NOTE

Public Muscle and Private Profit: A Flawed Scheme for Stemming Foreclosures Through the Power of Eminent Domain

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ABSTRACT

A new scheme, first introduced by Professor Robert C. Hockett, and later advocated for by Mortgage Resolution Partners, seeks to persuade municipalities and local governments to use its sovereign power of eminent domain to seize residential mortgages. The power of eminent domain is the power to take property for a public need, traditionally used to seize real property to build public lands such as parks and roads. In seizing intangible mortgages and servicing rights, however, this scheme would interfere with the secondary mortgage market and harm the many different interests involved. Although the scheme's stated purpose of preventing another foreclosure crisis is honorable, its intrusion into the secondary mortgage market will do more harm than good. Investors, faced with an unprecedented new risk, will flee the market, drying up necessary capital for mortgage lenders. Furthermore, the scheme, at its core, is a profit-making investment, and should not be allowed as a "public use." The state model legislation that this Note puts forth would limit the definition of public use in order to forbid this dangerous exercise of eminent domain.

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Introduction: Paving with Good Intentions

Though the American spirit of entrepreneurialism smiles upon innovative ways of making a profit, such ends should never be achieved through a private actor's misappropriation of governmental powers. Those powers should ideally interfere in any market only to correct imperfections. A new scheme, however, should it come to fruition, would place the sovereign power of eminent domain in the hands of private actors for their own profit.

That scheme, first introduced by Cornell Law Professor Robert C. Hockett[1] and later advocated for by Mortgage Resolution Partners ("MRP")—a San Francisco-based firm which labels itself a "community advisory firm"[2]—seems simple at first. Essentially, under the scheme ("MRP Scheme"), a city or municipality would use its sovereign power of eminent domain to seize residential mortgages.[3] With the loan in its possession, the government would renegotiate the terms of the mortgage with the original borrower to reduce the principal amount owed and adopt the role of the loan's servicer.[4] The government would then receive the monthly payments from the borrower in accordance with the terms of the loan.[5]

Proponents of the MRP Scheme seek to prevent a foreclosure crisis through wide-scale principal reduction.[6] A closer inspection, however, reveals a profit-making scheme that places a tremendous sovereign power in the hands of private actors to bypass market barriers found in typical arm's length transactions. Particularly troubling, by seizing loans through eminent domain in order to alter the terms of a loan, a municipality bypasses contractual obligations established in mortgage securitization contracts.[7] The scheme allows private actors to flex public muscle for their own gain. Furthermore, the scheme will do more harm than good, and there are alternatives available for the problems that MRP and Professor Hockett address.[8]

Recently, MRP has advocated for its scheme in various states, hoping that municipalities will accept the idea. San Bernardino, California, looked to be the first city to adopt the scheme but ultimately abandoned the proposal due to unresolved issues surrounding its validity.[9] Though the MRP Scheme received more attention following this rejection, no municipality was willing to be the first to move for-

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

2 *Fact or Fiction*, MORTGAGE RESOL. PARTNERS, http://www.mortgageresolution.com/fact-or-fiction (last visited Jan. 5, 2015).

3 Hockett, *supra* note 1, at 124–25.

4 *Id.* at 151.

5 *Id.*

6 *Id.* at 137. Principal reduction is the reduction of the total amount owed on the mortgage.

7 *Infra* Part II.B.

8 *Infra* Part III.B.

9 Alejandro Lazo, *San Bernardino County Abandons Mortgage Plan*, L.A. TIMES, Jan. 25, 2013, at B3.

ward with the scheme.[10] MRP eventually found a city to take the lead when Richmond, California, adopted the plan in the summer of 2013.[11] Richmond has yet to seize any mortgages, but its mayor, Gayle McLaughlin, has staunchly defended the plan and made her intentions to put the MRP Scheme into action very clear.[12] After Richmond, other cities warmed to the idea.[13]

The MRP Scheme has its fair share of detractors as well as supporters, and has become highly politicized. Many groups representing the interests of realtors, mortgage bankers, and investors oppose the plan as a significant intrusion on and disruption of the normal workings of their respective markets and as abusive governmental intervention.[14] Proponents of the plan see it as a means of fighting big banks and "corporate domination."[15] The MRP Scheme has even generated a lawsuit, which was eventually dismissed as not ripe.[16] As of this writing, there are no legal obstacles to the MRP Scheme.

The road to hell is often paved with good intentions. Despite the attractive short-term fix and the honorable intentions, the use of eminent domain to seize residential mortgages would, in the long run,

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10 *See, e.g.*, Jim Christie, *Nevada City Rejects Eminent Domain Plan for Mortgages*, REUTERS, Sept. 5, 2013, *available at* http://www.reuters.com/article/2013/09/05/northlasvegas-eminentdomain-idUSL2N0H104W20130905; Brian Collins, *Another City Rejects Eminent Domain*, NAT'L MORTGAGE NEWS (Sept. 5, 2013, 1:51 PM), http://www.nationalmortgagenews.com/dailybriefing/Another-City-Rejects-Eminent-Domain-1038633-1.html.

11 Alejandro Lazo, *Bay Area City May Seize Mortgages*, L.A. TIMES, July 31, 2013, at B2.

12 Laura Flanders, *Q&A: Gayle McLaughlin*, NATION, Dec. 9, 2013, at 5; *see also* Shaila Dewan, *A Long Shot Against Blight*, N.Y. TIMES, Jan. 12, 2014, at BU1 ("The risk that is really confronting us . . . is waiting on the sidelines for the next wave of foreclosures." (internal quotation marks omitted)).

13 *See, e.g.*, Shaila Dewan, *More Cities Consider Eminent Domain to Halt Foreclosures*, N.Y. TIMES, Nov. 16, 2013, at B4; Terrence Dopp, *Newark Advances Eminent Domain Plan to Slow Foreclosures*, BLOOMBERG (Dec. 5, 2013, 1:59 PM), http://www.bloomberg.com/news/2013-12-05/newark-advances-eminent-domain-plan-to-slow-foreclosures.html.

14 *See, e.g.*, Letter from Tom Deutsch, Exec. Dir., Am. Securitization Forum, to Luis Quintana, Mayor of Newark, N.J., et al. (Dec. 6, 2013) [hereinafter ASF Comment Letter to Newark], *available at* http://www.americansecuritization.com/WorkArea/DownloadAsset.aspx?id=10069; *Eminent Domain Resource Center*, SIFMA, http://www.sifma.org/issues/capital-markets/securitization/eminent-domain/overview (last visited Jan. 5, 2015).

15 Michael B. Marois, *California Mayor Attacks "Greed" with Eminent Domain Bid*, BLOOMBERG (Aug. 2, 2013, 12:33 AM), http://www.bloomberg.com/news/2013-08-02/california-mayor-attacks-greed-with-eminent-domain-bid.html (internal quotation marks omitted).

16 Order Granting Defendants' Motion to Dismiss and Denying Plaintiffs' Motion for a Preliminary Injunction, Wells Fargo Bank, Nat'l Ass'n v. City of Richmond, No. 3:13-cv-03663-CRB (N.D. Cal. Sept. 16, 2013), ECF No. 78. Plaintiffs in the case argued that the scheme was an unconstitutional taking of private property, as well as a violation of 42 U.S.C. § 1983. *See* Complaint at 34–35, Wells Fargo Bank, Nat'l Ass'n et al. v. City of Richmond, No. 3:13-cv-03663-CRB (N.D. Cal. Aug. 7, 2013), ECF No. 1.

harm the secondary mortgage market as well as homeowners and lenders in real estate markets. In Part I, this Note discusses the power of eminent domain, the current state of eminent domain legislation and jurisprudence, and some criticisms of eminent domain. Part II discusses the secondary mortgage market and demonstrates that eminent domain, as used by MRP, will interfere with the structures of mortgage financing. Part III shows how the MRP Scheme would use eminent domain in the mortgage market and why the MRP Scheme would be so damaging. Part IV proposes model legislation at the state level that would effectively halt the MRP Scheme and will explain why such legislation is the preferred solution.

I. PUBLIC MUSCLE: THE POWER OF EMINENT DOMAIN

Key to the MRP Scheme is the exercise of the sovereign power of eminent domain to seize residential mortgages. This Part analyzes the power of eminent domain, how it operates at the federal and state level, the role the judiciary often plays, and various criticisms of this tremendous power.

