CONTRACTUAL INEQUALITY

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Most individuals strive to satisfy every obligation laid out in standard form contracts such as mortgages, insurance plans, or credit agreements. Sophisticated parties, however, adapt and modify their obligations during contract performance by negotiating for lenient treatment and taking advantage of unclear terms. The common law explicitly authorizes variance from standardized contract terms during performance. When the same standard terms create value for sophisticated individuals and destroy value for others, the result is contractual inequality. Contractual inequality has grown without scrutiny by courts or scholars, enabling regressive redistribution of resources and creating economic inefficiency by sowing distrust in markets for consumer contracts.

To document the magnitude of contractual inequality, this Article provides novel empirical evidence from a case study of residential mortgage contracts. Data from a large nationwide sample show that many mortgage servicers choose not to utilize their power to foreclose on a borrower in default, with more than one-third of nonpaying borrowers avoiding foreclosure. Servicers disproportionately foreclose on borrowers in poor neighborhoods, regressively redistributing over $500 million in wealth to high-income communities each year. Moreover, servicers' unfettered freedom to choose who undergoes foreclosure may have reduced the value of mortgages to consumers, increasing market inefficiency.

Courts and regulators need not turn a blind eye to contractual inequality, allowing private market forces to determine the exercise of contract rights. This Article argues that lawmakers should gather information about inequalities in contract performance and disseminate such data to private and public enforcement authorities. By bringing these inequalities to light, lawmakers can take a first step toward more efficient contract markets and a more equal society.

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INTRODUCTION

Standard form contracts impose equality in contract terms across transactions.[1] All mortgage instruments, for instance, borrow their terms from the same federally drafted forms.[2] However, standardization in contract terms

1. *See, e.g.*, MARGARET JANE RADIN, BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW 9 (2013) ("Standardized form contracts, when they are imposed upon consumers, have long been called 'contracts of adhesion,' or 'take-it-or-leave-it contracts,' because the recipient has no choice with regard to the terms."); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1258 (2003) ("[I]n contrast to the Platonic ideal of a contract in which all terms are subject to bargaining, form contracts are usually offered on a take-it-or-leave-it basis—perhaps the price is negotiable, but often even this is not subject to bargaining.").

2. Most mortgage contracts include the exact same written terms because of "the huge dominance in the home mortgage market of Fannie Mae/Freddie Mac uniform mortgage instruments." Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077, 1079 (2007); *see Fannie Mae Legal*

does not mean that all transactions are equal. Despite assenting to the same terms, different parties may find that contract terms are utilized differently during performance.[3] The result is that one mortgage borrower may find multiple obligations waived, receiving an easy path to payoff, while a similarly situated borrower may be threatened with legal action at every turn.

This Article develops a theory of inequality in contract performance, rather than inequality in terms offered, across social groups.[4] Differences in performance across identical contracts, termed *contractual inequality*, have two implications.[5] First, they may unfairly privilege sophisticated parties and worsen existing social inequalities.[6] Second, individuals who are considering entering a new contractual relationship may be deterred by the possibility that they will be mistreated later during performance, resulting in fewer transactions and inefficient prices.[7] Households rely heavily on standardized consumer contracts to secure housing, pay for expenses, and insure against losses,

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Documents (New), FANNIE MAE, https://singlefamily.fanniemae.com/fannie-mae-legal-documents#legal-security-instruments [perma.cc/PQ5G-L9DN].

3. This Article builds a theoretical framework on a growing literature emphasizing the difference between the "real deal," which includes adjustments to the contract after formation, and the "paper deal" in the written contract. A large literature on consumer contracts has discussed the important role played by discretionary benefits, which are usually provided to the consumer by a firm wishing to gain a good reputation despite the formal contract terms being significantly less pro-consumer. *See, e.g.*, Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827 (2006); Lisa Bernstein & Hagay Volvovsky, *Not What You Wanted to Know: The Real Deal and the Paper Deal in Consumer Contracts—Comment on the Work of Florencia Marotta-Wurgler*, 12 JERUSALEM REV. LEGAL STUD. 128, 131 (2015); Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WIS. L. REV. 679.

4. This builds on a literature that has illuminated the difference between contracts as written and as enforced. *See, e.g.*, Bebchuk & Posner, *supra* note 3; Shmuel I. Becher & Tal Z. Zarsky, *Minding the Gap*, 51 CONN. L. REV. 69 (2019) (theorizing that firms' leniency in enforcing consumer contract terms can cause negative consequences for consumers); Meirav Furth-Matzkin, Selective Enforcement of Consumer Contracts: Evidence from the Retail Market (2021) (unpublished manuscript) (on file with the *Michigan Law Review*) (showing that retail return policies are differentially enforced against different types of customers); Jason Scott Johnston, *The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation Between Businesses and Consumers*, 104 MICH. L. REV. 857, 864–91 (2006) (noting that differential enforcement of contract terms against parties with different levels of sophistication and bargaining power may have regressive distributional consequences).

5. *See infra* Part II.

6. The primary focus will be on economic inequality, though similar disparities can arise across dimensions such as race, gender, age, sexuality, country of origin, and religion. Economic inequality has been growing exponentially in the last fifty years by many metrics. Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913–1998*, 118 Q.J. ECON. 1 (2003) (beginning the modern literature on inequality by collecting comprehensive quantitative data on the growth of inequality in income); Emmanuel Saez & Gabriel Zucman, *Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data*, 131 Q.J. ECON. 519 (2016) (calculating a broad-based definition of wealth and showing the sudden upturn in wealth inequality starting in the 1980s and continuing to the present day).

7. This phenomenon occurs due to incompleteness of contracting, especially due to the inability of contracting parties to credibly commit to not modifying the original contract.

but contractual inequality exposes the most disadvantaged populations to the highest risk of serious loss.[8]

This Article connects fundamental principles of contract law to the growth in economic inequality.[9] The common law of contracts has traditionally authorized contracting parties to treat social groups differently.[10] As long as parties satisfy the formal terms of a contract, remaining discretion in contract performance may be used to harm disadvantaged groups and benefit privileged groups.[11] When the written contract leaves some discretion to the parties, no contract law cause of action exists to challenge unequal treatment during performance.[12] Moreover, every consumer contract has some *incompleteness*, or areas in which contract performance can vary while satisfying

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PATRICK BOLTON & MATHIAS DEWATRIPONT, CONTRACT THEORY 37–39 (2005); *see also* Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203 (1997) (explaining that a particular type of incompleteness, the inability to commit to nonmodifiable contracts, gives rise to welfare loss).

8. Though consumer contracts touch on a wide variety of settings, including employment, services, retail goods, and online transactions that raise privacy concerns, this Article focuses largely on financial contracts. The largest and most significant contracts undertaken by most households are debt contracts. Household and business indebtedness has grown significantly over the past ten years. *See* CTR. FOR MICROECONOMIC DATA, FED. RSRV. BANK OF N.Y., QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT (2021), https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2021Q3.pdf [perma.cc/ME7F-NH8G]; Joshua Franklin & Kate Duguid, *The Decade of Debt: Big Deals, Bigger Risk*, REUTERS (Dec. 30, 2019, 1:19 AM), https://www.reuters.com/article/us-global-markets-decade-credit/the-decade-of-debt-big-deals-bigger-risk-idUSKBN1YY09Y [perma.cc/E2GK-2XF5]; *Nonfinancial Corporate Business; Debt Securities and Loans; Liability, Level*, FRED, https://fred.stlouisfed.org/series/BCNSDODNS [perma.cc/2Q57-PEPP] (last updated Dec. 9, 2021). Saez and Zucman posit that main drivers of wealth inequality include a large growth in debt among low- and middle-income households, Saez & Zucman, *supra* note 6, at 555, joining Mian and Sufi in their argument that households are dangerously overleveraged. ATIF MIAN & AMIR SUFI, HOUSE OF DEBT: HOW THEY (AND YOU) CAUSED THE GREAT RECESSION, AND HOW WE CAN PREVENT IT FROM HAPPENING AGAIN (2015).

9. Contract law in this Article refers to the traditional common law of contracts, as well as the set of commercial laws and assorted state and federal regulations targeting the origination and performance of formal contracts.

10. *See* OREN BAR-GILL, SEDUCTION BY CONTRACT 158–64 (2012) (describing the larger harms done to more unsophisticated consumers who are more present-biased when faced with complex contracts intended to take advantage of behavioral biases); Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 23–25 (2008) (noting that firms with "use-pattern information" about their customers can exploit this knowledge about contract performance to extract value from some customers, usually those who are already disadvantaged in other ways); Tess Wilkinson-Ryan, *The Perverse Consequences of Disclosing Standard Terms*, 103 CORNELL L. REV. 117 (2017) (suggesting that enhanced disclosure requirements may result in less consumer understanding of the underlying contract terms); Rory Van Loo, *Helping Buyers Beware: The Need for Supervision of Big Retail*, 163 U. PA. L. REV. 1311, 1357–58 (2015) (showing how big retailers' sales strategies may result in unequal outcomes across consumers).

11. *See* Bebchuk & Posner, *supra* note 3, at 827, 830; Becher & Zarsky, *supra* note 4, at 77–78; Furth-Matzkin, *supra* note 4; Johnston, *supra* note 4, at 859.

12. The law-and-economics literature on embedded options and incomplete contracts has described contracting parties' inability to bargain in advance for every possible action taken by every party in every possible contingency. Traditional contracts always allocate a certain

formal legal requirements.[13] For instance, parties are free to exercise their reserved discretion, breach their contracts, waive or enforce their counterparties' obligations, and modify or renegotiate their agreements without oversight from courts and regulators.[14] Courts and regulators have granted private parties the right to make these discretionary choices but have turned a blind eye to the *use* of this power,[15] allowing contractual inequality to grow unchecked.

This Article takes residential mortgage servicing as a case study for demonstrating the magnitude of contractual inequality. Consider two homeowners who have lost their jobs and cannot make payments on their long-term mortgages.[16] Both are embedded in their local communities and have children in local public schools. Each calls their mortgage provider and asks for their lender's cooperation in helping them keep their home.[17] Though both homeowners have the same credit score and their mortgages have similar interest rates and monthly payments, their two phone conversations proceed very differently. The first homeowner is given several options, including a "loss mitigation" program that can decrease her monthly payments or a short-term "forbearance" period during which she can temporarily stop payment.[18]

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amount of discretion to the parties that courts are not expected to "verify" and discipline. Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428, 1432–33 (2004) [hereinafter Scott & Triantis, *Embedded Options*]; Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RSRV. L. REV. 187 (2005).

13. A large literature in law and economics on incomplete contracts has noted the significant gaps left in most contracts, but it focuses primarily on courts as gap fillers rather than the parties themselves. *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87, 95 (1989) (proposing an economic theory of gap filling in incomplete contracts); Omri Ben-Shahar, *"Agreeing to Disagree": Filling Gaps in Deliberately Incomplete Contracts*, 2004 WIS. L. REV. 389, 390, 400 (noting that contractual incompleteness can arise in cases of disagreement across parties as well as agreement, meaning that gap filling must avoid exploitation of incompleteness). Exceptions to this include literature on "self-help remedies" in contract, which explicitly refers to the steps parties can take within the bounds of the contract terms to protect their interests. *See* Mark P. Gergen, *A Theory of Self-Help Remedies in Contract*, 89 B.U. L. REV. 1397 (2009) (coining the term "self-help remedies" and canvassing prior literature referring to this concept).

14. *See infra* Section I.B.

15. *See* Uri Benoliel & Shmuel I. Becher, *Termination Without Explanation Contracts*, 2022 U. ILL. L. REV. (forthcoming 2022), https://doi.org/10.2139/ssrn.3737774 [perma.cc/99KN-YHUN] (describing contracting parties' sometimes arbitrary and erroneous choices while terminating contracts according to the formal terms).

16. *See* Natalie Campisi, *Mortgage Delinquencies Spike Due to COVID-19: What to Do If You Can't Pay Your Loan*, FORBES (Aug 18, 2020, 11:05 AM), https://www.forbes.com/sites/advisor/2020/08/18/mortgage-delinquencies-spike-due-to-covid-19-what-to-do-if-you-cant-pay-your-loan [perma.cc/U2CT-NYKM].

17. *See How to Negotiate Debts with Your Lenders*, EQUIFAX, https://www.equifax.com/personal/education/debt-management/negotiate-debt-with-lenders [perma.cc/3DC8-RWAA].

18. For an overview of mortgage options, see Samuel C. Waters, *A View from the Trenches: The Legal Practitioner and Loss Mitigation*, 60 S.C. L. REV. 807 (2009). The Federal Trade Commission provides a guide to individuals facing debt collection in other contexts; the guide notes that statutory protections against aggressive debt-collection practices typically do not apply to

The second homeowner, on the other hand, is told that he must pay according to the terms of the mortgage, and he is advised that foreclosure proceedings may begin after four months of missed payments.[19] The first homeowner is ultimately allowed to stay in her home, while the second is forced to remove his children from school and relocate while saddled with a low credit score.[20]

Using a detailed commercial dataset on mortgage performance, this Article shows how common these disparities are and their devastating effect on consumers. Lenders and servicers making the foreclosure decision have significant discretion over which households face foreclosure rather than less costly alternatives like forbearance. The detailed data used in this Article show that 40% of borrowers who fell behind on their mortgage between 2000 and 2008 avoided foreclosure, largely due to the exercise of discretion by creditors.[21] Moreover, this Article is the first to show that a stark difference exists between creditors' treatment of borrowers in wealthy neighborhoods relative to those in poorer ones.[22] Loans in high-income neighborhoods are nearly 10% more likely to avoid foreclosure than identical loans in lower-income neighborhoods. The real impacts of foreclosure are widespread—uprooting families, destroying economic value, and negatively impacting communities.[23] Given the high cost of foreclosures, inequality in mortgage performance gives rise to $513 million in losses per year to poor neighborhoods that rich neighborhoods avoid.[24] Unequal treatment during foreclosure can also sow distrust of servicers that lowers the value of mortgages and creates economic waste.

The Article explains how existing legal regimes and economic incentives are powerless to scrutinize and discipline this type of inequality. Contracting

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the original creditor. *Debt Collection FAQs*, FTC (May 2021), https://www.consumer.ftc.gov/articles/debt-collection-faqs [perma.cc/SA4Q-RJ5J].

19. *See* Jeff Ostrowski, *Why the Coming Foreclosure Crisis Will Look Nothing Like the Last One*, BANKRATE (Sept. 1, 2020), https://www.bankrate.com/mortgages/foreclosures-crisis-wont-look-like-great-recession [perma.cc/6TW5-765C].

20. The average mortgage borrower experiences a drop of about 150 points in their credit score once foreclosure proceedings beign. Kenneth P. Brevoort & Cheryl R. Cooper, *Foreclosure's Wake: The Credit Experiences of Individuals Following Foreclosure*, 41 REAL EST. ECON. 747, 760 (2013).

21. *See infra* Section III.A.1.

22. *See infra* Section III.A.2.

23. Households, and particularly children, are strongly impacted by foreclosure. *See* Vicki Been et al., *Does Losing Your Home Mean Losing Your School? Effects of Foreclosures on the School Mobility of Children*, 41 REG'L SCI. & URB. ECON. 407 (2011); Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUS. STUD. 851 (2006); Scott Fay, Erik Hurst & Michelle J. White, *The Household Bankruptcy Decision*, 92 AM. ECON. REV. 706 (2002). Both the physical and mental health of households facing foreclosure dropped during the 2008 financial crisis. *See* Janet Currie & Erdal Tekin, *Is There a Link Between Foreclosure and Health?*, AM. ECON. J.: ECON. POL'Y, Feb. 2015, at 63; K.A. McLaughlin et al., *Home Foreclosure and Risk of Psychiatric Morbidity During the Recent Financial Crisis*, 42 PSYCH. MED. 1441 (2012).

24. *See infra* Section III.B.

parties have no legal obligation to behave cooperatively with their counterparties as long as they do not breach the contract's formal terms[25] or the common law duty of good faith.[26] Regulators have become more involved in scrutinizing contractual relationships over time, but their power has been tilted toward rulemaking and away from enforcement. The result is that parties' utilization of contract terms are primarily governed by extralegal forces such as market competition.[27] Contract law scholars have argued that economic incentives are sufficient to encourage parties to behave cooperatively, with no additional legal oversight needed.[28] This Article argues, however, that private economic incentives are insufficient in many cases to avoid harmful contractual inequality if transaction costs limit market efficiency.[29] Moreover, the private market cannot remedy existing social inequalities, which can occur when there is unequal bargaining power across contracts. For instance, when the same creditor lends to two debtors, one with high reputational influence and the other with little power to influence others, no private market force can prevent the creditor from treating the more powerful debtor better than the less powerful debtor. Private markets cannot discipline inequality without complementary legal mechanisms.[30]

This Article argues that lawmakers must intervene to bring contractual inequality to the attention of the public. Currently, contracting parties know nothing about how others in their position are treated during performance.

25. *See infra* Section IV.A.

26. No implied duty in contract law, including the pervasive duty of good faith, has been regularly interpreted to cover the utilization of well-defined contract rights. *See infra* Section IV.A.

27. This Article sets aside other social and psychological drivers of the behavior of contracting parties. Culture and behavioral factors contribute significantly to decisionmaking within households, and firms and may contribute to unequal treatment of different parties. Economic incentives could contradict these behaviors or reinforce them.

28. *See, e.g.*, Bebchuk & Posner, *supra* note 3, at 828; Gillette, *supra* note 3, at 620.

29. *See infra* Section IV.B.

30. Wealth and income gaps are commonly used to illustrate economic inequality, which can act as a comparator for measuring contractual inequality. *E.g.*, Taylor Telford, *Income Inequality in America Is the Highest It's Been Since Census Bureau Started Tracking It, Data Shows*, WASH. POST (Sept. 26, 2019), https://www.washingtonpost.com/business/2019/09/26/income-inequality-america-highest-its-been-since-census-started-tracking-it-data-show [perma.cc/5EZ5-9A6T]; James B. Davies, *Personal Assets from a Global Perspective*, UNITED NATIONS UNIV. WORLD INST. FOR DEV. ECON. RSCH.: WIDERANGLE (2005), https://www.wider.unu.edu/publication/personal-assets-global-perspective [perma.cc/T2NG-PVES] (arguing that both wealth and income must be considered for an accurate picture of economic well-being). Accordingly, income and wealth redistribution via taxation is a popular approach for reducing economic inequality. *See* Orsetta Causa & Mikkel Hermansen, *Income Redistribution Through Taxes and Transfers Across OECD Countries*, VOXEU (Mar. 23, 2018), https://voxeu.org/article/income-redistribution-through-taxes-and-transfers [perma.cc/5VL7-JDK8]; JUSTIN STEIL, STEPHEN MENENDIAN & SAMIR GAMBHIR, HAAS INST., RESPONDING TO RISING INEQUALITY: POLICY INTERVENTIONS TO ENSURE OPPORTUNITY FOR ALL 18 (2014), https://belonging.berkeley.edu/sites/default/files/HaasInstitute_InequalityPolicyBrief_FINALforDISTRO_2.pdf [perma.cc/F5C7-LBYF] (discussing increased tax rates on estates and capital gains as a tool for addressing inequality).

