

Eminent Domain for Underwater Mortgages: A Cure Worse Than the Disease?

by Dwight H. Merriam

No question about it—Richmond, California, has what Mayor Gayle McLaughlin calls “destabilized neighborhoods.” She says it is because of the foreclosure crisis—900 foreclosures last year, and it looks like 900 again this year. Mayor McLaughlin blames the crisis on the banks, which she accuses of predatory lending.

It is indeed an enormous problem for most of the country, and especially those in Richmond. Real people bear great burdens. Typical of them are Richmond residents Rodney Conway and his wife Vicki. Back during the high-flying market of 2005 they bought a 950-square-foot, two-bedroom home in Richmond for \$340,000, worth just \$140,000 today. They still owe Bank of America \$320,000 and are making payments of \$2,000 a month. Rodney Conway is disabled as a result of an accident in Lebanon in 1983 while on active duty in the Navy, and Vicki’s office job salary supplements Rodney’s disability check just enough for them to barely make ends meet. Says Rodney: “We don’t take trips or go to restaurants. We just went to a movie for the first time in a year. I’d like to be able to give my wife a nice birthday present, but I can’t afford it.”¹ They aren’t alone, of course. Along with them are more than 11 million American homeowners with 20% of all mortgages who are

also still underwater, and more than 5 million other families who have lost their homes to foreclosure.

But do not think all of those to be bailed out are among the working class. Many high-value properties in Richmond are being offered a helping hand. Two of them have loans over \$1 million, 43 are above \$600,000, and 121 are over \$500,000. The average loan balance is \$387,800; the median is \$378,920.²

There is widespread agreement that mass mortgage refinancing, which would necessarily include discounting the mortgages, is the surest way to quickly and greatly reduce the problem of short sales and foreclosures. Principal writedown is now off the table. A possible alternative is a government-financed trust to buy mortgages made at higher rates and offer refinancing.³ But so far, the federal government has done little, and the programs it does have—the Home Affordable Refinance Program (HARP) and Home Affordable Modification Program—for the most part have been ineffective.⁴

Richmond has everything that should, in theory, make it a highly successful community—great weather outside of the fog belt, a location across from tony Marin County, scenic vistas of

rolling hills, a majestic view of the Golden Gate Bridge, a harbor, miles of coastline, a good employment base, and decent private and public transportation infrastructure.

The banks did not pick Richmond as a preferred locale for predatory lending. The problem is that the city is crime-ridden, ranked by the FBI as the sixth most dangerous city in the country.⁵ The Mayor has chosen to pin the rap on the banks, however, rather than accepting responsibility for the failure to control crime, and she has a quick-fix program to make it all right. Richmond is the first city in the country to attempt to purchase mortgages at their “fair market value,” always less than the debt remaining, to, shall we say, “dewater” them. She explained in a television interview that the city first attempts to negotiate the voluntary sale of the mortgages at their discounted fair market value, but if the banks are not willing to do that, the city “will be considering eminent domain.”⁶ This summer, the city began its program by asking the holders of more than 620 underwater mortgages to sell the loans to the city at a discount, and the city would then refinance the loans in line with the current value of the homes.⁷

The city has engaged Mortgage Resolution Partners to assist in this

undertaking. This company describes itself as “a Community Advisory firm working to stabilize local housing markets and economies by keeping as many homeowners with underwater mortgages in their homes as possible.”⁸ The company has come up with a nifty acronym for helping communities use their power of eminent domain to acquire underwater mortgage loans—CARES™, which stands for Community Action to Restore Equity and Stability.

Mortgage Resolution Partners is reportedly consulting with at least three other municipalities in California and is in discussions with a dozen or more others in the state.⁹ North Las Vegas, Nevada, adopted a similar plan with the help of Mortgage Resolution Partners and has now been sued by a local taxpayer claiming violations of U.S. and Nevada state constitutions.¹⁰ As many as 5,000 local mortgages in North Las Vegas would qualify. The lawsuit claims that the use of eminent domain to take underwater mortgages from lenders exceeds Nevada state constitutional authority and the state’s eminent domain enabling statutes. It is also claimed to violate the Contracts, Commerce, and Due Process Clauses of the U.S. Constitution.

In Richmond, mortgages targeted are those held by out-of-state securitized bonds, residential mortgage-backed securitization (RMBS) trusts.¹¹ Two complaints challenging the program were filed concurrently in federal court, one by Wells Fargo and several of the mortgage holders on behalf of their trusts, and the other by the Bank of New York Mellon for its

trust.¹² These are the cases to watch, as they involve the highest visibility program and are definitive in their articulation of the claims.¹³ Other cities are being urged to hold off on initiating copycat programs to see how the Richmond cases turn out. As the president of the board of the Association of Mortgage Investors, Vincent A. Fiorillo, who is also a portfolio manager at DoubleLine, puts it: “We now have a test case. Richmond, Calif., is going to go out there and try and do this. There is no reason for anybody to do anything until we see how it plays out.”¹⁴

The trustees brought the claims after they had received offers for the voluntary sale of the mortgages below their value. Importantly, most of the mortgages are not in default or foreclosure and are still performing, so arguably, they have an increment of value above the value of the real estate securing the loan. As you might expect, the trustees argue that their mortgages are worth more than what they are being offered, and the offers for voluntary negotiation are illusory because mortgages in the private RMBS trusts, by their very nature as pooled packages of financial agreements, cannot be sold.¹⁵

Especially interesting is that both lawsuits focus on the issue of whether using eminent domain in this way to take from a private owner (the RMBS trust) for the benefit of private, individual homeowners is a “public use,” as is required for a government taking under the Fifth Amendment. The last time this issue made its way up through the courts to the U.S. Supreme Court in full-blown form

was in 2005, in the notorious case of the taking of Susette Kelo’s little pink house in New London for a private redevelopment project, which, we might note, was never built. While the government won the battle, many people believe that it lost the war because, while *Kelo* did not change the law, the case galvanized broad-based public opposition to the use of eminent domain.