A. Sovereign Power or Legalized Theft: The Origins and Nature of Eminent Domain

Eminent domain is the "right or power of a sovereign State to appropriate private property to particular uses, for the purpose of promoting the general welfare."[17] It is a power that inheres in the sovereign.[18] Thus, it is not granted by any constitutional decree or legislative enactment, and the United States Constitution only acts as a limit to the power.[19] The Fifth Amendment requires that property must be taken only for the furtherance of a public use and that the government must provide "just compensation."[20]

Eminent domain law exists at both the state and federal levels. The Fourteenth Amendment incorporates the same public use and just compensation limitations against the states.[21] Within these federal constitutional limits, state constitutions may set out similar public use

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17 1 JOHN LEWIS, A TREATISE ON THE LAW OF EMINENT DOMAIN IN THE UNITED STATES § 1 (2d ed. 1900).

18 *See, e.g.*, 11A WEST'S INDIANA LAW ENCYCLOPEDIA, EMINENT DOMAIN § 2 (2007).

19 United States v. Jones, 109 U.S. 513, 518 (1883) ("The power to take private property for public uses . . . belongs to every independent government. It is an incident of sovereignty . . . .").

20 U.S. CONST. amend. V.

21 2 RONALD D. ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE § 15.11, 957–58 (5th ed. 2012).

and compensation requirements,[22] and legislation generally develops detailed procedures for how property may be seized and what due process rights are available to those from whom property is taken.[23] These state laws, save for minor procedural differences, are often quite similar.[24]

That the government may swoop in and snatch away private property might seem like legalized theft.[25] Three requirements are in place, however, to mitigate the insidious potential of this power: the public use, just compensation, and necessity requirements.

1. Public Use

The first element of eminent domain—that property seized must be put to a public use—is arguably the most important and receives the most attention. James Madison, the drafter of the public use clause, feared that without such a requirement the government would be free to seize property at its whim, to the detriment of private citizens.[26] The concept of public use, however, is not as easy to define as it might seem. There are traditional uses of the eminent domain powers that are unquestionably considered to be public uses—such as seizing land for the construction of roads, highways, and public utilities.[27] Perhaps due to the almost tautological nature of the public use definition (that a public use is one that is useful to the public), state legislation gives common examples of public uses, in addition to a general definition.[28]

Perhaps what makes certain uses so unquestionably acceptable for eminent domain is the fact that these uses are open to the public

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22 *See, e.g.*, CAL. CONST. art. I, § 19; FLA. CONST. art X, § 6; GA. CONST. art I, § 3, para. 1; MICH. CONST. art. X, § 2; MINN. CONST. art. I, § 13; NEV. CONST. art. I, § 8(6); N.Y. CONST. art. I, § 7(a).

23 *See, e.g.*, CAL. CIV. PROC. CODE § 1240.010 (West 2007); FLA. STAT. ANN. § 73.012 (West 2004); GA. CODE ANN. § 22-1-2 (1982); MICH. COMP. LAWS ANN. § 213.1 (West 1998); MINN. STAT. ANN. § 117.012 (West 2014); NEV. REV. STAT. §§ 37.009–37.060 (2013); N.Y. EM. DOM. PROC. LAW § 101 (McKinney 2003).

24 *See* sources cited *supra* note 23.

25 Press Release, Green Party of the United States, Supreme Theft (June 28, 2005), *available at* http://www.gp.org/press/pr_2005_06_28.shtml.

26 Daniel B. Kelly, *The "Public Use" Requirement in Eminent Domain Law: A Rationale Based on Secret Purchases and Private Influence*, 92 CORNELL L. REV. 1, 9 (2006).

27 *See, e.g.*, Dohany v. Rogers, 281 U.S. 362, 366 (1930); Rindge Co. v. Cty. of Los Angeles, 262 U.S. 700, 706 (1923) ("That a taking of property for a highway is a taking for public use has been universally recognized, from time immemorial.").

28 *See, e.g.*, ARIZ. REV. STAT. ANN. § 12-1111 (2012); FLA. STAT. ANN. § 166.411 (West 2004); TEX. LOC. GOV'T CODE ANN. § 251.001 (West 2014); WASH. REV. CODE ANN. § 8.12.030 (West 2007).

after seizure: anyone can visit parks or drive on highways and roads, for example.[29] Indeed, a traditional and narrow perspective on public use is one that is limited only to instances where property seized remains open to the public.[30] The use of eminent domain to seize property and thereafter transfer it to a private party, however, has become an acceptable public use. This divergence from the more traditional view of public use was cemented in *Kelo v. City of New London*.[31] In *Kelo*, although the seized property was ultimately transferred to a private development company for purposes of developing private residences and public parks, the court found in the taking a valid public use.[32] *Kelo* remains the law on public use at the federal level.

2. Just Compensation

It has long been recognized that the government-sanctioned taking of private property, in order to satisfy due process of law, requires just compensation to be paid to the person from whom property is seized.[33] The requirement of just compensation not only acts as a means of assuring due process, but can also act as a deterrent from excessive government takings by making it more expensive.[34] Generally, the standard by which compensation is measured is the fair market value of the property seized, or the price that two parties would normally come to in an arm's length transaction.[35] This fair market value standard is also used at the state level.[36]

3. Necessity

The necessity requirement signifies that, to be valid, eminent domain must be the only means through which an end can be achieved.[37]

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29 *See* Ralph Nader & Alan Hirsch, *Making Eminent Domain Humane*, 49 VILL. L. REV. 207, 207 & n.5 (2004).

30 *See* Kelly, *supra* note 26, at 2–3.

31 Kelo v. City of New London, 545 U.S. 469 (2005).

32 *Id.* at 473–75; *see also id.* at 485 ("Petitioners contend that using eminent domain for economic development impermissibly blurs the boundary between public and private takings. Again, our cases foreclose this objection.").

33 *See, e.g.*, Lingle v. Chevron, U.S.A. Inc., 544 U.S. 528, 536–37 (2005).

34 Marisa Fegan, Note and Comment, *Just Compensation Standards and Eminent Domain Injustices: An Underexamined Connection and Opportunity for Reform*, 6 CONN. PUB. INT. L.J. 269, 274–76 (2007).

35 *See, e.g.*, Palazzolo v. Rhode Island, 533 U.S. 606, 625 (2001); Olson v. United States, 292 U.S. 246, 255 (1934).

36 *See, e.g.*, La. Power & Light Co. v. Roy, 198 So. 2d 484, 487 (La. Ct. App. 1967); State Highway Dep't v. Murray, 115 S.E.2d 711, 714 (Ga. Ct. App. 1960).

37 Robert C. Bird, *Reviving Necessity in Eminent Domain*, 33 HARV. J.L. & PUB. POL'Y 239, 240 (2010).

Unlike the previous two elements, the requirement of necessity is not explicitly stated in the U.S. Constitution, nor in most state constitutions.[38] This leaves the question of when eminent domain truly is necessary in the hands of the legislature, rather than the judiciary.[39] Many states have codified the necessity requirement in procedural laws governing condemnation and eminent domain.[40] Even where uncondified, the judiciary treats a sovereign's necessity determinations—like determinations on all aspects of eminent domain—with significant deference.

B. Painting the Roses Red: Judicial Deference and Legislative Wisdom

There is a scene in the Disney film *Alice in Wonderland* where the Red Queen's soldiers are frantically painting the white roses red because "the Queen, she likes them red."[41] A trip through eminent domain jurisprudence paints a similar picture. The courts, at both the state and federal levels, are highly deferential to the decisions of the legislatures. Should a state or federal authority determine that a particular use of the power of eminent domain is necessary for a public purpose, then this is likely to survive any challenge to its validity.

Perhaps the most explicit example of judicial deference can be found in the seminal case of *Berman v. Parker*.[42] In *Berman*, Congress sought to condemn blighted property in order to eliminate "all such injurious conditions by employing all means necessary and appropriate for the purpose."[43] The act declared condemnation necessary and for a public purpose.[44] Once the land had been put to public use—such as through the creation of streets, utilities, recreational facilities, and schools—the remainder of the land was to be leased or sold, with preference given to private enterprises over public agencies.[45] Owners of a department store in the area the government sought to seize ar-

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38 U.S. CONST. amend. V (explicitly stating only "public use" and "just compensation").

39 1A JULIUS L. SACKMAN, NICHOLS ON EMINENT DOMAIN § 4.11 (3d ed. 2011).

40 For instance, California requires that governing authorities seeking to flex the eminent domain muscle must file a "resolution of necessity." CAL. CIV. PROC. CODE § 1240.040 (West 2007). In Florida, governing authorities seeking condemnation must file a declaration of taking. FLA. STAT. ANN. § 74.031 (West 2004). The power to condemn in Florida "is in every case limited to *such* and *so much* property as is necessary for the public use in question." Brest v. Jacksonville Expressway Auth., 194 So. 2d 658, 661 (Fla. Dist. Ct. App. 1967).