Regulators can begin to understand and resolve this problem by requiring disclosure of data regarding contract performance to relevant regulatory authorities and to the public.[31] By disclosing the data to sophisticated parties, such as federal agencies, they can be used to facilitate redistribution and redress the distributive harms of contractual inequality.[32] Moreover, data disclosure could provide statistical evidence of inequality in contract performance that disparately impacts protected classes, opening the door to antidiscrimination lawsuits.[33] Finally, disclosures to private actors such as information aggregators, private regulators, and insurance companies could help private markets hold actors accountable for worsening social inequality.[34] Recognizing and addressing contractual inequality is essential for lawmakers to sustainably serve the needs of all types of contracting parties.

The Article proceeds as follows. Part I introduces contractual inequality and its potential harms, focusing on negative distributional effects and inefficiency. Part II describes how contract law worsens inequality, including traditional embedded options in contracts such as the exercise of reserved discretion, waiver, enforcement, modification, renegotiation, and breach. Part III introduces residential mortgage contracts as an empirical setting to demonstrate the magnitude of inequality in contract outcomes. Part IV lays out the limitations of using existing tools to oversee contractual inequality. Part V suggests disclosure reforms tailored to minimizing the negative impacts of contract law on social inequality and maximizing the efficiency of contract markets.

I. Inequality in Contract Performance

Boilerplate contracts are essential to households' income, education, and long-term financial well-being.[35] Contract terms, however, are written in legal language that ordinary individuals cannot understand.[36] Vanishingly few consumer contracts include negotiated terms; instead, businesses offer exactly

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31. *See infra* Part V.

32. Taxation is widely considered the most efficient way of redistributing income for the purpose of remedying inequality. Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 667–68 (1994).

33. *Cf.* Bethany A. Corbin, *Should I Stay or Should I Go? The Future of Disparate Impact Liability Under the Fair Housing Act and Implications for the Financial Services Industry*, 120 PENN ST. L. REV. 421, 427–29 (2015). Corbin's article examines disparate impact litigation under the Fair Housing Act, which was enacted in response to riots spurred by the impact of housing discrimination. Data disclosure may allow for more proactive, tailored legislative responses.

34. *See infra* Part V.

35. Many important standardized contracts for households are debt instruments, with mortgages, credit card agreements, and student loans relying on standardized forms. *See, e.g.*, BAR-GILL, *supra* note 10, at 1–4. Household debt is at an all-time historical high and is continuing to increase. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., FINANCIAL STABILITY REPORT 32 (2021) [hereinafter FINANCIAL STABILITY REPORT], https://www.federalreserve.gov/publications/files/financial-stability-report-20211108.pdf [perma.cc/S6LF-4WC6].

36. *See* Yannis Bakos, Florencia Marotta-Wurgler & David R. Trossen, *Does Anyone Read the Fine Print? Consumer Attention to Standard-Form Contracts*, 43 J. LEGAL STUD. 1, 3 (2014)

identical contracts to multiple consumers.[37] Even sophisticated parties who hire big law firms often find that their contract terms are identical to those used in other transactions.[38] A large fraction of the contract language is taken from other sources, including previous contracts written for similar transactions, forms drafted by law firms, and recommended language suggested by professional associations.[39] Written contracts therefore reflect historical custom and the psychology of the drafters more than the relevant details of a particular transaction.[40]

(finding that only 0.2% of software shoppers read end-user license agreements for one second or longer); Florencia Marotta-Wurgler, *Some Realities of Online Contracting*, 19 SUP. CT. ECON. REV. 11, 12 (2011) ("Like their brick-and-mortar counterparts, online sellers typically offer take-it-or-leave-it standard form contracts."); Shmuel I. Becher & Uri Benoliel, *The Duty to Read the Unreadable*, 60 B.C. L. REV. 2255 (2019) (using linguistic methods to show that contracts are as difficult to read as academic articles and concluding they exclude the typical consumer); *cf.* David A. Hoffman, *Relational Contracts of Adhesion*, 85 U. CHI. L. REV. 1395, 1403 (2018) (discussing the growth of plain English contracts by big companies intended to improve subjective consumer understanding).

37. *See* RADIN, *supra* note 1, at 7–9 (describing the proliferation of standard form contracts and the inability of consumers to find more favorable terms elsewhere); Bakos et al., *supra* note 36, at 1–2 (describing how in "untold billions of commercial transactions," buyers are "presented with a preprinted form contract . . . with little opportunity to negotiate the terms").

38. *See* MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN 6 (2013) (describing the big law firm business model as one that "relies on herd behavior, fails to provide incentives for innovation and thus rises and falls on volume-based, cookie-cutter transactions"); Julian Nyarko, *Stickiness and Incomplete Contracts*, 88 U. CHI. L. REV. 1, 3–7 (2021) (finding that even in the most sophisticated, high-dollar value transactions, big law firms rely on templates that may not include provisions that would be important to the transaction, such as the lack of choice-of-forum provision that harmed Sprint in the Sprint-Nextel merger). *But cf.* Adam B. Badawi, Scott D. Dyreng, Elisabeth de Fontenay & Robert W. Hills, *Contractual Complexity in Debt Agreements: The Case of EBITDA*, SSRN (May 7, 2021), https://doi.org/10.2139/ssrn.3455497 (showing significant personalization in commercial debt clauses defining accounting procedures, intended to strategically improve perceived financial health).

39. *See* GULATI & SCOTT, *supra* note 38, at 10 (noting the "ready availability of prefabricated contracts" in today's legal practice, resulting in "[f]ar too much of the revealed text [being] preserved in each new incarnation of the document"); Claire A. Hill, *Why Contracts Are Written in "Legalese,"* 77 CHI.-KENT L. REV. 59, 59–60 (2001) (discussing law firm use of forms); Nyarko, *supra* note 38, at 1 (finding that "external counsel rely heavily on templates" and that "[t]here is no evidence to suggest that counsel negotiate over the inclusion of dispute resolution clauses, nor that law firm templates are revised in response to changes in the costs and benefits of incomplete contracting"); Joseph M. Perillo, Keynote Address, *Neutral Standardizing of Contracts*, 28 PACE L. REV. 179, 182–85 (2008) (noting the proliferation of standardized contracts drafted by professional associations in the business-to-business context).

40. *See* BAR-GILL, *supra* note 10, at 2–3 (discussing the interaction between market forces and consumer psychology and noting that "competition forces sellers to exploit the biases and misperceptions of their customers" in the way they present their contracts); GULATI & SCOTT, *supra* note 38, at 33–43 (describing theories of boilerplate stickiness, many of which rely on custom and psychologically biased thinking); Hill, *supra* note 39, at 61–62, 73–75 (finding that psychological dynamics at play in contract drafting "represent departures from 'rationality,' as that term commonly is used in economics"); Nyarko, *supra* note 38, at 25 (noting that one explanation for lawyers' failure to change their templates is that lawyers "may be risk averse and afraid

Standardized "contracts of adhesion" signed by parties with unequal sophistication, such as a consumer and a firm, have concerned scholars for decades.[41] Because the consumer has relatively little power to negotiate and understand the contract terms, standard form contracts may contain terms that are one sided in favor of the firm. If a dispute arises, the more powerful firm is likely to prevail, ultimately decreasing the value of the contract to the less powerful consumer. To combat these harms, scholars have argued for more informed assent, careful drafting procedures, and judicial and regulatory measures to improve the quality of standard form contracts.[42] Regarding consumer financial contracts in particular, these concerns have spurred the creation of the Consumer Financial Protection Bureau (CFPB) to ensure that consumers assent to high-quality financial contracts.[43]

This Article focuses on a different issue with this market—the performance of standard form contracts. Transactions subject to the same terms evolve differently during performance as circumstances change, new information becomes available, and parties make decisions.[44] At the completion of the contract term, decisions made about performance mutate the written contract's "paper deal" into very different "real deals" for different transactions.[45] Contractual inequality occurs when two similar transactions with similarly situated parties end with different outcomes due to decisions made during performance.

Consider the example of two families trying to build their wealth. Each has a savings account at a local bank, where their paychecks are directly deposited and their bills are automatically paid each month. The system breaks down when their paychecks are delayed during the COVID-19 pandemic. Both families are charged an overdraft fee of $225 when their bills are paid

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of the unknown scenarios that may unfold if the templates are tampered with, ultimately leading to a status quo bias").

41. *E.g.*, Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173 (1983) (proposing that standard form contracts be held presumptively unenforceable on the theory that the power imbalance between parties has negative consequences for the integrity of contract law as a whole).

42. *E.g.*, Ian Ayres & Alan Schwartz, *The No-Reading Problem in Consumer Contract Law*, 66 STAN. L. REV. 545, 579–90 (2014) (proposing that regulators mandate a system of disclosures that would increase consumer understanding by highlighting unexpected terms and that courts should only enforce terms that consumers can be expected to understand); BAR-GILL, *supra* note 10, at 4–5 (arguing for disclosure regulation that would increase consumer ability to make better choices); Stephen J. Choi, Mitu Gulati & Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate*, 67 DUKE L.J. 1, 68 (2017) ("[C]ourts should be open to arguments that, as a matter of law, the clause in question has been emptied of meaning and functions as a black hole in the boilerplate."); Nyarko, *supra* note 38, at 74 (arguing that legal education should better prepare law students to challenge and re-evaluate standard form contracts).

43. Bar-Gill & Warren, *supra* note 10.

44. Contract law makes provision for these types of changes with doctrines of excuse, modification, and others. David V. Snyder, *The Law of Contract and the Concept of Change: Public and Private Attempts to Regulate Modification, Waiver, and Estoppel*, 1999 WIS. L. REV. 607.

45. *See, e.g.*, Becher & Zarsky, *supra* note 4.

without sufficient funds in the account.[46] At this point, their experiences diverge. The first family waits until the paycheck is deposited and calls the bank about the overdraft fee. The bank representative explains that they themselves opted into the overdraft protection program and that the standard fee is $225.[47] Ultimately, they pay the overdraft fee along with the other bills after their paycheck is processed. The second family calls the bank and complains about the charge. By asking to speak with a manager and threatening to post negative reviews of the bank on social media, they manage to get the overdraft fee waived.[48] This pattern repeats itself over the course of the pandemic, leaving the first family thousands of dollars poorer than the second.

This example highlights two key features of contractual inequality. First, the two transactions were largely similar until the overdraft fee was levied, with identical formal terms in each contract. Therefore, the literature on assent and consumer understanding of contract terms does not shed light on how and why the two families' experiences diverged. Second, the divergence may occur for any reason and need not be driven by animus or intent to harm the consumer. The second family may simply have had a more aggressive negotiating strategy, have been advised by a lawyer, or have promised the bank more business if they waived the fee. On the other hand, the bank representative may have been swayed by gender or racial bias.[49] Each of these explanations raises different concerns. Regardless, contractual inequality causes two types of harms.

First, in common with other settings, unequal treatment may be inherently undesirable. For instance, contractual inequality can worsen existing disparities across social groups, resulting in regressive redistribution or impermissible disparate impact. Second, unequal treatment generates economic inefficiency. Individuals who are considering entering into a standardized contract are aware that once the contract is signed, the company is free to stringently enforce the contract with them, while other customers are treated cooperatively and leniently. Consumers therefore may rationally distrust companies offering standard form contracts, ultimately choosing not to participate in key contracts because the law does not protect them against the risk of loss during performance. This phenomenon arises due to a commitment problem inherent to contract law, which does not allow parties to contract out of waiver, the exercise of discretion, modification, renegotiation, and breach. Consequently, inequality is particularly harmful in the contracts context. Each of these harms is discussed in turn below.

46. CFPB, CFPB STUDY OF OVERDRAFT PROGRAMS: A WHITE PAPER OF INITIAL DATA FINDINGS 23 (2013), https://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf [perma.cc/B8T8-BM9F].

47. *Id.* at 27–31.

48. *Id.* at 52.

49. *See, e.g.*, Ian Ayres, *Fair Driving: Gender and Race Discrimination in Retail Car Negotiations*, 104 HARV. L. REV. 817 (1991).

A. *Regressive Redistribution*

Social inequality has grown significantly in the last few decades.[50] High-income households have seen their income grow at four times the rate of low-income households in the last twenty years.[51] The large disparity in standards of living and opportunities for social mobility between rich and poor households was highlighted by the 2009 recession and gave rise to the Occupy Wall Street movement.[52] Since then, a significant movement among politicians, ac-

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50. Piketty & Saez, *supra* note 6; *The 2017 Tax Law and Who It Left Behind: Hearing Before the H. Comm. on Ways & Means*, 116th Cong. 14 (2019) (statement of Elise Gould, Senior Economist, Economic Policy Institute) (explaining that the difference between incomes of lower-class and upper-class Americans is consistently increasing); U.N. DEP'T OF ECON. & SOC. AFFS., WORLD SOCIAL REPORT 2020: INEQUALITY IN A RAPIDLY CHANGING WORLD, at 3, U.N. Doc. ST/ESA/372, U.N. Sales No. E.20.IV.1 (2020), https://digitallibrary.un.org/record/3847753?ln=en [perma.cc/GA35-HJQX] ("[I]nequality has increased in most developed countries and in some middle-income countries . . . since 1990."); Janet L. Yellen, Chair, Bd. of Governors of the Fed. Rsrv. Sys., Perspectives on Inequality and Opportunity from the Survey of Consumer Finances 1 (Oct. 17, 2014), https://www.federalreserve.gov/newsevents/speech/files/yellen20141017a.pdf [perma.cc/78D4-YBV4] ("The distribution of income and wealth in the United States has been widening more or less steadily for several decades, to a greater extent than in most advanced countries."). *But see* Ana Revenga & Meagan Dooley, *Is Inequality Really on the Rise?*, BROOKINGS INST. (May 28, 2019), https://www.brookings.edu/blog/future-development/2019/05/28/is-inequality-really-on-the-rise [perma.cc/X3VB-3JKW] (stating that although within-country inequality has increased in nations with advanced economies, total global inequality has declined since the 1990s as poor countries become wealthier).

51. Higher-income households have an average income that is 8% higher than their analogues twenty years ago, while lower-income households have seen their income increase by less than 2%. *See* JULIANA MENASCE HOROWITZ, RUTH IGIELNIK & RAKESH KOCHHAR, PEW RSCH. CTR., MOST AMERICANS SAY THERE IS TOO MUCH ECONOMIC INEQUALITY IN THE U.S., BUT FEWER THAN HALF CALL IT A TOP PRIORITY 15 (2020), https://www.pewresearch.org/social-trends/wp-content/uploads/sites/3/2020/01/PSDT_01.09.20_economic-inequailty_FULL.pdf [perma.cc/V549-8KGV].

52. *See* Emily Stewart, *We Are (Still) the 99 Percent*, VOX (Apr. 30, 2019, 9:00 AM), https://www.vox.com/the-highlight/2019/4/23/18284303/occupy-wall-street-bernie-sanders-dsa-socialism [perma.cc/QTS7-8RB6]. Occupy Wall Street formed in 2011 as a protest against the unchecked power of large financial institutions and the economic disparities that this power perpetuates. *About*, OCCUPY WALL STREET, http://occupywallst.org/about [perma.cc/FB5A-S3ND]; Mattathias Schwartz, *Pre-Occupied: The Origins and Future of Occupy Wall Street*, NEW YORKER (Nov. 20, 2011), https://www.newyorker.com/magazine/2011/11/28/pre-occupied [perma.cc/5QB7-YDD3]. As evidenced by its "We Are the 99 Percent" tagline, the movement was mainly focused on drawing attention to economic inequality and airing the grievances of nonwealthy Americans, rather than advocating for specific policy changes. Amy Dean, *Occupy Wall Street: A Protest Against a Broken Economic Compact*, HARV. INT'L REV., Spring 2012, at 12, 12–13. Although most Occupy Wall Street events dissipated by 2012, the movement brought economic inequality to the forefront of national conversations and hugely influenced mainstream politics. Stewart, *supra* (discussing the long-term impact of Occupy Wall Street); Arindrajit Dube & Ethan Kaplan, *Occupy Wall Street and the Political Economy of Inequality*, ECONOMISTS' VOICE, March 2012, at 1, 4–5, https://doi.org/10.1515/1553-3832.1899 (describing Occupy Wall Street's influence on public policy).

tivists, and voters has given a national stage to policy debates directly addressing inequality.[53] The global pandemic of 2020 highlighted how little progress has been made in remedying inequality, with low-paid essential workers risking their lives to supply the needs of much more affluent at-home workers.[54] Policy remedies have been difficult to find, in part due to the complex sources of the problem, including long-standing historical factors surrounding race and communities, systemic failures in public education, and misaligned economic incentives.[55] Most policies targeting inequality have focused on direct redistribution of wealth from rich to poor, usually through taxes and social welfare programs.[56]

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53. Several politicians in the Democratic Party have made reducing social inequality a prominent component of their platforms. *See, e.g.*, Annie Grayer, *Bernie Sanders Releases Tax Plan to Target Income Inequality*, CNN (Sept. 30, 2019, 8:03 AM), https://www.cnn.com/2019/09/30/politics/bernie-sanders-tax-plan-income-inequality/index.html [perma.cc/Z9UE-UYEC]; Kevin Breuninger & Tucker Higgins, *Elizabeth Warren Proposes 'Wealth Tax' on Americans with More Than $50 Million in Assets*, CNBC (Jan. 25, 2019, 9:10 AM), https://www.cnbc.com/2019/01/24/elizabeth-warren-to-propose-new-wealth-tax-economic-advisor.html [perma.cc/7BMG-44ZU]; Jessica Corbett, *'A Just Society': Ocasio-Cortez Unveils Legislative Package to Tackle American Poverty and Inequality*, COMMON DREAMS (Sept. 25, 2019), https://www.commondreams.org/news/2019/09/25/just-society-ocasio-cortez-unveils-legislative-package-tackle-american-poverty-and [perma.cc/48PS-SGET]; Maggie Astor et al., *6 Takeaways from the Biden-Sanders Joint Task Force Proposals*, N.Y. TIMES (July 9, 2020), https://www.nytimes.com/2020/07/09/us/politics/biden-sanders-task-force.html [perma.cc/A7TZ-Y3EC] (describing President Biden's policy proposals aimed at reducing economic and racial inequality).

