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## Renegotiation and Secured Credit: Explaining the Equity of Redemption

Marshall E. Tracht

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## Renegotiation and Secured Credit: Explaining the Equity of Redemption

*Marshall E. Tracht\**

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\* Associate Professor, Hofstra University School of Law (lawmet@hofstra.edu); J.D., M.B.A., 1990, University of Pennsylvania; B.A., 1983, Yale University. I am grateful to many people whose comments and criticisms have improved this Article, including Baruch Bush, Robert Ellis, Paul Shupack, Norm Silber, and Vern Walker. Permission is hereby granted for copies of this Article to be made and used by nonprofit institutions for educational purposes, provided that the author and Vanderbilt Law Review are notified and are identified on each copy, and proper notice of copyright is affixed to each copy.

"In general, all persons able to contract are permitted to determine and control their own legal relations by any agreements which are not illegal, or opposed to good morals or to public policy; but the mortgage forms a marked exception to this principle."<sup>1</sup>

## I. INTRODUCTION

"Once a mortgage, always a mortgage." This cryptic comment, oft-repeated, summarizes a central tenet of mortgage law: The equity of redemption<sup>2</sup> is essential, immutable, and unwaivable. In other words, every mortgage borrower has the right, at any time after default, to redeem the collateral by repaying the debt until the lender has completed a "foreclosure" on the collateral. Indeed, a mortgage substitute that would dispense with the equity of redemption is the holy grail of real estate finance, and has captured the efforts and attentions of lawyers and lenders for centuries.<sup>3</sup> Every effort, however ingenious, has been met by the unyielding resistance of the courts: one may not "clog the equity of redemption."<sup>4</sup> The idea that the equity

1. 4 JOHN D. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 1193, at 568-69 (5th ed. 1941).

2. The equity of redemption refers to the mortgage borrower's: right after default in every jurisdiction . . . to perform his obligation under the mortgage and have the title to his property restored free and clear of the mortgage. The important words to emphasize here are 'after default.' [T]he mortgagor . . . has the right to pay or otherwise perform his obligations after default under the mortgage at any time until a valid foreclosure sale.

GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 7.1, at 467 (3d ed. 1994).

3. In *Emanuel College v. Evans*, 21 Eng. Rep. 494, 495 (1625-26), the mortgage was disguised as a 500-year lease in an attempt to avoid the restrictions on mortgages. In *Noakes & Co. v. Rice*, [1902] App. Cas. 24, 32 (H.L. 1901) (appeal taken from Eng.), the mortgage provided (to no avail) that upon default the mortgagor would be barred "from all equity of redemption." See also H.W. Chaplin, *The Story of Mortgage Law*, 4 HARV. L. REV. 1, 11-12 (1890) (discussing other early examples including drafting a mortgage as a sale with an option to repurchase, or creating what we now know as a deed of trust, or using a deed absoluto).

4. Perhaps the classic statement of this is found in Pomeroy's *Treatise on Equity Jurisprudence*:

*Once a Mortgage, Always a Mortgage; Collateral Agreements and Agreements Clogging the Equity of Redemption*—In general, all persons able to contract are permitted to determine and control their own legal relations by any agreements which are not illegal, or opposed to good morals or to public policy; but the mortgage forms a marked exception to this principle. The doctrine has been firmly established from an early day that when the character of a mortgage has attached at the commencement of the transaction, so that the instrument, whatever be its form, is regarded in equity as a mortgage, that character of mortgage must and will always continue. If the instrument is in its essence a mortgage, the parties cannot by any stipulations, however express and positive, render it anything but a mortgage, or deprive it of the essential attributes belonging to a mortgage in equity. The debtor or mortgagor cannot, in the inception of the instrument, as a part of or collateral to its execution, in any manner deprive himself of his equitable right to come in after a default in paying the money at the stipulated time, and to pay the debt and interest, and thereby to redeem the land from the lien and encumbrance of the mortgage; the equitable right of redemption, after a default is preserved, remains in full

of redemption is an inherent and inseparable part of every mortgage is now so commonplace, so accepted, that it elicits relatively little comment or question.<sup>5</sup>

A few moments' reflection reveals how odd this doctrine is, especially in the commercial setting. If the equity of redemption is basic to mortgage law, freedom of contract is equally central to the realm of commercial finance. Although various procedural restrictions are imposed by law to help ensure that contracts are fair and efficient, the refusal to enforce a freely negotiated term in a commercial contract between sophisticated parties, while not totally unheard of, is something of an oddity.<sup>6</sup> The judicial resistance to waivers of protections by commercial mortgagors appears even more curious when we consider various subsidiary issues. For example, if such protections are not economically efficient, can their retention, over centuries of litigation and legal change, be squared with the oft-asserted thesis that the common law tends to adopt economically efficient rules? And if such protections are economically efficient, why must they be imposed by the law—wouldn't the parties themselves choose to include these terms?

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force, and will be protected and enforced by a court of equity, no matter what stipulations the parties may have made in the original transaction purporting to cut off this right.

POMEROY, *supra* note 1, § 1193, at 568-69.

5. Mortgage law has not proved completely inflexible as modern economic conditions have engendered new mortgage forms. In particular, shared appreciation mortgages and equity participations of various sorts have been reconciled with mortgage law despite concerns that they might have been held to clog the equity of redemption. See Laurence G. Preble & David W. Cartwright, *Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption*, 20 REAL PROP. PROB. & TR. J. 821, 821-23 (1985) (noting that the convertible loan and shared appreciation loan have changed the structure of real estate financing and that the anti-clogging doctrine should not be applied to these vehicles).

6. The inclination to leave commercial parties to the terms of the bargain shows up most clearly in the judicial reluctance to apply the unconscionability doctrine to protect commercial actors. See, e.g., *Canal Elec. Co. v. Westinghouse Elec. Co.*, 973 F.2d 988, 996-97 (1st Cir. 1992) (declining to find unconscionability where the parties to the contract were "highly sophisticated business entities"); *Tiffany v. Forbes Custom Boats, Inc.*, No. 91-3001, 1992 WL 67358, at \*10 (4th Cir. Apr. 6, 1992) (refusing to apply unconscionability doctrine to contract waiver provision where the complaining party was a "well-educated, experienced and successful lawyer"); *American Cas. Co. v. Federal Deposit Ins. Corp.*, 944 F.2d 455, 460 (8th Cir. 1991) (denying unconscionability protection for bargain struck by "adult business people"); *Johnson v. Mobil Oil Corp.*, 415 F. Supp. 264, 266 (E.D. Mich. 1976) (stating that unconscionability is an extraordinary remedy rarely available to business people); see also E. ALLAN FARNSWORTH, *CONTRACTS* § 4.28, at 313-14 (1982) ("Courts have generally been chary about using the doctrine of unconscionability to protect merchants and similar professionals and have declined to apply it in favor of sophisticated corporations." (citation omitted)). But see Jane P. Mallor, *Unconscionability in Contracts Between Merchants*, 40 SW. L.J. 1065, 1065-66 (1986) (asserting a trend toward the increasing use of unconscionability doctrine between commercial parties).

Since mortgages are security interests and mortgage law is in some sense parallel to the law of personal property security interests, the answer to these questions should exist somewhere in the extensive literature on secured credit that has developed over the last two decades. During this period, the efficiency of secured credit has been at the center of an extended debate, and numerous economic models have been advanced to demonstrate the ways in which secured credit may enhance economic relations.<sup>7</sup> The legal analysis once focused on basic issues of fairness—that is, the efficacy of security interests in securing repayment for the lender and in avoiding forfeiture by the borrower.<sup>8</sup> The more recent work has focused on efficiency, stressing the role of secured credit in helping lenders screen the quality of potential borrowers and enabling borrowers to signal their creditworthiness to lenders,<sup>9</sup> and in preventing various categories of potential misbehavior by the debtor<sup>10</sup> or by creditors<sup>11</sup> during the life of the credit relationship.<sup>12</sup>

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7. See, e.g., Frank H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984) [hereinafter Schwartz, *Continuing Puzzle*]; Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981) [hereinafter Schwartz, *Security Interests*]; Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986) [hereinafter Scott, *Relational Theory*]; Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436 (1997) [hereinafter Scott, *The Truth*]; Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984).

8. See, e.g., Jean Braucher, *Defining Unfairness: Empathy and Economic Analysis at the Federal Trade Commission*, 68 B.U. L. REV. 349 (1988); Arthur Leff, *Injury, Ignorance and Spite—The Dynamics of Coercive Collection*, 80 YALE L.J. 1 (1970); William C. Whitford, *The Appropriate Role of Security Interests in Consumer Transactions*, 7 CARDOZO L. REV. 959 (1986) [hereinafter Whitford, *Appropriate Role*]; William C. Whitford, *A Critique of the Consumer Credit Collection System*, 1979 WIS. L. REV. 1047 [hereinafter Whitford, *A Critique*].

9. See, e.g., Schwartz, *Security Interests*, *supra* note 7, at 14-21 (reviewing signalling theories).

10. The literature initially focused on the role of secured credit in enabling creditors to efficiently monitor the activities of the debtor during the life of the loan. See, e.g., Jackson & Kronman, *supra* note 7, at 1149-58 (proposing reduced monitoring costs as the principal benefit of secured credit); Levmore, *supra* note 7, at 55-57 (explaining secured credit as a mechanism for allocating responsibility and compensation for monitoring among creditors); Schwartz, *Security Interests*, *supra* note 7, at 11 n.28 (critiquing the monitoring cost explanation proposed by Jackson and Kronman); Shupack, *supra* note 7, at 1073-83 (reviewing scholarly theories concerning secured credit). More recently, the literature has explored the manner in which secured credit may serve a "bonding" function. That is, collateral may serve as a "hostage" that ensures proper behavior by the debtor, thus reducing the amount of monitoring needed by creditors. See, e.g., Scott, *The Truth*, *supra* note 7, at 1450-52.

This focus on the creation and life of the credit relationship, however, has lured attention away from the functions of the law upon default. This Article examines a commonly overlooked function of secured credit: establishing a constructive framework for renegotiation—rather than enforcement—upon default. An appreciation of this function is central to a full understanding of secured credit and, more particularly, of the proper shape of the legal rules that govern the enforcement of secured credit.

Moreover, it is commonplace for economic analyses of law to propose the use of majoritarian contractual defaults—that is, to propose that if a term has not been specified in a contract, the court should fill the gap by applying the term parties like the plaintiff and defendant would have chosen had they negotiated it (presumably, the *ex ante* profit-maximizing rule).<sup>13</sup> The standard corollary is that, if the parties have specified a term in their contract, it presumably reflects the economically efficient provision and should therefore be enforced. Recent research has shown, however, that contractual terms will not always reflect the efficient outcome, even in transactions between knowledgeable and sophisticated parties operating in competitive markets.<sup>14</sup> As shown below, secured creditor remedies appears to be an area where this is true, a fact with significant ramifications for how we should think about the law of secured transactions.<sup>15</sup>

This Article approaches these issues by examining the role of the equity of redemption (and other borrower protections) in mortgage law. The thesis is that the equity of redemption—the immutable core of mortgage law—can best be understood as a mechanism for creating efficient incentives for the lender and borrower to renegotiate the terms of their contract should default occur. This perspective takes aspects of the law that are otherwise perplexing—like the insistence

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11. For a recent discussion of the functions of security in reducing lender misbehavior, see Picker, *supra* note 7, at 657-63, 669-70.

12. See, e.g., George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225, 228 (1992) (“The most plausible explanations of secured debt advanced in the literature are the following: (a) it reduces the cost of screening the borrower before its debt is purchased; (b) the borrower’s willingness to grant security is a reliable indicator of its creditworthiness; (c) secured debt reduces the cost of monitoring the borrower after the debt is purchased; and (d) it reduces the cost of enforcing a debt claim in the event that the borrower defaults.”)

13. See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 90-91 (1989); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 607 (1990).

14. See *infra* Part VI.

15. See *id.*

that even sophisticated commercial parties cannot waive their protections in the initial loan documents but may be able to waive them in a workout agreement,<sup>16</sup> and the fact that the primary remedy available to secured creditors (foreclosure) is rarely utilized<sup>17</sup>—and demonstrates their underlying coherence.

Although this Article examines real property mortgages, the underlying analysis is generally applicable to personal property security interests, and it provides an important counterpoint to a prominent tendency in discussions surrounding the newly-proposed revision of Article 9. The new draft of Article 9 nearly bifurcated the post-default rights of consumer and commercial debtors on the plausible ground that commercial debtors, unlike consumers, have sufficient bargaining power to contract with lenders for efficient remedies.<sup>18</sup> However, as shown below, the dynamics of the credit market may in fact preclude the negotiation of efficient post-default provisions even for commercial debtors.<sup>19</sup> Unless this point is meaningfully addressed, the assumption that commercial parties can fend for themselves is problematic.

This Article is divided into two broad sections. The first half reviews the law and commentary on mortgagor protections. Part II provides a brief overview of the equity of redemption and other mortgagor protections and the traditional legal justifications for their

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16. See *infra* notes 50-52 and accompanying text.

17. See *infra* text accompanying notes 151-53.

18. The extent to which the protections afforded by Article 9 should be waivable in commercial versus consumer transactions has been a topic of considerable debate in the deliberations over Revised Article 9, as evidenced by numerous changes over the course of the Article's drafting. As of the Proposed Final Draft dated April 15, 1998, subsection 9-602(a) provided for an extended list of rights of debtors and obligations of creditors that were not waivable; however, subsection (b) stated that: "An obligor other than a consumer obligor in a consumer goods transaction or a secondary obligor may waive or vary the rules referred to in subsection (a) to the extent and in the manner provided by other law." In other words, these rights were to be generally waivable by commercial borrowers. However, the draft approved (subject to style correction) by the American Law Institute and the National Conference of Commissioners on Uniform State Laws on July 30, 1998 omitted subsection 9-602(b), thus eliminating the general ability for commercial debtors to waive these protections. Nonetheless, a number of the protections in the Revised Article 9 apply only to consumer transactions. For example, section 9-613 provides a safe-harbor, "except in a consumer-goods transaction," regarding the required contents of a notification of disposition; section 9-616(b) requires a notice and explanation of surplus or deficiency to be sent in a consumer-goods transaction; and, section 9-620 provides different rules for the right of the secured party to accept the collateral in satisfaction of the debt where the collateral is "consumer goods." Moreover, some individual provisions permit waiver by non-consumer debtors but not by consumer debtors or in transactions involving consumer goods. Thus, section 9-207(4) provides for the secured party's right to use or operate collateral "except in the case of consumer goods, in the manner and to the extent agreed to by the debtor."

