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COMMENT

EMINENT DOMAIN FOR THE SEIZURE OF UNDERWATER MORTGAGES

Sarah Thompson*

Like many cities in the United States, Richmond, California suffered greatly from the recent mortgage crisis. The foreclosure crisis hit Richmond hard in 2009, when more than 2,000 homes in Richmond went into foreclosure.¹ This figure is especially shocking given that there were 18,659 owner-occupied housing units in the city at that time.² In 2012, the city saw an additional 914 foreclosures and a foreclosure rate of thirty out of 1,000 homes (well above the national average of thirteen of every 1,000 homes).³ Today, it is reported that nearly forty-six percent of homes in Richmond are “underwater,” meaning that what is owed on the mortgage is more than the current value of the property.⁴ Seeking to put an end to the foreclosures, the City of Richmond announced a plan on July 30, 2013 to use the power of eminent domain to buy underwater mortgages from lenders.⁵ The city plans to buy the mortgages for eighty percent of a home’s current value, a price they believe is high enough to amount to the just compensation that is required by the Fifth Amendment’s

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1. KRIS HARTLEY, RICHMOND EQUITABLE DEVELOPMENT INITIATIVE, TRANSFORMING THE HOUSING CRISIS IN RICHMOND 4 (2009).

2. *City of Richmond*, BAY AREA CENSUS, <http://www.bayareacensus.ca.gov/cities/Richmond.htm> (last visited Sept. 10, 2013).

3. Robert Rogers, *Richmond Mortgage Crisis: By the Numbers*, CONTRA COSTA TIMES (May 25, 2013, 12:00 PM), http://www.contracostatimes.com/ci_23317434/richmond-mortgage-crisis-similar-yet-unique-within-nationwide.

4. E. Scott Reckard, *Richmond Plan to Seize Underwater Loans Faces Key Challenges*, L.A. TIMES (Sept. 10, 2013, 3:13 PM), <http://www.latimes.com/business/money/la-fi-mo-richmond-eminent-domain-mortgages-20130910,0,2114249.story>.

5. Les Christie, *California city’s drastic foreclosure remedy: Seizure*, CNN MONEY (July 30, 2013, 2:28 PM), http://money.cnn.com/2013/07/30/real_estate/richmond-underwater-homes/.

protection against the taking of private property.⁶ Richmond would then convert the acquired mortgages into FHA loans with smaller principals that correspond with the current value of the home.⁷ FHA loans are insured against default by the Federal Housing Authority (a section of the United States Department of Housing Development) and are issued by private, FHA-approved lenders. On August 7, 2013, several banks representing the bond investors that owned these underwater mortgages filed suit against the city, challenging the plan's constitutionality. Given the current state of eminent domain law, which allows for eminent domain to be exercised for the public purpose of economic development, some argue that Richmond's plan passes constitutional scrutiny.⁸ However, this use pushes the boundaries of legitimate exercise of eminent domain, even under the majority opinion in *Kelo v. City of New London, Conn*, which confirmed that economic development is proper grounds for states to exercise eminent domain.⁹

Upholding the constitutionality of the Richmond plan would be inconsistent with the purpose of the doctrine of eminent domain, which allows for taking of private land for public use. Furthermore, such a move would animate the fears voiced by the critics of the Supreme Court's decision in *Kelo v. City of New London, Conn*, including the concern that eminent domain would be used to disproportionate advantage certain individuals with little justifiable public benefit.¹⁰ Finally, Richmond's particular use of eminent domain may lead to lender backlash as lenders may increase the rates on mortgages in cities that have used eminent domain in order to hedge against the risk of government seizure.

6. Jacob Gershman, *Is Mortgage Seizure Plan a Win-Win or Lose-Win?*, WSJ L. BLOG (Aug. 8, 2013, 10:24 AM), <http://blogs.wsj.com/law/2013/08/08/is-mortgage-seizure-plan-a-win-win-or-lose-win/>.

7. Marc Joffe, *Richmond, CA's Eminent Domain Mortgage Scheme Could Set An Ugly National Precedent*, FORBES (Sept. 5, 2013, 8:00 AM), <http://www.forbes.com/sites/realpin/2013/09/05/richmond-cas-eminent-domain-mortgage-scheme-could-set-an-ugly-national-precedent/>.

