Property law and the mortgage crisis: Libertarian fantasies and subprime realities

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Libertarian thinking is on the rise in the United States, but libertarians wrongly characterise regulation as a deprivation of both freedom and property rights and an inefficient interference with the free market. While libertarians are correct to praise the value of freedom, they fail to appreciate how regulations promote liberty, property and efficiency. The subprime crisis reminds us that neither property nor liberty nor the market can exist without law. Laws establish minimum standards for economic and social relationships appropriate to a free and democratic society that treats each person with equal concern and respect. Property rights are structured by law to protect consumers from unfair practices and to ensure that economic relationships comply with minimum standards of decency.

A THOUGHT EXPERIMENT

What would markets look like if there was no law? In his satirical novel *Jennifer Government*, Max Barry answers this question. He brings to life a libertarian dystopia where deregulation has run amok.[1] In Barry's world, governments have been privatised and the free market is almost entirely unfettered by laws or rules. Freely negotiated contracts and competition among market actors determine the kind and level of services rendered in the economy. Laws exist that prohibit force or fraud but people have to pay to have those laws enforced. If you want government services, you have to pay for them. Laws prohibiting murder, for example, are enforced only if the victim's family or friends hire government employees to bring the murderer to justice. People get the police protection they are willing and able to pay for. The system is thought to be efficient; if you cannot afford government services, then the benefits to you of government outweigh the costs and it makes sense for government to refuse to help you. Bribery of the police is not only tolerated but encouraged, again for efficiency reasons. If you hire the police to find a murderer, the murderer can offer the police more money to leave him alone. Competition between murderers and victims results in the efficient level of investment in justice. In this land of liberty, there are no limits on freedom of contract, so people are free to agree to any terms they like. Moreover, it is customary for written contracts to be enforced to the letter – no matter what they say. Contracting parties are free to hire either private or public agents to enforce the terms of those contracts.

The book begins when the hero signs an employment contract without reading it. Big mistake. That contract was dreamed up by the marketing department of his company, which believes that the company could sell more sneakers if consumers thought the sneakers were so cool that people were willing to kill – or be killed – to get a pair. The marketers create a successful advertising campaign to drum up demand for the sneakers until it reaches a frenzy. But they severely limit the supply of the shoes until their potential customers are chomping at the bit. The company is now about to release the shoes for sale and seeks to increase demand even further.

The contract obligates our hero to kill a few customers as they clamber outside the store eager to get a pair of the shoes. Because our hero has already signed the contract (remember he forgot to read it…), he is bound by its penalties if he fails to perform – penalties that would make Shylock look generous by comparison. And those penalities, like all contract terms, are unregulated. It's a free market after all. Our hero has nothing to complain about because we all have duties to read our own

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[1] Barry M, *Jennifer Government* (Doubleday, 2003). An earlier description of Barry's book appears in Singer JW, "Things That We Would Like to Take for Granted: Minimum Standards for the Legal Framework of a Free and Democratic Society" (2008) 2 Harv L & Pol'y Rev 139.

contracts, don't we? If the contract has terms we don't like, it's our own fault for signing, isn't it? And although killing is technically illegal in Barry's parallel universe, the police will aid the family of a murder victim in finding the murderer only if the family is willing and able to hire them to do so. The marketers of course choose poor victims to kill; their families will be no threat because they cannot afford police protection.

At the climax of the novel, the marketing director copies the Founding Fathers and issues a declaration of independence, freeing the corporation from the evil bonds of government dictatorship so that even the remaining laws against murder no longer apply. Economic competition slides inexorably into military conflict. Thomas Hobbes's nightmare comes true: a "time of Warre, where every man is Enemy to every man … and which is worst of all, continuall feare, and danger of violent death; And the life of man, solitary, poore, nasty, brutish, and short".[2]

Barry's novel teaches that freedom without law is not liberty, and the free market without a legal structure is not a market in any sense we would recognise. Liberty is not possible without regulation; paradoxically, the liberty we experience in the private sphere is only possible because of the regulation we impose in the public sphere. Indeed, it is fair to say that when we talk about liberty, we are talking about the benefits of living within a just regulatory structure.

Subprime mortgages

We do not have to look far to see what happens if markets have inadequate legal structures. The subprime mortgage crisis has much to teach us in this regard. It seems that Barry's world of unregulated market relations is one with which we have come to have some unpleasant familiarity.

Remember what happened. Some lenders targeted low-income communities or customers and marketed unaffordable loans to buy homes. Mortgage brokers steered those buyers to these subprime loans because they got higher commissions from selling these loans than others. Some new home buyers were duped into taking out these loans because they had adjustable rate mortgages with low, affordable payments up-front and higher, unaffordable rates later. The sales tactics either misled the borrowers about these facts or reassured the buyers that they could refinance when the time came to pay the higher rates. Some buyers lied about their incomes in order to buy homes to flip them later. The mortgage brokers and lenders may even not have checked to see if borrowers were telling the truth about their stated incomes. Some lenders gave loans without asking the borrowers what their income was.

All of this depended on the assumption or belief that home values would continue to rise. If those values did rise, then the whole deal would be beneficial for all participants. When the higher interest rate kicked in, the borrower would either sell the property at its higher value or refinance the loan by finding a bank that would pay off the earlier loan and grant a new one. Even if the buyer failed to pay the higher interest rate and the bank foreclosed on the property, the buyer might still be better off than if he or she had not bought the property because property values had increased so much. If the property were sold at foreclosure, the bank would get its money back with interest and the home buyer would get the excess. Everyone would be happy and wealthy. Whether they were wise was something they were to find out.