19. See *infra* Part VI.

status as mandatory, unwaivable rules. Part III examines the range of explanations that have been advanced by commentators to supplement the traditional reasoning of the courts, demonstrating in each case the shortcomings of the explanation in the context of commercial transactions.

The second half of this Article advances a new justification for the law's insistence on the equity of redemption in commercial mortgages. Part IV offers a more detailed exploration of the functions of mortgage law and examines the problems inherent in the mortgage loan workout situation, while Part V demonstrates the role of the equity of redemption in resolving these problems. Part VI then shows that, even if the equity of redemption is an efficient term, negotiations among market actors may not result in its contractual adoption, thus providing an economic rationale for its imposition as a peremptory command of law rather than a default rule.

## II. THE EQUITY OF REDEMPTION AND MORTGAGOR PROTECTION LAWS

American Colossus Real Estate Trust ("Colossus"), owner of over \$2 billion worth of apartment buildings across the United States, borrows \$22 million from First National Bank of Big City ("FNB") to acquire another building for its portfolio. Two years later, Colossus defaults and FNB seeks to enforce its rights under its loan agreement, note, mortgage, and guaranties. As any real estate practitioner knows, and any novice could learn with a few minutes research, FNB cannot enforce its contractual rights. Rather, it can enforce some of those rights, subject to considerable state-law limitations, in a specified order and manner—even if its contractual agreements say otherwise. FNB has those remedies accorded a mortgagee, and no more; Colossus has the rights and protections accorded a mortgagor, even if it explicitly waived them in its contractual agreements. Mortgage law is remarkable in modern finance in the extent to which it is governed by concepts of status ("mortgagor" and "mortgagee") rather than contract, relegating parties to pre-defined positions with mandatorily imposed rights and remedies. A mortgagee may take certain steps, in a certain defined order, at the risk of forfeiting its rights. A mortgagor has various opportunities to cure its default, redeem its collateral, or escape deficiency liability, all defined by law.

In its simplest form, the mortgage could be understood as an agreement that if FNB's loan were not repaid, Colossus would permit FNB to satisfy the debt with the mortgaged property. The comple-



mentary problems that are commonly said to lie at the heart of foreclosure law are the risk of forfeiture of the debtor's equity<sup>20</sup> in the collateral and the realization of an unjust windfall by the foreclosing lender. That is, suppose the property has a fair market value of \$27 million and FNB forecloses its \$22 million mortgage. If the property were simply turned over to FNB upon Colossus' default, or if a foreclosure sale were held and (as is often the case) the lender bids on the property for the amount of the debt, then FNB would receive \$27 million in property to satisfy a \$22 million debt, for a windfall gain of \$5 million. Conversely, in either of these scenarios, Colossus would suffer a forfeiture of \$5 million of "equity" in the property.

Concern over this risk of forfeiture is said to lie behind almost every major element of mortgage law.<sup>21</sup> Start with the equity of redemption, which is the borrower's right to redeem the property by repaying the debt at any time until the foreclosure<sup>22</sup> has been completed. The equity of redemption provides the borrower with the right, even after default, to repay the mortgage debt and free the property from the mortgage lien, and so retain any value that the property has in excess of the debt. The equity of redemption has been an established rule of mortgage law since the early seventeenth century and was the first major legal protection for mortgage borrowers.<sup>23</sup>

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20. A borrower's "equity" refers to the value of the property in excess of the liens on that property. See BLACK'S LAW DICTIONARY 540 (6th ed. 1990).

21. See, e.g., James Geoffrey Durham, *In Defense of Strict Foreclosure: A Legal and Economic Analysis of Mortgage Foreclosure*, 36 S.C. L. REV. 461, 470 (1985); Sheldon Tefft, *The Myth of Strict Foreclosure*, 4 U. CHI. L. REV. 575, 575-76 (1937). This concern is not unique to real property foreclosure. Ronald Mann recently cited this threat of forfeiture as one of the major functions of secured credit, using the example of a \$120,000 loan secured by a lien on a drill press, which could be sold on foreclosure for \$100,000, and the loss of which would diminish the value of the borrower's business by \$400,000. See Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 646-47 (1997) [hereinafter Mann, *Explaining*]. According to Mann, the lender's ability to inflict a \$300,000 loss (the \$400,000 decline in the value of the business less the \$100,000 value realized upon foreclosure) is crucial leverage to compel the borrower to repay the debt. See *id.* Mann's example does not discuss why a borrower who can gain \$400,000 by purchasing a new drill press for \$120,000 would be unable or unwilling to do so—a possibility that reduces the lender's ability to inflict a loss from \$300,000 to \$20,000, and that Professor Mann has since recognized. See Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 215-19 (1997) [hereinafter Mann, *Strategy*].

22. While we commonly talk about "foreclosing a mortgage," it is more precise to refer to foreclosing the equity of redemption. That is, a decree of foreclosure determines that after a specified date or event, the borrower will have no further right to redeem the property. See BLACK'S LAW DICTIONARY 646 (6th ed. 1990).

23. See generally David Sugarman & Ronnie Warrington, *Land Law, Citizenship and the Invention of 'Englishness': The Strange World of the Equity of Redemption*, in EARLY MODERN CONCEPTIONS OF PROPERTY 111, 111-21 (John Brewer & Susan Staves eds., 1995).

Under strict foreclosure (where foreclosure vests title in the lender), there will be a forfeiture by the borrower and a windfall to the lender if the property is worth more than the debt.<sup>24</sup> The American attempt to solve this problem is found in the foreclosure sale: the property is sold at auction, in an attempt to secure the value of the property for application to the debt, with any excess returned to the mortgagor.<sup>25</sup>

Foreclosure sales, in turn, are criticized for routinely realizing less than the fair value of the foreclosed properties.<sup>26</sup> While the rule in England is that the lender may not purchase the mortgage property,<sup>27</sup> in America the lender is almost always the purchaser, buying the property for the amount of the debt or less.<sup>28</sup> Other bidders are

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24. See, e.g., Steven Wechsler, *Through the Looking Glass: Foreclosure by Sale As De Facto Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 859 (1985) (noting that this result was unfair, harsh, and oppressive). This statement must be qualified by recognition of the substantial costs that the lender may incur in converting its ownership of illiquid real property into cash. It is quite possible that the property is worth more than the debt, and thus the borrower faces a forfeiture, yet the lender will not realize a windfall because of the substantial transaction costs involved in foreclosing upon and disposing of the collateral. See Mann, *Strategy*, *supra* note 21, at 221-25; Debra Pogrud Stark, *Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform*, 30 U. MICH. J.L. REFORM 639, 675-77 (1997).

25. Interestingly, "[i]n some early cases mortgagors complained that foreclosure by sale benefitted mortgagees and sought to have mortgagees limited to a decree of strict foreclosure. This objection, though sometimes conceded by the courts, was brushed aside on the ground that the sale would equally benefit mortgagors." Tefft, *supra* note 21, at 589 (citing *Lansing v. Goelet*, 9 Cow. 346 (N.Y. 1827)); 2 JOSEPH STORY, EQUITY JURISPRUDENCE § 1025 n.1 (13th ed. 1886)). The mortgagors' objections arose from the liberal way strict foreclosure had been applied by the English Chancellor, giving mortgagors repeated opportunities to exercise the right of redemption and even to reopen the foreclosure and redeem after the foreclosure had been completed. This is still true in England today. See E.H. BURN, CHESHIRE AND BURN'S MODERN LAW OF REAL PROPERTY 702 (15th ed. 1994). As a result, mortgages in England are normally enforced by exercise of a power of sale, rather than by foreclosure, and execution of the contract of sale terminates the mortgagor's equity of redemption. See *id.* at 696.

26. For some recent examples of this criticism, see James S. Hering, *Real Property Foreclosure in Texas: What is Deficient About the Texas Deficiency Judgment Statute?*, 37 S. TEX. L. REV. 377, 380-81 (1996); Basil H. Mattingly, *The Shift from Power to Process: A Functional Approach to Foreclosure Law*, 80 MARQ. L. REV. 77, 78-79, 95 (1996).

27. See BURN, *supra* note 25, at 700.

28. This is not a new observation. See, e.g., Edgar Noble Durfee & Delmar W. Doddridge, *Redemption from Foreclosure Sale—The Uniform Mortgage Act*, 23 MICH. L. REV. 825, 833 (1925) (noting that "in nearly every case the property is bid in by the mortgagee"); Robert K. Lifton, *Real Estate in Trouble: Lender's Remedies Need an Overhaul*, 31 BUS. LAW. 1927, 1937 (1976) (stating that "in about 99 percent of public foreclosure sales the mortgagee ends up as the only bidder"); Mattingly, *supra* note 26, at 78 n.7 (discussing several studies of this phenomenon); Tefft, *supra* note 21, at 590 (noting, in 1937, that "[i]n practice, therefore, the mortgagee had little competition at the sale and usually became the successful bidder"). Patrick Bauer provides some data that supports these observations, finding that out of 1,831 mortgage foreclosure sales in two Iowa counties between 1881 and 1980, the foreclosing creditor purchased the property 1,672 times (91.3%). See Patrick B. Bauer, *Statutory Redemption Reconsidered: The Operation of Iowa's Redemption Statute in Two Counties Between 1881 and 1980*, 70 IOWA L. REV. 343, 361 (1985). Debra Stark found that third parties were the prevailing

discouraged by a variety of factors, including the difficulty of securing adequate information about the property and arranging financing for a foreclosure sale purchase.<sup>29</sup> Thus, the argument goes, properties seldom bring their fair market value when sold at foreclosure, and are often sold for less than the amount of the mortgage debt even if the property is worth substantially more.<sup>30</sup> Although some states permit non-judicial foreclosure while others attempt to offer a greater degree of protection to borrowers by requiring foreclosure through judicial process, this criticism is made under both systems.<sup>31</sup>

The perceived inadequacy of foreclosure sales led many states, during the nineteenth century, to adopt a second category of mortgagor protection laws: statutory rights of redemption.<sup>32</sup> Under these statutes, a borrower has the right to redeem the property from the foreclosure sale purchaser by paying the amount bid at the foreclosure sale (with interest and costs, in some cases), for months and in some cases years after the foreclosure sale. Statutory rights of redemption have been justified on various grounds. By permitting the mortgagor to retain possession through the statutory redemption period, the disruption of foreclosure is reduced.<sup>33</sup> Moreover, the extended redemption period may permit a borrower facing temporary hardships to recover and redeem the property.<sup>34</sup> But the primary justification for the statutory right of redemption is that it forces purchasers to bid the full value of the property to protect themselves from the risk of post-sale redemption.<sup>35</sup> Alternatively, statutory redemption rights are justified as providing a remedy for the mortgagor in those cases where the bid price is inadequate.<sup>36</sup>

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bidders in approximately 10% of Illinois judicial foreclosure sales in 1993 and 1994. See Stark, *supra* note 24, at 663. Steven Wechsler found that mortgagees purchased the foreclosed property in approximately three-quarters of the foreclosure sales he studied, with third parties purchasing the foreclosed property in one-quarter. See Wechsler, *supra* note 24, at 870.

29. See Mattingly, *supra* note 26, at 94-102; Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 493 (1991); Stark, *supra* note 24, at 651.

30. See generally Mattingly, *supra* note 26, at 85-88 (arguing that foreclosure sales are neither conducted in a commercially reasonable manner nor by a method that produces competitive bidding).

31. See, e.g., *id.* at 95 (noting that the sale process is remarkably similar once a court orders a foreclosure).

32. See Bauer, *supra* note 28, at 345 n.9; Tefft, *supra* note 21, at 590.

33. See Patrick B. Bauer, *Judicial Foreclosure and Statutory Redemption: The Soundness of Iowa's Traditional Preference for Protection over Credit*, 71 IOWA L. REV. 1, 70-71 (1985); Wechsler, *supra* note 24, at 860.

34. See Durfee & Doddridge, *supra* note 28, at 839; Schill, *supra* note 29, at 496.

35. See Durfee & Doddridge, *supra* note 28, at 840; J. Douglass Poteat, *State Legislative Relief for the Mortgage Debtor During the Depression*, 5 LAW & CONTEMP. PROBS. 517, 526 (1938); Wechsler, *supra* note 24, at 860.

36. See Durfee & Doddridge, *supra* note 28, at 839-40.

Finally, many jurisdictions have anti-deficiency statutes. Products of the Great Depression,<sup>37</sup> these statutes bar lenders from bringing deficiency actions against borrowers on certain types of loans (such as residential mortgages<sup>38</sup> or purchase money mortgages<sup>39</sup>), or after non-judicial foreclosure sales,<sup>40</sup> or they limit deficiency judgments to the amount of the debt less the fair value of the property if the property sells for less than fair value at the foreclosure sale.<sup>41</sup> Anti-deficiency statutes are perceived as another source of protection for the borrower against the inadequacies of foreclosure: at least if the property sells for less than its fair value, the borrower is not liable to make up the difference to the lender.

Thus, the equity of redemption, statutory rights of redemption, and anti-deficiency statutes are all responses, at least in part, to the perceived risk of forfeiture. Despite these protections, commentators continue to decry the inadequacy of the foreclosure process as a means of realizing the full value of the collateral for borrowers.<sup>42</sup> While it is true that cases of forfeiture can be found, however, common sense and empirical data both call into question the perception that forfeiture is a substantial problem.<sup>43</sup> For example, in a recent examination of foreclosure sales in Cook County, Illinois, Debra Poggrund Stark found that more than two-thirds of all judicial foreclosure cases were dismissed before the sale, indicating that borrowers "were able to protect their equity in the property."<sup>44</sup> Moreover, in roughly ninety percent of the foreclosure sales held, the

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37. For a discussion of the enactment of anti-deficiency statutes (and other mortgagor protections) during the Great Depression, see generally Poteat, *supra* note 35.

