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The San Bernardino Eminent Domain Solution*

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Everyone would like to solve the lingering problems of the housing bubble; those problems just don't seem to pass and instead continue to create havoc for the national economy and, in particular, for certain local economies. The county of San Bernardino, along with some neighboring cities, has decided to address its issues by using eminent domain to "force buy" underwater loans, effectively reduce their principal, and move on.

There is something to be said for the use of collective action to solve this kind of problem. The problem can be said to be the classic one in which interested parties would jointly benefit if they collaborate, but non-collaboration by any one individual might lead to greater benefits for that individual. Yet, non-collaboration by all leads to worse results for everyone. And worse still, there seems to be no structure or catalyst for collective action.

Nevertheless, in this case, even if collective action works, the results conflict with another saying — money is a coward. Those injured by San Bernardino's use of eminent domain to capture liens that are performing won't forget that, and a new important risk will have been added to the list that investors must contemplate as they ponder whether to invest in residential mortgages or something else with comparable risk profiles and comparable returns. In particular, they will remember San Bernardino.

It is not at all clear that the value of a performing underwater mortgage is equal to the value of a new mortgage that is fully secured with the same borrower but for a lesser amount of principal. That, however, seems to be an

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underlying assumption of the program. If that were true, then the holders of the lien would want the loan refinanced at that lesser principal. Since they do not, it must be that the value is less and, therefore, the program contemplates a loss to the holders of the lien.

The Program

The county of San Bernardino and the cities of Ontario and Hesperia, all in California, have established a Joint Authority in order to assist them in "preserving home ownership and occupancy for homeowners with negative equity within their jurisdictions." The Authority will implement a program which will include the Authority's acquisition of underwater residential mortgage loans by eminent domain. The program excludes the power to acquire homes by eminent domain. At the present time, the three jurisdictions are soliciting investors to assist them in implementing the program.

Under the program, funds would be borrowed from private sector investors and an escrow established to implement the program. The escrow would be approximately equal to the value of the compensation to be given to holders of the liens that are acquired through eminent domain. Employing its eminent domain power, the Authority would purchase, at fair market value (funds coming from the escrow), underwater mortgages whose payments are current.[1] Then, loan by loan, it will accept a discounted repayment of the mortgagor's obligations at a level at which the mortgagor can obtain new financing in the marketplace. Those newly financed loans[2] would then be conveyed as payment in kind to those investors who loaned the funds to the Authority to establish the escrow. Those investors would be free to securitize those loans.

The theoretical plan for the program contemplates that the Authority

[1] According to Professor Robert Hockett of Cornell Law School, those would include single family, owner-occupied residences within each municipality's jurisdiction; first liens to have LTV of greater than 100%; the aggregate fair market value of loans secured by a home to total 85% of the value of the home itself; and the value of qualifying homes not to exceed 105.3% of FHA approved loan amounts, thus permitting a 95% LTV. Priority would be given to first mortgage loans in private securitization trusts.

[2] It is unclear how these loans are originated or by whom.

would hope to "treat together all loans in connection with which any specific trustee acts on behalf of some private label securities trust presently holding the liens."

The purpose clearly is to untie the Gordian knot and move out of the cycle of recursive collective action problems, a term used by Prof. Robert Hockett of Cornell Law School in his memorandum on the program to describe actions taken individually that are reasonable but when taken collectively aggravate the environment for all participants.[3] To successfully implement the plan, however, several hurdles have to be overcome.

Hurdles

Any jurisdiction implementing such a program would have to have the power to engage in eminent domain activities, including, specifically in this case, using those powers through a joint authority and exercising them to take private property when neither it, nor the owner, nor the lien holder is exhibiting any clear harm to the community. Perhaps collectively dozens or hundreds of underwater loans might be found to be harmful, but individually it is difficult to say that any one is. Yet, the eminent domain will be of one lien at a time. Prof. Hockett cites a U.S. Supreme Court case as authority to do so,[4] but that leaves room for debate about whether the true benefit in the San Bernardino cases would be to each individual homeowner that has its principal reduced rather than the community as a whole.[5] If to the individuals and not for the greater benefit of the community as a whole, that would be a public taking of private property from one private person (the owner of the lien) for the benefit of a different private person (the borrower); Kelo found the taking in that case to be for a public benefit even though it was a taking from one private person from another; this case might not.