The whole thing was profitable enough by itself but was made more so by the magic of securitisation. Mortgages were great investments but they did carry risks of non-payment, especially in the case of subprime mortgages sold to buyers who probably could not pay them back at the contracted-for interest rates. So sophisticated financial actors packaged lots of mortgages together and "securitised" them, giving buyers bits and pieces of bundled mortgages. The hope was that this would "spread the risk" and that the safety of more secure mortgages would outweigh the risks of the less secure ones. This hope was touching but appears to have been misplaced; if you spread garbage on the lawn, it may be less visible than if you put it in a big pile but it is nothing more than thinly-spread garbage.

[2] Hobbes T, *Leviathan* (Tuck R (ed), Rev Student Ed, Cambridge University Press, 1996), Pt 1 Ch 13 at pp 88-89 (originally published 1651).

Efficiency was supposedly achieved by dividing the pools of mortgages into groups called "tranches", distinguished by how much risk they posed. The lower-risk tranches were thought to be more secure since they would be paid first out of whatever money was available if foreclosures occurred; it simply did not occur to anyone that everyone would default at once. The higher-risk tranches were more likely to result in defaults but paid higher interest rates in the meantime to compensate for the higher risk. This mechanism allowed buyers who tolerated less risk to purchase more secure pools of mortgages and those willing to risk default in exchange for higher returns in the short run to purchase the less secure pools of mortgages.

The effect was magnified by another form of magic called "leverage". Instead of using one's own money to buy securitised mortgages, one could borrow money to do so, passing the risk on to others. And lenders emerged to satisfy this market given the high profits to be earned by these mortgages as the value of real estate kept going up and up and up and the riskier loans paid higher and higher interest rates – an effect of the federal deregulation of usury in the 1980s.

The whole thing was a beautiful sight to behold and made a lot of people a lot of money – until two things happened. First, many people stopped paying their mortgages because they could not afford the higher interest rates when the mortgages moved from the initial low rates to the adjusted higher rates. Second, the housing bubble burst. Like all markets in the past, the price of housing did not keep going up forever. It stopped rising and began to fall. Since the whole system was premised on the continuing rise of real estate values, the combination of defaults in mortgage payments and lower housing prices brought the system to a screeching halt. Because the mortgages had been securitised and sold to millions of investors, the subprime crisis quickly became a financial crisis. And because of the increasing globalisation of commerce and finance, the United States crisis became a world crisis. The world was posed at the edge of a cliff with the prospect of another Great Depression clearly in view. What was to be done?

LIBERTARIAN FANTASIES

One option would have been to do nothing. Let the market take care of it. As President Ronald Reagan famously said, "government is not the solution to our problem; government is the problem". This was the libertarian solution. Libertarians want limited government. One version of the libertarian position is that the only things that government should do is to protect us from force, theft and fraud.[3] There should be laws against battery and murder and the like and there should be laws protecting private property from invasion, harm or involuntary seizure. The only duties we have to others are to refrain from physically harming them, taking their things against their will, or refusing to do what we have voluntarily promised to do. Other than that, people should be free to act as they like, to use their property as they wish, and to sell their services and their property on terms they have chosen.

On this view, the subprime crisis was not a crisis at all. There would have been a period of adjustment but the market would have solved the problem without government assistance. The government should have responded by doing nothing. Foreclosures would have happened; people would have gone bankrupt; businesses would have failed. But eventually, everything would have righted itself. This view had some popular appeal because any government action to respond to the crisis appeared to subsidise the very people (the borrowers and the lenders) who had created the crisis in the first place. Why save them from their own bad investments? Why reward their folly? Why take taxpayer money to help the miscreants who acted so foolishly?

This position is not a fringe position in United States politics. By a vote of 228 to 205, on 29 September 2008, the House of Representatives initially voted against bailing out bankrupt American financial institutions.[4] Although the Senate voted for the bill a couple of days later, 25 Senators voted against it.[5] The bailout bill eventually passed, but popular anger over it is believed to

[3] Sandel M, *Justice: What's the Right Thing to Do?* (Farrar, Straus and Giroux, 2009) p 62.

[4] Hulse C, "House Rejects Bailout Package, 228-205; Stocks Plunge", http://www.nytimes.com/2008/09/30/business/30bailout.html (29 September 2008).

[5] "Senators Who Voted No", http://www.politico.com/blogs/thecrypt/1008/senators_who_voted_no.html (1 October 2008).

have fuelled the creation of the Tea Party political movement that led to huge increases in representation by Republicans in the Congress and State houses in the November 2010 elections.[6] Part of the anger is based on the moral outrage associated with helping those who created the problem and leaving other victims to fend for themselves. Part of the anger is based on the moral obtuseness of banks that paid huge bonuses to the very executives who caused their institutions to fail and which are not doing enough to solve the problem they themselves caused. But part of the anger is based on the fundamental notion that government should not be running the economy. It should be neither directing private investment nor interfering in the mechanisms by which markets work and adjust for changes in circumstances. It should not be choosing winners and losers in the game of economic competition but rather should defer to the invisible hand of the market.

A libertarian response to the subprime crisis would have counselled doing nothing in response to the crisis.[7] Why did President Bush reject this approach? Wasn't he the leader of the party of small government? The party that believes in the marketplace? Why did John McCain, the Republican candidate for President in 2008, support legislation to respond to the crisis? Both Bush and McCain professed strong support for the libertarian position. For example, President Bush threatened to veto legislation sponsored by Representative Barney Frank that would have made federally insured mortgages available to help distressed home owners refinance their loans on more affordable terms.[8]& And McCain initially opposed assistance to the families who bought homes with loans they could not afford to pay back. Rather, McCain obliquely suggested that those families were to blame for their own troubles: they faced foreclosure because they made poor decisions: "I have always been committed to the principle that it is not the duty of government to bail out and reward those who act irresponsibly, whether they are big banks or small borrowers", McCain said.[9]

In the end both Bush and McCain rejected the "do-nothing" approach because they were convinced that this would have plunged the country, and perhaps the world, into a deep and lasting depression. President Bush pushed for the bailout bill that was eventually passed and McCain voiced support for helping the banking industry if the systemic effects of non-intervention were substantial. "Government assistance to the banking system should be based solely on preventing systemic risk that would endanger the entire financial system and the economy."[10] Based on this approach, McCain grudgingly seemed to favour the Federal Reserve Bank's bailout of Bear Stearns.[11] When asked if "the Fed went too far in helping Bear Stearns", McCain said, "It's a close call, but I don't think so".[12] The fantasy of small government ran head-on into the reality of the subprime crisis. In the end, the felt need to do something prevailed. It was generally understood that a massive governmental response was required to head off a complete breakdown in the financial system and the resulting loss of credit needed to run the world's economies.[13]

[6] "Tea Party Outraged by Bailouts" (Katie Couric interview of Kellen Guida), http://www.cbsnews.com/video/watch/?id=6139786n (25 January 2010).