54. Aaron van Dorn, Rebecca E. Cooney & Miriam L. Sabin, *COVID-19 Exacerbating Inequalities in the US*, 395 LANCET 1243, 1243 (2020) (describing COVID-19's disproportionately large impact on racial minorities and economically disadvantaged communities); Catherine Thorbecke & Arielle Mitropoulos, *'Extreme Inequality Was the Preexisting Condition': How COVID-19 Widened America's Wealth Gap*, ABC NEWS (June 28, 2020, 11:42 AM), https://abcnews.go.com/Business/extreme-inequality-preexisting-condition-covid-19-widened-americas/story?id=71401975 [perma.cc/653N-YT87] (illustrating that the coronavirus crisis has resulted in the ultrarich getting richer and the bottom 40% of earners getting poorer).

55. Historical policies that limited lending in certain neighborhoods based on race, known as redlining, continue to contribute to racial segregation and adversely affect the wealth of nonwhite neighborhoods. *See* Amy Scott, *Inequality by Design: How Redlining Continues to Shape Our Economy*, MARKETPLACE (Apr. 16, 2020), https://www.marketplace.org/2020/04/16/inequality-by-design-how-redlining-continues-to-shape-our-economy [perma.cc/CY5X-E3U3]. Moreover, children in poor communities have fewer educational opportunities and show diminished academic performance, perpetuating systemic inequalities. EMMA GARCÍA & ELAINE WEISS, ECON. POL'Y INST., EDUCATIONAL INEQUALITIES AT THE SCHOOL STARTING GATE (2017), https://files.epi.org/pdf/132500.pdf [perma.cc/3VEW-ABSX]. Finally, minorities and women are discouraged from pursuing highly paid and skilled work due to discrimination, lack of human capital, and preference. Chang-Tai Hsieh, Erik Hurst, Charles I. Jones & Peter J. Klenow, *The Allocation of Talent and U.S. Economic Growth*, 87 ECONOMETRICA 1439 (2019); *see also* DANYELLE SOLOMON, CONNOR MAXWELL & ABRIL CASTRO, CTR. FOR AM. PROGRESS, SYSTEMATIC INEQUALITY AND ECONOMIC OPPORTUNITY 1 (2019), https://cf.americanprogress.org/wp-content/uploads/2019/08/StructuralRacismEconOpp-report.pdf [perma.cc/E358-74QK] ("Eliminating current disparities among Americans will require intentional public policy efforts to dismantle systematic inequality . . . .").

56. *See* Kaplow & Shavell, *supra* note 32, at 667.

Legal scholars have focused on the role of law in the creation and exacerbation of harmful social inequality.[57] Economic, gender, and racial inequality have been aggravated by differential use of legal tools against social groups. The criminal justice system, administrative agencies, and other public actors have been heavily studied by scholars[58] and regulated by lawmakers[59] as a source of social inequality. Public law scholars have a deep interest in the differential understanding of how legal institutions interact differently with the rich and the poor.[60] Research on access to justice has highlighted that providing the opportunity to litigate may benefit the most powerful to the detriment

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57. This discourse typically focuses on the existence of social inequality across various sociological classes, as well as the growth of economic inequality in recent decades. *E.g.*, THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY (Arthur Goldhammer trans., Harv. Univ. Press 2014) (2013). Discourse on social inequality has heavily influenced and been influenced by social movements and significant events like the 2008 financial crisis. *See, e.g.*, Sarah Gaby & Neal Caren, *The Rise of Inequality: How Social Movements Shape Discursive Fields*, 21 MOBILIZATION 413, 413–14 (2016) (arguing that political movements such as Occupy Wall Street have increased public discourse and awareness of social inequality); Leanne S. Giordono, Michael D. Jones & David W. Rothwell, *Social Policy Perspectives on Economic Inequality in Wealthy Countries*, 47 POL'Y STUD. J. S96 (2019) (explaining that the 2008 financial crisis led to an increased interest in social inequality among public policy scholars).

58. *See, e.g.*, Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1682–83 (1975) (studying discretion in administrative decisionmaking and its effect on interest-group pressures); Robert Heller, Comment, *Selective Prosecution and the Federalization of Criminal Law: The Need for Meaningful Judicial Review of Prosecutorial Discretion*, 145 U. PA. L. REV. 1309, 1329–31 (1997) (discussing the high level of discretion available to prosecutors and arguing for oversight by judges); MICHELLE ALEXANDER, THE NEW JIM CROW: MASS INCARCERATION IN THE AGE OF COLORBLINDNESS (10th anniversary ed. 2020) (reframing disparate impact in the criminal system as a deliberate mechanism for subordinating minority races by the differential usage of incarceration).

59. Mandatory minimums were originally instituted in response to calls of racial discrimination by judges in the sentencing process:

> For decades, racial and other "legally unwarranted" disparities in sentencing have been the subject of considerable empirical research, which has in turn helped to shape major policy changes. Most importantly, the U.S. Sentencing Guidelines and their state counterparts were adopted with the goal of reducing such disparities. In 2005, when the Supreme Court's decision in *United States v. Booker* rendered the formerly mandatory Guidelines merely advisory, Justice Stevens's dissent predicted that "[t]he result is certain to be a return to the same type of sentencing disparities Congress sought to eliminate in 1984."

Sonja B. Starr & M. Marit Rehavi, *Mandatory Sentencing and Racial Disparity: Assessing the Role of Prosecutors and the Effects of* Booker, 123 YALE L.J. 2, 4–5 (2013) (quoting United States v. Booker, 543 U.S. 220, 300 (2005) (Stevens, J., dissenting in part)). However, mandatory minimums ultimately worsened discrimination by prosecutors. *See id.* at 71.

60. Constitutional law scholars have argued that socioeconomic class should be a "suspect classification" under the Equal Protection Clause. *See, e.g.*, Mario L. Barnes & Erwin Chemerinsky, *The Disparate Treatment of Race and Class in Constitutional Jurisprudence*, LAW & CONTEMP. PROBS., Fall 2009, at 109; Bertrall L. Ross II & Su Li, *Measuring Political Power: Suspect Class Determinations and the Poor*, 104 CALIF. L. REV. 323 (2016). Criminologists have heavily investigated the "criminalization of poverty," referring to the phenomenon where the inability to pay is evidence of criminal culpability in a variety of contexts. *See, e.g.*, Kaaryn Gustafson, *The Criminalization of Poverty*, 99 J. CRIM. L. & CRIMINOLOGY 643, 646 n.12 (2009) (emphasis omitted).

of the weak.[61] Even differences in contract formation between genders and racial groups have been studied and litigated as having an impermissible disparate impact on protected classes.[62]

Contractual inequality refers to a less-studied disparate impact—differences in value created by contract performance across social groups.[63] Among consumers subject to the same contract terms, for example, some may consistently be treated well while others are treated poorly.[64] Disparities in contract performance are particularly important to deter and remedy due to contracts' essential role in facilitating the exchange of labor for income, the accumulation of savings, and the purchase of consumer goods, education, investments, and other assets.

Disparities in performance may be particularly harmful if they are regressive. For instance, suppose the bank customer whose overdraft fee was not waived is Black and poor. The unequal treatment meted out by the bank adds to the list of obstacles facing poor and Black individuals trying to build wealth.[65] Since the Black family is part of a protected class, the bank's conduct could even violate federal antidiscrimination law.[66] Though bank overdraft fees have been widely studied and regulated, regulators do not quantitatively assess how many fees are waived for Black customers relative to others.[67]

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61. Omri Ben-Shahar, *The Paradox of Access Justice, and Its Application to Mandatory Arbitration*, 83 U. CHI. L. REV. 1755 (2016).

62. For a summary of this literature and litigation, see Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economics Analysis*, 73 TEX. L. REV. 787 (1995).

63. Literature in consumer law, particularly focusing on predatory lending, has created frameworks for thinking about the distributional implications of contract formation. Existing work focuses on the *formation* of contracts that are onerous or abusive, while this Article looks at contract *performance*. *See, e.g.*, Abbye Atkinson, *Rethinking Credit as Social Provision*, 71 STAN. L. REV. 1093, 1154–57 (2019) (describing how private debt supplanted social insurance); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1270–98 (2002) (discussing the role of predatory lending in financing home purchases and other large household expenditures).

64. *See, e.g.*, Furth-Matzkin, *supra* note 4, at 9–10.

65. For an overview of the evidence on the racial wealth gap, see THOMAS SHAPIRO, TATJANA MESCHEDE & SAM OSORO, INST. ON ASSETS & SOC. POL'Y, THE ROOTS OF THE WIDENING RACIAL WEALTH GAP: EXPLAINING THE BLACK-WHITE ECONOMIC DIVIDE (2013), https://heller.brandeis.edu/iere/pdfs/racial-wealth-equity/racial-wealth-gap/roots-widening-racial-wealth-gap.pdf [perma.cc/KGP8-L829].

66. See Peter E. Mahoney, *The End(s) of Disparate Impact: Doctrinal Reconstruction, Fair Housing and Lending Law, and the Antidiscrimination Principle*, 47 EMORY L.J. 409 (1998), for a discussion of disparate impact and the difficulty in proving claims of disparate impact.

67. Another example of this is the generic guidance provided during COVID-19 to waive overdraft fees. Despite this guidance, many banks profited significantly from overdraft fees during the pandemic. Bd. of. Governors of the Fed. Rsrv. Sys., Fed. Deposit Ins. Corp. & Off. of the Comptroller of the Currency, Joint Statement on CRA Consideration for Activities in Response to COVID-19 (Mar. 19, 2020), https://www.fdic.gov/news/financial-institution-letters/2020/fil20019a.pdf [perma.cc/QUT3-ERQW]; Annie Nova, *Banks Will Collect More Than $30 Billion in Overdraft Fees This Year. Here's How to Avoid Them*, CNBC (Dec. 1, 2020, 5:31 PM), https://www.cnbc.com/2020/12/01/banks-will-get-30b-in-overdraft-fees-this-year-heres-how-to-avoid-them-.html [perma.cc/97U9-BEKG].

It is essential to note that disparate treatment may be economically rational. For instance, the bank could rationally believe that the second family's threat to tweet about the company's behavior would lose them more money than the lost overdraft fee. Or the bank may have noticed that aggressive overdraft-fee negotiators bring more business to the bank, making it profitable to keep those customers happy. The bank may not even be aware of the individual's gender, race, or wealth. The distributive harm remains in this case, however, since there is a disparate impact on underprivileged populations.

Moreover, economic efficiency cannot always justify contractual inequality because even sophisticated parties sometimes make inefficient choices, resulting in arbitrary performance inequalities.[68] A large legal literature has demonstrated that legal actors making discretionary choices are influenced by behavioral factors. For example, a famous study found that judges were more lenient in cases heard early in the day, with leniency dropping significantly until judges had a lunch break.[69] Increasing discretion awarded to prosecutors in charging decisions and judges in criminal sentencing led to larger disparities in sentences between Black and white defendants.[70] Individuals are not the only decisionmakers subject to these inefficient impacts. The literature on discretion in administrative lawmaking finds evidence that agencies make decisions that are biased in favor of interest groups and lobbies.[71]

The legal system is indirectly responsible for distributional harms of contractual inequality because the threat of court enforcement limits parties' ability to walk away from their contractual obligations. Contracts scholars have argued that contract law can act as a powerful force for progressive redistribution at formation, including the use of unconscionability and other principles to protect vulnerable contracting parties.[72] However, these doctrines do not typically extend to contract performance, leading to worsening inequality.

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68. Consider, for example, drafting errors in boilerplate. *See* GULATI & SCOTT, *supra* note 38, at 150.

69. Shai Danziger, Jonathan Levav & Liora Avnaim-Pesso, *Extraneous Factors in Judicial Decisions*, 108 PNAS 6889, 6890–92 (2011). Note that the size of the effect was challenged by Andreas Glöckner, *The Irrational Hungry Judge Effect Revisited: Simulations Reveal That the Magnitude of the Effect Is Overestimated*, 11 JUDGMENT & DECISION MAKING 601 (2016).

70. *See, e.g.*, Jon Sorensen & Donald H. Wallace, *Prosecutorial Discretion in Seeking Death: An Analysis of Racial Disparity in the Pretrial Stages of Case Processing in a Midwestern County*, 16 JUST. Q. 559 (1999); Robert J. Smith & Justin D. Levinson, *The Impact of Implicit Racial Bias on the Exercise of Prosecutorial Discretion*, 35 SEATTLE U. L. REV. 795 (2012); Crystal S. Yang, *Free at Last? Judicial Discretion and Racial Disparities in Federal Sentencing*, 44 J. LEGAL STUD. 75 (2015).

71. *See, e.g.*, Anthony M. Bertelli & Christian R. Grose, *Secretaries of Pork? A New Theory of Distributive Public Policy*, 71 J. POL. 926 (2009) (showing empirical evidence that administrative discretion can result in discretionary redistribution).

72. Eric A. 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 (1995).

B. *Inefficiency of Incomplete Contracts*

A more subtle, but potentially more destructive, harm can arise from inequality in contract performance. Parties who anticipate unequal treatment and fear that they may be in the group that incurs losses due to their counterparty's decision will expect diminished value from the contract. As a result, they may face inefficiently high prices. Moreover, the fear of being treated uncooperatively during performance may make already disadvantaged groups choose to opt out of the market. This chilling effect arises from the fact that contracts are incomplete, meaning that firms have many options to modify the performance of contracts, with the decisions made during performance potentially leading to widespread economic loss.[73]

Returning to the example of banking, consider how new bank customers may behave in light of overdraft fee policies. More than 5% of American households have no bank account, limiting their access to a variety of financial benefits such as low-cost checking, direct deposits, and access to fairly priced loans.[74] Unbanked individuals may hear of stories like the one above and decide that the risk of incurring overdraft fees is high enough that they will only open a bank account when offered a bonus, despite the hidden costs associated with these "perks."[75] Even worse, disadvantaged populations such as Black or immigrant families may realize that they are less likely to receive waivers and choose not to open a bank account at all, relying on expensive check-cashing services.[76] Economically efficient transactions that could have occurred in the absence of performance inequality are undermined by the possibility that firms will treat groups unequally.

Note that contract incompleteness causes harm in two ways. First, it can lead to inefficient pricing and quality in markets for consumer contracts.[77] Exceptional customer service and other hallmarks of high-quality contract performance cannot be guaranteed. Therefore, rational customers will refuse

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73. Contracts do not—and often should not—specify the full set of actions parties should take in every contingency. *See* B. Douglas Bernheim & Michael D. Whinston, *Incomplete Contracts and Strategic Ambiguity*, 88 AM. ECON. REV. 902 (1998). Moreover, parties cannot commit to taking certain actions, such as avoiding modification upon mutual agreement. Jolls*, supra* note 7. For empirical studies on this subject, see Patrick Bajari & Steven Tadelis, *Incentives Versus Transaction Costs: A Theory of Procurement Contracts*, 32 RAND J. ECON. 387 (2001), and Sarath Sanga, *Incomplete Contracts: An Empirical Approach*, 34 J.L. ECON & ORG. 650 (2018).

74. *See* MARK KUTZBACH, ALICIA LLORO & JEFFREY WEINSTEIN, FED. DEPOSIT INS. CORP., HOW AMERICA BANKS: HOUSEHOLD USE OF BANKING AND FINANCIAL SERVICES 12 (2020), https://www.fdic.gov/analysis/household-survey/2019report.pdf [perma.cc/B53V-TLU9].

75. Bonuses are rarely giveaways, and consumers may be hit with back-end fees that cost more than the bonus provided. *See, e.g.*, Margarette Burnette, Alice Holbrook & Ruth Sarreal, *Bank Sign-Up Bonuses: 5 Things to Look Out For*, NERDWALLET (Dec. 13, 2021), https://www.nerdwallet.com/article/banking/5-reasons-ignore-bank-signup-bonuses [perma.cc/3EVR-M7NA].

76. Indeed, Black families are much less likely to participate in the formal financial market than other racial groups. *See generally* MEHRSA BARADARAN, THE COLOR OF MONEY (2017) (discussing the harms and effects of the racial wealth gap and segregated economy).

77. *See* Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 79 (1979).

to pay full price for these amenities, and companies will be less likely to provide perks during contract performance. If firms could credibly commit to cooperating with their customers during breakdown of the relationship, the transaction would be more valuable. Second, the expectation of uncooperative behavior from firms can lead the market for consumer contracts to dwindle in trade volume and even die out in certain markets.[78] Some contracts may include too much risk for consumers to participate. The harm here arises from a value-creating trade that did not occur—if the consumer could be assured of good treatment, they would participate in the market, improving both their own and their counterparty's bottom line. Contractual inequality could result in disadvantaged populations leaving markets for consumer contracts to the detriment of the entire economy.

Can incompleteness be eliminated by changing contract design? The gap between formal contracts as drafted and the economic value generated by the relationship arises from discretion in the hands of contracting parties. Written contracts do not specify the actions parties should take in every contingency, instead leaving the contract terms incomplete, waiting to be filled in by the parties or the courts. Economists have shown that it may be optimal to structure contracts in this way because gaps in a contract's specification of rights or obligations can increase the value generated by a contractual relationship by allowing parties to tailor the contract to unexpected situations that arise during the contract term.[79] Moreover, parties to a contract can take advantage of incompleteness to make dynamic adjustments to the contract during the course of performance.[80] Legal scholarship typically looks to courts to fill these gaps.[81] However, most incompleteness is resolved by unilateral or joint action by the parties before courts get involved in contract disputes.[82] How parties fill these gaps determines the inequality the contract will generate.

Insurance contracts, for instance, are fraught with incompleteness.[83] The contract may specify the general outlines of coverage, but no contract can specify every detail of a particular claim. In theory, insurers could offer a con-

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78. *Id.* at 87.

79. *See* Bernheim & Whinston, *supra* note 73, at 920.

80. *See, e.g.*, Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927 (1990) (explaining the interplay between discretionary choices within incomplete contracts and the interpretation of formal contract terms).

81. Default rules are typically thought to fill gaps in incomplete contracts, since parties can contract away from the default. This account has been challenged, however, due to the cost of contracting away from defaults. *See* Ayres & Gertner, *supra* note 13; Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651 (2006).

82. *See, e.g.*, Bernstein & Volvovsky, *supra* note 3, at 129–31; Hadfield, *supra* note 80.

