A Crisis of Confidence and Legal Theory: Why the Economic Downturn Should Help Signal the End of the Doctrine of Efficient Breach

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Dawinder S. Sidhu*

INTRODUCTION

The doctrine of efficient breach is a common feature of a first-year foundational course in contract law.¹ In what follows, I argue that this familiar doctrine should be condemned, if not discarded.

An efficient breach compels, or at least encourages or invites, a party to intentionally break a contract if he can enter into a second more profitable one and remain better off after compensating the non-breaching party.² An efficient breach is said to take place when, for example, A agrees to give B a widget for $1, C subsequently offers A $3 for the same widget, A breaches his contract with B who suffers $.50 in damages, and A takes the deal with C—at the end of the day, A will pay B $1.50 and keep $1.50, thereby increasing his profit ($1.50 versus $1).³ The breach is considered “efficient” in these circumstances because the breaching party (A) is in a better economic position; the good, service, or entitlement contracted for (the widget) is put to higher use and resides with the

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¹ See David W. Barnes, The Meaning of Value in Contract Damages and Contract Theory, 46 AM. U. L. REV. 1, 20 (1996) (“It is hard to find a first-year contracts casebook that does not teach the basic principles of efficient breach.”); id. at 2 n.6 (listing a number of major contract casebooks that address the doctrine, including texts by legal luminaries such as E. Allan Farnsworth, William F. Young, Lon L. Fuller, Melvin A. Eisenberg, and Charles L. Knapp & Nathan M. Crystal).

² See Craig S. Warkol, Note, Resolving the Paradox Between Legal Theory and Legal Fact: The Judicial Rejection of the Theory of Efficient Breach, 20 CARDozo L. REV. 321, 321-22 (1998) (noting that an efficient breach instructs “a party to a contract to breach if they can compensate the other party and remain better off than if they had fully performed the contract”).

³ See, e.g., RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 57 (1st ed. 1972) (“I sign a contract to deliver 100,000 custom-ground widgets at $.10 apiece to A, for use in his boiler factory. After I have delivered 10,000, B comes to me, explains that he desperately needs 25,000 custom-ground widgets at once since otherwise he will be forced to close his pianola factory at great cost, and offers me $.15 apiece for 25,000 widgets. I sell him the widgets and as a result do not complete timely delivery to A, who sustains $1000 in damages from my breach. Having obtained an additional profit of $1250 on the sale to B, I am better off even after reimbursing A for his loss.”).
party that values it more (C), as reflected in the higher purchase price; and the non-breaching party (B) is compensated in lieu of performance. Because of the higher profit resulting from these exchanges, an efficient breach is thought to enhance not only individual pockets but net social wealth as well—"[s]ociety is also better off."6

The doctrine of efficient breach is championed by law and economics scholars,7 who are members of a school of thought that generally believes that the law should be informed by descriptive economic principles and seeks to build a stronger link between the two disciplines as a result.8 In addition to touting the economic justifications of an efficient breach, these scholars eschew any moral

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4. See Marco J. Jimenez, The Value of a Promise: A Utilitarian Approach to Contract Law Remedies, 56 UCL A L. REV. 59, 71 n.50 (2008) ("[A] breach of contract is efficient if it is Pareto superior, that is, if the breaching party’s gains exceed, and are actually used to compensate, the nonbreaching party’s losses."); William S. Dodge, The Case for Punitive Damages in Contracts, 48 DUKE L.J. 629, 653 (1999) (explaining that a breach is Kaldor-Hicks efficient if the breaching party’s gains exceed the nonbreaching party’s losses and the former is not required to compensate the latter); E. Allan Farnsworth, Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract, 94 YALE L.J. 1339, 1380 (1985) ("Economic analysis posits that if there is a second buyer who values the widget more highly than you or I do, it is efficient for that buyer to acquire the widget.").

5. See Michael B. Dorff, Selling the Same Asset Twice: Towards a New Exception to Corporate Successor Liability Rules, 73 TEMPLE L. REV. 717, 749 (2000) ("By definition, the breach creates sufficient additional wealth to pay the victim her expected benefits from performance and still grant greater rewards to the breaching party than would have been gained by performance. The wealth created by the breach is thus necessarily greater than the wealth that would have been created by performance."); Claire Moore Dickerson, From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm, 22 FLA. ST. U. L. REV. 955, 967 n.52 (1995) ("[t]he ‘right’ to break a contract is not predicated on the nature of the contractual right, . . . [but] rather on the ground that the breach is supposed to lead to a better use of resources." (quoting Daniel Friedmann, The Efficient Breach Fallacy, 18 J. LEGAL STUD. 1, 4 (1989)) (alterations in original)).

6. With reference to the situation in supra note 3, Posner declares:

Since B was willing to pay me $0.15 per widget, it must mean that each widget was worth at least $0.15 to him. But it was worth only $0.14 to A—$0.10, what he paid, plus $0.04 ($1000 divided by 25,000), his expected profit. Thus the breach resulted in a transfer of the 25,000 widgets from a lower valued to a higher valued use.

POSNER, supra note 3, at 57.


8. "According to law and economics, the aim of the law is to encourage efficient behavior. . . . According to this view, a court errs when it fails to encourage efficient behavior." Joshua P. Davis, Taking Uncertainty Seriously: Revising Injunction Doctrine, 34 Rutgers L.J. 363, 428-29 (2003). In the context of contract law, for example, Posner and Andrew M. Rosenfield write, "If the purpose of the law of contracts is to effectuate the desires of the contracting parties, then the proper criterion for evaluating the rules of contract law is surely that of economic efficiency. . . . A law of contract not based on efficiency considerations will . . . be largely futile." Richard Posner & Andrew M. Rosenfeld, Impossibility and Related Doctrines in Contract Law: An Economic Analysis, 6 J. LEGAL STUD. 83, 89 (1977).
objections to the doctrine. They emphasize that, as the damages remedy for a breach of contract is compensatory in nature regardless of the breaching party's motive, a party to a contract may breach unilaterally for selfish reasons without incurring any different or additional penalty. As the compensation does not depend on the intent of the breaching party, whether an efficient breach is “right” or “wrong” are, according to economic theorists, moral questions outside of the ambit of—and not a relevant consideration in—contract law.

In 2006, I published an article arguing against the propriety of the doctrine of efficient breach. In particular, I posited that an efficient breach is morally problematic because it degrades contracts as well as the social cooperation and mutual trust that are necessary for individuals to voluntarily commit to do or not do something. Further, an efficient breach, as traditionally defined, is not efficient at a micro level, because a non-breaching party is not fully compensated for his losses, and is not efficient at a macro level, because such a strategic breach leads to a discounting of goods, services, and entitlements in the market due to the possibility that a contracting party may not perform in order to take advantage of a new, “better” deal. In other words, even assuming that morality is immaterial to an assessment of the doctrine, the doctrine is inefficient on its advocates’ own economic terms.

The article was written in the era of Enron and similar corporations who had used creative accounting techniques to artificially inflate their respective stock prices and, consequently, their resultant worth and executive officers’ pay. The exposure of these accounting irregularities and the attendant exaggerated income statements took down not only these specific companies, but the soundness and stability of the stock market as well. While this fallout was relevant to my discussion of the efficient breach theory, it supplied only the backdrop for the general notion that the short-sighted and selfish economic behavior of a few may have significantly deleterious impacts on practically all others, and at most

9. See, e.g., Patton v. Mid-Continent Sys., Inc., 841 F.2d 742, 750 (7th Cir. 1988) (“Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promisee's actual losses.”) (Posner, J.). This Article does not challenge the rule, as others have argued elsewhere, that punitive damages are appropriate where a party willfully breaches a contract. See generally, e.g., Dodge, supra note 4.

10. See, e.g., Jody S. Kraus, The Correspondence of Contract and Promise, 109 COLUM. L. REV. 1603, 1635-36 (2009) (“Economic analysts of contract law tend to regard such distinctions in moral obligation as superfluous. For purposes of their models, they presume that all they need to know is the price of performance and the price of breach.”); id. at 1636 n.65 (“Indeed, economic analysts often fail even to note that the efficient breach hypothesis might be interpreted as approving immoral conduct.”).


12. See id. at 74-83.

13. See id. at 84-91.
provided thematic support for my substantive attack on the doctrine.¹⁴

The economic situation since then is as well known as it is bleak. America has experienced the longest and most severe economic turmoil since the Great Depression.¹⁵ To wit, in early 2010 the national unemployment rate was in double digits, 14.8 million Americans were unemployed, and another 9.4 million were “underemployed.”¹⁶ On the global scale, the World Bank has predicted the largest decline in global trade in eighty years and projected the likely loss around the world in dollars to exceed $50 trillion—more than global gross domestic product.¹⁷ The primary cause for this significant downturn is no secret: the collapse of innovative financial instruments that were backed by subprime mortgages.¹⁸

While the corporate accounting fiascos of the last decade provided context to my take on efficient breaches, it is my sense that the present economic crisis resulting from reckless subprime lending and related collateralization practices provides evidence that the doctrine of efficient breach should be condemned and discarded. The purpose of this Article is to explore these two related topics: the merits of the doctrine in light of the present economic climate and the commensurate impropriety of its open advancement by law and economics scholars.

To understand subprime behavior and efficient breaches, it is imperative to first examine the necessary social predicate for economic transactions. Accordingly, Part I will offer an overview of society and the market, highlighting the importance of reciprocity and trust to both. Part II will define the economic transactions implicated by this Article: basic contracting, efficient breach of contract, and the subprime behavior of the current economic crisis. The discussion of subprime behavior in this section will include a description not only of its contents but also its consequences on society and the market, including a depletion of the trust and confidence required for a functioning economy and productive society.

14. See id. at 99 (“[A] cursory examination of the stock market should lead one to understand the impact a few bad apples (e.g., Enron, Worldcom, et cetera) can have on all prospective investors who are fearful that another corporation may turn into a Global Crossing or Tyco. The lack of consumer confidence in corporations mirrors the possible loss of confidence potential parties to a contract may experience in other parties and in the institution of contracting itself.”).

15. See, e.g., Edmund L. Andrews, U.S. Details $800 Billion Loan Plans, N.Y. TIMES, Nov. 26, 2008, at A1 (“Most economists agree[d] that the United States is in the worst financial crisis since the Great Depression, and that it has already fallen into a severe recession that is likely to be one of the deepest in decades.”).


18. See Daniel J. Morrisey, The Securities Act at its Diamond Jubilee: Renewing the Case for a Robust Registration Requirement, 11 U. Pa. J. BUS. L. 749, 750 (2009) (“[T]he chaos was caused by the collapse of debt obligations collateralized by sub-prime mortgages, a $12 trillion dollar industry engineered by the leading investment banks of Wall Street.”).
Part III will make explicit the nexus between subprime behavior and efficient breaches by explaining that subprime behavior and efficient breaches are linked by shared elements; they are opportunistic in nature, are interested in unilateral gain, involve solely short-term thinking without consideration of long-term effects, completely disregard any widespread third-party or broader social consequences, and entail significant negative externalities. The results of subprime activity suggest that economic behavior possessing these traits diminishes trust in other market participants and in the financial instruments that are designed to facilitate reliable social cooperation. Given these economic and social consequences, I argue that the doctrine of efficient breach should be disapproved as a legal theory, its open promotion discouraged, and at a minimum its discussion tempered by an honest admission of its deficiencies and practical limitations.

My objections to the doctrine stem from the doctrine’s essence—an unmitigated selfishness, myopia, and neglect for adverse consequences on others—and a broader economic culture in which individuals believe they are immune from any culpability or social responsibility because their underlying actions are technically legal and perhaps rational on an individual scale. This opportunism, combined with the formal and intellectual cover provided to it, emboldens financial actors to the inevitable detriment of the economy and members of our society. It is the doctrine’s contribution to a destructive ethos in which unabashed individual financial enrichment is pursued at the expense of the greater good and at the risk of systemic breakdowns in the economy that is at the heart of my concern.

This Article will be permeated by two considerations. First, that individual and collective psychology, and human nature generally, play a critical role in economic behavior and the fluctuations in the economy. Concepts such as confidence and trust, for example, will help explain the dangers of subprime activity and the doctrine of efficient breach. Second, that as a result, social norms related to proper individual or corporate conduct can direct economic behavior even as we await modified regulatory regimes or stricter formal legal constraints on economic actors.19

In arguing against the doctrine, I realize that I am trekking an uphill climb. Law and economics “has become, by almost any measure, the most dominant school of legal thought in the last half a century.”20 The extent to which efficient breach is ingrained in first-year law school curricula demonstrates its prevalence

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19. My thoughts as to the possible ways in which efficient breaches may retain some semblance of mutuality and trust under the law are available elsewhere. See Sidhu, supra note 11, at 86-88 (proposing that liquidated damages, containing a clause with graduated damages depending on when breach occurs, may come closest to satisfying the moral and efficiency camps of the efficient breach debate).

in legal academia. If an idea within the law and economics movement may be significantly detrimental to society either in value-based or economic terms, it becomes necessary to remonstrate with the legal community about this idea precisely because of, not in spite of, the familiarity doctrine or the clout of the movement itself. As no other scholarship has addressed squarely the doctrine of efficient breach as it relates to the current economic decline, and as I have addressed the doctrine in the past, I am inclined to take on this formidable path.