[7] David Kirkham, a Utah Tea Party activist disagreed with the federal bailout of financial institutions: "President Bush said that where we have to abandon free market principles to save the free market and fundamentally, we just don't agree. There's just no way", Bohn K, "Utah GOP Convention Rejects Incumbent Sen Robert Bennett", http://www.cnn.com/2010/POLITICS/05/08/utah.bennett.convention/index.html?hpt=T2 (9 May 2010).

[8] Herszenhorn DM, "Bush Advisers Oppose Housing Measure, and Vow a Veto" *New York Times* (7 May 2008) at C2; see Press Release, Rep Barney Frank, "Frank Announces New Economic, Mortgage and Housing Rescue Proposal", http://originatortimes.com/content/templates/standard.aspx?articleid=2948&zoneid=5 (13 March 2008).

[9] Sidoti L, "McCain Leaves Housing Crisis Options on Table: GOP Presidential Nominee Places Limits on Government Assistance" (Associated Press, 26 March 2008, LexisNexis Academic).

[10] Sidoti, n 9.

[11] "Casting McCain as Opponent of Fed Intervention in Mortgage Crisis, Blitzer Ignored His Approval of Bear Stearns Aid", http://www.mediamatters.org/items/200803280005 (26 March 2008).

[12] "Casting McCain as Opponent of Fed Intervention in Mortgage Crisis, Blitzer Ignored His Approval of Bear Stearns Aid", n 11.

[13] This does not mean there was agreement on exactly *what* to do – far from it.

Libertarian thinking legitimately focuses on the benefits of freedom of action. In United States culture, most of us prize the ability to lead our own lives on our own terms. Laws do appear to limit our freedom in this sense. But it is wrong to conclude that law necessarily interferes with liberty. The subprime crisis teaches us that the libertarian position suffers from four basic flaws. They are (1) the problem of *externalities*; (2) the protection of *property rights*; (3) the need for *minimum standards* for market relationships; and (4) the *demand for law*. Let us consider these four flaws in turn.

THE PROBLEM OF EXTERNALITIES

The libertarian approach ignores the problem of externalities. Many contractual relations can cause harm to others and laws are needed to limit the negative external effects of those contracts. The subprime crisis dramatises this point. Market actors created packages of property rights that not only backfired on those who created them but undermined the world economy.

Libertarians assume that contracts generally concern only the parties to the agreement. If both sides want the arrangements they have agreed to, why is it anyone else's business to interfere?[14] Libertarians also generally assume that people should be free to use their own property as they wish. As long as we do not use our property to harm others, then they have no right to tell us what to do in our own homes and businesses.

This view assumes that most conduct is what John Stuart Mill called a "self-regarding act"; that is, an act that does not affect others and thus does not legitimately concern them.[15] Of course, others may have opinions about whether we should act as we are acting but if we care about giving individuals freedom to live their own lives on their own terms, we have no right (no legitimate interest) in telling them what to do. On the other hand, acts that affect others (especially acts that harm others) can be legitimately regulated by the state. Effects on third parties (beyond the two parties to a free contract) are called "externalities" by economists and lawyers. Externalities are impacts of private actions on others who have not agreed to those actions or otherwise endorsed them and who may have reason to complain when those impacts are hurtful or annoying.

The subprime crisis makes abundantly plain that contracts do not only affect the parties who agreed to them. Property law has long regulated the packages of property rights that one is allowed to create in the United States. These property rules limit freedom of contract and thus seem to be contrary to a libertarian world view. However, after the subprime crisis, it will no longer be hard for property law professors like myself to explain why the law should limit the kinds of packages of property rights we are allowed to create. The subprime mortgages, securitised and leveraged, repackaged and resold, had the minor side effect of wrecking the world economy – not to mention reducing our daughter's college fund by 30% just as she was about to head off to college. These contracts – these complicated packages of property rights – had enormous effects on the public at large, the United States and world economies, and the pocketbooks of millions of Americans. Many are losing their homes and jobs because of these new-fangled property rights and contractual arrangements.

Libertarians tend to focus on individuals and revel in their ability to act freely without constraint imposed on them by others – especially from the state. This kind of freedom is called *negative liberty* by philosophers; it is the freedom from being controlled by others. We all value this kind of freedom of action; it is precious and deeply ingrained in American culture and politics. But it is important for us to understand that many actions affect others, whether or not the actor intends to impose those effects on others.

I may want to hold a noisy party in my apartment on the first floor, but I should not be surprised if the young couple upstairs on the second floor wants me to be quiet after midnight so that their baby can get some sleep. I may want to promise that my property will never be used to build a grocery store that competes with your store four blocks away, but the resulting non-competitive covenant may harm

[14] See Schwartz A, "Justice and the Law of Contracts: A Case for the Traditional Approach" (1986) 9 Harv J L & Pub Pol'y 107.

