empire on Shaky Loans,* N.Y. TIMES, Dec. 28, 2008, at A1; Denise Trowbridge, *Home Lenders Lifting Threshold: Time of Easy Credit for Buyers Ends as Foreclosures Mount*, COLUMBUS DISPATCH, Aug. 9, 2007, *available at* http://www.dispatch.com/live/content/local_news/stories/2007/08/09/mortgagefallout.ART_ART_08-09-07_A1_NL7ILQS.html.

[416] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2040, 2045 (2007); Macey et al., *supra* note 5, at 801 ("[B]ecause the originators and brokers did not hold the loans they created, standards and diligence in originating loans were compromised."); Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2213–15, 2220 (2007); Schmudde, *supra* note 5, at 734 ("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." (footnote omitted)); For a critique of this view, *see* Zywicki & Adamson, *supra* note 212, at 52–53 (2009).

[417] *See* Zywicki & Adamson, *supra* note 212, at 8 ("Wall Street pooled $508 billion worth of subprime mortgages in 2005, up from $56 billion in 2000.")

prices fell was only 5.4%.[418] Another factor in the market failure was that a perverse broker compensation system rewarded brokers for selling borrowers unsuitably risky loans. Specifically, the system gave brokers incentives to place borrowers in loans with the highest rates and fees, often in subprime rather than prime loans.[419]

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 behavioral studies relating to limitations in our decision-making capabilities when presented with complex information.[420] For example, explaining each provision in an adhesion contract to the consumer would not improve efficiency,[421] according to Korobkin, because consumers are boundedly rational decision-makers who may be able to process as few as five "salient" terms.[422] His recommendation is that 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 adhesion contract terms.[423]

Korobkin's solution is to turn these decisions over to legislators and judges, who are better qualified to 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.[424] 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

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[418] *See* Baily, Elmendorf & Litan, *supra* note 218, at 10 (this index measures prices for the same dwelling in different markets).

[419] Warren, *supra* note 258, at 36 (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. Fannie Mae estimates that 50% of the borrowers who were sold expensive subprime mortgages would have qualified for prime-rate loans).

[420] Korobkin, *supra* note 25, at 1206.

[421] *Id.* at 1246–47.

[422] *Id.* at 1205, 1222, 1227–28. A "salient" attribute is one that "buyers consider." *Id.* at 1206.

[423] *Id.* at 1206–1207.

[424] *Id.* at 1280.

value of an alternative term to potential buyers."[425] This analysis will require either direct evidence in the form of economic studies and projections, or reliance "on more general theoretical principals [sic], familiar to all law-and-economics scholars."[426] 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.

IV. A PROPOSED JUDICIAL SOLUTION—STANDARDIZED CONTRACTS THAT WARRANT A PRESUMPTION OF ASSENT

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 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. Any pretense of social justice in contract law is left badly askew, as courts have effected a transfer of power from individuals to corporations by permitting the organizations that draft adhesion contracts to impose their own terms, as "private laws," on individuals without their consent.[427] 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.[428] He was wrong in supposing that firms must exert monopoly power to achieve this result—all they needed was for courts to enforce terms that are too long and complex to be read or understood by the average individual.[429]

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.[430] While certainly not the U.C.C.'s finest achievement, this rule nevertheless revised the common

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[425] *Id.* at 1283.

[426] *Id.* at 1284.

[427] Larry Bates, *Administrative Regulation of Terms in Form Contracts: A Comparative Analysis of Consumer Protection*, 16 EMORY INT'L L. REV. 1, 2 (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."); Kessler, *supra* note 25, at 640 (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").

[428] Kessler, *supra* note 25, at 640–41.

[429] *Id.* at 640.

[430] U.C.C. § 2-207 (2002); White & Mansfield, *supra* note 30, at 266.

