A Federalist Blessing in Disguise: From National Inaction to Local Action on Underwater Mortgages

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I. Introduction

The Great Recession that began with collapsing U.S. home prices in 2006 left American households with stunning negative home equity—an extraordinary excess of mortgage debt liabilities over home values. This debt overhang, which has remained as high as $700 billion through the year 2012,[1] is the principal impediment to local and national macroeconomic recovery.[2] Experts and lay people alike recognize that we must deal with the negative-equity crisis in order to repair our communities and restart our economy.[3]

What seems to be less widely recognized, however, is just how concentrated the crisis is both in certain geographic areas of the country and among

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[1] Karen Dynan, Vice President & Co-Director, Econ. Studies, The Brookings Inst., Address Before the Annual Research Conference of the Dutch Central Bank: The U.S. Household Debt Overhang (Oct. 25, 2012), *available at* http://www.brookings.edu/research/speeches/2012/10/25-household-debt-dynan.

[2] *See generally* Fed. Reserve Bd., The U.S. Housing Market: Current Conditions and Policy Considerations (2012), *available at* http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf; 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. (forthcoming 2013) [hereinafter Hockett, *It Takes a Village*]; Robert Hockett, *Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt*, 19 Current Issues in Econ. & Fin., no. 5, 2013, at 1, *available at* http://www.newyorkfed.org/research/current_issues/ci19-5.pdf [hereinafter Hockett, *Paying Paul*]; William C. Dudley, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at the New Jersey Bankers Association Economic Forum in Iselin, New Jersey: Housing and the Economic Recovery (Jan. 6, 2012), *available at* http://www.newyorkfed.org/newsevents/speeches/2012/dud120106.html.

[3] *See infra* Part II.D.

certain toxic loans disproportionately originated there—and how these factors might account for the ineffectiveness of federal responses to date.[4] Predominately local problems are less likely to receive adequate attention from higher levels of government. Fortunately, they *are* apt to be taken with adequate seriousness by local authorities. Under our federal system of government, local governments have both the incentive and the authority to mitigate the negative-equity crisis, which will ultimately promote both local and national interests.

This essay describes the national and local impacts of the negative-equity crisis, the role that particular types of mortgage loans play in the crisis, the reasons for policy failures to date, and a solution that many local governments are considering to solve the problem locally—namely, using their powers of eminent domain to purchase toxic mortgage loans owed-on by local borrowers, then reducing principal to keep families in their homes and mitigate the economic and social costs of negative equity.

II. Sizing the Problem: National Tragedy, Local Calamity

A. *National Effects*

Over six years have passed since the latest residential-real-estate bubble burst, bringing unprecedented financial turmoil and a macroeconomic slump that continues to this day. Housing prices dropped nationally by thirty-five percent in the years 2005–09.[5] Although home values fell, the fixed-mortgage debt obligations incurred by millions of American homeowners during the bubble years did not. In consequence, well over ten million mortgaged homes nationwide are now "underwater" (having a market value lower than the debts they secure), and millions of those loans are seriously delinquent, meaning the crisis is far from over.[6]

Negative equity imposes dramatic costs even prior to or absent a loan default. Homeowners with negative equity spend significantly less on property maintenance because they do not consider themselves to be real owners.[7] As noted above, they also spend less on consumer goods and services, thereby dragging down macroeconomic growth and employment,[8] and, in so

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[4] *See infra* Part III.

[5] *See* Atif Milan, Francesco Trebbi & Amir Sufi, *Foreclosures, House Prices, and the Real Economy*, Vox (Feb. 10, 2011), http://www.voxeu.org/article/foreclosures-house-prices-and-real-economy.

[6] The Alliance of Californians for Cmty. Empowerment, The Ctr. for Popular Democracy & The Home Defenders League, California in Crisis: How Wells Fargo's Foreclosure Pipeline Is Damaging Local Communities 6 (2013), *available at* http://populardemocracy.org/wp-content/uploads/2013/03/California-in-Crisis-Final-Report-compressed.pdf.

[7] *See* Brian T. Melzer, Mortgage Debt Overhang: Reduced Investment by Homeowners with Negative Equity 17–22 (Aug. 2012) (unpublished manuscript), *available at* http://www.kellogg.northwestern.edu/faculty/melzer/Papers/CE_debt_overhang_08_16_2012.pdf.

[8] *See, e.g.*, Fed. Reserve Bd., *supra* note 2, at 3; *see also* Dudley, *supra* note 2.

doing, imperiling the solvency of other mortgagors too.[9] The inability of American borrowers with negative equity to refinance to lower current interest rates is estimated to have cost the American economy ninety billion dollars per year in lost disposable income.[10] Negative equity and the threat of resulting foreclosure also impose significant social-welfare costs, including increased costs for physical and mental health care.[11]

Turning from non-default-related to default-related costs, negative equity is generally considered to be the single greatest predictor of loan default,[12] which of course leads to additional costs. Expected default rates are as high as seventy-five percent for loans that are forty percent underwater—that is, loans that have a combined loan-to-value ratio (CLTV) of 140%.[13] In states like California, a postdefault foreclosure or short sale (a sale at less than the balance due, approved in advance by the lender) reduces the Proposition 13–assessment cap to the forced sale price, significantly reducing property-tax revenues for the foreseeable future. Foreclosures and short sales also typically lead to disproportionate numbers of investment purchases, which turn owner-occupied neighborhoods (particularly in communities of color) into transient rental areas, imposing significant additional social and economic costs on the community.[14] It is unsurprising, then, that

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[9] *See, e.g.*, FED. RESERVE BD., *supra* note 2, at 3; *see also* Hockett, *It Takes a Village*, *supra* note 2; Robert Hockett, Recursive Collective Action Problems (Mar. 26, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239849 [hereinafter Hockett, *Recursive Collective Action Problems*]; Robert Hockett, *Six Years on and Still Counting: Sifting Through the Mortgage Mess*, 9 HASTINGS BUS. L.J. (forthcoming 2013) (manuscript at 1) [hereinafter Hockett, *Six Years*]; Dudley, *supra* note 2. Note also that even the dismal consumer spending and growth numbers we have are skewed upward owing to the "shadow stimulus" produced by the twenty-four- to thirty-six-month period necessary to complete foreclosure and eviction in connection with defaulted mortgage loans. For each homeowner who is ultimately evicted, the period in question represents a period free of housing costs—costs that resume after eviction, diverting that much more away from would-be consumer spending.

[10] *See* Alan Boyce, *Streamlined Refinance and Other Ideas to Improve the Mortgage Market*, ABSALON PROJECT, 8 (Oct. 22, 2010), http://absalonproject.com/wp-content/uploads/2010/11/Streamlined-Refinance-and-Other-Ideas.pdf.

[11] *See* Craig Pollack, *When Dreams Are Destroyed by the Foreclosure Crisis, Health Suffers Too*, ROBERT WOOD JOHNSON FOUND. (Oct. 21, 2011), http://www.rwjf.org/en/blogs/human-capital-blog/2011/10/when-dreams-are-destroyed-by-the-foreclosure-crisis-health-suffers-too.html.

[12] *See* Frank T. Pallotta, *Eminent Domain Is No Solution to Negative Equity Problem*, AM. BANKER (July 18, 2012, 8:00 AM), http://www.americanbanker.com/bankthink/eminent-domain-no-solution-to-negative-equity-1050989-1.html; *see also* Laurie S. Goodman, Roger Ashworth, Brian Landy & Ke Yin, *Negative Equity Trumps Unemployment in Predicting Defaults*, J. FIXED INCOME, Spring 2010, at 67–72; Stan Liebowitz, *New Evidence on the Foreclosure Crisis: Zero Money Down, Not Subprime Loans, Led to the Mortgage Meltdown*, WALL ST. J. (July 3, 2009), http://online.wsj.com/article/SB124657539489189043.html (calling negative equity the single greatest cause of foreclosure).