[15] Mill JS, *On Liberty* (Himmelfarb G (ed), Penguin Books, 1974) (originally published 1859).

the neighbourhood by reducing needed competition, raising prices and making it harder for people to buy food. I may want to build a factory and lower the costs of doing business, but if I spew pollution into the air I should not be surprised that other property owners in town want to regulate the way I manufacture goods to ensure that they have clean air to breathe and clean water to drink. I may want to borrow money with a low interest rate that balloons later to one I cannot afford and the bank may want to package that loan with others and transfer the rights on the open market, but if the effect of marketing such rights is to bring the world to the brink of depression I should not be surprised that many wish for regulations to stop me from doing it again in the future.

The structure of property rights

Libertarians assume that we should be free to contract on any terms we like and that any laws that inhibit those freedoms necessarily take away our liberty. But libertarians are also generally proponents of robust property rights. Many libertarians fail to recognise the contradiction between these normative commitments. If we want owners to have full powers over their own property, then we have to limit the power of owners to enter contracts that limit those powers. For example, if we want owners to be able to move when they wish and sell their property so that this can happen, we need to refuse to enforce contractual arrangements that prohibit the transfer of land.

United States property law is based on a traditional way of structuring property law called the "estates system". The estates system defines a small number of basic ways to divide up interests in land. When particular rights are transferred from one person to another, the estates system requires a set of other rights to go along for the ride, defining a few bundles of rights that owners can create. In effect, these rules impose mandatory terms in real estate contracts. For example, contracts that prohibit the sale of land are usually void, as are covenants restricting occupancy of land by race or religion. Similarly, we do not allow owners to create landlocked parcels: if you sell your backyard you must grant the new owner a right of way to cross your remaining land to get to a public road.

If owners are to have full power over their own land, they must be free to use it as they wish. They must also be free to transfer it by gift or sale and to mortgage it as security for a loan. To be an "owner" in American culture is to have broad powers over one's property. For this to be true, contracts that limit those powers must be viewed skeptically. When I sell my land, I may want to sell it on the condition that you use it only for residential purposes. That may serve my own interests if I own land nearby but it does limit what you can do with your land, especially if circumstances change. United States law allows land-use restrictions like this to be created but does provide mechanisms for undoing these "restrictive covenants" if they inhibit land use too much. If we have no limits on the covenants one can impose on land, then owners may be more and more restricted over time in what they can do on their own land. To ensure that owners have a large amount of freedom to use their property as they see fit, we must limit the enforceability of contractually-created land-use restrictions.

For this reason, the core policy underlying the traditional property law system is not "freedom of contract" but the promotion of "alienability". Traditionally, this has meant increasing the marketability of land by preventing owners from creating certain kinds of encumbrances on ownership such as future interests and land-use restrictions. Property law consolidates powers over land in current owners, freeing them to use their property as they wish without restrictions imposed by prior owners. Historically, this policy effectively took power away from feudal lords and pushed it downwards to give it to those who lived on the land. Rather than having to ask the lord if you can do something on your own land, you can just go ahead and freely use your property as your wish.

The alienability policy underlying American property law thus promoted "freehold" (rather than feudal) ownership and prevented the enforcement of arrangements that could lead to the re-emergence of feudalism. Full control over land was thought to increase the autonomy of owners, while the absence of restrictions on land use promoted its free use and efficient transfer to others. In addition, making land transferable made it subject to market forces and thus played a role in dispersing ownership of land among many people rather than leaving ownership concentrated in the hands of a few aristocratic families.

Land-use restrictions may initially serve the interests of those who create them, but over time their utility may diminish. In addition, transaction costs may inhibit owners of restricted parcels from contracting with the owners of the parcels benefited by the restrictions to remove the restrictions. If all of this is correct, the policy of promoting alienability by giving owners full powers over their land actually has democratising effects: it prevents oppression, encourages mobility, ensures freedom, protects both efficiency and equality, and generates widespread dispersal of ownership.

But this means there is an important tension between the concept of "freedom of contract" and the concept of "ownership". Property law restricts the ability of owners to divide up property rights in ways that lead to the undue concentration of ownership or that encumber real estate with socially undesirable limitations on use or transfer. We do this to protect the autonomy of current owners and to promote equal access to land ownership. *Property law achieves these goals by limiting freedom of contract*. Here is the paradox: the more absolute the use rights of current owners, the more restrictions on freedom of contract society must impose.

Consider also the need to limit freedom of contract to enable everyone to become an owner. Do I have freedom of contract if no-one will contract with me? Do I have the freedom to possess property if no-one will sell to me? Suppose I have enough money to buy a shirt. I cannot become an owner of a shirt if no-one will sell one to me. This is not a hypothetical problem. If store owners will not let me in because of my race, my own freedom to contract and to purchase property is meaningless.

The *Civil Rights Act* (US) of 1866 grants all persons the "same right … to make and enforce contracts … as is enjoyed by white citizens".[16] To grant individuals the same right to contract as is enjoyed by white citizens, the courts have interpreted this law to impose a duty on retail stores to sell goods to customers regardless of their race. The customer's *right to contract* is protected by imposing a *duty to contract* on the store. This seems to violate freedom of contract norms; ordinarily, free contract means you get to choose whether to contract with someone *or not*. But the 1866 *Civil Rights Act* has been interpreted to *require* stores to enter contracts with customers if the only reason for the refusal to contract is the race of the customer. The right to contract of the patron limits the freedom of contract of the store owner.

The patron's right to contract is also a right to buy the goods offered by the store; this protects the patron's right to become an owner of the shirts sold in the store. However, the law protects the right to acquire property by denying the store owner the freedom not to sell the shirts. Again, society limits freedom of contract in order to enable individuals to become owners and to enjoy equal access to the market economy.

The concept of "freedom of contract" certainly appears to be in some tension with the concept of "ownership". Worse still, both concepts appear to be in tension with themselves. The right to contract is enforced by imposing a duty to contract; thus, freedom of contract is promoted by limiting freedom of contract. The right to acquire property is enforced by imposing a duty to sell; thus, property rights are promoted by limiting property rights. What all this means is that *contractual freedom promotes both liberty and equality only if it occurs within boundaries set by law*.