83. *E.g.*, Jean-Marc Bourgeon & Pierre Picard, *Insurance Law and Incomplete Contracts*, 51 RAND J. ECON. 1253, 1253 (2020) ("[T]he link between the circumstances of the claim and the indemnity payment is rarely specified in detail in the insurance contract, and it is often limited to exclusions or force majeure clauses. In other words, more often than not, insurance contracts are incomplete." (footnote omitted)).

tract that specified the precise documentation required of every claimant before being paid. The company may still choose to waive those conditions and pay the claim without full documentation.[84] Therefore, it is both too costly and likely unappealing to specify the insurer's course of action in every conceivable scenario. Instead, some discretion is afforded to the parties in the language of the contract. The insurer can decide how exactly to administer claims, when to pay out, and how much coverage to award in each situation to fill the gaps in the contract language.[85]

Despite technological advances prompting attempts to make fully complete contracts a reality,[86] solving commitment problems once and for all is not realistic. Mandatory embedded options, such as the option to waive specific provisions, are based on fundamental principles of contract law that underpin centuries of jurisprudence.[87] Moreover, some flexibility in enforcing contracts is often desirable, despite the risks it introduces. Parties in some cases prefer to see how circumstances external to the contract evolve before committing to a course of action.[88] To understand whether incomplete contracts create significant welfare loss, lawmakers and scholars must assess the extent to which parties use their discretion to modify contract outcomes and the reasons behind it.

Information about contract performance is hard to find, however, because courts are generally unwilling or unable to scrutinize these actions.[89] A large literature has studied the effect of discretionary action in generating disparate outcomes in other contexts, including administrative law and criminal justice.[90] Affording discretion to contracting parties is different from those contexts because individuals can opt out of contracts but not out of the criminal justice system or the administrative state. But although unequal treatment within a contract may not raise concerns about coercion, it still raises concerns about economic efficiency. Despite this, inequality is classified as "relational," meaning that parties' discretionary choices are outside the purview of courts and regulators.[91]

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84. *See, e.g.*, Bebchuk & Posner, *supra* note 3; Becher & Zarsky, *supra* note 4; Furth-Matzkin, *supra* note 4; Johnston, *supra* note 4.

85. Scholars have discussed contractual inequality in the insurance context more than in others, with Schwarcz proposing a similar disclosure remedy to the one in this Article. Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. REV. 394, 414–20 (2014).

86. *See* Richard T. Holden & Anup Malani, *Can Blockchain Solve the Hold-Up Problem in Contracts?* 20–28 (Nat'l Bureau of Econ. Rsch., Working Paper No. 25833, 2019), https://doi.org/10.3386/w25833 (proposing that perfect commitment in contracts can be achieved with blockchain and automated "smart" contracts).

87. *See* Jolls, *supra* note 7, at 204.

88. *See* Bernheim & Whinston, *supra* note 73, at 903–04.

89. *See infra* Section IV.A.

90. *See supra* note 58.

91. *See* Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 3, 19 (A. Mitchell Polinsky & Steven Shavell eds., 2007);

The common law of contracts also prevents parties from agreeing to limit contract incompleteness. Mandatory embedded contract options, such as breach and modification, cause inefficiencies because no party can commit fully to not breaching or not renegotiating a contract.[92] Waiver and the exercise of discretion are difficult to contract around as well, although some doctrines exist to discipline their usage.[93] These legal levers are discussed in turn below.

II. How Contract Law Creates Unequal Outcomes

The common law of contract has long enabled contractual inequality.[94] Consider a typical debtor-creditor relationship in which the debtor is facing financial pressure. What choices does a debtor have when faced with the possibility that future payments will be difficult to make? The debtor could decide to prepay in anticipation of financial distress or offer partial payment after distress occurs in an exercise of discretion. The debtor could also breach and make no payment at all. Second, what choices does a creditor have if faced with the possibility that the debtor may be unable to make payments? The creditor could preemptively offer the debtor a modification of the debt obligations to make it easier for the debtor to make payments. The creditor could also waive the debtor's obligation to pay on time, providing a forbearance period to accommodate the debtor's needs while preserving their rights to collect on the original agreement.

More broadly, the exercise of reserved discretion, waiver of obligations, and the decision to breach, modify, enforce, or renegotiate a contract can each be utilized to generate unequal outcomes from standard form contracts. Empirical studies in economics, finance, and accounting have shown that contractual inequality is widespread in the context of health-insurance contracts, commercial debt, and household borrowing.[95] This Part uses examples from

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Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1091 (1981); Bernstein & Volvovsky, *supra* note 3, at 129–30.

92. *See* Jolls, *supra* note7, at 204.

93. The duty of good faith applies to these contract levers. *See infra* Section IV.A.1.

94. Scott & Triantis, *Embedded Options*, *supra* note 12, at 1447–52.

95. *E.g.*, Aviva Aron-Dine, Liran Einav, Amy Finkelstein & Mark Cullen, *Moral Hazard in Health Insurance: Do Dynamic Incentives Matter?*, 97 REV. ECON. & STAT. 725 (2015) (demonstrating that consumers of health insurance strategically utilize health care depending on the structure of the health-insurance plan, while satisfying the formal requirements of the contract terms); Kristopher Gerardi, Kyle F. Herkenhoff, Lee E. Ohanian & Paul S. Willen, *Can't Pay or Won't Pay? Unemployment, Negative Equity, and Strategic Default*, 31 REV. FIN. STUD. 1098 (2018) (finding that decisions to default on or breach mortgage contracts depend on private experiences of job loss and the value of housing assets, with approximately a third of defaults being classified as "strategic" or discretionary); Kevin C.W. Chen & K.C. John Wei, *Creditors' Decisions to Waive Violations of Accounting-Based Debt Covenants*, 68 ACCT. REV. 218 (1993) (providing evidence that financial covenants attached to commercial debt agreements are strategically waived, to the benefit of firms with higher chances of future success); Michael R. Roberts, *The Role of Dynamic Renegotiation and Asymmetric Information in Financial Contracting*, 116 J. FIN. ECON. 61 (2015) (showing that the average corporate bank loan is renegotiated every nine months to account for new information).

this literature to demonstrate the principles of contract law generating performance inequality and their widespread impacts.

A. *Exercise of Discretion*

A party exercises its discretion when a range of options would satisfy the requirements of a formal contract and the party can unilaterally choose among these options. One form of exercising discretion arises when a party has explicitly reserved the right to make a discretionary choice within the formal contract terms, such as the choice of production amount in an output contract or the choice to exert efforts in an exclusive dealing contract, or more generally the type of choice governed by a mandatory common law duty of good faith.[96] Discretion also exists in the utilization of well-defined formal obligations, such as the choice to enforce a right, as will be discussed below.

A well-studied example of the exercise of discretion arises in the context of health-insurance contracts. Consumers of health care purchase insurance plans to smooth their potential expenditures over the contract term. A plan typically specifies the amount of coverage, comprising a deductible that is paid out of pocket and partial or complete coverage of expenditures above the deductible amount. Economists have documented that consumers obtain health care in a way that minimizes their out-of-pocket expenditures.[97] For instance, it is cheaper to visit the doctor for a checkup at the end of the year, when the deductible has already been spent and insurance covers additional care, than waiting until the following January to get a checkup that will require out-of-pocket-payment. It would be entirely within the bounds of the formal contract to strategically reschedule doctor's visits to the end of the year. If sophisticated consumers decide to get more specialist care in years when their spending is already high, the insurance company bears the cost and no contract term can be used to deny the claim. This generates inequality among insurance companies. Companies whose sophisticated consumers strategically reschedule their health care consumption will have to pay out more, while companies with unsophisticated consumers will pay out less.[98]

Note that the inequality in this example arises directly from the incompleteness of the insurance contract. Insurance companies could require their customers to provide documentation that doctor's visits were scheduled in a

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96. The Restatement (Second) of Contracts states that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." RESTATEMENT (SECOND) OF CONTRACTS § 205 (AM. LAW INST. 1981). Likewise, the Uniform Commercial Code "imposes an obligation of good faith in [every contract's] performance and enforcement." U.C.C. § 1-304 (AM. L. INST. & UNIF. L. COMM'N 2019).

97. *See* Aron-Dine et al., *supra* note 95, at 725, 737; Liran Einav & Amy Finkelstein, *Moral Hazard in Health Insurance: What We Know and How We Know It*, 16 J. EUR. ECON. ASS'N 957, 958–60 (2018).

98. Indeed, insurance companies anticipate this behavior and attempt to find customers without strategic consumption patterns. Liran Einav et al., *Selection on Moral Hazard in Health Insurance*, 103 AM. ECON. REV. 178 (2013).

timely fashion or could ration discretionary medical care to limit strategic consumption. Instead, insurance companies have taken another tactic for limiting the cost of inequality—they set premiums to compensate for the possibility of strategic health care consumption.[99] Parties bargain for and assent to agreements that leave discretion in their hands, explicitly allowing for unequal outcomes to arise.

B. *Breach of Contract*

Parties to a contract can always choose to breach their obligations to their counterparty. The option to breach is embedded in every contract and comes with the implicit cost of damages or other restitution from the harmed party.[100] Breach-of-contract claims require no showing of fault and therefore impose strict liability on a breaching party.[101] This can be thought of as putting a "price" on breach. When two sets of parties are engaged in similar contracts, the strategic choice by one party to breach while its analogue continues to perform generates contractual inequality.

The strategic choice to breach has been studied by economists and lawmakers in the context of mortgage default. The decision to stop making payments on a mortgage constitutes breach—the terms of all mortgage contracts require mortgagees to make timely payments.[102] Occasionally, default is unavoidable, with the mortgagee facing a liquidity crisis that makes payment impossible. On the other hand, some may decide to breach despite being able to perform if necessary. This is referred to as *strategic default*.[103] Mortgagees would rationally prefer to default if the value of their home drops so low that they no longer have any equity interest in the home, that is, if the mortgage is underwater. In this case, further payments toward a principal amount that is too high would be wasted. Moreover, failing to pay would force the creditor or servicer to choose whether to foreclose on the property. If the loan is underwater, foreclosure may not make the creditor whole. By strategically defaulting, a mortgagee may benefit by remaining in the house without payment

99. *See id.* at 214–15.

100. Since Holmes, breach has been thought of as a valid, if not ideal, choice to be made by parties to the contract. *See* O.W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else."). Recent scholarship in law and economics has sought to separate the moral requirements of contracts from the economic requirements, holding breach to be potentially efficient. For a history and an attempt at reconciliation of the economic and moral views of breach, see Richard R.W. Brooks, Essay, *The Efficient Performance Hypothesis*, 116 YALE L.J. 568 (2006).

101. For a review of the history of strict liability for breach of contract, as distinguished from fault regimes in tort, see Robert E. Scott, *In (Partial) Defense of Strict Liability in Contract*, 107 MICH. L. REV. 1381 (2009).

102. *See* Gerardi et al., *supra* note 95.

103. Tess Wilkinson-Ryan, *Breaching the Mortgage Contract: The Behavioral Economics of Strategic Default*, 64 VAND. L. REV. 1547 (2011) (summarizing the literature on strategic default and concluding that changing social norms encourage strategic mortgagee decisionmaking).

until the home's value increases. On the other hand, strategic defaults are considered both morally dubious and potentially harmful to the value of neighboring properties and communities.[104]

The choice to breach, therefore, generates inequality across creditors, investors, and servicers. Some are lucky to have a portfolio of high-performing loans without many defaults at all. Others are faced with many defaults, resulting in poor performance and low returns. Despite this, the reasoning behind the choice to default is not considered by courts or regulators.[105] Damages are equivalent whether or not the breach was strategic, even though creditors with more strategic defaulters face larger losses.[106] Since the option to breach a contract cannot be modified by agreement, this lever is embedded in every single contract and can always result in unequal outcomes.[107]

C. *Waiver and Enforcement*

When a contract imposes obligations on one party, the counterparty is empowered to waive those obligations. Waiver is a unilateral decision not to enforce a legal right, usually a right explicitly authorized by the written contract.[108] The exact nature of waiver is highly litigated and debated, since an offer to waive an obligation may be retracted at any time as long as compliance with the obligation is still possible.[109] The party entitled to waive the other's performance is also empowered to insist on performance. Therefore, the choice to enforce is the opposite of the choice to waive.[110] There is no legal

104. Michael G. Bradley, Amy Crews Cutts & Wei Liu, *Strategic Mortgage Default: The Effect of Neighborhood Factors*, 43 REAL EST. ECON. 271, 273 (2015) (finding that strategic default is "contagious" in neighborhoods, leading to higher aggregate financial risks); Luigi Guiso, Paola Sapienza & Luigi Zingales, *The Determinants of Attitudes Toward Strategic Default on Mortgages*, 68 J. FIN. 1473, 1498–1502 (2013) (showing that homeowners prefer not to default on underwater mortgages when they believe they have a moral obligation to perform on their contract); Michael J. Seiler, *Understanding the Far-Reaching Societal Impact of Strategic Mortgage Default*, 22 J. REAL EST. LITERATURE 205 (2014) (noting the spillover effects of strategic default on the financial sector, neighborhood welfare, and other economic sectors).

105. The choice to stop paying is one of the many options embedded in contracts that are not interrogated by courts. In the mortgage example, strategic default may not work in states where the borrower can be sued for a "deficiency judgement" that compensates the lender if the house price is below the unpaid loan amount. However, if there is no deficiency judgement available in a state, there is no legal requirement that a borrower in default be unable to make a payment on the property. *See, e.g.*, Christopher Combs, *Strategic Defaults Are Not "Illegal,"* COMBS L. GRP. (Sept. 26, 2012), https://combslawgroup.com/strategic-defaults-are-not-illegal [perma.cc/SU9S-KLBR].

106. *See, e.g.*, Christopher Mayer, Edward Morrison, Tomasz Piskorski & Arpit Gupta, *Mortgage Modification and Strategic Behavior: Evidence from a Legal Settlement with Countrywide*, 104 AM. ECON. REV. 2830 (2014).

107. *See* Jolls, *supra* note 7 (discussing the commitment problems arising from contracts always being modifiable).

108. Snyder, *supra* note 44, at 625–26.

109. *Id.* at 630.

110. *Id.*

obligation for contracting parties to enforce their legal rights by filing a lawsuit, but they may choose to do so unilaterally.[111] Waiver and enforcement can create inequality across counterparties—the same party can offer a waiver to counterparty A while enforcing the original terms of the agreement against counterparty B.

A large literature in finance and accounting has studied how waiver, relative to enforcement, generates unequal outcomes in the context of commercial debt.[112] Lenders include financial covenants in their debt agreements, meaning that if a borrower's financial condition is worse than expected, lenders may terminate the relationship even if the borrower is still making payments.[113] These covenants are often waived, but only for those borrowers who are likely to have continued future value.[114] Covenant violations that are not waived have significant consequences, including inability to obtain follow-on financing and limitations on future investments.[115] Despite this, covenant violations can provide an opportunity for creditors to step in, assert control rights, and ultimately increase the debtor's value.

Waiver in this context generates inequality between debtors whose violations are waived and those whose violations are not. These disparities occur among sophisticated parties, who can change the price of debt to account for the possibility of covenant violations, following the pattern of insurance companies and mortgage lenders mentioned above.[116] On the other hand, less informed parties are often at the receiving end of differential waiver policies.[117] Recent experimental evidence shows that customers wishing to make retail returns despite violating the technical requirements of the store's written return policy are provided with different waivers by store clerks.[118] In a variety of contexts, then, waivers give rise to unequal outcomes across parties that are otherwise similar.

D. *Modification and Renegotiation*

Contract modifications arise whenever the rights or obligations laid down in the express contract are changed to accommodate new and different circumstances facing the parties. Valid modifications, which are usually written,

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111. *Id.* at 632.

112. *See, e.g.*, Chen & Wei, *supra* note 95.

113. *See id.* at 221–22.

114. *Id.* at 219–22.

115. Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights and Firm Investment Policy*, 92 J. FIN. ECON. 400 (2009) (showing empirical evidence that while violations of debt covenants lower firms' opportunities for future investment, they also increase firm value due to increased control from the creditor).

116. *See* Michael Bradley & Michael R. Roberts, *The Structure and Pricing of Corporate Debt Covenants*, 5 Q.J. FIN., no. 2, June 2015, art. 1550001, https://doi.org/10.1142/S2010139215500019.

117. Bebchuk & Posner, *supra* note 3, at 833–34 (discussing hotel checkout policies); Furth-Matzkin, *supra* note 4 (addressing retail return policies).

118. Furth-Matzkin, *supra* note 4.

preserve the fundamentals of the contract in a way that is *mutually* agreed upon by the parties while changing some terms. Since both parties must assent to a modification, it has a fundamentally different character than the one-sided tools available to contracting parties. On the other hand, the ability of one party to "hold up" its counterparty and strategically demand a modification, as well as the proliferation of unilateral modification clauses, has turned this bilateral tool into an increasingly unilateral one.[119] The hold-up problem has led to limitations being placed on modifications, primarily in the form of bilateral agreements due to changed circumstances or unilateral changes by prior agreement including notice and opportunity to review the changes.

Despite these limitations, modifications continue to be a regular part of many contractual relationships, with unilateral modification clauses becoming increasingly common.[120] Yet scholars and lawmakers have noted that modification does not happen in cases when it would be socially optimal, such as during the financial crisis of 2008 when homeowners were foreclosed on instead of being offered modifications.[121] The federal government created the Home Affordable Modification Program in response, which subsidized lenders who offered streamlined modifications to their borrowers.[122] The effect of this program was much smaller than anticipated, and research has shown that this lack of modification caused inefficiently high levels of foreclosure during and after the crisis.[123]

Unlike modification, which doesn't replace the original contract, renegotiation creates an entirely new contract between two parties who contracted previously. As it is never unilateral, renegotiation is a more mutual tool. However, the choice *not* to renegotiate, just like the choice *not* to modify, is unilateral. Recent studies have shown that private credit agreements are regularly

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119. *See* Daniel A. Graham & Ellen R. Peirce, *Contract Modification: An Economic Analysis of the Hold-Up Game*, LAW & CONTEMP. PROBS., Winter 1989, at 9; Steven Shavell, *Contractual Holdup and Legal Intervention*, 36 J. LEGAL STUD. 325 (2007).

120. *See, e.g.*, David Horton, *The Shadow Terms: Contract Procedure and Unilateral Amendments*, 57 UCLA L. REV. 605 (2010); Shmuel I. Becher & Uri Benoliel, *Sneak In Contracts*, 55 GA. L. REV. 657 (2021).

121. *See infra* text accompanying notes 165–166; DIANE E. THOMPSON, NAT'L CONSUMER L. CTR., WHY SERVICERS FORECLOSE WHEN THEY SHOULD MODIFY AND OTHER PUZZLES OF SERVICER BEHAVIOR (2009), https://www.nclc.org/images/pdf/pr-reports/report-servicers-modify.pdf [perma.cc/AM73-9PP5].

122. 12 U.S.C. § 5219.

