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By Email (eminentdomainOGC@fhfa.gov)

RE: FEDERAL HOUSING FINANCE AGENCY
[No. 2012–N–11]
Use of Eminent Domain to Restructure
Performing Loans

To Whom It May Concern:

In your request for public input, you write:

> *FHFA has significant concerns about the use of eminent domain to revise existing financial contracts and the alteration of the value of Enterprise or Bank securities holdings. In the case of the Enterprises, resulting losses from such a program would represent a cost ultimately borne by taxpayers. At the same time, FHFA has significant concerns with programs that could undermine and have a chilling effect on the extension of credit to borrowers seeking to become homeowners and on investors that support the housing market.*
>
> *Among questions raised regarding the proposed use of eminent domain are the constitutionality of such use; the application of federal and state consumer protection laws; the effects on holders of existing securities; the impact on millions of negotiated and performing mortgage contracts; the role of courts in administering or overseeing such a program, including available judicial resources; fees and costs attendant to such programs; and, in particular, critical issues surrounding the valuation by local governments of complex contractual arrangements that are traded in national and international markets.*

My views on the "Use of Eminent Domain to Restructure Performing Loans" are as follows.

The Eminent Domain Power is Broad

Eminent domain is an ancient prerogative of sovereign governments. Federal and state governments have limited that power by requiring that a government use eminent

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domain to achieve a public purpose and pay just compensation upon its exercise. *See, e.g.*, Brown v. Legal Foundation of Washington, 538 U.S. 216, 231-32 (2003). The Supreme Court has taken an expansive view of the "public purpose" requirement. Kelo v. City of New London, 545 U.S. 469 (2005) (holding that use of eminent domain to achieve economic development is legitimate exercise of government power); *see also* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 602 (1935) ("If the public interest requires, and permits, the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain; so that, through taxation, the burden of the relief afforded in the public interest may be borne by the public.").

Some commentators have argued that Kelo would not permit the use of eminent domain to restructure performing loans. This is a complete misreading of Kelo. The Supreme Court's suspicion of the transaction between one massive company and the small city at issue in Kelo is not analogous to the use of eminent domain by many local governments to condemn mortgages held by a range of financial companies. The Court's earlier case, Hawaii Housing Authority v. Midkiff, 467 U.S. 229 (1984), provides further support for the use of eminent domain to assist a broad swath of the public when faced with a market failure. In Midkiff, the Court upheld the use of eminent domain to take real property that had been concentrated in a small number of hands in order to make it more widely available. The bottom line is that there is a clear "public purpose" that is consistent with relevant Supreme Court precedent.

Some commentators have argued that the use of eminent domain in this context will amount to a regulatory taking. *See* Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922) (holding that government action can amount to a taking when it destroys a property right). This argument does not appear to have merit. First, the government action here contemplates compensation for those with a direct financial interest in the transaction -- the mortgagees. Second, those who might claim a regulatory taking (such as investors in mortgage-backed securities) are quite removed from the original transaction between homeowner and originating lender. Third, even if there was a finding that there was a regulatory taking, the appropriate result would be to divvy up the compensation determined at the condemnation hearing among the various parties who are found to have an interest in the award of the fair market value of the mortgage. This dispute among the claimants should not impact the underlying taking itself, nor should it increase the amount of compensation that the condemning authority should have to pay. If it did, it would lead to an absurd result where the condemning authority was required to pay a multiple of the fair market value of the property to pay off (i) the holder of the mortgage, perhaps a trustee of a mortgage-backed security (the "MBS"); (ii) investors in securities secured by the MBS, such as the trustee of a CDO^2; as well as (iii) the trustee of a derivative, such as a synthetic CDO, that is not secured by the MBS but that the synthetic CDO happens to reference.

Eminent Domain Will Not Cause Losses; It Will Cause Losses to Be Realized

Many commentators have argued that the use of eminent domain will cause losses for investors and taxpayers. That is not right. The exercise of eminent domain will result in a concomitant payment of just compensation to the owner of the mortgage. This just compensation will be the fair market value of the property. The fair market value may be based on a variety of measures, such as comparable sales or expected cash flow. While there is reason to be skeptical that fair market value will be as low as proponents of the use of eminent domain (such as Mortgage Resolution Partners) suggest, the fact is that the fair market value is the fair market value. *See* James G. Greilsheimer and Cynthia Lovinger Siderman, *Valuation of Real Estate in Eminent Domain Proceedings During Recession*, N.Y.L.J. Sept. 6, 2012, *available at* http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202570214868&thepage=1. What is likely of greater concern to those opposing the use of eminent domain in this context is that it will force them to "mark to market" such that their losses will be realized for accounting purposes. While this has great import for investors, it is not relevant for purposes of evaluating the constitutionality of the use of eminent domain in this context.

