

## Memorandum of Law and Finance

### *Breaking the Mortgage Debt Impasse: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Local Economic Recovery*

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#### *Introduction: It Takes a Village*

Six years after residential real estate prices peaked and then plunged, U.S. primary and secondary mortgage markets continue to languish in self-worsening slump.<sup>1</sup> As the modifying phrase “self-worsening” suggests, feedback effects constitute a critical component both of the problem and of its stubborn persistence.<sup>2</sup> These effects operate both as between property prices and mortgage default rates, and as between primary and secondary mortgage markets and broader local and regional economies.<sup>3</sup>

As it happens, the mentioned feedback loops are themselves critically mediated through uncoordinated market decisions taken by multiple actors who face formidable collective action hurdles – hurdles that can prevent forward or hasten backward movement by endowing individual expectations with significant “self-fulfilling prophecy” properties.<sup>4</sup> These latter are the source of the aforementioned “feedback” effects – effects that can amplify optimism into dysfunctional bubble or boom, and pessimism into bust and protracted depression.<sup>5</sup>

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<sup>1</sup> Telling statistics are supplied in abundance below, Section II.

<sup>2</sup> The structural dynamics are laid out below, Sections I and II.

<sup>3</sup> Id. Mortgage markets causally interact with the broader economy with particular force because homes are the principal form that wealth takes among that broad American middle class upon whose healthy consumer expenditure both economic growth and employment depend. See Robert Hockett, *Six Years On and Still Counting: Sifting Through the Mortgage Mess*, 9 HAST. BUS. L. J. \_\_\_ (2012) (forthcoming). More again, *infra*, Sections I and II.

<sup>4</sup> Classic cases in point are bank runs (before deposit insurance), hyperinflations, and liquidity traps. See again *infra*, Sections I and II. Also Robert Hockett, *Recursive Collective Action Problems*, 5 J. APP. ECON. \_\_\_ (2012).

<sup>5</sup> The one typically follows the other, with assets symmetrically undervalued by uncoordinated markets during busts just as they have been previously overvalued by uncoordinated markets during antecedent booms. See Hockett, *id.*; also Robert Hockett, *A Fixer-Upper for Finance*, 87 WASH. U. L. REV. 1213 (2010).

Because the hallmark of such “recursive collective action problems,” as we shall here call them, is their aggregating multiple individually rational decisions into collectively self-defeating and even self-worsening outcomes,<sup>6</sup> their solution requires the presence of a collective agent empowered to act on behalf of all parties to optimize joint outcomes.<sup>7</sup>

Against this structural backdrop, some acute observers have come to recognize that some such “collective agent” will be required to solve that collective action challenge which lies at the heart of that self-worsening slump which continues to afflict U.S. local and regional mortgage markets – and, through them, our local, regional, and hence national economies.<sup>8</sup> The question is, what person or entity is best situated to discharge this critical function?

For a number of reasons comprehensively elaborated below,<sup>9</sup> many though not all of them rooted in the inherently state-centered character of contract, commercial, trust and real property law under our constitutional order,<sup>10</sup> the federal government and its instrumentalities are *not* now well suited to this task.<sup>11</sup> At best they are but complementarily situated.

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<sup>6</sup> See again *infra*, Section II. The term “recursive collective action problem” is introduced in Robert Hockett, *Bretton Woods 1.0: An Essay in Constructive Retrieval*, 16 N.Y.U. J. LEGIS. & PUBLIC POL’Y \_\_ (2012) (forthcoming). Also Hockett, *Recursive Collective Action Problems*, J. APP. ECON., *supra* note 4. These problems’ defining feature is their “spiraling” tendency – upward (as in inflations) or downward (as in bank runs and slumps) – as rooted in uncoordinated, “self-fulfillingly prophetic” individual decisions. More, again, *infra*, Section II.

<sup>7</sup> See sources cited *supra*, notes 4 through 6. This will also be an apt place to note that we shall often lump “coordination” and “collective action” challenges together, notwithstanding their subtle distinctions. We do so partly for reasons of simplification that does no harm in the present context, and partly because *collective agents* address *both* kinds of challenge.

<sup>8</sup> See, e.g., Federal Reserve Board, *The U.S. Housing Market: Current Conditions and Policy Considerations*, White Paper, January 4, 2012, at 3; and William C. Dudley, “Housing and the Economic Recovery,” Remarks at the New Jersey Bankers Association Economic Forum, January 6, 2012, available at <http://www.newyorkfed.org/newsevents/speeches/2012/dud120106.html>.

<sup>9</sup> See again *infra*, Section II.

<sup>10</sup> See *infra*, Section IV, for more on our state-centered federal system and the reservation of contract, commercial, and especially trust and real property law to the states pursuant thereto.

<sup>11</sup> In addition to Section IV, Section II, in which the failures of the FHFA, the GSEs, HAMP and HARP are explained, is germane to this point. I hasten to note here that Howell Jackson proposed a resolution to the crisis using Tarp moneys and eminent domain authority as early as 2008. See Howell E. Jackson, *Build a Better Bailout*, CHRISTIAN SCIENCE MONITOR, September 25, 2008, available at <http://www.csmonitor.com/Commentary/Opinion/2008/0925/p09s02-coop.html>.

The author of this Memorandum proposed something similar, in this case employing TARP moneys to fund FHA purchases of voluntarily relinquished troubled mortgages, which he suggested would be forthcoming in abundance owing to distressed market conditions. FHA would thereby itself be solving a collective action problem then underwriting (fragmented) market undervaluation of the mortgages in question. See Hockett, *Bailouts, Buy-ins, and Ballyhoo*, 52 CHALLENGE 36 (2009), elaborating more fully on proposals made by author in several op-eds over the autumn of 2008.

For reasons adduced *infra*, Sections II and IV, I think that at this point the local route is more promising than the federal, as well as, for reasons adduced *infra*, Section III, less costly to the public fisc. (The Plan proposed

States and their instrumentalities – their municipalities in particular – are by contrast very well situated to play the appointed role.<sup>12</sup> That in turn raises the question by what means, and under what legal and constitutional authority, states and their municipalities might best discharge this critical function.

This Memorandum addresses and answers that question. The answer it reaches is that traditional state eminent domain authority, as typically delegated in turn by the states to their municipalities and cognate authorities, is by far the best ground upon which to act. The Memorandum also finds that a combined condemnation and mortgage restructuring plan of a particular form will be by far the best legally and financially feasible option. We shall call this “the Municipal Plan” (or “the Plan”).

The Memorandum proceeds as follows. Section I describes the source and structural dynamics of the ongoing mortgage crisis still facing the nation, its states, and their municipalities.<sup>13</sup> Section II then outlines the general form that solutions to crises of this kind must take – a form that corresponds to the structure of the crisis itself. Section II also explains why no such solution has yet been forthcoming.<sup>14</sup> In essence, it indicates, coordination hurdles of the same form as rendered the crisis possible now render its solution impossible, absent some duly authorized collective agent able to act on behalf of the interested parties – a role, as just noted, that municipalities are best situated to play.

