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## The Constitutionality of Using Eminent Domain to Condemn Underwater Mortgage Loans

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## NOTE

### THE CONSTITUTIONALITY OF USING EMINENT DOMAIN TO CONDEMN UNDERWATER MORTGAGE LOANS

*Katharine Roller\**

*One of the most visible and devastating components of the financial crisis that began in 2007 and 2008 has been a nationwide foreclosure crisis. In the wake of ultimately ineffective attempts at federal policy intervention to address the foreclosure crisis, a private firm has proposed that counties and municipalities use their power of eminent domain to seize “underwater” mortgage loans—mortgage loans in which the debt exceeds the value of the underlying property—from the private securitization trusts that currently hold them. Having condemned the mortgage loans, the counties and municipalities would reduce the debt to a level below the value of the property and then sell the new loans to private investors. This Note contends that while the condemnation of “underwater” mortgage loans is likely constitutional under the Takings Clause of the Fifth Amendment to the U.S. Constitution, it would likely not survive an Article I Contracts Clause challenge, despite the moribund nature of Contracts Clause jurisprudence over the last half-century.*

#### TABLE OF CONTENTS

INTRODUCTION .....	140
I. THE MORTGAGE SEIZURE AND REFINANCE PLAN .....	141
A. <i>The Foreclosure Crisis</i> .....	142
B. <i>The Strategy and Structure of the Plan</i> .....	144
II. CONSTITUTIONALITY UNDER THE TAKINGS CLAUSE .....	148
A. <i>Conceivable Public Purpose</i> .....	149
B. <i>Rational Relationship to Public Purpose</i> .....	152
III. CONSTITUTIONALITY UNDER THE CONTRACTS CLAUSE .....	152
A. <i>Relevance of the Contracts Clause</i> .....	154
B. <i>Degree of Impairment</i> .....	155
C. <i>Significant and Legitimate Public Purpose</i> .....	157
D. <i>Necessity and Proportionality</i> .....	158
CONCLUSION .....	161

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## INTRODUCTION

The 2007–2008 financial crisis caused foreclosures to skyrocket from a precrisis average of 252,000 per year<sup>1</sup> to more than 900,000 in 2009.<sup>2</sup> The federal government’s attempts to solve this wave of foreclosures failed to provide meaningful relief to either individual homeowners or the struggling housing market.<sup>3</sup> As a result, the number of foreclosures rose even higher—to more than one million in 2010<sup>4</sup>—before falling slightly to more than 860,000 between March 2011 and March 2012.<sup>5</sup> As of January 2012, another 1.4 million homes were in the process of foreclosure, moving through the pipeline to join the 3.3 million homes that have gone into foreclosure since the crisis began.<sup>6</sup>

Federal policy failures, however, do not limit the creativity of local governments.<sup>7</sup> In 2011, the private investment firm Mortgage Resolution Partners approached San Bernardino County, one of the counties hit hardest by the foreclosure crisis, proposing an unusual solution that the county could implement without the federal government.<sup>8</sup> Its proposal targeted “underwater” home loans, loans in which the outstanding balance is greater than the value of the real estate that secured the debt. Local governments would use eminent domain to seize these loans from the financial institutions that hold them. They would then cut the debt to 95 percent of the value of the real estate and sell the loans to select private investors. The firm claimed that this plan would be everything federal efforts were not: flexible, cheap, aimed at underwater homeowners, indifferent to moral hazard, and not premised on loan holders’ voluntary compliance.<sup>9</sup>

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1. See Teresa Mears, *Foreclosure Rate Declining but Still High*, MSN REAL ESTATE (Dec. 5, 2012, 6:36 AM), <http://realestate.msn.com/blogs/listedblogpost.aspx?post=86125cd7-7098-4322-8ad7-e2e7b7d76f82&ref=bfv>.

2. Binyamin Applebaum, *Cautious Moves on Foreclosures Haunting Obama*, N.Y. TIMES, Aug. 19, 2012, at A1, available at <http://www.nytimes.com/2012/08/20/business/economy/slow-response-to-housing-crisis-now-weighs-on-obama.html?pagewanted=all&r=0>.

3. *Id.*; see also Gregory Scott Crespi, *The Trillion Dollar Problem of Underwater Homeowners: Avoiding a New Surge of Foreclosures by Encouraging Principal-Reducing Loan Modifications*, 51 SANTA CLARA L. REV. 153, 178–87 (2011); David Reiss, *Eminently Reasonable*, NAT’L L.J., Sept. 24, 2012, at 35.

4. Applebaum, *supra* note 2.

5. *CoreLogic Reports More Than 860,000 Completed Foreclosures Nationally in the Last Twelve Months*, CORELOGIC (Mar. 15, 2012), <http://www.corelogic.com/about-us/news/corelogic-reports-more-than-860,000-completed-foreclosures-nationally-in-the-last-twelve-months.aspx>.

6. *Id.*

7. See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

8. Ben Hallman, *San Bernardino Eminent Domain Fight Closely Watched by Other Struggling Communities*, HUFFINGTON POST (Sept. 1, 2012, 4:25 PM) (updated Sept. 25, 2012, 3:29 PM), [http://www.huffingtonpost.com/2012/09/01/eminent-domain-mortgages\\_n\\_1836710.html](http://www.huffingtonpost.com/2012/09/01/eminent-domain-mortgages_n_1836710.html); see also *New State Ice Co.*, 285 U.S. at 311 (Brandeis, J., dissenting); Reiss, *supra* note 3.

9. See Joe Nocera, Op-Ed., *Housing’s Last Chance?*, N.Y. TIMES, July 10, 2012, at A21, available at <http://www.nytimes.com/2012/07/10/opinion/nocera-housings-last-chance.html>;

A number of localities have publicly considered adopting this plan to condemn underwater loans (“the Plan”), or some variation of it, since the firm first pitched it to counties and municipalities in California’s Inland Empire. San Bernardino County was the first to consider adopting the Plan,<sup>10</sup> although it later decided against doing so;<sup>11</sup> Chicago and Sacramento, among others, have also taken steps toward implementing the Plan.<sup>12</sup> Recently, Richmond, California became the first city to begin implementing the Plan, and a coalition of investors has already filed suit against the city.<sup>13</sup>

This Note argues that seizing underwater mortgage loans, although a constitutional exercise of the power of eminent domain, is unconstitutional under the Contracts Clause. Part I describes the conditions that have led local governments to consider the Plan and outlines how the Plan would function. Part II argues that the Plan would likely be constitutional under the Takings Clause because it is a rational response to the problems of blight and market malfunction. Part III, however, considers the Contracts Clause bar to the implementation of the Plan and concludes that the Plan may resurrect this clause from its jurisprudential grave by presenting the first serious Contracts Clause concerns in decades.

#### I. THE MORTGAGE SEIZURE AND REFINANCE PLAN

The Plan is a response to the social and economic conditions created by the financial crisis of 2007–2008. Section I.A provides a brief background of the foreclosure crisis, focusing on the facts and conditions that bear on the constitutional analysis in Parts II and III. Section I.B explains how the Plan

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Robert Hockett, *It Takes a Village: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Economic Recovery* 15–35 (Cornell Law Sch., Research Paper No. 12-12, 2012), available at <http://ssrn.com/abstract=2038029>.

10. See Matthew Goldstein & Jennifer Ablan, *Exclusive: Investors Tout Controversial “Condemnation” for Housing Fix*, REUTERS, June 8, 2012, available at <http://www.reuters.com/article/2012/06/08/us-mortgages-condemnation-housing-idUSBRE85719Z20120608>.

11. Alejandro Lazo, *San Bernardino County Abandons Mortgage Plan*, L.A. TIMES, Jan. 25, 2013, at B3, available at <http://articles.latimes.com/2013/jan/25/business/law-fi-eminent-domain-20130125>.

12. Chi. City Council Res. R2012-695 of the J. Comm. of the Comm. on Fin. & Comm. on Hous. & Real Estate (Chi., Ill. 2012); Hudson Sangree, *Sacramento Area Officials Explore Using Eminent Domain to Aid Underwater Homeowners*, SACRAMENTO BEE, Aug. 11, 2012, at 1A, available at <http://www.sacbee.com/2012/08/11/4715792/sacramento-area-officials-explore.html>.