[13] *Negative Equity: Stage One of Distressed Real Estate Inventory*, PRO TECK VALUATION SERVICES (July 19, 2012), http://www.proteckservices.com/hvf-lessons-from-the-data/negative-equity-stage-one-of-distressed-real-estate-inventory/.

[14] *See* David Garcia, *What Can Be Done to Stop Absentee Landlords*, STOCKTON CITY LIMITS (Dec. 4, 2012), http://stocktoncitylimits.com/2012/12/04/what-can-be-done-to-stop-absentee-landlords/; Jennifer Inez Ward, *New Report Shows Foreclosed Flatland Homes Being Snapped Up by Outside Investors*, OAKLAND LOC. (June 29, 2012, 11:57 PM), http://oakland

the Department of Housing and Urban Development finds that every foreclosure can cost the homeowner, nearby neighbors, and the local government as much as $44,000 in the form of reduced property values, transaction and moving costs, and the utilization of otherwise-unnecessary government services.[15] Lenders compound these costs by generally refusing to allow borrowers to rent back their homes after losing them in a foreclosure or a short sale, for fears that these transactions will not be arm's length and will encourage moral hazard.[16]

As a direct consequence of high levels of negative equity across the nation, then, America's hard-hit cities will continue to struggle with massive economic and social costs until governments take effective action.[17] In order to protect their citizens, governments must directly and proactively reduce negative equity rather than accept a continuing economic drag and further costs from inevitable further defaults. It is the loans that are toxic, not the homes or the borrowers.

B. *Local Concentration*

Although the mortgage debt crisis is crippling our entire nation's economy, it is crucial to understand that the *worst* of the problem is remarkably *localized* in character. Although, as noted earlier, housing prices dropped nationally by thirty-five percent in the years 2006–09,[18] prices at the end of 2012 in the hardest-hit local neighborhoods were more than seventy-five percent lower than their bubble peaks.[19] As a result, there are some neighborhoods in which more than eighty percent of mortgage loans are underwater.[20] The degree to which the affected loans are underwater—or the

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local.com/article/new-report-shows-foreclosed-flatland-homes-being-snapped-outside-investors-0.

[15] *See* Dep't of Hous. & Urban Dev., Economic Impact Analysis of the FHA Refinance Program for Borrowers in Negative Equity Positions 9–10 (2013) [hereinafter HUD Report], *available at* http://portal.hud.gov/hudportal/documents/huddoc?id=ia-refinancenegativeequity.pdf (using HUD's citation of the Joint Committee calculation of local-government costs).

[16] *See, e.g.*, Brian Bean & Tim Hardin, *Short Sale Lease-Back Program Ramps Up*, Press-Enterprise (Oct. 5, 2012, 11:45 AM), http://www.pe.com/real-estate/company-news/20121005-short-sale-lease-back-program-ramps-up.ece; Loren Berlin, *Selling Homeowners Short: Bank Strategy Backfires in Foreclosure Crisis*, Huffington Post (Jan. 20, 2012,1:28 PM), http://www.huffingtonpost.com/2012/01/20/foreclosure-short-sale-homeowners_n_1217200.html (noting that recent changes permit some lease-backs, but under extremely limited conditions including purchase by a not for profit and borrower financial distress); Jason Opland, *Short Sale Lease Back Program*, RealTown (Feb. 10, 2013), https://www.realtown.com/jasonopland/blog/short-sales/short-sale-lease-back-program.

[17] On page one, the *HUD Report* concludes that failing to prevent only one million foreclosures would create a net cost of twenty-four billion dollars. HUD Report, *supra* note 15, at 1.

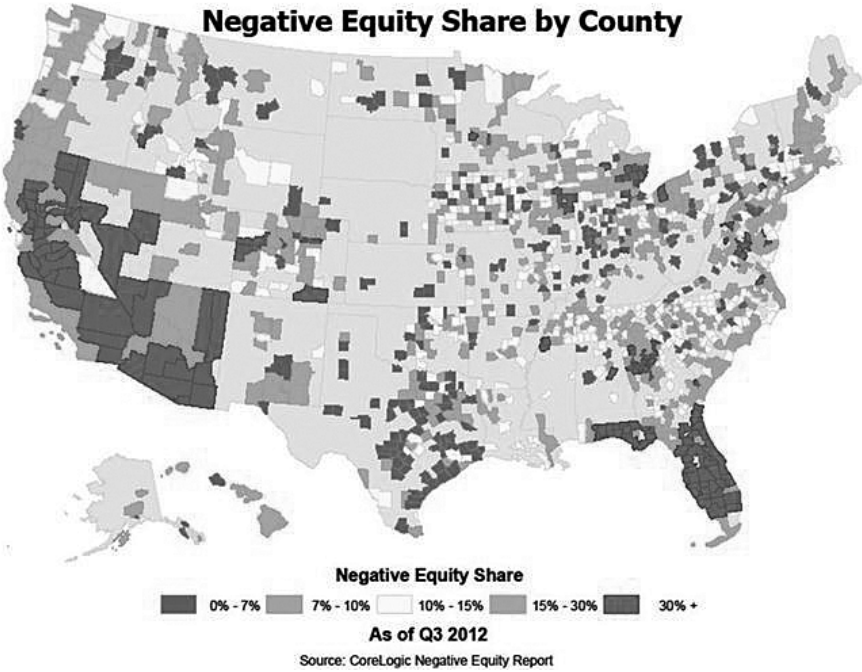
[18] *See National Historic Data HPI*, CoreLogic (Feb. 2013), http://www.corelogic.com/research/hpi/february-2013-national-historic-hpi-data.pdf.

[19] *See infra* chart accompanying note 24 (zip code–level data provided for zip codes 89030 and 89101).

[20] *See infra* chart accompanying note 24 (zip code–level data provided for zip codes 30274, 30296, and 30297).

quantum of "negative equity"—is nothing short of astonishing: there are communities with significant percentages of loans with CLTV ratios (the ratio of total mortgage debt to home value) greater than 200%.[21]

County-level effects. Plummeting home prices have left significant percentages of homeowners underwater, but the effects are not distributed evenly across the nation. Negative equity is concentrated in particular counties, as shown in the following map:[22]



Zip code–level effects. Focusing even more locally on neighborhoods at the *zip code level* shows that the negative-equity crisis is even more concentrated in hard-hit neighborhoods. The following map shows the zip codes with the most foreclosures in 2012.[23] They are highly concentrated in and around Atlanta, Chicago, Detroit, eastern coastal Florida, Las Vegas, the Los Angeles exurbs, Phoenix, and the Sacramento/Stockton/Vallejo region northeast of San Francisco.

[21] *See infra* chart accompanying note 24.

[22] Press Release, CoreLogic, CoreLogic Reports 1.4 Million Borrowers Returned to "Positive Equity" (Jan. 17, 2013), *available at* http://www.corelogic.com/research/negative-equity/corelogic-q3-2012-negative-equity-report.pdf.

[23] *Foreclosures: 100 Hardest Hit Zip Codes*, CNNMoney, http://money.cnn.com/interactive/real-estate/foreclosure-rate/2013/ (last visited May 20, 2013). This graphic is based on data gathered by RealtyTrac LLC.