Here is a final example of the tension between property and contract. In 1828, the United States promised the Cherokee Nation in a solemn treaty that if the Cherokees would give up their land in the east and move west into Indian Country (now the State of Oklahoma) that the Cherokee Nation would be granted:

> a permanent home, … which shall, under the most solemn guarantee of the United States, be, and remain, theirs forever – a home that shall never, in all future time, be embarrassed by having extended around it the lines, or placed over it the jurisdiction of a Territory or State, nor be pressed upon by the extension, in any way, of any of the limits of any existing Territory or State.[17]

The United States broke that pledge, opened Cherokee lands for sale to non-Indians and draped the jurisdiction of the State of Oklahoma over what had been Cherokee country. If we hold the United States to its word in the Treaty of 1828 because we believe in freedom of contract, then the Cherokee Nation would today have the power to evict hundreds of thousands of residents from the State of

[16] 42 USC § 1981(a).

[17] *Treaty with the Cherokees, 1828*, Preamble, 7 Stat 311; *accord*, *Treaty with the Cherokees, 1835*, Art 5, 7 Stat 478 (Treaty of New Echota).

Oklahoma. If we believe in both freedom of contract and property rights, how do we handle this situation? What matters here is not the proper answer but the recognition that a value judgment must be made about conflicting property rights and the extent to which we will – or will not – enforce the terms of a contract. Whichever way we go, we will be violating someone's property rights or ignoring someone's contract rights.

Libertarian calls for limited government cannot help us to adjudicate conflicts among property rights or among conflicting contractual commitments. Regulatory choices must be made to define what "contract" and "property" mean. To protect rights of free contract and private property, laws are needed to draw boundaries in a manner that accords with democratic values. Markets cannot exist without laws to define them. And choosing those laws requires us to exercise wise judgment rather than adopt a knee-jerk hostility to "government regulation".

THE NEED FOR MINIMUM STANDARDS

Libertarians assume that we should be free to contract on any terms we like and that any laws that prevent us from freely contracting as we wish necessarily take away our liberty. But is it true that liberty means freedom to make any contracts at all?

The libertarian approach fails to acknowledge the need for *minimum standards* for market relationships. Because the marketplace is not a war zone, it cannot operate without rules of the road. Even if we limit ourselves to promoting the libertarian goals of preventing force, theft and fraud, we must enact a robust regulatory system to achieve those ends. For example, when people give mixed messages about the deals they are making, we need to figure out how to interpret what the deal really was. But more than this, if we envision living in a society of free and equal individuals who have the power to live their own lives on their own terms, then we must regulate the terms of contracts to make that possible. If people are free to create feudal property arrangements that tie people to the land, committing them to serve the lord of the manor, then they have entered a life of servitude. Since libertarians are committed to a form of social life that allows individuals the freedom to choose how to live, contracts of indentured servitude must be prohibited.

Suppose I enter a contract of indentured servitude by which I agree to serve you for seven years. You are a hard taskmaster and after a year I announce that I want to quit. You are a libertarian and an advocate of freedom of contract and you argue that I should be free to make any contract I wish and I should be free to commit myself and to be bound by any promises I freely make. But I am a libertarian too and I argue that the courts cannot compel me to continue working for you. I may be free to make promises but I should be free to leave and work for someone else. If I am bound to you for seven years, I am nothing more than a slave. And slavery is the very opposite of freedom.

Most libertarians agree that the concept of liberty means that we must abolish slavery. Slavery contracts are out of bounds precisely because they give up freedom. But if this is so, then in order to have freedom, we must outlaw contracts of slavery or indentured servitude. More than that – we must outlaw arrangements that amount to slavery in fact if not in name. A contract that requires an employee to buy food and lodging from the employer and which sets the price of these necessities above the employee's wages effectively ties the employee to the employer as surely as does a contract of slavery, at least when the contract is enforced by prohibiting the employee from leaving and satisfying the debt by taking a job elsewhere.

The slavery example is often thought to be an extreme one but this is not so. Consider normal employment contracts today. If I promise to work for an employer but change my mind, will the courts force me to work for that employer? *The answer is no*. They may make me pay damages for breach of contract but they will not issue an injunction forcing me to take the job. Forced labor is outlawed by the Thirteenth Amendment to the United States *Constitution*. That means that a contract by which I commit myself to work for you for a specified period is an unenforceable contract; I am free to breach it upon payment of damages. A libertarian state will not enforce labor contracts by forcing people to work for others. Some contracts are definitely out of bounds even if one wants to live in a libertarian polity.

Contracts in a democracy must be regulated to exclude those that create relationships of servitude. Jedediah Purdy has explained that democracies that promote the autonomy of individuals must therefore regulate the "terms of recruitment" by which individuals ally themselves with others in joint projects.[18] Historical evidence for this proposition abounds. After the Civil War, former slave owners tried to perpetuate slavery by enacting Black Codes to regulate the conduct of the freedmen and supported those laws with employment contracts that amounted to a newly-minted slavery system.[19] Both those Codes and those contracts had to be ignored or overridden if the Thirteenth Amendment was going to have any teeth. Regulation of private contracts was essential to ensuring that slavery was not re-created through the means of private contract.

Even if a contract is within the range of agreements that is allowable in a free society, libertarians still must enact regulations to determine how to interpret what a contract means and whether the circumstances under which it was made were sufficiently free. Libertarians themselves say it is appropriate to regulate to prevent force, theft and fraud.

Force means we do not enforce promises made under duress. If I hold a gun to your head and say "your money or your life", that is not a voluntary agreement. The point is to enforce *freely negotiated* contracts, not coerced seizures of property. But how can we tell when a deal is sufficiently free? The United States government "purchased" most of the land in the United States from Indian nations. But those agreements were at the point of a gun. The Indian nations signed them, but were they freely negotiated deals? And if they were not, and we non-Indians cannot point to a just source of title for our land, what then?[20] Were the treaties sufficiently freely made that we non-Indians can say that we derive our title to land from the first possessors of the land? Or were they sufficiently coerced that we have no just origin to which we can trace our titles?