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.[431] This effort demonstrates that it should be possible to revise the objective theory of assent and the duty-to-read rule to enforce today's contracts of adhesion without affecting the consumers' right to 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 drafting party could reasonably believe the adherent's conduct manifests informed assent to the material terms of the contract. The act of signature will not satisfy this requirement if it is unreasonable to believe that the intended recipients of the contract would have given their informed assent to the contract's material terms as a condition of signature. Indeed, signature will not provide evidence of assent if the adhesion contract was written and presented in accordance with commonly followed business practices, which are widely recognized to deny the adherent the opportunity to read and understand the contract's terms.[432] These practices should be amended so that they produce adhesion contracts capable of establishing assent through the adherent's signature.

Under the revised duty to read and the objective theory of assent, courts will ask one fundamental question when the adherent raises lack of assent to a material disputed term as a defense to formation: Would a reasonable person in the drafting party's position have believed that the recipient of the standardized consumer contract understood the disputed material term before engaging in the action or inaction taken as a manifestation of assent?

If the answer to the 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 through 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."[433] Thus, while the test is an objective one, objectivity does not imply that the test can be applied without regard to the nature and context of each

[431] White & Mansfield, *supra* note 30, at 266.
[432] *See supra* Part III.
[433] Rakoff, *supra* note 25, at 1242–43.

transaction.[434] As with open price term cases where the courts determine a reasonable price using evidence of market prices at the time of delivery when the parties fail to agree,[435] the courts would determine a reasonable loan term using evidence of terms available in the lending market and the parties' circumstances at the time of contracting when the parties failed to agree.

Allowing consumers to challenge the validity of adhesion contracts for lack of mutual assent will certainly impose additional costs on businesses, which they may pass on to consumers. But the current system of enforcing the drafting parties' terms in adhesion contracts, without the consumers' informed assent, shifts all the externalities of adhesion contracts to consumers. For an estimated 99% of the contracts entered into in this country,[436] the drafting parties do not have to incur the costs of negotiating with the opposing party to win agreement on desired terms. Lengthy and sophisticated contracts drafted by counsel for one of the parties to the contract are enforced in court despite the lack of any legal representation for the other party. And the drafting party is not even required to provide an agent capable of explaining the terms of these complex agreements to the other party before they are bound. Thus, the drafting party obtains legal enforcement of its contract terms without incurring the costs necessary to obtain the other party's informed assent. Courts rely on the duty-to-read rule to shift these costs to the consumer, but when the drafting party writes adhesion contracts in a language foreign to consumers, and fails to provide an agent who will translate them into laymen's language, the rationale behind the duty-to-read rule has failed.[437]

If the doctrine I propose 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) of Contracts*. As with any other contract, the validity of standardized contracts could be challenged for lack of mutual assent. If there was no intrinsic or extrinsic evidence of mutual assent, and no judicial admissions of formation, the parties' alleged agreement would not be enforced. In the case where the consumer admitted that an oral agreement had been reached, or that the parties reached agreement through a combination of forms, written representations, and

[434] Since lack of assent is an invalidity defense, the parol evidence rule should not exclude consideration of any relevant evidence on the issue. *See* RESTATEMENT (SECOND) OF CONTRACTS § 214(d) (1981).

[435] U.C.C. § 2-305(1)(b).

[436] *See* Slawson, *Standard Form Contracts, supra* note 25, at 529.

[437] White & Mansfield, *supra* note 30, at 242–43 (describing the historical survey of Edward Stevens of nineteenth-century law relating to illiterate parties, including cases that imposed a duty on literate parties to read and explain the contract to illiterate parties and cases imposing liability on illiterate parties who failed to request that the contract be read to them).

performance, but that no agreement had been reached as to the disputed term, the matter would be handled as a missing term case.[438]

One aspect of the analysis will be the "readability" of the contract—the subject of the largely unsuccessful "Plain English" movement of the 1970s.[439] 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 consumer is bound by the terms of a contract that is incomprehensible to him when he has been given no reasonable means of understanding its terms. 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 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.[440]

Since adhesion contracts are noted for their uniformity among industries, guidance from court decisions on whether the standard for