8. See *Kelo v. City of New London, Conn.*, 545 U.S. 469, 474 (2005).

9. *Id.* at 484.

10. *Id.* at 483; Charles E. Cohen, *Eminent Domain After Kelo v. City of New London: An Argument for Banning Economic Development Takings*, 29 HARV. J.L. & PUB. POL'Y 491, 544 (2006) ("[T]here is always a risk that the claimed public benefit relied upon to justify the taking is 'merely incidental' to the true benefits accruing to the benefited private transferee; in other words, 'that the underlying program is . . . a ruse.'").

In response to Richmond's proposed course of action, state legislatures should amend eminent domain laws to prohibit the use of eminent domain to buy underwater mortgages. Instead of using the power of eminent domain to solve the foreclosure problem, states should approach lenders with moral-hazard-reducing principal reduction plans for homeowners who are on the edge of default and demonstrate inability to pay. These plans would include features that will reduce the risk that homeowners nearing foreclosure will cease making mortgage payments once they believe that the government will buy and refinance their loan. This plan would provide a fix for those on the verge of default.

I. Background

A. *The Mortgage Crisis*

The early 2000s saw a boom in the housing markets and rapid growth in subprime mortgage lending. In fact, the yearly percentage of subprime mortgages of all mortgages issued increased from nearly eight percent in 2003 to twenty percent in 2006.¹¹ Many see the boom in subprime mortgage lending as the central cause of the housing crisis.¹² Subprime loans, because they are loans made to individuals with poor credit history, demonstrate a higher risk of default than prime loans made to borrowers with better credit.¹³ Thus, these loans are given higher interest rates to hedge against the increased risk of default. Many agree that a pattern of deregulation and predatory lending practices led to unhealthy growth of the subprime mortgage market.¹⁴ With increased access to mortgages came increased demand for housing and home prices were artificially inflated.

11. Raymond H. Brescia, *Capital in Chaos: the Subprime Mortgage Crisis and the Social Capital Response*, 56 CLEV. ST. L. REV. 271, 282 (2008).

12. See, e.g., Richard E. Gottlieb & Vivian I. Kim, *Eminent Domain: Will Local Governments Attempt to Use This Extraordinary Power to Purchase Troubled Residential Mortgages?*, BANKING & FIN. SERVICES POL'Y REP., 1, 2 (Nov. 2012).

13. Subprime loans are classified in contrast to Prime loans, where borrowers match credit history requirements set out by the Government Sponsored Enterprises (GSE) like Fannie Mae and Freddie Mac. Adam B. Ashcraft, Til Schuermann, FED. RES. BANK OF N.Y., STAFF REP. NO. 318, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 2 (2008).

14. See, e.g., Brescia, *supra* note 11, at 288.

In late 2007, the housing bubble burst.¹⁵ Home prices plummeted and foreclosure rates skyrocketed as owners either failed to make the high payments that they had agreed to or chose to walk away from homes that were now worth far less than the money owed on the home's mortgage. As a result, Richmond and similar cities suffer from a glut of empty, bank-owned homes. These vacant homes are a breeding ground for crime and negatively affect the value of neighboring properties.¹⁶ In order to keep homes with underwater mortgages from joining the stock of vacant properties, Richmond proposed to use eminent domain to buy and refinance underwater mortgages.

B. Current State of Eminent Domain Law

The Fifth Amendment of the United States Constitution states that private property shall not “be taken for public use, without just compensation.”¹⁷ Courts have struggled to determine what exactly constitutes a “public use.”¹⁸ The court rejected the idea that the public use means that the seized property must actually be used by the general public.¹⁹ Since the early 1900s, the Supreme Court has equated the concept of public use with the broader idea that property can be taken for a public purpose.²⁰ In *Berman v. Parker*, the Court upheld the constitutionality of the District of Columbia Redevelopment Act.²¹ This plan, where Congress used eminent domain to acquire private, blighted property in order to

15. Jeff Holt, *A Summary of the Primary Causes of the Housing Bubble and the Resulting Credit Crisis: A Non-Technical Paper*, 8 J. BUS. INQUIRY 120, 126 (2009) (“Home prices reached their peak in the 2nd quarter of 2006 . . . foreclosure start rates increased . . . by 75 percent in 2007 compared to 2006.”).

