

---

---

## STEMMING THE TIDE OF FORECLOSURE: EVALUATING THE USE OF EMINENT DOMAIN TO RELIEVE UNDERWATER HOMEOWNERS

Marissa Schaffer\*

*More than six years since the housing bubble burst in 2007, over twelve million homes nationwide remain underwater—one out of every five homes with a mortgage. These homeowners are more likely to default on their mortgage payments because the overall principal value of their mortgages is greater than the value of their home. Being underwater limits an individual homeowner’s ability to recover from financial shocks, such as job loss or reduction in income, and at an aggregate level, it threatens another wave of foreclosures. Further, securitization of residential mortgages has inhibited refinancing, even when advantageous to all stakeholders.*

*This Note evaluates a proposal that aims to overcome a collective action problem between borrowers, lenders, mortgage servicers, and government actors by recalibrating the value of underwater mortgages. Using the power of eminent domain, local municipalities would seize underwater mortgages from private-label securitization trusts, compensating the trusts with the true fair market value of the mortgage (which, by definition, would be less than the current home value). The municipalities, in conjunction with a venture capitalist fund, would refinance the mortgage with a government-approved vendor at a value closer to the true*

---

\* J.D. Candidate 2014, Columbia Law School; B.A. 2009, Swarthmore College. The author would like to thank Professor Michael Heller for his guidance and comments. The author would also like to thank Jonathan and Toby Schaffer, Zachary Schaffer, and Daniel Sartori for their unwavering support and patience during this process, and always. Many thanks to the *Columbia Business Law Review* editorial staff for their dedication in preparing this Note for publication.

*market price. This proposal would likely survive a constitutional challenge and should be piloted in communities burdened by trillions of dollars of household debt.*

I. Introduction .....	217
II. Securitization of Residential Mortgages .....	220
A. Features of Securitization.....	223
1. Mechanics .....	223
2. Parties and Their Economic Incentives .....	224
3. The Effect of Securitization on Principal Reduction .....	226
B. The Current Market.....	229
1. A Potential Wave of Foreclosures.....	229
2. Principal Reduction .....	231
C. Federal Efforts.....	233
1. Home Affordable Refinance Program.....	233
2. Home Affordable Modification Program .....	235
3. Failure of HARP and HAMP.....	236
III. State and Federal Eminent Domain: Background and Limiting Principles.....	239
A. State and Federal Authority.....	240
B. Public Use Limitation .....	241
C. Just Compensation Limitation .....	243
D. Intangible Property .....	243
IV. The Proposal .....	244
A. Case Studies: San Bernardino County and Richmond, California .....	245
B. The Proposal's Specifics .....	247
C. A Local Solution.....	250
V. Constitutionality of the Proposal: Responding to SIFMA.....	251
A. Public Use .....	251
1. SIFMA's Argument .....	252
2. Analysis.....	253
B. Just Compensation.....	255
1. SIFMA's argument .....	255
2. Analysis.....	256
C. SIFMA's Other Claims.....	257

D. Motivations of the Financial Industry .....	260
VI. Conclusion .....	263

## I. INTRODUCTION

The housing bubble burst almost seven years ago.<sup>1</sup> By the first quarter of 2011, the decline in home prices surpassed that of the Great Depression.<sup>2</sup> In the hardest hit areas of the country, housing prices slid more than fifty percent off their highs.<sup>3</sup> The “Sunbelt”—a region that experienced dramatic housing booms prior to 2006—faced the greatest correction.<sup>4</sup> This area, “where housing booms were fueled by borrowed money . . . [has become a] long-term laggard[] under the weight of those debts.”<sup>5</sup> One implication of these debts is an increased likelihood of homeowners foreclosing on their homes.

Foreclosure occurs when a borrower fails to make timely payments on his or her home mortgage, resulting in the lender claiming its security interest in, and thus physical possession of, the residential property.<sup>6</sup> Foreclosures affect

---

<sup>1</sup> See Ruth Mantell, *Home Prices Off Record 18% in Past Year*, *Case-Shiller Says*, WALL ST. J. MARKETWATCH (Dec. 30, 2008, 11:49 AM), <http://www.marketwatch.com/story/home-prices-off-record-18-in-past-year-case-shiller-says>.