38. See, e.g., ARIZ. REV. STAT. ANN. § 33-814(G) (West 1990) (no deficiency action against one- or two-family dwellings); CAL. CIV. PROC. CODE § 580b (West Supp. 1999) (no deficiency judgment against dwelling of up to four families occupied by purchaser).

39. See, e.g., FLA. STAT. ANN. § 702.06 (West 1994) (mortgagee will not be able to bring a deficiency suit where mortgagee is the purchaser and the loan was for the purchase price of the property involved); N.C. GEN. STAT. § 45-21.38 (1997) (the mortgage notes must explicitly identify the mortgage as a purchase money mortgage to be afforded this protection); OR. REV. STAT. § 88.070 (1998) (no deficiency judgments on purchase money mortgages).

40. See, e.g., CAL. CIV. PROC. CODE § 580b (West Supp. 1999) (referring to "deed of trust").

41. See, e.g., IDAHO CODE § 6-108 (1998) (covers "any case involving a foreclosure of a mortgage"); ME. REV. STAT. ANN. tit. 14 § 6324 (West Supp. 1998) (provided the mortgagee is the purchaser at the foreclosure sale); N.Y. REAL PROP. ACTS. LAW § 1371 (McKinney 1979) (provided the judgment is "just and equitable"); N.D. CENT. CODE § 32-19-06 (1996) (looks to "fair value," not foreclosure sale value).

42. Mattingly, for example, argues for substantial revisions to the foreclosure process primarily to mitigate the risk of forfeiture. See Mattingly, *supra* note 26, at 113-32.

43. Most recently, Mann has provided an important empirical validation of this point. Examining the secured lending of a finance company, a bank, and an insurance company, Mann found that lenders seldom foreclose because of the expectation that they will realize very little from a forced liquidation of the collateral. See Mann, *Strategy*, *supra* note 21, at 166-212.

44. Stark, *supra* note 24, at 663.

value of the property was not great enough to yield a windfall for the lender, given the amount of the debt and the foreclosure sale and carrying costs.<sup>45</sup> In an earlier empirical study of foreclosure sales in New York State, Steven Wechsler found that mortgagees profited on about half the resales of properties in which they purchased, but they incurred losses on the other half, with the losses outweighing the gains.<sup>46</sup> These results are supported by a recent study of distressed residential loans in Texas, which indicated that distressed borrowers with equity tend to sell their properties and repay the mortgage, while distressed borrowers with little or no equity force the lender to foreclose.<sup>47</sup> In other words, defaulting borrowers are generally rational and do not quietly permit the forfeiture of their equity.<sup>48</sup>

Regardless of the true extent of the "lost value" problem toward which mortgagor protections are supposedly directed, the law is jealous of any potential imposition on these various mortgagor protections. The equity of redemption is universal: it exists in every state, and in every mortgage.<sup>49</sup> It cannot be waived in the loan agreement or mortgage<sup>50</sup> and any attempt to avoid or limit ("clog") the equity of redemption as part of the initial transaction is void.<sup>51</sup> The

45. See *id.*

46. See Wechsler, *supra* note 24, at 882; see also Jerry R. Jackson & David L. Kaserman, *Default Risk on Home Mortgage Loans: A Test of Competing Hypotheses*, 47 J. RISK & INS. 678, 685-87 (1980) (showing that default depends more on rational borrower choice than opportunistic mortgagee actions).

47. See Thomas M. Springer & Neil G. Waller, *Termination of Distressed Residential Mortgages: An Empirical Analysis*, 7 J. REAL EST. FIN. & ECON. 43, 43-48 (1993) (examining 209 distressed Texas mortgages and determining that the borrowers' "equity position" is the best predictor of foreclosure).

48. This may also shed light on the failure of third parties to bid at most foreclosure sales. If foreclosure sales most often do not result in windfalls for the purchaser, then there is even less reason for a potential purchaser to put up with the various impediments faced at a typical foreclosure sale. See *supra* notes 26-31 and accompanying text.

49. For an excellent discussion of the difficulties that the equity of redemption has caused for modern real estate financing techniques, see Jeffrey L. Licht, *The Clog on the Equity of Redemption and Its Effect on Modern Real Estate Finance*, 60 ST. JOHN'S L. REV. 452 (1986). The point of this Article is not to critique the application of mortgagor protections to any particular financing structure, but to explore the value, if any, in mandating protections for commercial mortgagors.

50. See, e.g., *Oakland Hills Dev. Corp. v. Lueders Drainage Dist.*, 537 N.W.2d 258, 263 (Mich. Ct. App. 1995); *Russo v. Wolbers*, 323 N.W.2d 385, 390 (Mich. Ct. App. 1982).

51. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 3.1 (1997). The *Restatement* provides:

(a) From the time the full obligation secured by a mortgage becomes due and payable until the mortgage is foreclosed, a mortgagor has the right to redeem the real estate from the mortgage under the principles of § 6.4.

(b) Any agreement in or created contemporaneously with a mortgage that impairs the mortgagor's right described in subsection (a) of this Section is ineffective.

*Id.* Or, as it has been more artfully stated, "[n]o words of Scrivener nor any invention of Counsel can make that which was intended as a mortgage to work as an absolute assurance."

law is less clear, however, when it comes to waivers of the equity of redemption as part of a voluntary workout between the borrower and lender. Some courts permit such waivers if the court, after careful scrutiny, is convinced that the waiver is substantively fair to the borrower.<sup>52</sup> Many statutory protections are also unwaivable, although the rule is not universal. And although some of these statutory protections distinguish between categories of mortgages, many apply to all mortgages.

The standard judicial explanation for the preemptory nature of mortgagor protections is that desperate borrowers are helpless in the face of lenders' demands and so must be safeguarded from unfair oppression. The classic statement is from the 1762 case of *Vernon v. Bethell*: "[N]ecessitous men are not, truly speaking, free men, but, to answer a present exigency, will submit to any terms that the crafty may impose upon them."<sup>53</sup> Or, as the New Jersey Court of Chancery wrote in a still-cited<sup>54</sup> 1832 case:

There would have been, without [judicial protection of the equity of redemption], a door open for the imposition of every kind of restraint on the equity of redemption, and thereby the borrower, through necessity, would have been driven to embrace any terms, however unequal or cruel; which would

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Sugarman & Warrington, *supra* note 23, at 116 (quoting LORD NOTTINGHAM'S MANUAL OF CHANCERY PRACTICE AND PROLEGOMENA OF CHANCERY AND EQUITY 280 (D. Yale ed., 1975)).

52. See, e.g., *Ringling Joint Venture II v. Huntington Nat'l Bank*, 595 So. 2d 180, 183 (Fla. Dist. Ct. App. 1992) (upholding executory deed in lieu of foreclosure as part of an extension agreement after default, but noting that "[s]uch arrangements should be carefully scrutinized to assure that they do not violate the favored right of redemption"); *Gillam v. Michigan Mortgage Inv. Co.*, 194 N.W. 981, 982 (Mich. 1924) (stating that a commercial debtor may waive the equity of redemption in a workout, where the waiver is "supported by reasonably adequate consideration" and is "fairly made without fraud and duress"); *Oakland Hills Dev. Corp.*, 537 N.W.2d at 263-64 ("Courts must carefully scrutinize any transaction in which a mortgagor waives the equitable or statutory right of redemption."); *Russo*, 323 N.W.2d at 390 ("[A]ny contract by which the mortgagor sells or conveys his interest to the mortgagee is viewed suspiciously and is carefully scrutinized in a court of equity. [The exchange] must be fair, frank, honest, and without fraud, undue influence, oppression or unconscionable advantage . . ."); *Humble Oil & Refining Co. v. Doerr*, 303 A.2d 898, 908 (N.J. Super. Ct. Ch. Div. 1973) ("[A]lthough a mortgagor can at a later date, after the original mortgage transaction, surrender his equity of redemption to the mortgagee and enter into an option or agreement to sell, it must be a fair bargain for an independent and adequate consideration. From the earliest days courts of equity have carefully scrutinized such arrangements."). But see RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 3.1 cmt. f, illus. 13-15 (1997) (stating that deed in lieu of foreclosure transactions are valid, but executory deed in lieu transactions—which waive the equity of redemption upon any future default—are not); *id.* § 3.1 reporters' note, at 114 (stating that the treatment of executory deed in lieu transactions "represents a close question under the clogging principle").

53. *Vernon v. Bethell*, 28 Eng. Rep. 838, 839 (Ch. 1762).

54. See, e.g., *Blackwell Ford, Inc. v. Calhoun*, 555 N.W.2d 856, 859 (Mich. Ct. App. 1996); *Humble Oil*, 303 A.2d at 907.

have tended greatly to the furtherance of usury, and the conversion of the equitable jurisdiction of the court into an engine of fraud and oppression.<sup>55</sup>

This "unfair bargaining power" justification is susceptible to several obvious criticisms. First, the need to protect necessitous borrowers does nothing to explain why wealthy and sophisticated commercial borrowers cannot waive the equity of redemption.<sup>56</sup> Indeed, the historical timing of the equity of redemption seems to fly in the face of this rationale, since it arose in England at a time when loans were increasingly being made to wealthy merchants rather than "necessitous men."<sup>57</sup> Second, if credit markets are competitive, competition will prevent lenders from taking undue advantage of borrowers: If one lender insists on unreasonable terms, the borrower can go to the lender down the block.<sup>58</sup> On the other hand, if the market is not competitive and the lender does have market power, the prohibition of one term (waiver of the equity of redemption) will not solve the problem; the lender can use its market power to extract some other concession from the borrower, such as a higher interest rate.<sup>59</sup> Thus, if the equity of redemption is to be justified on the grounds of unequal bargaining power, it is important not only to specify what market failure has created this inequality of bargaining power, but also to explain why prohibiting one type of term (waiver of protections upon default) is a meaningful solution to the problems caused by this inequality.<sup>60</sup> In short, the case law lacks a coherent and convincing ex-

55. *Youle v. Richards*, 1 N.J. Eq. 534, 538 (N.J. Ch. 1832). Comparable statements are legion. See, e.g., *Conway's Ex'rs & Devises v. Alexander*, 11 U.S. (7 Cranch) 218, 237 (1812) ("[A]s lenders of money are less under the pressure of circumstances which control the perfect and free exercise of the judgment than borrowers, the effort is frequently made by persons of this description to avail themselves of the advantage of this superiority, in order to obtain inequitable advantages.")

56. See, e.g., *Lifton*, *supra* note 28, at 1942-45 (advocating broader differentiation in rules applicable to commercial versus consumer mortgagors, because "[commercial borrowers are] equally, if not more, sophisticated than the lender; their bargaining powers are comparable and their equity claims are essentially the same—they each represent competing business interests").

57. William M. McGovern, Jr., *Forfeiture, Inequality of Bargaining Power, and the Availability of Credit: An Historical Perspective*, 74 NW. U. L. REV. 141, 146-47 (1979).

58. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW*, 127-29 (5th ed. 1998); Alan Schwartz, *The Law and Economics Approach*, in *UNIVERSAL ECONOMICS: ASSESSING THE ACHIEVEMENTS OF THE ECONOMIC APPROACH* 221, 231 (Gerard Radnitzky ed., 1992).

59. Moreover, it is likely that even a party with market power would prefer to establish a contract with efficient terms and use its market power to extract a higher price, rather than impose inefficient terms on the transaction, and that striking the objectionable term will therefore put both parties in a worse position. See, e.g., ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 252 (1988); Richard A. Epstein, *Uneconomicity: A Critical Reappraisal*, 18 J.L. & ECON. 293, 313-14 (1975); Schwartz, *supra* note 58, at 233-34.

60. See *infra* Part VI.

planation for its steadfast insistence that there be an equity of redemption in every commercial transaction.

### III. MARKET FAILURE AND MORTGAGOR PROTECTIONS

It is often suggested that in a competitive marketplace with no market failures, restrictions on freedom of contract are inefficient.<sup>61</sup> This is the basis for numerous critiques of regulation, whether judicial, legislative, or administrative. The corollary also provides a primary justification for legal interventions in the market: when the marketplace is not competitive or there are systematic market failures, regulation can enhance efficiency.<sup>62</sup> Thus, it is not surprising that mortgagor protections are subject to criticism as inefficient interventions in the market, or that the primary justifications for them are drafted in terms of market failure.

On the most basic level, it is easy to understand the arguments against mortgagor protections and the adverse effects they may have on both borrowers and lenders. The lender may be required to incur substantial cost and delay in seeking to enforce its rights, reducing the ultimate recovery to the lender on a defaulted loan. Lenders will have to pass these increased losses through to borrowers by raising the cost of mortgage loans. Further, if borrowers have extensive protections, it becomes relatively easy for the borrower to increase the costs to the lender through various methods of objection and delay. This opportunity to force a greater loss on the lender creates a moral hazard problem. Borrowers, aware that lenders' remedies are of limited efficacy, may be more likely to default or to attempt to compel the lender to agree to a loan modification or renegotiation.

The Article 9 literature discloses another way in which mortgagor protections may have adverse effects, both in terms of efficiency

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61. See Eric L. Talley, *Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule*, 46 STAN. L. REV. 1195, 1195 (1994) ("[A]n oft-recited theme in the law and economics literature is that when individuals act rationally, and transaction costs are negligible, restrictions on contractual freedom cannot enhance economic efficiency."); cf. POSNER, *supra* note 58, at 284-87 (discussing whether moral objections to efficiency are well-founded).