13. See Alejandro Lazo, *U.S. Warns Against Eminent-Domain Mortgage Seizures*, L.A. TIMES, Aug. 8, 2013, <http://articles.latimes.com/2013/aug/08/business/law-fi-eminent-domain-lawsuit-20130809>; Christopher Matthews, *Feds Say No Way to Using Eminent Domain to Help Underwater Homeowners*, Aug. 9, 2013, TIME, <http://business.time.com/2013/08/09/feds-say-no-way-to-using-eminent-domain-to-help-underwater-homeowners/>. This development occurred shortly before this Note was sent to the printer. A team of investors including Fannie Mae, Freddie Mac, BlackRock, and Bank of New York Mellon has filed suit against the city and its private partner, Mortgage Resolution Partners.

is structured and why its implementation would likely give rise to legal challenges.

### A. *The Foreclosure Crisis*

When housing prices peaked in 2006, the widespread assumption on Wall Street was that they would continue to rise forever.<sup>14</sup> Investors believed, and rating agencies agreed, that securities backed by pools of residential mortgage loans—even subprime loans or loans extended without documentation from borrowers—were safe, attractive investments.<sup>15</sup> When the housing bubble burst and the sudden devaluation of those mortgage-backed securities sparked the financial crisis, the federal government bailed out the banks that had made these bad bets.<sup>16</sup> But the government did not bail out the homeowners who were unable to make their monthly payments.<sup>17</sup> There were several reasons for this—expense, complexity, belief that failing homeowners posed less risk than failing banks, and contempt for homeowners who had lived beyond their means—and perhaps there was no effective and fair way to implement such a program.<sup>18</sup> The result was a national foreclosure crisis that has cost 3.3 million Americans their homes.<sup>19</sup>

Homeowners with subprime loans were the first to default.<sup>20</sup> Some had been targets of predatory or discriminatory lending or even outright fraud, while others had signed documents obligating them to pay loans that they did not understand or did not care to understand.<sup>21</sup> By 2008, the crisis had spread beyond subprime loans.<sup>22</sup> The foreclosures of subprime mortgages had flooded the housing market with vacant homes, which caused prices to plummet. At the same time, the general economic slowdown had wiped out savings and terminated jobs for homeowners who previously could have afforded their monthly payments.<sup>23</sup> Those homeowners, desperate to stave off foreclosure, stopped spending on other things. The depression of consumer spending caused unemployment to rise, which caused more foreclosures and

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14. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 6, 111 (2011) [hereinafter FCIC REPORT], available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

15. See *id.* at 8–9, 18, 44.

16. *Id.* at 373–75.

17. The Home Affordable Modification Program can lower monthly payments and encourage (but not require) principal reduction and short sales, but it does not provide cash aid. See MAKING HOME AFFORDABLE, <http://www.makinghomeaffordable.gov> (last visited Apr. 4, 2013).

18. See Crespi, *supra* note 3; Applebaum, *supra* note 2; Reiss, *supra* note 3.

19. CORELOGIC, *supra* note 5.

20. See Vikas Bajaj & Louise Story, *Mortgage Crisis Spreads Past Subprime Loans*, N.Y. TIMES, Feb. 12, 2008, at A1, available at [http://www.nytimes.com/2008/02/12/business/12credit.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2008/02/12/business/12credit.html?pagewanted=all&_r=0).

21. FCIC REPORT, *supra* note 14, at 6–9, 78, 90, 160–64.

22. Bajaj & Story, *supra* note 20.

23. See *id.*

made it impossible for renters to buy or homeowners to move, further depressing housing prices and causing even more foreclosures.<sup>24</sup>

Underwater homeowners both contributed to and suffered from this cycle. Underwater homeowners cannot sell their houses in the traditional way, since the purchase prices of the homes are not enough to pay off their loans;<sup>25</sup> instead, they must resort to short sales, where the holder of the loan takes the purchase price in full satisfaction of the debt, usually waiving the holder's right to the deficiency.<sup>26</sup> As a mortgage holder that waives the deficiency will have to write off thousands, sometimes tens of thousands or hundreds of thousands, of dollars, many are reluctant to give their permission for a short sale.<sup>27</sup> Many underwater homeowners are therefore trapped in homes that they can neither leave nor refinance, even if they can no longer afford them. It is unsurprising, then, that underwater homeowners are significantly more likely to default and go into foreclosure than homeowners who still have equity in their homes.<sup>28</sup> This creates a vicious circle: underwater homes go into foreclosure, foreclosures drive down the value of nearby homes, and as the value of those nearby homes sinks below the debt owed on them, they, too, go underwater.<sup>29</sup>

The foreclosure crisis is unlikely to end in the next few years, although the foreclosure rate has declined between 2010 and 2012 and will likely gradually continue to do so.<sup>30</sup> One analyst recently estimated that, over the next few years, homeowners will likely default on 17.7 percent of the 52.5 million residential mortgage loans in the United States.<sup>31</sup> Many of those homeowners are likely to default because they are underwater.<sup>32</sup> When those 7.4 to 9.3 million homeowners default, that will only add to the inventory of unsold housing, depressing prices and driving more homeowners underwater and

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24. See FCIC REPORT, *supra* note 14, at 389–90; Li Gan & Qinghua Zhang, *The Market Thickness and the Impact of Unemployment on Housing Market Outcomes*, TEX. A&M UNIV., <http://econweb.tamu.edu/gan/academic/gan-zhang-housing.pdf> (last visited Apr. 4, 2013) (“[B]eing unemployed practically prevents a household from entering the housing market as a buyer.”).

25. See Bajaj & Story, *supra* note 20.

26. Nelse Thompson Miller, *Short Sales Overview with an Emphasis on Broker Issues*, PRAC. REAL EST. LAW., May 2010, at 9, 13.

27. FCIC REPORT, *supra* note 14, at 406.

28. See Joe Nocera, Op-Ed., *To Fix Housing, See the Data*, N.Y. TIMES, Nov. 5, 2011, at A19, available at <http://www.nytimes.com/2011/11/05/opinion/to-fix-the-housing-crisis-read-the-data.html>.

29. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-34, VACANT PROPERTIES: GROWING NUMBER INCREASES COMMUNITIES' COSTS AND CHALLENGES 48 (2011) [hereinafter GAO].

30. See CORELOGIC, *supra* note 5.

31. *Strengthening the Housing Market and Minimizing Losses to Taxpayers: Hearing Before the Subcomm. on Hous., Transp., & Cmty. Dev. of the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 31 (2012) (statement of Laurie S. Goodman, Senior Managing Director, Amherst Securities), available at <http://www.gpo.gov/fdsys/pkg/CHRG-112shrg76281/pdf/CHRG-112shrg76281.pdf>.

32. See *id.*

therefore closer to default.<sup>33</sup> The light at the end of the tunnel is a long way off.

A variety of players hold mortgage loans: Fannie Mae and Freddie Mac hold the largest number, accounting for 23% and 13% of home mortgage debt, respectively.<sup>34</sup> Banks and other major financial institutions hold another 33%, and other investors—such as individuals and credit unions—hold 7%.<sup>35</sup> Finally, governmental and private pools or trusts hold 22% of home mortgage debt. Private securitization trusts, specifically, hold 12% of all home mortgage debt.<sup>36</sup> Private securitization trusts are the entities that administer mortgage-backed securities. The trustees that operate these trusts oversee a pool of mortgage loans on behalf of a group of investors who buy securities from the trust on the strength of the loans in the trust's portfolio.<sup>37</sup> Usually the day-to-day administration of the loans in the collateral pool is handled by a loan servicer, a business that specializes in processing payments and collecting on delinquent loans.<sup>38</sup> Loans held by private securitization trusts or other private investors are three times as likely to be underwater as loans held by Fannie or Freddie.<sup>39</sup>

#### B. *The Strategy and Structure of the Plan*

There is a growing consensus that principal reduction—permanently reducing the amount of a loan's outstanding principal balance—is key to stemming the flood of foreclosures.<sup>40</sup> It is the most effective modification strategy for the long term because it takes account of the new economic realities that families face, such as permanently lower wages and long-term unemployment or underemployment.<sup>41</sup> And only principal reduction addresses the vicious circle of underwater homes driving down the value of nearby properties until they, too, go underwater.<sup>42</sup> Indeed, in the fourth quarter of 2012, principal reduction was used in more than one-third of modifications to loans held in bank portfolios, which have more flexibility in

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33. See *id.*; Nocera, *supra* note 28.

34. *Mortgage Debt Outstanding*, BOARD GOVERNORS FED. RES. SYS. (Dec. 2012), <http://www.federalreserve.gov/econresdata/releases/mortoutstand/mortoutstand20121231.htm>.

35. *Id.*

36. *Id.*

37. See FCIC REPORT, *supra* note 14, at 42–43.

38. See *Making Payments to Your Mortgage Servicer*, FED. TRADE COMMISSION (June 2010), <http://www.ftc.gov/bcp/edu/pubs/consumer/homes/rea10.shtm>.

