American Revolutionary, James Otis Jr. is noted for many sayings one of which is “a man’s house is his castle.” During this revolutionary’s era, his intent was that the government should not be able to breach the walls of personal dwellings. The modern version of this quote has taken on new meaning. “Every man’s home is his castle” has been taken quite literally. During the housing boom of the last decade, builders endeavored to make this statement a reality by building larger and larger homes across the United States. Wrapped in the “American dream,” our citizens continually traded up in housing, comfortable housing to luxurious domains. The result was subdivision after subdivision of “McMansions.”

Income levels did not grow at the same rate as housing prices. The infamous housing bubble was born. Disparity between housing costs and income levels necessitated more and more exotic mortgage instruments. These new and “innovative” loans were fueled by the notion that property values always increase and collateral is king. Both borrowers and Wall Street drank the Kool-Aid as nontraditional mortgages allowed homeowners to be able to afford high-priced homes, many times deferring principal and interest payments to a later date. In high appreciation markets homeowners stretched themselves to make payments on houses that would increase in value. The financial strain they judged was temporary and worth it because of the financial reward they would reap in the future. Everybody became a speculator; nobody wanted to be left behind as the gravy train left the station.

The practice was clearly unsustainable and the bubble burst in 2007. Startled as if awakened from a deep sleep, homeowners discovered that property values move with the market and markets can move down. Defaults on subprime loans were the first evidence. Many of these loans were adjustable-rate mortgages, which when indexed from their gimmicky initial rates, experienced a dramatic payment increase. Already on the edge financially, homeowners began to default in the subprime arena. The trouble began in the sand states first: California, Nevada, Arizona and Florida. They had enjoyed the most increase and as the old adage goes, "The bigger they are the harder they fall." Values began to retreat dramatically as supply levels grew and financing disappeared. Within the course of months, millions of homeowners found themselves saddled with underwater mortgages, owing much more than their house was worth. Equity had evaporated. The castle walls were breached.

Since the collapse of 2007, the crisis has spread nationwide. Even conscientious borrowers now find themselves owing more on their property then they could sell it for. Core logic estimates 11.1 million residential properties or 23% of all US homes are in a negative equity situation as of December 31, 2010. The same organization goes on to say that another 10% of homeowners will suffer the same fate if home prices fall 5 to 10% more as projected in 2011. The negative equity is like economic flypaper. Homeowners are trapped; many have given up plans to upsize, others are forced to make difficult decisions if they have to move for relocation or other required reasons. Faced with the economic realities, there are some homeowners out there who would've done the math and have simply decided to "walk away" from their mortgages.

Property owners who have decided to abandon their mortgages but are capable of fulfilling them are termed "strategic defaults." They are homeowners that have faithfully made their payments and can continue to make such payments. However they make the calculated decision that it is not in their financial best interests to continue to do so. Strategic defaulters borrowed the money in good faith with every intention of fulfilling their obligations. Faced with the catastrophic decline in the real estate market, these borrowers choose an "efficient breach" of contract. Law students understand the concept; to breach a contract, if breaching the contract is worth more than performing on the contract.

An efficient breach of a mortgage contract, a strategic default, may make sense from an economic point of view, but what about the ethics of the situation? If a person can perform on their mortgage payments and simply choose not to, is it right? The debate is at the forefront of the lending industry. Some would contend the answer to this question will have systemic influence on the economic future of America. If you Google "strategic default" your browser will show page after page of hyperlinks to blogs, discussion forums, and online articles from national publications. I have narrowed my study to the opinions of two academics who have published on the subject. Luigi Zingales, Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business and Brent T. White an associate professor of law at the James E. Rogers College of Law at the University of Arizona. Zingales argues that strategic defaults undermine the financial system while White contends strategic default is an acceptable rational moral decision. Let us first turn to Zingales' position.

From a research standpoint, Zingales notes that strategic default in and of itself is hard to define. What does it exactly mean to be able to pay a mortgage? If a homeowner defaults because they are unwilling to work extra hours is that a strategic default or necessary one? Irrespective of where the definition lies, there is a growing body of evidence that strategic defaults are rising at levels never seen before.

The most convincing evidence comes from a study by Experian a credit reporting company and the consulting firm of Oliver Wyman. The Study tried to identify people who go straight from always being current on their mortgages to being 180 days late. The catch is the same property owners stay current on all their other debt obligations including credit cards and auto loans. Obviously if someone pays credit cards but not their mortgage it's probably because they want to default on their mortgage not because they must. The study estimates that approximately 27% of defaults among people with high credit scores appear to be strategic. Another survey that Zingales himself contributed to indicated from his sample of 1000 Americans who had defaulted 36% made a strategic decision.