123. *See* OFF. OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 97–103 (2015), https://www.sigtarp.gov/sites/sigtarp/files/Quarterly_Reports/July_29_2015_Report_to_Congress.pdf [perma.cc/6364-4UJS]; Sumit Agarwal et al., *Policy Intervention in Debt Renegotiation: Evidence from the Home Affordable Modification Program*, 125 J. POL. ECON. 654, 657–58 (2017); *see also* Renae Merle, *After Helping a Fraction of Homeowners Expected, Obama's Foreclosure Prevention Program Is Finally Ending*, WASH. POST (Dec. 30, 2016), https://www.washingtonpost.com/news/business/wp/2016/12/30/after-helping-a-fraction-of-homeowners-expected-obamas-foreclosure-prevention-program-is-finally-ending [perma.cc/SH76-9QHJ].

modified and renegotiated.[124] Violations of debt covenants, for example, often trigger renegotiations.[125] Recent research has shown that loan covenant violations and subsequent renegotiations of debt contracts were an important factor in the macroeconomic collapse during the 2008 financial crisis.[126] Selective failures to modify and renegotiate in a cooperative manner can generate inequality between debtors with a path to performance and those who face inevitable financial loss. Just as in the case of breach and waiver, there is no way for parties to opt out of modification and renegotiation. Every contract includes the embedded option not to modify or renegotiate, potentially generating unequal outcomes across similarly situated parties.

III. INEQUALITY IN RESIDENTIAL MORTGAGE FORECLOSURE

To quantify the impact of contractual inequality, this Article considers one of the most important types of contracts in the United States—residential mortgages. Mortgages are the largest and most consequential contracts that a typical consumer will enter into during their lifetime. American households, taken together, have $11 trillion in outstanding mortgages.[127] Over 30% of income nationwide is eaten up by housing costs, a large fraction of which are mortgage payments.[128] The health and efficiency of mortgage markets have important consequences because they decide where and how households live. In turn, this contributes to the economic welfare of these households, the education of their children, the political climate of their local community, and the long-term development of towns and cities.[129]

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124. Roberts, *supra* note 95 (noting that renegotiation occurs about every nine months, accounting for new risks); Michael R. Roberts & Amir Sufi, *Renegotiation of Financial Contracts: Evidence from Private Credit Agreements*, 93 J. FIN. ECON. 159 (2009) (noting that 90% of private credit agreements are renegotiated before maturity).

125. Mitchell Berlin & Loretta J. Mester, *Debt Covenants and Renegotiation*, 2 J. FIN. INTERMEDIATION 95 (1992); Nicolae Gârleanu & Jeffrey Zwiebel, *Design and Renegotiation of Debt Covenants*, 22 REV. FIN. STUD. 749 (2009).

126. Gabriel Chodorow-Reich & Antonio Falato, *The Loan Covenant Channel: How Bank Health Transmits to the Real Economy*, 77 J. FIN. 85 (2022).

127. FINANCIAL STABILITY REPORT, *supra* note 35, at 28.

128. JOINT CTR. FOR HOUS. STUD., HARV. UNIV., STATE OF THE NATION'S HOUSING 2020, at 34 (2020), https://www.jchs.harvard.edu/sites/default/files/reports/files/Harvard_JCHS_The_State_of_the_Nations_Housing_2020_Report_Revised_120720.pdf [perma.cc/9ZTU-88AB].

129. *See* Tammy Leonard & James C. Murdoch, *The Neighborhood Effects of Foreclosure*, 11 J. GEOGRAPHICAL SYS. 317 (2009); Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUS. POL'Y DEBATE 57 (2006); Creola Johnson, *Renters Evicted En Masse: Collateral Damage Arising from the Subprime Foreclosure Crisis*, 62 FLA. L. REV. 975, 984 (2010); William H. Rogers & William Winter, *The Impact of Foreclosures on Neighboring Housing Sales*, 31 J. REAL EST. RSCH. 455 (2009); W. Scott Frame, *Estimating the Effect of Mortgage Foreclosures on Nearby Property Values: A Critical Review of the Literature*, 10 ECON. REV. (FED. RSRV. BANK ATLANTA), no. 3, 2010, https://www.atlantafed.org/-/media/documents/research/publications/economic-review/2010/vol95no3_frame.pdf [perma.cc/FL4E-XVUY].

Moreover, mortgage markets underpin a large part of the national economy, as was highlighted during the 2008 financial crisis and the recession that followed. Government subsidies, both explicitly in the tax code and implicitly through reinsurance by government-sponsored entities (GSEs), have greatly expanded the mortgage market and have made high homeownership rates possible.[130] The large volume of mortgage debt contracts and the large quantity of data collected about them makes them an ideal case study for determining the extent to which contractual inequality arises in standard form contracts.

Given the importance of mortgages to the welfare of American households, lawmakers have given a great deal of thought to the structure and oversight of mortgage debt contracts.[131] A typical mortgage is signed by a lender and a borrower; the lender promises funds to cover the purchase of a house, and the borrower promises to repay those funds over time. If the borrower stops making payments, the lender has the right to recover the property by utilizing the foreclosure process set out in the contract. The contract terms include some individually negotiated terms, such as the amount of loan, interest rate, and type of payment structure. In large part, however, the rights and obligations of the parties are derived from standard form terms that are common across most mortgages.[132] Moreover, contract formation is subject to state and federal regulation that further regularizes terms.[133]

At first glance, it seems as if mortgages can proceed in one of two ways—either the borrower makes payments on time and pays off the loan, or else the lender forecloses on the property. However, a wide variety of alternatives exist for both borrowers and lenders, leading to many different potential outcomes arising from the same contract. The first choice is made by the borrower, who may decide to prepay, pay exactly the required amount, make partial payment, or fail to pay altogether. In response, the lender has many options that are not

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130. Michael S. Carliner, *Development of Federal Homeownership "Policy,"* 9 HOUS. POL'Y DEBATE 299 (1998) (describing government policies implicitly and explicitly subsidizing homeownership); Wayne Passmore, *The GSE Implicit Subsidy and the Value of Government Ambiguity*, 33 REAL EST. ECON. 465, 467 (2005) (quantifying the value of GSE reinsurance and showing that secondary markets rely heavily on implicit guarantees).

131. A large number of the CFPB's existing regulations focus on mortgages and real estate transactions. *See Code of Federal Regulations*, CFPB, https://www.consumerfinance.gov/rules-policy/final-rules/code-federal-regulations [perma.cc/9L5H-KJXH].

132. For standard form mortgages, including those drafted by bar associations, real estate groups, and GSEs, see, for example, NAT'L CONSUMER L. CTR., FORECLOSURE PREVENTION COUNSELING app. B at 315 (3d ed. 2013) [perma.cc/5WY7-42TD], and *Fannie Mae Legal Documents (New)*, *supra* note 2. *See also Standard Form Contract for Purchase and Sale of Real Estate*, NYSTATEMLS, https://www.nystatemls.com/documents/forms/NYStateMLS_Draft_Purchase_Contract.pdf [perma.cc/TM2S-PE6J]; REAL PROP. L. SECTION, N.Y. STATE BAR ASS'N & COMM. ON REAL PROP. LAW, BAR OF N.Y.C., RESIDENTIAL CONTRACT OF SALE (2000) [hereinafter RESIDENTIAL CONTRACT OF SALE], https://www2.nycbar.org/RealEstate/Forms/Residential_Contract_pdf.pdf [perma.cc/5K5V-MTQK].

133. An example is the CFPB's required "Know Before You Owe" rule. Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z), 78 Fed. Reg. 79,730 (Dec. 31, 2013) (to be codified at 12 C.F.R. pt. 1024, 1026).

restricted by the formal contract terms.[134] The lender can decide whether to credit partial payments as satisfying the borrower's obligation, sparing the borrower from being classified as delinquent. The lender also has the option to charge or waive late fees.[135] Moreover, the lender can choose whether to intervene at the first sign of underpayment or to abstain until a serious delinquency develops. Lenders who intervene early can ask why the underpayment happened and offer modifications or repayment plans to help the borrower become current again.[136] The wait-and-see approach, on the other hand, is cheaper and allows the borrower to self-cure by repaying unpaid amounts.[137]

If the borrower becomes seriously delinquent, typically meaning 90–120 days without making a payment, the lender gains the right to foreclose on the property.[138] This does not mean that the lender *must* foreclose on the property; the lender can once again choose to offer a repayment plan or modify the contract to help the borrower become current.[139] The borrower can also choose to sell the property and avoid payment as long as the unpaid principal is covered by the proceeds of the sale. Finally, the lender can choose not to foreclose, temporarily waiving the borrower's obligation to pay in order to retain title. This option, also described as forbearance, was mandated during the COVID-19 pandemic to ease financial burdens on homeowners during the economic downturn.[140] In normal economic conditions, a large fraction of mortgage lenders forbear from foreclosing on delinquent homeowners despite having no legal obligation to do so.[141]

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134. Prepayment penalties must be specified in the written contract. FREDDIE MAC, PREPAYMENT PENALTY MORTGAGES 2 (2006) [perma.cc/YQK8-647H].

135. Rocket Mortgage, one of the largest originators of new mortgages, explicitly mentions this option in their guides to consumers. *See* Victoria Araj, *How to Avoid Mortgage Loan Servicing Fees*, ROCKET MORTGAGE (Aug. 16, 2021), https://www.rocketmortgage.com/learn/avoiding-servicing-fees [perma.cc/J5BV-UFN8].

136. *Id.*

137. Servicers often foreclose on mortgages that could be profitably modified or would benefit from forbearance because their incentives are not aligned with maximizing the value of the mortgage transaction. THOMPSON, *supra* note 121, at 129–30.

138. Since the CFPB passed regulations in 2013, all lenders must wait 120 days before foreclosing on a property. 12 C.F.R. § 1024.41(f) (2021); *I Can't Make My Mortgage Payments. How Long Will It Take Before I'll Face Foreclosure?*, CFPB, https://www.consumerfinance.gov/ask-cfpb/i-cant-make-my-mortgage-payments-how-long-will-it-take-before-ill-face-foreclosure-en-1849 [perma.cc/M9BL-7KKQ] (last updated Sept. 9, 2020).

139. Under current CFPB regulations, lenders must offer loss mitigation options to borrowers if they have a loss mitigation program, but they need not actually make a modification or offer a repayment plan. 12 C.F.R. §§ 1024.39, .41 (2021); *see also* Agarwal et al., *supra* note 123.

140. The original mortgage-forbearance action was later superseded by the Center for Disease Control's order to desist from any housing eviction to limit the spread of COVID-19. *See CARES Act Mortgage Forbearance: What You Need to Know*, CFPB, https://www.consumerfinance.gov/coronavirus/mortgage-and-housing-assistance/cares-act-mortgage-forbearance-what-you-need-know [perma.cc/248U-DXPZ]; Temporary Halt in Residential Evictions to Prevent the Further Spread of COVID-19, 86 Fed. Reg. 16,731 (Mar. 31, 2021).

141. See the empirical analysis *infra* Section III.A.

To further complicate the set of possible outcomes from a mortgage contract, lenders often sell the ownership and servicing rights attached to a mortgage.[142] Investors purchase the ownership rights, either at the individual contract level or through shared pools of mortgages.[143] The servicing rights for these mortgages are assigned to specialized servicers, who are given the right to make decisions such as offering modifications, foreclosing, or waiving obligations.[144] These agreements, part of the process of securitization, both split up the rights and obligations under the contract and pool the risks of multiple mortgages together to minimize the risk of default that any one party bears.[145] By spreading the risk in this way, securitization changes servicers' incentives to modify, waive, or foreclose in any particular contract.

A. *Measuring Mortgage Inequality*

To quantify inequality, a dataset is required that follows a pool of contracts with terms that are facially equivalent but actually result in different, measurable values to each party. Very few sources of such data exist. One intuitive source would be contract disputes, which would include information about a contract signed by its parties as well as the resulting actions taken. This data has a well-documented analytical issue, since litigated cases are very rare and create a biased sample of contracts.[146] Other databases that cover contract terms exist, but they do not follow parties until performance is complete or breach occurs, meaning that the value of the contract to each party is unknown.

This Article uses a large commercial database to fill this gap—loan-level mortgage servicer data. Assembled by Black Knight, this database gathers information from mortgage servicers on the monthly payment status of each loan over more than twenty years.[147] It also collects details of the mortgage contract itself, including the structure of the terms, as well as the loan's status as delinquent, default, foreclosure, or modified on any given date.[148] Taken

142. *See* Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REGUL. 1 (2011); CHRISTOPHER K. ODINET, FORECLOSED: MORTGAGE SERVICING AND THE HIDDEN ARCHITECTURE OF HOMEOWNERSHIP IN AMERICA (2019).

143. Levitin & Twomey, *supra* note 142, at 4–6.

144. *Id.*

145. *Id.*

146. The issue of selection into litigation, often called the Priest-Klein hypothesis, has been heavily discussed. *See* George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984).

147. *Data Solutions and Actionable Analytics*, BLACK KNIGHT, https://www.blackknight-inc.com/what-we-do/data-services [perma.cc/SA7F-7YMH].

148. Note that this dataset is collected from servicers, who have some discretion in how to describe delinquency and forbearance. Some servicers may accept partial payment as satisfying the contract terms, while others may code partial payment as a delinquency. More broadly, forbearance here refers to evidence that a servicer has reported a delinquency but has not foreclosed. There may be repayment plans, late fees, and other payments made that are external to the mortgage contract itself. These payments are not included unless they are reported to the data provider. These data are the most comprehensive available but may have some limitations.

together, the data covers 160 million mortgage loans nationwide and includes over a hundred contract attributes.[149] Because residential mortgage contracts vary on relatively few terms, such as size, interest rate, and payment structure, it is relatively easy to capture the variation in contract terms in quantitative form. The large size of the dataset makes it possible to find a set of comparable loans that share the same features. Little variation in formal terms and large sample sizes distinguish residential mortgage data from other data sources used in empirical contracts scholarship and provide an ideal setting to test hypotheses about standard form contracts.[150]

The sample for analysis is limited to mortgage performance prior to 2009 to capture the market before the financial crisis of 2008 permanently altered the regulatory landscape. The resulting sample covers 36.7 million loans originated between 2000 and 2008.[151] Moreover, the analysis focuses on loans that households fell behind on by at least four months, referred to as the mortgage being "in default." Once the loan is in default, the lender or servicer has the power to decide to foreclose or to pursue an alternative course of action.

Out of the full sample of loans, 6.8%, or just less than 2.5 million loans, fell into default before 2009. Focusing on this defaulted sample, the first question is how many loans directly move into foreclosure relative to those that are modified or avoid foreclosure altogether. The second question is whether lenders and servicers exacerbate existing social inequalities by providing more benefits and acting more cooperatively in high-income areas.

1. Foreclosure and Its Alternatives

When a homeowner falls into financial distress and has to stop making mortgage payments, they are confronted with a very different reality than the carefully documented process used to originate the mortgage. At the time of formation, a completely rational and forward-looking borrower knows that they have a less than 10% chance of missing multiple payments, so they give little attention to what will happen if they default.[152] Once default occurs, however, the homeowner quickly becomes acquainted with the legal rights and

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149. *Data Solutions and Actionable Analytics*, *supra* note 147.

150. Typically, contract datasets contain several hundred data points, or perhaps thousands, while the present analysis covers more than a million contracts. *See, e.g.*, Theodore Eisenberg & Geoffrey P. Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts*, 30 CARDOZO L. REV. 1475 (2009); Florencia Marotta-Wurgler, *What's in a Standard Form Contract? An Empirical Analysis of Software License Agreements*, 4 J. EMPIRICAL LEGAL STUD. 677 (2007).

151. The sample selection was intended to avoid the regulations proposed in the 2009 draft of the Dodd-Frank Act. Note that the author has completed several checks of the data by separately studying the effects year by year and the same effects exist in each time period. Results are available on request.

152. *See* Christopher L. Foote & Paul S. Willen, *Mortgage-Default Research and the Recent Foreclosure Crisis*, 10 ANN. REV. FIN. ECON. 59, 60 (2018).

choices available to the lender (or investor and servicer).[153] Most importantly, after default occurs, lenders can give borrowers a notice of foreclosure and then proceed to either take title to the property or sell the property at a foreclosure auction, retaining any gains from this sale as payment to cover the outstanding debt.[154] Some states authorize the lender to sue the borrower to recover additional money owed if the sale does not cover the debt in full.[155] On the other hand, if the sale covers more than the amount owed, the lender must pay back additional gains to the borrower.[156]

The inefficiency of this process is that foreclosed properties lose value quickly.[157] Foreclosed properties are likely to sit vacant and unmaintained for months or years.[158] Outdoor spaces deteriorate, unused plumbing and wiring degrade, and abandoned items and other detritus make the property unsightly and difficult to sell.[159] Vacant properties also attract squatters and criminals, potentially impacting the neighborhood as a whole.[160] Moreover, sales of foreclosed properties happen at times that are not optimal for the local market and without a dedicated seller trying to obtain the highest possible price for the property.[161] As a result, foreclosed properties sell at 30% or more below the price a seller would have paid in better circumstances.[162] A foreclosed house in a neighborhood also lowers neighboring properties' values by 1%.[163] Taken

153. This Part refers to lenders as having the right to make certain decisions, even though many mortgages are securitized, with servicing rights being assigned to a separate entity that ultimately makes the decision to foreclose or offer forbearance.

154. Jean Folger, *The 6 Phases of Foreclosure*, INVESTOPEDIA (June 20, 2021), https://www.investopedia.com/financial-edge/0510/the-6-phases-of-a-foreclosure.aspx [perma.cc/A95M-LBGL].

155. *See, e.g.*, Combs, *supra* note 105.

156. ODINET, *supra* note 142, at 74.

157. *See* ADAM J. LEVITIN & SUSAN M. WACHTER, THE GREAT AMERICAN HOUSING BUBBLE 125–27 (2020).

158. Adam Boessen & Alyssa W. Chamberlain, *Neighborhood Crime, the Housing Crisis, and Geographic Space: Disentangling the Consequences of Foreclosure and Vacancy*, 39 J. URB. AFFS. 1122, 1124–26 (2017).

159. *See id.* at 1123.

160. *See id.* at 1124.

161. Forced sales depress house prices significantly. *See, e.g.*, John Y. Campbell, Stefano Giglio & Parag Pathak, *Forced Sales and House Prices*, 101 AM. ECON. REV. 2108, 2108–09 (2011).