Theft means that one cannot take what belongs to another but it is often harder than one might think to determine who owns a particular property right. The law of mortgages began when a land owner borrowed money from another person who demanded that the borrower turn over the deed to the borrower's land to the lender. If the borrower did not pay on the appointed day, then the lender would keep the deed to pay off the debt. But suppose the land was worth far more than the debt? Did the lender have the right to keep the deed, sell the land and make a killing on the deal? Suppose the loan was for $1,000 and the land was worth $200,000?

A libertarian might say that a deal is a deal. The borrower took a chance that did not pay off and the law should not protect the borrower from his or her own mistake. The courts in both England and the United States have ruled to the contrary. Such an arrangement merely gives the lender security for the repayment of the loan; once the loan is paid back with interest, the excess belongs to the homeowner, not the lender. This is the law in all 50 States in the United States. Indeed, one might conclude that this is what the deal really was about; the borrower did not intend to pay 20,000% interest on the loan when she handed over the deed and the lender had no right to believe that that is what the deal meant. There is a question of *interpretation* in most arrangements that arises either because the deal itself is ambiguous or because implicit understandings of what is being promised differ between the parties.

Consider the recent healthcare legislation passed in the United States. It prohibits insurance companies from cancelling insurance when the insured party gets sick – something that, amazingly, was not previously illegal. Imagine paying insurance premiums for 30 years. You are diagnosed with cancer and the insurance company immediately cancels your insurance based on incomprehensible language in small print on page 17 of the contract that effectively allows the company to cancel rather than pay for your healthcare whenever you get sick and demand insurance coverage for medical care. A libertarian might say that this is fine; you should read your agreement and understand what you

[18] Purdy J, *The Meaning of Property: Freedom, Community, and the Legal Imagination* (Yale University Press, 2010); Purdy J, "People as Resources: Recruitment and Reciprocity in the Freedom-Promoting Approach to Property" (2007) 56 Duke LJ 1047.

[19] Soifer A, "Status, Contract, and Promises Unkept" (1987) 90 Yale LJ 1916.

[20] Singer JW, "Original Acquisition of Property: From Conquest and Possession to Democracy and Equal Opportunity" (Ind LJ, forthcoming 2011).

were getting into. But a libertarian might just as easily say that this is a case of fraud. What have you been paying for all these years? Is it reasonable to think that you intended a gift to the insurance company? That you expected nothing in return for 30 years of premiums?

When you buy a car and hand the money over to the dealership, you expect them to give you the car. If they don't want to give you the car, they have to give you your money back. The one thing they are not allowed to do is to keep the money and the car. That is both fraud and a form of theft. And the car better have an engine in it – one that does not explode when you turn the ignition key. And if all this is so, then even a libertarian needs to interpret contracts in ways that go beyond the letter of the agreement to figure out what the deal really was. What did the parties really expect out of the deal? What did they have a right to expect?

Thus, even if one is committed to freedom of contract, one must make complex judgments about when a contractual arrangement is sufficiently voluntary to enforce and how to interpret contracts when terms of the mutual promises are ambiguous or the parties give mixed messages. And in a democracy that treats each person as a free and equal individual, contracts that deprive persons of basic freedoms are beyond the pale; they cannot be enforced. Even libertarian advocates of freedom of contract must acknowledge that there are some demands one is not allowed to make in a free and democratic society. Freedom of contract has distinct limits even if one is strongly in favour of limited government and "free markets".

THE DEMAND FOR LAW

Finally, the libertarian approach ignores the widespread *demand for law* in the face of social problems. When it comes down to it, most so-called libertarians actually favour laws that contradict their own theory. Although many Americans profess to distrust government regulation, the truth is that, by strong majorities, they demand it and strongly favour many individual laws that establish minimum standards for market relationships. People profess a skeptical attitude toward government while demanding government action to regulate market relationships.[21] Libertarians focus on ensuring that individuals have freedom to do as they please, and if this is a fundamental value, then libertarians should be interested in the fact that *most people want laws that create minimum standards for market relationships*. If we are focused on giving people the freedom to get what they want, then we cannot ignore their *demand for law*.

Only dreamers and fringe groups actually favour living in the minimal state that libertarians claim to want. Those who opposed the bank bailouts in the United States, for example, often argued against government interference with the free market or government takeover of private institutions. But there was no clamour to get rid of the FDIC (the Federal Deposit Insurance Corporation) that insures the money in bank accounts up to US$250,000. Most Americans were overjoyed and relieved that we had established a regulatory structure after the Great Depression that ensured that at least the money we had in our bank accounts would not disappear. There was no movement to abolish the FDIC and let the chips fall where they may.

Nor did we hear calls to abolish all mortgage regulations that protect homeowners by ensuring that they have notice before banks foreclose on their homes for non-payment of mortgages. No-one publicly urged that we should repeal laws that require landlords to use court proceedings to evict tenants and go back to allowing landlords to throw tenants and their belongings out on the street with no notice. And when 29 miners died recently in West Virginia, no-one was arguing publicly that the accident would not have happened if only we had fewer government regulations. Rather, we heard widespread worries about the inadequacy of existing mining safety regulations or enforcement mechanisms.

[21] A Gallup poll taken 26-27 January 2010 found that 57% of Americans were worried that there would be too much government regulation of business and 50% thought government should be less involved in regulating business: Newport F, "Americans Leery of Too Much Gov't Regulation of Business", http://www.gallup.com/poll/125468/Americans-Leery-Govt-Regulation-business.aspx?utm_source=email%2Ba%2Bfriend&utm_medium=email&utm_campaign=sharing&utm_term=Americans-Leery-Govt-Regulation-Business&utm_content=morelink (2 February 2010).