16. Lydia DePillis, *Wall Street has so far Crushed a Drastic Foreclosure Fix: One California Town Could Change That*, WASH. POST WONKBLOG (Sept. 10, 2013; 11:45 AM), <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/09/10/wall-street-has-so-far-crushed-a-drastic-foreclosure-fix-one-california-town-could-change-that/>.

17. U.S. CONST. amend. V. The fifth amendment was incorporated as against the states in land without just compensation in *Chicago, B. & Q.R. Co. v. City of Chicago*, 166 U.S. 226, 241 (1897).

18. Lynn E. Blais, *Urban Revitalization in the Post-Kelo Era*, 34 FORDHAM URB. L.J. 657, 661 (2006).

19. *Strickley v. Highland Boy Gold Min. Co.*, 200 U.S. 527, 531 (1906) (“In discussing what constitutes a public use, it recognized the inadequacy of use by the general public as a universal test.”)

20. *See*, *Mt. Vernon-Woodberry Cotton Duck Co. v. Ala. Interstate Power Co.*, 240 U.S. 30, 32 (1916) (equating “public use” and “public purpose” by stating, “If that purpose is not public, we should be at a loss to say what is. The inadequacy of use by the general public as a universal test is established.”).

21. *Berman v. Parker*, 348 U.S. 26, 36 (1954).

redevelop or sell the land to private developers, was deemed to serve a public purpose.²² In *Hawaii Hous. Auth. v. Midkiff*, the Court held that the Hawaii Land Reform Act's practice of breaking up large estates by using eminent domain to purchase and then sell land to individuals who had held leases to small portions of the large estates qualified as a public purpose.²³

Relying on *Berman* and *Midkiff*, the Supreme Court, in the controversial *Kelo v. City of New London, Conn.*, affirmed the City of New London, Connecticut's development plan that would pass real property from a private owner to a private developer.²⁴ The Court held that the city had "carefully formulated an economic development plan that it believes will provide appreciable benefits to the community, including—but by no means limited to—new jobs and increased tax revenue."²⁵ The broad public use definition applied in *Kelo* is consistent with prior applications by the Court.²⁶ However, critics of the *Kelo* decision found it unsettling that private actors could disproportionately gain from the use of eminent domain, whereby land is only supposed to be taken for public use or purpose, and could possibly do so based on political influence.²⁷

Kelo, explicitly and implicitly, asked for a state legislative reaction. Justice Stevens wrote in the majority opinion that "nothing in our opinion precludes any State from placing further restrictions on its exercise of the takings power."²⁸ Today, forty-three states have enacted post-*Kelo* statutes to limit their use of eminent domain.²⁹ Statutory reactions to *Kelo* have varied. For example, the Michigan legislature amended its constitution in 2006 to expressly state that "[p]ublic use' does not include the taking of private property for transfer to a private entity for the purpose of economic development or enhancement of tax

22. *Id.* at 32 ("Subject to specific constitutional limitations, when the legislature has spoken, the public interest has been declared in terms well-nigh conclusive.").

23. *Haw. Hous. Auth. v. Midkiff*, 467 U.S. 229, 233 (1984).

24. *Kelo v. City of New London, Conn.*, 545 U.S. 469, 474 (2005).

25. *Id.* at 483.

26. Corinne Calfee, *Kelo v. City of New London: The More Things Stay the Same, the More They Change*, 33 *ECOLOGY L.Q.* 545, 567 (2006).

27. Carol L. Zeiner, *Eminent Domain Wolves in Sheep's Clothing: Private Benefit Masquerading as Classic Public Use*, 28 *VA. ENVTL. L.J.* 1, 21 (2010).

28. *Kelo*, 545 U.S. at 489.