39. Hallman, *supra* note 8. The distressed state of most trusts' portfolios can be attributed largely to the fact that Fannie and Freddie were less willing to buy subprime and other risky loans than were private securitization trusts. See FCIC REPORT, *supra* note 14, at xxvi.

40. JOHN GRIFFITH & JORDAN EIZENGA, CTR. FOR AM. PROGRESS, SHARING THE PAIN AND GAIN IN THE HOUSING MARKET 1, 10–14 (2012), [http://www.americanprogress.org/wp-content/uploads/issues/2012/03/pdf/principal\\_reductions.pdf](http://www.americanprogress.org/wp-content/uploads/issues/2012/03/pdf/principal_reductions.pdf); see also Laurie Goodman et al., *The Case for Principal Reductions*, J. STRUCTURED FIN., Fall 2011, at 29, 31–32.

41. GRIFFITH & EIZENGA, *supra* note 40, at 1, 7.

42. See Goodman et al., *supra* note 40, at 37–38.

modifying loans than do securitization trusts.<sup>43</sup> Principal reduction is thus usually in the best interest of all parties.<sup>44</sup> While the benefits to homeowners and the local economy are obvious, the holder of the mortgage loan also benefits.<sup>45</sup> A homeowner who makes payments renders his loan a performing asset—a steady source of cash. By contrast, a vacant home eats up the note holder's money in taxes, insurance, utilities, maintenance, and inspections, while providing no income.<sup>46</sup> If the trust forecloses on the mortgage, the foreclosure itself can cost up to \$50,000, according to one estimate.<sup>47</sup>

Why is principal reduction so rare, then? For loans held in private securitization trusts, the structure of the securitization agreement itself can often restrict the ability of the servicer or the trustee to modify loans, even when it would be in the best interest of investors to do so.<sup>48</sup> The agreements also set up a fee system for the servicers who administer the loans, and that system creates perverse incentives for the servicer to avoid principal reduction in order to keep the homeowner in default and ultimately to foreclose.<sup>49</sup> For example, many servicers are paid a percentage of the outstanding principal on their serviced loans, which means that principal reduction has a direct negative effect on their compensation.<sup>50</sup>

The Plan would seek both to compensate for that inflexibility and perversity on the part of the private securitization trusts and to profit from it. Although the new, refinanced loans would have a lower face value because the amount of the debt would be slashed, they would theoretically have greater expected value because the homeowner would be more likely to repay that debt. A \$200,000 loan that the homeowner is likely to pay in full is

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43. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, at 28 tbl.20 (2013), available at <http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2012/mortgage-metrics-q4-2012.pdf>; see also Ruth Simon, *Study Buys Mortgage Modification*, WALL ST. J., Apr. 4, 2009, at B2, available at <http://online.wsj.com/article/SB123875775797386333.html> (“Servicers said they have more flexibility to rework loan terms for mortgages they own than for those held by investors.”).

44. Robert J. Shiller, *Reviving Real Estate Requires Collective Action*, N.Y. TIMES, June 24, 2012, at BU6, available at <http://www.nytimes.com/2012/06/24/business/economy/real-estates-collective-action-problem.html>.

45. See *id.*

46. See GAO, *supra* note 29, at 34–35.

47. J. ECON. COMM., 112th CONG., SPECIAL REP. ON SHELTERING NEIGHBORHOODS FROM THE SUBPRIME FORECLOSURE STORM 14 (Apr. 2007).

48. See Will Cejudo et al., *Modifying Residential Mortgage Loans: Tax Consequences for REMICs and REMIC Investors*, 7 J. TAX'N FIN. PRODUCTS, no. 3, 2008, at 41, 42–43 (noting that certain tax provisions in pooling and servicing agreements “effectively prohibit . . . the modification of an existing mortgage loan” in the form of principal reduction). *But see* Karen Weise, *When Denying Loan Mods, Loan Servicers Often Wrongly Blame Investors*, PROPUBLICA (July 23, 2010, 6:50 AM), <http://www.propublica.org/article/when-denying-loan-mods-loan-servicers-often-blame-investors-wrongly> (arguing that the influence of contractual provisions in prohibiting modifications is overrated).

49. Diane E. Thompson, *Foreclosing Modifications: How Servicer Incentives Discourage Loan Modification*, 86 WASH. L. REV. 755 *passim* (2011).

50. *Id.* at 807.



worth more than a \$300,000 loan that he will likely walk away from or be unable to pay. The administrators of private securitization trusts are aware of this trade-off but have been unable or unwilling to pursue principal reduction under the current securitization and servicing agreements.<sup>51</sup> For this reason, Mortgage Resolution Partners decided that its version of the Plan would target only loans held by private securitization trusts;<sup>52</sup> other entities considering the Plan would likely do the same.

The Plan proceeds in several steps. First, the local government enacting the Plan would set up new loan securitization trusts with the help of a private firm. Second, the locality would raise money from private investors. This money would be used to fund the third step: the local government would use its power of eminent domain to condemn the mortgage notes and take control of them from the old securitization trusts,<sup>53</sup> and the private investors' money would pay the old trusts the required "just compensation."<sup>54</sup> At this stage, a court would almost always get involved because the valuation of the loans would likely be disputed.<sup>55</sup>

Once the loans were in the local government's control, the government would write the principal down to some amount below the fair market value of the home to create equity for the homeowner.<sup>56</sup> The government would then transfer the refinanced loans to the new securitization trusts set up by the locality, and the private investors who funded the condemnation phase of the plan would be repaid in shares of the securities backed by the refinanced loans.<sup>57</sup> At the end of the process, the homeowners who were previously underwater would have equity in their homes and reduced monthly

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51. See Hockett, *supra* note 9, at 18.

52. Alejandro Lazo, *Eminent Domain Mortgage Plan Is Targeted*, L.A. TIMES, Sept. 11, 2012, at B1, available at <http://articles.latimes.com/2012/sep/11/business/la-fi-eminent-domain-20120911>.

53. The Plan is generally described as a plan to seize "mortgages," but it is more accurate to say that the locality would seize the note—the loan—secured by the mortgage on the property. Because the mortgage follows the note, the end result is the same: the local government would own both the note and the mortgage that secures it. See U.C.C. § 9-203(g) (2010).

54. U.S. CONST. amend. V. As proposed by Mortgage Resolution Partners, homeowners could choose whether their loans would be considered for the Plan; participation would be completely voluntary. Rick E. Rayl, *Eminent Domain and Underwater Mortgages: Framing the Debate, Part 1*, CAL. EMINENT DOMAIN REP. (July 25, 2012), <http://www.californiaeminentdomainreport.com/2012/07/articles/eminent-domain-and-underwater-mortgages-framing-the-debate-part-1/>.

55. See *Examining California County's Controversial Proposal to Use Eminent Domain to Provide Relief for Underwater Homeowners*, AM. BANKR. INST. (July 26, 2012), <http://news.abi.org/podcasts/118-examining-california-countys-controversial-proposal-to-use-eminent-domain-to-provide-re>.

56. Mortgage Resolution Partners' version of the Plan would reduce the principal to 95 percent of the home's fair market value, but there is no special significance to the 95 percent figure—local governments could choose some other benchmark below the value of the home securing the loan. Hockett, *supra* note 9, at 33.

57. Mortgage Resolution Partners, *Homeownership Protection Program*, at 12, available at [online.wsj.com/public/resources/documents/EMINENT-powerpoint.pdf](http://online.wsj.com/public/resources/documents/EMINENT-powerpoint.pdf) (last visited Apr. 4, 2013).

payments based on the new principal balance. Ultimately, homeowners would end up in much the same situation that they started in—making payments to a servicer that administered their loans on behalf of a securitization trust—but on substantially better financial terms. If everything went according to plan, homeowners would be rescued from dire financial straits at no cost to the government, and communities would benefit from a reduction in foreclosures.<sup>58</sup>

Although San Bernardino County ultimately decided not to pursue condemnation of underwater mortgage loans,<sup>59</sup> Richmond, California has begun implementation of the Plan, and other cities and counties across the country have demonstrated an interest in it.<sup>60</sup> In Chicago, where 100,000 mortgage loans are underwater, primarily in minority neighborhoods, city aldermen have held a preliminary hearing on adopting the Plan.<sup>61</sup> Similarly, the Berkeley City Council voted to look into the Plan in conjunction with Alameda County and the Oakland City Council,<sup>62</sup> and city council members in Sacramento and Elk Grove, California, have also taken steps toward implementing the Plan.<sup>63</sup> Finally, Suffolk County, New York, where one in ten home mortgage loans is underwater, has indicated an interest in the Plan,<sup>64</sup> as has the city government in Detroit,<sup>65</sup> where more than 40 percent of mortgage loans are underwater.<sup>66</sup>

The securities industry, which packages, sells, and administers the mortgage-backed securities that the Plan would target, has publicly opposed its adoption.<sup>67</sup> The high rate of defaults has already undermined the stability of the mortgage loan pools backing these securities; the industry fears that the future viability of such products would be seriously endangered if investors

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58. See Robert C. Hockett, *Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt That Can Benefit Literally Everyone* 18–20 (Cornell Law Sch., Research Paper No. 12-64, 2012), available at <http://ssrn.com/abstract=2173358>.