62. See, e.g., POSNER, *supra* note 58, at 401-03 (comparing and contrasting the "two methods of public control"—the common law and administrative regulation); William N. Eskridge, Jr., *One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psychological Dynamics of the Home Sale and Loan Transaction*, 70 VA. L. REV. 1083, 1214-17 (1984) (discussing various market failures as justifications for intervention in the residential mortgage market). For a more general discussion of institutional choice and law as a cure for market failure, see Neil K. Komisar, *Exploring the Darkness: Law, Economics, and Institutional Choice*, 1997 WIS. L. REV. 465.



and equity—mortgagor protections may destroy an important mechanism that borrowers use to signal their creditworthiness. As Professor Scott has pointed out, if borrowers have better information about their likelihood of default than lenders can easily determine, penalty clauses may play an important role in securing loans for marginal borrowers.<sup>63</sup> Assume a lender wants to determine whether a borrower is a “good” borrower (less likely to default) or a “bad” borrower (more likely to default). Further, imagine that borrowers know which type they are, but good borrowers have difficulty finding a clear way to communicate their quality to the lender in a way that bad borrowers cannot copy. One way to provide this information is to agree to pay a penalty of some kind upon default. A bad borrower, knowing that default is likely, is unlikely to agree to such a penalty, but a good borrower, knowing default is not likely, will agree. Thus, the ability to offer the creditor harsh and effective remedies upon default may help lenders distinguish between more and less creditworthy borrowers and so make credit more available to worthy but marginal borrowers.<sup>64</sup>

For these reasons,<sup>65</sup> mortgagor protections have been harshly criticized as an unwarranted interference in the market, whose costs lack corresponding benefits.<sup>66</sup> By increasing lender losses upon de-

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63. See, e.g., Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1131 (1981); Robert E. Scott, *Rethinking the Regulation of Coercive Creditor Remedies*, 89 COLUM. L. REV. 730, 741-56 (1989).

64. As Professor Scott pointed out, the “lost value” problem can in fact help this process to function. See Scott, *supra* note 63, at 730-32. The criticism of foreclosure on many items of personalty (particularly household goods) is that the lost value is extreme: this type of collateral is of great value to the borrower, who is using it, but has very little market value or value to the lender. See *id.* at 756-59. Thus, foreclosure on such assets deprives the borrower of valuable assets while realizing little or nothing for the lender. See *id.* at 758. In other words, foreclosure is punitive rather than remedial. See *id.* As Scott argues, however, this can be an important element in making the credit system function. See *id.* at 787-88. If the collateral is valuable, then the lender may have an incentive to induce breach (or an incentive not to work with a defaulting borrower who needs a renegotiation or other temporary accommodation) in order to obtain the collateral. See *id.* at 764-65. If the collateral is of little value to the lender, the lender will not induce breach; yet if it has value for the borrower, then it will be effective in deterring “bad” borrowers from seeking credit. See *id.* at 746-49. Scott’s article provided an important counterpoint to the extensive Article 9 literature that identified the “lost value” problem as a major flaw in personal property financing, without recognizing the vital purposes that penalty provisions can serve. For a related point in the commercial context, see Triantis, *supra* note 12, at 246-47.

65. Of course, these are not the only grounds upon which such provisions have been attacked. Most recently, mortgagor protections have been criticized for contributing to the erosion of personal responsibility in our society. See James B. Hughes, Jr., *Taking Personal Responsibility: A Different View of Mortgagee Antideficiency and Redemption Statutes*, 39 ARIZ. L. REV. 117, 120 (1997).

66. See, e.g., David J. Dietrich, *The Montana Judicial and Non-Judicial Foreclosure Sale: Analysis and Suggestions for Reform*, 49 MONT. L. REV. 285, 322 (1988) (redemption statutes in-

fault, mortgagor protections force lenders to raise the interest rates they charge.<sup>67</sup> These higher rates not only make mortgages more expensive for all borrowers, but they have a disproportionate impact on marginal borrowers, both because they can least afford the increase and because lenders will be less willing to lend to marginal borrowers (and so will tighten credit standards).

But mortgagor protections also have their defenders. Michael Schill has provided the most thorough justification of mortgagor protection laws, at least as applied to consumers, arguing that they correct some basic market failures.<sup>68</sup> Schill draws the following distinction between the equity of redemption (which the courts regulate) and other financing terms (which the courts do not regulate): borrowers are able to evaluate the latter with reasonable accuracy, but systematically misvalue the former.<sup>69</sup> In Schill's analysis, mandatory mortgagor protections are a form of compulsory insurance, imposing a slightly higher interest rate on each borrower in exchange for additional protections should circumstances disable the borrower from performing according to the mortgage loan agreement.<sup>70</sup> While

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crease cost of credit); George M. Platt, *Deficiency Judgments in Oregon Loans Secured by Land: Growing Disparity Among Functional Equivalents*, 23 WILLAMETTE L. REV. 37, 49 (1987) (arguing that "the debtor's statutory right to redeem is chimerical" and that it succeeds only in lengthening the foreclosure proceeding and increasing lender costs); Tefft, *supra* note 21, at 590, 596 (stating that "[s]tatutory rights of redemption should be abolished; they operate to discourage bidding"). See generally Terrence M. Claurette, *State Foreclosure Laws, Risk Shifting, and the Private Mortgage Insurance Industry*, 56 J. RISK & INS. 544, 544-52 (1989) (showing that laws favoring borrowers increase mortgagee costs).

67. For estimates of the amount of this effect, see Terrence Claurette, *The Impact of Interstate Foreclosure Cost Differences and the Value of Mortgages on Default Rates*, 15 AM. REAL EST. & URB. ECON. A. J. 152 (1987); Mark Meador, *The Effects of Mortgage Laws on Home Mortgage Rates*, 34 J. ECON. & BUS. 143, 146-47 (1982); Schill, *supra* note 29, at 496-97.

68. See Schill, *supra* note 29, at 498-500.

69. See *id.* at 491, 500. In justifying borrower protections as remedies for consumers' cognitive limitations, Schill is part of an extensive literature. See, e.g., Braucher, *supra* note 8 (defending "fairness" as a standard of enforcing proper terms in consumer transactions where market failures prevent consumers from protecting themselves); Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983) (exploring the need to protect consumers based on imperfect information); Norman I. Silbor, *Observing Reasonable Consumers: Cognitive Psychology, Consumer Behavior and Consumer Law*, 2 LOY. CONSUMER L. REP. 69 (1990) (examining the psychological evidence for consumers' inability to act as rational maximizers). As Scott has written, "at bottom, all attempts to justify current regulation [of consumer credit transactions] rest on the evidence that individual debtors make systematic cognitive errors and are vulnerable to impulsive behavior." Scott, *supra* note 63, at 766.

70. See Schill, *supra* note 29, at 495-500. A similar argument is made by Charles Kahn & Abdullah Yavas, who expanded the concept of mortgagor protection as insurance for risk-averse mortgagors. See Charles M. Kahn & Abdullah Yavas, *The Economic Role of Foreclosures*, 8 J. REAL EST. FIN. & ECON. 35, 45-46 (1994). The ability to renegotiate upon default, and the bank's incentive to do so (where it values the collateral less than does the borrower) is insurance

such insurance could be offered by the marketplace, Schill demonstrates that consumers may have systematic cognitive limitations that prevent them from adequately valuing this insurance. In other words, because consumers underestimate the likelihood of various misfortunes that could lead them to default (unemployment, health problems, and so forth), they would refuse to purchase mortgage insurance against these risks even if it were offered on actuarially advantageous terms. Given these cognitive failures, mandatory insurance through mortgagor protection laws can be justified as a reasonable correction for a malfunctioning market.<sup>71</sup>

The argument that mortgagor protections are intended to shield borrowers from the effects of their own undue optimism is reflected elsewhere in the traditional literature.<sup>72</sup> But while such cognitive limitations are plausible, indeed likely, in consumer markets, they are less convincing as an explanation for intervention in commercial mortgage transactions. We generally expect commercial entities to be able to gauge risk effectively, and, at the very least, there is good reason to be skeptical of claims that mandatory and inflexible legal rules will systematically outperform commercial parties in measuring and allocating risk. Schill specifically notes that his model of market failure is unpersuasive as applied to commercial actors and

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for the borrower. When the legislature imposes a mandatory protection, it increases the insurance aspect, which will benefit very risk-averse borrowers.

71. Obviously, these protections could go too far, offering greater protections than even informed, risk-averse borrowers would choose. In the extreme, we might expect to see other mechanisms substituted for mortgage loans. This appears to be happening in France, where foreclosure takes at least three years—and even longer if the borrower engages in delaying tactics. The inefficiency of mortgage law, combined with the costs of recording a mortgage, have resulted in the rise of unsecured loans to purchase homes, backed by a surety company that charges the borrower a fee for issuing the guaranty. Upon default, the surety pays the lender, and then may pursue its remedies against the borrower. For a fuller description, see Charles Austin Stene & Anne Zissu, *Le Pret Immobilier Cautionne: An Innovative Substitute for the French Mortgage*, 3 J. HOUSING RES. 401, 401-06 (1992).

72. [R]elief will be granted where there has been a misreliance upon the “mirage of hope.” Ordinarily the courts have talked in terms of granting relief because of solicitude for the “impecunious landowner” or “necessitous men [who] are not, truly speaking, free men.” But another most important factor is in the mortgagee playing upon the optimism to which all mankind is prone, the “over-confidence in one’s own capacities and faith in a special providence [which] leads us to over-sanguine commitments.” Equity takes this human failing into account.

GEORGE E. OSBORNE, MORTGAGES 147 (2d ed. 1970) (citations omitted); see also RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 3.1 cmt. f (1997) (noting that “subsequent executory agreements are not . . . shielded from the clogging doctrine”); McGovern, *supra* note 57, at 143, 147-48 (discussing the historical trends of relief for mortgagors and mortgagees).

suggests that mortgagor protection laws should not cover commercial borrowers.<sup>73</sup>

External effects are another category of market failures that often justify legal intervention in the market. If mortgage defaults have negative effects on parties other than the lender and borrower, which the lender and borrower do not take into account in their dealings, then public regulation to mitigate these externalities may be justified.<sup>74</sup> Certainly, externality arguments have been used to justify some mortgagor protection laws, particularly in periods of widespread economic failure.<sup>75</sup> However, it is difficult to see the particular external effects that warrant singling out commercial mortgage relationships from other financial contracts,<sup>76</sup> and there do not appear to be any comprehensive or persuasive attempts to justify commercial mortgagor protections on the basis of externalities.<sup>77</sup>

A related justification for mandatory mortgage law may arise from the efficiencies of standardized contracting.<sup>78</sup> It may be that lenders and borrowers could maximize the net benefits of their contractual relationships through individually crafted loan documents. However, lenders and borrowers as a group may face lower costs if

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73. See Schill, *supra* note 29, at 533-34; see also Greg Weselka, Note, *Real Property Deficiency Judgments—Texas Enacts Fair Market Value Statutes*, 23 TEX. TECH. L. REV. 871, 905-06 (1992) (arguing that commercial mortgagors do not need anti-deficiency protection because they can bargain at arm's length).

74. See Eric Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 285 (1995) (arguing that some mandatory protections are justified to prevent undue risk-taking by persons protected by the welfare state).

75. See, e.g., Samuel R. Olken, *Charles Evans Hughes and the Blaisdell Decision: A Historical Study of Contract Clause Jurisprudence*, 72 OR. L. REV. 513, 576-77 (1993) (noting appellee's argument in *Home Building & Loan Association v. Blaisdell*, 290 U.S. 398 (1934), that mortgage moratoria were valid exercises of the police power that did not violate the Contracts Clause because rampant foreclosure sales caused real estate depreciation that prolonged the depression and led to civil unrest).

76. Externality arguments have been used to justify other restrictions on contractual freedom in the commercial context. See, e.g., Paul Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237, 239-41 (1981) (arguing that penalty clauses in contracts typically are not enforced in order to prevent commercial parties from externalizing the cost of dispute resolution by using publicly-funded courts).

77. This obviously relates to the extensive debate about the effects of secured credit on noncontractual creditors, such as tort claimants. Some have argued that a primary function of secured credit is to externalize costs of business failures onto noncontractual creditors, to the benefit of sophisticated contractual creditors and shareholders. For further discussion of this argument, see Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice and Law*, 82 CORNELL L. REV. 301, 335-37 & n.167 (1997). However, there does not appear to be any attempt to tie these concerns to the structure of real property mortgage law.

78. This explanation has been advanced as a potential justification for mandatory corporate law. See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1567-69 (1989) (discussing the need for a mandatory uniform legal regime to maintain the public good of a standard corporate form).

their rights and obligations are clearly defined. If each mortgage agreement is unique, there will be less judicial precedent on point in any particular dispute and less certainty about the parties' entitlements. Thus, the mortgage finance system may function most efficiently overall if borrowers and lenders have mandatory, predefined rights, even if any particular loan might have been more efficiently structured by individualized negotiations between the parties. This justification, however, does not explain what is special about mortgage law. It is hard to see why mortgages require a more standardized framework than other areas of commercial contracting.

Of course, there are justifications for consumer protection law apart from market failures such as externalities and imperfect information. For example, Anthony Kronman has justified contract regulation on paternalistic grounds, seeing a role for government in preserving individual liberty and welfare.<sup>79</sup> In the commercial context, however, these autonomy and welfare concerns carry much less weight because we have little concern for the autonomy and welfare of commercial entities. Rather, contractual freedom of commercial entities is an instrumental goal, desirable because and to the extent it furthers other ends—primarily the goal of economic efficiency.<sup>80</sup>

Another set of justifications for mortgagor protections in the consumer context can be found in the importance or sanctity of the homestead. As Margaret Radin has written, people become emotionally attached to their homes, so that their sense of well-being may become closely linked with the preservation of the home.<sup>81</sup> Indeed, residences are accorded a special place in many areas of our legal system, ranging from the home mortgage income tax deduction to bankruptcy exemptions. Mortgagor protections can also be defended in terms of fairness<sup>82</sup> or distributional equity.<sup>83</sup> But whatever the merits

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79. See Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763 (1983). But see Scott, *supra* note 63, at 776-82 (responding to Kronman and rejecting paternalistic and distributional arguments against self-enforcing creditor remedies).

80. I do not mean to suggest that this is the only relevant goal to consider. Contractual freedom may also further other interests, such as the dispersion of power throughout society as a bulwark against government oppression, and the freedom of commercial entities may also be instrumental in securing liberty for natural persons, who use these entities to further personal goals.

81. See Margaret Jane Radin, *Property and Personhood*, 34 STAN. L. REV. 957, 991-1002 (1982) (discussing how the "personhood perspective" in relation to the home is "implicit in our law").

82. See, e.g., 1 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 128 (1960) (discussing the equity of redemption in terms of unconscionability); McGovern, *supra* note 57, at 143-44 (discussing historical notions of fairness in the creditor-debtor relationship).

83. See Schill, *supra* note 29, at 490 n.4.

of these arguments in the consumer context, they are suspect as justifications for mandatory borrower protections in financing agreements between sophisticated commercial entities.