I hope the substance of this Article will generate agreement that the doctrine, because of its potential adverse consequences, should be put to rest. If not, this Article hopefully will stimulate a robust conversation on whether we should move in that direction.

I. A COMMERCIAL AND POLITICAL SOCIETY

"Every human society relies to some extent upon cooperation among its members to achieve social purposes. . . . Society is concerted action, cooperation." 22

In this Part, I offer an overview of the essential building blocks of and context for the doctrine of efficient breach: social behavior, contracting, and the role of governance. While the doctrine is a unique feature of American contract law, it is not possible to properly appreciate or assess it without first understanding these particular elements. With a more fundamental perspective, the essence of and problems with the doctrine will become more apparent. And with this perspective, the recent financial activity that led to the economic downturn and its relationship to the doctrine will also be made clear.

A. HUMAN NATURE AND SOCIETY

The natural state of society is one in which man is free of restraint and his liberty at a maximum. In other words, in this state man is not governed by any supervisory agent and instead is subservient to nature alone. 24 The Framers

21. See Warkol, supra note 2, at 327-34 (examining several preferred contracts casebooks to prove that the theory of efficient breach is "widely adopted by legal academics").


23. See THOMAS HOBBES, LEVIATHAN 86 (A.R. Waller ed.,1904) (1651) ("THE Right Of Nature . . . is the Liberty each man hath, to use his own power, as he will himselfe [sic], for the preservation of his own Nature; that is to say, of his own Life; and consequently, of doing any thing, which in his own Judgement and Reason, hee [sic] shall conceive to be the aptest means thereunto. BY LIBERTY, is understood, according to the proper signification of the word, the absence of externall [sic] Impediments: which Impediments, may oft take away part of a mans power to do what hee [sic] would; but cannot hinder him from using the power left him, according as his judgement [sic], and reason shall dictate to him.").

24. See JOHN LOCKE, TWO TREATISES OF GOVERNMENT bk. II, ch. IV, § 22, at 132 (Hafner Press 1947) (1689) [hereinafter LOCKE, TWO TREATISES] ("The natural liberty of man is to be free from any superior power on earth,
understood that legitimate government exists only if man voluntarily surrenders part of his natural rights and subjects himself to the rule of an external body, recognizing not only that government depends on the consent of the governed, but also that it is the first-order position of man to be without government.25 Perhaps because government appears to be an “indispensable necessity,”26 we often forget, as Thomas Paine observed, the critical distinction between natural society and government, thereby conflating the two.27

A man in a natural state may be without governmental interference but is subject nonetheless to the forces of nature proper and human nature, the realities of which render a solitary natural position a practically infeasible, albeit intuitively appealing, situation. At least a few of these realities are worth mentioning to make this point. First, as a practical matter, man left to his own devices is unlikely to satisfy his wants and needs.28 He may thus turn to others for assistance and their goods, services, and labor.29 Second, man may reliably seek out others to enrich his existence and take advantage of social pluralism, specifically the fact that men come from different circumstances and have varying skills, abilities, opinions, passions, interests, etc.30 Third, as a matter of inclination, man will gravitate instinctively towards social interaction. Man is an inherently “social being” and is “disposed to live with others.”31

25. See The Federalist No. 2, at 5 (John Jay) (Justin McCarthy et al. eds., rev. ed. 1901) (“[T]he people must cede to it some of their natural rights, in order to vest it with requisite powers.”).
26. Id.
27. See Thomas Paine, Common Sense 1 (Peter Eckler 1918) (1776) (“Some writers have so confounded society with government, as to leave little or no distinction between them; whereas they are not only different, but have different origins.”).
28. See Aristotle, Politics bk. I, at 54-55 (Benjamin Jowett trans., Random House 1943) (“[T]he individual, when isolated, is not self-sufficing; and therefore he is like a part in relation to the whole. But he who is unable to live in society, or who has no need because he is sufficient for himself, must be either a beast or a god . . . .”).
29. Indeed, the field of economics is premised on the fact that man’s wants exceed his means to meet those wants. See Richard A. Posner, Economic Analysis of Law Posner 3 (7th ed. 2007) (defining economics as “the science of rational choice in a world—our world—in which resources are limited in relation to human wants”).
30. It is because of this heterogeneity that we have the “factions” that James Madison identified and addressed in his own political theory. See The Federalist No. 10, at 45-46 (James Madison) (Justin McCarthy et al. eds., rev. ed. 1901) (“The latent causes of faction are thus sown in the nature of man; and we see them everywhere brought into different degrees of activity, according to the different circumstances of civil society. A zeal for different opinions concerning religion, concerning government and many other points, as well of speculation as of practice . . . . So strong is this propensity of mankind to fall into mutual animosities, that where no substantial occasion presents itself, the most frivolous and fanciful distinctions have been sufficient to kindle their unfriendly passions and excite their most violent conflicts.”).
Examples may help visualize this state of natural liberty. One can imagine a man on his own trying to survive as a hunter or shepherd. One can further envision a family or small pack doing the same, hunting or living a simple agrarian life. Assuming that these activities allow the man or his group to subsist, there likely will come a point at which this internal, enclosed, isolated dynamic may not be sufficient to fulfill the individual's or pack's requisite wants or needs.

Starting with "needs" first, a man injured by the collapse of his dwelling after a storm or afflicted by an unknown disease may attempt to obtain the services of someone who he believes may improve his condition—a soothsayer, apothecary, or physician. While this individual may provide his services free of charge, it is to be expected that man does not act out of benevolence but will want something in exchange. Or, say the hunter has experienced an unusually productive day, the benefits of which neither he nor his family will be able to consume. Rather than let the surplus go to waste, the hunter may be interested in bartering the excess for other goods or services. The surplus can be of some value and provide some utility to someone else, even though the unit itself has no residual use for

32. These examples are adapted in part from Sidhu, supra note 11, at 68-74.
33. See Paine, supra note 27, at 2 ("A thousand motives will excite them thereto; the strength of one man is so unequal to his wants, and his mind so unfitted for perpetual solitude, that he is soon obliged to seek assistance and relief of another, who in his turn requires the same. Four or five united would be able to raise a tolerable dwelling in the midst of a wilderness; but one man might labor out the common period of life without accomplishing anything: when he had felled his timber he could not remove it, nor erect it after it was removed; hunger in the mean time would urge him from his work, and every different want call him a different way.").
34. See id. ("Disease, nay even misfortune, would be death; for though neither might be mortal, yet either would disable him from living, and reduce him to a state in which he might rather be said to perish than to die.").
35. See Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 26-27 (R.H. Campbell & A.S. Skinner eds., Liberty Fund 1981) (1776) ("[M]an has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and shew them that it is for their own advantage to do for him what he requires of them. Whoever offers to another a bargain of any kind, proposes to do this... It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.") (emphasis added); cf. John Rawls, Political Liberalism 51 (1993) ("Every interest is an interest of a self (agent), but not every interest is in benefits to the self that has it. Indeed, rational agents may have all kinds of affections for persons and attachments to communities and places... Rational agents approach being psychopathic when their interests are solely in benefits to themselves."); R. H. Coase, Essays on Economics and Economists 95 (1994) ("Self-interest is certainly, in Smith's view, a powerful motive in human behaviour, but it is by no means the only motive.").
it. Perhaps most common and likely is the possibility that the hunter will think it convenient and wise to focus on his craft. Foregoing the opportunity to produce anything else in light of his dedication to hunting, he will be compelled to look to others for the necessary goods and services, such as specialized bows and arrows to use when tracking prey.  

With respect to "wants," suppose this farmer generates enough produce to satisfy the needs of himself and his family, but they are simply and understandably tired of eating the same products year in and year out. The farmer may therefore seek to trade some of his or her goods for others in order to obtain new food items, perhaps a species of fish that is not native to the region or spices from an exotic land that will improve the taste of his or her otherwise normal meals. On the further end of the "wants" spectrum is a situation that may be most familiar to contemporary Western society, wherein the purpose of the acquisition is exclusive and simple possession—not consumption—of the item. A piece of art exemplifies this category of transaction.

Each of these examples—in which man responds to needs or wants by interacting with others—demonstrates not only the limited capacity of man to satisfactorily operate by himself, but also the commensurate inevitability and necessity of social interaction, which exists independent of the presence of formal government. Importantly, in each scenario there is a reciprocal benefit. The injured or sick man obtains relief (or at least an attempted cure), while the service provider obtains compensation in some form; the hunter gets bows and arrows, while the craftsman venison; the farmer with excess food or a bored palette obtains haute cuisine, while the person he traded with receives something for which he was willing to part with the food; and the sophisticated consumer attains a piece of art to admire, while the artist is offset by some good or service in

36. See SMITH, supra note 35, at 37 (explaining that ultimately, man “supplies the far greater part of [his wants] by exchanging that surplus part of the produce of his own labour, which is over and above his own consumption, for such parts of the produce of other men’s labour as he has occasion for”).

37. See id. at 27 (“In a tribe of hunters or shepherds a particular person makes bows and arrows, for example, with more readiness and dexterity than any other. He frequently exchanges them for cattle or for venison with his companions; and he finds at last that he can in this manner get more cattle and venison, than if he himself went to the field to catch them.”).

38. Human needs are inherently part of nature, not government. See Jeanne L. Schroeder, The End of the Market: A Psychoanalysis of Law and Economics, 112 HARV. L. REV. 483, 493 n.25 (1998) (“‘Need’ is ‘the experiential counterpart to nature. Need comes as close to instincts as is possible in human existence.’”) (citation omitted). The human tendencies in response to such needs are considered, at least by some, to be independent of government as well. See Cass R. Sunstein, The Partial Constitution 138 (1993) (identifying “universal human needs” that are to be met in “any just society”); David Hume, Idea of a Perfect Commonwealth, in 1 ESSAYS: MORAL, POLITICAL, AND LITERARY 480, 481 (T. H. Green & T. H. Grose eds., 1875) (“All plans of government, which suppose great reformation in the manners of mankind, are plainly imaginary.”); cf. Lon L. Fuller, Reason and Fait in Case Law, 59 HARV. L. REV. 376, 386 (1946) (explaining that “there are certain human needs that are relatively constant, [however] the concrete expression that shall be given these needs is always conditioned by the social context in which they operate”).
return. In short, the promise of reciprocity and mutual benefit lies at the heart of viable social intercourse.

The concept of trust exemplifies this fundamental aspect of reliable transacting and itself becomes a commodity and quality in trade partners. Trust indicates that an individual possesses an understanding of the mutuality undergirding social interactions of an economic nature. Niall Ferguson, in his recent primer on the history of money and lending, astutely recognized that “money is a matter of belief, even faith: belief in the person paying us; belief in the person issuing the money he uses or the institution that honours his cheques or transfers. Money is not metal. It is trust inscribed.” Adam Smith similarly recognized that “[t]he success of people almost always depends upon the favour and good opinion of their neighbours and equals; and without a tolerably regular conduct these can very seldom be obtained. The good old proverb, therefore, that honesty is the best policy, holds, in such situations, almost always perfectly true.”

“Every man” in society, Smith posited, “lives by exchanging, or becomes in some measure a merchant.” As these interactions become more frequent, regular, and sophisticated, the ability of man to participate similarly becomes more refined and productive. It is in this fashion that “society itself grows to be what is properly a commercial society” and that commerce contributes to “benevolence and fellow feeling” by encouraging “intercourse and confidence among people and nations.” In sum, man meets his wants and needs only insofar as he is able to exchange, and it is trust and confidence that permit man to

39. Again, this is based on the expectation, articulated by Smith, that man will not act out of benevolence, but out of self-interest. See Smith, supra note 35.
40. See Smith, supra note 35, at 26 (“Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of.”).
41. Niall Ferguson, The Ascent of Money: A Financial History of the World 29-30 (2008); see Smith, supra note 35, at 292 (“When the people of any particular country have such confidence in the fortune, probity, and prudence of a particular banker, as to believe that he is always ready to pay upon demand such of his promissory notes as are likely to be at any time presented to him; those notes come to have the same currency as gold and silver money, from the confidence that such money can at any time be had for them.”).
42. Adam Smith, The Theory of Moral Sentiments 97 (Anthony Finley 1817) (1759).
43. Smith, supra note 35, at 37.
44. See id. at 28 (“[T]he certainty of being able to exchange all that surplus part of the produce of his own labour, which is over and above his own consumption, for such parts of the produce of other men’s labour as he may have occasion for, encourages every man to apply himself to a particular occupation, and to cultivate and bring to perfection whatever talent or genius he may possess for that particular species of business.”).
45. Id. at 37.
46. Gordon S. Wood, Revolutionary Characters: What Made the Founders Different 106 (2006). The benefits of free exchange between the people are such that some Framers viewed it as the role of a federal government to facilitate international commerce and replicate the same benefits on a global scale. See id. at 109 (noting that Jefferson and others believed that “commerce among nations in international affairs was the equivalent to affection among people in domestic affairs” and that they hoped foreign policy would be based on “the natural ties of commerce”); id. at 168 (“[F]or Madison, Jefferson, . . . Paine, [and others,] peaceful trade among the people of various nations became the counterpart in the international sphere to the sociability of people in the domestic sphere. . . . [T]hey envisioned[ed] a world held together by the natural interests of nations
expect the benefit of his bargain and transact reliably and orderly with others. As we will see, it is trust and confidence, the essential elements of a productive and sustainable society, which are implicated and endangered by the doctrine of efficient breach.