59. Lazo, *supra* note 11.

60. See *supra* note 13 and accompanying text.

61. Mary Ellen Podmolik & John Byrne, *Mayor Resists Eminent Domain Plan*, CHI. TRIB., Aug. 15, 2012, § 2, at 2.

62. Andrew S. Ross, *Eminent Domain Mortgage Plan Gaining Support*, S.F. CHRON., Aug. 1, 2012, at E1, available at <http://www.sfgate.com/business/bottomline/article/Eminent-domain-plea-gaining-support-3751091.php>.

63. Sangree, *supra* note 12.

64. Jennifer Medina, *California County Considers a Rescue Plan for Struggling Homeowners*, N.Y. TIMES, July 15, 2012, at A14, available at <http://www.nytimes.com/2012/07/15/us/a-county-considers-rescue-of-underwater-homes.html>.

65. Peter S. Goodman, *Eminent Domain as Underwater Mortgages Fix: Why Some Cities Are Considering Unorthodox Measure*, HUFFINGTON POST (Oct. 1, 2012, 11:22 AM) (updated Oct. 1, 2012, 12:52 PM), available at [http://www.huffingtonpost.com/2012/10/01/eminent-domain-mortgages\\_n\\_1917391.html](http://www.huffingtonpost.com/2012/10/01/eminent-domain-mortgages_n_1917391.html); Hallman, *supra* note 8.

66. Richard Florida, *The Geography of Underwater Homes*, ATLANTIC CITIES (Aug. 23, 2012), <http://www.theatlanticcities.com/housing/2012/08/geography-underwater-homes/3034/>.

67. See, e.g., *Eminent Domain Resource Center: Activity*, SIFMA, <http://www.sifma.org/issues/capital-markets/securitization/eminent-domain/activity/> (last visited Apr. 4, 2013).

believed that their collateral could be seized at any moment by local governments.<sup>68</sup> The securities industry is also concerned that the loans seized from securitization trusts would be significantly undervalued, forcing the trusts to take a heavy loss on hundreds or thousands of condemned loans.<sup>69</sup> A leading securities industry group has commissioned a memorandum outlining legal arguments against the Plan from O'Melveny & Myers LLP.<sup>70</sup> This memorandum is the first serious consideration of potential legal challenges to the Plan. On the other side, Mortgage Resolution Partners' consultant, Cornell Law School Professor Robert Hockett,<sup>71</sup> has issued two white papers offering legal and policy justifications for adopting the Plan.<sup>72</sup>

The Plan is a novel idea, and supporters and adversaries alike are taking it seriously. As local governments adopt it, the resources and attention brought to bear on ensuing legal challenges will likely be formidable. Some legal issues, particularly state constitutional issues and the valuation of condemned loans, would vary based on state law and the specific details of each implementation of the Plan. But wherever the Plan is instituted, there will be two important questions under the U.S. Constitution: first, whether the Plan is a constitutional exercise of state power under the Takings Clause, and second, whether the contractual impairment that the Plan would cause would violate the Contracts Clause. Both Professor Hockett in his white papers and O'Melveny & Myers in its memorandum touch on these issues, but their treatment is cursory and, more importantly, represents the perspective of paid consultants.<sup>73</sup> This Note seeks to fill a void in the emerging commentary by supplying an impartial and detailed analysis of these constitutional questions.

## II. CONSTITUTIONALITY UNDER THE TAKINGS CLAUSE

The Plan is built on the power of eminent domain, which is governed by the Takings Clause of the Fifth Amendment, which states, "nor shall private property be taken for public use, without just compensation."<sup>74</sup> For a taking

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68. *See id.*

69. AM. BANKR. INST., *supra* note 55.

70. Memorandum from Walter Dellinger et al., O'Melveny & Myers LLP, to Sec. Indus. & Fin. Mkts. Ass'n, *San Bernardino Eminent Domain Proposal 3* (July 16, 2012) [hereinafter O'Melveny & Myers] (on file with recipient), available at <http://www.sifma.org/workarea/downloadasset.aspx?id=8589939523>.

71. Alison Frankel, *Eminent Domain, MBS and the U.S. Constitution: A One-Sided Fight?*, REUTERS (July 11, 2012), available at <http://blogs.reuters.com/alison-frankel/2012/07/11/eminent-domain-mbs-and-the-u-s-constitution-a-one-sided-fight/> (noting that Hockett was hired by Mortgage Resolution Partners to research the legality of exercising eminent domain over private mortgage loans).

72. Hockett, *supra* note 9; Hockett, *supra* note 58.

73. *See* Hockett, *supra* note 9; Hockett, *supra* note 58; O'Melveny & Myers, *supra* note 70.

74. U.S. CONST. amend. V. Contracts are condemnable property for eminent domain purposes. *Long Island Water Supply Co. v. Brooklyn*, 166 U.S. 685, 690 (1897); *see also* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 19 n.16 (1977).

to be constitutional, it must first be “for public use,” and second, just compensation must be paid to the property owner in exchange for the taken property. A taking satisfies the public use requirement as long as it serves a “public purpose”; the property need not literally be open to “use by the public.”<sup>75</sup> Courts apply rational basis review to determine whether a taking is constitutional, largely deferring to the policy judgments of legislative bodies and asking only whether the taking was rationally related to a conceivable public purpose.<sup>76</sup>

Section II.A argues that the Plan serves two public purposes that are likely to pass constitutional muster: the prevention or repair of neighborhood blight and the correction of market dysfunction in the residential mortgage market. Section II.B contends that the Plan is rationally related to achieving each of these public purposes and therefore is constitutional under the Takings Clause.<sup>77</sup>

#### A. *Conceivable Public Purpose*

The Plan would serve two independently sufficient public purposes under the Takings Clause: stopping blight in residential neighborhoods and correcting dysfunction in the residential mortgage market. Foreclosures can poison the neighborhoods in which they take place by creating vacant properties,<sup>78</sup> which cause blight,<sup>79</sup> raise crime rates,<sup>80</sup> and reduce the property value of nearby homes.<sup>81</sup> And underwater homes, even when occupied, drag down the aesthetic and financial condition of the neighborhood, both because the homeowners may wish to put every penny toward their loan payments rather than maintenance and because they may not be motivated to invest in maintenance and improvements for a house they fear that they will lose.<sup>82</sup>

Addressing blight is the classic public purpose for a taking that transfers property from the hands of one private party to another.<sup>83</sup> More than fifty years ago in *Berman v. Parker*, the Supreme Court held that governments

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75. *Kelo v. City of New London*, 545 U.S. 469, 479–80 (2005) (internal quotation marks omitted).

76. *Haw. Hous. Auth. v. Midkiff*, 467 U.S. 229, 241 (1984).

77. The question of “just compensation” only arises once a taking is found to be constitutional, and the inquiry is irrelevant to the threshold question of constitutionality. This Note will not address it.

78. GAO, *supra* note 29, at 24–25.

79. *Id.* at 1.

80. See Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUD. 851, 862–63 (2006).

81. GAO, *supra* note 29, at 44–46. Boarded-up windows, homes stripped of metal pipes, graffiti, and squatters are all classic symptoms of blight. See, e.g., FCIC REPORT, *supra* note 14, at 10, 14; Alex Kotlowitz, *All Boarded Up*, N.Y. TIMES, Mar. 8, 2009 (Magazine), at MM28, available at <http://nytimes.com/2009/03/08/magazine/08Foreclosure-t.html>.

82. Hockett, *supra* note 9, at 52–53.

83. See, e.g., *Berman v. Parker*, 348 U.S. 26, 33–34 (1954).

can condemn private property and sell it to other private parties in the service of a plan to address blight, even if not all the condemned properties are themselves blighted.<sup>84</sup> The Court's most recent decision on the "public use" test, *Kelo v. City of New London*, pushed *Berman* to its limits by lowering the standard from "blight" to mere "distress."<sup>85</sup> A city may now condemn a swath of private homes based solely on the justification that the area needs "economic rejuvenation," even when there is no actual blight.<sup>86</sup> Areas considering the Plan—such as the Inland Empire, Detroit, and Chicago—have seen the damage that foreclosures can inflict on their communities. Their exercise of the power of eminent domain would be consistent with *Berman* and arguably less aggressive than *Kelo*.