Zingales notes other characteristics of the strategic defaulter. Most obvious is that the more someone owes on a declining asset, the more likely they are to default. A New York Fed study estimates that households with mortgages 50% more than their homes are worth are 25% more likely to walk away. 62% seems to be a major tipping point where more than half make a strategic default decision. The demographics are interesting as well, strategic defaulters tend to be highly educated, wealthier, older and at the top end of the credit score range. Given these statistics, characteristics, and strong monetary incentives, Zingales is surprised how many homeowners choose not to default on their home mortgages.

The law does not provide much incentive to stay put. 11 states are nonrecourse meaning the lender can not come after any other assets other than the real estate secured by the mortgage. And while 39 other states permit the lender to pursue other assets of the borrower, most lenders will not go through the effort and expense of a deficiency judgment.

Likewise, the tax code does not really impede people from defaulting strategically either. Until recently people owed taxes for any foregone debt. If you walked away from away from your house and it was worth $100,000 less than you owed the bank for it, that 100K was essentially income, and you had to pay tax on it. In December of 2007, Congress, in an effort to facilitate renegotiation of underwater mortgages, made mortgage debt cancellation nontaxable for personal residences. The unintended consequence was to reduce the cost of walking away.

So if it makes financial sense, and it's legal, and there aren't extreme tax consequences, what does keep people from strategic default? Zingales argues that it's their sense of what's right. According to other research papers, more than 80% of Americans think it's immoral to default on the mortgage if you can pay for it. And this group of 80% is 77% less likely to declare their intention to default strategically than people who don't find the act immoral. It's perceived social norms that seem to affect propensity to walk away. But interestingly, knowing someone who defaulted strategically or living in an area where people done so makes a person much more likely to make the same decision and default strategically.

Zingales believes there is a real systemic risk if homeowners begin to abandon their mortgages strategically. The more people who walk away, the more vacant houses there are, the more auctions that occur, and the subsequent of effect further depresses real estate prices. The additional decline pushes more homeowners into negative territory and the vicious cycle causes more foreclosures. The cycle will lead to more strategic defaults and a lessening of social stigma. Every time the borrower defaults, moreover he makes mortgages more expensive and the mortgage market less efficient in the future. The higher cost and reduced availability of credit would further depress housing prices completely nixing the possibility of economic recovery. Undermining the social norm to repay mortgages Zingales equates to being in a burning theater and making the "rational" decision to trample other people as you rush to the exit.

Zingales proposes a solution. To prevent the complete breakdown of social norms– a breakdown that could take decades to reverse–mortgages need to be renegotiated on a wholesale level. Zingales espouses a reduction in mortgage principals, a plan opposed by most major lenders. He suggests a revision of the bankruptcy code that would require lenders to give homeowners the option of resetting their mortgages to the current value of the houses. In exchange, lenders would get 50% of the houses future appreciation. To prevent potential fraud The capital gain would be measured based on the average of houses selling in the area rather than on the change in value in the actual house.

Professor Zingales acknowledges the proposal would be somewhat unpopular since it doesn't duly favor any constituency; subsequently any opposing constituency will not have interest either. He quips, "Since it doesn't spend tax revenue, it is not favored by politicians who never tire of rescuing some people with other peoples money."

Brent T. White, Associate professor at Arizona University takes the opposite perspective of Zingales on the morality of strategic default. White notes that the housing collapse has seen many Americans losing half the value of their homes and owning several hundred thousand dollars more than they're worth. It is unlikely that they can dig out of their negative equity hole for decades. Many of these homeowners have contacted their lenders about loan modifications or short sales to no avail. The homeowners are current on their mortgage and can't receive "assistance" until they are several payments behind. Many "strategic defaulters" do so in order to bring their lenders to the table; when the effort is unsuccessful they simply continue the process and walk away.

White says that the arguments against strategic default boil down to two points. First, underwater homeowners have promised to pay their mortgages back when they signed mortgage contracts. It would be immoral to break these promises. Second, if underwater homeowners defaulted in mass the housing market would likely crash again and worse (Zingales primary argument). If that happened strategic defaulters would bear moral responsibility for contributing to the destruction of the American economy. White disagrees on both points.