Section III then details the Plan mentioned above, indicating both how its structure responds point for point to the structure of the crisis, and how its use of the eminent domain authority capitalizes on municipalities’ optimal positioning for purposes of collectively addressing the coordination challenges that now underwrite ongoing mortgage inertia.<sup>15</sup> It also emphasizes the role of public/private partnering between municipalities and lenders – including lenders who currently hold mortgage debt – in the Plan. It emphasizes how this feature enables municipalities to proceed at no cost to the public fisc – another important advantage, particularly in strapped times such as these.

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here is investor-funded.) The author continues to think along his own earlier, as well Professor Jackson’s, lines, however, in finding that federal action would still make for a welcome complement. See again *infra*, Section II.

<sup>12</sup> As explained more fully *infra*, Sections III through V.

<sup>13</sup> Commencing at page 4.

<sup>14</sup> Commencing at page 15.

<sup>15</sup> Commencing at page 28. Appendix A, which complements this Section, provides fuller financial detail for those possessed of more specialized transactional knowledge in the form of a sample hypothetical term sheet.

Section IV comprehensively lays out the legal and constitutional basis of the Plan, indicating how the latter carries out precisely that purpose which underlies the traditional state eminent domain authority.<sup>16</sup> Section V then catalogues the immensely destructive spillover consequences – for borrowers, lenders, neighborhoods, families, local property values and assessments, local revenue bases, state and local economies, social services, crime rates, and more – of further delay in addressing the crisis.<sup>17</sup> Prevention of all of these consequences, it indicates, constitutes precisely that exigent public purpose for which state eminent domain authority exists in our law.

Although this Memorandum constitutes an integrated whole, readers who are interested primarily in the Plan’s financial and economic details and rationale will wish to focus particularly on Sections I through III. Readers who, by contrast, are interested primarily in the Plan’s constitutional basis and legal-procedural detail should focus particularly on Sections III through V.

Because the applicable law referenced here is, by its terms, particularly solicitous of the financial, broader economic, and attendant necessities faced by localities *in extremis*, however, and is indeed part of our federal system precisely in order to afford these localities means of efficient address of the same, the financial and economic analysis of the earlier Sections cannot but inform the specifically legal and constitutional analysis of the later Sections. It is hoped, then, that at least some readers will read all that follows rather than cherry-picking.

On that integrative note, the Memorandum’s Conclusion ties up loose ends and looks forward.<sup>18</sup> Against the backdrop of up to ten or more million impending foreclosures to come in the very near future,<sup>19</sup> it suggests, we are apt to see many municipal condemnation actions, brought pursuant to sundry specific, locally responsive, finely tuned variants of the Plan here described, in the months just ahead.

### ***I. The Present Crisis – Root Causes and Structural Dynamics***

As observed above in introducing the present discussion, the nation, the states, our cities and even the globe remain trapped in the fallout of a financial crisis whose epicenter

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<sup>16</sup> Commencing at page 35. Appendix B, which complements this Section, provides fuller legal and constitutional detail for those possessed of more specialized legal-procedural and doctrinal knowledge in the form of a sample hypothetical filing and supporting brief.

<sup>17</sup> Commencing at page 48.

<sup>18</sup> Commencing at page 54.

<sup>19</sup> See again *infra*, Section II, for this and additional telling statistics. Also Section V.

comprised and comprises a not very large number of U.S. localities.<sup>20</sup> The crisis itself was the culmination of a decades-long credit-fueled asset price bubble that focused primarily on residential real estate. The latter for its part both was, and remains, disproportionately located in Florida, California, and several additional “sun belt” or “sand” states.<sup>21</sup>

The credit in question, for its part, stemmed in the main from persistent, historically unprecedented trade surpluses that were accumulated over more than a decade by heavily low-wage-labor-endowed new entrants to the liberalized global economy following the breakup of the old “eastern” bloc of erstwhile socialist nations.<sup>22</sup> Flows of this credit were particularly difficult, if not indeed impossible, for domestic monetary authorities like the U.S. Federal Reserve to “sterilize,” given the openness of U.S. financial markets to the wider world.<sup>23</sup>

The theretofore unprecedented “global savings glut,” as then Federal Reserve Governor Ben Bernanke christened it in 2005,<sup>24</sup> served as the predicate to a classic recursive collective action problem of the kind noted above in introducing this Memorandum. The hallmark of these problems, again, is their capacity to bring about situations in which multiple uncoordinated decisions – even blameless, individually rational such decisions – aggregate into collectively self-damning outcomes.<sup>25</sup>

Arms races, “bums’ rushes,” bank runs and busts are familiar examples of this common phenomenon – as are, in non-recursive form, those game-theoretic perennials known as the “prisoner’s dilemma” and “tragedy of the commons.”<sup>26</sup> So too, we now know, are asset price bubbles and busts.<sup>27</sup>

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<sup>20</sup> As more statistics related infra, Section II reveal, affected communities are disproportionately, though certainly not solely, located in Florida, California, and neighboring southwestern states. In this sense, the situation is not unlike that which followed the nation’s last residential real estate bubble and bust, in the late 1920s. See Hockett, *A Fixer-Upper for Finance*, supra note 5; also Hockett, *Bailouts, Buy-Ins, and Ballyhoo*, 52 CHALLENGE 36 (2009).

<sup>21</sup> See supra, note 20. Also infra, Section II, for relevant statistics.

<sup>22</sup> Notably China and the East Asian “tiger” economies, but also others. See Daniel Alpert, Robert Hockett, and Nouriel Roubini, *The Way Forward: Moving Past the Post-Bubble, Post-Bust Economy to Renewed Growth and Competitiveness*, White Paper, New America Foundation, October 2011.

<sup>23</sup> See Alpert, Hockett, & Roubini, *The Way Forward*, id. Also Hockett, *Bretton Woods 1.0* supra note 6.

<sup>24</sup> See Ben S. Bernanke, *The Global Savings Glut and the U.S. Current Account Deficit: Remarks at the Sandridge Lecture, Virginia Association of Economists*, March 10, 2005, available at: <http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/>.

<sup>25</sup> See Alpert, Hockett, & Roubini, *The Way Forward* supra note 22; also Hockett, *A Fixer-Upper for Finance*, supra note 5; and Robert Hockett, *Bubbles, Busts, and Blame*, 37 CORNELL L. FORUM 14 (2011).