As one would expect given the obvious limitations of these rationales, the law has often recognized that commercial borrowers are in need of less protection than consumer borrowers.<sup>84</sup> This tendency is present in mortgage law to some extent,<sup>85</sup> yet the differentiation between consumer and business mortgagors is still rather limited in most jurisdictions.<sup>86</sup> Many mortgagor protections—the equity of redemption, anti-deficiency statutes, one-action rules, and so forth—apply to both consumer and commercial mortgagors. Some statutes limit their protections to residential borrowers and some courts have indicated a greater willingness to permit commercial borrowers to waive the equity of redemption in workout situations subject to strict judicial review of the fairness of the transaction.<sup>87</sup> But the fact of judicial scrutiny is itself surprising—in how many other contexts do courts insist on scrutinizing commercial transactions before granting them a presumption of enforceability?

Absent the identification of a market failure, or of some value that trumps efficiency concerns in this context, it is difficult to justify the imposition of mandatory protections for commercial mortgagors. To put the question bluntly, if Donald Trump agrees to waive the equity of redemption in order to secure a mortgage loan from a syndicate of money center banks, why should the law interfere? Thus we face a question that lies at the heart of the law of mortgages (of both real property and personalty): Is there any reason why the equity of redemption cannot be waived, or is this a mere historical artifact, an irrationality in the largely rational body of the common law?

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84. In fact, it is easy to compile a list of legal protections for consumers that are not extended to commercial actors. Examples where consumer protections are generally not available to commercial parties include usury statutes, the Truth in Lending Act, and the unconscionability doctrine generally.

85. See, e.g., *Palcar Real Estate Co. v. Commissioner*, 131 F.2d 210, 211-12 (8th Cir. 1942) (holding that commercial mortgagor may waive the statutory right of redemption in the initial mortgage).

86. Residential mortgagees often have greater protections in fact, even if the law applicable to residential mortgagees and commercial mortgagees is identical, because the standardized forms used for most residential mortgages, at the behest of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association, are drafted to be relatively pro-consumer. See Curtis J. Berger, *ULSIA and the Protected Party: Evolution or Revolution?*, 24 CONN. L. REV. 971, 974 (1992).

87. See *supra* note 52 and accompanying text.

## IV. THE FUNCTIONS OF MORTGAGE LAW

It has often been suggested that the common law has a tendency to adopt economically efficient rules.<sup>88</sup> If this is so, then it seems likely that a rule as universally followed as the immutability of the equity of redemption is economically efficient. It is not hard to suggest reasons why the equity of redemption, or various other mortgagor protections, may be efficient in the majority of mortgage relationships.<sup>89</sup> But even if the equity of redemption benefits most parties, is there any reason to require it, rather than letting parties negotiate the term for themselves? This question takes on added weight when one considers the downside of the equity of redemption: it typically results in an added layer of delay and litigation expense upon default. One can easily imagine settings in which the equity of redemption might appear to be a desirable mortgage term and settings in which it might not. The puzzle, then, is why the term is a mandatory element of the mortgage relationship rather than a negotiable default rule.

The analysis below suggests that the equity of redemption may in fact be efficient, helping the parties to create appropriate incentives for renegotiation upon default.<sup>90</sup> Moreover, it may be difficult or impossible for the parties to negotiate such a provision even though it is efficient because of signalling problems present in the loan origination process.<sup>91</sup> Ultimately, an understanding of this problem may help to find the grain of sense in the seemingly irrational judicial incantations of unequal bargaining power as the justification for the equity of redemption.<sup>92</sup>

A. *The Mortgage Context*

To understand the role of the equity of redemption, we must start with its obvious effects. The equity of redemption generally increases the amount of time it takes for the lender to enforce its rights

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88. See, e.g., John C. Goodman, *An Economic Theory of the Evolution of the Common Law*, 7 J. LEGAL STUD. 393, 393 (1978). But see E. Donald Elliott, *The Evolutionary Tradition in Jurisprudence*, 85 COLUM. L. REV. 38, 62-72 (1985) (discussing economic models of efficient legal evolution in the context of other evolutionary theories of law); Gillian K. Hadfield, *Positive Political Theory and Public Law: Bias in the Evolution of Legal Rules*, 80 GEO. L.J. 583, 583-86 (1992) (disputing efficiency of the common law).

89. They may create efficient incentives for breach, allocate bargaining power in an efficient manner, or be a desirable means of dividing risks among the parties.

90. See *infra* Part V.

91. See *infra* Part VI.

92. See *supra* notes 53-60 and accompanying text.

and increases the costs incurred by the lender in enforcing its rights. Can delay and increased enforcement costs be good things?

At this point, a few factors pertinent to real estate lending should be discussed. First, commercial real estate is relatively illiquid, and converting property value to cash can be expensive and time consuming. Thus, it is not uncommon for a borrower with equity to have difficulty in making its mortgage payments. Moreover, the high costs of transferring interests in real property make the risk of lost value a real one should the lender speedily foreclose on the collateral. This risk is complicated by the difficulty of valuing commercial property, another facet of an illiquid market.

Second, commercial mortgage loans may go into default for any of a host of reasons pertaining to the overall state of the economy or local real estate market, bankruptcy or default of a tenant, the abilities or honesty of the owner or manager, natural catastrophes, or myriad other factors. While the parties may form opinions as to the cause or causes of any particular default, these are often subject to debate and may be expensive and difficult for a court to determine accurately.

Finally, consider a typical mortgage loan scenario: the lender has largely performed its contract by funding the loan and its obligations thereafter are ancillary at most. There is little opportunity for the lender to default once the loan is advanced. While discussions of foreclosure law often ascribe the position of "power" to the lender, in a very real sense the borrower has the power: the borrower has received the lender's full performance and the lender is at risk for repayment. The result, not surprisingly, is an effort to create mechanisms that will ensure good faith performance by the borrower.

With these factors in mind, it becomes clear that a properly structured mortgage agreement must accomplish at least three distinct objectives. First, it should permit efficient screening or signaling in the mortgage loan market, so that appropriate loan decisions are made. Second, it should provide incentives for efficient behavior by the lender and borrower during the life of the loan. Third, it should provide incentives for efficient enforcement or renegotiation should the loan go into default. The question of signalling or screening is addressed in Part VI. The creation of efficient incentives during the life of the loan, and for renegotiation upon default, are the subjects of the sections immediately below.



*B. Efficient Incentives During the Life of the Loan*

The lender, having fully performed its obligations by advancing the loan proceeds, will insist on protections to maximize the probability that the borrower will be willing and able to repay the loan as it comes due. A mortgage prevents misbehavior by the borrower in two primary ways. First, by giving the lender a property interest in the collateral, the mortgage prevents the borrower from entering into certain transactions with other parties (subsequent lenders or purchasers) that would be inconsistent with the lender's interest.<sup>93</sup> Second, it provides that certain types of misbehavior will give the lender the right to accelerate the loan and, if the borrower does not redeem the collateral by repaying the debt in full, foreclose.<sup>94</sup> In these ways, the mortgage gives the lender leverage to induce the borrower to perform its contractual obligations, and also provides the remedy of foreclosure for the lender should the borrower nonetheless breach.

Inducing performance by the borrower and increasing the assets available to the secured creditor are not the only functions of a security interest, however. In thinking about the loan relationship, it is worth considering what the parties would consider full, good faith performance. It could mean the enforcement of the written contract according to its terms, but the parties would probably want more than that. They would also like to know that, should problems develop in the future, they would each engage in good faith negotiations to maximize their joint profits.

If an efficient renegotiation is possible, yet the parties fail to reach it, there are both public and private costs. The parties suffer from the failure to maximize the value of their joint undertaking. The public also suffers as the parties move their dispute resolution process from the realm of private negotiations, in which the parties bear all of the costs, to the courts, which are subsidized by public funds.<sup>95</sup> A system of law that encourages effective renegotiation is therefore a benefit not only for the parties but also for the courts and taxpayers.

Thus, a well-crafted security arrangement should serve a function that has gone relatively unnoted in the legal literature: it should provide a structure that encourages the lender and borrower to

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93. See, e.g., Triantis, *supra* note 12, at 247 (noting that security interests impair the future marketability of collateral).

94. See, e.g., *id.* at 245-49 (discussing value of security interest for maximizing enforcement efficiency).

95. For an elaboration of this argument in the context of liquidated-damages provisions, see Rubin, *supra* note 76, at 238.

renegotiate the loan if renegotiation is efficient. Further, an efficient security arrangement would do this without creating opportunities for the parties to compel inefficient renegotiations or otherwise act opportunistically during the loan term. The following sections explore the role of mortgage law in fostering efficient renegotiation.

### C. *Efficient Renegotiation upon Default*

#### 1. The Benefits of Renegotiation

If the borrower defaults, the parties may resort to their legal rights and remedies: the lender may choose to enforce its contractual and security rights, and the borrower may decide whether to redeem the collateral by paying the mortgage debt. However, in many situations it may be better for the borrower and lender to enter into a renegotiated credit arrangement. If this appears to be the case, the parties presumably would prefer to engage in good faith negotiations to secure a workout agreement. Yet, for a number of reasons, they may find themselves unable to reach an efficient renegotiation even if one is available.

To understand the renegotiation problem, we must begin with a quick review of the literature on fully contingent contracts. Whenever contractual performance extends over a period of time, the initial allocation of rights may be rendered inefficient by changing circumstances.<sup>96</sup> An ideal contract would provide the optimal rights and remedies for each party, for each possible future state of the world.<sup>97</sup> However, such a contract, often referred to as “fully state-contingent,” is not only impossible to achieve (because it would take perfect foresight and drafting),<sup>98</sup> but would require the parties to negotiate and draft myriad provisions pertaining to extremely improbable events, incurring unjustified transaction costs.<sup>99</sup> Given the limits of human foresight and other costs of negotiating a fully specified contract, contracts are always incompletely state-contingent.<sup>100</sup>

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96. See Clayton P. Gillette, *Commercial Relationships and the Selection of Default Rules for Remote Risks*, 19 J. LEGAL STUD. 535, 535-36 (1990); Scott, *supra* note 13, at 603-05.

97. See Talley, *supra* note 61, at 1206 n.48 (noting that a “completely contingent contract . . . is more of a theoretical construct than an empirical reality”).

98. See *id.* at 1206 (stating that “completely contingent contracts are unfeasible”).

99. See *id.*

100. A contract may be “obligationally complete,” meaning that it sets forth each party’s rights and obligations under every future state of the world (such as “I have given you the car

Even if a fully specified contract could be drafted, its efficacy would be limited by the costs and errors of enforcement—in particular, courts may be unable to accurately and inexpensively determine the precise meaning of the agreement<sup>101</sup> and each of the factors relevant to carrying out the specified bargain. As Gur Huberman and Charles Kahn have shown, when the costs of drafting a complete contract are combined with these limits on contract enforcement, it may be optimal for the parties to leave various contingencies untreated in the initial contract in the expectation that, should those contingencies arise, the relationship will be renegotiated.<sup>102</sup> If the parties take this route, then they may prefer not to draft the initial contract to provide for their best guess as to the outcome of the renegotiation; rather, they may want the initial contract to incorporate those terms that will be most conducive to a successful renegotiation should the relevant contingencies in fact come to pass.<sup>103</sup>

To be more specific, a mortgage default is not only the setting for a possible foreclosure proceeding, but the occasion for negotiations regarding a restructuring of the loan obligation. Under various scenarios, it may make sense for the lender to agree to forbear on its remedies and renegotiate the borrower's repayment obligations. For example, if the loan default is caused by temporary conditions that the lender and borrower both expect to pass quickly, and if foreclosure entails substantial cost, both sides may gain by agreeing to interim

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and you will pay me \$5,000 tomorrow"). Yet an obligationally complete contract is not necessarily complete in the sense of being optimally state-contingent—that is, it may not provide the optimal rights and remedies for every future state of the world. See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 730 (1992).

101. For a similar point in a different context, see THE FEDERALIST NO. 37, at 229 (James Madison) (Clinton Rossiter ed., 1961), which states: "All new laws, though penned with the greatest technical skill, and passed on the fullest and most mature deliberation, are considered as more or less obscure and equivocal, until their meaning be liquidated and ascertained by a series of particular discussions and adjudications."

102. See Gur Huberman & Charles Kahn, *Limited Contract Enforcement and Strategic Renegotiation*, 78 AM. ECON. REV. 471, 471 (1988) [hereinafter, Huberman & Kahn, *Limited Contract Enforcement*]; Charles Kahn & Gur Huberman, *Default, Foreclosure and Strategic Renegotiation*, 52 LAW & CONTEMP. PROBS. 49, 51 (1989) [hereinafter, Kahn & Huberman, *Default*].

103. Kahn and Huberman write that:

[O]ur approach emphasizes that property rights may be assigned initially on a strategic basis. In some circumstances it is desirable to assign property not to the party who has the greatest ultimate use for the property, but to the party who should be endowed with bargaining power in subsequent periods. While a lender typically has less use for the secured property than does a borrower, a security contract assigns the property right to the lender in case of default in order to give the lender the power to extract as much value as possible when default occurs.

Kahn & Huberman, *Default*, *supra* note 102, at 61.

relief such as a temporary payment moratorium. Or suppose the borrower has specialized knowledge or abilities relating to the collateral, so that the property is worth more to the borrower than to the lender or to third parties.<sup>104</sup> A renegotiation in which the borrower retains control of and an interest in the property may be value-maximizing for both borrower and lender. In other cases, the optimal result may follow from enforcement of the original mortgage terms without renegotiation. For example, if the default was caused by the dishonesty or incompetence of the borrower, foreclosure may maximize the value of the asset. Moreover, the threat of foreclosure rather than renegotiation when the borrower is at fault may provide an important incentive for borrowers to be careful and honest.<sup>105</sup>

If contracting were costless and courts could easily and accurately determine the causes of default, the intentions and abilities of the borrower and lender, and all other factors relevant to the renegotiation decision, then the parties could specify in the initial contract what should happen to the collateral under each possible default scenario. The court would determine which default scenario had occurred and then impose the efficient resolution on the parties, all as specified in the initial contract. However, given that such a detailed and prescient contract is impossible, the lender and borrower may maximize their joint benefits by leaving many specific default scenarios untreated in the initial contract—if they can renegotiate upon default.