B. SOCIAL PATHOLOGIES AND GOVERNMENT

Human nature speaks to the underlying human condition, in which man has needs and wants, will respond affirmatively to meet them, and must interact with others as part of this response. Human nature, however, does not limit or dictate the means by which man may seek to meet these ends; it, in fact, admits of quite antisocial behavior. Man, as it turns out, is “ambitious, vindictive, and rapacious.” Accordingly, while man can exchange freely and fairly, man also may obtain goods, services, and other necessaries and conveniences in ways that do not respect the reciprocity or reflect the mutuality described above.

For example, a shepherd may be relieved of his sheep in the middle of the night by another without the shepherd’s consent or prior knowledge. He may be assaulted and have sheep physically taken from him. He may be threatened with violence and give up his sheep to escape an imminent beating. He may negotiate an exchange of sheep for what is represented as gemstones, only to find out later that the minerals are cheaper imitations. Man, acting free of restraint, may steal, take by force, intimidate, and defraud, among other things. In addition to expecting that man will not act benevolently and instead out of self-interest, it also must be accepted that man, in furthering his self-interest, may ignore completely the natural rights of others.

A functioning, healthy society cannot tolerate such behavior—the prospect of unregulated antisocial behavior breeds insecurity and thereby stifles intercourse in commerce.”; id. at 169 (discussing how commerce could achieve foreign policy interests without—and thus was a theoretical substitute for—war).

47. History is replete with examples of the brutality, cruelty, dishonesty, and callousness that man is capable of towards his fellow man. See, e.g., Hannibal Travis, Genocide in Sudan: The Role of Oil Exploration and the Entitlement of the Victims to Reparations, 25 ARIZ. J. INT’L & COMP. L. 1, 30 (2008) (table comparing death tolls of various genocides); id. at 29 n.150 (listing “other mass killings that may qualify as genocide but that are less often discussed in genocide case law and scholarly writing . . . “). See generally National Public Radio, War Crimes in the 20th Century: An Eight Part Series (1999), available at http://www.npr.org/programs/specials/warcrimes.


50. See HOBBES, supra note 23, at 85 (explaining that a state of nature equates to a “warre [sic] of every man against every man” wherein “there be no Propriety, no Dominion, no Mine and Thine distinct; but only that to be every mans [sic], that he can get; and for so long, as he can keep it”).
among the people and hinders the satisfaction of human wants and needs.\textsuperscript{51} Accordingly, proper society is predicated on some degree of regularity and security—the knowledge that transactions that are the product of an honest negotiation will be facilitated and those based on external, forced considerations curbed, if not eliminated.\textsuperscript{52}

The members of natural society are thus faced with two realities. First, a safe and regulated environment is a prerequisite for the regular, fair social intercourse in which the necessities and conveniences of life may be met.\textsuperscript{53} Second, that in a state of nature, the conscience of man alone is insufficient to provide the conditions for a secure community and guard against harmful social behavior, commercial and otherwise.\textsuperscript{54}

Accordingly, a supervisory agent—or “umpire”—is needed\textsuperscript{55} to keep the conduct of man within certain equally applicable, publicly known rules and thereby provide an orderly environment within which members of society can comfortably interact.\textsuperscript{56} The only object of this common power is “to preserve the members of . . . society in their lives, liberties, and possessions.”\textsuperscript{57} Restrictions on the original liberty of man generally may be traced directly to this sole justification and end of government.\textsuperscript{58}

\textsuperscript{51} Id. at 84 (“In such condition, there is no place for Industry; because the fruit thereof is uncertain: and consequently no Culture of the Earth; no Navigation, nor use of the commodities that may be imported by Sea; no commodious Building; no Instruments of moving, and removing such things as require much force; no Knowledge of the face of the Earth; no account of Time; no Arts; no Letters; no Society; and which is worst of all, continuall feare [sic], and danger of violent death; And the life of man, solitary, poore [sic], nasty, brutish, and short.”).

\textsuperscript{52} See FRIEDRICH A. HAYEK, THE ROAD TO SERFDOM 72-73 (1944) (“[The rule of law] means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge.” It also enables “people to predict the behavior of those with whom they must collaborate . . . .”).

\textsuperscript{53} See CHARLES DE SECONDAT MONTESQUIEU, 1 THE SPIRIt OF LAWS 151 (Thomas Nugent trans., Colonial Press 1900) (“The political liberty of the subject is a tranquility of mind arising from the opinion each person has of his safety. In order to have this liberty, it is requisite the government be so constituted as one man need not be afraid of another.”).

\textsuperscript{54} See The Federalist No. 51, at 322 (James Madison) (Clinton Rossiter ed., 1961) (“[W]hat is government itself but the greatest of all reflections on human nature? If men were angels, no government would be necessary.”); Oliver W. Holmes, The Path of the Law, 10 Harv. L. Rev. 457, 459 (1897) (noting the “distinction between law and morals” and that society is not comprised only of “good” men who find their “reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience”).

\textsuperscript{55} Locke, Of Civil Government, supra note 24, at 72 (“[T]here only is political society where every one of the members has given up his natural power, surrendered it into the hands of the community . . . . [T]hus . . . the community comes to be the umpire by settled standing rules, impartial and the same to all parties . . . .”).

\textsuperscript{56} See JEAN-JACQUES ROUSSEAU, ON THE SOCIAL CONTRACT 76 (Maurice Cranston trans., 1968) (noting that a common arrangement under a unified sovereign “establishes equality among the citizens in that they all pledge themselves under the same conditions and must all enjoy the same rights”).

\textsuperscript{57} Locke, Two Treatises, supra note 24, bk. II, ch. XV, § 171, at 209.

\textsuperscript{58} See J. Morris Clark, Guidelines for the Free Exercise Clause, 83 Harv. L. Rev. 327, 330-31 (1969) (“The purpose of almost any law can be traced back to one or another of the fundamental concerns of government: public health and safety, public peace and order, defense, revenue.”).
That a supervisory agent is needed to ensure the safety and welfare of the people is, of course, embraced by the United States. Its government—the entity to which members of the American political community have ceded their natural rights and from which these members expect a blanket of robust liberty and security—is to provide this basic, fundamental purpose. As explained in The Federalist Papers, “[t]he principal purposes” of the government are “the common defense of the members; the preservation of the public peace, as well against internal convulsions as external attacks; the regulation of commerce with other nations and between the States; the superintendence of our intercourse, political and commercial, with foreign countries.” Security and commerce are themes emphasized in other sections which make clear that the proposed federal government exists to secure the people against threats to their security, facilitate commerce with other political communities, regulate commercial intercourse more generally, and develop and manage a uniform system of currency to be used for trade.

Just as natural social interaction is premised on the possibility of mutually beneficial intercourse between members of society, a nation in which antisocial behavior is diminished and safety assured depends on the reciprocity of individual citizens. Each member must give up natural rights to a sovereign, consent to its regulatory and punitive powers, and agree to abide by the rules of conduct. In the immediate aftermath of the Civil War, the Supreme Court found occasion to reiterate the political theory of the nation: “When one becomes a member of [organized] society, he necessarily parts with some rights or privileges which, as an individual not affected by his relations to others, he might retain.” The resulting “body politic . . . is a social compact by which the whole people covenants with each citizen, and each citizen with the whole people, that

60. See *The Federalist* No. 41, at 256 (James Madison) (Clinton Rossiter ed., 1961) (“Security against foreign danger is one of the primitive objects of civil society.”).
61. See *The Federalist* No. 42, at 264 (James Madison) (Clinton Rossiter ed., 1961) (“The second class of powers lodged in the general government consist of those which regulate the intercourse with foreign nations . . . .”).
62. See *The Federalist* No. 22, at 143-44 (Alexander Hamilton) (Clinton Rossiter ed., 1961) (“[T]here is no object . . . that more strongly demands a federal superintendence” than the “want of a power to regulate commerce[,]”).
63. See *The Federalist* No. 42, at 267 (James Madison) (Clinton Rossiter ed., 1961) (noting that the government is vested with the power “to coin money, [and] regulate the value thereof”); *The Federalist* No. 30, at 188 (Alexander Hamilton) (Clinton Rossiter ed., 1961) (“Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion and enables it to perform its most essential functions. A complete power, therefore, to procure a regular and adequate supply of revenue, as far as the resources of the community will permit, may be regarded as an indispensable ingredient in every constitution.”).
64. See *Rousseau, supra* note 57, at 62 (submission to a common power entails “reciprocal commitment between society and the individual” wherein all individuals give up original liberty in exchange for protection).
all shall be governed by certain laws for the common good.” These laws “requir[e] each citizen to so conduct himself, and so use his own property, as not unnecessarily to injure another. This is the very essence of government . . . .”\textsuperscript{66} For a member to disregard his reciprocal obligations would be to undermine the common good and the protective benefits expected of a political society and to pull the collective community back towards a devolved, insecure and nasty natural state of man. If others follow suit and ignore their reciprocal commitments to their fellow members, “[t]he growth of this kind of injustice would bring about the ruin of the body politic.”\textsuperscript{67} The doctrine of efficient breach, as will be shown, effectively invites individuals to ignore the welfare of another and subvert the greater good in the process.

\section{II. The Transactions}

“[E]veryone else was doing it, and the profits were too alluring.”\textsuperscript{69}

With an understanding of human nature and the development of a commercial society, it is now appropriate to address the relevant transactions that take place within this human and social context: simple contracting, an efficient breach, and the subprime transactions that were the hallmark of the current economic crisis. The behavior of market participants with respect to these subprime transactions reveals how unilateral short-term profit-seeking, without any consideration for externalities or possible long-term consequences, can have remarkably negative effects on the economic welfare of society as a whole. This lesson from the subprime saga will be most useful in assessing the merits of the doctrine of efficient breach.\textsuperscript{70}

\subsection{A. Defining Efficient Breach}

A “contract” generally is a promise or set of promises, enforceable under the law, to do or not do something.\textsuperscript{71} A legally sufficient contract requires an offer,
acceptance, and consideration.\textsuperscript{72} For example, a situation in which a seller delivers lumber to a buyer and, in return, the buyer promises to pay the seller $5000 in thirty days would be regarded as a valid contract (performance for promise).\textsuperscript{73} Similarly, a contract would be said to exist where a seller promises to deliver lumber to a buyer in thirty days and, in return, the buyer promises to pay the seller $5000 on delivery of the lumber (promise for promise).\textsuperscript{74} By contrast, a seller delivering lumber to a buyer and, in return, the buyer giving the seller $5000 does not amount to a contract (performance for performance); this is a simple exchange or bargain that neither party can enforce by way of law.\textsuperscript{75}

An efficient breach is an aspect of contract law in which one party to a contract intentionally breaches in order to enter into a second opportunity and is better off even after compensating the non-breaching party.\textsuperscript{76} For example, imagine there is a seller—who has promised to deliver lumber in thirty days to a buyer who in turn has paid the seller $5000 for this commitment—who breaches the contract after fifteen days because he learned of a wealthy and desperate buyer willing to pay $15,000 for the same lumber. If the original buyer finds substitute lumber from another seller for $7500 to make up for the non-performance of the original seller, the original seller must give back the original buyer the original sale amount ($5000) and pay the damages incurred ($2500). As the original seller’s legal obligations are limited to paying compensatory damages, there is no punitive dimension to the original buyer’s remedies at law.\textsuperscript{77} In the end, the original seller is considered “better off” under the doctrine of efficient breach because his ultimate take-home ($15,000 minus the $7500 paid to the original buyer, or $7500 total) is greater than the amount of the original sale ($5000).\textsuperscript{78}

\textsuperscript{72} See Farnsworth, supra note 22, at 578.
\textsuperscript{73} See id.
\textsuperscript{74} See id. at 577-78.
\textsuperscript{75} See Holmes, supra note 54, at 462 (“The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else. . . . If you commit a [breach of] contract, you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference.”).
\textsuperscript{76} For information on why this is deemed “efficient,” see supra note 3.
B. SUBPRIME ACTIVITY

The present economic crisis is tied to a particular type of contracts—mortgages. Several factors created the conditions for a surge of mortgage contracts. The government’s interest in expanding home ownership and the people’s interest in getting in on rising home values contributed to an increased demand for housing. Low interest rates—designed in part to encourage economic activity in the aftermath of the September 11, 2001 terrorist attacks—furthered the attractiveness of and desire for homeownership. While some prospective homeowners undoubtedly qualified for and bought mortgages at the prime rates, others seeking property but unable to obtain such prime mortgages were offered and took subprime mortgage contracts, generally defined as loans sold to riskier borrowers at higher interest rates.

In other words, mortgages were available to individuals who had poor credit and were more likely to default on a loan at rates that pushed mortgage payments

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79. See Marvin N. Bagwell, Can't Live Without Air: Title Insurance and the Bursting of the Real Estate Bubble, 30 Pace L. Rev. 180, 206 (2009) (“The real estate bubble—more properly, the bursting of the bubble—is the parent of the crisis.”).

80. See Hank Paulson, Housing Policy Must Be Set on Sustainable Basis, WASH. POST, July 30, 2010, available at http://www.washingtonpost.com/wp-dyn/content/article/2010/07/29/AR2010072905007.html (“A significant root cause of the crisis was the combined weight of government policies promoting homeownership. . . . Homeownership was overstimulated to the point that it was unsustainable and dangerous to the broader economy.”).