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[438] This doctrine would require homeowners facing foreclosure as a result of misleading mortgages to obtain counsel, but experts in the field are already seeking an increase in legal representation for homeowners in foreclosure to protect their legal rights. *See* MELANCA CLARK & MAGGIE BARRON, FORECLOSURES: A CRISIS IN LEGAL REPRESENTATION 7 (2009), http://brennan.3cdn.net/a5bf8a685cd0885f72_s8m6bevkx.pdf (describing the reasons counsel are necessary in foreclosure actions and listing nonprofit legal services programs, law school clinics and private bar initiatives that are currently providing these services); Institute for Foreclosure Legal Assistance (IFLA), http://www.foreclosurelegalassistance.org/ (describing 34 legal assistance programs providing representation to homeowners in foreclosure in 27 states and the District of Columbia).

[439] 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 (McKinney 2001) (consumer contracts must be "[w]ritten in a clear and coherent manner using words with common and every day meanings"); 73 PA. CONS. STAT. ANN. § 2205 (West 2008) (consumer contracts "shall be . . . easy to read and understand").

[440] White & Mansfield, *supra* note 30, 233–34 (collecting supporting data—including literacy research to show that many U.S. citizens cannot understand federally mandated disclosure information—and stating that, "[a]mong, 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"); Davis, *supra* note 300, at 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, "[t]he 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").

mutual assent is satisfied should be expected in the near term. In the mortgage context, a large percentage of residential mortgage loans are documented on Fannie Mae/Freddie Mac uniform mortgage instruments.[441] Now that Fannie Mae and Freddie Mac are in conservatorship, perhaps the level of fraud perpetrated by brokers and lenders leading to the latest crisis will motivate Fannie Mae and Freddie Mac to consider revising their form mortgages so that borrowers can understand and assent to their terms.[442] Statutes may also provide guidance, such as New York's one-page statutory form mortgage.[443]

A closely related issue is length.[444] 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 one inch by one 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. Corporations that insist on their own terms without consumer assent should seek relief from their legislators in the form of default rules.

The setting in which the individual is expected to read the contract should also be considered. If the drafting party does not give the consumer the time or opportunity to read the form contract before signing it, the drafting party cannot argue that he reasonably believed the consumer had 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 consumer with the terms of the transaction until after it has been consummated. In the Orwellian world of contract law to which

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[441] Patrick A. Randolph, Jr., *The Future of American Real Estate Law: Uniform Foreclosure Laws and Uniform Land Security Interest Act*, 20 NOVA L. REV. 1109, 1113 (1996) (an estimate made prior to the increase of subprime mortgages states that 90% of all real estate loans use Fannie Mae or Freddie Mac forms).

[442] *See* Gerald Korngold, *Legal and Policy Choices in the Aftermath of the Subprime and Mortgage Financing Crisis,* 60 S.C. L. REV 727, 737–39 (2009) (raising the question of what will happen to Fannie and Freddie mortgage forms post-conservatorship; also noting that based on their power over the secondary market, Fannie and Freddie forms trump rights given by states, such as ban on prepayment penalties, and reduce the ability of attorneys to negotiate terms on behalf of their clients).

[443] N.Y. REAL PROP. LAW § 258, sched. M (McKinney 2005).

[444] Literacy surveys and readability studies confirm this common sense intuition. *See* White & Mansfield, *supra* note 30, at 264 ("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* Warren, *supra* note 258, at 35 (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").

consumers are now subject, the contract formed by acceptance of an offer is not formed until the consumer has assented, by silence, to the drafting party's terms which are contained in product packaging accessible only after the consumer has performed his own contractual obligations in full by paying the purchase price.[445] Credit card agreements and phone service agreements provide that they may be amended at any time and that continued use of the service constitutes acceptance.[446]

Until our culture has adapted to the new law, notice of the significance of reading the contract will be crucial. Apathy and indifference must be overcome. Like the many Americans who no longer vote, many consumers have come to believe that their views and concerns do not count—that there is no point in attempting to read form contracts because the powerful 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.[447] Motivating consumers to read form contracts can be achieved in various ways. Warnings may state that the contract contains terms concerning the consumers' obligations under the contract, as well as restrictions on the consumers' rights and remedies against the company, and that these terms may affect the consumer's decision to sign the contract.