<sup>26</sup> See sources cited id. The standard renditions of the prisoner’s dilemma and tragedy of the commons do not involve feedback effects and accordingly need not be self-worsening. Indeed, collective action-problem-solving conventions can sometimes emerge pursuant to iteration of these situations. What we are calling recursive collective action problems, by contrast, simply self-worsen with iteration, hence involve either indeterminate

The problem in the present instance, with whose *sequelae* a comparatively small number of U.S. municipalities continue disproportionately to struggle, unfolded on the one hand pursuant to the classic familiar pattern, while on the other hand on the strength of the historically anomalous global credit glut just noted.<sup>28</sup> For as long as that surplus of credit remained disproportionately attracted to U.S. dollar-denominated assets – as, given the unique global role of the dollar, it was bound to do for as long as our trading partners declined to recycle them at home<sup>29</sup> – borrowing costs in this country could not but remain low.<sup>30</sup> And so they did, for well over a decade.<sup>31</sup>

But when credit costs – in the form either of low interest charges or high obtainable loan-to-value ratios (LTVs) – remain inexpensive over some lengthy interval, and at some point early on in that interval some discrete class of assets like real estate and the financial instruments appurtenant to it begin rising in value, for whatever exogenously given reason, at

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equilibria or no equilibria at all. See again Hockett, *Recursive Collective Action Problems*, supra note 5; and Hockett, *Bretton Woods 1.0*, supra note 6..

<sup>27</sup> Some of course do not simply “now” know this, but long in effect have observed it. See sources cited supra, notes 25 and 26. See also the work of Geanakoplos cited infra, note 33; and the important work on procyclicality in the monetary and financial systems of my colleague Tobias Adrian with Hyun Shin, e.g. Tobias Adrian & Hyun Song Shin, *Procyclical Leverage and Value at Risk*; FRBNY Staff Reports, No. 338 (2011), available at [http://www.newyorkfed.org/research/staff\\_reports/sr338.html](http://www.newyorkfed.org/research/staff_reports/sr338.html); Tobias Adrian et al., *Monetary Cycles, Financial Cycles, and the Business Cycle*, FRBNY Staff Reports, No. 421 (2010), available at [http://www.newyorkfed.org/research/staff\\_reports/sr421.html](http://www.newyorkfed.org/research/staff_reports/sr421.html); and Tobias Adrian et al., *Financial Intermediation, Asset Prices, and Macroeconomic Dynamics*, FRBNY Staff Reports, No. 422 (2010), available at [http://www.newyorkfed.org/research/staff\\_reports/sr422.html](http://www.newyorkfed.org/research/staff_reports/sr422.html). See also HYUN SONG SHIN, *RISK AND LIQUIDITY* (2010).

<sup>28</sup> See Alpert, Hockett, & Roubini, *The Way Forward*, supra note 22.

<sup>29</sup> The reasons for hoarding dollar denominated assets have included, inter alia, foreign exchange holding for defense against possible speculative attacks upon domestic currencies of the kind that characterized the Asian Financial Crisis of the late 1990s, domestic inflation prevention in the high growth rates at home, possible currency manipulation in order to maintain exports, and other, less pressing imperatives. See Alpert, Hockett, & Roubini, *The Way Forward*, supra note 22; and Hockett, *Bretton Woods 1.0*, supra note 6. Also MARTIN WOLF, *FIXING GLOBAL FINANCE* (2<sup>nd</sup> ed., 2010).

<sup>30</sup> See sources cited supra, notes 22, 23, and 24. Please note that, for the time being at least, with the term “borrowing costs” I am lumping together credit of the form extended in return for interest payments on the one hand, and credit that varies with available leverage ratios as determined by varying collateral requirements on the other hand. There are some contexts and associated purposes for which it is important to distinguish them, for reasons very well conveyed by Geanakoplos in the sources cited just below, note 33. For the moment, the present context is not one of them.

The Fed in during the era to which we here allude might have been able to do more by way of reining in credit, including through interest rate policy or, more potently, the regulation of leverage ratios. But there were reasons for it to be cautious about doing so, and the free inflow of credit from abroad under liberal global financial arrangements would have rendered the task both delicate and difficult in any event. See, e.g., Alpert, Hockett, & Roubini, *The Way Forward*, supra note 22; Hockett, *A Fixer-Upper for Finance*, supra note 5; and Hockett, *Bretton Woods 1.0*, supra note 6.

<sup>31</sup> See again sources cited supra, notes 22, 23, and 24.

more rapid rates than the effective interest or collateral haircut rates, it quickly becomes rational for more individuals than before to begin borrowing and buying the assets in question.

Moreover, and more ominously for present purposes, it also becomes rational for at least some individuals – so-called “speculative buyers” – to borrow to buy only to *sell*, with a view ultimately to profiting on the emerging, then widening spread between low borrowing costs and high, then accelerating capital appreciation rates.<sup>32</sup> *And these comparatively few speculative buyers, crucially, come increasingly to determine the prices that even conservative buyers must pay – and indeed borrow to pay.*<sup>33</sup>

Once even a relatively small threshold number of speculative market actors begin acting on rational “spread-legging” calculations like these, the ensuing credit-fueled asset appreciation process can become self-accelerating. It can do so, indeed, for as long as the credit that fuels it remains overabundant. More buying then comes to mean more price rises, which means greater spreads between low leveraging costs and high capital gains, which in turn brings on more expectation of yet further price rises, which issues in further accelerated buying<sup>34</sup> – and so on,

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<sup>32</sup> See sources cited *supra*, note 25. The assets in question might first begin (moderately) rising in value for reasons rooted in “fundamentals” – for example, demographic changes that bring more first-time buyers into housing markets. The problem is that over-abundant credit can then enable even initially moderate price rises rooted in fundamentals to accelerate into much steeper price rises rooted in credit-enabled, self-fulfilling price-rise expectations themselves.

<sup>33</sup> This point is critical, particularly when questions of blame are on the agenda. One need not be a “house-flipper” to get caught up in and thus inadvertently further contribute to the mortgage bubble dynamic, any more than one need be a “bread-flipper” to be drawn into and thereby contribute further to the dynamic of a consumer price hyperinflation. Perfectly sober, even regretful parties can be prompted to buy now rather than later simply by rational recognition of the fact that, so long as the inflation or hyperinflation is underway, prices will be so much higher in future as to render it sensible to buy now rather than later. It also bears noting that not only speculators, but fraudsters as well can disproportionately determine these higher market prices that the great majority of sober and honest purchasers must pay. See Hockett, *A Fixer-Upper for Finance*, *supra* note 5; Hockett, *Bubbles, Busts, and Blame*, *supra* note 25; and Hockett, *Recursive Collective Action Problems*, *supra* note 6.