29. *Enacted Legislation Since Kelo*, CASTLE COALITION, http://www.castlecoalition.org/index.php?option=com_content&task=view&id=510 (last visited Sept. 10, 2013).

revenues.”³⁰ California experienced more moderate reforms with comparably broad blight exceptions for the use of eminent domain to seize properties in areas of poor economic health.³¹ This blight exception allows for seizure of properties in the name of economic development, if the property meets certain physical conditions, like “incompatible land uses that prevent the development of those parcels or other portions of the project area” and economic criteria, such as “[d]epreciated or stagnant property values,” and “[a]bnormally high business vacancies.”³²

III. Using Eminent Domain to Purchase Underwater Mortgages is Inconsistent with the Public Purpose Test

Based on *Kelo’s* expansive definition of public purpose Richmond’s plan arguably may pass constitutional muster. Helping individuals avoid foreclosure may reduce community crime rates, limit the price deflationary impact that vacant homes have on a community, and help the community appear economically viable to potential investors. These goals are consistent with *Kelo’s* holding that “[p]romoting economic development is a traditional and long-accepted governmental function, and there is no principled way of distinguishing it from the other public purposes.”³³

However, this plan represents an extension of eminent domain that would disproportionately benefit a few homeowners and private investors in a way that is inconsistent with eminent domain’s purpose and with the public benefit test. In his majority opinion in *Kelo*, Justice Stevens wrote that deferential, rational basis review of states’ use of eminent domain “does not . . . alter the fact that transfers intended to confer benefits on particular, favored private entities, and with only incidental or pretextual public benefits, are forbidden by the Public Use Clause.”³⁴ The use of eminent domain to target a few individual homeowners and a private investment company flirts with this idea of “favored private entities” because, through this plan, the city is targeting a

30. MICH. CONST. art. X, § 2.

31. Ilya Somin, *Is Post-Kelo Eminent Domain Reform Bad for the Poor?*, 101 NW. U. L. REV. 1931, 1934 (2007).

32. Ilya Somin, *The Limits of Backlash: Assessing the Political Response to Kelo*, 93 MINN. L. REV. 2100, 2132 (2009) (discussing California Senate Bill 1206).

33. *Kelo*, 545 U.S. at 470.

34. *Id.* at 490.

few underwater mortgages under the guidance of Mortgage Resolution Partners (MRP), a private investment group. The city and MRP are picking winners and losers, and there is evidence that this selectivity is not wholly based on targeting blighted areas, as the plan includes the condemnation of mortgages on homes worth over a million dollars.³⁵ States and local governments should not be allowed to target a few lucky individuals who are selected to have their mortgage payments reduced. This plan will benefit few homeowners who are on the edge of default, but any general public purpose is merely secondary.

MRP also seeks to benefit substantially from this plan. MRP will pay the upfront cost of buying the mortgages and will charge \$4,500 to refinance each condemned mortgage.³⁶ On top of this fee, the investment group will also profit from the refinanced loans. For example, it has been speculated that the purchase of a \$300,000 mortgage on a home now worth \$150,000 may yield around \$25,000 in profit to be split by the city and MRP.³⁷ Profit to this multi-state private enterprise does not serve an actual public purpose. Although *Kelo* affirmed that eminent domain could be used to pass property to private developers, there must be some underlying public purpose at the end.³⁸ Here, the purported public purpose at the base of MRP's plan is secondary to the disproportionate gains felt by a few homeowners.

IV. This Use of Eminent Domain will Cause Negative Practical Repercussions

It is very likely that this plan will bring negative repercussions for future investors who seek to borrow money from banks to mortgage properties located in cities that have used eminent domain in this way. Banks may be hesitant to give loans in areas where mortgages have been seized by eminent domain, or they might still give out loans but at higher interest rates in order to

35. Carolyn Said, *Pricey Homes in Richmond's Eminent Domain Plan*, S.F. CHRONICLE (Aug. 20, 2013, 4:56 PM), <http://www.sfgate.com/business/article/Pricey-homes-in-Richmond-s-eminant-domain-plan-4745146.php>.

36. *Id.*

37. Nick Timiraos & Jeannette Neumann, *Richmond's Seizure Plan Complicated by Size of Mortgages*, WALL ST. J. (Aug. 14, 2013, 7:04 PM), <http://blogs.wsj.com/moneybeat/2013/08/15/richmonds-seizure-plan-complicated-by-size-of-mortgages/>.