The issue of unrealized losses is particularly important where there is a second mortgage. Because borrowers are so underwater, the junior lien typically has no economic value other than nuisance value (a borrower would need to commence a lawsuit to force a junior lender to choose to foreclose, or not, its interest in order to clear the junior lien's cloud on title). Taking the mortgages by eminent domain will terminate the nuisance value of the junior mortgage to the benefit of all the other parties with an interest in the property. Given, however, that many of the junior lenders are the same financial institutions that hold the first mortgages, there will still be significant opposition from the financial industry to the use of eminent domain to reduce junior liens to their fair market value of zero.

The Use of Eminent Domain Will Not Chill the Credit Markets

A common argument by the investing community is that pro-borrower changes will destroy the credit markets. This argument has been used in the context of municipalities filing for bankruptcy, sovereign nations defaulting on bonds and pro-debtor changes to the bankruptcy laws. This long term chilling of the credit markets has never actually happened.

The rule of law must of course be respected, or else lenders will flee a particular market. But eminent domain has long been part of the legal framework of the housing market. While the large scale use of eminent domain is an unexpected application, we are in extraordinary times. And given the federal government's failure to implement a solution to the problems that communities face, it is utterly appropriate for local governments to use their intrinsic powers to address this crisis.

The worst case scenario for future residential borrowers is that mortgages may be priced slightly higher to address the remote possibility that a government will use its power of eminent domain during some future crisis.

Federal and State Consumer Protection Laws

As a general rule, federal and state consumer protection laws do not apply to state and local governments.

The Effects on Holders of Existing Securities

As discussed above, holders of existing securities may realize their losses more quickly as a result of this application of eminent domain, but a condemnation hearing should award them the fair market value of their condemned property.

The Impact on Performing Mortgage Contracts

This application will terminate some performing mortgage contracts. Such a result is completely in accord with the legitimate exercise of the power of eminent domain.

The Role of the Courts

The role of the courts is not of particular note here. Courts often handle large litigations involving many parties fighting over extraordinarily large sums of money (for example, mass tort litigations such as those relating to tobacco, asbestos and black lung). Given that the investor, lender and servicer industries are relatively concentrated, courts might find this to be a relatively straightforward challenge.

Fees and Costs

There will be fees and costs associated with a widespread application of eminent domain. But the existence of high costs and fees would not present a constitutional problem. It may, however, present a practical impediment to the widespread application of eminent domain. Even so, these costs and fees will not be any greater proportionately than those applicable in other eminent domain proceedings and they may, in fact, be lower proportionately. The condemning government will need to assess the impact of such fees and costs on its objectives and act accordingly.

Valuation of Contracts

Courts are well able to value residential mortgage transactions. There are established appraisal techniques to do so. Indeed, the application of these techniques in the residential mortgage context may be among the most straightforward.

* * *

There has been a lot of fear-mongering by organizations such as the American Securitization Forum over the application of eminent domain to residential mortgages. While there may be many legitimate business reasons for the Forum to oppose its use, its inconsistency with Takings jurisprudence should not be one of them.

While I do not have the expertise to evaluate the business objections to its use, I will note that my study of housing policy in the 1930s reveals a federal government that could act quickly, elegantly and forcefully in the housing markets. Initiatives such as the Home Owners Loan Corporation and the Federal Housing Administration did not solve all of our problems but they were solid steps in the right direction.

The federal government's responses to the current crisis in the housing markets have been at cross purposes, half-hearted and self-defeating. So it is not surprising that local governments are attempting to fashion solutions to the problem with the tools at their disposal. Courts should, and likely will, give these democratically-implemented and constitutionally-sound solutions a wide berth as our ship of state tries to right itself after being swamped by a tidal wave of mortgage defaults.

Sincerely,

/s/
David Reiss