Credit for first rigorously modeling the disproportionate influence of “optimists” in a general equilibrium model with heterogeneous investors rests with the prescient and ever-brilliant John Geanakoplos. See John Geanakoplos, *Promises, Promises* 305-07, in *THE ECONOMY AS A COMPLEX EVOLVING SYSTEM II*, pp. 285-320 (W. B. Arthur et al., eds., 1997); John Geanakoplos, *Liquidity, Default, and Crashes: Endogenous Contracts in General Equilibrium*, in *ADVANCES IN ECONOMICS AND ECONOMETRICS: THEORY AND APPLICATIONS*, ECONOMETRIC SOCIETY MONOGRAPHS, EIGHTH WORLD CONFERENCE, 2:170 (Cambridge U. Press, 2005); and, more recently, John Geanakoplos, *The Leverage Cycle*, *NBER MACROECONOMICS ANNUAL*, pp. 1-65 (2010), at 43. The same works highlight the importance of distinguishing between interest and leverage (collateral) in some critical contexts. They do not reference fraudsters, but the logic carries over to their case as well.

<sup>34</sup> Note again that the accelerated buying might be done by speculators or fraudsters acting pursuant to profit motives, but also might be done by ordinary “buy and hold” buyers who simply decide to buy sooner rather than later in order to avoid having to pay more at later dates. In this sense the bubble is, again, much like a consumer price hyperinflation, which can be fueled not only by commodities speculators but also by ordinary consumers hoping to preempt higher payment requirements apt to set in at later dates.

for as long as (1) the leveraging remains inexpensive, and (2) there remain further, untapped prospective new entrants to affected markets.<sup>35</sup>

And again, it bears emphasis, the comparative minority of *speculative* buyers in these circumstances increasingly determine the prices that *all* entrants must pay. Even cautious new “buy and hold” purchasers who would have entered the home markets in any event – a young couple or new family seeking their first home, say – effectively fall hostage to the decisions of levered-up “house-flippers” whose purchases the credit glut renders prospectively profitable.<sup>36</sup>

The real estate bubble of the later 1990s and early 2000s was self-accelerating pursuant to precisely this “feedback loop” pattern. As more investors noticed the profits to be made by purchasing residences, mortgage-backed securities (MBS), or associated instruments on low cost credit and then reselling, more were drawn into or otherwise affected by such transactions.

Some were of course prompted by speculative profit-seeking for their own accounts. Others were pressed into participating by clients on whose accounts they traded.<sup>37</sup> Still others were pressed in effect by the speculators themselves, via the disproportionate impact the latter’s transactions exerted on prices that even ordinary folk had to pay – and, increasingly, to borrow to pay.<sup>38</sup> And as more came to transact on these terms, prices naturally rose higher, at accelerating rates, increasing profit opportunities yet further.

In effect, a spontaneously emergent “Ponzi,” or “pyramid” process developed in the nation’s largest primary and secondary real estate markets over the 1990s and early 2000s – a process that, crucially, requires no actual Ponzi or schemer to commence or persist.<sup>39</sup> The non-

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<sup>35</sup> This is of course what accounts for some mortgage originators’ having sought ever more “marginal” borrowers to whom to lend on ever more risky, “sub-prime” terms – and even non-marginal buyers to switch into more marginal, higher risk higher return mortgage arrangements – as the pool of prospective new buyers shrank and the bubble neared its prospective-new-entrant-determined natural limiting perimeter. It also accounts for the uptick in fraudulent credit practices as the limits of pools of new entrants, and thus of the bubble itself, were at long last approached. See Hockett, *A Fixer-Upper for Finance*, supra note 5.

<sup>36</sup> It bears noting, moreover, that many of these speculative buyers and fraudsters whose purchases set the prices that even cautious and honest buyers had to pay purchased *multiple* properties, in effect leveraging up their own influence on prices. See id.

<sup>37</sup> Much anecdotal evidence suggests that many hedge fund managers sought to pull out of or even short real estate during the late stages of the bubble, only to be told by their clients that they would withdraw their funding and invest elsewhere were the managers to do so. See, e.g., Hockett, *Fixer-Upper*, supra note 5; and Geanakoplos, *Promises, Promises*, supra note 33.

<sup>38</sup> See sources cited supra, note 33.

<sup>39</sup> This is a core message of Hockett, *Fixer-Upper*, supra note 5, in which the term “spontaneously emergent Ponzi process” is introduced. See also Hockett, *Bubbles, Busts, and Blame*, supra note 25; and Hockett, *Recursive Collective Action Problems*, supra note 6. Blame there might have been, but it is altogether unnecessary to explain

necessity of any such Ponzi or schemer in these processes is important. It is precisely the sense in which processes of this sort stem from classic coordination problems – problems that result from, rather than defying, individual rationality, even ethically blameless such rationality.

This is not to say there was no blame or irrationality during our recent property price bubble; there always is, bubble or no.<sup>40</sup> It is only to say that these would have been inessential, and in that sense didn't lie at the core of the crisis.<sup>41</sup> All that was needed was underpriced credit, which was destined to remain underpriced for as long as the aforementioned capital surpluses built up in Asia and elsewhere over the years leading into the crisis held out or, worse yet, continued to grow – as they did.

Hence there is no need to point fingers at anyone – home buyer, lender, or secondary market investor – in explaining what happened. There is only a need to clear up the wreckage that these individuals are no better positioned collectively to clear than they were to prevent.

To appreciate all of this more concretely, it is instructive before moving on to consider a typical transaction of the era from the distinct points of view of the parties concerned.

From the lender's or investor's point of view, then – whether first mortgagee or second, portfolio loan holder or MBS buyer – it made sense during the boom to make investments that would have looked less prudent in earlier times, precisely in virtue of the steady appreciation of collateral wrought by the bubble itself.<sup>42</sup> Borrowers were, after all, less apt to default given the luxuriant refinancing opportunities which that appreciation afforded. And the growing expected values (EVs) of performing loans and underlying collateral more than offset expected losses from incremental default rate increases in any event.<sup>43</sup>

From the buyer's point of view, in turn, accepting loans from the mentioned investors – even “second” such loans, and the higher-cost nonprime, or higher-complexity adjustable rate loans that many originators increasingly channeled them toward<sup>44</sup> – made sense both for

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what happened over the course of our most recent bubble and bust. The idea of a “naturally occurring Ponzi process” figures prominently in the exceedingly prescient ROBERT SHILLER, *IRRATIONAL EXUBERANCE* (2000), which introduces this critically important idea.

<sup>40</sup> See again, in particular, Hockett, *Bubbles, Busts, and Blame*, supra note 25.

<sup>41</sup> Id.

<sup>42</sup> See again Hockett, *A Fixer-Upper for Finance*, supra note 5; and Hockett, *Recursive Collective Action Problems*, supra note 6.

<sup>43</sup> Id.