38. *Kelo*, 545 U.S. at 478.

combat the risk of government seizure.³⁹ One Security Industry and Financial Markets Association (SIFMA) executive commented that “the use of eminent domain confronts lenders and investors with an unquantifiable new risk, which will reduce the amount of credit available to potential homeowners.”⁴⁰ If enough governments seek to use eminent domain in this way “it is possible that lenders would react by changing the terms of housing credit nationwide, rather than focusing a reaction on individual communities.”⁴¹

Finally, the Richmond plan induces moral hazard. If the City of Richmond acts in this capacity, then homeowners who are underwater on their mortgages may stop making payments in the hopes that the government will seize and refinance their mortgage. Other refinance options (discussed below) may be available to reduce the moral hazard that may create incentives for owners to avoid default.

V. Recommended Reforms

A. States Should Ban the Use of Eminent Domain for Purchasing Private Mortgages

First, in order to regulate the use of eminent domain proposed by the City of Richmond, state legislatures should modify state eminent domain law to prohibit seizure mortgages. State legislation should indicate, using the following model language, that “in order to ensure that the public purpose behind eminent domain is served, eminent domain shall not be used for the purchase of individual homeowner mortgages.” Although states have passed post-*Kelo* eminent domain reform, they have not specifically addressed the potential use at issue in Richmond.⁴² It is evident that this use is inconsistent with the public purpose test and will be harmful to mortgage owners if applied.

39. Ngai Pindell, *Nevada's Residential Real Estate Crisis: Local Governments and the Use of Eminent Domain to Condemn Mortgage Notes*, 13 NEV. L.J. 888, 902 (2013).

40. Gottlieb, *supra* note 12, at 6 (quoting Press Release, SIFMA, SIFMA Opposes Use of Eminent Domain; Will Cause Irreparable Damage to Recovering Housing Market (Sept. 7, 2012), available at <http://www.sifma.org/news/news.aspx?id=8589940215>).

41. Pindell, *supra* note 39, at 902.

42. *Id.* at 898.

State legislatures are in the best position to install this ban on the use of eminent domain to purchase private mortgages. First, states are experienced in and familiar with the eminent domain issues facing a post-*Kelo* world. It would be sensible and relatively simple for them to incorporate the proposed limit into their existing post-*Kelo* regulatory framework. Second, regulating this issue on the state level will allow for states to ban this use of eminent domain that is inconsistent with the public purpose test, while maintaining legitimate uses of eminent domain for blight removal and other public purposes based on each state's priorities. Finally, eminent domain falls within the state's police power.⁴³ The state is in the best position to operate its police power, within the federal Constitutional limits. The Supreme Court recognizes this in their eminent domain jurisprudence by instituting a "longstanding policy of deference" to state and local legislatures to operate within the doctrines Constitutional limits.⁴⁴

B. States Should Approach Banks with Moral-Hazard Reducing Principal Reduction Plans

Although this Comment does not address the broader policy reforms that are necessary to ensure that the mortgage crisis does not occur again, it is obvious that forward-looking reform of predatory lending practices, loan securitization markets, and individual borrowing requirements need to be implemented.

Within the scope of this Comment's proposed reform is the immediate effect that the Richmond plan seeks to effectuate: helping those who are already underwater on their mortgages. This is an important goal, as underwater mortgages default at a higher rate, suffer the greatest losses at liquidation, and negatively impact both local and large economies.⁴⁵

The Richmond plan is right in that principal reduction is the key to helping homeowners on the edge of default. It is evident that many of the homes with underwater mortgages will not regain their bubble-level prices.⁴⁶ For mortgages on the edge of

43. Robert Hockett, *It Takes A Village: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Local Economic Recovery*, 18 STAN. J.L. BUS. & FIN. 121, 160 (2012).

44. *Kelo v. City of New London, Conn.*, 545 U.S. 469, 480 (2005).

45. Hockett, *supra* note 43, at 135.

46. *Id.* at 136.

default, held by those who can demonstrate an inability to pay, principal reduction would offer a mutually beneficial solution for banks and homeowners.⁴⁷ Often banks will collect more from payments on reduced mortgages than they would collect if homeowners walked away from their underwater mortgage. Especially given low home prices, low demand, and glut of foreclosed houses in cities like Richmond, it is unlikely that banks will be able to quickly resell foreclosed homes.⁴⁸ Homeowners stand to gain because they will be able to stay in their homes, with a more feasible mortgage payment.

