

# Underwater Mortgages: Can Eminent Domain Bail Them Out?

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## INTRODUCTION

### The Genesis of the Concept

DISCUSSION OF THE USE OF EMINENT DOMAIN TO seize “underwater” residential mortgages began in mid-2012, when it was conceived as a potential way to improve the housing market and to assist homeowners who had outstanding mortgages exceeding the value of their respective homes. The movement was initiated by Mortgage Resolution Partners (MRP), a group of venture capitalists from San Francisco hoping to convince county and local officials in San Bernardino, California, to use the governmental power of eminent domain to seize control of private residential mortgage-backed securities with the intent of cutting the principal balances of negative-equity borrowers. This, of course, would be done for a fee.

As proposed by MRP, the group would work with local governments to find large institutional investors willing to finance the condemnation process. Under the plan, the local government would take title to the loans, without taking title to the actual homes, and pay the original mortgage owner the “fair value” with the money provided by institutional investors. MRP would then work to restructure or issue new loans to reduce homeowners’ monthly mortgage payments while selling the restructured loans back to the private market, with the proceeds paying back the original financiers.

The plan was met with varying levels of approval, resistance and concerns. Objections were raised by both the Securities Industry and Financial Markets Association and the Federal Housing Finance Agency, who maintain

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that such seizures would represent an unconstitutional use of the sovereign’s eminent domain power, and an unjustified interference of investors’ rights.<sup>1</sup> Although several academics and MRP support the plan, an article from *The Wall Street Journal* notes that the White House rejected the idea when it was presented by a group of

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congressional Democrats two years ago.<sup>2</sup> Instead, the president has suggested his own plan to help property owners who own homes with underwater mortgages.<sup>3</sup> Legislation was also introduced in Congress to prohibit the four major government-sponsored mortgage providers from buying loans in any community that utilizes the eminent domain scheme.<sup>4</sup> The initial target areas of this scheme—San Bernardino and Sacramento, California, and the City of Chicago—analyzed the plan and declined to proceed, but the plan appears to have some new life, and is being mentioned as a possible option for smaller cities in different parts of the country. In particular, the City of Richmond, California, sent notices this summer to the holders of more than 600 underwater mortgages, asking them to sell the loans to the City. If they refuse to sell, Richmond has indicated that it will use its eminent domain powers to seize the mortgages, and will partner with MRP to finance the takings. These efforts quickly led an investor group—including institutions such as BlackRock and PIMCO—to file a federal lawsuit seeking an injunction to prevent Richmond from moving forward with its eminent domain plan. This lawsuit may end up being the first of many.

Does the government have the authority to acquire a mortgage by eminent domain? Is condemning a mortgage to reduce payments truly a “public use” under the Fifth Amendment to the U.S. Constitution? Will the plan really save people money and help the real estate market, or is it just a ploy that will reward and enrich the financiers? This article will seek to address those questions through looking at the legal theory underlying the plan, some of the practical considerations that will need to be addressed by the courts and the parties, and the current status of the plan.

### LEGAL THEORY OF THE MRP PLAN

#### Legal Authority and ‘Public Use’

Eminent domain has historically been used by governments to build roads, government buildings such as schools and municipal buildings, and more recently as a tool for municipal redevelopment, the latter use having given rise to increased public scrutiny of property rights since the U. S. Supreme Court decided the matter *Kelo v. City of New London*<sup>5</sup> in 2005, and allowed a local government agency to use eminent domain to take private property for “economic development” purposes. As areas have developed, the government’s need to acquire property rights has generally increased, and so has the

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potential use—and abuse—of the sovereign power of eminent domain. Under the Fifth Amendment, private property may be taken only for a public use, and can be taken only if just compensation is paid to indemnify the owner for his or her loss. Bearing this constitutional limitation in mind, what is the public use that supports the MRP plan? The first possible suggested use is that the plan could prevent blight, keep local property taxes in line with the actual current value of the property, and thereby help to maintain vibrant communities. The second public use proffered, which is more national in scope, is that the removal of underwater loans from the marketplace would speed along the overall economic recovery by freeing up monies currently being applied to underwater mortgages, or perhaps by reducing the potential for foreclosures and limiting the foreclosure crisis that exists today. These possible “public” uses would, however, likely require an expansion of existing legal precedent which has extended only to the more traditional understanding of public uses.