<sup>44</sup> For more on the lenders' channeling even prime borrowers toward more profitable non-prime loans, see, e.g., Hockett, *A Fixer-Upper for Finance*, supra note 5; also CHARLES MORRIS, *THE TWO TRILLION DOLLAR MELTDOWN* (2<sup>d</sup> ed., 2010).

distinct reasons and for the same reasons that extending this credit made sense to investors: For one thing, as noted above, most buyers had little choice but to buy on the terms set by the speculator-driven boom market itself. For another, appreciating home values made refinance easy in any event, well before adjustable rate mortgage loan payments might adjust upward. Indeed, the then-esteemed Fed Chairman publicly told buyers as much.<sup>45</sup>

That of course takes us to the regulators. From many of their points of view – particularly those who were not charged with overseeing the financial or monetary systems as integrated wholes – heightened regulatory concern looked unnecessary for counterpart reasons to those just considered.<sup>46</sup> Steadily rising home values meant less risk – less risk to borrower, lender, secondary market investor, and hence general public alike from the points of view of these non-systemic regulators.<sup>47</sup>

Much the same calculus appears to have affected, in this case more problematically, the thinking of that authority charged with overseeing our financial system as one systemically integrated whole on behalf of all actors – that all-important collective monetary agent known as the Fed<sup>48</sup> – though in this case there were additional, seemingly more compelling reasons to stand back.<sup>49</sup>

One such reason stemmed from the salutary consequences of the “wealth effect” wrought by home price appreciation on consumer demand. These were consequences that were bound to appeal in view of (1) U.S. growth- and employment-imperiling real wage stagnation from the 1970s onward, combined with (2) the Fed’s maximum sustainable growth and employment mandates.<sup>50</sup>

Another seemingly compelling reason for Fed inaction was the fact that it likely could not fully sterilize incoming credit in any event – at least not without either (1) backtracking on

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<sup>45</sup> See, e.g., *Greenspan Says Personal Debt is Mitigated by Housing Value*, N.Y. TIMES, Feb. 24, 2004, at C11.

<sup>46</sup> See Hockett, *A Fixer-Upper for Finance*, supra note 5; Hockett, *Bubbles, Busts, and Blame*, supra note 25.

<sup>47</sup> Id.

<sup>48</sup> The critical role of the central bank or monetary authority as necessary collective agent in respect of the financial system is a central theme of Hockett, *A Fixer-Upper for Finance*, supra note 5; Hockett, *Bubbles, Busts and Blame*, supra note 25; and Hockett, *Bretton Woods 1.0*, supra note 6. See also Robert Hockett, *Money, Finance, and Collective Action*, 6 J. APP. ECON. \_\_ (2012).

<sup>49</sup> See again Hockett, *Bretton Woods 1.0*, supra note 6.

<sup>50</sup> See Alpert, Hockett, & Roubini, *The Way Forward*, supra note 22. The mentioned mandate is codified at 12 U.S.C. § 225(a).

global financial openness, or (2) using blunt policy instruments widely thought apt to kill healthy transaction activity economy-wide.<sup>51</sup>

In short, then, even altogether blameless decisions taken by all concerned parties, with the possible exception of that collective agent that is the central bank, would have been consistent with what we have been through – and, as Section II will soon demonstrate, what we are still going through. It was precisely most parties’ acting in financially defensible manners that enabled the bubble to form, then expand for as long as the credit remained inexpensive and prospective new entrants to real estate markets could be tapped.

And for as long as this process continued, in turn, even the great majority of sober, non-speculative investors and home buyers had to transact on terms set by the bubble. Home buyers were forced, in other words, to enter into fixed debt obligations, with ever higher principal, simply in order to purchase and inhabit ever more expensive, speculative-market-valued, variably priced homes.<sup>52</sup>

Once the pool of prospective new home buyers was finally exhausted, however, and prices in consequence peaked and then plunged, millions of home-buyers could not but now find themselves suddenly “underwater,” hunkering down under “debt overhang” with “negative equity.” Their variable rate assets – not to mention lender collateral – had plummeted in value, while their fixed debt obligations had not. That left them with more in debt obligations – often *very* much more – than in underlying home equity.

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<sup>51</sup> See Hockett, *Bretton Woods 1.0*, supra note 6. It is perhaps worth noting, if only in passing, that scholars at the Bank for International Settlements – notably Claudio Borio and William White – have been consistently more optimistic about the prospects of “leaning” (against the proverbial wind) as distinguished from “cleaning” (up after a crash, the policy preferred in American circles since the end of the Martin and Volcker eras, at any rate). See again Hockett, *A Fixer-Upper for Finance*, supra note 5; Hockett, *Bubbles, Busts, and Blame*, supra note 25; and Hockett, *Money, Finance, and Collective Action*, supra note 48. A very good overview of the pro-leaning position, with critique of the pro-clean position, is William R. White, *Should Monetary Policy Lean or Clean?*, working paper, available at [http://www.bnm.gov.my/files/publication/conf/hilec2009/s04\\_sp\\_white.pdf](http://www.bnm.gov.my/files/publication/conf/hilec2009/s04_sp_white.pdf). The American consensus appears to be shifting now a bit more toward the BIS position once favored by earlier Fed Chairmen William McChesney Martin and Paul Volcker, but it is not there yet and could not have been further from it over the course of the late 1990s and early 2000s. See sources just cited. The author and his FRBNY colleagues Tobias Adrian and Meg McConnell are now working along these lines in constructing what we are calling a “macroprudential tool kit.”

<sup>52</sup> See, again, Hockett and Geanakoplos sources cited supra, note 33. It should be noted that by “fixed nominal debt obligations” we mean obligations that do not change with market prices, in contrast to variable market prices themselves. The latter’s varying upward is what opens spreads and makes borrowing to buy more attractive; its varying downward is what leaves debt overhang that can induce debt deflation.

And as this left the *mortgagors* vulnerable, of course, so has it left mortgagees who rely on their payments – along with everyone else whose wellbeing depends on the health of the mortgage markets. That, as we’ll soon see, is all of us.

So this is where much of the nation, and in particular those states and municipalities that have been since the start at the heart of the crisis, now find themselves. As of January 2012, fully \$7 trillion in household home equity wealth had been lost since 2006, while nearly one quarter – over 22% – of the 52.5 million mortgaged homes in the U.S. were underwater.<sup>53</sup>

If for the sake of illustrative case study we concentrate attention on, say, California (“the State”) and one of its counties in particular, San Bernardino (“the County”) – both of which lay at the epicenter of the bubble and bust – the figures are yet higher: 2 million homes, representing 30% of the total Statewide, and 168,000 homes, representing 43 % of the total Countywide.<sup>54</sup> These remarkable numbers are of course but the balance sheet manifestations of slumped and still sagging, record-low post-bubble home prices which, nearly six years after the peak and the plunge, are down 34% from 2006 levels nationwide, 50 % Statewide, and over 50% Countywide.<sup>55</sup>

Yet all of this, worrisome as it all is, is not all. Matters are growing yet worse. Notwithstanding periodically transient, scattered signs of improvement in some shifting national localities, the S&P Case Shiller 20 City Index now shows home prices down fully 9% from their previous post-bubble high – itself low in relation to longer term trend – reached in 2010.<sup>56</sup> The counterpart state and County figures are proportionately worse: approximately 11% for the State, and 14% for the County.<sup>57</sup> Meanwhile, a backlog of nearly 400,000 homes nationwide awaited liquidation at the end of 2011, with another 2.86 million mortgages twelve or more months delinquent.<sup>58</sup> And again the State and County figures are worse.<sup>59</sup>

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<sup>53</sup> CoreLogic. See also Alpert, Hockett, & Roubini, *The Way Forward*, supra note 22. Also Michael Campbell & Robert Hockett, *White Paper in Support of the Home Mortgage Bridge Loan Assistance Act of 2012*, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1987159](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1987159).