<sup>2</sup> See Mark Gongloff, *Housing Shocker: Home Prices Still Falling*, WALL ST. J. MARKETBEAT (May 31, 2011, 9:03 AM), <http://blogs.wsj.com/marketbeat/2011/05/31/housing-shocker-home-prices-still-falling/> (citing Case-Shiller Index).

<sup>3</sup> Letter from Gavin Newsom, Cal. Lt. Gov., to Eric Holder, Att’y Gen., and Joseph Wayland, Acting Ass’t Att’y Gen., Antitrust Div. 1 (Sept. 10, 2012) (on file with author).

<sup>4</sup> See Richard Florida, *Foreclosures Still Concentrated in Sunbelt Cities*, ATLANTIC (Jan. 28 2011, 10:00 AM), <http://www.theatlantic.com/business/archive/2011/01/foreclosures-still-concentrated-in-sunbelt-cities/70395/>.

<sup>5</sup> Binyamin Appelbaum, *Where Housing Once Boomed, Recovery Lags*, N.Y. TIMES, Apr. 3, 2012, at A1.

<sup>6</sup> See generally GEORGE LEFCOE, REAL ESTATE TRANSACTIONS (3d ed. 1999) (explaining the foreclosure process from a real estate finance perspective).

the community beyond the individual homeowner and contribute to a cycle of decline; they “depress home prices, which depress consumer expenditures, which depress employment and income, which heighten the incidence of default and foreclosure, which depresses home prices yet further.”<sup>7</sup> How do we break this cycle?

One potential solution is to focus on the nation’s borrowers who are currently “underwater.”<sup>8</sup> There are twelve million homes nationwide that are underwater—nearly a quarter of all homes with mortgages.<sup>9</sup> Unless these underwater homeowners can restructure their mortgages, between 7.4 million and 9.4 million of them are in danger of defaulting over the next six years.<sup>10</sup>

Lack of collective action between borrowers, lenders, servicers, and government actors is at the root of the problem. There is gridlock when so many stakeholders are involved in any one residential mortgage.<sup>11</sup> Due to their inability to work together and communicate to serve the best interests of all actors, the heavy weight of excessive debt remains.<sup>12</sup> The economy as a whole is left with “the wreckage of trillions of dollars of household debt that cannot

---

<sup>7</sup> Robert Hockett, *Six Years On and Still Counting: Sifting Through the Mortgage Mess*, 9 HASTINGS BUS. L.J. 373, 375 (2013) [hereinafter Hockett, *Six Years*].

<sup>8</sup> A house is “underwater” when the value of the house is less than the outstanding principal on the house’s mortgage loan. *See Underwater Mortgage Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/u/underwater-mortgage.asp> (last visited Mar. 5, 2014).

<sup>9</sup> *See* Newsom, *supra* note 3, at 1.

<sup>10</sup> *See* Hockett, *Six Years*, *supra* note 7, at 374.

<sup>11</sup> Gridlock is a result of the “tragedy of the anticommons.” When private property (in this case, residential mortgages) is owned by too many parties, “everybody loses . . . [since too much private ownership] wrecks markets, stops innovation, and costs lives.” MICHAEL HELLER, *GRIDLOCK ECONOMY: HOW TOO MUCH OWNERSHIP WRECKS MARKETS, STOPS INNOVATION, AND COSTS LIVES* 2 (2008).

<sup>12</sup> *See* Robert J. Shiller, *Reviving Real Estate Requires Collective Action*, N.Y. TIMES, June 24, 2012, at BU6 (arguing the inability of creditors to work together maintains high levels of debt).

be repaid.”<sup>13</sup> The national economy, consumer spending, and housing prices all stand to gain if these borrowers are able to refinance their mortgages such that the mortgages reflect the true and fair market value of the property.