81. See Chad D. Emerson, A Troubled House of Cards: Examining How the Housing and Economic Recovery Act of 2008 Fails to Resolve the Foreclosure Crisis, 61 Okla. L. Rev. 561, 567 (2008) (“The low interest rates [set by the Federal Reserve] not only navigated the economy through the post-9/11 challenges but also provoked such prolific lending that it would transform itself from the solution to the problem.”).

82. See Bank Regulation/Thrift Regulation, 23 No. 5 BANKING & FIN. SERVICES POL'Y REP. 13, 18 (2004) (reporting that “[l]ow interest rates have spurred strong demand for housing [and] rising rates of homeownership.”).

83. “Subprime” is distinct from “prime” as well as from another category of mortgages—“Alt-A”—which are towards the subprime end of the spectrum but are “near-prime.” Mortgage Market Turmoil; Causes and Consequences: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs, 110th Cong. 4 (2007) (statement of Roger T. Cole, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System). Because this Article focuses on the most dangerous of mortgage contracts, subprime, it will not dedicate attention to “Alt-A” activity.

84. See Oren Bar-Gill, The Law, Economics and Psychology of Subprime Mortgage Contracts, 94 CORNELL L. REV. 1073, 1087 (2009) (“In theory, subprime loans are sold to riskier borrowers. While low-risk borrowers get low price—specifically, low-interest-rate prime loans—high-risk borrowers get high price—specifically, high-interest-rate subprime loans.”); 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, 1016 (2009) ("[S]ubprime loans are generally targeted to borrowers who have tarnished credit histories and little savings available for down payments." (internal quotation marks and citation omitted)). But see C. Lincoln Combs, Comment, Banking Law and Regulation: Predatory Lending in Arizona, 38 Ariz. St. L.J. 617, 621 (2006) ("[T]he definition of the subprime market itself is difficult to pin down, and there is no standard within the mortgage industry upon which to base this definition.") (citing Kathleen C. Engel & Patricia A. McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 Tex. L. Rev. 1255, 1350 (2002)).
at the margins of or beyond what the individuals could realistically afford.\textsuperscript{85} Subprime mortgage contracts requiring borrowers to put little or no money down were particularly alluring,\textsuperscript{86} but they only exacerbated the likelihood of default. Borrowers did not have to meet a threshold of financial wherewithal, and the borrowers' personal investment into the property was limited and thus minimally deterred borrowers from walking away.\textsuperscript{87} Subprime activity was lacking other safeguards, as well. For example, lenders approved subprime loans without looking into a borrower’s income or assets.\textsuperscript{88}

Why would lenders extend mortgage contracts to individuals who were bad credit risks, where the loan terms rendered loan satisfaction a modest prospect, where the borrowers did not have to meaningfully demonstrate their financial soundness, and where the lenders themselves seemingly turned a blind eye to the financial condition of the borrowers? Quite simply, lenders charged significant fees to borrowers for originating subprime loans\textsuperscript{89} and subsequently sold the mortgages to Wall Street, which in turn created securities backed by these loans.\textsuperscript{90} Lenders not only made money in selling the loans, but did so by passing the risks associated with the subprime mortgages to financial investors.\textsuperscript{91} In short, loan “[o]riginators were hardly bothered by this lack of creditworthiness because they were able to sell the loans they made to promoters who bundled

\textsuperscript{85} See Kurt Eggert, \textit{The Great Collapse: How Securitization Caused the Subprime Meltdown}, 41 CONN. L. REV. 1257, 1272 (2009) (“Subprime loans are typically more prone to default than prime, resulting in the generally higher interest rates and fees that subprime borrowers pay. Even before the subprime crisis, non-prime loans were estimated to be six times as likely to go into default as prime loans. However, attempting to compensate for risk by charging higher prices for subprime loans only adds to the risk, as the higher interest rate and/or fee makes the subprime loan more likely to default.”).

\textsuperscript{86} See Lauren E. Willis, \textit{Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price}, 65 Md. L. Rev. 707, 779 (2006) (“No money down and a quick decision were more frequently cited by subprime borrowers than by borrowers overall as reasons for choosing a particular lender or broker.”).

\textsuperscript{87} See Jacob Werrett, \textit{Achieving Meaningful Mortgage Reform}, 42 CONN. L. REV. 319, 323-24 (2009) (commenting on the fact that borrowers could obtain these subprime loan products by investing little to none of their own money).

\textsuperscript{88} See Daniel J. Morrissey, \textit{The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review}, 44 U. Rich. L. Rev. 647, 666 (2009) (“With cheap money and home prices soaring, banks and other mortgage-makers eased their lending policies, creating the ‘liar loan’ phenomenon where mortgages [were] approved without requiring proof of the borrower’s income or assets.” (internal quotations omitted) (alteration in original)).

\textsuperscript{89} See Bar-Gill, \textit{supra} note 84, at 1104 (“[T]he lender charges fees for administrative services associated with the loan-origination process, such as preparing documents, notarizing documents, and sending e-mails, faxes, and courier mail. . . . Some subprime lenders charge up to fifteen different origination fees, and these fees can add up to thousands of dollars or up to 20 percent of the loan amount.”); Oren Bar-Gill & Elizabeth Warren, \textit{Making Credit Safer}, 157 U. Pa. L. Rev. 1, 39 (2008) (referencing a Wall Street Journal article for the proposition that “mortgage brokers received 27% higher fees for originating subprime mortgages than for originating conforming loans” (citation omitted)).

\textsuperscript{90} See, e.g., Rick Brooks & Constance Mitchell Ford, \textit{The United States of Subprime: Data Show Bad Loans Permeate the Nation; Pain Could Last Years}, WALL ST. J., Oct. 11, 2007, at A1 (“Wall Street bought lots of subprime loans and packaged them into securities for sale to investors.”).

\textsuperscript{91} See Eggert, \textit{supra} note 85, at 1259 (observing that by selling the loans to Wall Street, “subprime lenders could quickly unload much of the risk of the subprime loans”).
them to back [securities] that were sold by Wall Street firms."

For their part, investment houses profited. "Wall Street firms not only received interest on the short term loans, but also additional fees from the increased subprime securitization." These firms also transferred the risks inherent in these subprime mortgages to investors, who purchased the mortgage-backed securities in secondary markets, and to purchasers of credit default swaps, financial instruments which were effectively bets against the viability of the mortgage-backed securities. To induce investors, Wall Street engineered these securities such that the rating agencies would confer top ratings onto the securities, giving the impression that the borrowers in the underlying mortgage contracts were good credit risks. The credit agencies themselves not only generated revenues from assigning ratings to the securities but also counseled Wall Street firms on how the securities might be packaged to receive favorable credit ratings.

Such profit-driven behavior had a cyclical effect. Wall Street's interest in subprime mortgages that could be securitized soared, with firms seeking and obtaining more of the high fees that attended the high-risk loans. Lenders, in selling subprime loans to the financial institutions, were able to "recoup the money lent and relend it to new subprime borrowers." As the universe of borrowers dwindled and the best credit risks were siphoned off the top, in order to

94. See Wilmarth, supra note 84, at 969 (posing that financial institutions distributed securities backed by subprime mortgages, in part, to "transfer to investors (at least ostensibly) the risks associated with securitized loans and other structured-finance products").
95. See Douglas G. Baird & Robert K. Rasmussen, Antibankruptcy, 119 YALE L.J. 648, 679 (2010) ("A credit default swap is a two-party contract under which one party (the protection seller) acquires the credit risk of a loan from a counterparty (the protection buyer) in exchange for a fee. If there is a default or some other ‘credit event’ (such as bankruptcy) on the loan, the protection buyer receives cash equal to the face value of the loan.").
96. See Eggert, supra note 85, at 1266 ("The securitization is set up so that the majority of the resulting securities would be rated AAA by the rating agencies, indicating that they should be highly secure."); see also Roger Lowenstein, Triple-A Failure, N.Y. TIMES, Apr. 28, 2008, § MM, at 36 (describing the credit rating process); Karl S. Okamoto, After the Bailout: Regulating Systemic Moral Hazard, 57 UCLA L. REV. 183, 200-02 (2009) (discussing credit ratings and different tranches of securities).
97. See Stephen Labaton, Debt-Rating Agencies are Under Scrutiny by S.E.C., N.Y. TIMES, Sept. 27, 2007, at C4 ("[Credit agencies] simultaneously rated various mortgage-backed securities and provided advice to Wall Street investment firms about how to package them so as to gain higher credit ratings. The credit agencies also receive fees from the investment firms.").
98. See Wilmarth, supra note 84, at 970 ("The volume of nonprime mortgages rose from $250 billion in 2001 to $1 trillion in 2006. Nearly 10 million nonprime mortgages were originated between 2003 and mid-2007."); id. at 1016 ("Subprime loans increased from $190 billion in 2001 to $540 billion in 2004, $625 billion in 2005 and $600 billion in 2006.").
99. See The Role of the Secondary Market in Subprime Mortgage Lending: Hearing before the H. Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs., 110th Cong. 67 (2007) [hereinafter The Role of the Secondary Market] (prepared testimony of Michael D. Calhoun, Center for Responsible Lending ("[T]he growth of the subprime market offered mortgages that provided a higher-risk investment with potential for higher returns. Wall Street became ravenous for these loans, seeking mortgages that provide a high yield.").
100. Eggert, supra note 85, at 1259.
meet Wall Street's demand for subprime mortgages and ensure their own commissions, lenders became increasingly lax in their already flexible practices—again rendering satisfaction of the loan terms a distant possibility and default close to a certainty.  

Psychology helps explain the spiraling, viral behavior of each of the actors in the subprime crisis. Yale economist Robert Shiller notes that "the ultimate cause of the global financial crisis is the psychology of the real estate bubble," specifically the spreading belief among the varying actors in the subprime market that the short-term gains would continue indefinitely. Shiller identifies this "social contagion" as "the most important single element" to understanding the real estate boom. A leading account of the financial crisis describes how individual agents in the aforementioned subprime network "couldn't resist" the underlying transactions "because, well, everyone else was doing it, and the profits were too alluring."  

C. CONSEQUENCES OF THE SUBPRIME ACTIVITY

As everyday individuals yielded to pervasive social interests in homeownership, facilitated by government incentives, the demand for homes rose, and prices escalated accordingly. As individuals continued to enter the real estate market, significant revenues continued to be generated for various actors in the financial sector. But this process, which relied on new homeowners for its sustainability, ultimately shut down. The high housing prices were the product more of national speculation about the value of homeownership than of objective indicia of home value. A market correction ensued, closing the gap between the values anticipated by the psychological groupthink and the values dictated by economic fundamentals, and thus leading to a decline in home values.  

101. See The Role of the Secondary Market, supra note 99, at 67 ("Th[e] demand from Wall Street encouraged subprime lenders to abandon reasonable qualifying standards, to forget about standard documentation requirements, and to ignore whether borrowers could actually afford the loan."); Bar-Gill, supra note 84, at 1075 ("During the five years preceding the crisis, the subprime market experienced staggering growth as riskier loans were made to riskier borrowers."); WilmARTH, supra note 84, at 1020-24 (addressing the increasing riskiness of subprime loans).


103. Id. at 41.

104. Barrett, supra note 69.


106. See id. at 4 ("Economic fundamentals do not match up with the price increases.").

107. See Sec'y Henry M. Paulson, Jr., Remarks at The Ronald Reagan Presidential Library (Nov. 20, 2008), available at http://findarticles.com/p/news-articles/political-transcript-wire/mi_8167/is_20081120/secretary-treasury-henry-paulsons-remarks/ai_n50786329 ("The U.S. housing correction was clearly the spark that ignited the financial crisis.").
2008, these dropped by an estimated $6 trillion,108 and in 2008 home prices dropped twenty percent, the largest decline in seven decades.109 The bubble burst.

Borrowers with subprime mortgage contracts were unable to meet their loan obligations—an unsurprising result given that they were high-risk consumers and the mortgage rates were above prime. The jig was effectively up with the correction in home pricing; the readjusted, depressed value of the borrowers’ homes was exceeded by the mortgage contracts, and refinancing options were scarce.110 Borrowers began to default on their payments and foreclosures followed.