To understand the depth of the local problems in some of these areas, consider the following chart, which provides a sample of zip codes with the percentage of underwater mortgages and the percentage housing-price decline from peak through the end of 2012:[24]

ZIP Code	City	State	% Underwater	% Price Decline
92301	Adelanto	CA	64%	-70%
93501	Mojave	CA	65%	-71%
93505	California City	CA	72%	-71%
33035	Homestead	FL	68%	-69%
33127	Miami	FL	57%	-70%
33142	Miami	FL	62%	-66%
30274	Riverdale	GA	85%	-71%
30296	Riverdale	GA	84%	-66%
30297	Forest Park	GA	81%	-72%
89030	North Las Vegas	NV	77%	-76%
89101	Las Vegas	NV	75%	-76%
89106	Las Vegas	NV	72%	-71%
89115	Las Vegas	NV	77%	-72%

The degree to which homes are underwater in these neighborhoods is astonishing. The vast majority of the underwater loans in these zip codes have CLTVs near or in excess of 200%. In this context, remember that, as noted earlier, estimated default rates for loans of "only" 140% CLTV are as high as seventy-five percent.[25] The toxic loans in these communities are not

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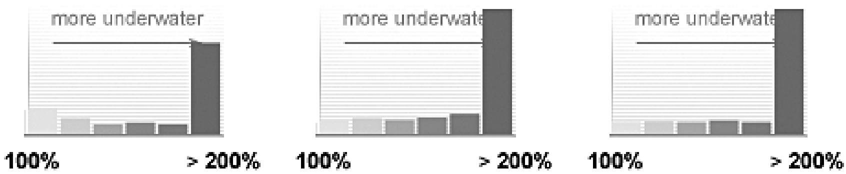
[24] *See US Housing Crisis—Negative Equity Infographic*, ZILLOW, http://www.zillow.com/visuals/negative-equity/#4/39.98/-106.92 (last visited May 20, 2013) [hereinafter *Negative Equity Infographic*]. There are numerous sources of data for home prices and negative equity. The authors use Zillow data extensively because the data is available online without charge. Readers may check the data and conduct further research into neighborhoods of interest without cost.

[25] *See Negative Equity: Stage One of Distressed Real Estate Inventory*, *supra* note 13.

just underwater—they are in the deep end. Some sample CLTV distributions of underwater loans from zip codes in the chart above follow.[26]

Distributions of Combined Loan-to-Value Ratios of Underwater Loans by Zip Code:



CA 93501 **GA 30296** **NV 89030**

CLTVs of this magnitude are immensely harmful to communities. Neighbors lose their homes and cities lose property tax base. To make matters worse, the same development that drains off those public revenues—the abandonment of homes—also raises municipal abatement costs.[27] Remaining homeowners accordingly not only find growing numbers of blighted homes springing up around them, but also find city and school services cut and local business losing revenue. The aggregate monetized loss wrought by such developments is now estimated at $2 trillion nationwide, and this is, again, a loss that is locally concentrated.[28] There is little surprise, then, in the growing numbers of bankruptcy among municipalities at the core of the nation's bubble and bust.[29]

C. *Role of PLS Loans*

Centrality of PLS loans. Just as important as geographic concentration in the nation's ongoing mortgage mess is the concentration of certain types of toxic mortgage loans. The loans in question are those originated to pool into trusts, securitize, and then sell off to investors throughout the world without any government guarantee. These are the loans bundled in so-called "private-label securitizations" (PLSs). The types of loans originated for PLSs, their concentration in certain "boom" communities, and a number of serious practical and legal limitations on the operations of PLS trusts have placed PLS loans at the core of the housing crisis. The Federal Housing

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[26] *See Negative Equity Infographic*, *supra* note 24.

[27] *See* U.S. Gov't Accountability Office, GAO-12-34, Vacant Properties: Growing Number Increases Communities' Costs and Challenges 37–48 (2011).

[28] Debbie G. Bocian et al., Ctr. for Responsible Lending, Collateral Damage: The Spillover Costs of Foreclosures 2 (2012), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/collateral-damage.pdf.

[29] *See, e.g.*, Steven Church et al., *San Bernardino, California, Files Chapter 9 Bankruptcy*, Bloomberg (Aug 2, 2012, 6:38 PM), http://www.bloomberg.com/news/2012-08-02/san-bernardino-california-files-for-bankruptcy-protection-2-.html.

Finance Agency (FHFA) notes that these loans have represented over sixty percent of problem loans throughout the crisis and concludes that PLS loans "represent the crux . . . of the problem we face in foreclosure prevention. If we are going to stabilize the housing market, we have to address" those loans.[30] Why are these loans the crux of the national housing crisis?

PLS loans were typically originated for borrowers with lower credit ratings (such as subprime or low-documentation loans) or lower income levels (such as option adjustable-rate or interest-only loans, which offer low initial monthly payments that later rise). These loans increased the pool of available purchasers and thereby increased demand and housing prices, particularly in boom areas with disproportionate Latino and African American populations.[31] Areas with the greatest amount of PLS loan originations also saw the greatest price appreciation during the boom and the greatest price depreciation during the subsequent bust,[32] driven by the spiral of economic downturn, income reductions, unemployment, inability to refinance or sell mortgaged homes at the principal balance due, and resulting foreclosures and short sales that further exacerbated the same factors.

Structural infirmities in PLSs.[33] PLSs also suffer structural defects that limit the ability of the trust to modify or otherwise deal with underwater loans the way that a traditional bank lender can (and often does) with loans in its own portfolio.

A small number of banks and other institutions service the millions of underwater PLS loans on behalf of the ultimate trust investors. These servicers are overwhelmed and ill equipped to handle the unprecedented volume of bad loans. Many of the pooling and servicing agreements (PSAs) pursuant to which most loans are securitized prohibit or otherwise prevent the trustee or loan servicer from modifying or selling underwater loans in sufficient number. The same agreements typically require unanimity or supermajority voting among holders of mortgage-backed securities (MBSs) in order to change these rules, which in any event would be severely limited by income-tax-law limitations on trust activities.

Second liens also play a prominent role in our mortgage dysfunction story. The problem these present is that, unless they are modified along with

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[30] James B. Lockhart III, Dir., Fed. Hous. Fin. Agency, Speech at the American Securitization Forum in Las Vegas, Nevada 5 (Feb. 9, 2009), *available at* http://www.fhfa.gov/webfiles/823/ASFSpeech2909.pdf.

[31] *See*, *e.g.*, Dr. Raul Hinojosa Ojeda, The Continuing Home Foreclosure Tsunami: Disproportionate Impacts on Black and Latino Communities 2 (2009). It should be noted that this disproportionate targeting of African American and Latino communities highlights concerns raised by many that a perverse form of "reverse redlining" fueled much of the boom in "the boom years."

[32] James Thomas & Robert Van Order, A Closer Look at Fannie Mae and Freddie Mac: What We Know, What We Think We Know and What We Don't Know 16 (March 2011) (unpublished manuscript), *available at* http://business.gwu.edu/creua/research-papers/files/fannie-freddie.pdf (noting correlation but not necessarily cause and effect).

[33] For further discussion of these structural infirmities, see generally Hockett, *It Takes a Village*, *supra* note 2; Hockett, *Six Years*, *supra* note 9.

first liens, first lienholders lack incentive to modify.[34] But second lienholders themselves lack incentive to modify owing to the "liquidity power" they hold over mortgagors, whose second liens often secure Home Equity Lines of Credit (HELOCs) to which they need access when financially strapped as they are now post-bust. Moreover, often the second lienholders are banks—banks that service the first-lien-secured loans themselves. This of course constitutes a significant conflict of interest standing in the way of constructive agreement among creditors. In short, then, communities and local borrowers are forced to bear the costs of negative equity as first- and second-mortgage owners in effect act jointly as holdouts.[35]

The securitization structure as we presently find it and have just described it simply cannot operate properly in this crisis. Government intervention is required to protect not just the community but also all parties to the mortgage market, including investors.[36] As a representative of the American Securitization Forum (ASF), an industry trade group, has stated before Congress:

> Ultimately, it must be recognized that the seismic economic challenges in the United States, the epicenter of which is the housing market, are too great for purely private sector loan modification solutions . . . . Although industry-driven loan modification and loss mitigation actions have been and will continue to be key components to preventing avoidable foreclosures, there are limits to their effectiveness in addressing the extraordinary challenges in the housing market. As such, we believe expanded government programs may be effective in bridging this gap, and helping to address the potential foreclosures that commercial and contractual arrangements cannot prevent. The nationwide home price correction and persistent uptick in foreclosures present systemic risks to the national economic infrastructure. Moreover, foreclosures are bad for everyone—borrowers, communities and investors.[37]

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[34] *See* Letter from Edward J. DeMarco, Acting Dir., Fed. Hous. Fin. Agency, to Elijah E. Cummings, Ranking Member, Comm. on Oversight and Gov't Reform 2 (Jan. 20, 2012), *available at* http://democrats.oversight.house.gov/images/stories/12012_Response_to_Cummings_Principal_Forgiveness.pdf.