41 ALICE IN WONDERLAND (Walt Disney Pictures 1951).

42 Berman v. Parker, 348 U.S. 26 (1954).

43 *Id.* at 28 (internal quotation marks omitted).

44 *Id.* at 29.

45 *Id.* at 30.

gued that the taking was unconstitutional because the area was not a slum and that the property, once seized, would be put under private management.[46]

The Court upheld the plan as constitutional and declared "[i]t is within the power of the legislature to determine that the community should be beautiful."[47] Justice Douglas, writing for the majority, went on to clarify:

> Once the object is within the authority of Congress, the right to realize it through the exercise of eminent domain is clear. For the power of eminent domain is merely the means to the end. . . . [And] the means by which it will be attained is also for Congress to determine.[48]

The Court made perfectly clear its willingness to allow the legislature to determine for itself what constitutes a public use. If Congress wanted the roses red, they must be red.

A more recent case, *Hawaii Housing Authority v. Midkiff*,[49] held that when there is some "conceivable" public purpose related to the exercise of eminent domain, the Court cannot substitute its judgment for a legislature's as to what constitutes such a public use.[50] The Court relied heavily on the principles already established in *Berman* and reaffirmed that the exercise of eminent domain is "coterminous" with the scope of a sovereign's police power and that the role courts play in reviewing the legislature's judgment is "an extremely narrow one."[51] The court also stated, albeit in a footnote, that "the Contract Clause has never been thought to protect against the exercise of the power of eminent domain," declaring off-handedly that the government may seize property even when it interferes with existing contracts.[52]

Judicial deference to legislative enactments is largely the same at the state level. Although the judiciary retains the power to declare a taking unconstitutional, substantial deference is granted to a legislative enactment declaring a particular exercise of eminent domain to be for the public use.[53] Of the fifty states in the union, only four—

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46 *Id.* at 31.

47 *Id.* at 33.

48 *Id.*

49 Haw. Hous. Auth. v. Midkiff, 467 U.S. 229 (1984).

50 *Id.* at 241–43.

51 *Id.* at 240 (quoting *Berman*, 348 U.S. at 32) (internal quotation marks omitted).

52 *Id.* at 243 n.6. As will be further explained below, because the MRP Scheme hopes to seize mortgages that have been securitized in accordance with securitization contracts, this footnote is of vital importance for the MRP Scheme.

53 *See, e.g.*, Yonkers Cmty. Dev. Agency v. Morris, 45 A.D.2d 889, 890 (N.Y. App. Div.

Arizona, Colorado, Missouri, and Washington—exclusively reserve the public use question to the judiciary.[54]

C. *Criticisms of Eminent Domain*

Given the scope of the power of eminent domain, it is no surprise that many are critical of the power. Generally, those who are more conservative or libertarian fear the power of the government to seize land from unsuspecting citizens.[55] Those with more liberal inclinations fear that powerful corporations and individuals often end up directly benefiting from a sovereign's use of eminent domain, at the expense of the poor and racial minorities.[56] Critics do not, however, attack or challenge the validity of the power itself. Most critics accept the government's occasional need to seize land for public purposes such as roads and parks.[57] Instead, criticism often focuses on the application of the public use, just compensation, and necessity elements.

For instance, many critics focus on the inadequacy of just compensation. One particularly normative approach focuses on the sanctity of the home and the inability of a "fair market value" standard to appraise the subjective value a family or a homeowner places upon their property.[58] Similarly, Lee Anne Fennell finds that "subjective" values might not just mean the sentimental value placed on a person's

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1974) (holding that the determination of whether a condemnation is a public use is a judicial question, with the resolution depending on legislative finding); Black Rock Placer Mining Dist. v. Summit Water & Irrigation Co., 133 P.2d 58, 61–62 (Cal. Dist. Ct. App. 1943) (holding that public use is a question of law, although deference will be paid to legislative judgment, as expressed in enactment).

54 ARIZ. CONST. art. 2, § 17 ("Whenever an attempt is made to take private property for a use alleged to be public, the question whether the contemplated use be really public shall be a judicial question, and determined as such without regard to any legislative assertion that the use is public."); COLO. CONST. art. 2, § 15 ("[W]henever an attempt is made to take private property for a use alleged to be public, the question whether the contemplated use be really public shall be a judicial question, and determined as such without regard to any legislative assertion that the use is public."); MO. CONST. art. 1, § 28 ("[W]hen an attempt is made to take private property for a use alleged to be public, the question whether the contemplated use be public shall be judicially determined without regard to any legislative declaration that the use is public."); WASH. CONST. art. 1, § 16 ("Whenever an attempt is made to take private property for a use alleged to be public, the question whether the contemplated use be really public shall be a judicial question, and determined as such, without regard to any legislative assertion that the use is public . . . .").

55 Paul Boudreaux, *Eminent Domain, Property Rights, and the Solution of Representation Reinforcement*, 83 DENV. U. L. REV. 1, 2 (2005).

56 *Id.*

57 Nader & Hirsch, *supra* note 29, at 207.

58 *See generally, e.g.*, John Fee, *Eminent Domain and the Sanctity of Home*, 81 NOTRE DAME L. REV. 783 (2006) (arguing that current eminent domain law does not adequately protect the home).

home, but could also include such "hard" valuations as the cost of moving and restarting life elsewhere.[59] The more sentimental and personal values placed on property are unique to the original owner and thus nontransferable because the new possessor will not hold the same subjective values and sentimental history.[60] Eminent domain is therefore inefficient, so the argument goes, because of the failure to compensate for this "subjective premium."[61]

Another common criticism of eminent domain posits that, due to judicial deference, the public use requirement has become a legal nullity, and that it is too easy for a legislature to simply declare a project to be for a public use.[62] Central to this belief is the fear that a corrupt government could potentially abuse its power and seize land for inefficient projects, or perhaps for political favors.[63] Some even fear that the label of blight—long considered a valid public use—is being abused so as to sweep any redevelopment project under this label and thus claim it as a public use.[64] Many of those who fear that the expanded definition of public use allows for governmental abuse also fear abuse of the eminent domain powers by private parties.[65] Particularly troublesome is the ability of a private actor to get around holdouts who refuse to sell their land by convincing the legislature, in exchange for favors or some other illicit consideration, to label the acquisition of the land by the private company as a public benefit.

This last criticism of eminent domain is perhaps the one most applicable to the current MRP Scheme. Because the use of eminent domain to seize residential mortgages is highly unorthodox compared to the traditional seizure of real property and tangible assets, however, it is necessary to first understand mortgage financing in order to fully grasp the MRP Scheme's effect.

II. The Mortgage Finance System

Exercising the power of eminent domain to take possession of a mortgage is much more complicated than seizing a single piece of property. The American system of mortgage financing is compli-

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59 Lee Anne Fennell, *Taking Eminent Domain Apart*, 2004 Mich. St. L. Rev. 957, 963.

60 *Id.* at 964.

61 *Id.*

62 *See* Nader & Hirsch, *supra* note 29, at 208.

63 Gary Becker, *On Eminent Domain*, Becker-Posner Blog (June 27, 2005, 7:35 AM), http://www.becker-posner-blog.com/archives/2005/06/index.html.

64 *See, e.g.*, Martin E. Gold & Lynne B. Sagalyn, *The Use and Abuse of Blight in Eminent Domain*, 38 Fordham Urb. L.J. 1119, 1120 (2011).

65 Boudreaux, *supra* note 55, at 2.

cated.[66] Seizing a mortgage affects the interests of many different parties.[67] It is not just the owner of the land to which the mortgage is secured or the original lender who may be harmed or benefitted.[68]

A. Your Friendly Neighborhood Special-Purpose Vehicle: The Modern Mortgage Finance System

Banking, for better or for worse, has evolved from an already complicated concept into a multifaceted, and almost bewilderingly complex industry. Although not entirely gone, the traditional image of a community-focused local bank is not the dominant model, and the same can be said of mortgage lending.[69]

The traditional loan to a single homebuyer is a relationship between the borrower and the loan originator.[70] It begins with an individual or family who decides to buy a house and needs to borrow the money to acquire it.[71] The borrower and originator work together to determine the terms of the mortgage loan.[72] The originator requires information about the borrower's income, credit, and any other pertinent financial information in order to determine the creditworthiness of the borrower and the available repayment options.[73] Once the loan is made, the lender retains the loan on its books and acts as servicer by receiving all monthly payments, sending out bills, and taking care of administrative issues.[74] Any modifications to the terms of the loan are made pursuant to an agreement between the lender and the borrower.[75]

This model started to change around the time of the Great Depression when Congress, seeing a need to increase liquidity in the mortgage market, established the Federal National Mortgage Association ("FNMA," or, more commonly, "Fannie Mae").[76] Congress in-

66 *See* WILLIAM A. FREY, WAY TOO BIG TO FAIL: HOW GOVERNMENT AND PRIVATE INDUSTRY CAN BUILD A FAIL-SAFE MORTGAGE SYSTEM 33–42 (Isaac M. Gradman ed., 2011).