First white addresses the promise issue. He states mortgages are contracts and like every other contract, they are purely legal documents, not a sacred promises. Just as when you signed your cell phone contract you "promised" to make a standard payment of say $100 for multiple years. Two months later, the new iPhone comes out and the price of the cell service is half of what you're paying (as an iPhone user I can say that's a highly unlikely scenario). You realize it makes financial sense to terminate early and pay the $300 and make up for it by your monthly savings. Have you broken a sacred promise? There's absolutely nothing immoral about exercising this option, in fact, you would be wise to do so.

Although more substantial than a cell phone contract, mortgages are contracts too. It's no different principle. The mortgage explicitly sets forth the consequences of breach. The lender has contemplated in advance what they want if the mortgage or is unable or unwilling to continue making payments. After this contemplation, the lender has written into the contract what their compensation will be for breach. In some states, the lender can even pursue a deficiency judgment to pay the difference between the funds received from the foreclosure and the balance remaining on the debt. It's an agreement, and no one forced the lender to sign the contract. You can be sure that the lender wouldn't hesitate to exercise the right to take the defaulters house if it was financially advantageous to do so. The lender is not concerned with morality or social responsibility in this equation. The borrower must be willing to accept the consequences of nonperformance, which can include foreclosure, and the risk of deficiency judgment.

To summarize, the law does not treat breach of a mortgage contract as a moral wrong. Sure you should keep your promises, that's a fine principle. But the promise to pay your mortgage should not be regarded as more sacred than any other promise. It certainly shouldn't carry a moral stigma. The marriage covenant is a promise that 50% of Americans break on a regular basis. Most would certainly regard this promise as more significant than a promissory note and yet the stigma of divorce has waned. A more accurate description of the social norm around promises is that one should keep one's promises unless one is compelled with enough reason not to. For instance if a family member fell seriously ill no one would regard it as immoral for someone to break a rental agreement in order to care for the family member. The Landlord might very well pursue the renter for the remainder of the lease payments as "promised" but most would say the renter behaved appropriately given the change of circumstances.

White continues the argument against the promise perspective noting that as a result of the unprecedented severe housing collapse many underwater homeowners now find themselves pouring most if not all of their disposable income into a house that is no longer a sound investment but may in fact be a threat to their financial security. Given the dead end road of many of these mortgages, homeowners should not have to have a 20-year sentence for situations beyond their control. Possibly they can "afford" it but the additional money saved by defaulting could be applied to a retirement account or a child's education, both of which are more important obligations.

Professor White then moves on to confront the second argument. The notion is that strategic defaulters have a moral responsibility to shore up the economy. He questions why it is wrong for an underwater homeowner to make the "best financial decision for his family" because it might contribute to the collapse of the economy. White notes the irony of arguing that individuals in the capitalistic society must make personal economic decisions for the collective good. He feels it is unfair to ask a homeowner to prop up the housing market on his own back.

Why is it that only the homeowners and not the financial institutions are called upon to sacrifice their own economic well being for the common good? White draws attention to how lenders modify mortgages for underwater homeowners only when it is in their financial interest to do so. No lender would modify mortgage for homeowner when they are still making payments on time, for heaven sakes that's throwing money away. What would the shareholders think? This is why underwater homeowners typically have to default on their mortgages before lenders will even talk to them. Possibly less people would choose to strategically default if lenders were less intransigent and willing to negotiate upside down mortgages. If you're going to apply the principles of morality and social responsibility they should not only fall only on the shoulders of homeowners but also on financial institutions and large corporations.

The Mortgage Bankers Association recently defaulted on a $70 million mortgage in their Washington DC office; Morgan Stanley did the same on a $1.5 billion mortgage encumbering five buildings in San Francisco. Morgan Stanley raked in record profits that year. Neither were criticized for their immoral decisions. White notes, "apparently what's good for Morgan Stanley or the Mortgage Bankers Association is good for America. Only the little guy must take his lumps for the common good."

White favors the world where all actors, both corporate and individual, are legally required to act in the socially responsible way. In such a world, White believes institutional lenders would be required to take responsibility for their actions by writing down at least part of the principal on underwater mortgages, echoing Zingales proposal. White believes we should not be guilt tripping underwater homeowners into holding on to their homes. Instead we should focus on equitable and practical solutions to the negative equity crisis. Morals don't enter the equation.

It is interesting that both authors come to the same conclusion on a solution despite their diametrically opposed perspectives on the morality of strategic foreclosures. Douglas French, in another article on strategic foreclosure, put the whole situation in perspective when he stated, "No obituary will ever read, 'He was a good and ethical man. He died broke, his family suffered, but he never missed a payment to Fannie Mae.'"