[35] *See, e.g.*, Nick Timiraos, *Second-Mortgage Standoffs Stand in Way of Short Sales*, WALL ST. J., Nov. 27, 2010, at A5; Sumit Agarwal et al., Second Liens and the Holdup Problem in First Mortgage Renegotiation (Sept. 2012) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2022501.

[36] *See Private Sector Cooperation with Mortgage Modifications—Ensuring That Investors, Servicers, and Lenders Provide Real Help for Troubled Homeowners: Hearing Before the H. Comm. on Fin. Services*, 110th Cong. 21–23 (2008) (testimony of Tom Deutsch, Deputy Exec. Dir. Am. Securitization Forum); *see also* Hockett, *It Takes a Village*, *supra* note 2 (manuscript at 18) ("The fragmentation of ownership interests both in pools of mortgage loans and, thereby, even the individual mortgage loans themselves, renders it impossible for creditors to act in concert to modify underlying loans.").

[37] Deutsch, *supra* note 36, at 4.

How can governments help themselves and everyone else at the same time, in keeping with what the ASF has called for? Experts agree—write down principal on mortgage debt.

D. Principal Write-Downs

Virtually every major economist, federal regulator, and economic organization agrees that reducing principal on loans is critical to solving the negative-equity crisis and restarting the economy. These include Martin S. Feldstein, former Chairman of the Council of Economic Advisers under President Reagan: "To halt the fall in house prices, the government should reduce mortgage principal when it exceeds 110 percent of the home value."[38] This approach would be consistent with the actions of Iceland, which recovered quickly from its housing bubble by offering principal reduction on every loan that exceeded 110% of the value of the house and by reducing principal on loans denominated in foreign currencies in proportion to the devaluation of the local currency.[39]

Others pressing for principal reduction include the International Monetary Fund, which the United States relies on to enforce sound financial and monetary policies throughout the world;[40] Ben Bernanke, Chairman of the Federal Reserve Board of Governors;[41] Alan Blinder, former Vice Chairman of the same;[42] and Neil Barofsky, former Special Inspector General for the Troubled Asset Relief Program (TARP).[43]

The conservative policy group American Action Forum also has summarized the problem and solution quite well:

> The person who owes $450,000 on a house that is currently worth $300,000 is almost assuredly never going to pay the full amount he owes; eventually, he will either be granted a loan modification

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[38] Martin S. Feldstein, Op-Ed., *How to Stop the Drop in Home Values*, N.Y. Times, Oct. 12, 2011, at A29.

[39] *See Fighting Recession the Icelandic Way*, Bloomberg (Sept. 26, 2012, 8:21 AM), http://www.bloomberg.com/news/2012-09-26/is-remedy-for-next-crisis-buried-in-iceland-view-correct-.html.

[40] *See* Int'l Monetary Fund, World Economic Outlook April 2012: Growth Resuming, Dangers Remain 114–17 (2012), *available at* http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/text.pdf ("Bold household debt restructuring programs, such as those implemented . . . in Iceland today, can significantly reduce the number of household defaults and foreclosures and substantially reduce debt repayment burdens."); Travis Waldron, *IMF Chief Christine Lagarde Calls for U.S. Mortgage Relief*, ThinkProgress (Apr. 13, 2012, 2:10 PM), http://thinkprogress.org/economy/2012/04/13/464030/imf-chief-christine-lagarde-calls-for-us-mortgage-relief/.

[41] *See* Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Independent Community Bankers of America Annual Convention (Mar. 4, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080304a.htm.

[42] *See* Alan S. Blinder, Op-Ed., *How to Clean Up the Housing Mess*, Wall St. J., Oct. 20, 2011, at A17.

[43] *See* Neil Barofsky, *Foreclosure Crisis Lessons Not Yet Learned*, Huffington Post (Oct. 5, 2011, 11:13 AM), http://www.huffingtonpost.com/neil-barofsky/foreclosures-mortgage-crisis-_b_995922.html?page=1.

> to reduce the principal or else he will walk away—no matter how much we try to shame him into "doing the right thing." The cost of walking away in most states amounts to little more than the inability to buy another house in the next five years . . . . Ultimately, America has a choice: Do we continue to insist that the people who made bad bets in the housing market get punished . . . or do we focus on creating policies that have the best chance of ending our economic malaise?[44]

It is, then, widely appreciated that principal write-downs will have to be done on a broad swath of underwater mortgage loans. Debt loss must be formally recognized in a manner commensurate with the devaluation of loan collateral—the homes that secure the home loans. Current efforts to address the problem by reducing interest rates or extending the terms of loans simply do not work—it's the debt overhang that's the thing.

Reducing the interest rate and extending the term of a loan can reduce the borrower's monthly payment, which yields some benefit by increasing disposable income. However, it leaves the borrower underwater and therefore still at high risk of default. The evidence from existing loan modifications demonstrates this. Loan modifications that reduce principal outperform those that reduce interest rates or extend terms, and the greater the principal reduction the greater the outperformance.[45] In addition, banks already write down principal on loans that they hold in their own portfolios at significant rates because it is in their own economic interest to do so in order to prevent losses from unnecessary defaults.[46]

Why then has principal reduction not yet occurred broadly for PLS loans, and how can governments, particularly hard-hit local governments, ensure that it does before it's too late?

III. Impediments and Solution: A Fixable Failure of Federalism

Governments have failed to curb the negative-equity crisis to date for three main reasons, each stemming from our federal system: conflicting national and local policy interests, the blocking powers of special-interest groups at the federal level, and federal preemption of local regulatory actions.

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[44] Ike Brannon, *A Cure for the Housing Blues*, Wkly. Standard (Nov. 7, 2011), http://www.weeklystandard.com/articles/cure-housing-blues_604177.html.

[45] Arthur Acoca et al., The Performance of New Private-Label Mortgage Loan Modifications After 2009, at 4, 6 (2012), *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Private_Label_Mortgage_Loan_Modification.pdf.

[46] *See* Hockett, *It Takes a Village*, *supra* note 2; *see also* Hockett, *Paying Paul*, *supra* note 2, at 3; David Streitfeld, *Big Banks Easing Terms on Loans Deemed as Risks*, N.Y. Times (July 2, 2011), http://www.nytimes.com/2011/07/03/business/03loans.html.

A. *Conflicting Policy Interests*

In dealing with the Great Recession, the federal government focused its attention and funding on the national financial system, not local interests. One mortgage investor asked the Treasury Department at the time "why the government isn't positioning itself to use more of its fiscal resources to help remediate problems for homeowners. The answer was that many representatives on the Hill didn't feel it was their problem—that we had very serious pockets of problems concentrated in a few states."[47] There is, of course, no contradiction between such concentration and the national significance of the problem, but cities nevertheless experience the worst of things before federal instrumentalities do. Even after the Treasury Department promised Congress to use federal funding to buy loans out of trusts as part of a deal to save TARP, for example, Treasury used the funding instead to save the national banking system by making direct investments in banks, leaving the negative-equity crisis to grind on.[48] Local governments with a more immediate interest in, but fewer resources available for, addressing the housing crisis were left behind.

In fairness to the federal government, national programs require a national policy focus. This is not often easy to come by in a crisis that affects different parts of the country differently. As the head of the FHFA has observed, a national policy for federally controlled mortgage companies, such as one to reduce principal, must be "clear and transparent, having a . . . general acceptance of reasonableness if not fairness. And it would have to be clearly and publicly described so that more than a thousand mortgage servicers could apply the rules the same way."[49] Principal reduction is "a particular concern for [Fannie Mae and Freddie Mac] because unlike other mortgage market participants that can pick and choose where principal forgiveness makes sense, the Enterprises must develop the program to be implemented by more than one thousand seller/servicers."[50] Local governments can of course pick and choose, implementing policy as they see fit locally without regard to different conditions and different policy goals in other parts of the country. They are accordingly better situated than the federal government to take the lead in addressing—and finally ending—the crisis.