67 *See* Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 13–14 (2011).

68 *See* Diane E. Thompson, *Foreclosing Modifications: How Servicer Incentives Discourage Loan Modifications*, 86 WASH. L. REV. 755, 763 (2011).

69 Levitin & Twomey, *supra* note 67, at 11.

70 Anna T. Pinedo, *Easing into a New Model for Housing Finance: A Postmortem on Securitization and the Financial Crisis*, 41 UCC L.J. 157, 161 (2009).

71 FREY, *supra* note 66, at 33.

72 *See id.*

73 *Id.*

74 Levitin & Twomey, *supra* note 67, at 11.

75 *See id.*

76 Ann Graham, *Introduction: Reforming the Secondary Mortgage Market*, 35 HAMLINE L. REV. 327, 329 (2012).

tended for Fannie Mae to purchase mortgages from lenders in order to provide the lenders with more funding.[77] This provided more liquidity and capital to lenders, and they were able to originate more loans to homeowners, who could not purchase a home without some help through mortgage financing.[78]

This evolution led to the current system of mortgage finance. Typically, the loan originator will sell off the original loan to either a government-sponsored enterprise ("GSE") (such as Fannie Mae) or to a private financial institution.[79] The institution that purchases a loan for resale is called the "sponsor" and will pool together multiple loans through securitization.[80] Securitization can be defined as the transfer of a payment right.[81] In the context of mortgage lending, the sponsor collects rights to receive income from monthly payments made by the borrowers of many underlying loans. The securities are transferred to a trust established through a Single-Purpose Vehicle ("SPV"), and investors purchase certificates in this trust.[82] The investors have no legal ownership over the loans underlying the investment, but receive payment derived from the payment of each individual loan.[83]

This structure makes the roles of the servicer and trustee very important. The servicer is the entity that handles all of the administrative issues, such as collecting payments from borrowers, sending out monthly billing information, and making any modifications to the underlying loans.[84] The loan originator, who held an undivided interest in the loan, traditionally bore this responsibility, and handled all other administrative issues.[85] When the lender sells the loans, however, it sells the servicing rights as well.[86] A larger-scale entity is better situated to handle the administrative issues for the burdensome amount

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77 *Id.*

78 Pinedo, *supra* note 70, at 161.

79 *Id.* at 161–62.

80 Levitin & Twomey, *supra* note 67, at 13.

81 More specifically, Jonathon C. Lipson defines securitization as the "purchase of primary payment rights by a special purpose entity that (1) legally isolates such payment rights from a bankruptcy (or similar insolvency) estate of the originator, and (2) results, directly or indirectly, in the issuance of securities whose value is determined by the payment rights so purchased." Jonathan C. Lipson, *Re: Defining Securitization*, 85 S. CAL. L. REV. 1229, 1233 (2012).

82 FREY, *supra* note 66, at 37; Levitin & Twomey, *supra* note 67, at 13–14.

83 Thompson, *supra* note 68, at 763.

84 Levitin & Twomey, *supra* note 67, at 23.

85 *Id.* at 11.

86 FREY, *supra* note 66, at 35.

of individual loans in the trust.[87] The trustee, tasked with overseeing the servicer, acts as the legal protection for the investors and has the ability to fire the servicer at the request of the investors.[88]

There are both major benefits and costs to this new structure of mortgage financing. The primary benefit of securitization, particularly in the context of the secondary mortgage market, is to provide more capital and liquidity for the lenders who originate the loan.[89] By selling the loans to another entity, that lender receives more capital with which it can create additional loans and help other borrowers find housing.[90] Additionally, by selling off the loan, the lender can shield itself from the credit risk of the loan and send it off to other entities that are better positioned to handle that risk.[91] Securitization is also useful for diversifying risk by pooling together assets such that only a small percentage of the total investment may experience some kind of default or defect.[92]

A primary downside of this new arrangement is the separation, and addition, of interests and breakdown of ownership.[93] This makes the whole system much less personal. A borrower may have had a friendly and professional relationship with their local banker, but undoubtedly is not familiar with the numerous investors who now have some nominal interest in their loan.[94] Furthermore, the separation of roles can lead to significant conflicts between those roles and their respective interests.[95] These relationships are governed by a contrac-

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87 *See* Levitin & Twomey, *supra* note 67, at 25 (finding that "megaservicers" faced servicing costs of thirty-six dollars per loan, compared to an industry average of forty-seven dollars per loan).

88 Thompson, *supra* note 68, at 765–66.

89 Andrea J. Boyack, *Laudable Goals and Unintended Consequences: The Role and Control of Fannie Mae and Freddie Mac*, 60 AM. U. L. REV. 1489, 1495 (2011).

90 Pinedo, *supra* note 70, at 161.

91 These types of sales are described as a "moral hazard" in the "Originate-To-Distribute" Model, whereby lenders will make excessively risky loans, knowing they can be sold off. *See* Steven L. Schwarcz, *The Future of Securitization*, 41 CONN. L. REV. 1313, 1318–21 (2009). A discussion of this aspect of securitization exceeds the scope of this paper, but it suffices to say for now that there are means of mitigating the risk of this hazard, as exemplified by recent legislation, such as the Dodd-Frank Act.

92 For a further discussion on the benefits of securitization, see Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061 (1996).

93 *See* Levitin & Twomey, *supra* note 67, at 69–70, 75–76.

94 *Id.* at 7 (discussing how most homeowners do not know that their private lender bank securitizes their mortgages by reselling to third-party servicers).

95 *See, e.g.*, John P. Hunt, *What Do Subprime Securitization Contracts Actually Say About Loan Modification? Preliminary Results and Implications* 1–2 (Berkeley Ctr. for Law, Bus. & the Econ., Working Paper, Mar. 25, 2009), *available at* http://www.law.berkeley.edu/files/Subprime_Securitization_Contracts_3.25.09.pdf.

tual arrangement known as a Pooling and Servicing Agreement ("PSA"), inherent in all securitizations.[96] The PSA, however, gives rise to some problems of its own.

B. PSAs and a Collective Action Problem

The PSA is the contractual arrangement that, among other things, lays out the legal rights of investors and the legal duties of the servicer and the trustee.[97] Although these documents are very often similar among different securitizations, they are not standard, and the specific terms of the arrangements can vary.[98]

When it comes to trustees, the PSA is the indenture under which the securities are issued.[99] The terms set out the legal rights of the investors and are structured to ensure that the trustee and servicer act in the best interest of the investors—for example, servicers must service the loans as if for their own account.[100] In practice, however, the PSAs can create many complications that make enforcing investors' rights difficult. For instance, if the investors seek to petition the trustee to assert a legal right against the servicer for failure to perform its duties, many PSAs require twenty-five percent (or more) of the investors to join the petition.[101] This gives rise to an inherent collective action problem, as the investors may be too dispersed to meet the twenty-five percent threshold.[102]

Another issue involves loan modification. Generally, when individual borrowers are having problems making their payments, they can default on the loan—which leads to foreclosure—or they can work with the servicer to modify the terms of the loan and hopefully make them more favorable to the borrowers.[103] There is a conflict of interest inherent in these two options. It is in the best interest of the investors to modify the loan and continue receiving some payment, however diminished, whereas it may be in the best interest of the servicer to foreclose.[104] This is because if the borrower is not making his

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96 Levitin & Twomey, *supra* note 67, at 31.

97 *Id.* at 31–32.

98 FREY, *supra* note 66, at 117.

99 Levitin & Twomey, *supra* note 67, at 31.

100 *Id.*

101 FREY, *supra* note 66, at 117.

102 Levitin & Twomey, *supra* note 67, at 62.

103 FREY, *supra* note 66, at 40.

104 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, 172–73 (2011).

payments on time, the servicer continues to collect more and more in late fees, which it would not receive if it timely modified the loan to the benefit of the borrower.[105] The servicer may instead delay action and collect late fees, which it does not have to contribute to the trust (unlike the proceeds it receives through regular and timely payments).[106] Additionally, the PSA may set out limits on modifications, such as limiting the types of modifications allowed or requiring servicers to repurchase any loans for face value that they modify, or by requiring specific conditions, such as an imminent threat of default, before modification can occur.[107]

Professor Hockett and MRP cite these barriers to loan modification as a primary reason why eminent domain is necessary.[108] As the argument goes, because loan modification is necessary to prevent foreclosures, eminent domain must be used to seize the individual loans from the contractual arrangements that give rise to the barriers to loan modification, and place them in the hands of the government.[109] The government, in turn, will be willing and able to modify the loans for the borrower. Although Professor Hocket and MRP correctly identify a number of substantial barriers to loan modification, these barriers are not insurmountable. As will be discussed below, many commentators have put forth ideas on how to amend PSAs to better align servicers' incentives.[110] Understanding these factors and the nature of mortgage securitization, the MRP Scheme can now be fully evaluated.