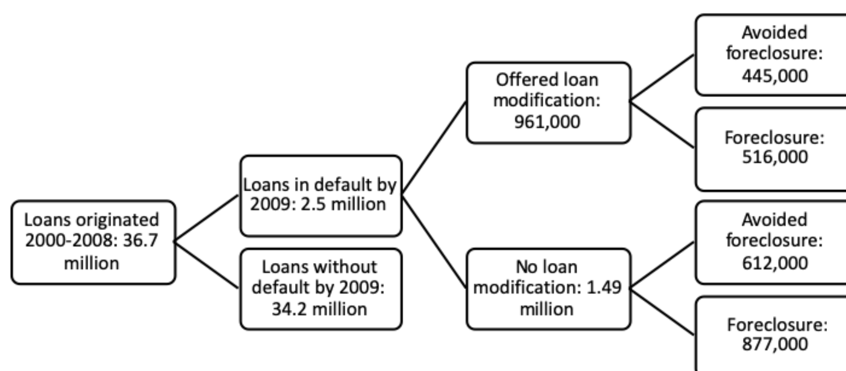
162. *Id.* at 2117; Sarah Davis, *How to Buy a House at Auction: Can You Really Get a Home for 50% Off?*, MONEY UNDER 30 (Oct. 26, 2020), https://www.moneyunder30.com/how-buy-house-at-auction [perma.cc/67YY-FRJ7]; *see also* LEVITIN & WACHTER, *supra* note 157, at 6–8, 13.

163. A large literature works to understand the costs of foreclosure for neighborhoods. Immergluck & Smith, *supra* note 129; Kristopher Gerardi, Eric Rosenblatt, Paul S. Willen & Vincent Yao, *Foreclosure Externalities: New Evidence*, 87 J. URB. ECON. 42, 42 (2015); Elliot Anenberg & Edward Kung, *Estimates of the Size and Source of Price Declines Due to Nearby Foreclosures*, 104 AM. ECON. REV. 2527, 2529 (2014); Zhenguo Lin, Eric Rosenblatt & Vincent W. Yao, *Spillover Effects of Foreclosures on Neighborhood Property Values*, 38 J. REAL EST. FIN. & ECON. 387, 387 (2009). Not only do foreclosures lower nearby property values, they also increase the odds of default. Sumit Agarwal, Brent W. Ambrose, Souphala Chomsisengphet & Anthony

together, the pecuniary costs alone of foreclosure are very large, with additional losses due to family displacement, physical and mental health, and community investment.[164]

Alternatives to foreclosure, therefore, have been discussed often and in a variety of contexts. An important alternative is loan modification, which was elevated to federal policy in 2009 with the Home Affordable Modification Program.[165] Loan modifications offer lower payments for longer periods, restructuring debt to make it more likely that a homeowner can make payments while living in a home and maintaining its value. Though this process seems like a win-win for borrowers and lenders, it is not commonly used.[166] As shown in Figure 1, loans that were in default prior to 2009 were offered loan modifications in substantial quantities, but the majority (60%) of loans that were four months behind were not modified despite the potential benefits. However, the failure to modify obligations does not imply that foreclosure will immediately result.

FIGURE 1: OUTCOMES OF DISTRESSED LOANS IN BLACK KNIGHT DATA



B. Sanders, *Thy Neighbor's Mortgage: Does Living in a Subprime Neighborhood Affect One's Probability of Default?* 40 REAL. EST. ECON. 1, 20 (2012) (finding a 1% increase in foreclosures increases the odds of default by 2.9% for neighboring homes).

164. Costs are estimated to vary anywhere between $26,230 and $77,935 in pecuniary value alone, with further costs associated with future financial health, child welfare, and neighborhood value excluded from the calculation. Rebecca Diamond, Adam Guren & Rose Tan, *The Effect of Foreclosures on Homeowners, Tenants, and Landlords* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27358, 2020), https://doi.org/10.3386/w27358.

165. Empirical evidence on HAMP suggests that lenders lack sufficient incentive to modify mortgages, even with subsidies. Agarwal et al., *supra* note 123, at 695–701; Jean Braucher, *Humpty Dumpty and the Foreclosure Crisis: Lessons from the Lackluster First Year of the Home Affordable Modification Program (HAMP)*, 52 ARIZ. L. REV. 727, 772–77 (2010). *See generally* Diane E. Thompson, *Foreclosing Modifications: How Servicer Incentives Discourage Loan Modifications*, 86 WASH. L. REV. 755 (2011).

166. Braucher, *supra* note 165.

An important alternative that came to prominence during the COVID-19 pandemic[167] is forbearance—the choice *not* to exercise the right to foreclose. Lenders and servicers have no legal obligation to complete the foreclosure process. Loan forbearance is related to the contract law concept of waiver, with some courts interpreting long forbearance periods as a waiver of the lender's right to foreclose.[168] Without changing the contract terms, lenders who waive the requirement of on-time payments for several months may ultimately allow borrowers to live in a home for years without making a payment. Figure 1 shows that regardless of whether a loan is modified, 42% of defaulted loans never end in foreclosure.[169] Foreclosure, therefore, is not the inevitable result of borrowers failing to make payments.

2. Social Inequality in Contract Outcomes

Do differences in contract performance contribute to social inequality? Servicer data can shed light on this by measuring forbearance rates across households with different characteristics. One hypothesis is that the discretionary choice to foreclose occurs more often in low-income neighborhoods, while forbearance is more common in high-income neighborhoods.[170] Similar disparities are likely to exist across race, gender, level of education, and other important characteristics.[171]

167. *Learn About Forbearance*, CFPB (Mar. 25, 2021), https://www.consumerfinance.gov/coronavirus/mortgage-and-housing-assistance/help-for-homeowners/learn-about-forbearance [perma.cc/B6GY-AEQG].

168. H.K. Lucke, *Non-contractual Arrangements for the Modification of Performance: Forbearance, Waiver and Equitable Estoppel*, 21 U.W. AUSTL. L. REV. 149, 154, 159, 175 (1991).

169. Following the theory of the drivers of contractual inequality, the choice to avoid foreclosure by the borrower's counterparty depends heavily on the counterparty's identity. About 18% of the defaulted loans had their servicing rights transferred at some time during the contract term. Among the sample of "transferred" loans, more than 90% of the loans were not foreclosed on. *See supra* notes 142–145 and accompanying text.

170. This Article remains agnostic about the *reason* for these disparities. There are several economic reasons why lenders and servicers would choose to prioritize high-income borrowers for discretionary good will. For example, they may believe that high-income borrowers are more likely to be repeat customers, or to be able to harm the reputation of the company if they are subject to a foreclosure. Indeed, high-income borrowers may be more likely to avail themselves of legal mechanisms to challenge the foreclosure, leading lenders and servicers to prioritize foreclosures on low-income borrowers. Finally, some research in finance and economics suggests that delayed foreclosure may not be a benefit to some households, who suffer from the "debt overhang" problem that results—the household cannot access new sources of credit and are strangled by their existing debts. *See, e.g.*, Brian T. Melzer, *Mortgage Debt Overhang: Reduced Investment by Homeowners at Risk of Default*, 72 J. FIN. 575 (2017). Such households would benefit from selling the property and declaring bankruptcy, if necessary, to get a fresh start on their finances. *Id.* at 587.

171. Data used in this analysis show disparities across multiple dimensions that may be of interest to lawmakers. Results are available from the author upon request.

Mortgage data matched with census data on income can directly test this hypothesis. Standard linear regression models can test whether there is a statistical relationship between the two variables, controlling for all other factors included in the model.[172] Avoiding foreclosure is the dependent variable, and can be thought of as equivalent to forbearance, or temporary nonenforcement of the right to foreclose. Reported in the first row of Table 1 is the relationship between a neighborhood's mean income and the probability of forbearance. Since other characteristics of the borrower and the loan are separately included in the regression, the variable labeled "Mean Income > 100k" reflects the neighborhood, not the individual. The number reported can be interpreted as the difference in forbearance probability for the same individual when they move from a lower-income to a higher-income neighborhood. The coefficients of other regressors, such as credit score, separately describe the likelihood of forbearance varying with credit score or other characteristics. Table 1 shows these results.

Forbearance is strongly correlated with income. The first row of column 1 shows that high-income neighborhoods have a .033 higher probability of avoiding foreclosure. To put this number in context, remember that the average individual in a lower-income zip code has a 42% chance of avoiding foreclosure. The regression coefficient tells us that if the same individual moved to a high-income neighborhood, they would avoid foreclosure 45.3% of the time. High-income neighborhoods are measured as those with an average income above $100,000 per year, which corresponds to the richest 20% of zip codes. Another way to state the magnitude of this effect is that neighborhoods with high incomes are 8% more likely to receive forbearance than lower-income neighborhoods.[173]

The following rows of column 1 show the effect of formal contract terms on the propensity of defaulted loans to avoid foreclosures. A surprisingly robust pattern emerges—most formal terms have little to no impact on the foreclosure decision. Starred regressors, including credit score and loan amount, have very small magnitudes consistent with a zero effect on foreclosure avoidance. Interest rate and loan-to-value ratio also have no effect. Mortgages with different structures do have a varying propensity to avoid foreclosure: first mortgages have a higher foreclosure risk than second mortgages, whereas adjustable-rate mortgages are more likely to end in foreclosure than fixed rate mortgages.[174]

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172. Mathematically, the test can be described as follows, where Y_l is a dummy variable for avoiding foreclosure, *z* refers to zip code, *s* refers to state, *t* to year/month, and *l* to loan.

$$Y_1 = \beta_{HI} HighIncome_z + \sum \beta_C Characteristics_l + \Gamma_s + \Gamma_t + \epsilon_{lst}$$

173. This can be calculated as the difference in probabilities across neighborhoods, divided by the lower-income neighborhood's forbearance rate.

174. Adjustable-rate mortgages vary in payments over time and are therefore riskier than fixed-rate mortgages. Lenders or servicers who prefer to avoid risk in their income streams may prefer the certain payout from a foreclosure to the uncertain payout from a modification or forbearance.

TABLE 1: REGRESSION OF FORECLOSURE AVOIDANCE ON CHARACTERISTICS

	(1)	(2)
	No Foreclosure	No Foreclosure
Mean Income > 100k	0.0332***	0.0284***
	(0.00748)	(0.00465)
Property Appreciation		0.361***
		(0.0181)
Servicing Transfer		0.603***
		(0.0128)
Credit Score	-0.000901***	-0.000575***
	(0.0000292)	(0.0000401)
Loan Amount	2.95e-08+	1.15e-09+
	(1.70e-08)	(7.19e-09)
Interest Rate	-0.0771	-0.0731
	(0.164)	(0.130)
Loan-to-Value Ratio	0.000000669	0.00000118
	(0.000000863)	(0.000000998)
First Mortgage	-0.215***	-0.202***
	(0.0105)	(0.0103)
Adjustable Rate	-0.143***	-0.128***
	(0.0173)	(0.0140)
Constant	0.871***	0.232***
	(0.0225)	(0.0353)
State & Time FEs	Yes	Yes
Observations	2,595,891	2,504,217

Standard errors clustered at the state level in parentheses

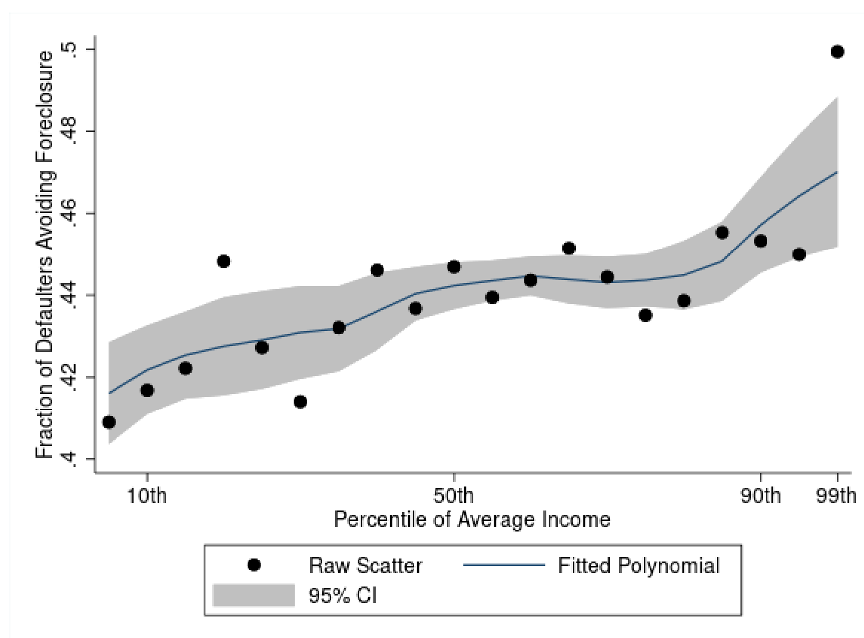
+ p<0.10; * p<0.05; ** p<0.01; *** p<0.001

To isolate the effect of discretionary forbearance, the regression is run again with two additional controls. The first regressor controls for the rate of property appreciation between the mortgage's origination and the homeowner's default, measured as an average across the property's zip code. This ensures that only homes with similar liquidation values are being compared. Second, the regression controls for the fraction of loans whose servicing rights are transferred, leading to principal-agent problems between servicers and lenders. Controlling for these characteristics can be thought of as comparing financially equivalent mortgages in rich and poor communities.

Column 2 presents the results of this comparison. Forbearance patterns still differ by wealth, with rich neighborhoods avoiding foreclosure 2.8% more often than poor neighborhoods. Moreover, the regression shows that highly appreciated homes are more likely to receive forbearance, in contrast with the expectation that lenders may receive more from the sale of appreciated homes. Finally, servicing transfers make forbearance more likely, suggesting that foreclosure avoidance is driven in part by the assignment and sale of mortgage servicing rights.

Figure 2 visually represents the relationship between discretionary choices and neighborhood income. Comparing the 90th percentile of income to the 10th shows that a homeowner being in a 10th percentile neighborhood has 4% less of a chance of avoiding foreclosure than if the same homeowner lived in a 90th percentile neighborhood. Compared to the average avoidance rate of just above 40%, this is an increase of almost 10%. Moreover, the very richest neighborhoods, marked as the 99th percentile here, avoid foreclosure nearly 50% of the time. As in the literature on economic inequality generally, the most well-off receive disproportionately large benefits from contractual inequality, despite being governed by the same contract terms.

FIGURE 2: RELATIONSHIP BETWEEN INCOME AND FORBEARANCE



The cost of foreclosure is typically estimated to be about $80,000 per home.[175] Given the 2.5 million borrowers in default in 2009, we can calculate

175. S. REP. NO. 110-251, at 41 (2007) [hereinafter JOINT ECONOMIC COMMITTEE REPORT].

the excess losses to low-income neighborhoods driven by differential forbearance rates. Low-income neighborhoods could have benefited by a total of $5.14 billion if they had received the same forbearance rates as high-income neighborhoods.[176] This difference means that low-income neighborhoods faced $572 million in excess losses per year compared to high-income neighborhoods.[177] Different choices made by lenders and servicers during contract performance generate serious inequities across the same types of individuals in different neighborhoods.

B. *Implications of Mortgage Inequality*

The large disparities in outcomes of mortgages in default significantly impact communities. The empirical analysis establishes two important facts. First, similarly situated households often face very different outcomes when they stop making payments on their mortgages. Nearly 40% of households in default manage to avoid foreclosure, though their mortgage servicer has every right to repossess the collateral. Second, discretion is exercised differentially in rich and poor neighborhoods. More than $500 million in foreclosure losses incurred by low-income neighborhoods are avoided by richer neighborhoods due to the discretionary choices of servicers during contract performance. Mortgage providers are using their discretion regressively, whether intentionally or unintentionally.

Why are lenders and servicers treating borrowers in rich neighborhoods better than those in poor neighborhoods? One economically rational reason for this inequality would be that borrowers in rich neighborhoods are better credit risks. That is, these borrowers are more likely to pay off their loans, so naturally the mortgage provider is willing to be more accommodating. This explanation is unlikely to hold in this setting, however, due to the rich quality of data used in the analysis. Measures of borrower creditworthiness, including credit score and debt-to-income ratio, are included in the regression at the individual level. Conditional on these important indicators of ability to repay, average neighborhood income is not likely to be informative. Moreover, the regression controls for the appreciation of house prices in that zip code. Therefore, it is more likely that servicers are making the decision to extend forbearance based on qualities correlated with wealth but not directly determining creditworthiness. Examples of such characteristics include time and

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176. Using the number from Table 1, the difference in forbearance rates is .033 between the estimated 2 million defaulted borrowers in lower income neighborhoods and the estimated 500,000 defaulted borrowers in high-income neighborhoods. This is approximated based on the fact that 20% of homes are in neighborhoods with a mean income higher than $100,000.

177. This estimate is a conservative lower bound of the number used in a 2007 report by the majority staff of the Joint Economic Committee to estimate the cost of foreclosure during the subprime crisis. *See* G. THOMAS KINGSLEY, ROBIN SMITH & DAVID PRICE, URB. INST., THE IMPACTS OF FORECLOSURES ON FAMILIES AND COMMUNITIES 20–21 (2009) (citing JOINT ECONOMIC COMMITTEE REPORT, *supra* note 175), https://www.urban.org/sites/default/files/publication/30426/411909-The-Impacts-of-Foreclosures-on-Families-and-Communities.PDF [perma.cc/WSX5-3SWG]; *see also* Diamond et al., *supra* note 164.

skill in negotiating, timeliness of responding to mail notifications, and other "soft skills" that correlate with social class.[178]

Two features of these results should trouble lawmakers. First, regressive redistribution through contract performance is inherently troubling. Poor neighborhoods are already less able to bear losses from foreclosures, let alone disproportionately large losses relative to their richer counterparts. Moreover, poorer neighborhoods have many other characteristics that raise legal concerns—where mean incomes are lower than $100,000 a year, a larger fraction of the population is Black than in zip codes with higher mean incomes.[179] Disparate treatment of neighborhoods with different racial characteristics raise the possibility of actionable disparate impacts under federal laws such as the Fair Housing Act, the Equal Credit Opportunities Act, and the Constitution's Equal Protection Clause.[180] These results may be an argument in favor of more aggressive redistribution away from wealthy neighborhoods toward poor neighborhoods, primarily through the tax code but also through public benefits and consumer law.[181]

The second cause for concern arising from these results is the possibility of economic inefficiency due to firms' use of discretion. Lenders and servicers can unilaterally decide to delay or avoid enforcing their foreclosure right against borrowers in default. Borrowers are aware that lenders and servicers have power during contract performance, and they cannot be sure that discretion will be exercised in their favor. Therefore, borrowers will only enter into contracts with low enough up-front costs to account for potential losses from stringent contract enforcement.[182] Borrowers without full understanding of financial products may therefore be enticed by good "deals" like interest-only and balloon loans, which decrease payments up front but cause financial catastrophe if anything goes wrong.[183] The result is welfare loss—contracts that would have been valuable to both parties will not be signed because there is no mechanism to guarantee a higher payout to borrowers. The total loss to

178. *See* Johnston, *supra* note 4.