Critics contend that the Plan, which seeks to prevent blight before it occurs or worsens, is distinguishable from *Kelo*, which sought to remedy preexisting blight.<sup>87</sup> This echoes some courts' concerns that because blight could arise at any time, "[t]he specter of condemnation hangs over all property."<sup>88</sup> If the Plan were adopted as a strictly preventive measure in wealthy areas not suffering the effects of blight, courts might well strike it down on this theory. But areas currently considering the Plan—Detroit and Chicago, for instance—have already seen the effects of blight on their communities.<sup>89</sup>

It is also true that the Plan focuses narrowly on the taking itself, unlike the "comprehensive" and multifaceted development scheme in *Kelo*.<sup>90</sup> But it is inaccurate to say that "the systematic transfer of property from A to B is the *scheme itself*."<sup>91</sup> As described in Part I, the condemnation is only one part of the Plan, and the Plan's ultimate goal is refinancing the loans after their condemnation. Simply transferring the notes from A to B would likely have no effect on the foreclosure rate because the homeowners who signed those notes would still be underwater. The Plan would therefore have a "comprehensive character" beyond the taking itself.<sup>92</sup>

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84. *Id.* at 34.

85. See 545 U.S. 469, 480–81 (2005). The "distress" that the *Kelo* Court found sufficient consisted of rising unemployment, population decline, and a lack of "leisure and recreational opportunities." *Kelo*, 545 U.S. at 473–75. The Court did not contend that living conditions in the community were substandard or that living there was actively unpleasant. *Id.* "Blight," on the other hand, is more severe: "[m]iserable and disreputable housing conditions" that "suffocate the spirit," and "an ugly sore . . . on the community which robs it of charm." *Berman*, 348 U.S. at 32.

86. *Kelo*, 545 U.S. at 483.

87. O'Melveny & Myers, *supra* note 70, at 4.

88. *Kelo*, 545 U.S. at 503 (O'Connor, J., dissenting).

89. See Chi. City Council Res. R2012-695 of the J. Comm. of the Comm. on Fin. & Comm. on Hous. & Real Estate 2 (Chi., Ill. 2012); Susan Saulny, *Razing the City to Save the City*, N.Y. TIMES, June 21, 2010, at A16, available at <http://www.nytimes.com/2010/06/21/us/21detroit.html>.

90. O'Melveny & Myers, *supra* note 70, at 3–4 (quoting *Kelo*, 545 U.S. at 484).

91. *Id.* at 4.

92. *Kelo*, 545 U.S. at 484.

The second public purpose that condemning and refinancing underwater mortgages serves is correcting dysfunction in the residential mortgage market.<sup>93</sup> As discussed in Section I.B, it is frequently in the best interest of all parties to modify a homeowner's loan when the homeowner is having difficulty making his monthly payments, because a vacant home becomes an expensive proposition for the holder of the mortgage note.<sup>94</sup> The pooling and servicing agreements can prevent trustees from pursuing modifications even when modifying the loans would better serve the trust's investors, and servicers reap higher fees from foreclosing on troubled homeowners than from keeping them in their homes.<sup>95</sup> These are symptoms of serious dysfunction in the residential mortgage market. Perverse incentives and collective-action problems combine to harm homeowners, neighborhoods, and cities, while mortgage holders and servicers are forced to pay for foreclosures that are not in their interest to begin with and that cause significant damage to the reputation of their industry.<sup>96</sup> Nobody wins.

Case law endorses the use of eminent domain to address such market dysfunctions. In *Hawaii Housing Authority v. Midkiff*, the Supreme Court approved the use of eminent domain to address a land oligopoly in Hawaii where a "large number of persons declare[d] that they [were] willing but unable to buy [houses] at fair prices."<sup>97</sup> And in *Ruckelshaus v. Monsanto Co.*, the Court endorsed the condemnation of trade secrets to remedy barriers to entry in the pesticide market that undermined competition.<sup>98</sup> These takings do not address blight or acute economic distress but rather use the power of eminent domain to remake a broken system, bestowing an immediate benefit on some players to create a better playing field for everyone.<sup>99</sup> This is what the Plan aims to do—by removing artificial barriers to loan modification, which have caused a breakdown in the system, the Plan seeks to bestow a benefit on the market as a whole.<sup>100</sup> By aiming to correct this kind of market malfunction, the Plan serves an established public purpose and stands on firm constitutional footing.

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93. Cf. *Haw. Hous. Auth. v. Midkiff*, 467 U.S. 229, 242 (1984) (correcting market failure in land market is a legitimate public purpose).

94. See *supra* Section I.B.

95. See *supra* note 49 and accompanying text.

96. See Shiller, *supra* note 44.

97. *Midkiff*, 467 U.S. at 242.

98. 467 U.S. 986, 1015 (1984).

99. See *Ruckelshaus*, 467 U.S. 986 (where a cumbersome, expensive registration process for pesticides deterred new entrants from the market, disclosing trade secrets from previous applications to new applicants was constitutional); *Midkiff*, 467 U.S. at 232, 242 (where land was concentrated in the hands of only seventy-two private landowners, "correcting market failure" in the "malfunctioning" land market by redistributing fees simple to individual homeowners was constitutional).

100. See generally Hockett, *supra* note 9.

### B. Rational Relationship to Public Purpose

The second half of the rational basis test asks whether the Plan is a rational means of preventing blight or correcting market malfunction. The Plan need not be the *best* way to achieve those ends—or even a *good* way; it merely needs to be a rational means of doing so.<sup>101</sup> This is a low standard for state action to meet.<sup>102</sup> As discussed in Section I.B, principal reduction is essential to slowing foreclosures and is more effective as a long-term strategy than other types of loan modification.<sup>103</sup> Targeting underwater homeowners in particular is certainly rational: because they are far more likely to default, reducing a loan’s principal so that a homeowner is no longer underwater would instantly lower his chance of defaulting.<sup>104</sup>

Critics warn that the Plan could raise rates on new loans, reduce the availability of credit, and thereby make it harder to sell the existing backlog of vacant properties.<sup>105</sup> Though this concern may be legitimate, it is irrelevant to the constitutional analysis. “States are not required to convince the courts of the correctness of their legislative judgments” to survive rational basis review.<sup>106</sup> As long as it remains “at least debatable” that seizing underwater mortgage loans to reduce the principal will have at least some effect on the foreclosure rate, the second prong of the rational basis test will be satisfied.<sup>107</sup> Because local governments could rationally conclude that imposing principal reduction on loans secured by underwater homes would both protect neighborhoods from blight and correct a malfunction in the residential mortgage market, the Plan would likely survive rational basis review.

### III. CONSTITUTIONALITY UNDER THE CONTRACTS CLAUSE

Article I of the Constitution provides that “[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts.”<sup>108</sup> Although the Contracts

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101. See *Midkiff*, 467 U.S. at 240–41 (“[T]he Court . . . will not substitute its judgment for a legislature’s judgment as to what constitutes a public use ‘unless the use be palpably without reasonable foundation.’” (quoting *United States v. Gettysburg Elec. Ry. Co.*, 160 U.S. 668, 680 (1896))).

102. See *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 463–70 (1981) (sustaining a milk packaging regulation meant to encourage the use of environmentally superior options under the rational basis test, even though evidence strongly suggested that the regulation had precisely the opposite effect—increasing the use of environmentally damaging paper-board packaging).

103. See *supra* Section I.B.

104. See *The Foreclosure Plan: Can’t Pay or Won’t Pay?*, *ECONOMIST*, Feb. 21, 2009, at 32, available at <http://www.economist.com/node/13145396>.

105. See, e.g., O’Melveny & Myers, *supra* note 70, at 5; *SIFMA Opposes Use of Eminent Domain; Will Cause Irreparable Damage to Recovering Housing Market*, *SIFMA* (Sept. 7, 2012), <http://www.sifma.org/news/news.aspx?id=8589940215>.

106. *Clover Leaf Creamery*, 449 U.S. at 464.