The consequences are devastating. In 2008 alone, a record of more than two million homeowners lost their homes to foreclosure.111 Five million more homeowners are estimated to have lost their homes in 2009 and 2010.112 To provide a sense of scope, in September of 2008 roughly 24% of mortgages were in default and 11.5% in foreclosure.113 In November 2008, 42.5% of subprime mortgages were “seriously delinquent.”114 The loss of ownership in homes impacted another class of individuals—renters—“who clearly had no role in the mortgage process,” but nonetheless “found themselves with little notice to vacate their homes.”115 With homeowners and renters compelled to leave residential properties, “[n]eighborhoods around the country were littered with vacant and abandoned properties, which can depress the values of nearby homes and create havens for blight and crime.”116 One can only imagine the effect on major cities such as Phoenix, where the foreclosure rate was thirty-three percent, and Los Angeles, where the rate was thirty-four percent.117

Families of homeowners and renters were kicked out of their homes, while Main Streets were depleted by as much as a third of their residents. As for Wall

108. Wilmarth, supra note 84, at 967.
110. See Shane M. Sherlund, The Past, Present, and Future of Subprime Mortgages 11 (Bd. of Governors of the Fed. Reserve Sys., Fin. & Econ. Discussion Series Paper No. 2008-63, 2008) (“House price appreciation seems to be the primary determinant of default and prepayment behavior. Borrowers with subprime mortgages could more easily prepay when house price appreciation was high (almost regardless of the initial credit quality of the loan), but found it more difficult to prepay once house price appreciation slowed and turned negative.”) (quoted in Bar-Gill, supra note 84, at 1135 n.215).
111. See McClendon, supra note 109, at 132.
113. Id. (citation omitted).
114. Id. (citation omitted).
116. Id.
117. See Green, supra note 112, at 12 n.21 (citation omitted).
Street, financial institutions entangled in subprime behavior incurred $1.32 trillion in losses as of mid-2009, which was projected to rise to $3.1 trillion by the end of 2010.118 Seventeen major institutions heavily involved in subprime lending were crippled as a result. For example, Lehman Brothers filed for bankruptcy while others escaped total ruin by being bailed out or nationalized by governments (Citigroup, Bank of America, AIG, RBS, UBS) or by being salvaged by fellow private entities (Bear Stearns, Merrill Lynch, Wachovia, Washington Mutual, National City, and Countrywide).119 Financial bailouts by the U.S. government—a burden effectively borne by U.S. taxpayers—are estimated to total $9.7 trillion.120 The financial sector generally took a significant hit; the value of the Dow Jones Wilshire 5000 index was reduced by $6.9 trillion in 2008, its worst year ever,121 while the total loss in global trade is estimated to exceed $50 trillion.122

As noted above, trust is the essential cornerstone of a well-functioning economic society.123 At the most fundamental and pervasive level, the financial meltdown led to a multi-faceted “crisis of confidence” in which trust in the economy was depleted. As Thomas Friedman notes, “it’s all about confidence.”124 At one level, consumers and the public at large lacked trust in financial institutions.125 In other words, there were concerns that financial institutions—the entities blamed for the poor economic condition of the nation—could not be

118. See Wilmarth, supra note 84, at 1043-44, 1046.
119. See id. at 1044-46.
123. See supra notes 41-46 and accompanying text.
124. See Thomas L. Friedman, Rescue the Rescue, N.Y. TIMES, Oct. 1, 2008, at A29 (“This is a credit crisis. It’s all about confidence. What you can’t see is how bank A will no longer lend to good company B or mortgage company C. Because no one is sure the other guy’s assets and collateral are worth anything . . . .”).
125. See Raymond H. Brescia, Trust in the Shadows: Law, Behavior, and Financial Re-Regulation, 57 BUFF. L. REV. 1361, 1362-63 (2009); see also Bob Tedeschi, Ethics Standards for Brokers, N.Y. TIMES, Nov. 4, 2007, at 11 (“Mortgage brokers, who have borne much of the blame in recent months for the subprime mortgage crisis, are now trying [to] reassure borrowers that they are worthy of trust.”).
counted on to remain solvent and do right by the people’s hard-earned money. This belief had a significant domino effect; as the people could not differentiate between “trustworthy” banks and those undeserving of trust, consumers and investors “put their money under their mattresses rather than in banks.”

At another level, the crisis of confidence took hold of the financial institutions themselves. Even if these institutions had sufficient capital to lend, they were uncertain as to the true value of securities. In addition, banks lacked trust in prospective borrowers. First, banks were distrustful of each other and thus were disinclined to lend to other banks. Second, banks were uncertain as to which businesses and individuals were genuinely trustworthy under recalibrated and more sensible credit standards.

Credit froze as a result of these crises of confidence. The consequences of a barren credit market reached far and wide, leaving businesses and families in the dust. Indeed, banks’ inability or unwillingness to lend means that “businesses cannot meet their payrolls and so must fire employees, who cannot repay their mortgages or buy goods from other businesses, and so forth.” This is precisely why an absence of trust has been called “the kiss of death on Wall Street, where

126. See, e.g., Richard K. Gordon, On the Use and Abuse of Standards for Law: Global Governance and Offshore Financial Centers, 88 N.C. L. Rev. 501, 541 (2010) (“The failure of any bank may lead to the failure of other banks, and even a loss of confidence in the entire banking system.”); Kenneth Ayotte & David A. Skeel, Jr., Bankruptcy or Bailouts?, 35 J. Corp. L. 469, 472 (2010) (suggesting that news that a major investment bank [Lehman] was “financially distressed” was the cause of “the general disruption and crisis of confidence”).


130. See Helene Cooper & Eric Dash, Obama Presses Biggest Banks to Lend More, N.Y. Times, Dec. 14, 2009, at A1 (In response to President Obama’s insistence that banks lend to small businesses and homeowners, banks noted that they have a “responsibility to carefully evaluate the qualifications of each client, lest there be a repeat of the bad lending practices that contributed to the financial crisis to begin with.” One bank executive remarked in explaining the limited lending that, “We simply want to assure that we make qualified loans.”); see also Press Release, The White House, President Obama and Secretary Geithner Announce Plans to Unlock Credit for Small Businesses (Mar. 19, 2009), available at http://www.whitehouse.gov/the_press_office/President-Obama-and-Secretary-Geithner-Announces-Plans-to-Unlock-Credit-for-Small (“[A}s the flow of credit has dried up during this recession, small business owners who were prudent and responsible have been set back by the behavior of others in our financial system who were not. Businesses with strong credit histories have seen loan applications denied due to conditions that have nothing to do with their own actions and are now struggling to expand their businesses, make their payments or even keep workers on their payrolls.”).

confidence has always been the most precious asset of all," and precisely why President Obama deemed financial institutions “essential to our economy.” “They provide capital and credit to families purchasing homes, students attending college, businesses seeking to start up or expand,” he explained. Without such capital and credit, banks cannot lend to businesses that in turn cannot keep people on the rolls or bring on new hires. The American people identified unemployment as the most important domestic issue facing the nation, as jobs are relatively difficult to come by because of this dire capitalization and credit situation. Indeed, unemployment nationally is hovering around ten percent, with 14.8 million unemployed and another 9.4 million “underemployed.”

III. ANALYSIS

“The individual, short-term actions of a bond trader or subprime lender may make sense in that they will yield a quick profit, but taken together ... the behavior of the herd can destabilize the entire system ...”

The question becomes how the subprime financial activity that rocked the very foundation of the economy relates to the doctrine of efficient breach and, as a corollary, how the significant consequences of subprime behavior forecast, or are indicative of, any possible negative effects of efficient breaches. As it turns out, there are meaningful, undeniable similarities between the subprime transactions and efficient breaches. Accordingly, the problems associated with subprime activity apply and may pass over this link, forged and reinforced by several shared characteristics, to efficient breaches. It is the purpose of this section to make clear the already extant similarities between the two and to thereby suggest that the doctrine should be condemned and retired as an element of primary contract law instruction.

134. White House Press Release, supra note 133.
136. See Pfeffer, supra note 16.
137. Barrett, supra note 69.
A. THE RELATIONSHIP BETWEEN SUBPRIME ACTIVITY AND EFFICIENT BREACH

There are strong parallels between subprime transactions and efficient breaches such that the lessons from the former ought not to be ignored with respect to our view of the latter. At least five factors establish links between the two forms of contracting in society:

1. OPPORTUNISM

Subprime transactions and efficient breaches are both opportunistic in nature. While economic actions are inherently self-interested, opportunism is decidedly different. It generally may be defined as "self-interest seeking with guile" or pursuing self-interest in ways that do not respect "norms of fair dealing, good faith, and candor." Opportunism "may arise when one party realizes that the other cannot effectively retaliate if the first party unexpectedly changes the course of its dealings to exact a transfer of wealth" or when there are "information asymmetries" such that "the party that holds the information advantage can selectively or inaccurately present information to the other party."

There is little doubt that financial agents acting in the subprime market displayed acute opportunism of both stripes. First, borrowers taken in by the promise of homeownership and presentation of ostensibly sound mortgage products were left with no recourse against the lenders when the value of their homes inevitably experienced a correction, when the initial rates of their mortgage contracts escalated, or when there was an absence of refinancing options. Their response was effectively limited to default and foreclosure. "Retaliation," as it were, was impossible as the lenders passed risks inherent in the subprime mortgages to others. Second, lenders took significant advantage
of informational asymmetries in knowingly offering risky and complex loan instruments to unsophisticated borrowers without the options to make meaningful choices in their loan options, and without an understanding that their loans were not offered as sustainable means to homeownership on Main Street but were presented to create securities that enriched Wall Street.142

An efficient breach is per se opportunistic. In an efficient breach, by definition, a party intentionally breaks a legally binding agreement with another in order to take advantage of a second, more profitable deal where the breaching party can compensate the non-breaching party. A deliberate breach is perhaps the exact opposite of good faith. In addition, an efficient breach falls within the traditional meaning of opportunism. First, as will be detailed below, in an “efficient breach” situation, a non-breaching party that enters into a contract only to have it breached by a party seeking a better deal is not able to fully recover from the breaching party because an efficient breach does not contemplate—or therefore require the breaching party to compensate—all of the losses that a non-breaching party may incur.143

An efficient breach is a product of informational asymmetry in that a breaching party holds the critical cards. For example, the breaching party holds out to the other party that he will hold his promise or perform, as reflected in the contract. But unbeknownst to the non-breaching party, the party in breach knows that he is considering or shopping for other contracts, estimates idiosyncratic values of performance and non-performance based on the possibility of accepting a new contract, and ultimately knows of his intention to breach the original contract despite the other party’s expectation of performance.144 The doctrine of efficient breach does not require or encourage the disclosure of such private information to

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142. See, e.g., Raymond H. Brescia, Part of the Disease or Part of the Cure: The Financial Crisis and the Community Reinvestment Act, 60 S.C. L. REV. 617, 621 (2009) (“[I]nformation asymmetries existed between prospective borrowers and brokers because the industry representatives had greater information than the borrowers about the mortgage market, the impact of exotic loan terms, and the risks associated with expectations of perpetual growth in housing values.”); Brescia, supra note 125, at 1396 (“Mortgage brokers in the subprime mortgage market exploited asymmetries of information to market and sell mortgage products to prospective borrowers from communities where credible lending options were scarce.”).

143. As will be discussed below, remedies for an efficient breach are not sufficient to offset the losses of the non-breaching party. See infra notes 162-68 and accompanying text.

144. All of this information exists prior to breach. The doctrine of efficient breach, however, is concerned only with information—i.e., actual costs and benefits—at the time of breach. See, e.g., Eric A. Posner, Economic Analysis of Contract Law After Three Decades: Success or Failure?, 112 YALE L.J. 829 (2003) (distinguishing between efficient breaches, which look to valuations at the time of a breach, with other rules that examine the parties’ expectations before performance).
level the imbalance between the breaching party and non-breaching party.145 Put differently, the promisor has the “right to substitute efficient breach for performance upon payment of expectation damages.”146 What the non-breaching party receives—performance or damages—is entirely up to the breaching party and need not be communicated to the non-breaching party until the actual breach.

2. UNILATERAL INTEREST

The flip-side of self-centered opportunism is a complete disregard for the other party to a transaction; the other party is not treated as a mutual beneficiary of a given deal, but rather as a means for one-sided profit-making. This unilateral interest in financial dealings with another person is a second trait common to subprime activity and efficient breaches.

With respect to subprime mortgage contracts, as noted above, the actors in the subprime market transferred risks associated with the loans to others, thus relinquishing any interest in the continued viability of the original transaction between the lender and borrower or any residual care for how the homeowner fared in the aftermath of their contractual agreement.147

An efficient breach is by definition unilateral.148 Melvin A. Eisenberg writes, “the theory of efficient breach contemplates unilateral termination of contracts by

145. Indeed, in contrast to the doctrine of efficient breach, which is indifferent to the informational idiosyncrasies between the parties, legal scholars have observed that rules inducing parties to voluntarily disclose their private understandings of the contract and valuations with respect to performance would maximize both mutuality and efficiency. See generally, e.g., Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 YALE L.J. 87 (1989); Charles J. Goetz & Robert E. Scott, The Mitigation Principle: Toward a General Theory of Contractual Obligation, 69 VA. L. REV. 967 (1983).


147. See, e.g., Vazire, supra note 141, at 59 (“Subprime mortgage loan originators increasingly made loans with the intention of selling them quickly into the secondary market. . . . Because they would no longer bear the long-term (or sometimes even short-term) risk of borrower default, originators became unconcerned with ensuring their loans’ viability. Instead, originators’ new concern was ensuring that there would be a secondary market purchaser for each loan.”); Cassandra Jones Havard, Democratizing Credit: Examining the Structural Inequities of Subprime Lending, 56 SYRACUSE L. REV. 233, 264 (2006) (“[T]he presence of the secondary market makes individual lenders calloused to the actual performance of the loan. Securitization allows lenders to divert the costs of subprime loans to borrowers who are already economically at risk. . . . Unless and until the secondary market [compels lenders to care about performance of the underlying loans], subprime lenders will be allowed to be unconcerned about loan delinquencies, or the costs and consequences of those delinquencies to individual homeowners.”).

the promisor without the consent of, or even discussion with, the promisee.” 149

The willful breach of a contract indicates the breaching party’s interest in his own economic welfare and a commensurate disinterest in the non-breaching party’s expectations as to performance and the aftermath in which the breaching party will be compelled to find, negotiate, and secure performance from another party. While the breaching party likely will attempt to ascertain the non-breaching party’s losses in the event of a breach, this is done only in so far as to determine whether the breach will be advantageous to the breaching party. Moreover, a breach is said to be efficient if the breaching party can—though is not required to—pay damages to the non-breaching party that are exceeded by the profits from a second deal. 150

3. SHORT-TERM THINKING

Individuals engaged in subprime lending or efficient breaches seek only short-term gains and lack long-term perspectives as to their economic behavior. The subprime crisis was typified by financial actors who were interested in receiving significant immediate benefits from mortgage fees and securities backed by subprime mortgages, and whose long-term thinking was confined to ensuring that there remained a steady stream of accepted mortgages that could be commodified and sold off. 151 For example, while this stream was dependent upon the housing market, financial actors, ostensibly content with the short-term gains, neglected to assess whether the real estate values were excessively—and unsustainably—set in the long-term. 152 This myopia ultimately crippled large

149. Melvin A. Eisenberg, Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law, 93 CALIF. L. REV. 975, 1019 (2005); see also id. at 1000 (“[Generally,] a contract can be terminated in two very different ways—mutually, by rescission, or unilaterally, by breach. The theory of efficient breach contemplates only unilateral termination by breach . . . .”).