179. Zip codes with mean incomes less than $100,000 per year have a 14% Black population on average, while zip codes with higher incomes are 6% Black on average.

180. Disparities in modifications, for example, should be actionable under the definition of "creditor" in 15 U.S.C. § 1691a(e) as anyone who would "extend[], renew[], or continue[] credit" to a borrower. However, this author is not aware of the statute being used to bring claims on the basis of disparate-impact data of the sort utilized in this Article. *See, e.g.*, Mahoney, *supra* note 66.

181. A long literature in law and economics has shown that redistributive taxation is often the most efficient way to remedy inequality across social groups. *See, e.g.*, Kaplow & Shavell, *supra* note 32. Cases where redistribution is more efficiently carried out through regulation or litigation include those where the tax system doesn't correctly target harmed populations. *See* Zachary Liscow, *Is Efficiency Biased?*, 85 U. CHI. L. REV. 1649 (2018); Rory Van Loo, *Broadening Consumer Law: Competition, Protection, and Distribution*, 95 NOTRE DAME L. REV. 211 (2019).

182. This could exacerbate behavioral reasons for consumers to prefer financial contracts with low payments at first, despite these products causing long-term losses. *See, e.g.*, Bar-Gill & Warren, *supra* note 10, at 33–45.

183. *See, e.g.*, Martin C. Seay, Gloria L. Preece & Vincent C. Le, *Financial Literacy and the Use of Interest-Only Mortgages*, 28 J. FIN. COUNSELING & PLAN. 168 (2017).

low-income neighborhoods is likely greater than $572 million because the calculation does not account for welfare loss from incomplete contracts.[184] Moreover, this number does not account for decreases in access to credit for low-income borrowers.[185]

Similar issues plague all the unilateral, discretionary choices both borrowers and lenders make through the course of the mortgage. Borrowers can privately choose to default or make insufficient payments.[186] Lenders and servicers can choose to modify contractual obligations rather than enforce their right to foreclosure.[187] Each of these mechanisms can cause both borrowers and lenders to either opt out of the mortgage market due to rational expectations about their counterparty's behavior or to enter the market based on incorrect, overoptimistic expectations.[188] Parties have little scope to contract their way out of these issues due to the standardized nature of contract drafting and the deep commitment problems that always leave some discretionary choices available to the parties.[189] Taken together, it is likely that this analysis shows just one of many examples of contractual inequality in the setting of residential mortgages alone.

Similar phenomena are likely occurring in a variety of contracts, including rental and employment contracts. In each case, different norms and regulations may influence contract performance. For instance, mortgage servicers

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184. *See supra* note 177 and accompanying text.

185. This mechanism relies on low-income borrowers having rational expectations that contractual inequality exists, namely that they are less likely to benefit from discretion if they live in lower-income neighborhoods. Alternatively, if borrowers are not rational and are overoptimistic about the cooperative behavior of their lender or servicer, welfare loss will arise from *too much* access to credit, with many borrowers taking on mortgages that ultimately will not benefit them.

186. Borrowers' strategic default when default costs are low, such as when property value drops below unpaid mortgage balance (an underwater mortgage), generates welfare loss because their use of discretion within an incomplete contract degrades the value of the contract for their counterparty. *See* William Adams, Liran Einav & Jonathan Levin, *Liquidity Constraints and Imperfect Information in Subprime Lending*, 99 AM. ECON. REV. 49 (2009); Dwight M. Jaffee & Thomas Russell, *Imperfect Information, Uncertainty, and Credit Rationing*, 90 Q.J. ECON. 651 (1976).

187. *See, e.g.*, Mayer et al., *supra* note 106 (showing evidence of some modification programs having strategic impacts on lender and servicer incentives).

188. Each of these effects was likely at work around the 2008 financial crisis, with widespread overoptimism creating the housing bubble and low expectations after the crash causing the collapse of the private securitization market. *See* Daniel O. Beltran & Charles P. Thomas, *Could Asymmetric Information Alone Have Caused the Collapse of Private-Label Securitization?* 4–5 (Bd. of Governors of the Fed. Rsrv. Sys., Int'l Fin. Discussion Papers, Working Paper No. 1010, 2010), https://doi.org/10.2139/ssrn.1708242; Manuel Adelino, Antoinette Schoar & Felipe Severino, *Credit Supply and House Prices: Evidence from Mortgage Market Segmentation* (Nat'l Bureau of Econ. Rsch., Working Paper No. 17832, 2012), https://doi.org/10.3386/w17832; Yueran Ma, *Bank CEO Optimism and the Financial Crisis*, SSRN (Dec. 7, 2015), https://doi.org/10.2139/ssrn.2392683.

189. The GSEs, including Fannie Mae and Freddie Mac, draft form contracts that determine the legal relationship between borrowers and lenders of loans that they repackage and sell. Modifying these forms could generate legal risk and would require even higher compliance costs than GSE regulations already impose. *See* Forrester, *supra* note 2.

face different incentives in mortgage markets due to the existence of secondary markets, which pool mortgages and modify the economic relationship between lender and borrower. Landlords and employers may have better incentives. Nevertheless, every contract is incomplete in some way, and the embedded options that generate contractual inequality remain the same.[190] Landlords have incentives to differentially waive on-time rent payments depending on their private needs or preferences, while employers can utilize their discretion to fire or demote employees that they feel are not a good fit for their company. As long as these tools remain in the hands of one party, often the more sophisticated one, contract performance has the potential to generate and exacerbate social inequality.

IV. The Limitations of Existing Oversight

Undesirable inequality in contract performance, like the regressive redistribution documented in Part III, is largely driven by the choices of private actors. This Part explores the mechanisms available in law and in markets to limit contractual inequality.

A. *The Legal Invisibility of Inequality*

Existing tools in contract law that could minimize the negative impacts of inequality have not been utilized to that end. The common law doctrine naturally suited to overseeing contract performance is the duty of good faith.[191] The duty of good faith is widely considered a mandatory requirement underlying all contractual obligations.[192] However, the legal requirements on a party acting in good faith do not match the typical layperson's understanding of the term "good faith."[193] Instead, courts ask if the parties contemplated the action taken at the time of formation and if they would have bargained for the action taken had they contemplated the particular circumstances, even if the action

190. *See* Shmuel I. Becher, *Asymmetric Information in Consumer Contracts: The Challenge That Is Yet to Be Met*, 45 AM. BUS. L.J. 723 (2008).

191. Daniel Markovits, *Good Faith as Contract's Core Value*, *in* PHILOSOPHICAL FOUNDATIONS OF CONTRACT LAW 272, 273–74 (Gregory Klass, George Letsas & Prince Saprai eds., 2014).

192. *Id.* at 272–73. This is not universally true. For example, Texas does not extend the implied duty of good faith to commercial contractual relationships, including the lender-borrower relationship. English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983). Likewise, Pennsylvania does not impose an implied contractual duty of good faith in the lender-borrower relationship. Temp-Way Corp. v. Cont'l Bank, 139 B.R. 299, 319–20 (E.D. Pa. 1992), *aff'd*, 981 F.3d 1248 (3d Cir. 1992) (mem.).

193. Though the definition has historically referred to "honesty in fact," recent interpretations have considered an action to be in good faith if it supports the original intent of the parties. Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 371, 377 n.35 (1980); Clayton P. Gillette, *Limitations on the Obligation of Good Faith*, 1981 DUKE L.J. 619.

appears uncooperative or stringent to the counterparty.[194] The duty of good faith requires fairness and honesty in exercising one's discretion as reserved explicitly by the contract, but most jurisdictions do not require fairness in the exercise of contract rights such as waiver, modification, or breach.[195] Moreover, in evaluating whether an action taken during contract performance violated the duty of good faith, most jurisdictions do not consider alternative actions that were available to the party.[196] That is, an action that was reasonably fair and honest will satisfy the duty even if alternative actions would have increased the contract's value.[197] This diverges from the traditional law-and-economics view of contract law, which posits that the purpose of contract law is to give incentives for value maximization.[198] Courts do not interpret the

194. The duty of good faith in performance protects parties from taking unfair opportunities within the contract relation by encouraging the parties to "respect freedom of contract and establish their contractual relations as sites of intrinsically valuable reciprocal recognition." Markovits, *supra* note 191, at 272. Even though the parties remain free to renegotiate or rescind their obligations, the covenant of good faith prevents one party from abusing this freedom to exploit the other party's vulnerabilities to renegotiate the terms of the contract for their personal gain. However, this duty "neither adds to the obligations that contracts impose nor recasts the substantive terms of actual contracts," but rather "is an attitude that contracting parties might take to the agreements that they have in actual fact made" based on their original intent to collaborate. *Id.; see also* Mkt. St. Assocs. Ltd. P'ship v. Frey, 21 F.3d 782 (7th Cir. 1994) (holding that when a contract's explicit terms do not cover an unforeseen situation, the duty of good faith prevents one party from taking opportunistic advantage of another against the parties' original intent and cooperative venture).

195. Consider *Stoney Glen, LLC v. Southern Bank & Trust Co.*, a case regarding the duty of good faith as applied to an agreement settling obligations due under a promissory note. 944 F. Supp. 2d 460, 462–63, 467 (E.D. Va. 2013). In that case, the agreement was expressly conditioned on the receipt of certain financial disclosures from the plaintiff. In the first set of disclosures, the plaintiff mistakenly excluded his wife's holdings, but included them in the second set of disclosures. The plaintiff argued that the defendant violated the duty of good faith by terminating the settlement agreement in response to the inadvertent nondisclosure. *Id.* at 462–63. The *Stoney Glen* court agreed, noting that "every exercise of a contractual right involves some exercise of 'discretion'—either in determining whether a right has accrued or in deciding whether to exercise a right that has accrued." *Id.* at 467; *see also* Carma Devs. (Cal.), Inc. v. Marathon Dev. Cal., Inc., 826 P.2d 710, 726 (Cal. 1992) ("The covenant of good faith finds particular application in situations where one party is invested with a discretionary power affecting the rights of another. Such power must be exercised in good faith."). *But see* Ernie Haire Ford, Inc. v. Ford Motor Co., 260 F.3d 1285, 1291 (11th Cir. 2001) ("Unless no reasonable party . . . would have made the same discretionary decision . . . , it seems unlikely that the party's decision would violate the covenant of good faith . . . ." (cleaned up) (quoting Sepe v. City of Safety Harbor, 761 So. 2d 1182, 1185 (Fla. Dist. Ct. App. 2000))).

196. Scholars have argued that the duty of good faith ought to be broadened to require cooperative and fair behavior by parties, but this view is not widely adopted. *See, e.g.*, Chunlin Leonhard, *Subprime Mortgages and the Case for Broadening the Duty of Good Faith*, 45 U.S.F. L. REV. 621, 627–28 (2011).

197. *Compare* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 279 (6th ed. 2012) (describing courts' current application of the "bargaining theory" of contracts, which enforces agreements regardless of the equivalent value of the promise), *with id.* at 283–86 (advocating for an "economic theory" of contracts, which considers multiple buyer and seller incentives to promote efficient contract enforcement).

198. Hermalin et al., *supra* note 91, at 21–22.

duty of good faith as requiring cooperative actions that raise the joint value of the contract for both parties.

Alternatively, courts could consider evidence of inequalities in performance during disputes over the contract's interpretation. However, the Restatement and the common law have been hostile to the presentation of extrinsic evidence about performance in cases when there has been no defect in assent. The Second Restatement's language on standardized agreements succinctly states that contract language is "interpreted wherever reasonable as treating alike all those similarly situated, without regard to their knowledge or understanding of the standard terms."[199] If courts were faced with quantitative evidence that the same contract term generates highly disparate outcomes, it would no longer be reasonable to treat all parties to standardized contract terms as similar.[200] But courts have been unwilling to admit evidence that unsophisticated parties are harmed by contract performance while sophisticated parties have benefited, allowing contractual inequality to flourish.

Finally, regulators have not stepped into the vacuum left by the courts in overseeing contractual inequality.[201] Consider the role of the CFPB as created by Dodd-Frank in 2010. Its mandate largely focused on rulemaking, with some provision for oversight for enforcement purposes.[202] The CFPB's first public steps included limiting the type of consumer contracts that were considered enforceable, their terms, and how their formation should be structured.[203] The CFPB acted unilaterally in promulgating its Qualified Mortgage standards, which caused a significant decrease in risky lending.[204] The results of this regulatory action could be measured publicly using data from the Home Mortgage Disclosure Act.[205] The main steps the CFPB took regarding contract performance, on the other hand, had to do with debt servicing. For

199. RESTATEMENT (SECOND) OF CONTRACTS § 211(2) (AM. L. INST. 1981).

200. This issue is exacerbated by the Federal Rules of Civil Procedure requiring commonality between members of a putative class for a class action to be certified. FED. R. CIV. P. 23(a)(2). The difficulty of securing certification when the same situation affects members of a putative class differently has been discussed in the antitrust-litigation setting. *See, e.g.*, Pierre Cremieux, Ian Simmons & Edward A. Snyder, *Proof of Common Impact in Antitrust Litigation: The Value of Regression Analysis*, 17 GEO. MASON L. REV. 939, 939 (2010).

201. Many of the newest developments in contract law arrived not from common law cases but from new statutes or regulatory rulemaking that disciplines contractual relationships. *See, e.g.*, Nicholas J. Johnson, *The Statutory UCC: Interpretative License and Duty Under Article 2*, 61 CATH. U. L. REV. 1073, 1075 (2012) (describing the UCC's role in moving from "pure" common law toward statutory interpretation).

202. *See* Adam J. Levitin, *The Consumer Financial Protection Bureau: An Introduction*, 32 REV. BANKING & FIN. L. 321, 343 (2013).

203. *See* Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6407 (Jan. 30, 2013) (to be codified at 12 C.F.R. pt. 1026).

204. Anthony A. Defusco, Stephanie Johnson & John Mondragon, *Regulating Household Leverage*, 87 REV. ECON. STUD. 914, 917–18 (2020).

205. *Download HMDA Data*, CFPB, https://www.consumerfinance.gov/data-research/hmda/historic-data [perma.cc/V97C-UQUM].

instance, after the financial crisis of 2008, servicers were not responsive to customers and failed to credit payments properly, which ultimately led to thousands of preventable foreclosures.[206] The CFPB did regulate servicer behavior by promulgating Regulations X and Z,[207] and it entered into the national mortgage servicing settlement with a coalition of state attorneys general.[208] The effects of these regulations cannot be assessed using public data. Instead, the CFPB is limited to overseeing debt servicing through their supervision and examination functions only when the political will exists.[209] Ultimately, the CFPB's power is tilted toward the oversight of contract formation and away from scrutiny of contract performance.

Statutes such as the Federal Arbitration Act similarly impact contract formation more than performance. As courts have protected arbitration more stringently under the Act, contract disputes are increasingly resolved by arbitrators.[210] Parties subject to a mandatory arbitration agreement have less guidance about the types of actions that would fall foul of an arbitrator, since most arbitration is private and does not rely on other arbitral awards as precedents. Therefore, once parties sign an agreement with a valid, binding arbitration clause, they are relatively free from judicial scrutiny during performance. Taken together, contract law and regulation intervene less often in the performance of contracts than in their formation, allowing private preferences and incentives to determine the choices made within the gaps of formal contract terms.[211]

B. *Limitations of Market Competition*

Scholars in consumer and commercial contracts have noted that even in the absence of legal oversight, private market forces will limit the harms of

206. Michael Calhoun, *Lessons from the Financial Crisis: The Central Importance of a Sustainable, Affordable and Inclusive Housing Market*, BROOKINGS INST. (Sept. 5, 2018), https://www.brookings.edu/research/lessons-from-the-financial-crisis-the-central-importance-of-a-sustainable-affordable-and-inclusive-housing-market [perma.cc/HM5Q-YSSC].

207. *See* 12 C.F.R. §§ 1024.1, 1026.1 (2021).

208. *What Was the National Mortgage Settlement?*, CFPB (May 10, 2017), https://www.consumerfinance.gov/ask-cfpb/what-was-the-national-mortgage-settlement-en-2071 [perma.cc/JDZ3-7L7M].

209. CFPB, SUPERVISION AND EXAMINATION MANUAL pt. 1 (2021), https://files.consumerfinance.gov/f/documents/cfpb_supervision-and-examination-manual.pdf [perma.cc/7VFV-BPCU].

210. This pattern is more pronounced in consumer contracts than business-to-business contracts, but there are significant numbers in each category. Theodore Eisenberg, Geoffrey P. Miller & Emily Sherwin, *Mandatory Arbitration for Customers but Not for Peers: A Study of Arbitration Clauses in Consumer and Non-consumer Contracts*, 92 JUDICATURE 118, 121, 123 (2008).

211. Two important counterexamples to this are the Federal Trade Commission Act and state unfair and deceptive acts and practices (UDAP) laws, which have the potential to target uncooperative behavior during contract performance and have grown in importance and scope. Jeffrey P. Naimon & Kirk D. Jensen, *The UDAP-ification of Consumer Financial Services Law*, 128 BANKING L.J. 22 (2011).

unequal treatment.[212] One example the literature considers is hotel checkout policies.[213] Hotels may require on-time checkouts for badly behaved, opportunistic guests but not for well-behaved customers who genuinely need extra time.[214] This generates inequality across guests, but it comes with an important benefit: hotels have the option to enforce a strict checkout policy and minimize costs to themselves. Moreover, the hotel will not use this power in most cases because it would harm the hotel's reputation to kick out guests who might review the business on internet forums or recommend that their friends stay elsewhere. In this way, inequality is not eliminated but instead efficiently disciplined by the private market.[215]

This story is incomplete, however.[216] Most contracts do not occur in the type of competitive market that can encourage cooperative behavior.[217] First, competition fails in the face of transaction costs that deprive individuals of meaningful alternatives outside the contract. For instance, search and switching costs may make it difficult to shop across contracting parties in high-stakes markets, including the mortgage market. Disaggregated contract rights may make it costly or impossible to match reputation to a particular firm. Second, even when a competitive market with few transaction costs exists, it is unlikely to protect social groups that are already suffering ill effects from social inequality. Low-income parties from minority communities with little bargaining power cannot exert the same competitive pressures as more powerful parties. Therefore, contract terms that may serve powerful social groups may not help vulnerable groups and may even harm them.[218] Contractual inequality increases when there is an imbalance in bargaining power across parties to different contracts, each with the same terms.[219]

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212. *See, e.g.*, Bebchuk & Posner, *supra* note 3.

213. *Id.* at 834.

214. *Id.*

215. *See id.* at 827–28.

216. *See* Hermalin et al., *supra* note 91, at 39 (discussing the limitations of market competitiveness in the context of contracts); Yonathan A. Arbel & Roy Shapira, *Theory of the Nudnik: The Future of Consumer Activism and What We Can Do to Stop It*, 73 VAND. L. REV. 929 (2020).