<sup>54</sup> CoreLogic. For more on why San Bernardino makes for an illustrative case study, see, e.g., Jennifer Medina, *In California, Economic Gap of East vs. West*, NEW YORK TIMES, April 14, 2012, page 1, available at <http://mobile.nytimes.com/article;jsessionid=ADA9B1FACB49BF39B4CF50B58646AFBF.w6?a=938651&f=19>.

<sup>55</sup> See [www.dqnews.com](http://www.dqnews.com) for State - \$484K in 2007 and \$239K in Feb2012 - and [www.City-Data.com](http://www.City-Data.com) for County – approximately \$380K in 2007 and \$155K in 2011.

<sup>56</sup> See Robert Hockett, *Six Years On and Still Counting*, supra note 3; and Campbell & Hockett, *White Paper in Support of the Home Mortgage Bridge Loan Assistance Act of 2012*, supra note 53.

<sup>57</sup> See [www.dqnews.com](http://www.dqnews.com) for State - \$270K in July 2010 and \$239K in Feb 2012 - and [www.City-Data.com](http://www.City-Data.com) – approximately \$180K in 2010 and \$155K in 2011.

<sup>58</sup> Id.

<sup>59</sup> Figures forthcoming.

The upshot of these numbers is a current “shadow inventory” of some 3.25 million homes nationwide, 174,000 homes Statewide, and 14,000 homes Countywide that are either already foreclosed or on the brink of foreclosure.<sup>60</sup> These are inventories which, as they continue to grow, weigh all the more heavily on home prices, families, neighborhoods, towns, and the national, state, and local economies. In light of these trends, widely followed real estate analysts estimate that between 7.4 million and 9.4 million additional home loans nationwide now are at serious risk of default in the coming six years. That is an impending foreclosure tsunami of apparently unprecedented proportion, rather as our recent bubble and the global glut fueling it were either unprecedented or only once-precedented.<sup>61</sup> And this is assuming no further price declines or interest rate rises.

But alas, owing to feedback effects of the sort sketched above and to be encountered again just below, further such price declines *cannot* be realistically assumed away.<sup>62</sup> Underwater homeowners who live in the shadow of debt overhang don’t spend. That drains growth- and employment-maintaining consumer demand from the economy. Because homes represent by far the largest store of wealth for the great majority of middle class Americans, moreover,<sup>63</sup> and because that middle class in turn represents by far the greatest source of

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<sup>60</sup> CoreLogic, September 2011.

<sup>61</sup> See Testimony of Laurie S. Goodman, Amherst Securities Group, to the U.S. Senate Subcommittee on Housing, Transportation, and Community Development, March 15, 2012, available at [http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=0f96e0ff-8500-41a5-a0f2-0139d0df2e07](http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0f96e0ff-8500-41a5-a0f2-0139d0df2e07); and Laurie Goodman et al., *The Case for Principal Reductions*, 17 J. STRUC. FIN. 29 (2011). Also Gus Lubin, “Laurie Goodman on Why Another 11 Million Mortgages Will Go Bad,” *Business Insider*, July 26, 2011, available at [http://articles.businessinsider.com/2011-07-26/markets/30092548\\_1\\_shadow-inventory-default-rates-loans](http://articles.businessinsider.com/2011-07-26/markets/30092548_1_shadow-inventory-default-rates-loans).

The one possible precedent, of course, is that of the global and U.S. financial and housing economies of the late 1920s and 1930. See Hockett, *A Fixer-Upper for Finance*, supra note 5 for reminder that the 1920s featured a real estate bubble in addition to a financial market bubble, the pairing of which two always seems to issue in the longest-running post-bust debt deflations. Also Hockett, *A Jeffersonian Republic Through Hamiltonian Means*, 79 S. CAL. L. REV. 53 (2005). As for the uncertainty whether the prior case rivaled or surpassed the most recent in magnitude, this owes to want of data in connection with the previous instance. See Alpert, Hockett, & Roubini, *The Way Forward*, supra note 22. On debt deflations, see the same; the *locus classicus*, for its part, is of course Irving Fisher, *The Debt-Deflation Theory of Great Depressions*, 1(4) ECONOMETRICA 337 (1933).

<sup>62</sup> See, e.g., Alpert, Hockett, & Roubini, *The Way Forward*, supra note 22; Federal Reserve Board, supra note 8; Dudley, supra note 8; and Campbell & Hockett, *White Paper in Support of the Home Mortgage Bridge Loan Assistance Act of 2012*, supra note 53, for further elaboration of the dynamics described in this paragraph. See also Adrian and Shin sources cited supra, note 27, and Geanakoplos sources cited supra, note 33. Finally, see again Fisher, as cited id.

<sup>63</sup> This is another important motif in the work of Robert Shiller. See SHILLER, *IRRATIONAL EXUBERANCE*, supra note 39. Also ROBERT SHILLER, *MACRO MARKETS* (1993); ROBERT SHILLER, *THE NEW FINANCIAL ORDER* (2003); and ROBERT SHILLER, *THE SUBPRIME SOLUTION* (2008). See also the second edition of the aforementioned *IRRATIONAL EXUBERANCE*, published in 2005 with addition chapters on the housing bubble. And Robert Hockett, *Just Insurance Through Global Macrohedging*, 25 U. PA. J. INT’L ECON. L. 107 (2004).

American consumer demand, the drag on the larger economy is massive. Indeed it is by far the heaviest drag on general post-crisis recovery.<sup>64</sup>

To be sure, not all currently troubled mortgages are underwater. Some homeowners are now facing difficulty keeping current on monthly payments simply for reasons of temporary un- or underemployment stemming as radial effects from the broader underwater-mortgage-induced slump. For this class of mortgagor, the author of this Memorandum and a colleague at the Fed have designed a Home Mortgage Bridge Loan Assistance Program, informed by a successful Pennsylvania program put into place during the steel slump of the early 1980s. The bill that would institute the program, happily, is now poised for adoption in the State of New York.<sup>65</sup> But ...