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[47] Ralph Daloisio, Remarks at the American Securitization Panel: Coming to Grips With Government Intervention 43 (2008), *available at* http://www.americansecuritization.com/uploadedfiles/GovtIntervention.pdf.

[48] *See* Matt Taibbi, *Secrets and Lies of the Bailout*, ROLLING STONE (Jan. 4, 2013, 4:25 PM), http://www.rollingstone.com/politics/news/secret-and-lies-of-the-bailout-20130104.

[49] Edward DeMarco, Acting Dir., Fed. Hous. Fin. Agency, Keynote Address at the Brookings Institution Event: Addressing the Weak Housing Market: Is Principle Reduction the Answer? 13 (Apr. 10, 2012), *available at* http://www.fhfa.gov/webfiles/23876/Brookings_Institution_-_Principal_Forgiveness_v11R-_final.pdf.

[50] *Id.* at 19.

B. Blocking Power

The need for national consensus to make national policy has impeded a federal solution that reduces principal. The federal government's early, tentative, and limited attempt to reduce principal triggered the formation of the Tea Party,[51] whose opposition both stalled subsequent federal efforts in the area and endangered other White House initiatives. With such power, some interest groups are able to block federal action, even where that action is of great interest to other stakeholders. Special-interest groups have also been able to block action at the state level. Proposed legislation in Arizona to implement principal reduction through the use of eminent domain was killed in committee by opposition from banking groups, for example.[52] Failures to implement meaningful relief have left only voluntary federal programs in place, which rely for their implementation on the very mortgage industry that created the problem and has done nothing to solve it.

The Home Affordable Mortgage Program (HAMP), to begin with, does not prioritize write-downs (it was not meant to do so).[53] What is more, on those rare occasions that parties do employ HAMP for this purpose, they do so by in effect bribing servicers—ironically, simply to induce them to do what is independently in the interest of those creditors they are meant to "serve." Even apart from all of this, however, is the fact that HAMP offers no means at all of getting around the central obstacle upon which we are here focused—the contractual restrictions that PSAs place upon servicers whether they are bribed by federal money or not.[54] What all of this means is that HAMP is simply not useful for the task with which we are here concerned, even granting the limited good it has done for some mortgages in connection with which underwater status is not the principal problem.

C. Federal Preemption

We have seen that the federal government has the funds to fix the crisis, but not the consensus or will to do so. Hard-hit local governments have the will, but not the funds. The problem is that municipalities finance their operations, overwhelmingly, out of *property-tax* revenues. And in the present context, of course, this means that the very challenges that call on them to *spend* their revenues—the underwater loans and attendant foreclosure and blight crises—*also deny them their revenue base*. And all this happens, as if

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[51] *See Santelli Says Tea Party Rant 'Woke People Up,'* CNBC (Nov. 2, 2010, 1:41 PM), http://www.cnbc.com/id/39966818.

[52] *See* Howard Fischer, *Lenders Convince Lawmakers to Kill Relief Plan for 'Under Water' Homeowners*, E. Valley Trib., (Mar. 15, 2012, 12:25 PM), http://www.eastvalleytribune.com/money/article_8dc858da-6ed4-11e1-bd37-0019bb2963f4.html.

[53] *See* Hockett, *It Takes a Village*, *supra* note 2 (manuscript at 21–22); *see also* Hockett, *Paying Paul*, *supra* note 2, at 4.

[54] *See* Hockett, *It Takes a Village*, *supra* note 2 (manuscript at 18–22); *see also* Hockett, *Paying Paul*, *supra* note 2, at 3–4; Hockett, *Six Years*, *supra* note 9 (manuscript at 20–21).

to compound the irony, precisely as abatement costs wrought by evictions are apt to rise.

As a result, cities have typically turned to their regulatory powers over real property to try to mitigate the costs of the crisis. These powers are limited, however, particularly by preemption of state laws governing lending and servicing. The nature of the federal system again works against the local governments.[55]

How, then, can municipalities act? How can it be politically feasible, and how can the cities set policy? How can they do so practically, given that they are even more cash strapped these days than the federal government?

IV. Seizing the Initiative: The Municipal Plan

From 2008 through 2009, three legal academics, including one of the present authors, separately advocated federal purchases—voluntary and, where necessary, compulsory under eminent domain—of troubled mortgage loans and associated financial assets.[56] By 2010, additional advocates, including a member of Congress, had joined the call.[57] For several reasons, however—one of them probably being the earlier discussed local concentration of the problem—the federal government has yet to act on a scale matching the magnitude of the problem.

Yet cities can act, and doing so is actually quite simple. Under their own eminent domain authority, states and/or their municipalities can purchase underwater mortgage loans out of PLS trusts at fair value, thereby breaking through PSA contract rigidities to do what so many PSAs now prevent current holders (and their fiduciaries) themselves from doing—modifying loans and thus making them payable.[58] Or for homeowners unable to afford even a lower principal balance, the cities can permit a short sale and

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[55] *See, e.g.*, Lei Ding et al., Ctr. for Cmty. Capital, State Anti-Predatory Lending Laws: Impact and Federal Preemption Phase I Descriptive Analysis 31 (2009) *available at* http://www.ccc.unc.edu/documents/Phase_I_report_Final_Oct5,2009_Clean.pdf (arguing that federal preemption of state anti-predatory-lending laws leads to higher foreclosure rates); Press Release, Fed. Hous. Fin. Agency, FHFA Sues the City of Chicago Over Vacant Buildings Ordinance (Dec. 12, 2011), *available at* http://www.fhfa.gov/webfiles/22832/chicago_lawsuit_121211.pdf (describing a federal preemption suit against the City of Chicago's action regarding vacant property).

[56] *See* Robert C. Hockett, *Bailouts, Buy-ins, and Ballyhoo*, Challenge, Mar./Apr. 2009, at 36, 51; Howell E. Jackson, Op-Ed., *Build a Better Bailout*, Christian Sci. Monitor (Sept. 25, 2008), http://www.csmonitor.com/Commentary/Opinion/2008/0925/p09s02-coop.html; Lauren E. Willis, *Stabilize Home Mortgage Borrowers, and the Financial System Will Follow* 2–3 (Loyola-LA Legal Studies, Paper No. 2008-28, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1273268.

[57] *See* Robert Kuttner, A Presidency in Peril 57–58 (2010); Brad Miller, *UnHAMPered*, New Republic (Feb. 24, 2010), http://www.newrepublic.com/article/unhampered#.

[58] *See infra* Parts IV.A–C; *see also* Hockett, *It Takes a Village*, *supra* note 2 (manuscript at 28–35); Hockett, *Paying Paul*, *supra* note 2.

rent back with an option to purchase, ensuring the family stays in the home and maintaining the neighborhood's stability.

This would be consistent with the urgings of the ASF, which has called upon the federal government to solve the crisis by purchasing loans out of securitization trusts—something that can occur only through the use of eminent domain, because as noted before, the trusts cannot voluntarily sell the loans under their own PSAs and applicable tax laws:

> TARP could purchase individual distressed loans out of MBS trusts, which could give the Treasury Department unlimited discretion to modify those loans. Historically, whole loans have not been sold out of securitization trusts by servicers for a variety of legal, tax, and accounting constraints. The ASF supports, where feasible, facilitating such purchases as part of a broader range of loss mitigation alternatives . . . .[59]

It would also be consistent with the urging of the Securities Industry and Financial Markets Association (SIFMA), whose head publicly urged the federal government to buy loans out of PLS trusts, stating:

> Securitization is a critical engine of today's economy, making available additional capital for borrowers. The recent turmoil has stalled large parts of this market and restarting it will help ensure consumers get the loans they need for homes . . . . I am disappointed Treasury is choosing to de-emphasize the asset purchase portion of the TARP program. Based on my experience with the Resolution Trust Corporation, I believe a key ingredient to a strong recovery is the creation of price discovery through some type of transparent purchase program.[60]

It also bears noting that eminent domain authority can be used to address a related problem noted above—one that many have found most intractable. Specifically, entities that use the eminent domain plan can compulsorily purchase second-lien-secured loans as well—or, if preferred, simply the liens that secure them—converting the loans to unsecured consumer debt. Even the prospect that this might be done should bring second lienholders to the table—including such as till now might have been acting as holdouts.