Assuming that is hurdled, then the question arises whether a performing mortgage lien is the same as other intangibles that in the past have been

[3]He references Prisoner's Dilemma and the Tragedy of the Commons as examples.

[4]Kelo v. City of New London, 545 U.S. 469 (2005).

[5]He also cites Hawaii Housing Authority v. Midkiff, 467 U.S. 229 (1984), but in that case, most parties involved wanted to transfer fee simple once federal tax complications could be reduced (which the use of eminent domain apparently did).

found to be susceptible to a taking through eminent domain. Prof. Hockett cites in his memorandum no performing mortgage lien cases on point, although he does cite to some dicta that is on point as dicta.[6] That is a tougher hurdle for the Authority to overcome, but let's assume that it can be convincingly done.

The program must then deal with the mechanics of what is contemplated. One of the embellishments to the program, for example, one that seems to be needed to move the case by case approach of the program to scale, is that which would have the Authority agree directly with a trustee of a private label security to exercise eminent domain with respect to all of the liens held in the securitization. REMIC rules will have to be handled. The fiduciary duty of the trustee must be addressed. If all of that is possible, then one could reduce mortgage principal payments for a large group of homeowners scattered in many areas of a jurisdiction and sidestep the "tragic commons" result. The trustee in effect would be a collective representative and avoid the individual interests that prevent any collective good from happening in this confused situation. But to achieve that, the contractual and statutory limitations on the trustee would have to be negotiated between the trustee and all of the interested parties, although Prof. Hockett sees a way to avoid that and have it just the trustee and the Authority. Assuming the authority cannot have that one on one negotiation, then the program will face a tedious and time consuming process, comparable to the early days of mortgage modifications; the possibility of prolonged litigation is real.

Easier problems they face are still difficult — what would be a fair market value for underwater mortgages that are current, for example. It is unlikely that a city or county appraisal will be uncontested by the parties in interest. Conceptually, it is very difficult to determine value in that situation, regardless of any particular bias in either of the parties. If holders of the liens really believed that writing down principal of performing loans would result in a fully secured loan of the same value, it seems as though

[6] Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935) (Borrower was not performing); Western Fertilizer & Cordage, 244 Neb. 95 (1993) (Not an eminent domain case).

they would do that voluntarily; they would not need to be coerced by the government. If that is true and they are not writing them down, they must believe that they will suffer a loss in the process. The program doesn't relieve that concern.

How should the liens against which the power is exercised be selected? Which neighborhoods will they cover, for example, keeping in mind fair lending laws and disparate treatment and impact? Is the community benefit argument available when Fannie and Freddie loans are not included? What is the role of the homeowner in the process — is its approval necessary or desirable? While it is unlikely that jurisdiction over the parties is a major hurdle, the investor that lives outside the jurisdiction may not feel that way and may wish to have his or her day in court to contest it.

Which investment bank or pension fund will become the investor, when the result of the program will be to cause harm to a great number of other investors, is yet another problem. The investment community makes hard choices and does not carry a great deal of compassion into its business meetings. Nevertheless, it is particularly true in investment banking that what goes around comes around, and that certain opportunities available at some time in the future might not be made available to those who caused major losses for the fraternity earlier.

The remaining problem

Even if all of these hurdles, and others not raised, are overcome, there is one serious problem remaining. At the end of the day, this program has elevated a remote possibility into a real risk in any future secondary offerings that might be made. Even if loans are held in portfolio, this new risk must be considered. Lenders will of necessity now be forced to try to calculate that risk and to price it into the loans. The translation of the cost of that additional risk into the price of the loan will price some members of the community out of credit, notwithstanding that all lenders compete furiously. Some investors may find that this one additional risk in the residential mortgage field, having suffered through the difficulties and losses of the past decade, to be one risk too many, and look for other safer ways to put their funds to work. Money, after all, is a coward.

So ironically, this program may turn out to be just another recursive collective action because the authors are not looking at the entire picture but only at the part of it that interests them currently. The entire picture would include all defaulted or at risk loans, whether held by private investors or GSEs. It would also include consideration and integration of how the investors that currently hold the liens would act in the future when presented with the opportunity to buy loans located in San Bernardino.

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