At first blush, this renegotiation might appear a fairly easy matter. If transaction costs are low, the legal entitlements of the parties upon default (including the legal rules governing foreclosure)

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104. See Mann, *Explaining*, *supra* note 21, at 647 n.79 (listing factors that can cause a debtor to value collateral at more than market value); Mann, *Strategy*, *supra* note 21, at 202 (explaining why real estate lender prefers to leave many defaulting borrowers in possession of the collateral). In general, we can expect collateral to be worth more in the hands of the borrower than the lender, because lenders are usually not efficient managers of the types of assets that are assigned as collateral. See Helmut Bester, *The Role of Collateral in a Model of Debt Renegotiation*, 26 J. MONEY CREDIT & BANKING 72, 73 (1994) (noting that creditors are less efficient as managers of a project's assets than debtors); Huberman & Kahn, *Limited Contract Enforcement*, *supra* note 102, at 471 (discussing lender inefficiency as a rationale for contract renegotiation).

105. See Huberman & Kahn, *Limited Contract Enforcement*, *supra* note 102, at 480:

The threat of taking over the borrower's assets is useful in inducing types of behavior that the bank desires (for example, prudent investment policies), but which it would be difficult for a court to verify. If default does occur, the inferior clause, having served its purpose, can be renegotiated away.

*Id.*

might affect the allocation of benefits between them,<sup>106</sup> but would not prevent an efficient outcome.<sup>107</sup> The lender and borrower would arrive at a renegotiated loan if this maximized their joint returns. But loan workouts are not low transaction cost settings. Not only is it costly to draft and enforce contracts, but several additional types of transaction costs affect the renegotiation: the workout situation is a bilateral monopoly with asymmetric information.<sup>108</sup> Moreover, the possibility of renegotiation may itself create incentives for opportunistic behavior by the parties.<sup>109</sup> Given these problems, the parties will want the initial mortgage agreement to incorporate incentives to conduct renegotiations efficiently. It is in the context of this high-transaction-cost renegotiation that the economic justification for the equity of redemption appears.

## 2. Barriers to Renegotiation

The first obstacle to renegotiation is the existence of a bilateral monopoly.<sup>110</sup> In the workout situation, the borrower and lender each face constraints on their ability to exit the relationship. To the extent that the borrower and lender are locked into dealing with each other, they can be expected to engage in difficult and time-consuming negotiations, as each party attempts to garner a greater share of the benefits available from a renegotiation.<sup>111</sup>

The bilateral monopoly problem is compounded by the presence of private information. To take the simplest example, a party will generally be unwilling to communicate to the other side the value it places on a potential contract, because that disclosure would enable the other side to set its price at the highest level to which the first

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106. This would affect the initial pricing of the loan, but not the disposition of the collateral upon default.

107. This is a straightforward application of the Coase theorem. See generally Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

108. In an analogous situation, Talley analyzed the enforceability of liquidated damages provisions as a situation of renegotiating a bilateral monopoly with asymmetric information. See generally Talley, *supra* note 61.

109. See *infra* Part IV.C.3.

110. A bilateral monopoly arises when parties have no choice but to negotiate with each other, and so neither party faces the constraint of competition in conducting its negotiations. See POSNER, *supra* note 58, at 68-69 (discussing bilateral monopolies in the context of transaction costs).

111. Cf. Talley, *supra* note 61, at 1198 (referring to this situation as a "bilateral monopoly").

party would agree.<sup>112</sup> The presence of private information can pose a significant barrier to successful negotiations.<sup>113</sup>

In the mortgage default context, the fundamental, though certainly not the only, informational asymmetry appears in each party's knowledge of the other's perceived valuation of the collateral. Given the illiquid nature of commercial real estate markets, property valuation is subjective even in the best of cases, a problem compounded by the specifics of the borrower's and lender's situations.<sup>114</sup> A borrower may value a property at more than "market value" because of ego considerations, because the borrower can manage or develop the property more efficiently than others due to knowledge developed in working with the property,<sup>115</sup> and so on. Conversely, the lender may or may not be willing to foreclose on the property depending on its evaluation of the market for the property, its internal management skills, or its regulatory and accounting needs.<sup>116</sup> These internal valuations and considerations are not apparent to the other side in the negotiations, nor can they easily be communicated in a credible fashion.

Where one party (say, the lender) has market power, and the other (say, the developer) has private information, the result may be inefficient contracting.<sup>117</sup> The developer may desire special terms, but can only justify those desires by disclosing the value of the project. Yet, if the developer discloses how valuable the project is and the lender has market power, the lender will use that market power to extract additional profits from the developer. Therefore, the developer may prefer not to disclose, so as not to share excess profits, and

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112. This is strictly true only where the second party has some market power; if the market is fully competitive and contracting is costless, the second party will only be able to extract the market price regardless of its knowledge.

113. See Jason Scott Johnston, *Default Rules/Mandatory Principles: A Game Theoretic Analysis of Good Faith and the Contract Modification Problem*, 3 S. CAL. INTERDISC. L.J. 335, 340-50 (1993) [hereinafter Johnston, *Default Rules/Mandatory Principles*] (discussing inefficiencies resulting from incomplete information); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615, 631-36 (1990) [hereinafter Johnston, *Strategic Bargaining*] (showing how strategic bargaining concerns can prevent parties from disclosing information that is needed for the parties to arrive at an efficient contract).

114. Cf. Shupack, *supra* note 7, at 1092 (noting that different creditors may value even readily marketable collateral differently, depending on the costs they would face in foreclosure or repossession, and disposition).

115. See Mann, *Strategy*, *supra* note 21, at 204-05 (discussing borrowers' expertise as a factor in workouts).

116. See Marshall E. Tracht, *Workouts, Foreclosure, and Bankruptcy, Chapter 11*, in ALVIN ARNOLD, *REAL ESTATE INVESTOR'S DESKBOOK* ¶ 11.04[4][h] (3d ed. 1994).

117. See Ayres & Gertner, *supra* note 13, at 94.

instead accept less efficient contract terms to keep a larger share of the profits.

Market power may be relatively rare in U.S. lending markets, which are quite competitive. However, relational contracting models suggest that one purpose of secured financing may be to lock the borrower into a relationship with the lender, ensuring the lender that it will reap the rewards of investing time and money in its lending relationship with the borrower.<sup>118</sup> In other words, the point of relational contracting is that the parties may agree to give each other monopoly power to avoid other inefficiencies. But to the extent that the mortgagee and mortgagor develop a relationship that makes them more efficient contracting partners than the alternatives, they each have a greater stake in keeping the relationship alive—and this makes each party vulnerable to strategic or opportunistic behavior by the other.<sup>119</sup> Thus, parties to a relational financing contract may create a situation where, after default, they are negotiating in a situation of asymmetric information and market power, and renegotiation is therefore difficult and contentious.<sup>120</sup>

### 3. The Problem of Opportunistic Renegotiation

Moreover, the possibility of renegotiation may itself create problems, as parties become tempted to threaten default in order to extract improved terms from the other side.<sup>121</sup> If courts are unable to provide a perfect remedy for breach, then a promisor may find it advantageous to breach a contract where the net costs of performing exceed the expected damages that would be awarded by a court.<sup>122</sup> If the promisee is aware of the costs and benefits of performance to the promisor, then the promisee will know whether the promisor's threat of breach is real. If it is, the parties can renegotiate the contract; if not, the promisee will refuse to renegotiate. Thus, if the promisee

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118. Cf. Goetz & Scott, *supra* note 63, at 1092-95 (discussing rationales for entering into relational contracts).

119. See, e.g., *id.* at 1101 (noting relational contracting vulnerability to strategic or opportunistic behavior).

120. Even if the mortgage relationship is not properly viewed as a relational contract, the fixed costs of refinancing may be large enough to give the lender market power vis-à-vis the borrower.

121. For more detailed analyses of this problem, see generally Daniel A. Graham & Ellen R. Peirce, *Contract Modification: An Economic Analysis of the Hold-Up Game*, 52 LAW & CONTEMP. PROBS. 9 (1989); Johnston, *Default Rules/Mandatory Principles*, *supra* note 113; William P. Rogerson, *Contractual Solutions to the Hold-Up Problem*, 59 REV. ECON. STUD. 777 (1992); Scott, *supra* note 13, at 612-15.

122. See Johnston, *Default Rules/Mandatory Principles*, *supra* note 113, at 344-45.

knows what it will cost the promisor to perform, the promisor cannot extract a compromise by falsely claiming a willingness to breach the contract. Similarly, if the court can award perfect damages, the promisee has no reason to compromise its rights when the promisor threatens to breach. Nor will the promisee compromise if the promisee can secure substitute performance in the market.

Under more realistic assumptions, however, a party may threaten breach to secure an opportunistic renegotiation. If the promisee cannot verify the promisor's costs and benefits of performance, and cannot get full compensation or substituted performance if the promisor breaches, the promisor may threaten breach even when it would rather perform than pay damages.<sup>123</sup> The promisee, not knowing whether the promisor will carry out its threat, may compromise rather than risk the losses it would suffer from the promisor's breach. Knowing that the promisee may fold under such a bluff, the promisor has an incentive to threaten breach even when it would rather perform the contract than pay damages—that is, when performance of the contract is efficient. This dynamic results in unnecessary costs as parties renegotiate efficient contracts, and risks inefficient deadlocks where the renegotiation fails.

In the mortgage context, the renegotiation scenario typically arises when the borrower defaults or threatens to default on the mortgage debt. The lender may be unsure whether the borrower is unable to repay the loan, or can in fact repay the loan but is defaulting in order to secure concessions from the lender.<sup>124</sup> If the borrower cannot repay the debt, it is possible that it is in the joint interest of the borrower and lender to restructure the debt. But the lender will be reluctant to agree to a restructuring if it cannot verify that the borrower actually needs these concessions and is not just bluffing in an attempt to obtain improved loan terms. Moreover, the lender may have a strategic reason for refusing to renegotiate where it is unclear whether the borrower's threat of default is genuine or opportunistic: By developing a reputation for toughness, the lender may reduce the likelihood that other borrowers will make opportunistic threats of default. Thus, there is a reason to believe that lenders might prefer to err against renegotiating with borrowers, and that efficient renegotiations may not take place.

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123. See Bester, *supra* note 104, at 76; Graham & Peirce, *supra* note 121, at 9-12; Johnston, *Default Rules/Mandatory Principles*, *supra* note 113, at 345.

124. See Bester, *supra* note 104, at 73.



As Professor Johnston points out, even if it were possible, simply forbidding contract modifications would not be a satisfactory solution to the risk of opportunistic threats, because circumstances may in fact have changed the costs or benefits of performance, making renegotiation the efficient path.<sup>125</sup> The goal, then, is to develop a legal regime that will discourage opportunistic contract modifications while encouraging efficient ones.

## V. THE EQUITY OF REDEMPTION AS AN AID TO RENEGOTIATION

We have identified two related problems. First, the parties want to be able to renegotiate the mortgage transaction as circumstances develop, but these renegotiations face various barriers.<sup>126</sup> Second, if these barriers are successfully reduced, the increased possibility of renegotiation may create an opportunity for costly strategic bluffing.<sup>127</sup>

The equity of redemption may provide a partial cure for these twin problems. It reduces the barriers to renegotiation in several distinct ways. First, it provides the borrower with an exit option, mitigating the lender's monopoly position. Second, the equity of redemption creates a period of unavoidable delay during which a defaulting borrower has an opportunity to convince the lender that the claimed reason for its default is genuine. Moreover, it gives the insolvent or illiquid borrower a bargaining chip that may enable it to convince the lender of its *bona fides*. Finally, it does this without substantially impairing the ability of the lender to impose a loss on a borrower who falsely claims to be unable to repay in the hope of extracting concessions.<sup>128</sup>

Consider a new office building that goes into default because the lease-up period takes longer than anticipated. If the problem is caused by exogenous factors, then it may be efficient to renegotiate the loan to permit the borrower to retain the asset. However, if the problem is caused by the borrower's lack of management skills, rene-

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125. Barring renegotiation may result in certain types of efficiency. In particular, it would eliminate the incentive for parties to falsely threaten breach to secure an inefficient redistributive renegotiation. It may also strengthen the value of secured credit as a signalling device. Cf. Douglas Gale & Martin Hellwig, *Incentive-Compatible Debt Contracts: The One-Period Problem*, 52 REV. ECON. STUD. 647, 647-49 (1985). Moreover, the parties' inability to commit themselves not to renegotiate may prevent them from achieving the most efficient contract in the first place. See Johnston, *Default Rules/Mandatory Principles*, *supra* note 113, at 348 n.24.

126. See *supra* Parts IV.C.1-2.

127. See *supra* Part IV.C.3.

128. See Bester, *supra* note 104, at 77.

gotiation may not be efficient. Perhaps the initial loan agreement could provide that for defaults caused by market conditions the parties will negotiate in good faith to modify the loan agreement, but that if the default is caused by the borrower the lender will be entitled to enforce its remedies. The problems with such a contractual agreement are obvious: determining the cause of the default may be difficult, and judicial determination may be expensive and error-prone.<sup>129</sup>

Moreover, this contractual solution would create incentives for inefficient strategic behavior by both sides. The borrower knows that it can force a renegotiation of the agreement if it can persuade a court that market conditions have forced a default.<sup>130</sup> The lender knows that it can enforce its strict remedies only if it can demonstrate the fault of the borrower. The outcome will be determined not by the parties' actual beliefs about the causes of the problem, but by judicial perceptions of the situation.

Now consider the scenario where the cause of default is irrelevant to the parties' rights, but the lender's remedies are constrained by the equity of redemption. Should the borrower threaten default, the lender must decide whether the borrower is honest or bluffing—which will generally turn on whether the property is worth more or less to the borrower than the debt that is owed. The borrower may find it difficult to communicate its subjective valuation credibly, so the primary problem the parties face is one of communication and trust.

Given this negotiation problem, the equity of redemption (and concomitant need to foreclose the mortgage) may facilitate the workout process. In the terminology introduced by Guido Calabresi and Douglas Melamed, the equity of redemption does not change the lender's entitlement to have the value of the collateral applied to its debt upon default.<sup>131</sup> However, it does change the way in which this entitlement is protected, substituting a liability rule for a property rule.<sup>132</sup> While it has become common to stress the value of clear entitlements, protected by property rules, in reducing transaction costs,<sup>133</sup> the equity of redemption appears to be an example of a liability rule

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129. See *supra* Part IV.C.