150. See supra notes 3-4.

151. See Press Release, The White House, Weekly Address: President Obama Applauds Important Step Forward on Financial Reform (Dec. 12, 2009), available at http://www.whitehouse.gov/the-press-office/weekly-address-president-obama-applauds-important-step-forward-financial-reform (stating that the economic crisis was due in large part to “the irresponsibility of large financial institutions on Wall Street that gambled on risky loans and complex financial products, seeking short-term profits and big bonuses with little regard for long-term consequences”); see also Raymond H. Brescia, Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response, 56 CLEV. ST. L. REV. 271, 299-300 (2008) (“One of the chief causes of the crisis is the fact that subprime mortgage loans were made under market forces that encouraged brokers and originators to promote mortgages with little regard for the viability of the borrower, driven by a short-term desire for the profits generated by mortgage origination and securitization, as opposed to the long-term concerns that surround safe and sound lending practices.”); Steven A. Ramirez, Subprime Bailouts and the Predator State, 35 U. DAYTON L. REV. 81, 84-85 (2009) (noting that the economic meltdown stemmed from large financial institutions that, from 2004-2007, “pursued short-term profits without regard to risks borne by their firms in one of the greatest credit bubbles in history”).

152. See SHILLER, supra note 102, at 31; see also Frank Rich, Who Wants to Kick a Millionaire?, N.Y. TIMES, Dec. 21, 2008, § WK, at 10 (criticizing Wall Street’s “illusory short-term profits and long-term ignorance”). Comparing executives and employees at Wall Street firms to “gamblers at a casino” who could “collect their winnings while the roulette wheel was still spinning” aptly illustrates how they were enriched in the short-term
financial institutions unprepared for the inevitable correction of speculative home
values; indeed, "AIG literally gambled its viability away in the name of short-term profits."153

The doctrine of efficient breach operates in a closed or "limited universe"154
that begins and ends with the two opportunities presented in the two contracts—
the original deal and the apparently more lucrative one. An efficient breach looks
no further. In other words, an efficient breach is by definition short-term in nature
and does not consider any long-term considerations outside of the two necessary
contracts needed for an efficient breach situation.155

4. INDIFFERENCE TOWARDS POTENTIAL THIRD-PARTY OR SOCIETAL CONSEQUENCES

Subprime activity and efficient breaches exhibit not only temporal shortsight-
edness, but also a deliberate indifference towards the consequences of their
actions on third parties or on society generally. In the subprime situation, we have
seen that loan originators and brokers were unconcerned with borrowers, let
alone third parties or the viability of the American economy, as they hoped only
to simply package and transfer the risks associated with them.156 With respect to
an efficient breach, its "closed" universe consists only of the initial contract
between the breaching party and the non-breaching party, and a second more
attractive deal between the breaching party and a third party. There is no
consideration or acknowledgment of any individuals other than these parties in
the efficient breach calculus.

Indeed, proponents of the doctrine of efficient breach, consistent with the law
and economics principles that give life to the doctrine, condone the particular
subprime transactions that led to the economic meltdown. For example, Judge
Posner contends that the individual actions of actors in the subprime market—
borrowers and bankers—were completely "rational" and in keeping with their
respective self-interests.157 Judge Posner concedes, however, that these actions,
taken as a whole, were significantly disastrous for society.158 But the doctrine of
efficient breach looks only to individual transactions, thus turning a blind eye to

155. See, e.g., David Baumer & Patricia Marschall, Willful Breach of Contract for the Sale of Goods: Can the Bane of Business Be an Economic Bonanza?, 65 Temp. L. Rev. 159, 171 (1992) ("Viewed in isolation, the surplus value created by a contract may be enhanced if a deliberate breach occurs, but the long-term effects on business relationships are abstracted out of the analysis.").
156. See supra notes 90-92 and accompanying text.
158. See id. at 106, 112. There should be little doubt that each individual subprime transaction has social
the problems they may collectively exact on the market or society more broadly.

5. PRESENCE OF ACTUAL EXTERNALITIES

This disregard of long-term consequences or the impact on others is particularly important as both subprime behavior and efficient breaches generate significant negative externalities. These externalities may be categorized into two general categories: the transactional and the fundamental.

First, accounts of the present economic downturn are replete with examples of negative externalities created by subprime transactions and imposed on borrowers, neighborhoods, and cities. Such negative transactional externalities are many and include, for starters, lost jobs, abandoned houses, and depleted cities, resulting in lowered home values in developments and towns, an enhanced specter of crime, and a greater demand on public services such as police protection. Moreover, because of the resulting frozen credit market, businesses and individuals have been precluded from obtaining loans to expand their operations, employ workers, and buy properties, among other things, and have been forced to bear the costs of locating alternative means of securing credit. All the while, billions of dollars were diverted from general public use and the American taxpayers bankrolled large financial institutions and the broader economy to bring them from the brink.

A breach generally is said to be efficient if the breaching party is able to compensate the non-breaching party and come out ahead. The non-breaching party is compensated, economic theory posits, if he is "indifferent" to performance or an award of damages. The compensation to be paid to the non-breaching party under the doctrine is expectation damages, defined generally as "[c]ompensation awarded for the loss of what a person reasonably

(159) See, e.g., Bar-Gill, supra note 84, at 1137 ("First, borrowers will face higher rates for other credit transactions and reduced access to credit. Second, borrowers will lose some or all of their accumulated home equity if the lender forecloses. Finally, the borrower will have to bear the transaction costs of relocating to another house or apartment.").

(160) See, e.g., Kathleen C. Engel, Do Cities Have Standing? Redressing the Externalities of Predatory Lending, 38 CONN. L. REV. 355, 356-60 (2006) (describing the externalities of predatory loans, a subset of subprime mortgages, on cities, including declining property values, home vacancies and area decay, increased demands for police protection and sanitation services, and diminished tax revenues); Bar-Gill, supra note 84, at 1136 n.220 (referencing articles on externalities imposed on neighborhoods and cities).

(161) See Warkol, supra note 2, at 321-22.

(162) See Eyal Zamir, The Missing Interest: Restoration of the Contractual Equivalence, 93 VA. L. REV. 59, 118 (2007) ("Full expectation damages make the promisee indifferent between performance and breach while at the same time making the promisor (and society at large) better off.").

(163) See Tess Wilkinson-Ryan, Do Liquidated Damages Encourage Breach? A Psychological Experiment, 108 MICH. L. REV. 633, 634 (2010) ("Economists claim that the theory of efficient breach allows us to predict when parties will choose to breach a contract if the legal remedy for breach is expectation damages.").
anticipated from a transaction that was not completed." But expectation damages fail to account fully for the losses, particularly certain transactional costs, incurred by the non-breaching party. The doctrine does not consider, for example, the expenses that the non-breaching party may incur in attempting to recover a compensatory sum through adversarial dispute resolution mechanisms, such as mediation or litigation. Nor do expectation damages consider the non-breaching party's "disappointment, annoyance, [and] even actual emotional distress." Thus, it can hardly be said that expectation damages would make a non-breaching party "indifferent" towards breach. As a result, a breach that is "efficient" within the meaning of the doctrine may nonetheless generate externalities and ultimately leave the non-breaching party worse off.

Second, subprime behavior and efficient breaches are bound by a more fundamental set of externalities. The characteristics of subprime behavior and an efficient breach—opportunism, disregard for the other contracting party, short-term thinking, indifference towards third parties and society, and the presence of significant externalities—reflect the undermining of trust and reciprocity that form the basis for all orderly and reliable economic interactions between members of society. A breach directly and unilaterally breaks the bond between contracting parties and elevates individual self-interest above the mutuality that is to be expected from voluntarily assumed agreements formalized by contracts. As to subprime behavior, the shifting of risks to other actors in the market acts to sever the relationship between the original parties to a contract and create an irrevocable and growing distance between the lender and the borrower. Quite simply, "[t]he subprime mess came from violation of trust."

B. LESSONS APPLICABLE TO THE DOCTRINE OF EFFICIENT BREACH

Subprime behavior shows that economic transactions marked by the aforemen-

164. BLACK'S LAW DICTIONARY 394 (7th ed. 1999).
165. See William J. Woodward, Jr., Contractarians, Community, and the Tort of Interference with Contract, 80 MINN. L. REV. 1103, 1143 (1996) ("Even if the promisor were to pay damages voluntarily, the promisee would probably expend time and energy to get the money.").
166. Id.
167. See id. at 1144-45 ("[I]n our system of expectation damages, the plaintiff will never be as well off following the breach as she would have been with full performance.").
168. See, e.g., Brescia, supra note 151, at 272 ("The worst abuses of the subprime market came about because of a breakdown of economic relationships that were, in the past, bound by trust and mutual interdependence.").
169. John Mixon, Fannie Mae/Freddie Mac Home Mortgage Documents Interpreted As Nonrecourse Debt (With Poetic Comments Lifted from Carl Sandburg), 45 CAL. W. L. REV. 35, 84 (2008). The layers of broken trust are several. See id. ("Many subprime borrowers trusted lenders to provide loans that were fairly priced and not designed for default. A fair number of lenders broke trust with borrowers by predatory practices and they broke trust with financial markets through outright fraud as they offered their defective mortgage-backed securities around the world. Some borrowers were party to the fraud, and the entire securitization debacle reduced trust in financial institutions at an international level.").
tioned five elements, while ostensibly carried out in conformance with principles of efficiency or self-interested rationality on an individual level, can be considerably harmful to other economic agents and to society more generally in the long term when practiced collectively. The subprime fiasco demonstrates, more specifically, that such opportunistic behavior can degrade confidence that the people and that the market have in all other economic participants and in the very financial instruments that gave rise to the initial transactions.

The subprime behavior, in other words, validates the “Market for Lemons” situation first described by and attributed to Gary Akerlof. The insight of the “market for lemons” is recognizing the impact of consumer uncertainty or a lack of confidence in the market. In particular, Akerlof observed that if consumers are unable to distinguish between those “good” or “bad” goods, they will effectively discount all goods, thus eroding the market for those goods. For example, a car buyer that cannot separate a reliable vehicle from a “lemon” will be inclined to build into the price of all cars the possibility that a given car may be a “lemon.” This distance between the actual value of cars and the lower value assigned to cars by the prospective buyer means that transactions are occurring in far from optimal conditions, resulting in inefficiencies, and cutting against the health of the car market.

This general principle of economic psychology applies with undeniable force to a present economy that, as noted above, is marked by a lack of confidence in various market participants and market goods. For example, lenders do not know who are good credit risks, banks do not know which other banks will remain solvent, investors do not know which rating agencies are objective and honest, and consumers cannot identify which investment products are worthy of buying. The absence of trust—or the “crisis of confidence”—has effectively

171. See, e.g., Jeff Schwartz, Reconceptualizing Investment Management Regulation, 16 GEO. MASON L. REV. 521, 526 (2009) (“[A situation in which consumers cannot optimally assign risk] not only hurts the individual who makes the faulty purchase, but can undermine the competitive structure of the marketplace. If information problems are pervasive, they could lead to the phenomenon of adverse selection—where goods of different quality are sold at the same price because buyers are not sufficiently informed about the true value of the item they wish to purchase. Economic theory predicts that adverse selection leads to a predominance of low quality products as high quality ones are pushed out of the market because they are not being rewarded for their high quality.” (citing Akerlof, supra note 170)). But see Matthew Beville, Comment, Financial Pollution: Systemic Risk and Market Stability, 36 FLA. ST. U. L. REV. 245, 247 & n.9 (2009) (contending that “the credit crunch . . . created externalities entirely unrelated to the housing market” and that the subprime market was not a market for lemons).
172. See supra notes 123-34 and accompanying text.
173. See, e.g., Engel & McCoy, supra note 141, at 2048-54 (describing several “lemons” problems created by the securitization of subprime mortgages, including uncertainties as to loan risks, when loan obligations must be paid, and whether loan originators may be sued (citing Akerlof, supra note 170)).
stopped the flow of credit and brought the economy to a standstill.\textsuperscript{175}

Similarly, in an efficient breach, the breaching party degrades the trust of the non-breaching party.\textsuperscript{176} This trust is reflected in a contract—the non-breaching party bargains for promise or performance, commits to do or refrain from doing something and has been assured by the other party of a similar commitment in return. The expectations that the breaching party will perform and honor his word are upset, and the contract itself loses meaning. Accordingly, the non-breaching party experiences diminished trust in other individuals to serve as reliable partners to contracts of mutual and reciprocal benefit.\textsuperscript{177} Moreover, if a party deliberately backs out of a contract, the non-breaching party may cast doubt as to whether contracts can serve as effective and enforceable means of facilitating and ensuring otherwise informal and non-binding agreements. Richard A. Epstein notes, for instance, that to freely breach contracts is "to weaken the social fabric that helps to reinforce the shaky social norms that make self-help, and social life, possible."