Critically, however, this class of troubled mortgage is nowhere near being the principal drag upon mortgage market and more general economic recovery. That status is overwhelmingly held by underwater mortgages, which default at accelerating rates in proportion to their negative equity, suffer disproportionate losses on liquidation, and radiate through the larger economy pursuant to the feedback mechanisms noted in the previous paragraph but one. And notwithstanding this fact – that fact that they are the *real* proverbial “elephant in the room” – they are likewise, ironically, the one class of troubled mortgage about which virtually nothing has been done. This in turn stems from what turn out to be yet more coordination challenges that we elaborate next, in Section II.

Our foreclosure crisis, then, bad enough already, is prone to continued self-worsening just as the bubble from which it proceeds was self-augmenting. Mass foreclosures and expected foreclosures further depress home prices, which further depress consumer expenditures, which further depress employment and income, which further heighten the incidence of default and foreclosure, which further depress home prices – and so on, snowballing again.<sup>66</sup> And all of this, of course, correspondingly lessens the real value of those balance-sheet-overvalued assets – mortgage loans, MBS, and associated instruments – still on

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<sup>64</sup> Numbers. See sources cited *supra*, notes 63 and 64. For interesting anecdotal evidence as well as citations to multiple empirical studies by University of Chicago economist Amir Sufi, see Binyamin Appelbaum, *Where Housing Once Boomed, Recovery Lags*, NEW YORK TIMES, April 2, 2012, p. 1.

<sup>65</sup> See Michael Campbell & Robert Hockett, *The Home Mortgage Bridge Loan Assistance Act of 2012*, available at [http://www2.nycbar.org/pdf/report/uploads/9\\_20072233-BridgeLoanAssistanceProgram.pdf](http://www2.nycbar.org/pdf/report/uploads/9_20072233-BridgeLoanAssistanceProgram.pdf). Also Campbell & Hockett, *White Paper in Support of the Home Mortgage Bridge Loan Assistance Act of 2012*, *supra* note 53.

<sup>66</sup> A few numbers prove telling: The National Association of Realtors, in its December 2011 survey, finds that foreclosure sales on average result in a discount of 22% relative to non-distressed home sales. (That compares to 20% as of December 2010.) Short sales, for their part, averaged 13% below market. *Id.* And these are conservative estimates, inasmuch as RealtyTrac has found even larger discounts.

the books of the primary and secondary investors whose claims these properties secure.<sup>67</sup> No one, in other words, is spared.

The interested parties, meanwhile, hang back in holding patterns or “kick” the proverbial “can down the road,” many apparently hoping for “some miracle to happen” before the reality of more mass foreclosure, eviction, property degradation and booked asset devaluation, all temporarily stayed until recently by “robotizing” scandal-induced caution, recommences.<sup>68</sup> This waiting, itself rooted in coordination hurdles of the same sort as enabled the bubble and bust in the first place, is what now permits the downward spiraling to continue. Only a Plan of the form drawn up below, pursuant to which municipalities act as collective agents for the fragmented parties, can reverse the self-worsening trend. The following Section explains why.

## ***II. What Has to Happen, and Why It Does Not***

Home prices are *not* going to rise back to pre-crisis, boom-period levels. If they were, it would not have been a bubble that we’ve just experienced. The excess-credit-fueled, artificially overvalued housing market just was that bubble, hence is precisely what brought us the crisis we’re living through. Against that backdrop, the only conceivable options for ending the ongoing crisis are either (1) to restart and resume the bubble itself via some heretofore undiscovered artifice,<sup>69</sup> or (2) to revalue assets and liabilities formally as the markets

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<sup>67</sup> See, e.g., Federal Reserve, *supra* note 8; Dudley, *supra* note 8; Campbell & Hockett, *White Paper in Support of the Home Mortgage Bridge Loan Assistance Act of 2012*, *supra* note 53.

<sup>68</sup> For reasons addressed in full further below in this Section, programs like the federal government’s Home Affordable Mortgage Program (HAMP) and Home Affordable Refinance Program (HARP) have been notably unsuccessful. For one thing, only 2.26 million out of 14 million troubled mortgagors have modified their mortgages under these costly programs. For another, more troubling thing, fewer than 50% of these 2.26 million themselves were still current at year-end 2011. The reason is clear: Neither program has successfully addressed the underwater mortgage problem head on by bringing significant principal reductions to affected mortgages. Most modifications have simply capitalized previously missed mortgage payments or reduced monthly payments by less than 10%. But it is overwhelmingly underwater mortgages that default. See, e.g., Goodman, sources cited *supra*, note 61; also Alpert, Hockett, & Roubini, *The Way Forward*, *supra* note 22; and Chris Foote et al, *Negative Equity and Foreclosure*, Federal Reserve Bank of Boston Federal Government Policy Discussion Papers 08-3 (2008), available at <http://www.bos.frb.org/economic/ppdp/2008/ppdp0803.pdf>.

No plan of action that does not make significant use of principal modification so as to bring earlier, bubble-priced debt into line with current, post-bubble collateral value will do anything more than put off the inevitable day of re-reckoning, and in so doing worsen the losses and harms mentioned above and catalogued more fully below. See Alpert, Hockett, & Roubini, *The Way Forward*, *supra* note 1. Also Federal Reserve, *supra* note 8; Dudley, *supra* note 8; Campbell & Hockett, *White Paper in Support of the Home Mortgage Bridge Loan Assistance Act of 2012*, *supra* note 53.

<sup>69</sup> Some have proposed the artifice of more central bank purchases of MBS, others – for example, Ken Rogoff and, more recently, Paul Krugman – the artifice of targeted higher consumer price inflation. See, e.g.,

themselves have begun doing realistically.<sup>70</sup> Reflate the bubble, in other words, bringing variable rate assets back into line with the fixed debt obligations that financed their purchase, or trim back the debt obligations themselves: write down principal.

Since option (1), for its part, is at best only conceivable, not really practicable or desirable,<sup>71</sup> option (2) is the only realistic and desirable possibility. Debt must be trimmed back to eliminate negative equity, else the time-honored correlation between high LTV and default find expression in more rounds of foreclosure. It isn't a question of whether, but when – and how. We can act to ensure that the overhung debt's written off in an orderly, expeditious, well managed manner that is equitable, efficient, and value-preserving for all. Or we can continue to sit back and watch things unfold in a manner that proves chaotic, uncertainty-fraught, inequitable and colossally wasteful.<sup>72</sup>

All parties recognize this. So do commentators across a broad spectrum running from Reagan Administration economist Martin Feldstein to grassroots progressivist outfits like MoveOn.org, and from top mortgage insurer Radian Group to top bond fund PIMCO. What then prevents interested parties' writing down principal accordingly? What blocks their acting in their own best interests?

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Kenneth Rogoff, *The Bullets Yet to Be Fired to Stop the Crisis*, FINANCIAL TIMES, August 8, 2011, available at <http://www.ft.com/intl/cms/s/0/1e0f0efe-c1a9-11e0-acb3-00144feabdc0.html#axzz1s3nCG5bY>; Paul Krugman, *Not Enough Inflation*, NEW YORK TIMES, April 5, 2012, available at [http://www.nytimes.com/2012/04/06/opinion/krugman-not-enough-inflation.html?\\_r=1](http://www.nytimes.com/2012/04/06/opinion/krugman-not-enough-inflation.html?_r=1).