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

[445] *See* Hill v. Gateway 2000, Inc., 105 F.3d 1147, 1150 (7th Cir. 1997); ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1451 (7th Cir. 1996); i.Lan Sys., Inc. v. Netscout Serv. Level Corp., 183 F. Supp. 2d 328, 339 (D. Mass. 2002); Bischoff v. DirecTV, Inc., 180 F. Supp. 2d 1097, 1103–06 (C.D. Cal. 2002); Westendorf v. Gateway 2000, Inc., No. 16913, 2000 WL 307369, at *1 (Del. Ch. March 16, 2000); Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569, 570 (N.Y. App. Div. 1998); M.A. Mortenson Co., Inc. v. Timberline Software Corp., 998 P.2d 305, 313 (Wash. 2000).

[446] *See* Kortum-Managhan v. Herbergers NBGL, 204 P.3d 693, 698–701 (Mont. 2009) (reversing grant of motion to compel arbitration and dismiss action alleging violations of federal and state consumer protection statutes on grounds that plaintiff did not knowingly and intelligently waive her right to a jury trial).

[447] *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.").

obligations. As with cases involving disclosures in the sale of securities, the actual knowledge of the non-drafting party 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 the intended recipients of the contract 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%, 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.

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 misunderstanding as the appropriate interpretive tool. Under section 20 of the *Restatement (Second) of Contracts*, 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.[448]

This analysis best reflects the reality of the parties' dealings. While firms almost always eliminate the authority of their sales agents to alter contractual representations, 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 "click-wrap" transactions differ only in that the "sales talk" never deviates from the script. Consumers still rely on terms disclosed in the information provided about the product or service that is presented to assist them in making their choice, and they will scroll through the boilerplate without reading it before entering "I agree" as necessary to finalize the purchase.

[448] RESTATEMENT (SECOND) OF CONTRACTS § 20(2) (1981).

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.[449] The U.C.C. 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.[450] Similarly, a contract is enforceable even though the parties have not agreed upon terms as to specific quantities,[451] the place for delivery,[452] the time for shipment, delivery, or successive performances,[453] a description of performance,[454] the time and place of payment or delivery, the quality of the goods, or any particular warranties.[455] 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' assent is a legal fiction. As Rakoff noted, since courts can supply missing terms based on existing law, there is nothing in the concept of mass distribution or the needs of standardization that requires that the drafting party's terms must prevail.[456]

While the complexity of some transactions may increase the difficulty of drafting standardized form contracts that are easily understood by a lay audience, it is not impossible. Statutes have been enacted in several states that require insurance policies, among the most obtuse of all instruments devised by the legal profession, to be drafted in clear and understandable language.[457] Most states also require group insurers to

[449] Rakoff, *supra* note 25, at 1181.

[450] U.C.C. § 2-305 (2002).

[451] U.C.C. § 2-306.

[452] U.C.C. § 2-308.

[453] U.C.C. § 2-309.

[454] U.C.C. § 2-311.

[455] U.C.C. § 2-201, cmt. 1.

[456] Rakoff, *supra* note 25, at 1208, 1235.

[457] *See* Anderson & Fournier, *supra* note 342, at 402–06. 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. *See also* Scott B. Krider, Comment, *The Reconstruction of Insurance Contracts Under the Doctrine of Reasonable Expectations*, 18 J. MARSHALL L. REV. 155, 173–76 & 174 n.104 (1984). Krider argued that the reasonable expectations doctrine could be abandoned in insurance cases if these statutes mandating "easy to understand" 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. Krider also suggested that developing consumer interest groups would motivate these agencies. *Id.* at 175. *See also* Abraham, *supra* note

provide a certificate to insureds that explains the coverage provided under the master policy, including any significant conditions, exclusions or exceptions.[458] When the certificate varies from 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.[459]

Another remedy for complexity in financial adhesion contracts is education. Lenders who believe sophisticated financial instruments would be of mutual benefit to themselves and their consumer customers—as opposed to their high-income, sophisticated clients who are represented by counsel—should invest the time needed to explain the terms of these contracts to consumers as a condition of enforcement in contract. As in other situations where issues of proof may arise, such as sales of risky securities,[460] the execution of wills,[461] and defendants' statements in criminal cases,[462] a recording could be made of the

343, at 1190 (recommending judicial as well as regulatory controls in part because "the industry has tended to dominate the regulators").