It should be kept in mind in considering the foregoing that the purpose of the program is not to bail out the borrower; the policy analysis does not depend on the morality of the borrower's or the lender's prior actions in taking or making a toxic mortgage loan. The purpose is to save the neighbor, the community, and the city itself from the evils of negative equity. To

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[59] Deutsch, *supra* note 36, at 9.

[60] Press Release, Sec. Indus. & Fin. Mkt. Ass'n, Treasury's De-emphasis of Asset Purchases Through TARP Disappoints, but Securitization Focus Is Welcomed (Nov. 12, 2008), *available at* http://www.sifma.org/news/news.aspx?id=8912.

adapt the American Action Forum's reasoning, "Ultimately, [local governments have] a choice: Do we continue to insist that the people who made bad bets in the housing market get punished . . . or do we focus on creating policies that have the best chance of ending our economic malaise?"[61]

Each city must examine its own situation and make its own policy. This is consistent with the views of economists who see the need for locally tailored solutions, and it fits with the federal view that the problem is local. Lawrence Summers, former Treasury Secretary under President Clinton and former Economic Advisor to President Obama, has stated: "Surely there is a strong case for experimentation, with principal-reduction strategies at the local level."[62] Hal Varian, Chief Economist of Google, stated: "There are two different housing market problems, one due to excess supply the other due to insufficient demand . . . . Given the rather different circumstances of the two housing markets, it makes sense to write down mortgages differently based on local default conditions."[63]

Moreover, municipalities can tailor this plan to their local circumstances. They can, for example, adapt the plan to underwater condominiums if those constitute part or all of their underwater loan problems, or to duplex or single-family homes if these are the rub. Municipalities adopting the plan can, in other words, do something that FHFA says is desirable in explaining its own reticence about acting on a national scale: "[S]ome mortgage market participants can selectively offer principal forgiveness in cases tailored to their particular circumstances, objectives, and customers."[64]

Local action is also consistent with a growing movement to try new policy initiatives at the state or local level, including ones different from those pursued at the federal level. For example, many Republican-controlled states are experimenting with lowering taxes, or shifting from income taxes to consumption taxes, counter to federal income-tax increases. Their goal is to try to stimulate growth and be a catalyst for changing federal policy.[65] Successful local action on mortgage loans can be a similar catalyst for action at the federal level.

In addition, local action in California to permit residents to remain in their homes, either as owners with reduced principal or under a short sale and lease-back, would also further California state housing policy. California law makes first-mortgage loans legally or practically nonrecourse with

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[61] *See* Brannon, *supra* note 44.

[62] Lawrence Summers, Op-Ed., *How to Stabilize the Housing Market*, Wash. Post (Oct. 24, 2011), http://www.washingtonpost.com/opinions/how-to-stabilize-the-housing-market/2011/10/23/gIQA7lveAM_story.html.

[63] Hal Varian, *Should the Government Encourage Mortgage Principal Write-Downs?*, Economist (Oct. 27, 2010), http://www.economist.com/economics/by-invitation/guest-contributions/tailor_write-downs_local_market_conditions.

[64] Letter from Edward DeMarco, Acting Dir., Fed. Hous. Fin. Agency, to Tim Johnson, Chairman, Senate Comm. on Banking, Hous. & Urban Affairs, and Richard C. Shelby, Ranking Member, Senate Comm. on Banking, Hous. & Urban Affairs 3 (July 31, 2012), *available at* http://www.fhfa.gov/webfiles/24110/PF_LettertoCong73112.pdf.

[65] *See, e.g.*, Richard W. Stevenson, *Governors Push Bigger Reliance on Sales Taxes*, N.Y. Times, Jan. 25, 2013, at A1.

the intent that lenders bear the risk of any decline in housing prices that eliminates the borrower's equity. California enacted these overarching state laws after the Great Depression in order to eliminate the moral hazard of banks lending without sufficient underwriting and down payment, and to mitigate the downward spiral caused by borrower debt liability after a property crash.[66] Lenders are subject to moral hazard in their actions just as much as borrowers are.

Yet lenders are relentlessly using all available tactics to shift that risk back to underwater borrowers, including shame, guilt, and concerted refusal to deal with (or permit others to deal with) borrowers in subsequent sales or lease-backs of the homes.[67] Lenders refuse to acknowledge that their actions carry moral hazard, and that permitting them to evade the risk that California law places on them creates additional moral hazard. Purchasing the loans for fair value and then permitting the borrowers to remain in their homes ensures that lenders bear the risk that California law assigns to them, and that homeowners receive the benefit of the bargain that they made by taking out a nonrecourse mortgage loan.

The authors suggest that an effective policy requires localities to do the following: (a) target PLS loans, which is the most efficient use of resources and avoids federal preemption issues of dealing with loans under the ownership or conservatorship of the federal government; (b) take action that is not regulation, again in order to avoid preemption; (c) utilize existing legal powers to avoid the blocking power of special interests over new legislation at the state or federal level; (d) purchase local underwater mortgage loans and reduce principal directly, as some states are beginning to do rather than using their limited funds to pay lenders to write down uncollectible principal;[68] and (e) use eminent domain to condemn loans from PLS trusts given that the trusts' PSAs do not permit voluntary sales.

Two major questions come immediately to mind. Is it legal to condemn those loans? And is it practical? Fortunately, the answer to both questions is yes.

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[66] *See, e.g.*, CAL. CIV. PROC. CODE § 580(b) (West 2007) (mandating nonrecourse purchase money loans); CAL. CIV. PROC. CODE § 726(a) (West 1992) (creating a single action rule that makes other mortgage loans nonrecourse in practical terms); Thomas N. Jacobson, *The Purchase Money Dilemma*, CAL. REAL PROP. J., Spring 2010, at 35, 35.

[67] *See, e.g.*, Brent T. White, *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis*, 45 WAKE FOREST L. REV. 971, 997 (2010); Berlin, *supra* note 16 (detailing how banks require home buyers to promise not to rent back to the borrower).

[68] *See, e.g.*, Press Release, Ill. Governor's Office, Governor Quinn Announces Public-Private Partnership to Help Keep People in Their Homes (July 15, 2011), *available at* http://www3.illinois.gov/PressReleases/ShowPressRelease.cfm?SubjectID=3&RecNum=9551 (detailing Illinois efforts to purchase non-PLS loans using Hardest Hit Funds); Michelle Rindels, *Nevada Program Would Buy Underwater Mortgages*, LAS VEGAS REV.-J. (Feb. 9, 2013, 3:45 PM), http://www.reviewjournal.com/news/nevada-legislature/nevada-program-would-buy-underwater-mortgages (detailing similar efforts in Nevada).