The issue of using eminent domain as a tool to remove blight was addressed by the Supreme Court in *Berman v. Parker*.<sup>6</sup> In *Berman*, the Court upheld the District of Columbia’s power to redevelop blighted areas and eliminate “blighting factors or causes of blight” through eminent domain, which specifically included the power to transfer condemned property from the original owner to a private redeveloper. The plaintiffs owned a department store that was not declared blighted, but was scheduled to be condemned to clear the surrounding blighted areas.

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Plaintiffs argued that their property was not blighted and could therefore not be taken to merely make the community more attractive overall, and that taking land under eminent domain to give to a redeveloper violated the Fifth Amendment by taking “from one businessman for the benefit of another businessman.” The Court unanimously decided in favor of the agency by holding that the issue of large-scale blight could be addressed only with a large-scale integrated redevelopment plan.

The *Kelo* decision noted earlier is one of the most reviled and denounced Supreme Court decisions in decades. It has been cited for the notion that the constitutional “use” mandate is expansive enough to include taking property “from one private party and giving it to another.” In *Kelo*, the plaintiffs argued that economic development, the “public use” relied on for the taking and transfer of land to the New London Development Corporation, did not qualify as a public use under the Fifth Amendment. The Court held that once a legislative body finds a project will create new jobs, increase tax and other revenues, and revitalize a depressed area, then the project qualifies as a public use because it serves a public purpose. Further, the Court ruled that a government’s delegation of its eminent domain power to a private entity was constitutional where permitted by law. Although the *Kelo* Court permitted action analogous to that relied on by proponents of the MRP scheme, the opinion also affirms that the states may limit government’s power of eminent domain. *Kelo*, which relied on *Berman v. Parker* as authority for the passing of private property from one private owner to another private owner for a “public use,” was the subject of a torrent of law journal articles and editorials, and the driving force behind 44 states passing legislation limiting the use of eminent domain, and specifically protecting citizens from having their property taken for the purpose of conveying it to another private party.

One proponent of the MRP plan suggests that the use of eminent domain to acquire underwater mortgages is supported by a decades-old Supreme Court decision, *Louisville Joint Stock Land Bank v. Radford*.<sup>7</sup> In that case, a federal appeals court ruled that the Frazier-Lemke Amendment, a subsection of the Bankruptcy Act,<sup>8</sup> was consistent with the Federal Constitution. The amendment prevented distribution of the mortgagor’s property and allowed him to remain in possession despite defaulting on the terms of his mortgage. The Supreme Court invalidated the legislation at issue in that case on the ground that it failed to provide compensation for a right (the right of

possession) that had been taken from the mortgagee. Important is that the Court did not reach the second issue—whether the taking was for a public use, and never specifically authorized taking a mortgage so long as compensation is provided, but simply stated that the property of a mortgagee *may* be taken for public use if compensation is provided.

### IS A MORTGAGE “PROPERTY” THAT CAN BE TAKEN?

Assuming that the taking of mortgages is determined to satisfy the public use limitation, the next issue presented is whether a mortgage qualifies as “property” under the Fifth Amendment and state law. In New Jersey, as an example, the courts have broadly interpreted the language in relevant statutes such as the Local Redevelopment and Housing Law (LRHL) and Eminent Domain Act of 1971 that define “property.” Citing to *Harrison Redev. Agency v. DeRose*,<sup>9</sup> the New Jersey Supreme Court determined that “the language the Legislature used to define ‘real property’ and ‘property’ in the LRHL and the Eminent Domain Act cross-reference each other and require cognate interpretations.”<sup>10</sup> The LRHL defines “real property” as: “all lands, including improvements and fixtures thereon, and property of any nature appurtenant thereto or used in connection therewith, and every estate, interest and right, legal or equitable, therein, including terms for years and liens by way of judgment, mortgage or otherwise, and indebtedness secured by such liens,”<sup>11</sup> while the Eminent Domain Act defines “property” as “land, or any interest in land...”<sup>12</sup> The express mention of a mortgage, in addition to the catch-all “any interest in land” could potentially provide a government entity with support to condemn a mortgage interest.

Other states and federal appellate courts have historically held that a mortgagee has a property interest in a condemnation equal to the amount of the remaining balance on the loan in question.<sup>13</sup> As a simple example, a mortgagee who has a \$100,000 remaining balance on a mortgage loan secured to the property would be entitled to collect only up to \$100,000 in satisfaction of the mortgagee’s interest.

