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California County Considers Using Eminent Domain to Seize Underwater Mortgages

Local authorities from San Bernardino County in California and two of its cities have recently joined together to create a Joint Powers Authority (JPA) with the purpose of seizing and restructuring certain mortgages to help underwater homeowners in an effort to stimulate the local economy. This so-called "Homeownership Protection Program" is spearheaded by Mortgage Resolution Partners LLC (MRP), a San Francisco-based venture-capital firm, and would target mortgages that are not in default but which are owed by borrowers whose home values have depreciated to the point that that they are now less than the loan amounts — *i.e.*, "underwater."

Under the Program, local governments would take title to the mortgages (not the underlying real property)[1] and pay the mortgage holders "fair market value" using money provided by institutional investors. The government and investors would then issue new mortgages to homeowners writing down the loan amounts to slightly below the fair market value of the home, which would enable distressed homeowners to acquire equity and reduce their monthly payments. The restructured mortgages could then be sold to third-party investors, with the government recovering administrative costs and MRP earning a fee on each transaction.

This Program is a novel proposal, and as pointed out in recent news and by trade associations like the Securities Industry and Financial Markets Association (SIFMA) and the American Securitization Forum, there appear to be strong arguments that the Program would be not only unwise as a policy matter,[2] but unconstitutional.

Constitutional Restrictions on Eminent Domain

The Fifth Amendment to the U.S. Constitution states that private property can be taken only if the owner is provided "just compensation" and if the taking is for "public use." Courts have held that "just compensation" is determined by reference to the seized property's "fair market value," with the owner of condemned property being "entitled to receive 'what a willing buyer would pay in cash to a willing seller' at the time of the taking." *United States v. 564.4 Acres of Land*, 441 U.S. 506, 511 (1979) (quoting *United States v. Miller*, 317 U.S. 369, 374 (1943)).

[1] It is unusual, but not necessarily unconstitutional, to use eminent domain to seize intangible property. Takings of intangible property like air rights or trade secrets, however, typically have a more obvious public purpose than takings of mortgages.

[2] SIFMA submitted a letter to the local authorities warning that the Program could negatively affect mortgage interest rates and credit availability in affected areas, while also decreasing private investor confidence and the overall appetite for mortgage-backed securities.

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First, the investors holding the mortgages that the JPA seeks to seize could argue that the Program would constitute an impermissible taking because it would fail to provide "just compensation." Because the Program would target only mortgages with principle balances higher than the values of the properties securing them, payments due on an underwater mortgage necessarily would exceed the fair market value of the property itself. Also, as an economic reality, the Program could attract private investors and cover administrative costs only if the current mortgage holders are paid less than the fair market value of the properties securing them. Because the Program appears to depend on an undervaluation of the mortgages it is targeting, it seems likely to raise concerns about just compensation.

Second, although the "public use" requirement has been interpreted broadly and with significant deference to legislative acts, "it has long been accepted that the sovereign may not take the property of *A* for the sole purpose of transferring it to another private party *B*, even though *A* is paid just compensation." *Kelo v. City of New London*, 545 U.S. 469, 477 (2005). Nor may a government "take property under the mere pretext of a public purpose, when its actual purpose was to bestow a private benefit." *Id.* at 478. There would be a strong argument here that the actual purpose of the Program is to transfer wealth from current mortgage holders to homeowners and the private investors financing the Program. Indeed, the fact that the JPA proposes to cherry-pick mortgages that are current, as opposed to all underwater mortgages, suggests that the true purpose of the Program is to turn a profit and not to protect homeownership generally.

The purported public purpose of restructuring certain underwater mortgages would be to improve local housing markets. But even this objective would arguably be too attenuated and speculative to constitute public use, particularly when contrasted against traditional takings with obvious public character, such as building highways or community centers or even development of private corporate facilities that would create jobs and spur development.

Lastly, there may be precedent that the Program is prohibited by the Commerce Clause because by disrupting the mortgage-backed securities market, the Program would constitute the type of "parochial meddling with the national economy that the commerce clause was designed to prohibit." *City of Oakland v. Oakland Raiders*, 174 Cal. App. 3d 414, 421 (1985).[3]

Restrictions Under California Law

In addition to the constitutional issues, the Program may also be barred by California law. For example, local governments in California "may acquire by eminent domain only property within its territorial limits." Cal. Civ. Proc. Code § 1240.050. The mortgage loans targeted by the Program are likely held by securitization trusts located outside the city or county where the homes are located, so the JPA may lack authority under California law to implement the Program.

Furthermore, the taking of private property through eminent domain must be "necessary for the [proposed] project," which must be both "planned in a manner . . . most compatible with the greatest public good and the least private injury" and also "required" by "public necessity." *Id.* It is unclear whether the JPA has conducted sufficient planning or established the requisite showing of need to proceed with the Program.

Lastly, affected mortgage holders may also have affirmative causes of action against governmental entities and/or MRP under various state law theories, such as intentional interference with contract.

Conclusion

Because the Program has not yet been implemented, it remains to be seen how the JPA might exercise its eminent domain authority and what rationales it may offer. Nonetheless, there would be persuasive legal and

[3] Notably, the Federal Housing Finance Agency (FHFA), which is the federal agency that supervises the housing Government Sponsored Enterprises, has expressed increasing concern about state and local level actions that may adversely impact the functioning of the housing finance industry. *See* Statement of Alfred M. Pollard, FHFA General Counsel, before the U.S. House of Representatives Committee on Oversight and Government Reform, On Failure To Recover: The State of Housing Markets, Mortgages Servicing Practices, and Foreclosures (Mar. 19, 2012). In this regard, the FHFA filed suit against Chicago's Vacant Buildings Ordinance and certain Illinois county tax officials seeking to impose transfer taxes on the recording of real estate deeds by Fannie Mae and Freddie Mac.

policy arguments opposing this purported use of the eminent domain power.

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