[458] *See* WILLIAM F. MEYER, LIFE AND HEALTH INSURANCE LAW § 19:14, at 628–29 (1972).

[459] *See* Lecker v. Gen. Am. Life Ins. Co., 525 P.2d 1114 (Haw. 1974); Hayes Truck Lines, Inc. v. Inv. Ins. Corp., 525 P.2d 1289, 1291–93 (Or. 1974); Evans v. Lincoln Income Life Ins. Co., 585 P.2d 407, 410 (Okla. Civ. App. 1978); Romano v. New Eng. Mut. Life Ins. Co., 362 S.E.2d 334, 338–39 (W. Va. 1987).

[460] The Office of the Comptroller of the Currency (OCC) has recommended that trading personnel operating in emerging markets use recorded phone lines due to the "possibility of incomplete paper trails and the existence of legal risks in the [emerging markets]." As the OCC explains, "[r]ecordings will supplement, and in some cases validate, trade documentation, provide evidence in a legal or trade dispute, serve as a control mechanism for traders, and provide an audit trail." COMPTROLLER OF THE CURRENCY ADMINISTRATOR OF NATIONAL BANKS, COMPTROLLER'S HANDBOOK: EMERGING MARKET COUNTRY PRODUCTS AND TRADING ACTIVITIES 16 (1998), *available at* http://www.occ.treas.gov/handbook/emkt.pdf.

[461] *See* 10 GERRY W. BEYER, TEX. PRACTICE SERIES, TEXAS LAW OF WILLS §§ 52.17–52.23 (3d ed. 2002) (explaining how to prevent will contests by videotaping the will execution ceremony); Gerry W. Beyer & William R. Buckley, *Videotape and the Probate Process: The Nexus Grows*, 42 OKLA. L. REV. 43, 48 (1989) ("A properly prepared videotape of the will execution ceremony may prove indispensable in discouraging will contest actions or ultimately winning them if the contestant proceeds with the suit."); Lawrence P. Devens, *Review of the Elements of a Valid Will Under the Illinois Probate Act*, 22 DCBA BRIEF 32, 32 (2010) ("[V]ideotapes of the execution of the will with or without a testator's explanation of the will dispositions have been used as evidence of mental capacity and no undue influence."); Lisa L. McGarry, Note, *Videotaped Wills: An Evidentiary Tool or a Written Will Substitute?*, 77 IOWA L. REV. 1187, 1205–06 (1992). (noting that Indiana has passed legislation permitting the introduction of a videotape of the execution of a will as evidence of proper execution, authenticity, and the testator's intention, mental state and capacity, IND. CODE ANN. § 29-1-5-3(c) (LexisNexis 1989)).

[462] As chronicled in Thomas P. Sullivan, Andrew W. Vail & Howard W. Anderson III, *The Case for Recording Police Interrogations*, 34 LITIGATION 1, Spring 2008, at 33, the trend among state law enforcement departments towards recording custodial, stationhouse interrogations is growing steadily. As a matter of case law, statute, or

interview at nominal cost to alleviate these concerns. Certainly firms will incur added costs in providing additional oral explanations of the terms of any contracts that are unavoidably complex, and these costs may reduce the appeal of the loans since the costs will now have to be borne by the consumer. But Lauren Willis has ably demonstrated that widespread sales of highly-sophisticated subprime mortgages did not benefit consumers who did not appreciate the risk of foreclosure they were assuming.[463] Given the number of subprime loans used for refinancing, and the number that quickly led to foreclosure, these loans resulted in a net loss of homeownership, as well as lower household welfare despite a short-lived spike in homeownership.[464]