III. Private Profit: A Flawed Scheme with (Mostly) Good Intentions

The MRP Scheme is a radical new use of eminent domain that brings together this tremendous sovereign power with mortgage finance. This section shows how and why the MRP Scheme brings them together, and why letting the scheme go forward would do more harm than good.

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105 Frey, *supra* note 66, at 124; *see also* Thompson, *supra* note 68, at 777.

106 Frey, *supra* note 66, at 123.

107 Levitin & Twomey, *supra* note 67, at 33–34.

108 *See generally* Hockett, *supra* note 1, at 148–52.

109 *Id.*

110 *Infra* Part III.B.

A. The Mechanics and Philosophy Behind the MRP Scheme

The central concept behind the MRP Scheme is straightforward: the government uses its eminent domain power to seize residential mortgages, renegotiates with each borrower to reduce principal owed, and receives monthly payments in place of the original lender. The mechanics of the plan, however, are much more complicated. It helps to understand the overall scheme by looking at the various stages and the roles played in each stage. The scheme operates in three phases: fundraising, seizure, and repayment.

1. Fundraising Stage

The first stage sees the government raising funds from private investors.[111] The investment appears open to anyone with the money to front. The plan does, however, specifically contemplate that current holders of mortgage-backed securities would participate in funding the operation as well as "public and private pension funds, insurance companies, mutual funds and other investment firms."[112]

2. Seizure Stage

In the second stage of the scheme, the government identifies mortgages ripe for the taking and then takes them.[113] This stage is much more complicated than the first and involves many steps of its own.

In the seizure stage, the municipality must first identify mortgages to be seized.[114] This is where MRP plays an important role. In addition to its role as a vocal advocate, MRP enters into an advisory contract with the municipality and acts as an advisor responsible for locating loans.[115] In Richmond, California, alone, MRP has identified 624 loans.[116] In return for its service, the venture capital firm collects a flat fee of $4,500 per mortgage.[117] Herein lies the potential for profit. In just one city, MRP could collect close to $3 million.[118] Con-

111 Hockett, *supra* note 1, at 150–51.

112 *Id.* at 152.

113 *See id.* at 152–55.

114 *See id.* at 154–55.

115 *See, e.g.*, Advisory Services Agreement, Mortgage Resolution Partners LLC and City of Richmond ¶ 2(g), July 25, 2013, *available at* http://www.ci.richmond.ca.us/documentcenter/view/27354.

116 Dewan, *supra* note 12.

117 Advisory Services Agreement, *supra* note 115, ¶ 3.

118 This number was derived from multiplying the $4,500 dollar fee by the 624 mortgages identified for taking (a total of 2,808,000) and then rounding up the answer to 3 million.

sidering MRP's intention to take the plan nationwide, the potential for profit is significant.

Once loans are identified, MRP sends out notice to loan holders offering the opportunity to surrender the loan and all accompanying rights in return for an estimated fair market value.[119] The letter, however, makes clear the city's intention to exercise its power of eminent domain to take the loan anyway should the holder resist.[120] Once MRP and the municipality have identified the right mortgages, they must then proceed in accordance with the laws of the state where the mortgage is situated.[121] This stage will therefore vary between states. It is noteworthy that California has been a major target for MRP due to its unusual "quick-take" procedure,[122] whereby the municipality need only deposit the probable amount of compensation with the court (based on an appraisal by the municipality) and can take possession of the property even before a final judgment on the validity of the taking.[123]

Once the loan is seized from the original lender, the city will work with each individual borrower to renegotiate the terms of the mortgage.[124] The details on this section are unclear in any literature on the subject. It is unknown who will serve as negotiator, the procedures for the negotiations, or what role MRP may or may not play.[125]

3. Repayment

Once the municipality has taken the loan and has negotiated new terms with the borrower, it effectively acts as the servicer and receives monthly payments.[126] It is these funds that are used to pay back the original investors.[127] The investors presumably earn a profit through repayment with interest.

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119 Letter from the City of Richmond, California to Various Servicers of Targeted Loans (July 31, 2013) (on file with the George Washington Law Review).

120 *See id.* ("[Y]ou should be aware that, in the event that negotiations fail to result in agreement, and the City decides to proceed with the acquisition of the Loans through eminent domain, the owner will have the right to have the amount of just compensation to be paid by the City for the Loans fixed by a court of law.").

121 *See* Hockett, *supra* note 1, at 155, 161–62.

122 *See id.* at 154.

123 CAL. CIV. PROC. CODE § 1255.010 (West 2007); *see also* Mt. San Jacinto Cmty. Coll. Dist. v. Super. Ct. of Riverside Cnty., 151 P.3d 1166, 1168 (Cal. 2007).

124 Hockett, *supra* note 1, at 151.

125 It is likely MRP would take the lead, as it does play the role of negotiator and advisor in other contexts. *See* Advisory Services Contract, *supra* note 115, ¶¶ 1–3.

126 Hockett, *supra* note 1, at 151.

127 *Id.*

The main objective and philosophy behind the MRP Scheme is to prevent foreclosures through principal reduction and loan modification so as to come up with more favorable and manageable terms for the borrower.[128] Through the use of eminent domain, the MRP Scheme bypasses PSA contractual provisions that could prevent loan modifications.[129] Without the various interests governed by the PSA, or the potential disincentive for a servicer to modify an underlying loan, the government can achieve this principal reduction. Eminent domain is an effective method for overcoming contractual provisions because the Contracts Clause does not constrain the exercise of eminent domain.[130]

The municipalities and cities that wish to employ this plan cannot be faulted for seeing a quick fix. Concededly, the use of eminent domain to obliterate the contractual barriers in PSAs is quite clever. There are, however, serious problems with this plan.

B. The Likely Damage of the MPR Scheme

The MRP Scheme's intrusion into the mortgage finance space may have numerous adverse effects on the market.[131] Investors may be unwilling to purchase Residential Mortgage-Backed Securities ("RMBS") knowing there is a risk the government could seize their investment.[132] This effect could produce results perverse to the MRP Scheme's stated intentions: instead of helping homeowners in the long run, the scheme may dry up capital and make it much harder for potential homeowners to receive necessary mortgage loans.[133] Furthermore, it is difficult to overlook and validate the significant profits that private actors will make through the exercise of a sovereign power that should be reserved only for necessary government functions.[134]

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128 *Id.* at 137.

129 *Id.* at 138–42.

130 As noted in Part I.B, the Supreme Court has held that the requirements of the Contract Clause are secondary to the power of eminent domain. Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 243 n.6 (1984); *supra* note 52 and accompanying text. State Model Legislation is an ideal solution for preventing the MRP Scheme because constitutional challenges, such as claiming that the Contract Clause prohibits this particular use of eminent domain, are not likely to be effective.

131 *See, e.g.*, Memorandum from Alfred M. Pollard, Gen. Counsel, Fed. Hous. Fin. Agency, Summary of Comments and Additional Analysis Regarding Input on Use of Eminent Domain to Restructure Mortgages 5 (Aug. 7, 2013) [hereinafter FHFA Memorandum], *available at* https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/GCMemorandumEminentDomain.pdf.

132 ASF Comment Letter to Newark, *supra* note 14, at 7.

133 FHFA Memorandum, *supra* note 131, at 5.

134 *Supra* Part III.A.

Even if there weren't significant repercussions from the plan, it would still not be advisable, as there are less dramatic alternatives.

The use of eminent domain under the MRP Scheme would do significant damage to RMBS investors and the mortgage finance market at large by producing a chilling effect on the market.[135] When a government seizes a mortgage, it is taking away a source of income from the pool of securities making up the investment, and therefore harming an investor's return. Some commentators have estimated that investors may only receive compensation of at most eighty percent of the investment's fair market value, which may not be enough to compensate for the risk.[136] Investors would find the use of eminent domain to seize residential mortgage to be an unprecedented new risk adverse to their interests.[137] This risk will be difficult for those involved in the market to price—meaning that given the uncertainty of a government's decision to adopt the scheme, it is unclear what kind of discount on the investment investors would need to accept the risk.[138] Many investors may flee the market rather than make the investment. As a result, there would be less liquidity and capital flowing through the mortgage finance market, which means less capital for lenders trying to sell off the loans to be securitized.[139] Lenders would not be able to make as many loans, which would directly leads to less access to housing for potential homebuyers.