130. See *supra* Part IV.C.3.

131. A "property rule" is one that is protected by remedies (such as injunctive relief) that prohibit a nonowner from taking the entitlement without the owner's permission. A "liability rule" permits a non-owner to take the entitlement upon payment of damages to the owner. See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092 (1972).

132. See *id.*

133. See, e.g., COOTER & ULEN, *supra* note 59, at 100; POSNER, *supra* note 58, at 273-74.

that reduces transaction costs in a situation of asymmetric information.<sup>134</sup>

The equity of redemption requires that a period of time (determined by the foreclosure procedures of the jurisdiction) elapse between default and conversion of the collateral. This time factor is often discussed as an opportunity for the borrower to redeem the collateral, but this obscures a second crucial point. The foreclosure period is a time for negotiation between the borrower and lender. It is commonplace for economic analyses of law to note that negotiation is not costless, but it is still relatively uncommon to focus on the need for time within which negotiations can take place. Successful negotiations require an opportunity for the parties to exchange information in a credible fashion.<sup>135</sup> This bargaining process often involves sequential offers and responses calculated to communicate intentions and beliefs in a manner that simple statements of fact or intent cannot convey credibly. The equity of redemption, by compelling a period of delay between default and liquidation of the collateral, creates the time that may be needed for negotiations to succeed.<sup>136</sup>

In this way, the equity of redemption may serve a similar function in fostering settlements as do the rules of discovery in litigation contexts. Discovery proceedings encourage settlements in a number of ways.<sup>137</sup> First, by facilitating the exchange of information, they reduce the informational asymmetries that may block negotiations. Second, the prospect of costly and time-consuming discovery

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134. See Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027, 1058-61 (1995); A. Mitchell Polinsky, *On the Choice Between Property Rules and Liability Rules*, 18 ECON. INQUIRY 233, 234-35, 243 (1980).

135. "[C]ostly delays are necessary to communicate sufficient information credibly. The process of bargaining is inherently necessary to align the parties' expectations so as to allow an agreement; or, the process can fail, leading to an inefficient impasse or recourse to an arbitrator or court." John Kennan & Robert Wilson, *Bargaining with Private Information*, 31 J. ECON. LITERATURE 45, 101 (1993); see also Daniel A. Babush, *The Practitioners Corner*, 22 REAL EST. L.J. 332, 334 (1994) ("There are two keys to reaching a successful outcome. The first is maintaining communication throughout the acrimonious negotiation. The second is establishing a common view of the property's realistic potential.").

136. See generally Joseph Farrell & Robert Gibbons, *Cheap Talk Can Matter in Bargaining*, 48 J. ECON. THEORY 221 (1989) (discussing use of "talk" in trading probability of continued serious negotiations for bargaining position).

137. I do not mean to suggest that the effects of discovery are simple or that discovery always increases the likelihood of settlement. Some types of disclosure will increase the likelihood of settlement and other types will reduce it. See generally Robert D. Cooter & Daniel L. Rubinfeld, *An Economic Model of Legal Discovery*, 23 J. LEGAL STUD. 435, 435-39 (1994). Overall, however, the pooling of the information held by both parties is likely to result in a narrowing of the gap between the parties' expectations, thus facilitating settlement.

may encourage the parties to settle.<sup>138</sup> These very same factors apply to the equity of redemption and the concomitant need to foreclose.

The equity of redemption may also foster renegotiation by providing a valuable bargaining chip to a borrower who otherwise has little or nothing to offer.<sup>139</sup> A lender might be willing to work out a default situation if the borrower can convince the lender that it has faith in the project, but this may require more than verbal assurances from the borrower. The lender wants some tangible sign of the borrower's beliefs. If the loan is nonrecourse, offers to increase the interest rate or permit the lender to share in future appreciation of the collateral do nothing to satisfy this concern, because the borrower is offering nothing more than the lender is already entitled to through foreclosure on the property.<sup>140</sup> If the borrower has significant outside assets, an agreement to accept personal liability or to pledge additional assets may provide an adequate signal,<sup>141</sup> but for a borrower in financial distress, outside assets are often not available. The remaining signal available to the borrower is an agreement to waive the equity of redemption, thus ensuring the lender a higher recovery (by saving foreclosure delays and expenses) upon any future default.<sup>142</sup>

The role of the equity of redemption in fostering efficient renegotiations may explain a puzzling aspect of the law. While the equity of redemption cannot be waived in the initial loan documents, courts are sometimes willing to permit it to be waived in a workout context, subject to strict judicial scrutiny of the underlying fairness of the

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138. See Robert B. Wilson, *Strategic and Informational Barriers to Negotiation*, in *BARRIERS TO CONFLICT RESOLUTION* 108, 114 (Kenneth J. Arrow et al. eds., 1995):

[Discovery procedures] contribute to an equalized evidentiary basis for the trial, and before the trial they can narrow the informational gap and promote settlements; even the prospect of costly discovery can encourage early settlement. On the other hand, to the extent they impose costs on the other party they can enable a war of attrition . . .

*Id.*

139. See Tracht, *supra* note 77, at 344-46.

140. Cf. John M. Geppert & Gordon V. Karels, *Mutually Beneficial Loan Workouts*, 16 J. ECON. & FIN. 103, 109 (1992) (noting that borrowers will accept any workout offer from the lender where the borrower suffers no penalty for subsequent default).

141. See Mann, *Strategy*, *supra* note 21, at 204 (reporting that in eight out of twelve cases in which the lender agreed to a workout that included formal payment concessions, the borrower agreed "to make significant cash contributions of one form or another"). In one other case, the borrower agreed to assume personal liability for the loan unless it voluntarily conveyed the property to the lender—that is, unless it waived the equity of redemption—upon any future default. See *id.* at 206.

142. See *id.* For cases illustrating this principle, see *Wensel v. Flatte*, 764 S.W.2d 627, 628-29 (Ark. Ct. App. 1989) and *Gillam v. Michigan Mortgage Investment Corp.*, 194 N.W. 981, 982 (Mich. 1923).

transaction.<sup>143</sup> This makes sense, particularly where the court is convinced that the renegotiation would fail absent the waiver. It would be perverse for the court to insist on a term intended to aid a future renegotiation if it would doom the current one.

The equity of redemption also facilitates renegotiation by mitigating the bilateral monopoly problem, serving as a check on the lender's incentive to act opportunistically to obtain the collateral where the collateral value exceeds the debt. Should the lender attempt to secure the collateral by inducing a breach, or persist in acting unreasonably after default in order to secure the lion's share of the value available through renegotiation, the borrower has an "exit option": it can retain the property by refinancing prior to completion of the foreclosure by the lender. Indeed, Ronald Mann's recent empirical work supports the expectation that this would be a primary strategy for borrowers facing the prospect of default.<sup>144</sup> If lender enforcement were quick and inexpensive, the borrower might be unable to refinance in time. Thus, the delay caused by "cumbersome" foreclosure processes may alleviate the bilateral monopoly situation by creating an opportunity for the borrower to bring in third parties to compete with the lender.

On the other hand, the equity of redemption creates several opportunities for a mortgagor to try to enhance its position vis-à-vis the lender. Borrowers may be tempted to threaten default in order to secure a renegotiated agreement even if default is not in fact likely to occur.<sup>145</sup> The ability to impose costs on the lender through lengthy foreclosure processes may become another weapon in a borrower's negotiating arsenal, a tool in the destructive process of strategic bargaining. Thus, mortgagor protections may increase the risk of borrower opportunism.

These perverse incentives will be mitigated if the lender can recover these increased costs from the borrower. Consider the borrower's calculus: The borrower believes that the property is worth more than the debt, but is considering whether to threaten default to extract improved terms from its lender. Should the bluff fail, the lender has the right to use the collateral to collect its debt, plus interest (typically at a default rate) for the negotiation period, plus fees and costs. Where the borrower believes there is equity, the threat of bearing the lender's costs should the bluff fail should be a

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143. See cases cited *supra* note 52.

144. See *infra* text accompanying notes 151-53.

145. See, e.g., Bester, *supra* note 104, at 73 (discussing the possibility of a borrower strategically threatening default).

significant deterrent to strategic bluffing.<sup>146</sup> The same may be true if the loan was made with personal recourse against the borrower.<sup>147</sup> However, it is common for commercial real estate loans to be made on a nonrecourse basis.<sup>148</sup> This does not mean that lenders are unaware of the risk. It is common even for nonrecourse loans to have "carve-outs" from the nonrecourse provision, stating that the borrower will be personally liable for the debt in specified circumstances. These carve-outs are an attempt to deal with the moral hazard problem inherent in nonrecourse financing, and they typically address situations in which the borrower is at fault.<sup>149</sup> Among the situations for which lenders commonly seek personal liability is the assertion of a nonmeritorious defense, counterclaim, or bankruptcy proceeding by the borrower.<sup>150</sup>

In fact, the data supports the conclusion that the primary function of mortgage law, upon default, is to permit the extra-legal resolution of the situation, whether by refinancing and paying off the lender, selling the collateral, or negotiating a workout. Foreclosure is a last resort, rarely used unless the borrower has no equity to preserve and the parties find themselves unable to negotiate a resolution. Thus, out of nineteen troubled commercial real estate loans studied by Professor Mann, the borrower retained control of the collateral through a workout in eleven cases,<sup>151</sup> the property was sold in two,

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146 Similarly, lenders often insist that any debt or interest rate relief be paid for by a share of the "upside potential," making renegotiation relatively unattractive to a borrower who truly believes the property is worth more than the debt.

147. Cf. Bester, *supra* note 104, at 73, 84-85. Bester suggests that outside collateral (in addition to the mortgaged property) may serve this role, but there is no reason why the prospect of personal liability cannot equally serve to discipline borrowers and discourage opportunistic threats of default. *See id.*

148. *See* Mann, *Strategy*, *supra* note 21, at 201. Mann reports that all 21 of the troubled real estate loans in his study, made by an insurance company, were nonrecourse. *See id.* He does not state whether the nonrecourse provisions had any carve-outs of significance. *See id.*

149. *See, e.g.,* Billie J. Ellis, Jr. & Drew G. Alexandrou, *Negotiating and Documenting Real Estate Loan Transactions—Commonly Negotiated Provisions (with Forms)*, 17 BANKING & COM. LENDING L. 1, 13 (1997) (noting that the evolution of carve-outs in nonrecourse lending included "bad acts" by the borrower).

150. For an example of this type of nonrecourse carve-out in a forbearance agreement, see John D. Hastie, *Real Estate Workouts*, 1 REAL EST. DEFAULTS, WORKOUTS, & REORGANIZATIONS 235, 274 (1993), where it states that:

All limitations on recourse to the Borrower or any other person contained in the Loan Documents will be null, void and of no further effect on the date a Debtor Relief Proceeding is filed and thereafter the Borrower and all other such persons will be fully liable for payment of the Loan and the Lender will be entitled to exercise unlimited recourse against the Borrower and all other such persons.

*See also* Portia Owen Morrison & Mark A. Senn, *Carving Up The 'Carve-Outs' in Nonrecourse Loans*, PROB. & PROP. May/June 1995, at 8-10.

151. *See* Mann, *Strategy*, *supra* note 21, at 208.

and the property was consensually delivered to the lender in three.<sup>152</sup> The lender was forced to a contested foreclosure in only three cases (sixteen percent of the troubled loans studied).<sup>153</sup>

## VI. MORTGAGOR PROTECTIONS AS MANDATORY TERMS

The role of the equity of redemption in fostering efficient renegotiation after default may seem adequate justification for making it a mandatory element of mortgage law, but in fact this only brings the question back one stage. Even if we were to conclude that the equity of redemption is an efficient rule in most secured financing transactions, it remains for us to explain why it should be imposed on the parties, rather than presented as an optional or default term. After all, parties for whom the equity of redemption would be efficient could include it in their financing agreements. Presumably, though, there would be some parties for whom the equity of redemption would not be a valuable term (perhaps the probability of asymmetric information that would preclude efficient renegotiation is low), and these parties could choose to omit the equity of redemption. In fact, as noted above, parties have often sought to eliminate the equity of redemption from their transactions.<sup>154</sup> Thus, the question remains: Why is the equity of redemption a mandatory component of secured financing transactions? History and inertia seem weak explanations for the survival of a rule that parties have continually sought to overturn.

In fact, the judicial insistence on the equity of redemption can be justified economically—it may solve a market failure caused by the strategic bargaining incentives faced by borrowers.<sup>155</sup> Recent work has shown a variety of circumstances in which strategic bargaining may keep parties from incorporating an efficient term into their

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152. *See id.* at 210.

153. *See id.*

154. *See supra* text accompanying notes 3-4.

155. Various models have shown that different combinations of transaction costs may lead to inefficient contracts among sophisticated parties. *See, e.g.,* Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381, 381-83 (1990) (asymmetric information that cannot be verified, *ex post*, by the courts); Ayres & Gertner, *supra* note 13, at 93-95 (asymmetric information combined with market power in the informed party); Ayres & Gertner, *supra* note 100, at 732-35 (costless contracting, market power in the offeror, and private information in the offeree); Johnston, *Default Rules/Mandatory Principles*, *supra* note 113, at 634-35 (asymmetric information combined with market power in the uninformed party); Talley, *supra* note 61, at 1198-99 (asymmetric information and bilateral monopoly).

contract, and in which mandatory terms may allow the parties to reach efficient contracts otherwise unobtainable.<sup>156</sup>

Phillipe Aghion and Benjamin Hermalin offer a model directly relevant to the mortgagor protection scenario, showing that a borrower may be unwilling to ask for efficient contractual protections if such a request would lead the lender to view it (erroneously) as a high-risk borrower and therefore seek more onerous terms.<sup>157</sup> Moreover, they demonstrate that mandatory borrower protections may enhance the efficiency of contracts by including terms that borrowers desire but are unwilling to request given the response such a request would engender.<sup>158</sup> The efficiency of such restrictions depends on whether there will be a pooling equilibrium (all parties request or do not request protections, and the request or failure to request protections conveys no information to the other side) or a separating equilibrium (some types of borrowers request protection and others do not, thus communicating their "type" to the lender).<sup>159</sup>

Assume, for example, that real estate projects may be either "high-risk" or "low-risk," and that borrowers know which category their projects are in but that lenders find it impossible to determine the quality of the project. If lenders cannot distinguish between high-risk and low-risk projects, they will have to lend at an interest rate that reflects the average risk, and as a result, borrowers with low-risk projects will end up subsidizing borrowers with high-risk projects.