Others may argue that attempts to limit the enforcement of form contracts to contracts that consumers can understand will not cure the market failure that results in one-sided terms because consumers are not rational decision-makers. Consumers are "boundedly rational decision-makers," 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.[465] They cannot be relied upon to engage in "fully non-selective and compensatory decisions" using "weighted-added strategy" as the free market theory assumes, but instead fall short by ignoring information they must consider for the market to self-regulate.[466]

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.

rule-making by the courts, the police are now required to record interviews of felony suspects in Alaska, Stephan v. State, 711 P.2d 1156, 1162 (Alaska 1985); the District of Columbia, D.C. CODE ANN. §§ 5-116.01-03 (LexisNexis 2009); Illinois, 705 ILL. COMP. STAT. ANN. § 405/5-401.5 (West 2007); 725 ILL. COMP. STAT. ANN. § 5/103-2.1 (West 2006); 720 ILL. COMP. STAT. ANN. § 5/14-3(k) (West 2006); Massachusetts, Commonwealth v. DiGiambattista, 813 N.E. 2d 516, 533–34 (Mass. 2004) (recommending, but not requiring, electronic recording of all custodial interrogations); Minnesota, State v. Scales, 518 N.W.2d 587, 591–92 (Minn. 1994); New Mexico, N.M. STAT. ANN. § 29-1-16 (Supp. 2009); Wisconsin, WIS. STAT. ANN. §§ 968.073, 972.115 (West 2007); New Jersey, N.J. SUP. CT. R. 3:17, *available at* http://www.judiciary.state.nj.us/rules/rules_toc.htm; and, for homicides, North Carolina, N.C. GEN. STAT. § 15A-211 (LexisNexis 2009).

[463] Willis, *supra* note 5.

[464] *Id.* at 1195 n.58, 1184–99.

[465] Korobkin, *supra* note 25, at 1218–19.

[466] *Id.* at 1220.

Some commentators 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 are unlikely to be able to understand basic financial concepts contained in most credit disclosures.[467] 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 form contracts involving credit and that legislation should be adopted to protect consumers in this area.[468] 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.[469] 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.[470] 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, especially if the banks stop selling exotic financial products to inappropriate clients. Surely most Americans can understand their basic obligations under a 30-year, fixed-interest-rate mortgage. 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, for several decades, of the reasonable expectations rule to overturn standardized terms in insurance policies.[471] Perhaps this is due in part to the fact that many insurance companies fail to enforce their own exceptions in any standardized manner,[472] a fact that some commentators claim is true regarding standardized contracts generally.[473]

[467] White & Mansfield, *supra* note 30, at 234.

[468] *Id.* at 235–40.

[469] *Id.* at 258–59.

[470] *Id.* at 264.

[471] *Id.* at 263 ("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.").

[472] Anderson & Fournier, *supra* note 342, at 367.

[473] Bebchuk & Posner, *supra* note 398, at 833.

V. 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 undergone. Market discipline, regulation, and monetary policy have proven their limitations in preventing these disasters time after time, yet commentators continue to assume that these three tools are the only viable solutions. Meanwhile, courts have enforced adhesion contracts in all but exceptional cases, despite the fact that, contrary to the objective theory of assent, the drafting parties know they will not be read or understood by the consumers who will be bound to their terms. In both the Great Depression and the subprime mortgage crisis, financial institutions used their ability to enforce adhesion contracts without informed assent to create massive consumer debt obligations that were far beyond the consumers' financial means, with devastating consequences to the nation's economic well-being.

Although unlikely, Congress and state legislatures may pass statutes to limit abusive financial adhesion contracts. It may even be possible that during the future boom years that precede the busts, these statutes will be maintained and enforced by adequately-funded administrative agencies. But statutes and regulations cannot keep pace with the misleading and fraudulent practices of the parties that draft financial adhesion contracts. And they cannot meet the challenges of consumers who sign these contracts without understanding their terms. 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 enforcement of their financial adhesion contracts in court will warn financial institutions that the courts will not enforce a contract imposing imprudent, high-risk debt obligations on a consumer when the drafting party had no reasonable grounds for believing the consumer understood the terms of the agreement.