Additionally, sponsors seeking to buy loans may not purchase them from lenders situated in jurisdictions with a history of using eminent domain to seize mortgages.[140] These lenders will suffer a severe

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135 *See, e.g.*, FHFA Memorandum, *supra* note 131, at 5; *see also* Letter from Am. Bankers Assoc. et al. to Alfred Pollard, Gen. Counsel, Fed. Hous. Fin. Agency 2 (Sept. 7, 2012), *available at* https://www.aba.com/Advocacy/LetterstoCongress/Documents/Mortgage-ED-JointLetter-090712.pdf.

136 *See* Press Release, Ropes & Gray LLP, Injunction Action Filed in California to Protect American Retirees and Savers from Eminent Domain Mortgage Seizure Scheme (Aug. 7, 2013), *available at* http://www.ropesgray.com/news-and-insights/news/2013/08/Eminent-Domain-Case.aspx.

137 *See* ASF Comment Letter to Newark, *supra* note 14, at 7.

138 Letter from Tom Deutsch, Exec. Dir., Am. Securitization Forum, to Elliott Rothman, Mayor of Pomona, Cal., et al. 4–5 (Oct. 18, 2013) [hereinafter ASF Comment Letter to Pomona], *available at* http://www.americansecuritization.com/Issues.aspx?taxid=6587.

139 FHFA Memorandum, *supra* note 131, at 5; *see also* ASF Comment Letter to Newark, *supra* note 14, at 7. As noted above, Congress created Fannie Mae and Freddie Mac for the very purpose of increasing liquidity for loan originators by introducing buyers for mortgages. Fewer investors means less buyers of mortgages to securitize, which means less liquidity, and less liquidity means fewer loans to homeowners who need access to financing for housing. *See supra* text accompanying notes 76–78.

140 ASF Comment Letter to Newark, *supra* note 14, at 7.

drying up of liquidity. Lenders may therefore relocate their lending activity to other locations, which would deal a severe blow to borrowers in the old community.[141] Alternatively, some lenders at the origination level may require higher fees, larger down payments, or higher premiums in order to protect themselves from a potentially unexpected loss through eminent domain.[142]

Even without this effect on the market, the powers of the sovereign government should not be a weapon in a private actor's arsenal, as this could lead to corruption and abuses of the power for private gain by private actors who are not democratically accountable.[143] The MRP Scheme originated with a law school professor and has since been adopted by a private firm, which stands to make a substantial profit.[144] There is additional profit to be made for the investors who fund the municipalities with money needed to seize the mortgages and pay out the necessary just compensation.[145] It would appear that there is little risk to the investors who receive compensation back through the government's receipt of mortgage payments on the loans it seizes. The main justification for the plan is to help struggling homeowners,[146] but the homeowners whose loans are targeted are not those most in need. Although they are all underwater,[147] most of the loans targeted are still performing, and many of the borrowers have never defaulted.[148] It seems that loans are targeted for their potential as safe investments.

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141 *Id.*

142 PAMELA LEE, URBAN INST., EMINENT DOMAIN: THE DEBATE DISTRACTS FROM PRESSING PROBLEMS 12 (2013).

143 *See supra* text accompanying notes 62–65.

144 As noted above, in one city alone MRP could make around $3 million. *Supra* note 118 and accompanying text. It should be noted that Professor Robert Hockett has specifically stated that he does not stand to gain financially from the success of the MRP Scheme's implementation. Robert Hockett, *Sham Suits and Securitizers*, MRP BLOG (Sept. 20, 2013), http://mortgageresolution.com/sites/default/files/attachments/sham_suits_and_securitizers_12_september_2013.pdf. There is likely some reputation gain, however, from implementing one's brainchild successfully.

145 *See supra* text accompanying notes 126–27.

146 Hockett, *supra* note 1, at 127–28.

147 A loan is said to be "underwater" when the combined value of the borrower's outstanding principal and interest exceeds the value of the asset itself.

148 Press Release, Ropes & Gray LLP, *supra* note 136; *see also* ASF Comment Letter to Pomona, *supra* note 138, at 4; Letter from Tom Deutsch, Exec. Dir., Am. Securitization Forum, to Office of the Gen. Counsel, Fed. Hous. Fin. Agency 3 (Sept. 7, 2012), *available at* https://www.aclu.org/files/racialjustice/foia/Part%20II/79%20-%20Comment%20from%20T.%20Deutsch%20(American%20Securitization%20Forum)%209-7-2012.pdf.

The market conditions that MRP and Professor Hockett cite as compelling enough to warrant government intervention are diminishing, and the need for emergency action may no longer be necessary. Overall, there has been an improvement in mortgage performance. According to a recent Office of the Comptroller of the Currency ("OCC") Mortgage Metrics Report (one in a series of reports that MRP and Professor Hockett have relied on in making their own case), 90.6% of mortgages were performing in 2013, up from around 88.7% the previous year.[149] Furthermore, overall housing prices, including in Richmond, California, are on the upswing.[150]

There are also alternatives to the problems that Professor Hockett identifies regarding the disincentives to modify loans under PSAs. The MRP Scheme seeks to seize mortgages in order to circumvent contractual barriers in PSAs and unilaterally enact loan modifications.[151] But PSAs can be restructured in different ways to eliminate or mitigate these problems, and many writers and commentators have identified ways to do so. For instance, investors can demand stronger enforcement provisions in PSAs, or legislation could create a database of investors to make it easier to pool the requisite twenty-five percent investor interest in order to lodge complaints against a servicer.[152] Another possibility is to attack the incentive structure of PSAs through legislation.[153] Interestingly, not all scholars find that PSAs actually discourage loan modification, and some find that there is no significant effect.[154] The presence of viable alternatives shows that a drastic measure like the MRP Scheme is unnecessary.

IV. State Model Legislation to Prevent the MRP Scheme

This Note proposes legislation that will effectively prohibit the use of eminent domain to seize residential mortgages, as well as any other abusive use of this power. This section further discusses the ap-

149 Office of the Comptroller of the Currency, U.S. Dep't of the Treasury, OCC Mortgage Metrics Report: Disclosure of National Bank and Federal Savings Association Mortgage Loan Data, Second Quarter 2013, at 4 (2013).

150 *Richmond Home Prices and Values*, Zillow, http://www.zillow.com/richmond-ca/home-values/ (last visited Jan. 9, 2015).

151 *Supra* Part II.B.

152 Frey, *supra* note 66, at 136.

153 *See, e.g.*, Crespi, *supra* note 104, at 192–93 (suggesting a "carrot-and-stick" approach whereby the carrot is federal legislation eliminating legal risk facing servicers who negotiate principal reduction in good faith, and the stick is a federal investigation into servicers who resist demands for wide-scale modification).

154 Thompson, *supra* note 68, at 779 tbl.1.

proach of this legislation, why such legislation is the best approach, and how the federal government can get involved.

A. The Model Legislation

As eminent domain laws are expansive, involve technical procedures, and vary in many different ways among states, this model legislation seeks to touch upon only a few elements. States adopting the legislation would therefore bring these elements into conformity while leaving procedural law intact. The legislation begins by narrowing the definition of public use:

> Sec. 101—Public Use
>
> Public use shall not include the exercise of eminent domain when private parties stand to receive a monetary gain that is more than incidental to the condemnation, regardless of whether the seized property remains in the possession of the government.
>
> Sec. 102—Incidental Gain
>
> Gain to a private party is more than incidental to the condemnation when (a) derived through the government's use of the seized property or (b) the private party acts in a capacity that is more than ministerial.

These two sections must be read together in order to comprehend their full effect. The key phrase in Section 101 is "whether or not the seized property remains in the possession of the government." This provision differs from many eminent domain statutes currently enacted. After the controversial *Kelo* decision, many states enacted constitutional and legislative provisions to prevent the particular use of eminent domain involved in that case.[155] The wording and scope of these various provisions differ, but most seek to prevent the transfer of property to private parties, particularly if the transfer is under the guise of economic redevelopment.[156] One might wonder how MRP

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155 *See generally* Ann Marie Cavazos, *Beware of Wooden Nickels: The Paradox of Florida's Legislative Overreaction in the Wake of* Kelo, 13 U. PA. J. BUS. L. 685 (2011); Andrew P. Morriss, *Symbol or Substance? An Empirical Assessment of State Responses to* Kelo, 17 SUP. CT. ECON. REV. 237 (2009); Ryan Frampton, Note, Kelo v. New London *and the State Legislative Reaction: Evaluating the Efficacy and Necessity of Restricting Eminent Domain for Economic Redevelopment at the State Level*, 4 RUTGERS J.L. & PUB. POL'Y 730 (2007).