Accordingly, even if the transactional costs associated with an efficient breach—such as the non-breaching party's expenses in negotiating a deal for substitute goods or services—were internalized, an efficient breach would still generate a second, far more significant and fundamental externality: diminished

counterparties cannot distinguish firms with good risk models from those with poor ones, even firms with solid models may be assumed to pose excessive credit and systemic risks and may find it difficult to escape the contagion of latter day bank runs."; Robert Hockett, \textit{Bringing It All Back Home: How to Save Main Street, Ignore K Street, and Thereby Save Wall Street}, 36 FORDHAM URB. L.J. 427, 433-34, 441 (2009) ("Mass-psychological . . . phenomena in the subprime market make it such that the prevailing mood changes, tendencies become increasingly risk-averse, and uncertainties are resolved by assuming the worst . . . . [Absent a change in the collective,] each private party assumes the worst and seeks exit. This self-fulfilling prophecy steadily radiates outward: the market grows ever more jittery over the just enumerated uncertainties. . . . [W]hile we know that only a small minority of mortgages will actually default and only a minority of MBSs will actually prove to be 'toxic,' we don't know which ones." (citing Akerlof, \textit{supra} note 170)).

175. For other references to the market for lemons in the subprime context, see Listokin & Taibleson, \textit{supra} note 128, at 93 ("Without reliable ratings, complicated securities became untouchable at almost any price." (citing Akerlof, \textit{supra} note 170)); Brian J.M. Quinn, \textit{The Failure of Private Ordering and the Financial Crisis of 2008}, 5 N.Y.U. J. L. & Bus. 549, 552 n.7 (2009) ("The presence of asymmetric information in the financial markets can lead to a loss of trust and collapse as suggested by Akerlof in his lemons market model." (citing Akerlof, \textit{supra} note 170)).

176. \textit{See}, e.g., Wilkinson-Ryan, \textit{supra} note 163, at 641 ("[S]ubstantial evidence [exists] that parties are sensitive to perceived breaches of both formal and informal contracts, and that breach reduces interpersonal trust and cooperation."); Henry Mather, \textit{Searching For the Moral Foundations of Contract Law}, 47 Am. J. Juris. 71, 80 (2002) ([The doctrine of efficient breach] measures efficiency only in terms of the outcome for the two parties. It ignores the very significant social cost that is incurred every time an intentional breach of contract is discovered and diminishes the social trust that is the vital lifeblood of our social practice of contracting.").

177. \textit{See} Oren Bar-Gill & Omri Ben-Shahar, \textit{An Information Theory of Willful Breach}, 107 MICH. L. REV. 1479, 1483 (2009) ("[W]illful breach is a probabilistic indication that the breaching party is the type of transactor who readily chisels and acts in a dishonest way, and has likely exercised such bad faith in other occasions without being sanctioned. An act of willful breach reveals the true nature of the contracting partner: one who would take any opportunity to divert value, if he can get away with it.").

trust in market participants and in contracts as reliable and enforceable instruments of human cooperation. In other words, even if the particular actors in the limited universe of an efficient breach are at least made whole—the non-breaching party is fully compensated for his costs, the breaching party receives a profit, and the second contracting party receives the good or services which he valued more than the non-breaching party—there remain broader, societal costs of diminished trust in other market participants and in reliable market exchanges.

The promise of the doctrine of efficient breach, however, is an increase in social wealth. Because the breaching party receives a greater profit and the second contracting party receives a good or service that he values more than the non-breaching party, the argument goes, society as a whole is said to be better off. But, as noted above, whether the closed universe of efficient breach actors are economically improved as a result of the breach does not necessarily mean that wealth for others or society is maximized. In fact, the reverse is true. Mistrust is a byproduct of an efficient breach, and this absence of confidence is not a passing sentiment or value judgment, but rather a depletion of the psychological predicate necessary for one human to transact with another. This mistrust spreads from the specific efficient breach actors throughout the market.

Moreover, there need only be a very limited number of “lemons” for a crisis of confidence to ripple outwards and for the devaluation of relevant goods in the market to begin. The economic meltdown proves this fact. To wit, while “a small minority of mortgages” compared to all mortgages defaulted, “individuals irrationally fear that they are holding the underperforming investments disproportionately.”179 That is, “[e]ach individual worries, ‘I might have only the bad ones.’”180 And, “[f]earing this individually, such investors then, in effect, collectively make it so by stampeding to sell what they irrationally undervalue. In short, this is a classic collective action problem, one that, in this case, artificially deflates value.”181 This process—from individual default to collective panic—becomes a self-fulfilling prophecy, reinforcing itself with new instances and generating a degenerative cycle of mistrust and asset devaluation.

If, as Judge Posner suggests, “[t]he ultimate test of a rule derived from economic theory is not the elegance or logicality of the derivation but the rule’s effect on social wealth,”182 efficient breaches cannot be said to enhance social wealth even if they enhance the wealth of specific individuals. The merits and propriety of the efficient breach are not to be assessed by its “elegance” or “logicality,” as Judge Posner professes, but neither should they be adjudged on the basis of their legality or rationality on an individual level. Indeed, assuming

179. Hockett, supra note 174, at 441.
180. Id.
181. Id.
that the subprime behavior was permissible under the law and that the participants at each node of the subprime network were rational insofar as the individual transactions related to themselves only, there is no doubt the transactions as a whole have dealt a blow to the broader economy to the detriment of many individuals, families, employers, and nations that were not directly part of the subprime activity but were nonetheless susceptible to harm in this interlinked global economy.

C. THE END OF THE DOCTRINE

Some have suggested that the economic recession is an indictment of capitalism as it is presently practiced. In my estimation, capitalism per se did not fail; as Adam Smith and others have noted, it is human nature for individuals to pursue their self-interest, and that is precisely what those in the subprime mess did. What failed, however, were the lax bounds within which financial actors were able to pursue their self-interest.

More diligent regulation seems to be required. Imposing meaningful limits on financial conduct will not, however, be easy. Sufficient political will is lacking to proceed with financial reform. If a critical mass of politicians agree to move forward with reform to restore confidence in the market, the American people must be assured that the new regulatory regime is not shaped or influenced, in whole or in part, by Wall Street or those receptive to Wall Street.

183. See Bar-Gil & Warren, supra note 89, at 41 (acknowledging that “[i]t is clearly possible for a rational, informed consumer to take on a high-cost subprime mortgage with the understanding that adverse contingencies might lead to default and foreclosure” and suggesting that it is also possible that not all market participants were fully informed decisionmakers).

184. See Matthew Beville, Dino Falaschetti & Michael J. Orlando, An Information Market Proposal for Regulating Systemic Risk, 12 U. PA. J. BUS. L. 849, 876 n.138 (2010) ("[W]hile it may have been individually rational to invest in subprime mortgage securities, it left the entire system vulnerable to a negative housing market.").

185. See, e.g., POSNER, supra note 157, at 284 (claiming that "this depression is a failure of capitalism."); id. at 240 ("[T]he financial crisis is indeed a crisis of capitalism rather than a failure of government."); Martin Wolf, Liberalisation Sews Its Own Destruction, FIN. TIMES, Mar. 8, 2009 (arguing that an "ideological god," capitalism marked by financial liberalization, has "failed" and "look[s] as outdated as revolutionary socialism"); Muhammad Yunus, How Capitalism Failed, DAILY BEAST, Jan. 23, 2009, http://www.thedailybeast.com/blogs-and-stories/2009-01-23/how-to-save-the-poor/full/ ("This financial crisis offers an interesting illustration of the social failings of the existing capitalist system.").

186. See supra note 35.

187. See supra Parts III.A.1, 2, 4.

188. See Friedman, supra note 124 ("[I]t's our own failure to regulate our own financial system and to legislate the proper remedy that is doing us in."); Joseph E. Stiglitz, A $1 Trillion Answer, N.Y. TIMES, Nov. 30, 2008, § WK, at 9 ("Deregulation and the failure to adopt regulations to cover risky new financial products have contributed much to the current mess.").

189. See Wall Street Casino, N.Y. TIMES, Apr. 28, 2010, at A24 (noting that efforts to debate a financial reform bill have been blocked by politicians opposed to reform).

190. Cf. Stiglitz, supra note 188 ("Those who got us into this crisis cannot have undue influence in shaping the response.").
perceived to be sought in good faith and with a view towards fairness on Main Street, there is uncertainty as to what should be regulated and how.\textsuperscript{191}

Whether financial reform will take place, what it will contain, and whether it will instill public confidence in the market are all uncertainties at this point. Importantly, even if regulation is passed, it will lead entities to keep only their individual behavior within the proscribed limits of lawful conduct; it will not influence positive behavior more broadly or act as “contagion” for positive actions in society.\textsuperscript{192}

In contrast, social norms may encourage advantageous behavior and disincen-
tivize behavior that does not advance the public good in a manner more all-encompassing than the threat of legal sanction.\textsuperscript{193} Indeed, some suggest that social norms may be more effective than the law in shaping social expectations of proper behavior\textsuperscript{194} and that any formal regulation contemplated or implemented must in any case take account of such underlying community views to be effective.\textsuperscript{195}

Educational institutions generally are a traditional source of social norms and shared values. Schools, it has been said, “are in the business of reshaping people.”\textsuperscript{196} They “teach pupils not only instrumental skills . . . but also encourage them to ‘learn to accept social norms, or principles of conduct, and to act according to them.’”\textsuperscript{197} Law schools similarly impart specialized professional skills to students and retain a significant capacity to mold their character, inculcate a sense of responsibility towards their clients and towards the public at large, and ground their legal duties in concepts of justice, equality, and

\textsuperscript{191} Fareed Zakaria, Is Goldman Guilty?, WASH. POST, Apr. 26, 2010, at A15 (“Whatever the new rules, one thing will not change: We can’t be sure in advance which securities are ‘good’ and which are ‘bad.’”).

\textsuperscript{192} See Steven L. Schwarcz, Systemic Risk, 97 GEO. L.J. 193, 206 (2008) (“[T]he externalities caused by systemic risk would not be prevented or internalized because the motivation of market participants ‘is to protect themselves but not the system as a whole . . . . No firm . . . has an incentive to limit its risk taking in order to reduce the danger of contagion for other firms.’” (quoting President’s Working Group on Fin. Mkt., Hedge Funds, Leverage, and the Lessons of Long Term Capital Management 31-32 (1999))).

\textsuperscript{193} See generally, e.g., ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) (arguing that informal rules and social norms can regulate behavior notwithstanding the existence of formal law). Whether social norms supplement—or are a substitute for—the law is a question to be resolved elsewhere. (Indeed, this topic is the subject of significant scholarly debate. See generally, e.g., Yoshinobu Zasu, Sanctions by Social Norms and the Law: Substitutes or Complements?, 36 J. LEGAL STUD. 379 (2007)). The critical point is that social norms by themselves can influence behavior.

\textsuperscript{194} See, e.g., Cass R. Sunstein, Social Norms and Social Roles, 96 COLUM. L. REV. 903, 907 (1996) (“[C]hanges in norms might be the best way to improve social well-being . . . . [N]orm management is an important strategy for accomplishing the objectives of law . . . .”).

\textsuperscript{195} See, e.g., Elizabeth S. Scott, Social Norms and the Legal Regulation of Marriage, 86 VA. L. REV. 1901, 1927-28 (2000) (“If the legal requirement departs substantially from the expectations created by the norm standard . . . resistance is predictable and legal enforcement is likely to be costly.”).

\textsuperscript{196} David L. Kirp, Proceduralism and Bureaucracy: Due Process in the School Setting, 28 STAN. L. REV. 841, 854 (1976).

\textsuperscript{197} Id. (quoting Robert Dreeben, The Contribution of Schooling to the Learning of Norms, 37 HARV. EDUC. REV. 211, 214 (1967)).
fairness. 198

Because of this purpose, institutions of higher education, including law schools, are given wide latitude within which to explore ideas, expose students to different theories and views, challenge students with provocative and novel ways of looking at things, enable students to critically analyze both their own ideas and those of their classmates, and to create an environment in which this iterative and contemplative dynamic can take place on substantive terms without fear of reprisal. 199 Discussing the doctrine of efficient breach—either in courses or scholarship—may seem to be part and parcel of these core functions.