### PRACTICAL CONSIDERATIONS

#### Procedural Issues

If the condemnation of a mortgage is deemed to achieve a public use, and a mortgage is considered “property” that can be acquired via eminent domain, the procedural aspect of how the property is condemned would be

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addressed by each jurisdiction's statutes, codes and court rules. A typical condemnation action begins by having the condemning agency engage an appraiser to value the property to be taken. Depending on the jurisdiction, the parties would then engage in discussions in an attempt to settle at agreeable terms before any litigation costs would be incurred. Once the power of eminent domain is invoked by commencing the condemnation process, the litigation would likely be venued in a state court where the real property lies, but valid arguments may be made that could complicate the venue of the matter in several ways, including the following:

- If the condemned mortgage is federally owned or insured, should the matter be brought in the federal courts because of the federal government's interest?
- While most condemnation cases are litigated in the counties where the real property in question is located, since the "property" condemned is not the real estate, but rather the lien interest in the real estate, might a court need to determine if the venue should instead be in the locale where the loan was issued or is held?
- If the underwater loan in question was initiated or later assigned or sold to an investor along with a pool of other loans, should the taking of the loans be consolidated into one case in order to avoid piecemeal litigation?
- If the underwater loan(s) in question contain a clause that designates a choice of laws or venues for disputes, or some form of alternate dispute resolution such as arbitration, could those clauses be used by either party to attempt to litigate in non-traditional forums, and how could the power of eminent domain possibly be used in one state to take property in other states?

These and other procedural questions abound in what would represent uncharted waters for eminent domain litigation.

### VALUATION

Perhaps more troubling than the concerns over the constitutionality of the plan and the possible procedural nightmares its implementation may create is the apparent assumption that the taking of an underwater mortgage will be inexpensive, merely because the value of the property to which the mortgage has been secured has dropped, and that "value" of the mortgage will therefore

be reduced by the decline in value of the house. This is not necessarily so.

If the mortgage is performing (as many underwater mortgages apparently are), its "value" should be determined not by the value of the security interest—the realty—but rather by the potential income stream capitalized at an appropriate rate, one that may well be substantially lower than the original mortgage rate (because of lower current interest rates)—and the mortgage may therefore be worth *more, not less*, than its face value. (This is the same principle that explains why bonds increase in value when interest rates go down.)

Fair market value has ordinarily been determined as the price a willing and able buyer would pay to a willing seller. In this setting, the "property" owner, the holder of the mortgage, would likely argue that the mortgage should be valued based on the existing obligation of the mortgagor to pay the agreed upon principal and interest. The condemning agency would likely argue a value based on the current reduced value of the land secured by the mortgage. As was discussed above, a third option for valuation is to value the mortgage as being the balance remaining (pay-off balance) as of the date of taking. Of the three scenarios, the condemning agency loses two out of the three, as discussed next.

In the first scenario, a condemning agency must pay the value based on the principal plus the projected interest income. As an example, a property is currently appraised at \$70,000, but was purchased at \$125,000 before the real estate market collapsed. The mortgage has a principal balance of \$100,000, plus the mortgage company is collecting interest at a fixed rate that will provide \$25,000 of revenue over the remaining life of the loan. If the mortgagee decided to sell the mortgage, it would obviously seek to collect some portion of the future revenue as its profit on the sale. That future revenue has a value that was determined for these types of transactions regularly before the market collapse. A condemning agency might argue that a performing mortgage must be valued as if it was *not* performing, merely because the property securing the mortgage is currently worth less than the mortgage. However, in this scenario, the condemning agency may lose, because it would be on the hook for a value greater than the value of the property securing the mortgage, and could not reduce the value of the mortgage without taking a financial loss on the transaction.

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Under the second scenario, let us assume that the condemning agency is able to successfully argue that the mortgage's value is equal to the value of the real estate. It would then acquire the mortgage from the mortgagee for the determined value (\$70,000 using the scenario above), and attempt to substitute a mortgage loan with a principal amount less or equal to the real estate's current market value, (e.g., 80 percent of \$70,000). The catch here is that the new substituted mortgage rate is likely to be higher, because legal costs and transactional fees would all need to be recouped as part of the process. However, the mortgagor could still benefit by a reduced mortgage if the costs and fees are kept in check.