156 *See, e.g.*, CAL CONST. art. I, § 19(b) ("The State and local governments are prohibited from acquiring by eminent domain an owner-occupied residence for the purpose of conveying it to a private person."); TEX. CONST. art. I, § 17(b) ("'[P]ublic use' does not include the taking of property . . . for transfer to a private entity for the primary purpose of economic development or

could so brazenly put forth an idea that is seemingly contradictory to this principle.

The answer comes through a technicality. Depending on the final structure of the MRP Scheme, a municipality may avoid the prohibited *transfer* of property. Some accounts of the MRP Scheme by third parties state that the seized mortgages are sold off to investors, as they would be in a typical securitization.[157] MRP and Professor Hockett's literature, however, tend to give a different impression. In their account, the government seizes the mortgages and retains them, acting as a full-time servicer, and therefore stops the chain of events just prior to any actual transfer.[158]

But this does not mean there is no transfer of any kind. Private investors still receive a benefit through repayment.[159] This is not a transfer of the seized mortgage but is still a transfer of value—the income from the receipt of mortgage payments. The policy behind recently enacted statutory provisions is to prevent private profit through the use of eminent domain and through the use of seized property.[160] The wording of statutes specifically focusing on a *transfer* of property may still allow the MRP Scheme to slip through. Section 101 would close that gap.

In addition to closing the transfer gap in eminent domain legislation, Sections 101 and 102 prohibit the use of eminent domain whereby a private party receives a monetary gain that is "more than incidental." This language provides further protection against eminent domain abuse by preventing long-term profit-making schemes. Section 102 defines a gain that is more than incidental as one whereby the profit is derived through the use of the property. Specific to the MRP Scheme, this would include the government acting as servicer for seized mortgages and using those funds to pay back investors. Section 102 also defines gain that is more than incidental as gain derived

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enhancement of tax revenues."); *see also* Cavazos, *supra* note 155, at 698; Frampton, *supra* note 155, at 746.

157 *See, e.g.*, PATRICK D. DOLAN & LINDA ANN BARTOSCH, DECHERT LLP, UNDERWATER MORTGAGES DESERVE MORE THAN EMINENT DOMAIN (June 6, 2013), *available at* http://dechert.com/Underwater_Mortgages_Deserve_More_Than_Eminent_Domain_06-06-2013; *see also* Richard E. Gottlieb & Vivian I. Kim, *Eminent Domain: Will Local Governments Attempt to Use This Extraordinary Power to Purchase Troubled Residential Mortgages?*, BANKING & FIN. SERVICES POL'Y REP., at 1, 4, Nov. 2012.

158 Hockett, *supra* note 1, at 151.

159 *See* Part II.A.

160 Marc Mihaly & Turner Smith, Kelo*'s Trail: A Survey of State and Federal Legislative and Judicial Activity Five Years Later*, 38 ECOLOGY L.Q. 703, 707 (2011).

through acting in a nonministerial capacity.[161] This prevents MRP from reaping profit by acting as advisor to the municipalities that adopt its scheme.

Proponents of the MRP Scheme, and of the use of eminent domain in general, may fear that legislation like that proposed by this Note would neuter a viable and important power.[162] The language of these two sections, however, will not overly restrict the government's use of eminent domain for more traditional and legitimate uses. It is true that sometimes a municipality may require the aid of private parties, even with a valid exercise of eminent domain. For instance, when seizing land, a municipality may hire a tree removal service, and the provider of that service will surely stand to profit through compensation. The tree removal service does not, however, receive a profit through the government's ultimate use of the property—the tree removal service only primes the property for whatever use the government had in mind when it decided to utilize the power of eminent domain. Furthermore, tree removal is ministerial. Although the service provider may decide the best way to remove the trees, they are not making any determination about the use of the property. Nor is the private party making the initial decision to seize the property. This is unlike MRP, who identifies loans for seizure and makes decisions regarding the use of the loans.[163] As such, situations similar to the tree removal service would still be permissible under the proposed legislation.

Additionally, the government retains its powers of eminent domain to remove blight and other dangerous conditions. State law often considers blight removal a public use for which government may exercise the power of eminent domain.[164] Under the proposed legislation, that distinction remains if there is a legitimate need to remove blight. Furthermore, the government is not prevented from enlisting the use of private parties in removing blighted conditions. As ex-

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161 A nonministerial capacity is one where the actor exhibits some kind of discretion and control in decisionmaking. In this context, MRP's role as advisor, as laid out in the Advisory Services Contract, *see supra* note 115 and accompanying text, is clearly nonministerial. For an analogous concept of a "ministerial" function, see Office of the Comptroller of the Currency, Interpretive Letter No. 822, at 8 (Feb. 17, 1998), *available at* http://www.occ.gov/static/interpretations-and-precedents/mar98/int822.pdf (defining a "ministerial" role in the context of applying usury laws where a bank has branches in multiple states, and multiple branches play some kind of role in originating the loan).

162 *See, e.g.*, Cavazos, *supra* note 155, at 696–97.

163 *See, e.g.*, Advisory Services Agreement, *supra* note 115, ¶ 2.

164 *See, e.g.*, N.J. CONST. art. 8, § 3, para. 1; MINN. STAT. ANN. § 117.025(11)(a)(3) (West 2014).

plained above, should the government require the aid of private parties skilled at removing dilapidated houses or dangerous environmental conditions, such use of private parties would not violate Sections 101 and 102.

The model legislation also addresses the issue of just compensation:

> Sec. 201—Just Compensation Paid to Mortgage Investors
>
> When eminent domain is used to condemn residential mortgages that make up private label residential mortgage backed securities, just compensation shall be 115% of the fair market value of the Investment Certificate paid for by the investor, multiplied by the percentage at which the mortgage makes up the underlying investment. This amount is to be paid regularly for the remainder of the investor's interest in the Trust, according to the agreements governing the investment.

The provision regarding just compensation acts as a further deterrent to the use of eminent domain to seize mortgages by imposing a specific formula for determining just compensation paid to mortgage investors whose assets are harmed by the taking of the residential mortgages. Establishing just compensation at a specific amount above fair market value is not a novel concept.[165] This provision is necessary, as theoretically a municipality can still enact the MRP Scheme, skirt around the prohibition set out in Section 101, and bring about the same harms previously discussed.

Without the just compensation provision, a municipality could still seize mortgages with funding from nonprivate sources and activate the plan without MRP's involvement. This would not be an advisable plan, as the municipality would likely lack the expertise necessary for locating the targeted mortgages, and the administrative costs of negotiating with willing servicers alone could be prohibitive. But considering the fiery rhetoric and conviction of Gayle McLaughlin, it is not beyond the realm of possibilities that Richmond and cities like it would still attempt the scheme without private aid and thereby avoid the prohibition in Section 101.

The just compensation provision in the draft legislation discourages this course of action by imposing additional costs that make the scheme wholly undesirable. The central idea of the provision is to replace the income stream that would go to the mortgage investor

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165 *See* Nathan Burdsal, Comment, *Just Compensation and the Seller's Paradox*, 20 BYU J. PUB. L. 79, 94–98 (2005).

originating from the seized mortgage.[166] Not only does this act as a disincentive to municipalities seizing mortgages without the aid or funding of private actors, it would also eliminate the negative consequences of the plan. What will drive investors from the mortgage securities market is the potential to lose their investments due to eminent domain. Even with the precedent that the government may seize mortgages, however, there would not be a chilling effect on the market if investors knew that their interest would simply be replaced by a comparable return. Furthermore, the concerns highlighted above regarding the private profit gained from flexing public muscle is absent because if the municipality can get around the Section 101 prohibition, then clearly there is no private gain involved.

These two major provisions would not only prevent the MRP Scheme and similarly abusive applications of eminent domain, but will also impose barriers for any municipality trying to find loopholes in the provisions.

B. Why State Model Legislation Is the Best Approach

State model legislation is the ideal solution for reasons that have already been discussed. The alternative, a constitutional challenge, is unlikely to succeed. Many have challenged the MRP Scheme on these grounds, seemingly listing off a typical Constitutional Law I syllabus and conjuring up topics ranging from the Contracts Clause to the Dormant Commerce Clause.[167] Although these arguments are worth a read, a constitutional challenge at both the state and federal level would not succeed.