The libertarian credo is a powerful one in the American psyche. But so is the demand for law. Laws are necessary for free societies and the free market only exists because of a legal structure. When we focus on the laws that form the backdrop of modern American life, we will find that we are far more trustful of government than our libertarian ideology might lead us to believe. Surprisingly, Americans may be libertarians in our heads but we are progressives in our hearts. The recent successes of the Tea Party have obscured this basic truth.

Mortgage law

I have argued that despite our libertarian longings, Americans are actually strongly in favour of the rule of law and democracy and that this means that we favour regulation far more than our rhetoric would acknowledge. The laws of the 50 States as well as the federal government define minimum standards for market relationships compatible with the norms of a free and democratic society. Now consider the subprime crisis. If the question is what the minimum standards should be for market relationships, it would help to remember what the standards were before the subprime crisis led us to consider whether existing standards were adequate.

Mortgage law has a long history. The use of real estate as security for a loan existed in England before the Norman Conquest of 1066 and was common in the 12th century as well.[22] In its earliest form, the borrower would hand over title to the property to the lender in return for the loan. The lender would actually take possession of the property and "work" it (or hire others to do so) to make profits from the transaction. Later, the borrower would keep possession of the property; the transfer of the deed to the lender was simply a security device to protect the lender's financial interest in repayment of the loan. Title would be returned if the loan was paid, and if it were not paid before the appointed day the lender would keep title to the property even if the value of the property far exceeded the amount of the loan. This arrangement was lawful even though usury was thought to be sinful at the time.

England had two court systems: the law courts and the equity courts. Although the law courts would enforce mortgages and allow forfeiture of the land for non-payment of the debt, the equity courts began to allow the debtor more time to repay. The debtor was said to possess an "equity of redemption". By giving the borrower more time to pay back the loan, the equity courts effectively rewrote the contract. They did so because they viewed the terms as unfair. If the borrower could pay off the loan with a little more time, the lender would be made whole and the borrower would get his land back. To do otherwise would grant the lender a windfall; more than that, the lender would have committed a moral wrong by charging an interest rate far beyond what was necessary to protect the lender's legitimate interests. In so doing, the lender would be taking property from the borrower rather than using the land as security for the loan. Because the time to repay could not be indefinite, the courts developed rules that gave the lender the power to "foreclose" on the property and end the borrower's right to redeem.

Modern mortgage law in the United States is built on this foundation. Every State regulates mortgages to protect the interests of both borrowers and lenders. A libertarian approach to mortgage law would repeal all these regulations and allow lenders and borrowers to agree on any terms they like. No State adopts this approach, although some do allow arrangements that avoid the protections that mortgage laws grant to borrowers. The general practice in the United States is to treat mortgages as security arrangements. This means that if I borrow $100,000 and give the lender a "security interest" in my home which has a market value of $200,000, the deal constitutes a promise that I will repay the loan on the terms and times the contract states but also that, if I do not make the payments, the lender can "foreclose" on the property by arranging for its sale so that the lender can use the proceeds of the sale to pay off the remaining debt. Importantly, any proceeds of the sale beyond what is necessary to pay off the remaining debt goes to the borrower/homeowner; we refer to that as the borrower's "equity" in the home – a term that obviously has its origins in the fact that the equity courts protected the borrowers' interests in these transactions.

[22] Burkhart AM, "Lenders and Land" (1999) 64 Mo L Rev 249; Simpson AWB, *A History of the Land Law* (2nd ed, Oxford University Press, 1986) p 141.

State laws adopt a wide variety of techniques to ensure that lenders can recoup their loans with the contractually agreed-upon interest through the foreclosure process while protecting the borrower's equity in the home. Some do this by policing the price bid at the foreclosure sale so that the lender cannot buy the property at foreclosure for far less than its market value and then sue the borrower for the excess. Some do this by giving the borrower a "statutory right of redemption" to repurchase the property *after* foreclosure at the foreclosure price; if the foreclosure price is far less than fair market value, the borrower may borrow from another lender to take the property away from the foreclosure buyer. All States regulate mortgage procedures, giving the borrower notice of the foreclosure sale, some time to repay, and the right to bid at the foreclosure sale. Some States ban private foreclosure and require court-supervised foreclosures. All these regulations limit "freedom of contract" by regulating the mortgage contract and the nature of the security interest taken by the lender in the property held as collateral for the loan.

In 2008, the Supreme Judicial Court of the Commonwealth of Massachusetts ruled that some subprime mortgages may violate the State's consumer protection act.[23] That act prohibits "any unfair or deceptive act or practice".[24] A lender that had issued adjustable rate mortgages claimed that its actions were lawful because they did not violate the terms of the State's predatory lending statute. The court found that the consumer protection statute existed side-by-side with the predatory lending statute and might impose restrictions on lending that went beyond those defined in the predatory lending statute. The court also found that a reasonable jury might well conclude that it would be "unfair" to sell an adjustable-rate mortgage to someone who could not afford the payments when the higher rates kicked in when the loan amount was for 100% of the purchase price or the loan was subject to a stiff prepayment penalty. Such a loan would be "doomed to foreclosure" unless the borrower could refinance the loan at that time and that could only happen if property values increased sufficiently to make it possible for the borrower to obtain a new loan.

The court agreed with the findings of the lower court that it is unfair for a lender to issue such a loan given the fluctuations in the price of housing:

> To issue a home mortgage loan whose success relies on the hope that the fair market value of the home will increase during the introductory period is as unfair as issuing a home mortgage loan whose success depends on the hope that the borrower's income will increase during that same period.[25]

At the time the loans were given, there were already indications that housing prices might be stalling or even going down. Selling subprime mortgages in this setting made it far less likely that the borrower would be able to pay the loan rather than face foreclosure, and the fact that the loan was for 100% of the purchase price meant that it was unlikely the buyer could refinance. The court concluded that if the State Attorney-General could prove such loans were likely to face foreclosure because of the borrower's inability to pay, the borrower would be worse off financially than if the borrower had not granted the mortgage to the subprime lender. Such an arrangement strips the borrower of his or her wealth and a reasonable jury might well find such an arrangement to constitute an unfair business practice.