107. See *id.* (quoting *U.S. v. Carolene Prods. Co.*, 304 U.S. 144, 154 (1938)).

108. U.S. CONST. art. I, § 10, cl. 1.

Clause is aimed at protecting the expectation of contracting parties generally,<sup>109</sup> the immediate catalyst for its inclusion in the Constitution was debtor-relief legislation, which states passed in response to the straitened economic circumstances that followed the Revolutionary War.<sup>110</sup> The laws reduced foreign creditors' faith in American debts and, more generally, reduced all creditors' faith in their agreements.<sup>111</sup> It was these circumstances that inspired the creation of the Contracts Clause, to provide, in a larger sense, what a contract itself is meant to provide: stability of expectations.<sup>112</sup>

In the nineteenth century, the Contracts Clause provided "the constitutional justification for more cases involving the validity of state laws than all of the other clauses of the Constitution together."<sup>113</sup> Its power began to wane toward the end of the century, as the Supreme Court increasingly recognized that a state's police power can supersede private parties' desire to maintain the status quo through contract.<sup>114</sup> This move was finalized in *Home Building & Loan Ass'n v. Blaisdell*, in which the Supreme Court upheld a Minnesota mortgage moratorium law that gave borrowers additional time to catch up on payments in order to stave off foreclosure.<sup>115</sup> Many state laws now taken for granted—for example, consumer protection and labor laws—"impair[] the obligation of Contracts"<sup>116</sup> without setting off constitutional alarms. That said, the Supreme Court's twentieth-century Contracts Clause decisions have not been entirely toothless.<sup>117</sup>

To be constitutional under the Contracts Clause, legislation must satisfy a two-part test. The first prong requires that the law have a significant and legitimate public purpose, such as "the remedying of a broad and general social or economic problem."<sup>118</sup> The second prong requires that the character and scope of the contractual impairment be reasonably necessary to

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109. Richard A. Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. CHI. L. REV. 703, 706 (1984); Douglas W. Kmiec & John O. McGinnis, *The Contract Clause: A Return to the Original Understanding*, 14 HASTINGS CONST. L.Q. 525, 533 (1987).

110. *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 427 (1934); BENJAMIN FLETCHER WRIGHT, JR., *THE CONTRACT CLAUSE OF THE CONSTITUTION* 13–15 (1938); Epstein, *supra* note 109, at 706.

111. *Blaisdell*, 290 U.S. at 454–55 (Sutherland, J., dissenting).

112. *See id.* at 462; Charles A. Bieneman, Note, *Legal Interpretation and a Constitutional Case: Home Building & Loan Association v. Blaisdell*, 90 MICH. L. REV. 2534, 2552 (1992).

113. WRIGHT, *supra* note 110, at xiii.

114. *See Manigault v. Springs*, 199 U.S. 473 (1905); *Stone v. Mississippi*, 101 U.S. 814 (1880). The Contracts Clause's declining importance can also be traced to the expanded application of the Fourteenth Amendment's Due Process Clause, which gave courts a more powerful tool for limiting state regulation. WRIGHT, *supra* note 110, at 95.

115. *Blaisdell*, 290 U.S. at 437.

116. U.S. CONST. art. I, § 10, cl. 1.

117. *See, e.g., Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 249–50 (1978) (striking down an employee benefits law); *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 25–26 (1977) (striking down the repeal of a covenant limiting Port Authority of New York and New Jersey deficits).

118. *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411–12 (1983) (citing *Allied Structural Steel*, 438 U.S. at 247, 249, and *U.S. Trust Co.*, 431 U.S. at 22).



achieve that public purpose.<sup>119</sup> Before applying the two-prong test, however, courts ask two preliminary questions: Who are the contracting parties, and how seriously does the law impair the contractual obligations?<sup>120</sup> The responses to these two questions dictate how strictly a court will apply the two-prong test.<sup>121</sup> A court applies the test more strictly when a state seeks to impair its own obligations to other parties under contract because the state's self-interest is at stake.<sup>122</sup> Similarly, the more seriously contractual obligations are impaired, the more closely a court will scrutinize the public purpose of the statute and its proportionality to that public purpose.<sup>123</sup>

Section III.A explains why the Plan would implicate the Contracts Clause in the first place. Section III.B considers the preliminary questions that are necessary to the Contracts Clause inquiry—the identity of the contracting parties and the degree of impairment created by the plan—and argues that the Plan's impairment of contracts should be classified as serious and permanent. Section III.C contends that the Plan serves a significant and legitimate public purpose and therefore passes the first prong of the Contracts Clause test. But Section III.D argues that the scope of the Plan is not proportionate and necessary to its public purpose and that it therefore fails the second prong of the Contracts Clause test.

#### A. *Relevance of the Contracts Clause*

It could appear that the Plan presents no Contracts Clause problem because the state actor would seize a contract before altering it, effecting a forced sale of the contract instead of an impairment.<sup>124</sup> But such a formalistic approach would allow a state actor to circumvent the Contracts Clause by way of the Takings Clause; instead of impairing a contract directly, the state actor could simply take it, alter the contract itself, and then pass it along to a private party.<sup>125</sup> To read the Contracts Clause out of the Constitution in this

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119. *See id.*

120. *Id.*

121. *Id.*

122. *U.S. Trust Co.*, 431 U.S. at 25–26 (applying the rational basis standard to a “modification of a State's own financial obligations” and finding that “complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake”).

123. *Allied Structural Steel*, 438 U.S. at 244–45.

124. While the Supreme Court has noted in passing that “the Contract Clause has never been thought to protect against the . . . power of eminent domain,” *Haw. Hous. Auth. v. Midkiff*, 467 U.S. 229, 243 n.6 (1984), this statement was made in relation to the indirect impairment of a contract through the taking of real property. Here, the situation is different: what is taken is the contract itself, and therefore the impairment of the contract is not incidental or indirect. *See also Long Island Water Supply Co. v. Brooklyn*, 166 U.S. 685, 690 (1897) (noting that the Contracts Clause was no bar to a taking where the impaired contract was “a mere incident to the tangible property” being condemned).

125. *Cf. Pa. Coal Co. v. Mahon*, 260 U.S. 393, 414–15 (1922) (holding that states may not evade the requirement of just compensation for a taking simply by passing a law that diminishes the value of a property interest rather than taking it directly).

way would contradict the Supreme Court's statement that "[i]f the Contract Clause is to retain any meaning at all . . . it must be understood to impose *some* limits upon the power of a State to abridge existing contractual relationships, even in the exercise of its otherwise legitimate police power."<sup>126</sup>

One could also contend that a taking of a contract can never constitute an impairment because the contract holder receives just compensation and therefore suffers no financial loss. But this assertion conflates the interests protected by the Takings Clause and the Contracts Clause, when those interests are in fact quite different. The Takings Clause protects private parties from pecuniary loss caused by state action,<sup>127</sup> whereas the Contracts Clause protects against unfair surprise and preserves the institution of contract—the ability of contracting parties to be secure in their private ordering without having to constantly look over their shoulders for government interference.<sup>128</sup> Ignoring the different intent of these two constitutional provisions, and thereby allowing local governments to seize mortgage loan contracts under the Takings Clause, would render the Contracts Clause “a dead letter”<sup>129</sup> and leave the expectations of note holders unprotected. In other words, the Plan would be one case where the alteration in contractual obligations *would* be permissible under the Takings Clause but would *not* be permissible under the Contracts Clause.

#### B. *Degree of Impairment*

As a preliminary matter, a locality adopting the Plan would not impair contracts to which it was itself a party and therefore would not trigger the heightened scrutiny applied to a state's attempt to evade its own obligations.<sup>130</sup> The second preliminary question—the degree of impairment caused by the Plan—cannot be dealt with so quickly.

The degree of impairment worked by the Plan may prove difficult for courts to classify. Each loan would have supplied the trust with a steady income for years, and likely decades, to come, secured by an interest in real property. The Plan seeks to exchange for that value a one-time cash payment of an amount likely not commensurate with the fair market value of the collateral, much less with the total principal and interest that the homeowner would have been expected to pay over the lifetime of the loan. Of course, the local government seizing the mortgage loans would pay so little

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126. *Allied Structural Steel*, 438 U.S. at 242; see also *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 439 (1934) (“[The Constitution] precludes a construction which would permit the state to adopt as its policy the repudiation of debts or the destruction of contracts or the denial of means to enforce them.”).

127. See *supra* Part II.

128. See *Allied Structural Steel*, 438 U.S. at 245; Epstein, *supra* note 109, at 717 (“The contract clause is an explicit limitation upon the power of the state to trench upon individual rights . . .”); Bieneman, *supra* note 112, at 2552 (“[T]he Contracts Clause rests on the moral maxim that parties should be entitled to rely on promises made to them.”).

129. *Allied Structural Steel*, 438 U.S. at 241.