Robust academic freedom—expansive space within which to present and examine ideas—carries with it correlative academic responsibilities—rules for how professors are to act within that protected space. 200 For example, law professors are to "seek and to state the truth," 201 where this "commitment to truth requires intellectual honesty and open-mindedness." 202 In addition to ethical duties of pursuing their professional activities with candor and humility, law professors are to generate scholarship in order to "participate in an intellectual exchange that tests and improves their knowledge of the field, to the ultimate benefit of their students, the profession, and society." 203

But legal scholarship is not permitted to fester indefinitely in the abstract; its continued viability, as with other pursuits of knowledge and truth, depends and is

198. See, e.g., Richard C. Baldwin, "Rethinking Professionalism"—and Then Living It!, 41 EMORY L.J. 433, 445 (1992) ("Whether they realize it or not, [law] professors are not merely teachers of substance and skills; they are mentors in the process of professional training. They are the first professional role models students encounter. Professional values observed in law school will leave indelible marks on students' visions of the profession."); see also Martha C. Nussbaum, Cultivating Humanity in Legal Education, 70 U. Chi. L. REV. 265 (2003) (noting that "law is understood as not simply a set of technical maneuvers, but as a way of being active and influential in public life that has a definite normative ethical dimension," and that law schools must foster civic virtues in students because "a merely instrumental and technical preparation will not be sufficient" to equip students to be effective lawyers and citizens in the community). See generally Richard A. Matasar, Defining Our Responsibilities: Being an Academic Fiduciary, 17 J. CONTEMP. LEGAL. ISSUES 67 (2008) (proposing that law schools be viewed as "academic fiduciaries" with professors as trustees, students as primary beneficiaries, and the public as third-party beneficiaries).

199. See, e.g., Sweezy v. New Hampshire, 354 U.S. 234, 250-51 (1957) ("The essentiality of freedom in the community of American universities is almost self-evident. . . . To impose any strait jacket upon the intellectual leaders in our colleges and universities would imperil the future of our Nation. . . . Teachers and students must always remain free to inquire, to study and to evaluate, to gain new maturity and understanding: otherwise our civilization will stagnate and die."); Wieman v. Updegraff, 344 U.S. 183, 195 (1952) (Frankfurter, J., concurring) ("[U]nwaranted inhibition upon the free spirit of teachers . . . has an unmistakable tendency to chill that free play of the spirit which all teachers ought especially to cultivate and practice . . . .").

200. See Nancy B. Rapoport, Academic Freedom and Academic Responsibility, 13 GREEN BAG 189, 201 (2010) ("Academic freedom is like any great power: with it comes great responsibility.").


203. Id.
based entirely on whether it is plausible in fact. Legal scholarship disconnected from reality or refuted by its practical application to actual circumstances loses its character as a live theory. Benjamin Cardozo wrote, “The final cause of law is the welfare of society. The rule that misses its aim cannot permanently justify its existence.” Roscoe Pound similarly observed that:

Law . . . must be judged by the results it achieves, not by the niceties of its internal structure; it must be valued by the extent to which it meets its end, not by the beauty of its logical processes or the strictness with which its rules proceed from the dogmas it takes for its foundation.

In other words, a legal theory is valuable only to the extent that it improves society in actuality and is supported by positive feedback in the real world.

The doctrine of efficient breach, while satisfying law professors’ obligations to produce scholarship and advance ideas, lacks both the results and the social purpose necessary to maintain its status as a viable legal theory. First, with respect to its results, the doctrine of efficient breach does not sufficiently compensate the non-breaching party—it does not account fully for the transactional costs incurred by the non-breaching party. Nor do expectation damages—the remedy economic theorists contend will cover the non-breaching party’s expenses—make the non-breaching party “indifferent” towards whether he receives performance or damages. Critically, the intentional breach of contracts triggers a fundamental diminution of trust among people and in contracts. These deficiencies aside, an “efficient breach” is difficult to locate in actuality. Moreover, judges routinely reject the doctrine in actual cases. Indeed, proponents of the doctrine in academic contexts, most notably Judge

206. See supra notes 161-67 and accompanying text.
207. See id.
208. See supra notes 168-69 and accompanying paragraph in which they appear.
210. See, e.g., Ronald J. Scalise, Jr., Why No “Efficient Breach” in the Civil Law?: A Comparative Assessment of the Doctrine of Efficient Breach of Contract, 55 AM. J. COMP. L. 721, 763 (2007) (“The doctrine of efficient breach of contract has not been endorsed by civil law scholars and judges and is unlikely to be at any time in the near future.”); Warkol, supra note 2, at 334-43 (examining cases, including those within contract law casebooks, which indicate that judges rarely accept the doctrine).
Posner, decline to rely on the doctrine in resolving real cases before them.\textsuperscript{211} If the doctrine of efficient breach is hard to find amongst the innumerable contract situations that take place within the United States, is not utilized when it comes before its advocates in real cases, depletes confidence, and in any case leaves the non-breaching party worse off to negate the efficiency of an “efficient breach,” the doctrine should be discarded as an academic concept. At a minimum, its presentation in academic circles or courses should include a candid disclosure that the doctrine’s promises do not add up on paper nor are they identifiable in society.\textsuperscript{212}

Second, the question then becomes, what’s the point? In other words, what does the doctrine accomplish, practically, if it is theoretically unsatisfactory, one struggles to find it occur in the actual transactions, and its open promotion as an abstract concept is unmatched by judicial validation in actual disputes? The effect of the doctrine of efficient breach is this: the encouragement of the pursuit of opportunistic unilateral profit without any consideration for the broader impact on others or on contracts itself, and the cultivation of a myopic perspective in which self-interested gain is pursued in a cocoon completely divorced from and unconcerned about the rest of society. The doctrine of efficient breach contributes to an ethos in which short-term, individual gain is sought and in which “the collective” is beyond the consideration of the particular economic actor despite the externalities he generates. It contributes to an ethos in which subprime behavior is possible and is sanitized. Worse, it provides a cover of rationality that not only immunizes the actor from any sense of personal responsibility towards the social consequences of his self-serving actions on his fellow man or to the very legal instruments that enable him to exchange reliably, but that praises him for invoking a mechanism to maximize his wealth and allegedly that of society too. Because of these destructive influences on social thinking, the doctrine of efficient breach should be condemned.

Some may claim that the doctrine of efficient breach is simply a “doctrine”—it is a theory that is debated in the academy, and as such there should be little concern, if any, that it may influence social norms on proper behavior. While this view may have intuitive appeal, the fact remains that legal theory is not confined to the Ivory Tower or the rarified walls of a law school. Rather, legal theory has

\textsuperscript{211} See, e.g., Jed Handelsman Shugerman, Affirmative Duties and Judges’ Duties: United States v. Stockberger, 120 Haw. L. Rev. 1228, 1235 n.36 (2007) (“Judge Posner defer[s] and opt[s] not to apply his own theories to his decisions . . . in the area of ‘efficient breach.’’’); Warkol, supra note 2, at 337-38 (observing that Judge Posner discusses efficient breach in decisions, but conspicuously stops short of relying on it as a basis for resolving cases) (citing Patton v. Mid-Continent Sys., Inc., 841 F.2d 742 (7th Cir. 1988); Walgreen Co. v. Sara Creek Prop. Co., 966 F.2d 273 (7th Cir. 1992)).

\textsuperscript{212} Beyond this, legal scholars may wish to consider the merits of encouraging parties to include liquidated damages provisions in contracts as a way to contemplate “efficient breaches” while preserving mutuality at the same time. See Sidhu, supra note 11, at 86-88 (explaining how liquidated damages would accomplish the purported goals of an efficient breach and maintain mutuality amongst the parties).
seeped into the public arena and becomes not only fodder for public consumption, but is looked upon as guidance as to how one could or should act.

Perhaps the best example of this is a recent argument that touches upon both the subprime-induced economic downturn and efficient breach principles. University of Arizona law professor Brent T. White posited in a paper that individuals with underwater mortgage contracts—wherein the mortgage payments owed are greater than the value of the home itself—should intentionally default and “walk away” from their mortgage obligations. Specifically, White contends that because “individual homeowners are encouraged to behave in accordance with social and moral norms that require individuals to keep promises and honor financial obligations” in contrast to “lenders who seek to maximize profits irrespective of concerns about morality or social responsibility,” these “individual homeowners tend to ignore market and legal norms under which strategic default might not only be a viable option, but also the wisest financial decision.” In light of this “norm asymmetry,” White argues that “many more homeowners should be strategically defaulting.”

White apparently believes that homeowners should unilaterally break their mortgage contracts on purpose and thereby join lenders in maximizing their individual financial situations without concern for any moral objections or social consequences—in other words, homeowners should pursue their individual interests in the same manner as lenders and with the same disregard for others. This would not only obviate the imbalance between norms applicable to different actors in the subprime system, but would also enlarge the financial situations of both actors. In my estimation, White’s proposal seems problematic for reasons similar to the doctrine of efficient breach, namely that it promotes opportunistic, short-term individual gains and ignores completely and unabashedly broader social consequences including the devaluation of people as trustworthy partners and of contracts as reliable instruments of social cooperation. To the extent that the norms should be uniform, rather than homeowners behaving more like lenders, I would recommend that lenders act more like homeowners who honor commitments voluntarily made.

The merits of White’s argument aside, for purposes of this discussion it is sufficient to note that White’s theory has not been limited to intellectual debate. What started as a “discussion paper” has expanded into practical guidance for members of the public. For example, in featuring White in a discussion of “walking away,” National Public Radio said White would be offering “expert

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214. Id. at 972.
215. Id. at 973.
advice” on the subject.\textsuperscript{217} To his credit, White disclaimed that he was providing advice to homeowners.\textsuperscript{218} While White may not have directly instructed homeowners as to what they should or should not do, the open promotion of his theory helps create the conditions and provides the rational cover for homeowners to do what he suggests in his paper—that they walk away without caring about moral judgments or their social responsibility. Indeed, the paper itself is about norms, or the informal guideposts on proper behavior in society; it is difficult to believe that homeowners will not be influenced by or may not react to a paper on how they should act when the paper is affirmatively placed and discussed in the public sphere.\textsuperscript{219} If the legal theory does not intend to encourage people’s behavior or have any impact on the real world, one may then ask, as Cardozo and Pound may, what is the use of the theory in the first place?

This example reinforces the larger point that legal theory created in academia may very well make its way to the public, and there it retains the power to influence the behavior of the people and to furnish the intellectual justification for how people behave. It therefore remains important for legal theory to be challenged. There is no reason to suggest that the doctrine of efficient breach should be immune from this critical analysis and academic checking function. It is my contention that this examination of the doctrine of efficient breach is not only appropriate, but necessary given what the nation has experienced with subprime economic activity and the lessons that may be drawn from it. And it is my judgment, based on those lessons, that the doctrine of efficient breach should be discarded or tempered lest it enters the public realm and facilitates or legitimates socially destructive behavior.

\section*{Conclusion}

The doctrine of efficient breach is a staple of a first-year legal education. In this Article, I set out to explore both the merits of the doctrine based on an understanding of the subprime economic crisis and the attendant role legal scholars should play with respect to the doctrine.

In reviewing the doctrine, I attempted to leave undisturbed any moral claims against the doctrine and rely instead on its economic and social consequences to argue that there is a significant disconnect between the doctrine’s theoretical promises and reality. As the validity of a theory is to be determined by its results, I suggest that the doctrine should be dismissed as a viable theory and at least presented with candid information on its multiple deficiencies and negative

\begin{thebibliography}{9}
\bibitem{218} \textit{Id.}
\bibitem{219} I express no views as to the propriety of White’s discussion of his theory in popular public outlets, such as NPR. I write only in response to the accepted fact that the theory made it outside of the academic gates and has the potential to impact actual social behavior.
\end{thebibliography}
externalities.

My pragmatic assessment of the doctrine stems from the present economic downturn, itself caused by risky subprime behavior. The subprime saga indicates quite clearly how individualistic, opportunistic economic thinking divorced from a long-term perspective or the greater good can have considerable negative effects on the welfare of economy and on society as a whole. Subprime behavior and efficient breaches share a bond forged by meaningful similarities. Because of this unity, I argue that the by-products of efficient breaches, much like subprime behavior, are not only economic losses borne by society, but also a loss of confidence in other people and in the instruments that are traditionally used to satisfy a person's wants or needs.

What is worse, the doctrine of efficient breach approves of and cultivates an ethos of self-interested, short-term economic profit-making with complete disregard for long-term consequences, effects on third-parties or society collectively, and contracts as tools of social cooperation. It emboldens individuals in the community to act without consideration of others and to maximize their own balance sheets. It gives the false impression that the sole measure of whether transactions should be pursued is whether they are individually rational decisions in the short-term. It therefore shields from social castigation and individual conscience the actual consequences of those transactions after tomorrow and on others. The economic meltdown may be an indictment of a lax regulatory scheme, but it surely is indicative and reflective of a way of economic thinking that has prevailed in the financial world and that threatens the stability of the global economy. The doctrine of efficient breach is but a modest component of that overall mentality, but its size compared to the whole does not leave it any less capable of engendering destructive social views and therefore deserving of condemnation.

Individuals are self-interested—this is a function of human nature. But a functioning society is predicated on cooperation among the people, as Adam Smith and others understood. To the extent that law schools are capable of shaping social norms, it is these norms of reciprocity, mutuality, keeping one's word, and respecting the institutions that enable transactions to be carried out in orderly and predictable ways that legal theory should promote. To do so would be for law schools to pay tribute to their social purpose and to justify their exalted place in the American community.

The alternative is troubling—legal educators discuss without intellectual honesty a doctrine that degrades society and contracts. Consequently, for the doctrine to continue to be advanced as a viable theory would be to deplete confidence not only in the market as a trustworthy forum for social exchange, but in the legal academy as a factory for responsible social concepts.