A libertarian would scoff at this conclusion. If borrowers want to take this chance, why not let them? If we have a willing buyer and a willing seller, who is the state to step in and regulate the transaction? The consumer protection statute provides treble damages as a remedy for engaging in unfair or deceptive business practices. But why should the law tell someone they cannot take a chance they want to take? There is something to this argument; we do not, in fact, want to prevent people from making decisions just because we think they are not wise. Freedom means the ability to make choices about one's life and that includes one's finances.

At the same time, every State in the United States has a consumer protection statute. Not because we think consumers are likely to make unwise decisions. Those statutes exist to ensure that people get what they are paying for. Consumer protection laws reject the idea of "caveat emptor" – let the buyer

[23] *Commonwealth v Fremont Investment & Loan* 897 NE 2d 548 (Mass 2008).

[24] *Mass Gen Laws* ch 93A, § 11.

[25] 897 NE 2d at 740.

beware. If you buy a car, it should work. Before you buy stock, federal securities law requires the company to tell you if its debts exceed its assets and it is about to go bankrupt so that you can make an informed decision about whether to buy. And if you borrow money, the lender should not be able to sell you a loan you cannot afford while leading you to believe that you can afford it. Consumer protection laws exist not because people are stupid, but because *they have the right to be treated with common decency*. They exist because sellers of products and services have no right to defraud people. Sellers have the right to wax eloquent about their products but they have no right to lie about them.

Mortgage regulations may well be anathema to a libertarian. They interfere with freedom of contract by limiting the terms on which one can contract. They regulate property and diminish the rights of owners by making it illegal to create a particular package of property rights. They not only arguably interfere with liberty but decrease social welfare by stopping willing parties from dealing with each other on terms that they prefer. Why then are these regulations so pervasive? *Why then do they exist in every single State?* Don't Americans hate regulation and seek to end "big government"?

Mortgage regulations are pervasive and popular because people demand mortgage laws that protect the interests of homeowners who borrow money to purchase homes or who use their homes as collateral for other loans, such as loans to pay for college. Why do people demand these laws?

One answer is that the laws constitute paternalistic regulations to protect people from making stupid economic decisions. There is a cottage industry of academics writing scholarly articles explaining all the ways that people misjudge their own interests. Libertarian economists have long argued that markets are efficient and self-correcting and that government regulations only stop the market from doing its work to allocate resources efficiently. So-called "behavioural economists" have now come to the foreground to argue that people predictably make a great many errors in judging what is in their best interests. They focus on the short term and fail to see the long-term consequences of their actions; they seize on highly visible events and misjudge the chances of those events occurring; they protect themselves from fear by assuming that harmful events are unlikely to touch them personally, etc.[26] Regulations are therefore in place to protect borrowers from entering arrangements that result in 1000% interest or that are so inflexible that they lose their homes even if they can pay back their loans, with interest, two days late.

It is of course possible that the reason for mortgage regulations is to protect us from mistakes we are likely to make. After all, over time, we have a lot of evidence of mistakes that many people make and the regret they experience when they realise they signed a contract with onerous terms. Laws may well be passed for this reason. Social Security and Medicare, for example, may be understood as forced insurance programs. We know that we should save for retirement and end-of-life medical care and that if we don't do this we will regret it, so we legislate programs that force us to save. This achieves our purposes and satisfies our preferences for saving while acknowledging that we would not save as much as we would like to save if we made the decision month-by-month rather than adopting a framework that makes savings automatic. Similarly, mortgage regulations protect us from entering agreements we think we can comply with but which have draconian penalties for non-compliance. We want protection from such contracts because we know we underestimate the chances that we will default on our mortgage payments. Such regulations do not interfere with our preferences; they satisfy them by ensuring that our *long-term goals* are met.

I have been arguing, however, that there is another, more basic reason for regulations like these. We do not demand laws regulating market relationships mainly because we are stupid or irrational and want protection from doing dumb things. We demand laws because, in a free and democratic society, economic and social relationships must comport with certain minimum standards. Those minimum standards ensure that we treat each other with common decency. They ensure that deals are interpreted in light of the parties' legitimate expectations. *They ensure that we do not take undue advantage of each other*.

[26] Cassidy J, "After the Blowup: Laissez-faire Economists do Some Soul-searching–and Finger-pointing", *The New Yorker*, (11 January 2010) p 28; Thaler RH and Sunstein C, *Nudge* (Penguin, 2009).

In *The Once and Future King*, TH White explained King Arthur's conception of the mission of the knights of the Round Table: "What I meant by civilization when I invented it, was simply that people ought not take advantage of weakness".[27] Mortgage laws exist, not because we are stupid and need to be tied to the mast like Odysseus. They exist because we know that the profit motive may induce businesses to make money by asking customers to agree to terms that are unfair.

Laws exist not because customers are irrational but because businesses can be ruthless. Most business people are moral and caring, but competitive pressures can induce the best of us to demand a pound of flesh. Laws prevent us from making demands of each other that should not be made in a democratic society that treats each person with equal concern and respect. It is not true that liberty demands that all preferences be satisfied and that all actions are allowed. *There are some demands that we cannot make of each other in a free and democratic society*. Law exists to set those minimum standards. Regulation of the mortgage market is not an interference with personal liberty; nor is it an inefficient obstruction to social welfare. Mortgage law sets the minimum standards for fair dealing in a society that is premised on respect for each person and the protection of human dignity.

[27] White TH, *The Once and Future King* (Ace ed, 1996) p 381 (originally published 1939).