As suggested earlier, the central issue in these cases is going to be valuation. What is a performing underwater mortgage really worth? Is it worth only the value of the real estate securing the mortgage? Or is it worth more because it is performing? What would the price be for a truly arm’s length transaction with ample time for both the seller and the buyer to get to know the market and to negotiate? Think about Rodney and Vicki Conroy. As far underwater as their mortgage is, how risky is it really and how profitable will it be over the balance of the term?

In addition to this interesting legal issue of whether this is a public use (there is not one, and many think the Supreme Court is itching to have another look at that question, given the blowback from *Kelo*) and the untenable position of Richmond that the value of the mortgage equates to the fair market value of the security, there are other meritorious arguments.¹⁶ These trusts are pooled agreements involving properties all over the place—who says Richmond has the power of eminent domain in, for example, Idaho Falls? The Dormant Commerce Clause, there is a yawner, but it is also in play—can Richmond

burden interstate commerce? Look, bottom line, Lindsay Lohan has a greater chance of staying out of trouble than the city of Richmond. On top of the legal issues, all the heavy-duty lawyering adds great transaction costs, and the California housing market is on fire, up 28% year-over-year.¹⁷ And listing prices are up 40% year-over-year in Richmond.¹⁸ “Distressed properties” in Richmond—those that are bank-owned, REO, in foreclosure or short sales—are down to 11% versus 23% a year ago. Mayor McLaughlin is looking more and more like an ER doctor trying to give CPR to a patient leaving the hospital for home. The problem will be over long before the lawyers and judges are done with it.

There are those who support the use of eminent domain for this purpose, such as the left-leaning Demos, which describes itself as “a public policy organization working for an America where we all have an equal say in our democracy and an equal chance in our economy.”¹⁹ A senior fellow at Demos says “Just as redistricting and gerrymandering are battles between urban ex-urban political interests, the devastation of cities from the Great Recession provides an opportunity to realign political power. The eminent domain procedure addresses the real problem—fixing the local economy—and should be the way forward.”²⁰

Watch the Richmond cases to see if the U.S. Constitution can be stretched that far. ♦

Dwight H. Merriam is a partner at Robinson & Cole LLP, Hartford, Connecticut.

Endnotes

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- 5 “What’s the Most Dangerous City in America?” <http://newsfeed.time.com/2010/11/22/whats-the-most-dangerous-city-in-america/>
- 6 “California City Threatens to Use Eminent Domain to Stop Bank Foreclosures” [democracy.org http://www.youtube.com/watch?v=FKtyBDPi_A0](http://democracy.org/http://www.youtube.com/watch?v=FKtyBDPi_A0)
- 7 <http://www.scribd.com/doc/159641559/Complaint-for-Declaratory-and-Injunctive-Relief-Wells-Fargo-Bank-National-Association-v-City-of-Richmond-No-CV-12-3663-CRB-N-D-Cal-Aug-7-201>
- 8 <http://mortgageresolution.com> not to be confused with the Mortgage Resolution Fund <http://mortgageresolutionfund.org/>
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- 10 <http://www.housingwire.com/articles/north-las-vegas-eminent-domain-proposal-faces-pushback-homeowner; http://www.ralstonreports.com/blog/federal-lawsuit-filed-block-eminent-domain-scheme-north-las-vegas> This is the lawsuit <http://www.ralstonreports.com/sites/default/files/NLV-suit.pdf>
- 11 For details, go to <http://www.inversecondemnation.com/inversecondemnation/2013/08/guest-post-more-on-the-two-federal-lawsuits-challenging-the-underwater-mortgage-taking-scheme.html>
- 12 <http://www.inversecondemnation.com/files/2013-08-07filedrichmondcomplaint.pdf>
- 13 152 paragraphs and 120 pages in the Wells Fargo complaint with Ropes & Gray representing them, and 149 paragraphs and 139 pages with Mayer Brown representing The Bank of New York Mellon.
- 14 Alejandro Lazo, “Eminent Domain Proposal for Mortgages gains traction in California,” Los Angeles Times, August 6, 2013 <http://www.latimes.com/business/la-fi-0807-eminent-domain-20130807,0,5669410.story>
- 15 <http://www.inversecondemnation.com/files/2013-08-07filedrichmondcomplaint.pdf; http://www.scribd.com/doc/158927717/Complaint-for-Declaratory-and-Injunctive-Relief-The-Bank-of-New-York-Mellon-v-City-of-Richmond-No-13-3664-JCS-N-D-Cal-filed-Aug-7-2013>
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