A. *Legality*

A complete legal analysis of the proposed use of eminent domain is beyond the scope of this essay but available in other publications by one of the authors.[69] In summary, however, the power of eminent domain applies to all manner of intangible assets. These include bond-tax-exemption covenants,[70] contract rights,[71] insurance policies,[72] corporate equities,[73] businesses as going concerns,[74] hunting rights,[75] rights of way,[76] and sports franchises,[77] among others. The Supreme Court and state courts have even recognized that the power extends to mortgage loans and liens in particular.[78]

There is no real legal question, then, as to what species of property can be taken under the eminent domain power; for the answer is that the power extends to all forms of property. The only real question in eminent domain cases is whether the authority exercising the power exercises it for a bona fide public purpose and pays fair value for the property. Forestalling and reversing a continuing wave of destructive foreclosures, homelessness, blight, abatement cost rises, revenue loss, essential city service retrenchment, and likely municipal insolvency unsurprisingly constitutes one of the more compelling of eminent domain–justifying public purposes.[79] Fair value is, of course, an issue of fact, so questions about value are merely hypothetical until trial (although discussed below). Disagreements about value cannot

[69] *See* Hockett, *It Takes a Village*, *supra* note 2 (manuscript at 36–49); Hockett, *Paying Paul*, *supra* note 2, at 6–7.

[70] *See* Conn. Gen. Stat. §§ 12-242ee–yy (1995). For a description of how this innovative statutory provision, enacted to prevent bond covenants from draining revenues from the fisc of the State of Connecticut, has been used, see *Billions in Tax Revenue Stays in State, Thanks to Squire Sanders*, Squire Sanders, http://www.squiresanders.com/de/experience/casestudies/CaseStudyDetail.aspx?StudyID=493 (last visited May 20, 2013).

[71] *See, e.g.*, U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 21–26 (1977).

[72] *See, e.g.*, Lynch v. United States, 292 U.S. 571, 577–79 (1934).

[73] *See, e.g.*, Offield v. N.Y., New Haven & Hartford R.R., 203 U.S. 372 (1906).

[74] *See, e.g.*, Kimball Laundry Co. v. United States, 338 U.S. 1 (1949).

[75] *See, e.g.*, Swan Lake Hunting Club v. United States, 381 F.2d 238 (5th Cir. 1967).

[76] *See, e.g.*, City of Cincinnati v. Louisville & Nashville R.R., 223 U.S. 390, 404–07 (1912).

[77] *See, e.g.*, City of Oakland v. Oakland Raiders, 646 P.2d 835 (Cal. 1982).

[78] *See, e.g.*, Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 602 (1935) ("If the public interest requires . . . the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain."); W. Fertilizer & Cordage Co. v. City of Alliance, 504 N.W.2d 808, 816 (Neb. 1993) (holding that a mortgagee's lien on real estate is an interest that may be subjected to a taking for a public purpose and, therefore, may be the subject of an eminent-domain proceeding).

[79] *See, e.g.*, Kelo v. City of New London, 545 U.S. 469 (2005). The *Kelo* decision makes for a particularly interesting comparison. There, the U.S. Supreme Court upheld a taking of actual homes at fair-market value from predominantly elderly residents with significant non-monetizable sentimental attachments to the homes, then conveyed them to Pfizer in the name of a particularly speculative claim that this would economically revitalize the city of New London, Connecticut. What is contemplated here, by contrast, is a taking of underwater mortgage loans with no sentimental significance at truly fair value, in the name of a much more plausible claim that this will, by addressing a market failure, bring value to bondholders, homeowners, and wider communities alike.

invalidate a proposed use of eminent domain, but merely set the stage for the ultimate price in negotiation or litigation.

Opponents of the proposed use of eminent domain (including the ASF and SIFMA, which have changed their tune now that governments actually propose to follow their advice) have commissioned legal memoranda raising issues with the proposal's legal justification. However, both practicing lawyers and legal academics have repeatedly and publicly rebutted these memos.[80] In addition, the authors of this essay are in regular conversation with municipal governments across the nation, and none has found any of the opponents' legal arguments to have any merit. Each government must conduct its own analysis, of course, just as it does with the exercise of any of its powers. But none should treat these memoranda as a reason not to consider the program.

B. Practicality: Pricing and Purchasing Loans

The next concern is whether the use of eminent domain is practical given the funding required to purchase loans and the scarcity of local resources. There is a perception that writing down principal costs money. As one economist writes, "A more dramatic and costly policy step, but one with the best odds of ending the housing crash quickly and definitively, would have the government facilitate loan modifications with substantial principal write-downs."[81]

Fortunately, it is economically practical to implement the program because (a) the losses on underwater loans have already occurred; (b) properly underwritten loan acquisitions and principal reductions can increase the value of the loans, making rather than costing money; and (c) private funding is available to pay for and take the risks of the condemned loans.

Losses have already occurred. Underwater mortgage loans are simply financial assets, which financial institutions regularly trade and value. The collapse of housing prices caused losses on the loans; these losses have already occurred, and the markets provide regular evidence of this. For example, the FDIC recently sold a pool of 1100 underwater mortgage loans, of which eighty percent were current and only twenty percent delinquent, for

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[80] *See, e.g.*, *The Housing Crisis and Policy Solutions: Should Eminent Domain Be Used to Save Underwater Homeowners?*, Financial Services Panel Series, 112th Cong., (2012) (testimony of Robert Hockett, Professor at Cornell Law School), *available at* http://www.lawschool.cornell.edu/spotlights/upload/Testimony-of-Robert-Hockett-11-September-2012-Third-Round.pdf; David Reiss, Op-Ed., *Eminently Reasonable*, NAT'L L.J., Sept. 24, 2012; Roy Oppenheim, *Eminent Domain: A Foreclosure Fix From the Trenches*, YAHOO! HOMES (July 23, 2012, 5:50 PM), http://homes.yahoo.com/news/eminent-domain-foreclosure-fix-trenches-215000216.html.

[81] MARK ZANDI, MOODY'S ANALYTICS, TO SHORE UP THE RECOVERY, HELP HOUSING 5–6 (2011), *available at* http://www.economy.com/mark-zandi/documents/To-Shore-Up-the-Recovery-Help-Housing.pdf.

forty-three percent of unpaid principal balance.[82] As another example, Fannie Mae publishes the fair value of its investments in PLS securities, which reflect the fair value of the loans within the PLS trusts, and recently carried many of its investments at approximately half of the unpaid principal balance.[83]

The reason for this pricing is clear. The default rates on underwater loans are so high, and the amounts recovered after a default so low, that the expected values of the loans are significantly lower than face value. In a simple example, if a loan has a seventy-five percent chance of default, upon which the holder would collect only twenty percent of face value, and a twenty-five percent chance of collecting 100% of face value, the simple weighted-average value of the loan is only forty percent of face value, similar to the recent FDIC sale.

Value creation. Next, reducing principal can actually increase the value of a loan by reducing the likelihood of default. The FHFA has made this very clear in its own analysis of Fannie Mae's and Freddie Mac's portfolios of loans. The FHFA examined what would happen if Fannie and Freddie took every loan in their portfolios that exceeded a loan-to-value ratio of 115% and unilaterally wrote down principal to 115%—without even bothering to underwrite the borrowers.

The result was clear. This unilateral action would reduce Fannie's and Freddie's losses by twenty billion dollars (twenty percent of their loss reserves); if they also underwrote the borrowers, writing down principal to 115% would reduce losses by twenty-eight billion dollars (twenty-eight percent of their loss reserves).[84] Principal reduction works for everyone, including borrowers, lenders, and local communities.

Funding and risk mitigation. Here too, a straightforward answer awaits our discovery: private money can finance the purchases and thus spare the public fisc because private investors already buy underwater loans and work them out as an ongoing business. They can provide the capital and services that cities require, helping the cities (a) select and preliminarily value the appropriate underwater loans, (b) secure funding, (c) commence and conduct the legal proceedings pursuant to which eminent-domain authority is actually exercised, (d) restructure the loans once they are purchased, and (e) work with homeowners in connection with the foregoing. Significant legal, financial, and counseling expertise are required if all of these functions are to be discharged effectively. Yet this can all of it be had and be done, as one

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[82] David Morrison, *Self-Help FCU Purchases $141 Million in Mortgages*, CREDIT UNION TIMES (Nov. 13, 2012), http://www.cutimes.com/2012/11/13/self-help-fcu-purchases-141-million-in-mortgages.