130. See *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 25–26 (1977).

as just compensation because the prospect of every underwater homeowner continuing to make payments is slim. But not all underwater homeowners will default, and as the economy improves, fewer of them will fall behind or walk away. Replacing a loan that might be paid in full thirty years from now with a discounted approximation of the current value of the collateral seems like it would be a fairly serious impairment.

Supporters of the Plan might argue, however, that the degree of impairment would be minor because financial markets exchange cash flows for lump sums every day or because holders of mortgage loans willingly accept lump-sum payments in the form of foreclosure sale proceeds. But while cash flows are indeed exchanged for lump sums on a frequent basis, these transactions are carried out by willing buyers and sellers, not imposed by governmental fiat. It is up to market participants to decide whether a cash flow or a lump sum is in their best interest, and forcing one choice or the other on an investor could constitute a substantial impairment. As argued in Section III.A, this interest in private ordering is exactly what the Contracts Clause is designed to protect.

Similarly, it would be inaccurate to argue that the Plan would simply accelerate the monetary equivalent of a foreclosure sale because servicing agreements prescribe when a servicer is authorized to foreclose and when it is not.<sup>131</sup> The contracting parties thus get to choose under what conditions they are willing to settle for foreclosure sale proceeds rather than the continuing obligation of the loan.<sup>132</sup>

Furthermore, the Contracts Clause test measures the degree of impairment by the aggregate effect of the state action, not by the scale of impairment to each individual contract.<sup>133</sup> The financial firms that create private securitization trusts and sell the securities administer dozens of trusts that hold hundreds or thousands of loans each, so the impairment caused by writing down tens of thousands of loans would be significant. Therefore, even if a court were to find that the impairment of each individual mortgage loan would be minor, it would likely find the Plan's overall impairment of contracts to be serious. This impairment would also be permanent, a factor that the court would consider in the test's second prong. Assuming that the

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131. See Thompson, *supra* note 49, at 794 ("Subprime servicers, in particular, are expected to show 'strict adherence to explicit timelines,' offer and accept workouts from only a predefined and standardized set of options, and not delay foreclosure while loss mitigation is underway." (quoting DIANE PENDLY ET AL., CRITERIA REPORT: RATING U.S. RESIDENTIAL MORTGAGE SERVICERS 11 (2006))).

132. See *Allied Structural Steel*, 438 U.S. at 245 ("Contracts enable individuals to order their personal and business affairs according to their particular needs and interests. Once arranged, those rights and obligations are binding under the law, and the parties are entitled to rely on them.").

133. See, e.g., *id.* at 244–47 (analyzing impairment created by law imposing duty to provide pensions to employees according to the plaintiff employer's total impairment, not the impairment created in regard to each individual employment contract).

court would classify the Plan's impairment of contractual obligations as serious and permanent, courts would scrutinize it closely when applying the two-part Contracts Clause test.<sup>134</sup>

### C. *Significant and Legitimate Public Purpose*

The first prong of the test—that the law be aimed at a significant and legitimate public purpose—closely resembles the first part of the rational basis inquiry from the Takings Clause analysis described in Part II, with the qualifications that the public purpose must be “significant” as well as “legitimate” and that the seriousness of the Plan's impairment would require courts to scrutinize it more rigorously than rational basis analysis demands.<sup>135</sup>

The Supreme Court first began to develop the requirement that contract impairment serve a significant and legitimate public purpose in 1934, when the Court found that a foreclosure moratorium was valid in part because it was intended to address the general social and economic problem of the foreclosure crisis that accompanied the Great Depression.<sup>136</sup> In one of the Court's most recent Contracts Clause decisions, it found a legitimate public purpose in protecting vulnerable consumers from quickly escalating gas prices that would “cause hardship among those who use gas heat but must exist on limited fixed incomes.”<sup>137</sup> Conversely, the Court struck down a Minnesota pension law largely because there was no evidence in the record that a lack of pension benefits was a widespread social or economic problem or that, even if it were, the Minnesota legislature had had that public purpose in mind when it passed the law.<sup>138</sup>

The Court's most recent interpretations of the public purpose prong have considered the breadth of the class affected by the statute in determining whether the statute targets a broad social or economic problem.<sup>139</sup> For instance, the Court invalidated a law that targeted the narrow class of employers who (1) had more than one hundred employees, (2) had established a pension plan, and (3) had subsequently terminated the pension plan or left the state.<sup>140</sup> The Court did so partly on the ground that the law failed to satisfy the first prong of the Contracts Clause test because it had “an extremely narrow focus.”<sup>141</sup> In a subsequent case, the Court reiterated that to

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134. See *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411–12 (1983); *Allied Structural Steel*, 438 U.S. at 250.

135. See *Energy Reserves Grp.*, 459 U.S. at 411–12; *Allied Structural Steel*, 438 U.S. at 244–45.

136. *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934).

137. *Energy Reserves Grp.*, 459 U.S. at 416–17.

138. See *Allied Structural Steel*, 438 U.S. at 247–48.

139. *Id.* at 250; see also *Energy Reserves Grp.*, 459 U.S. at 411–12.

140. *Allied Structural Steel*, 438 U.S. at 248–50.

141. *Id.* at 248, 250.

serve a legitimate public purpose, a statute must not merely “provid[e] a benefit to special interests.”<sup>142</sup>

The Plan would likely satisfy the public purpose prong of the Contracts Clause test. Although critics argue that the Plan would confer a benefit on private firms that would assist local governments in administering it, any incidental benefits that would accrue to private parties, in addition to the public, would be irrelevant. The *purpose* of the Plan is to remedy the broad social and economic harms of the foreclosure crisis.<sup>143</sup> Furthermore, the class targeted by the Plan is actually quite large. Nationwide, 27.5 percent of borrowers are underwater,<sup>144</sup> and the proportion is far higher in places considering the Plan.<sup>145</sup> Even if eligibility were limited to loans held by private trusts, that would still include a sizeable number of homeowners—enough to avoid accusations of impermissibly “narrow focus.”<sup>146</sup> Indeed, the Court has already sanctioned a foreclosure crisis as a sufficiently broad and general social and economic problem to satisfy the test.<sup>147</sup> The current foreclosure crisis is the very definition of such a problem, and reducing the rate of foreclosures in distressed areas would therefore constitute a significant and legitimate public purpose.<sup>148</sup>

#### D. *Necessity and Proportionality*

The more difficult question is that of the second prong, which requires that the character and scope of the legislation be reasonably necessary and proportionate to the public purpose.<sup>149</sup> The Supreme Court has only relied on the second prong in one case—*Energy Reserves Group, Inc. v. Kansas Power & Light Co.*—in the last fifty years, which leaves the manner of its application somewhat uncertain.<sup>150</sup> In that case, the Court found an alteration of indefinite price escalation clauses in natural gas contracts to be of a

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142. *Energy Reserves Grp.*, 459 U.S. at 412.

143. It is also worth noting that in *Allied Structural Steel*, the State could not, even ex post facto, concoct a believable case that the legislation had been aimed at solving a broad economic or social problem, rather than at a particular employer that planned to abolish its pension plan. *Allied Structural Steel*, 438 U.S. at 247–48, 250.

144. *Nearly 2 Million American Homeowners Freed from Negative Equity in 2012*, ZILLOW (Feb. 21, 2013), <http://zillow.mediaroom.com/index.php?s=159&item=334>.

145. See, e.g., Louis Aguilar, *Almost Half of Metro Detroit Homeowners ‘Underwater’*, DETROIT NEWS (Feb. 13, 2013, 3:55 PM), <http://www.detroitnews.com/article/20130213/BIZ/302130352>.

146. See *Allied Structural Steel*, 438 U.S. at 248, 250.

147. *Home Bldg. & Loan Ass’n v. Blaisdell*, 290 U.S. 398, 444–45 (1934).