For one thing, *Kelo* is still the reigning precedent at the federal level.[168] The Court's acceptance of the redevelopment plan as a public use should give pause to any opponent of the MRP Scheme looking to mount a court challenge. That decision shows the high likelihood of the Court accepting the MRP Scheme as a public use. Furthermore,

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166 The amount to be paid is calculated by finding 115% of the fair market value (FMV) of the trust certificate, and then dividing that by an amount proportional to the value of the seized mortgage in relation to the rest of the certificate. In other words, if a seized mortgage makes up 5% of the value of the trust certificate, the just compensation to be paid is 5% of the value that equals 115% of the FMV. This amount is to be paid regularly to all investors in the trust certificate at a schedule similar to that established in the governing contracts of the investment.

167 *See generally, e.g.*, Kelly F. Huedepohl, Comment, *A Life Raft for Underwater Mortgages? Whether the Federal Constitution Permits State and Local Governments to Condemn Home Mortgage Contracts to Solve the Housing Crisis*, 49 WILLAMETTE L. REV. 275 (2012); Katharine Roller, Note, *The Constitutionality of Using Eminent Domain to Condemn Underwater Mortgage Loans*, 112 MICH. L. REV. 139 (2013).

168 *See supra* notes 31–32 and accompanying text.

as one District Court in California held, a court challenge is not ripe until the plan actually comes into effect and mortgages are seized.[169] Challengers would therefore have to wait until the harm starts before they can attempt to stop it.

State model legislation is the best approach because of the tradition of judicial deference to legislative determinations regarding eminent domain. As precedent shows, and as discussed above, legislation is supreme when it comes to eminent domain.[170] Should a state adopt the proposed legislation, manifesting its intent that the MRP Scheme and similar uses of the eminent domain power are not public uses, the MRP Scheme would have little viable chance of success. Thus, state model legislation is the best solution for preventing the MRP Scheme.

C. How the Federal Government Can Help

Congress and the federal government can play a limited role in preventing the MRP Scheme through conditional provisions that encourage states to adopt state model legislation like the one proposed.

The MRP Scheme has attracted federal government attention. Many members of Congress have expressed either support or disdain for the plan.[171] The issue was even brought up at the confirmation of newly appointed Federal Housing Finance Agency director, former Representative Mel Watt.[172]

Some legislators have attempted to address the issue at the federal level. These attempts show that federal action can play a limited, but still important role. Federal legislation can only indirectly disincentivize the MRP Scheme, but cannot forbid it. For instance, the recent Protecting American Taxpayers and Homeowners Act,[173] introduced by Representative Scott Garrett, would prohibit federal entities like the Federal Housing Administration, Fannie Mae, and Freddie

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169 Order Granting Defendants' Motion to Dismiss and Denying Plaintiffs' Motion for a Preliminary Injunction, Wells Fargo Bank, Nat'l Ass'n v. City of Richmond, No. 3:13-cv-03663-CRB (N.D. Cal. Sept. 16, 2013), ECF No. 78.

170 *See supra* Part I.B.

171 Letter from Sens. Pat Toomey, John Boozman, Mark Begich, and Heidi Heitkamp, to Shaun L.S. Donovan, Sec'y, U.S. Dep't of Hous. & Urban Dev., and Jacob J. Lew, Sec'y, U.S. Dep't of the Treasury (Nov. 27, 2013), *available at* http://www.mbaa.org/files/SenateLetterto HUDonEmDom.pdf (expressing concern over the MRP Scheme).

172 Mr. Watt was ambiguous when asked about his support for the issue and hinted that it should be left up to the states. Brent Nyitray, *Why Mel Watt Tacitly Approves Using Eminent Domain on Mortgages*, YAHOO! FINANCE (Nov. 28, 2013, 4:00 PM), http://finance.yahoo.com/news/why-mel-watt-tacitly-approves-210008203.html.

173 Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong (2013).

Mac from guaranteeing any mortgages that are attached to property located in districts that have used eminent domain to seize mortgages.[174] A previous bill attempted to do the same thing.[175]

The weakness in these attempts is that they can only control federal, not state agencies. They provide disincentives but do not directly counteract the problem. Although this helps, it cannot prevent the MRP Scheme on its own. A better role for the federal government would be a different approach—to provide incentives for states to adopt the state model legislation. This can be done through the Spending Powers Clause of the Constitution.

Article I, Section 8, clause 1 of the United States Constitution, also known as the Taxing and Spending Clause,[176] contains the implicit power to spend revenues for the general welfare of the people.[177] This clause has been recognized to allow the United States government to encourage behavior through conditioning the receipt of federal funds.[178] As long as the federal government meets key requirements, particularly ensuring that the conditions it imposes are not so coercive as to force the states to act,[179] it may condition certain federal spending on the adoption of the state model legislation. The federal government could therefore use this power, within constitutional boundaries, to help promote the adoption of state model legislation preventing the MRP Scheme.

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174 *Id.* §§ 108, 266.

175 Defending American Taxpayers from Abusive Government Takings Act of 2012, H.R. 6397, 112th Cong. (2012).

176 U.S. CONST. art. I, § 8, cl. 1.

177 *Id.* ("The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.").

178 *See* Nat'l Fed'n of Indep. Bus. v. Sebelius (*NFIB*), 132 S. Ct. 2566, 2601–02 (2012) (opinion of Roberts, C.J.) ("We have long recognized that Congress may use this power to grant federal funds to the States, and may condition such a grant upon the States' taking certain actions that Congress could not require them to take." (internal quotation marks omitted)); *see also* South Dakota v. Dole, 483 U.S. 203, 207–08, 210–11 (1987) (noting that the five requirements for the spending power are: (1) Congress must act in pursuit of the general welfare, (2) any conditions on the states' receipt of federal funds must be imposed unambiguously, (3) the conditions imposed on the receipt of funds must be germane to the purposes for which Congress approved the grant, (4) the condition cannot require action that would violate some other constitutional provision, and (5) Congress cannot offer the states inducements that amount to coercion).

179 *NFIB*, 132 S. Ct. at 2602 (opinion of Roberts, C.J.).

Conclusion

As expected, following Richmond, California's adoption of the MRP Scheme, other cities began to consider the possibility of using eminent domain in their own jurisdictions.[180] The plan has spread to other parts of California and even across the country to New Jersey.[181] Yet the MRP Scheme remains an untested idea. Hopefully, that is as far as the scheme will go.

The power of eminent domain is a tremendous sovereign power traditionally used for more common public needs, such as seizing land to build roads and public spaces. It is a potent weapon in the hands of the legislature, as jurisprudence often dictates significant deference. Many are critical of eminent domain for its potential to result in corruption when private parties and even government officials stand to gain through its use.

Although eminent domain has been used to seize more unorthodox assets—such as intangible property and even sports franchises[182]—it has not been used to interfere in mortgage financing. But the American system of mortgage financing is highly complex, and when a city or municipality seizes a mortgage, it is not simply taking one asset from one party. It interferes with the contractual rights and guarantees of multiple parties. The MRP Scheme works by using the state government's eminent domain power to separate the mortgages from the securitized assets they comprise and have the government act as servicer. In doing so, the government may receive mortgage payments, which it uses to pay off investors supporting the scheme and MRP, who stands to gain a significant profit in its role as advisor.

This scheme would do more harm than good. The intrusion into the secondary mortgage market would drive away investors, drying up a major source of liquidity for the individual lenders who originate the loans and provide access to housing. This could result in the opposite of the MRP Scheme's stated intentions—a contraction in the housing market. Furthermore, there is legitimate reason to fear this is simply a profit-making scheme that originated in the minds of a professor of

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180 Dewan, *supra* note 13.

181 *Id.*; Timothy P. Duggan, *Irvington's Eminent Domain Plan Not the Answer*, NJ.com Blog (Jan. 29, 2014, 9:02 AM), http://blog.nj.com/njv_guest_blog/2014/01/irvingtons_eminent_domain_plan.html.

182 *See, e.g.*, City of Oakland v. Oakland Raiders, 646 P.2d 835, 842–43 (Cal. 1982) (en banc) (holding that the law authorized the city to use eminent domain to seize intangible property).

law and a private firm, and does not benefit the public at large. Moreover, the scheme is unnecessary, as mortgage performance and housing prices are on the upswing, and there are alternative ways to fix the problems inherent in mortgage securitization documents—which Professor Hockett and MRP cite as the pressing justification for intrusion.

The state model legislation that this Note proposes would prevent the MPR Scheme by narrowing the definition of public use so that eminent domain cannot be used when private parties seek to use eminent domain for their own private benefit. This is a necessary change to eminent domain laws. Private parties should never be able to flex public muscle for their own benefit.