This Note evaluates a proposal that aims to overcome this collective action problem by recalibrating the value of underwater mortgages. The earliest version of the proposal was considered by San Bernardino County, California and the city of Richmond, California in partnership with venture capital firm Mortgage Resolution Partners (“MRP”).<sup>14</sup> It attempts to prevent potential foreclosures by reducing the principal on mortgages that are currently underwater, thereby reducing the disparity between the current home value and mortgage principal. By recalibrating the equity for borrowers currently underwater, the municipality would relieve the homeowner from burdensome mortgage payments and would stave off foreclosure. The proposal would use the government’s power of eminent domain to seize underwater mortgages from the financial institutions that hold them, issuing new mortgages to reflect the fair market value of the property.<sup>15</sup> This solution differs from alternative policy proposals in the wake of the mortgage crisis because it empowers local government, the entity most attuned to community issues. By focusing efforts on the hardest-hit areas of the country, resources can be directed in a more efficient manner. Taxpayers will not be involved, and the government will not incur any costs beyond program administration.<sup>16</sup>

---

<sup>13</sup> Newsom, *supra* note 3, at 1.

<sup>14</sup> See generally MORTG. RESOLUTION PARTNERS, HOMEOWNERSHIP PROTECTION PROGRAM: A SOLUTION TO A CRITICAL PROBLEM [hereinafter MRP PROPOSAL], available at <http://online.wsj.com/public/resources/documents/EMINENT-powerpoint.pdf> (outlining MRP’s proposal); Lydia DePillis, *Richmond’s Rules: Why One California Town is Keeping Wall Street Up At Night*, WASH. POST WONKBLOG (Oct. 5, 2013, 11:08 AM), <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/10/05/richmonds-rules-why-one-california-town-is-keeping-wall-street-up-at-night/>.

<sup>15</sup> See MRP PROPOSAL, *supra* note 14.

<sup>16</sup> See *id.* at 4.

---

---

This Note will evaluate and analyze the constitutional and policy arguments for and against the proposal. In addition, it will focus on San Bernardino County and Richmond, California as case studies of the potential effects of the proposal.<sup>17</sup> Part II will explain how so many borrowers came to possess underwater mortgages and why this is problematic. Part III will outline the law surrounding limitations on eminent domain and Part IV will explain the proposal in detail. Part V will evaluate the proposal's legality, addressing existing challenges from the financial sector.

## II. SECURITIZATION OF RESIDENTIAL MORTGAGES

The consequences of the mass foreclosure crisis of the last decade are now familiar. Millions of homeowners have been foreclosed upon,<sup>18</sup> leading to individual hardship and negative externalities, such as increased crime, decreased housing prices, reduced tax revenue, and decreased social capital.<sup>19</sup> The U.S. mortgage markets remain one of the principal drags upon economic recovery.<sup>20</sup> Then-Federal

---

<sup>17</sup> It is currently unclear whether San Bernardino County will adopt the proposal. MRP is also approaching other cities with its proposal. Telephone Interview with Robert Hockett, Professor, Cornell Law School (Apr. 12, 2013).

<sup>18</sup> In February 2009, 290,631 U.S. properties were foreclosed on, up thirty percent from February 2008 and six percent from January 2009. This marks the third highest total since RealtyTrac began reporting foreclosure figures in January 2005. See John P. Hunt 1 (Mar. 25, 2009) (unpublished paper) available at <http://ssrn.com/abstract=1369286>.

<sup>19</sup> "A high foreclosure rate creates negative externalities for communities. Foreclosures impose new costs on communities, as foreclosed properties are often magnets for crime and fire; push down the price of neighboring properties; and reduce property tax revenue for local governments. Foreclosures also have unquantifiable costs as debtors' relocation affects social relationships. Foreclosures have even been linked to public health problems . . ." Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1125 (2009).

<sup>20</sup> See Hockett, *Six Years*, *supra* note 7, at 374.