Approaching banks with moral-hazard reducing principal reduction agreements, as well as political pressure from state legislatures, could lead to principal reduction without distorting eminent domain. Such principal reduction agreements have been made in the past, but only on a small scale.⁴⁹ Banks will be more likely to agree to principal reduction under moral-hazard reducing schemes because they are currently hesitant to decrease principals for some individuals out of the fear that others will cease payments of their mortgage in the hopes of securing a principal reduction. A plan that would reduce this risk is one that allows for a gradual reduction of the principal, contingent on steady payments being made.⁵⁰ This contingency reduction encourages homeowners to make payments and provides lenders with some insurance of the borrower's intention to pay. Another plan includes a "shared equity plan," such that the principal is decreased but the bank can stand to recover a portion of the value if the price of the property increases in the future.⁵¹

47. Yuki Noguchi, *Fannie, Freddie Won't Write Down Mortgage Principal*, NPR (Feb. 29, 2013, 5:40 PM), <http://www.npr.org/2012/02/29/147635014/fannie-freddie-wont-write-down-mortgage-principal>.

48. *Id.* (Discussing how banks "make the decision that refinance and principal reduction is more financially advantageous to them than foreclosure or short sale").

49. An agreement with the five largest banks and the government led to a twenty billion dollar reduction in principals, but represented a mere, "drop in the bucket" compared with the approximately \$700 billion in negative equity that Americans carry on their homes." Scott Neuman, *The Mortgage Deal: A Reality Check*, NPR (Feb. 9, 2012, 4:19 PM), <http://www.npr.org/2012/02/09/146654318/the-mortgage-deal-a-reality-check>.

50. Nin-Hai Tseng, *3 Ways to Write Down Mortgages Without Moral Hazard*, CNN MONEY (Mar. 28, 2012, 11:57 AM), <http://finance.fortune.cnn.com/2012/03/28/principal-mortgage-reduction/>.

51. *Id.*

Politicians should approach both Government Sponsored Enterprises (GSE) Fannie Mae and Freddie Mac, which are privately owned banks that operate under a congressional charter for a public purpose (to provide liquidity, stability and affordability to targeted areas of the mortgage market) and other private banks.⁵² GSEs hold a number of mortgages that could be written down.⁵³ Last year, GSE banks declared that they would not allow for principal reduction but would instead opt for alternative loan restructuring methods.⁵⁴ However, approaching GSEs and other banks with moral-hazard reducing schemes might incentivize them to agree to reductions for those who can demonstrate inability to pay. Banks will be more likely to agree to schemes that protect against the risk of massive defaults in reliance on reduction, just as they are more likely to agree to plans like the contingent reduction arrangement or the shared equity plan that give banks a greater chance of making more money in the long-run. Also, forcing borrowers to prove inability to pay and keeping them on the hook for reasonable payments consistent with the value of the home reduces the risk that others borrowers will strategically stop payments in hopes of getting a smaller principal. Finally, lenders will be more inclined to give principal reductions if there is a lesser chance that homeowners will cease payment in reliance on a government initiated refinance plan.

VI. Conclusion

There is no doubt that relief is required for cities like Richmond. However, the use of eminent domain to purchase mortgages is not the proper method to solve the foreclosure crisis. Using eminent domain to buy individual homeowner mortgages benefits a few homeowners and investors disproportionately, making the public benefit secondary. Also, a plan like Richmond's may backfire and cause more harm than good by inadvertently facilitating more restrictions and high interest rates on loans given in areas that have employed loan-seizure plans. Local leaders in areas disproportionately affected by the housing crisis should channel the political power of their state or national

52. *Government Sponsored Enterprises*, FEDERAL HOUSING FINANCE AUTHORITY, <http://www.fhfa.gov/Default.aspx?Page=33> (last visited Sept. 22, 2013).

53. Hockett, *supra* note 43, at 144.

54. Noguchi, *supra* note 47.

legislators to approach banks with moral-hazard-reducing, principal-reduction plans. Perhaps the Richmond plan will shed light on the dire state of foreclosure-heavy cities and help give municipalities the political pressure necessary to negotiate principal-reduction plans with banks.