[83] *See* FED. NAT'L MORTG. ASS'N, QUARTERLY REPORT PURSUANT TO SECTION 13(D) OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDING JUNE 30, 2012, at 41 tbl.23 (2012).

[84] *See* Letter from Edward J. DeMarco to Elijah E. Cummings, *supra* note 34, at 19 (table of losses and loss mitigation).

of the authors has detailed elsewhere and as municipalities are already demonstrating.[85]

PSAs now harm the very people they were meant to protect—the bondholders—effectively now working as "suicide pacts." They do this by preventing securities markets from doing what they ordinarily do best—repricing assets in light of changed asset values and thereby facilitating efficient sale and transfer. This is precisely where eminent domain enters into our story. It enables municipalities to sidestep, on behalf of private parties, those very market-paralyzing securitization contracts that private parties can't sidestep, then refinance debt so that markets can once again do what they normally do best, which is to price goods efficiently and thereby recoup otherwise lost value. America's hard-hit cities did not sign these suicide pacts, and they are not bound to suffer because of them.

C. Practicality: Market Reaction

Finally, will there be unintended consequences that make action impractical? Isn't the market recovering on its own? Won't lenders refuse to do business with communities that use eminent domain to acquire these loans?

Although there have been signs of home-price increases nationally, hard-hit localities that suffered such large price declines and have homes with CLTVs in the range of 200% are highly unlikely to escape the negative-equity crisis from price appreciation alone. Multiple factors—including the temporary foreclosure moratoria to ensure proper filing of loan documentation, and the state attorneys' general settlement with mortgage-loan servicers in 2012—have in recent years artificially held distressed-sale properties off of the market.[86] As these factors retreat and backlogged inventory returns to an economy with continuing high unemployment, flat to falling incomes, and tight housing credit, prices are unlikely to rise dramatically over a long period, particularly in the local areas with the highest levels of negative equity.[87]

As for the claims about future credit flows, those who make these claims never explain how averting massive foreclosure costs, raising the expected values of currently default-prone assets, and paying fair value to PLS

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[85] *See* Hockett, *It Takes a Village*, *supra* note 2 (manuscript at 28–35); *supra* text accompanying note 64 (addressing the plan's amenability to multiple variations tailored to specific—even idiosyncratic—local needs and conditions state-by-state or city-by-city).

[86] *See, e.g.*, Blomquist, *Chasing Shadow Inventory: Sloppy Foreclosures and Unintended Consequences*, 14 CITYSCAPE: J. POL'Y DEV. & RES. 171, 172–73 (2012), *available at* http://www.huduser.org/portal/periodicals/cityscpe/vol14num1/Cityscape_Mar2012_chasing_shadow.pdf; Brennan, *How The $25 Billion Foreclosure Settlement Will Really Affect The Housing Market*, FORBES (Feb. 9, 2012, 4:31 PM), http://www.forbes.com/sites/morganbrennan/2012/02/09/how-the-25-billion-foreclosure-settlement-will-really-affect-the-housing-market/.

[87] *See, e.g.*, Miller, *Tight Credit Is Causing Housing Prices to Rise,* MATRIX (Feb. 6, 2013, 9:18 AM), http://www.millersamuel.com/blog/tight-credit-is-causing-housing-prices-to-rise/28275.

trusts that cannot now market these toxic assets can ever truly reduce available capital—especially given that the capital in question flowed *too* abundantly, thanks to predatory subprime lending promoted by the securitization industry, prior to the bust.[88] (Indeed, this excess credit just *was* the bubble that brought us the bust—and with it the harm that is now suffered by bilked investors, homeowners, and their communities alike.[89]) The only way in which credit might come to be unhealthily constrained, then, is if securitization industry groups conspiratorially *boycott* municipalities that work to mop up the mess they have left in the wake of the bubble they fueled, as some such groups shockingly have been threatening to do.[90] These threats are not going to succeed in frightening off hard-hit cities, however, which have nothing left to lose after what this industry has already done to them. And the threats invite action, moreover, from the Department of Justice and from regulators under color of antitrust and consumer-credit law. Indeed, officials have already begun turning attention to these acts of would-be extortion.[91] It would be hard to conceive a more broadly supported exercise, post-bubble-and-bust, of prosecutorial and regulatory authority than one invited by securitization industry "redlining" of cities now struggling precisely owing to "reverse redlining" by the boycotters themselves.

In fact, it would be impractical to do nothing and allow the negative-equity crisis to continue. None less than the International Monetary Fund has stated: "It would clearly help restart primary (new issuance) markets if some of the impaired 'legacy securities' could be cleared away . . . . There is still much work to be done in clearing away the legacy assets, and in this regard, public-private sector partnerships . . . are helpful."[92] New securitizations have occurred since the proposal to condemn loans first became public. The securitized loans have specifically warned of the risk factor, and have sold without a hitch.[93] Markets are aware of the risk and are pricing it

[88] The housing bubble was after all, like all bubbles, an overabundant credit-fueled asset-price bubble. *See generally* Hockett, *It Takes a Village*, *supra* note 2 (manuscript Parts I–II); Hockett, *Recursive Collective Action Problems*, *supra* note 9. For more on the financial and legal viability of the plan, see, for example, Reiss, *supra* note 80; Christopher Serkin, *Democratic Government and Eminent Domain*, in response to *From* Kelo *With Love: Revisiting* Kelo*'s Flawed Economics and Vacuous Constitutionalism*, ONLINE LIBR. L. & LIBERTY (Nov. 4, 2012), http://libertylawsite.org/liberty-forum/democratic-government-and-eminent-domain/.

[89] For further discussions, see again the observations adduced *supra*, note 85.

[90] Steven Gluckstern, *In Response to SIFMA's Announcement*, MORTGAGE RESOL. PARTNERS, http://mortgageresolutionpartners.com/in-response-to-sifmas-announcement (last visited May 21, 2013).

[91] *See, e.g.*, Press Release, Office of Lieutenant Governor of Cal., Lt. Gov. Gavin Newsom Sends Letter to US Attorney General Holder and Antitrust Division (Sept. 10, 2012), *available at* http://ltg.ca.gov/news.2012.09.10_USDOJ_Letter.html; Press Release, Office of Lieutenant Governor of Cal., Lt. Gov. Gavin Newsom: Local Governments Should Have Freedom to Explore Options to Address Mortgage Crisis (July 27, 2012), *available at* http://www.ltg.ca.gov/news.2012.07.27_SB_Mortgage.html.

[92] *See* INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: NAVIGATING THE FINANCIAL CHALLENGES AHEAD 93, 109 (2009).

[93] *See* SEC Filing, Prospectus Supplement: Sequoia Mortgage Trust 2012-4 (Sept. 20, 2012), *available at* http://www.sec.gov/Archives/edgar/data/1176320/000114420412052666/v744346_424b5.htm. The Sequoia transaction is expected to be oversubscribed. *See* Jon Prior,

in, as they should, and as they will whether any government actually condemns loans or not.

V. Conclusion: It Takes a Village

We hope we have made the point plain. Although the underwater-mortgage-loan problem bears considerable national consequences, it remains at its core a profoundly local problem tied to particular toxic loans originated locally. This fact bears two salient consequences. One is that the problem's disproportionately local character poses some obstacle to federal authorities' treating it with the seriousness that it warrants. The other is that the localities that have sufficient incentive to take the problem seriously, ironically, lack sufficient resources to act—precisely because the problem in this case strikes at local finances themselves by squeezing local property-tax bases.

The only way around this poignant double bind is for localities to use private funds in addressing their problems. In this case that's altogether fitting. The localities will do what they do best—make local policy as the government closest to the people—and at the same time will help private enterprise do what it does best but cannot do now because of the limitations of private securitizations.

Redwood Brings Seventh Jumbo RMBS to Market Since 2010, HousingWire (Sept. 10, 2012, 11:33 AM), http://www.housingwire.com/news/redwood-brings-7th-jumbo-rmbs-market.