Low-risk borrowers should be able to borrow at lower cost if they can demonstrate the quality of their projects, and they may attempt to do this by offering lenders greater protections in the event of default. High-risk borrowers may be unwilling to match this offer because, given their higher risk of default, the offer is relatively more

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156. See, e.g., Aghion & Hermalin, *supra* note 155, at 382-83; Ian Ayres, *The Possibility of Inefficient Corporate Contracts*, 60 U. CIN. L. REV. 387, 400 (1991) (noting that private incentives of competing parties lead to inefficient and substandard results); Ayres & Gertner, *supra* note 100, at 762-66 (noting inefficiencies that may arise when one party has private information and the other party has some market power); Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J.L. ECON. & ORG. 230, 247 (1993) (noting examples of the possibility that "court-imposed restrictions on private contracts [can] improve efficiency" when parties have asymmetrical information); Morten Hviid, *Default Rules and Equilibrium Selection of Contract Terms*, 16 INT'L REV. L. & ECON. 233, 241 (1996) (arguing that "default" rules of law enhance efficiency and lower transaction costs); Johnston, *Default Rules/Mandatory Principles*, *supra* note 113, at 340-50 (noting the inefficiencies that result from incomplete information).

157. See Aghion & Hermalin, *supra* note 155, at 383-87.

158. This obviously does not mean that all borrower protections enhance efficiency, only that given certain sets of assumptions, it is possible for such protections to do so.

159. See Johnston, *Default Rules/Mandatory Principles*, *supra* note 113, at 372, 385-88.



costly to them.<sup>160</sup> If this is so, then low-risk borrowers will be able to separate themselves from high-risk borrowers, but at the cost of granting greater than optimal protections to the lender (such as waiving the equity of redemption) in case of default. In other words, the need to signal the quality of their projects may induce good borrowers to consent to inefficient lender protections.<sup>161</sup>

Alternatively, high-risk borrowers may find it worthwhile to match the lender protections offered by low-risk borrowers, rather than being forced to pay the higher interest rates that would be required if lenders could identify them as high-risk.<sup>162</sup> If it is worthwhile for high-risk borrowers to match the signal offered by low-risk borrowers, the result will be a pooled equilibrium. Yet this result may not only be inefficient relative to the separating equilibrium that would be available if low-risk borrowers had a signal they could use to indicate their quality to lenders, it may be less efficient than the pooled equilibrium that would result if both types of borrowers refused to waive their protections.

Thus, one function of an immutable borrower protection, like the equity of redemption, may be to inhibit a form of inefficient competition between borrowers who would otherwise find themselves in the position of bargaining away an efficient contract term.<sup>163</sup> Note that this signalling problem cannot be solved through a default rule.<sup>164</sup> If the default rule is that mortgages contain the equity of redemption, lenders will ask each borrower to waive the protection and will draw inferences from the borrower's consent or refusal. Similarly, if the default rule is to omit the equity of redemption, then requests by borrowers to include it, even if it is efficient, may not be forthcoming.

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160. See Ayres, *supra* note 156, at 395.

161. For an analysis of this phenomenon in the context of corporate contracting, see *id.* at 392-401.

162. See *id.* at 397-98.

163. Ayres points to three principal types of intervention used to deal with this type of problem: penalty defaults, single-sided immutable rules, and immutable rules. See *id.* at 401-02. In Ayres's terms, the equity of redemption is a single-sided, immutable rule, in that the lender may agree to give the borrower more protections than the equity of redemption, but the borrower cannot agree to take less. See *id.*

164. Ian Ayres and Robert Gertner have pointed out that defaults may be chosen to compel the provision of information. See Ayres & Gertner, *supra* note 100, at 744-46. If the law imposes a default contrary to the desires of a party with private information, they may be forced to disclose that information in order to negotiate a contractual reversal of the default rule. In this way, parties are forced to disclose private information, correcting the informational asymmetry and allowing for an efficient separating equilibrium. However, separating equilibria are not always preferable to pooling equilibria, and where the pooling equilibrium is superior, a legal structure that facilitates nondisclosure may be preferable. See, e.g., Hviid, *supra* note 156, at 241.

Only an immutable rule can solve the dilemma. As the title to Aghion and Hermalin's article asserts, "Legal Restrictions on Private Contracts Can Enhance Efficiency."<sup>165</sup>

In Aghion and Hermalin's model, the efficient contract is not reached because seeking an efficient term will create a false impression (that the firm is a high-risk borrower, when in fact it is not). The contrary problem may also exist: a party may decline to seek efficient protections where the request will communicate truthful information to the opposing side about the likely value of performance.<sup>166</sup> Thus, good borrowers may prefer not to signal to lenders the full value of their projects, for fear of weakening their bargaining power in any subsequent renegotiation.<sup>167</sup>

This Article is not intended to offer or defend any particular model of either the initial negotiation between borrowers and lenders or of renegotiations. Economists have provided numerous game theory models from which to choose, and the primary conclusion that may be drawn is that results are highly sensitive to the particular assumptions on which any given model is built.<sup>168</sup> For example, Kahn and Huberman present a model in which a nonrecourse mortgage with strict foreclosure and an equitable right of redemption is most efficient in permitting optimal renegotiation upon the development of

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165. Aghion & Hermalin, *supra* note 155. Obviously, there are limits to this reasoning—it does not follow that all borrower protections enhance efficiency. If borrower protections are excessive, the moral hazard problem will outweigh negotiating benefits: borrowers who are largely insulated from the adverse effects of failure will take inadequate care to maximize returns on the project. *See id.* at 400; *see also* Ayres, *supra* note 156, at 403 (noting that the moral hazard dilemma undermines the fiduciary/agent relationship).

166. For example, Johnston, *Default Rules/Mandatory Principles*, *supra* note 113, at 368-73, argues that under the Uniform Commercial Code, the good faith requirement for the enforceability of modifications is an immutable rule that tends to permit efficient renegotiations while invalidating extortionate, inefficient ones. The good faith provision bars a party from extorting a contractual change on the pretense of changed circumstances. *See id.* If the court determines that the changed circumstances that purportedly warranted modification did not exist, then the modification may be held unenforceable. *See id.* However, the parties might find themselves unable to negotiate a "good faith" requirement for modifications if asking for such a term communicates information about the requesting party. *See id.* at 371-72; *see also* Ayres & Gertner, *supra* note 100, at 736 (noting that shippers may not disclose the extent of damages when contracting a liquidated damages clause for fear carriers may charge higher fees upon realizing the higher value of the cargo).

167. The concern is not that they will lose out in the current negotiation, because if the market is competitive the lender cannot insist on more than a market rate of return. However, if the disclosure affects subsequent renegotiations, when the parties are locked in a bilateral monopoly, the borrower may still have good reason not to want to disclose. *See* Johnston, *Default Rules/Mandatory Principles*, *supra* note 113, at 368-73.

168. *See, e.g.,* Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LITERATURE 1067, 1078-80 (1989) (discussing how attempts to model settlement negotiations "have produced, not a consensus among economists, but a variety of predictive and normative theories that are rivals to each other").

unforeseen contingencies.<sup>169</sup> Helmut Bester offers a model in which deficiency liability may be needed to induce efficient renegotiation.<sup>170</sup>

The underlying point is clear, however: Where there is significant private information, it cannot be assumed that unconstrained negotiations about post-default remedies will result in optimal terms, even among sophisticated commercial parties. Negotiations regarding remedies are subject to an adverse selection dynamic that inherently places them in a separate category from other contract terms. This adverse selection problem explains several aspects of mortgage law that are obscured by the conventional explanation that "necessitous men are not truly free" and that the mortgage is therefore executed in a situation of unequal bargaining power.<sup>171</sup> First, if borrower protections are simply a judicial response to unequal bargaining power, overreaching lenders will switch to unregulated terms. If lenders are prohibited from obtaining waivers of the equity of redemption, they will use their bargaining power to extract higher interest rates, require additional collateral, and so on. Judicial oversight of one term in a multifaceted relationship will not correct an imbalance in the parties' underlying positions. However, if the inefficient signalling argument is correct, then the courts' focus on default provisions makes sense: these are the provisions that lenders could attempt to use to distinguish between high- and low-risk borrowers (because their cost is correlated with the probability of default), and hence are the provisions that may be rendered inefficient by adverse selection. The market failure that this type of regulation addresses is not a general imbalance in bargaining strength between powerful lenders and impecunious borrowers, but the inability of the market to generate efficient post-default remedies in the presence of asymmetric information.

Moreover, if the risk of inefficient signalling is the primary market failure justifying the imposition of the equity of redemption, then it makes sense that courts insist on overseeing waivers entered into as part of a renegotiation, rather than simply permitting the equity of redemption to be freely waived after the initial transaction. The informational asymmetry that may cause inefficient pooling exists in the workout situation exactly as it does in the initial loan process. If the equity of redemption were freely waivable after the initial transaction, borrowers might find it impossible to resist lender

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169. See Kahn & Huberman, *Default*, *supra* note 102, at 58-59.

170. See Bester, *supra* note 104, at 73, 84-85.

171. See *supra* note 53 and accompanying text.

demands for waivers in workouts because lenders would read the refusal as a signal that the borrower lacks faith in its workout proposal. Simply prohibiting waivers as part of the workout process, however, would probably be inefficient: the borrower's ability to waive default rights as part of a workout may provide an important signal to the lender that the borrower has faith in its own workout proposal.<sup>172</sup> Judicial oversight provides a balance, limiting the ability of the lender to extract such a waiver simply out of the borrower's fear of signalling, without granting a valuable *quid pro quo*.

## VII. CONCLUSION

The traditional critique of coercive creditor remedies was couched in terms of fairness and equity: It was unfair for a defaulting borrower to suffer a forfeiture, and would result in unjust enrichment for the creditor to realize more than the amount of the debt. Traditional law and economics scholarship responded that the cost of banishing this type of unfairness was a less efficient credit market, in which marginal borrowers would bear the cost of additional protections either through more onerous credit terms or the denial of credit altogether. Defenders of borrower protections replied that the efficiency argument only worked in perfectly competitive markets, and that market imperfections (e.g., cognitive limitations of borrowers) provided an economic, not just a moral, rationale for regulation. However persuasive or unpersuasive these arguments may be in the consumer context, they have carried little weight in discussions of commercial transactions. As shown in this Article, however, the debate is not the "fairness" of intervention versus the "efficiency" of the free market, even in the context of sophisticated commercial parties. Even if we assume fully rational, sophisticated commercial parties operating in a competitive market, strategic bargaining may prevent the formation of efficient credit contracts absent a public structure of mandatory law governing creditor remedies.

That said, I do not claim that existing creditor protections are in any sense "optimal"—merely that signalling problems disprove the argument that restrictions on creditor remedies are inherently inefficient. The specification of economically efficient rights will depend, at the very least, on the development of game theory models that can accurately capture the dynamics of the marketplace. I admit

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172. See Tracht, *supra* note 77, at 344-46.

to some skepticism about the likelihood of developing such models, given the sensitivity of most models to small variations in assumptions. Indeed, assuming that credit markets vary extensively along a number of relevant dimensions (sophistication of borrower and lender, transaction size, contracting costs, market power, and informational asymmetries, to name a few), and that the legal system is unlikely to be able to tailor and apply optimal rules for each set of variables, the search for "optimal" rules of secured credit may be equivalent to searching for Lewis Carroll's snark. If so, then economics cannot provide definitive guidance in the search for efficient legal rules. It can only tell us when our arguments are unconvincing or incomplete, and perhaps help us to find that grain of truth, buried in the structure of the law, which we might otherwise miss.

The analysis offered above has broad ramifications: It suggests that in any market characterized by substantial informational asymmetries, there may be an economic justification for immutable legal rules. This provides a counterpoint to the increasing tendency towards contractarianism in various areas of law that have traditionally been viewed as immutable. For example, recent years have seen more extensive debate about the desirability of permitting corporate and partnership fiduciary duties to be contractually modified.<sup>173</sup> A similar debate is taking place in areas of bankruptcy law.<sup>174</sup> These debates have, in many cases, evolved into a debate about whether contractual or mandatory terms are more efficient.<sup>175</sup> The points that should be emphasized by the analysis presented here are (1) that the efficiency of immutable rules versus contractual rules will depend on the specific details of the market structure, and (2) that it requires a remarkable degree of self-confidence or hubris to conclude, in any given circumstance, that one's understanding of the market structure is sufficient to permit a confident choice between the two for any given rule.<sup>176</sup>

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173. See, e.g., Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993); Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); Symposium on the Future of the Unincorporated Firm, 54 WASH. & LEE L. REV. 389 (1997).

174. See, e.g., Thomas G. Kelch & Michael K. Slattery, *The Mythology of Waivers of Bankruptcy Privileges*, 31 IND. L. REV. 897 (1998); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998); Tracht, *supra* note 77.

175. See, e.g., Butler & Ribstein, *supra* note 173, at 15.

176. The ultimate conclusion is that the choice between proposed immutable and default rules in any particular case will be, in a sense, procedural rather than substantive, devolving to

Finally, the courts' long-standing and vigorous defense of the equity of redemption presumably reflects a deep-seated intuition that something is wrong with a waiver of redemption rights—even if courts have been unable to articulate the problem in a coherent fashion.<sup>177</sup> As shown in this Article, the common law rule may be rooted in an implicit or tacit understanding of important elements of market dynamics and contractual relationships, even though judges and legal scholars have never been able to offer detailed or convincing models of the processes at work. There is often a gap between what we think we understand about the world, and what we can rigorously explain about it; I hope this Article helps to bridge that gap in the realm of mortgage law.

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an analysis of the ability of and incentives for the respective proposed decisionmakers to avoid and correct mistakes.

177. I am grateful to my colleague Vern Walker for raising this point.