217. One important reason competition may fail is high market concentration that has not been dealt with through antitrust law. This Article does not discuss this important point, but the ripple effect of market concentration on areas of law outside antitrust has been discussed in other contexts. *See, e.g.*, Robert Cooter & Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 CALIF. L. REV. 1432, 1452 (1985) (noting the different dynamics of imperfectly competitive contract markets).

218. Johnston, *supra* note 4, at 884.

219. This differs from the traditional definition of unequal bargaining power seen in discussions around one-sided consumer contracts and unconscionability. This Article highlights inequality across parties facing the same contract terms, as opposed to inequality between the parties to a single contract.

1. Transaction Costs

Every contract is formed in the context of some market. Parties wishing to enter into a contractual relationship can choose across potential counterparties based on the price and characteristics of the transaction. For instance, borrowers can choose among mortgage providers and lenders can select borrowers that satisfy their pre-approval requirements.[220] If market participants base their decisions on their counterparties' reputations, counterparties will want to treat market participants well to stay competitive.[221]

Transaction costs, however, can dissociate choices from reputations. First, consider search or switching costs. When looking for a mortgage lender, for example, a borrower may know the name of their bank and a couple other highly advertised lenders from TV.[222] To discover the names and prices of more obscure local lenders, the borrower may have to spend time and money to search through the phone book or Google, or to ask her friends. Switching costs make it difficult to move from one contract to another, either by causing psychological distress or consuming resources.[223] These costs may include the damages paid to the original counterparty, as well as the types of mental and logistical costs that prevent consumers from shopping for mortgages to get the highest returns on their investments.[224] In all of these cases, one party would feel that the other party is their best hope at obtaining a service or minimizing their costs. Consequently, the party cannot utilize market mechanisms to hold the counterparty accountable for exploitative behavior. Consider a credit agreement including a unilateral modification clause. If the credit card company modifies the agreement to include a mandatory arbitration clause, the customer may wish to threaten to switch to another card company if her rights are not restored.[225] But if the customer has to endure a drop in her credit score to switch to another company, she may well choose not to switch, leaving the credit card company free to make any changes it wishes.

Second, consider the coordination costs created by a highly diffuse ownership structure to a contract. An important example of this arose during the financial crisis of 2008, after mortgages had been securitized and sold on a secondary market.[226] Investors, whose returns depended on good performance, were not in control of the debt collection process. Instead, it was outsourced to servicers through contractual agreements that gave them very

220. *See* Cooter & Eisenberg, *supra* note 217, at 1445.

221. BAR-GILL, *supra* note 10, at 28.

222. Alexei Alexandrov & Sergei Koulayev, *No Shopping in the U.S. Mortgage Market: Direct and Strategic Effects of Providing Information* 20–21 (CFPB Off. of Rsch., Working Paper No. 2017-01, 2018), https://doi.org/10.2139/ssrn.2948491.

223. Van Loo, *supra* note 181, at 223–24.

224. *Id.*

225. Becher & Benoliel, *supra* note 120, at 667–68.

226. Levitin & Twomey, *supra* note 142, at 7–8.

different incentives than those of the investors.[227] Outcomes for mortgagees varied depending on whether decisionmaking rights were assigned to a separate servicer during the securitization process or retained by the original contracting party.[228] Borrowers often did not know who their servicer was, nor were they able to choose which servicer would process their payments once their mortgage was securitized.[229] The result was a very high foreclosure rate that undermined the financial health of the entire nation.[230] By making it prohibitively costly to connect a counterparty with their earned reputation, coordination costs prevent firms from competing on reputation, leaving their performance of contracts entirely free from market oversight.

2. Heterogeneity and Unequal Bargaining Power

The problem of unequal bargaining power has been a longstanding concern in contract law. It is the underpinning of the doctrine of unconscionability,[231] and scholars concerned with one-sided contract terms, like those in standard form consumer contracts, have debated this issue. Typically, this literature discusses inequalities between counterparties to the same contract, such as a standard form consumer contract that benefits a large firm with significant bargaining power more than the small individual consumer without bargaining power.[232] Another important dimension of this issue arises from unequal bargaining power across similarly situated parties to different, comparable contracts.

Parties to the same exact contract terms may differ widely in their circumstances. For example, terms that allow a secured lender to repossess a borrower's property upon nonpayment are often identical across loans of the same type.[233] Whether the property is promptly repossessed, however, depends on the bargaining power of the individual borrower at the time of nonpayment. Some borrowers may be well informed and even litigious.[234] They can harm the lender's reputation and drive business away from them; in other words, they may be able to threaten the lender into leniency.[235] Borrowers with

227. ODINET, *supra* note 142.

228. Tomasz Piskorski, Amit Seru & Vikrant Vig, *Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis*, 97 J. FIN. ECON. 369, 371 (2010) (showing that securitized loans were more likely to end in foreclosure, while portfolio loans held by the lender were more likely to be renegotiated).

229. Levitin & Twomey, *supra* note 142, at 7.

230. *See id.*

231. U.C.C. § 2-302 (AM. L. INST. & UNIF. L. COMM'N 2019).

232. *See* sources cited *supra* note 4.

233. *See supra* note 132 and accompanying text.

234. Some scholars have called these consumers "nudniks." *See, e.g.*, Arbel & Shapira, *supra* note 216 (describing the emerging distinction between activist and passive consumers and the corporate reaction to the informed minority).

235. *See id.* at 947–48, 965–66.

small social networks or less information may have no alternative to relying on the lender's mercy.

Firms can take advantage of these differences to maximize their reputation while still harming less powerful consumers. In the example above, borrowers who complain the most will be treated cooperatively and given leniency in repossession, while those with the least power and influence will be treated poorly. Reputation provides no recourse for unequal treatment if consumers have unequal influence over a firm's reputation. Indeed, letting market incentives discipline firm behavior gives incentives for firms to treat their customers more unequally during contract performance.[236]

V. STRENGTHENING DISCLOSURE TO DISCIPLINE INEQUALITY

Lawmakers have the power to limit inequality in contract performance in a variety of ways. However, they must act carefully to avoid perverse consequences that ultimately hurt underprivileged populations. A cautionary tale arose in criminal law when attempts were made to discipline racial disparities in sentencing. Mandatory sentencing laws were promulgated in the 1980s and 1990s in part to limit disparate impacts of judicial discretion on communities of color.[237] Despite this intention, limiting judges' discretion did not eliminate disparities—prosecutors continued to treat disadvantaged defendants differently.[238]

A similarly naive solution in the context of residential mortgage servicing would be to limit discretion in lender and servicer behavior in a sweeping, standardized way. In March 2020, the federal government passed the CARES Act, which provides relief to debtors having trouble making payments on their mortgages and student loans. Mortgage borrowers may request forbearance to delay making payments on their home, and student loan borrowers may delay payments until at least January 2022.[239] Renters may not be evicted for nonpayment while the pandemic continues.[240] The debt forbearance offered during the pandemic is a rare and extreme example of lawmakers intervening in contract performance. All borrowers who meet regulatory guidelines may request the same discretionary benefits that were previously provided disproportionately to those in rich neighborhoods, limiting performance inequality.

236. *See* Becher & Zarsky, *supra* note 4, at 109.

237. *See* Starr & Rehavi, *supra* note 59, at 11.

238. *See id.* at 13; Joshua B. Fischman & Max M. Schanzenbach, *Racial Disparities Under the Federal Sentencing Guidelines: The Role of Judicial Discretion and Mandatory Minimums*, 9 J. EMPIRICAL LEGAL STUD. 729, 761 (2012).

239. CFPB, *CARES Act Mortgage Forbearance: What You Need to Know*, YOUTUBE (Apr. 2, 2020), https://youtu.be/br5EPugsnLs; *Coronavirus Info for Students, Borrowers, and Parents*, FED. STUDENT AID, https://studentaid.gov/announcements-events/coronavirus [perma.cc/4BEH-C9Y3].

240. *See* Zach Wichter, *CDC Extends Renter Eviction Moratorium to October 3*, BANKRATE (Aug. 3, 2021), https://www.bankrate.com/mortgages/cdc-extends-renter-eviction-moratorium-to-october-3 [perma.cc/KHC6-25PY].

A short-term ban on the use of legal tools that generate inequality does not address the long-term harms of unequal outcomes. In the case of the CARES Act, mortgage inequality will likely begin to grow immediately after the forbearance period passes. The results may be as negative as those of mandatory minimum sentences—poor communities that have trouble avoiding foreclosure will be more likely to see widespread foreclosures after the pandemic protections end, while rich communities will be more likely to receive extended forbearance. Ultimately, the legacy of pandemic mortgage policy may be a worsened wealth gap between already disparate neighborhoods, hammered into place by poor households' distrust of mortgage lenders that could lead to exit from homeownership altogether.

Instead of directly limiting discretion in performance, this Article proposes a disclosure-based approach that will allow for intervention tailored to particular contexts. Lawmakers must require contracting parties to disclose data on contract performance and outcomes, specifically including the legal levers discussed above: discretionary actions, modification, waiver, enforcement, and renegotiation.[241] The data should be released to regulators, and it should be available to the public, private enforcement authorities, and information aggregators. Interested parties should be able to get a complete picture of how contracts are being performed and the effects of performance on social inequality. More importantly, disclosure can help informed actors distinguish between disparities that fall afoul of antidiscrimination law, those that are not illegal but could cause reputational harms, and those that are irrelevant or even beneficial to social welfare.

How exactly would the process work? It would start with data on contract terms, including the form contracts that GSEs drafted for mortgages,[242] deposit account agreements that banks disseminate publicly,[243] material contracts filed with the Securities and Exchange Commission (SEC),[244] and contract characteristics collected in public databases like those mandated by the Home Mortgage Disclosure Act (HMDA).[245]

These terms are of great interest, but they are likely to be selectively enforced and otherwise modified once performance begins. Therefore, existing disclosure requirements should be extended to include consumer outcomes as well as original contract terms. In the context of mortgage servicing, this would mean requiring lenders and servicers to disclose the income, race, gender, and other demographic information of those borrowers able to continue making payments and those facing foreclosure. Moreover, it would include offers for loan modifications, imposition and waiver of late fees, foreclosure

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241. This proposal follows similar proposals in the insurance context. *See, e.g.*, Schwarcz, *supra* note 85.

242. *See, e.g.*, *Fannie Mae Legal Documents (New)*, *supra* note 2.

243. *See, e.g.*, BANK OF AM., DEPOSIT AGREEMENT AND DISCLOSURES (2021), https://www.bankofamerica.com/salesservices/deposits/resources/deposit-agreements [perma.cc/ES96-VTGF].

244. *See* 17 C.F.R. § 229.601(b)(10) (2020).

245. *See Download HMDA Data*, *supra* note 205.

filings, and other records lenders and servicers keep of their interactions with customers. Combined with data already compiled under HMDA about the characteristics of the mortgage application and the loan, this would give regulators a comprehensive picture of the mortgagor-mortgagee relationship.

Data collection can be mandated without a significant extension of regulatory power. Many regulators are already authorized to compile data on contract performance. The CFPB, federal banking regulators, and the SEC, as well as state insurance regulators and other state and local authorities, can promulgate rules and bring enforcement actions when contracts have not satisfied regulatory requirements.[246] These agencies engage in significant data collection. Returning to the mortgage example, the CFPB took over the collection and dissemination of HMDA data in 2011.[247] Current guidelines require mortgage originators to release home mortgage application and origination information, but loan delinquency, default, and foreclosure data are not released to the public.[248] This oversight means that regulators have more limited access to data on contract performance and that the public cannot hold regulators and contracting parties accountable for generating disparate impacts.

Implementing this more expansive disclosure regime has several key benefits. First, regulatory bodies like the CFPB would have incentives to replicate and extend the analysis performed in this Article to study inequality by race, age, disability, and other characteristics, covering a wider range of important contracts. The CFPB could not only quantify the losses to disadvantaged communities but could also pass that information to the Treasury Department or the Office of Management and Budget to consider when evaluating tax changes and other redistributive social policy. Moreover, the CFPB has the authority to audit servicers to understand why they treat borrowers unequally.[249]

Second, regulatory data on contract performance could streamline in-court disputes that require comparative data. Primarily, disclosing data on contract performance could expand the ability for regulators and private parties to detect impermissible discrimination and disparate impacts that could be actionable under antidiscrimination provisions.[250] For instance, if disparities similar to those shown in this Article existed across racial groups, there may be basis for a discrimination lawsuit. Creative lawyering could generate

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246. CFPB, CFPB SUPERVISION AND EXAMINATION PROCESS OVERVIEW (2017), https://files.consumerfinance.gov/f/documents/032017_cfpb_examination-process-overview_supervision-and-examination-manual.pdf [perma.cc/7VFV-BPCU] (describing the power of CFPB examiners to request and analyze confidential information from financial institutions); DIV. OF EXAMINATIONS, SEC, 2021 EXAMINATIONS PRIORITIES, https://www.sec.gov/files/2021-exam-priorities.pdf [perma.cc/B8Z6-HW6Z] (noting that the use of confidential consumer data and cutting-edge analytics is required for adequate protection of retail investors).

247. *History of HMDA*, FED. FIN. INSTS. EXAMINATIONS COUNCIL, https://www.ffiec.gov/hmda/history2.htm [perma.cc/C4EA-JLUD].

248. *Id.*

249. Servicers could justify their differential treatment of debtors on the basis of business necessity, insulating them from further liability.

250. *See, e.g.*, Mahoney, *supra* note 66.

other bases for suits alleging disparate treatment by contract parties. For instance, test cases could be filed claiming that highly disparate treatment of consumers by firms violates state and federal unfair and deceptive acts and practices statutes. If these are successful, they could remedy any inefficiency in contract performance by requiring firms to treat their customers equally or find a compelling justification not to.[251]

Third, and perhaps most importantly, disclosure of contract outcomes by government officials can augment existing private market forces that discipline inequality and inefficiency in contracts. Disclosing data about contractual inequality to private regulatory organizations or well-positioned third parties can strengthen parties' private incentives to act efficiently. Search engines and aggregators like Yelp already generate reputational incentives for cooperative behavior.[252] Regulators concerned about inequality can encourage aggregators to inform potential customers about unequal firms' performance quality and unequal treatment of disadvantaged populations. Consumers can then "vote with their dollars" for the companies who match their values. Alternatively, insurance companies[253] or private regulatory bodies[254] could each intervene to limit inequality. This approach also sidesteps common criticisms of disclosure policy, as it is aimed at sophisticated parties.[255]

Contractual inequality is just one of many sources of inequality in modern society, but lawmakers have a duty to understand it because it is enabled by the coercive power of the courts. Moreover, although its impact may be dwarfed by other forms of inequality, the significant losses created by unequal contract performance may be remedied with fewer political repercussions. Disclosures of contract-performance data create transparency and accountability and can

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251. When private market oversight fails, the inefficiency created by imperfect information about parties' actions during performance can be solved by ex post legal oversight. The threat of litigation ex post can give parties incentives to act cooperatively if both parties have private information and are able to harm their counterparty. Oliver Gürtler & Matthias Kräkel, *Double-Sided Moral Hazard, Efficiency Wages, and Litigation*, 26 J.L. ECON. & ORG. 337 (2010).

252. Chrysanthos Dellarocas, *Online Reputation Systems: How to Design One That Does What You Need*, MIT SLOAN MGMT. REV., Spring 2010, at 33, 34 [perma.cc/P23T-2SCY]; *see* Michael Luca, *Reviews, Reputation, and Revenue: The Case of Yelp.com* 4, 15 (Harvard Bus. Sch., Working Paper No. 12-016, 2016), https://doi.org/10.2139/ssrn.1928601.

253. For instance, lenders could offer mortgage borrowers insurance against harsh enforcement of foreclosure rights; the insurance company could guarantee that foreclosure would not occur within a year of default and could bargain directly with the servicer on behalf of the borrower to make this happen. *See* Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197, 224 (2012).

254. Private regulatory groups, such as the U.S. Green Building Council, have successfully used certification of high-quality products to align private and public aims. *See* Alison Gregor, *Aiming for Truly Sustainable Buildings*, N.Y. TIMES (Nov. 1, 2013), https://www.nytimes.com/2013/11/03/realestate/aiming-for-truly-sustainable-buildings.html [perma.cc/CD9G-46FL]. An industry group like the Better Business Bureau could do the same for contracting parties.

255. *See* OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 7–8 (2014).

encourage disadvantaged consumers to enter into banking, mortgage, insurance, and other key contracts, knowing that their experience will be monitored and observed by regulators and the public. Observing and remedying contractual inequality can provide benefits well beyond redistribution.

CONCLUSION

Contracts empower parties to create high-value relationships and facilitate key transactions. However, not every party is treated equally during contract performance. The same contract terms that can enable the American Dream or generate profits for one individual can be used to cause loss and harm to others, depending on how the terms are enforced.

This Article develops a theory of contractual inequality that shows how legally protected discretion in contract performance causes inequality in contract outcomes. The rights and obligations specified in formal contracts can be adjusted throughout performance, using tools like waiver, modification, and the exercise of discretion, as well as the option to breach or renegotiate the contract. As a result, parties can use their discretion to engage in regressive redistribution or ultimately cause economic inefficiency by being unable to commit to treating their counterparties cooperatively.

Using empirical data from a large sample of residential mortgages, this Article provides novel quantitative evidence that contract performance generates inequality on a large scale through the selective use of foreclosure on financially distressed homeowners. More than a third of mortgages in default avoid foreclosure, thereby avoiding some of the ill health, community displacement, and lost wealth that foreclosure brings. Homeowners in rich neighborhoods are nearly 10% more likely to avoid foreclosure than homeowners in poor neighborhoods despite facing exactly the same formal contract terms. Given the high cost of foreclosure, this means the richest neighborhoods are gaining $513 million more than poorer neighborhoods each year from the unchecked decisions of lenders and servicers.

Despite the potentially catastrophic effect on underprivileged parties, contract law has chosen not to discipline inequality, with years of jurisprudence defanging doctrines that could have played a role in minimizing the negative effects of inequality. Instead, private markets have been delegated the important role of overseeing contractual inequality. This Article argues that economic incentives are insufficient to deter the growth of harmful contractual inequality. Law has an important role to play in uncovering and remedying both the distributive and efficiency harms of inequality.

The Article proposes a disclosure regime to shed light on inequality and address it in a sustained way. Regulators can obtain data about inequality in contract performance. By disclosing this data to courts and private actors, they can incentivize parties to treat their counterparties equally and cooperatively. By scrutinizing inequalities in the performance of contractual obligations, lawmakers can foster trust and cooperation and help create both a more equal and more efficient society.