148. See *id.*

149. See *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 412 (1983).

150. *Id.* at 418–19. The *Allied Structural Steel* Court did not reach the second prong because the law at issue could not survive the first prong, *Allied Structural Steel*, 438 U.S. at 250, and the holding in *U.S. Trust Co.*, the only other case to invalidate a law under the Contracts Clause in modern times, depended on the heightened scrutiny applied when a state impairs its own obligations, *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 29 (1977).

character and scope reasonably necessary to achieve its purpose, both because the alteration was temporary and because it merely filled a gap in existing natural gas regulatory schemes.<sup>151</sup>

That the Plan would not resemble the law at issue in *Energy Reserves Group* in those aspects may point to a constitutional flaw in the Plan. This is because the impairment of contract rights under the Plan would be permanent and because the Plan cannot be described as merely a new variation on an existing regulatory scheme, given that this use of eminent domain is novel. But two factors complicate the analysis. First, the use of eminent domain is a familiar type of state action, and the Plan is therefore merely a new use of a longstanding governmental policy tool. Second, the Court in *Energy Reserves Group* upheld a law against a Contracts Clause challenge; the case therefore cannot necessarily be relied on to provide clear guidance about what a state may *not* do. And it is worth emphasizing that the Supreme Court has not struck down a state law under the second prong of the Contracts Clause test since 1934.<sup>152</sup>

One other case warrants discussion here because the legislation at issue was superficially similar to the Plan, but it ultimately has little to offer in determining how a court today would analyze the Plan under the Contracts Clause. *W.B. Worthen Co. v. Kavanaugh* concerned a number of Arkansas statutes enacted to alleviate the foreclosure crisis accompanying the Great Depression; these statutes offered a delinquent property owner benefits, such as additional time to make payments, and created new procedural hurdles for creditors attempting to foreclose.<sup>153</sup> The Court held that, although the foreclosure crisis in the wake of the Great Depression was a serious public problem, the Arkansas statutes meant to address it were oppressive and immoderate and therefore violated the Contracts Clause.<sup>154</sup> The legislature had, “[w]ith studied indifference to the interests of the mortgagee . . . taken from the mortgagee the quality of an acceptable investment for a rational investor.”<sup>155</sup>

Although *Kavanaugh* suggests that the Plan would be found unconstitutional, its import is limited. *Kavanaugh* preceded a long line of cases that approved more expansive impairments of contract obligations.<sup>156</sup> More importantly, *Kavanaugh* deviated from prior cases’ public-purpose and reasonable-means analyses by applying a more holistic kind of Contracts Clause

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151. *Energy Reserves Grp.*, 459 U.S. at 418–19.

152. *See W.B. Worthen Co. v. Thomas*, 292 U.S. 426, 433–34 (1934).

153. 295 U.S. 56, 61 (1935).

154. *Kavanaugh*, 295 U.S. at 60–62.

155. *Id.* at 60.

156. *See, e.g., Energy Reserves Grp.*, 459 U.S. 400 (allowing Kansas to invalidate contract provisions marking contract prices for natural gas to governmentally established prices for natural gas); *City of El Paso v. Simmons*, 379 U.S. 497 (1965) (allowing Texas to retroactively alter contracts for sale of public land to make it more difficult for defaulting buyers to reinstate their claims); *Veix v. Sixth Ward Bldg. & Loan Ass’n of Newark*, 310 U.S. 32 (1940) (allowing New Jersey to retroactively restrict withdrawals from building and loan associations and to prohibit members from suing to recover the value of their shares).

evaluation that judged the constitutionality of a law entirely by the severity of its impairment of obligations.<sup>157</sup> That severity-only analysis has been rejected by subsequent decades of Contracts Clause jurisprudence in favor of the two-prong test discussed above.<sup>158</sup> Although *Kavanaugh* is therefore merely an abandoned branch of the Contracts Clause tree, it demonstrates that the Court could be moved to deviate from its rigid test if it were to conclude that a state had simply gone too far in disturbing the private ordering of contracting parties.

It seems, then, that the facts of the past century of Supreme Court Contracts Clause cases have little to offer when it comes to assessing how the Plan would fare under the second prong of the test. There are simply too few cases from modern times to successfully draw a straight line between the impairment in contractual obligations that the Plan would cause and past impairments that have come before the Court. What is left is simply to apply the test according to its plain terms, taking existing case law into account.

Are the character and scope of the Plan reasonably necessary and proportionate to the nature and scope of the public purpose? That is, to alleviate the economic suffering and uncertainty of a municipality's residents, to address the blight caused by vacancies and dwindling property values, and to improve the health of the local economy and of the tax base by reducing the number of foreclosures, is it reasonably necessary and proportionate to alter or abrogate thousands of contracts seriously and permanently? It is unlikely that the Court would find the Plan to be a reasonably necessary and proportionate response. The few laws struck down under the Clause in the past century did not create such widespread and irreversible impairment.<sup>159</sup> The past one hundred years of Contracts Clause cases have upheld mortgage moratoria,<sup>160</sup> price controls,<sup>161</sup> retroactive modification of contracts for the sale of land,<sup>162</sup> and restrictions on the ability of certificate holders to withdraw those certificates.<sup>163</sup> But those impairments of contract rights are minor compared to "the repudiation of debts" that the Plan would create.<sup>164</sup>

Indeed, the clear precedent permitting foreclosure-moratorium legislation undermines the constitutionality of the Plan.<sup>165</sup> A court could easily find that if preventing foreclosures is the aim, there exists a clear alternative

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157. See *Kavanaugh*, 295 U.S. *passim*.

158. See *Energy Reserves Grp.*, 459 U.S. at 411–12; *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244–45 (1978).

159. See, e.g., *Allied Structural Steel*, 438 U.S. at 249–50 (striking down a law impairing one employer's employment contracts); *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 20–21 (1977) (striking down a repeal of covenant limiting Port Authority deficits that "permits a diminution of the pledged revenues and reserves," impairing the states' contract with Port Authority bondholders); *Kavanaugh*, 295 U.S. at 61.

160. *E.N.Y. Sav. Bank v. Hahn*, 326 U.S. 230, 234–35 (1945).

161. *Energy Reserves Grp.*, 459 U.S. at 415–16.

162. *City of El Paso v. Simmons*, 379 U.S. 497, 508 (1965).

163. *Veix v. Sixth Ward Bldg. & Loan Ass'n of Newark*, 310 U.S. 32, 38 (1940).

164. *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 439 (1934).

165. *Hahn*, 326 U.S. at 234–35; *Blaisdell*, 290 U.S. at 439.

that would (1) bear the Supreme Court's Contracts Clause imprimatur and (2) create only a temporary impairment rather than the permanent abrogation the Plan would create. A moratorium on foreclosures could stave off vacancies and the attendant blight while buying time for the market to improve and thus for housing prices to rise. This would be the sort of temporary impairment that the Court seems to favor. Because laws creating temporary impairments are necessarily limited in scope—limited to a certain period of time—they are more likely to be of a scope proportionate to the legitimate and significant public purpose at hand, satisfying the second prong of the test.<sup>166</sup> That the Court's limited Contracts Clause jurisprudence evinces a preference for foreclosure moratoria is likely probative in hypothesizing how a court would treat the Plan.<sup>167</sup>

More abstractly, the Plan's likely severe and permanent impairment of mortgage holders' contractual expectations prompts the following question: If the Contracts Clause does not prohibit *this*, what does it prohibit? The current Supreme Court is deeply concerned with precisely this type of question.<sup>168</sup> And if the Plan were to come before the Court, opponents of the Plan would be right to argue that if the Contracts Clause means anything at all, it means that a state and its instrumentalities cannot permanently impair the obligation of thousands, perhaps hundreds of thousands, of contracts, even in pursuit of a legitimate and praiseworthy public purpose.<sup>169</sup>

#### CONCLUSION

Local governments have started putting their power of eminent domain to novel use to rescue their communities from the foreclosure crisis. Although the Plan would be constitutional under the Takings Clause, it would be unlikely to survive a Contracts Clause challenge. Reducing the rate of foreclosures is a legitimate public purpose, and principal reduction is a rational—even proven—way of achieving that goal. Thus, the Plan satisfies the deferential rational basis review prompted by a Takings Clause challenge but fails under the more demanding Contracts Clause test. The Plan seeks to use eminent domain to pursue a scheme that local governments could not constitutionally carry out by other means and entails a permanent and serious impairment of loan contracts. Although the Plan would be aimed at a broad

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166. See *Energy Reserves Grp.*, 459 U.S. at 418–19; *Hahn*, 326 U.S. at 233–35; *Blaisdell*, 290 U.S. at 447.

167. See *Hahn*, 326 U.S. 230; *Blaisdell*, 290 U.S. 398.

168. Cf., e.g., Transcript of Oral Argument at 17, *Dep't of Health & Human Servs. v. Florida*, decided *sub nom.* *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566 (2012) (No. 11-398) (question of Justice Kennedy) (“Well, then the question is whether or not there are any limits on the Commerce Clause. Can you identify for us some limits on the Commerce Clause?”); *id.* at 28 (question of Justice Scalia) (“What—what is left? If the government can do this, what—what else can it not do?”).

169. See *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 242 (1978) (“If the Contract Clause is to retain any meaning at all . . . it must be understood to impose *some* limits upon the power of a State to abridge existing contractual relationships, even in the exercise of its otherwise legitimate police power.”).



social and economic problem, its scheme of principal reduction by fiat is not a necessary and proportionate response to that problem and would likely be unconstitutional under the Contracts Clause.