The third scenario could also present a losing proposition for the condemning agency because the mortgagee would need to be paid the principal balance still due on the mortgage. It is possible that the property owner could still benefit if the interest rate is high enough to permit a reduction in the portion of the mortgage payment attributed to the collection of interest, but the principal balance would remain the same unless the condemning agency was willing to operate at a loss. No proponent of the MRP plan has ever explained how a homeowner will be substantially helped if relieved of the burden of the mortgage, but still liable on the underlying debt as evidenced by the mortgage note, to which the original lender would presumably still have a monetary claim for any deficiency owed thereunder. Or does the plan envision taking the debt instrument as well? If that is the case, how does one measure the worth of that obligation? Is the debt of borrower Smith worth more than that of borrower Jones because Smith has a better job, better credit or more "skin in the game?"

Finally, the MRP plan's proponents totally understate the uncertainty and consequent chaos that the plan might introduce into the home finance industry. Which lenders and investors will become the condemnees, having their mortgage properties taken? Which will be the financiers? Will implementation of the plan actually tighten the credit market, making homes less affordable? And what will happen if it really does cost more than the proponents suggest, when the financiers realize that they may not be able to buy these mortgage interests at rock-bottom prices? If the plan is implemented, and the owners of the original loans are not made whole, they will sustain a series of losses from the write-offs which will cause them, and their investors, to likely litigate those issues and cause

even further uncertainty and turmoil in the credit and housing markets. Mortgages are backed by bonds and their investors include the retirement savings of many middle-income Americans, and changes to those investment portfolios are likely to have far-reaching implications. So far, the answers to these or any related questions have been notably absent.

### CONCLUSION

While few local governments have embraced the MRP plan so far, the concept of using eminent domain to take underwater mortgages is far from dead. Local government and community leaders have legitimate concerns about their constituents, many of whom are struggling with mortgage payments on inflated loans that have made their homes unaffordable, and nearly impossible for them to sell without sufficient equity to pay off the loans. However, the use of government's awesome power of eminent domain, at least at the present time, appears wrought with complications and does not appear likely to lead to any significant chance of furthering its stated "public" purpose—economic development. Instead, lengthy and expensive legal battles are all but certain to follow, as will disruptions to and changes in the credit industry, which may cause decreased access to capital for borrowers and to higher interest rates. With these legal uncertainties and potential economic ramifications, actions or options other than using eminent domain need to be considered.

Perhaps the Mayor of Elk Grove, California, Gary Davis, was on the money when he recently explained why the use of eminent domain to acquire underwater mortgages was rejected in his community: ■

*It just seemed that the risks outweighed the benefits. You're taking a tool ... designed for public works projects and using heavy-handed measures to weigh in on the free market.<sup>14</sup>*

Whether other government officials end up agreeing with Mayor Davis remains to be seen.

### ENDNOTES

1. <http://www.sifma.org/news/news.aspx?id=8589940215>.
2. <http://blogs.wsj.com/developments/2012/07/16/white-house-skeptical-of-plan-to-seize-mortgages-by-eminent-domain/>.
3. <http://www.whitehouse.gov/refi>.
4. Swanson, Jann, "Congress Gets Bill Prohibiting Eminent Domain Mortgage Seizures," *Mortgage News Daily*, Sept. 13, 2012, [http://www.mortgagenewsdaily.com/09132012\\_eminent\\_domain\\_loan\\_mods.asp](http://www.mortgagenewsdaily.com/09132012_eminent_domain_loan_mods.asp).

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5. *Kelo v. City of New London*, 545 U.S. 469 (2005).
6. *Berman v. Parker*, 348 U.S. 26 (1954).
7. *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935).
8. *Frazier-Lemke Amendment*, § 75(s) of the Bankruptcy Act, 48 U.S.C. 1289.
9. *Harrison Redev. Agency v. DeRose*, 398 N.J. Super. 361, 409-11 (App. Div. 2008).
10. *Town of Kearny v. Discount City of Old Bridge, Inc.*, 205 N.J. 386, 405 (2011).
11. *New Jersey Statutes Annotated* 40A:12A-3.
12. *New Jersey Statutes Annotated*. 20:3-2(d).
13. *It is a principle of equity that if a mortgage exists upon condemned premises, and it is necessary to the security of the mortgagee, the mortgagee is entitled to receive the condemnation money, to be applied to the mortgage debt, and is invested with appropriate remedies to enforce the right. Mary Lee C. & R. Co. v. Winn*, 97 Ala. 495 (Ala. 1892).
14. Sangree, Hudson, "Bay Area firm's idea to lift underwater homeowners to positive equity loses steam," *The Sacramento Bee*, May 19, 2013.