These would amount to mere partial reflation of the bubble, but are nevertheless suboptimal for reasons elaborated in Alpert, Hockett, & Roubini, *The Way Forward* supra note 22. One reason is that the proverbial inflation "genie" is difficult to get back into the "bottle" once out. The other is that inflation tends disproportionately to harm old-age pensioners and those with lower incomes, at least unless and until we are prepared to countenance central bank targeting of more asset classes in open market operations, per Robert Hockett, *How To Make QE More Helpful: By Fed Shorting of Commodities*, BENZINGA FINANCE, October 14, 2011, available at <http://www.benzinga.com/news/11/10/1988109/how-to-make-qe-more-helpful-by-fed-shorting-of-commodities#>.

<sup>70</sup> See Alpert, Hockett, & Roubini, *The Way Forward*, supra note 22; Goodman Testimony, supra note 61. Also Campbell & Hockett, *White Paper in Support of the Home Mortgage Bridge Loan Assistance Act of 2012*, supra note 53.

<sup>71</sup> See supra, note 69.

<sup>72</sup> It should be noted that, in view of the losses entailed by default and foreclosure themselves, markets value foreclosure-prone properties and associated MBS at rates even lower than marked-down and accordingly no-longer foreclosure-prone properties and associated MBS. Hence the Municipal Plan, the details of which are laid out in Section III of this Memorandum, should restore home, mortgage, and MBS values to pre-crisis levels, just not bubble-era levels. For more on the way in which the same recursive collective action problem as results in artificially overvalued assets during a bubble results in artificially undervalued assets during a bust, see Robert Hockett, *Bailouts, Buy-Ins, and Ballyhoo*, 52 CHALLENGE 36 (2009); also Hockett, *A Fixer-Upper for Finance*, supra note 5; and Hockett, *Recursive Collective Action Problems*, supra note 6.

In light of what has been noted above about coordination problems, it will be recognized at once that this is not unlike asking what prevents all parties from exiting safely from a burning theatre. Actions that would be taken by multiple parties in situations like that in which we now find ourselves, if they would not be self-defeating, must be orchestrated. They inherently pose collective action challenges that properly authorized collective agents – in effect, orchestral conductors – must address on behalf of the many diffuse parties concerned.

In this sense, the present revaluation impasse – the challenge to plenary principal writedowns – just is the flipside of the precedent bubble itself.<sup>73</sup> Much as it was individually rational and indeed unavoidable, absent forceful Fed regulation of leverage conditions, for individual market actors to enter into transactions that ultimately aggregated into the bubble, and just as it is individually rational, absent direction, for each theatergoer to press toward the exit on learning of fire, so is it rational for each creditor post-bubble, absent combined orchestration, to await others' revaluing first.

Why? There are several reasons to catalogue, but the most “deep-structural” one is that the last to revalue in such circumstances ultimately faces *least need* to revalue. Everyone else's revaluing eliminates debt overhang, thereby lowers aggregate default risk, and so raises property prices. That in turn lessens the degree to which any last mortgage remains underwater – indeed it will probably lift it *above* water. Every mortgagee therefore has reason to wish to be last, rather as each fleeing theatre-goer has reason to wish to be first.<sup>74</sup> All accordingly wait for the others to act, in effect reenacting the Vaudeville routine in which two parties first try to crowd through one door, then step back, each saying, “after you.” Under such circumstances, no one gets anywhere.<sup>75</sup>

This is of course problem enough, structural as it is. And yet it is but one of the full cluster of collective action problems we face where would-be plenary principal write-down is concerned. For there are many additional impediments, most rooted in contractual practices begun during the boom years which few thought would end, to privately ordered loan modification in contemporary mortgage markets. It will be helpful here briskly to catalogue the

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<sup>73</sup> See again Hockett, *Bailouts, Buy-Ins, and Ballyhoo*, id.; and Hockett, *Recursive Collective Action Problems*, supra note 6.

<sup>74</sup> The symmetry here is no accident. Note that bubble participants also have reason to wish to be first – as do runners on banks and on assets in busts.

<sup>75</sup> The shtick is often associated with the French cartoon characters Alphonse and Gaston. See, e.g., this portrayal: [http://en.wikipedia.org/wiki/Alphonse\\_and\\_Gaston](http://en.wikipedia.org/wiki/Alphonse_and_Gaston). (Thanks to Bob Shiller for finding and sending the image.) The situation is also reminiscent of that posed by the apocryphal Kansas statute reported in Prosser's canonical casebook on the law of tort: The statute purportedly required, of any two trains nearing each other from opposed directions, that each train stop and await the other one's passage.

most formidable of these. Doing so renders all the more clear why the Plan sketched below is so urgently necessary.

The first additional impediment to plenary mortgage loan modification, then, stems from the securitization arrangements pursuant to which most contemporary mortgage loans are now held – arrangements which, we shall see, are accordingly the first targets of the Plan we propose below. The fragmentation of ownership interests both in pools of mortgage loans and, thereby, even the individual mortgage loans themselves, renders it impossible for creditors to act in concert to modify underlying loans.<sup>76</sup> There is no way for these hundreds of thousands of people even to find one another, let alone act together. In effect, mortgage loan pooling puts the traditional creditor coordination problem, endemic to all situations involving multiple creditors, “on steroids,” if one may speak in the current vernacular.

The problem is rendered yet worse by pool tranching structures that can place some pool participants – for example, senior and junior tranches – at odds with each other where the timing of modification is concerned: the so-called “tranch warfare” problem.<sup>77</sup> And this is not even to mention the fact that each pool holds multiple loans, each distinct one of which would have to be dealt with, in the event of impending insolvency, by the fragmented and fragmented-interest-holding creditors.<sup>78</sup>

The second additional impediment to plenary loan modification likewise stems from the securitization arrangements that proliferated during, and indeed helped to fuel, the real estate bubble. Because securitized creditors are too dispersed to act in concert, as just noted, the pooling and servicing agreements (PSAs) pursuant to which mortgage loans are aggregated vest authority to collect loan payments in a single collective agent – the servicer, typically a banking institution. But the same PSAs’ terms often flatly prohibit, or otherwise strictly limit – for example, through supermajority consent requirements – servicers from modifying pooled loans.<sup>79</sup> They also prohibit or limit their *selling* such loans.<sup>80</sup> So the one party explicitly vested

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<sup>76</sup> In theory, of course, indenture trustees and servicers are charged with the task of acting on behalf of the dispersed creditors; but as will become apparent below, the PSAs pursuant to which securitization trusts are formed typically limit these agents’ capacities to do what needs doing right now. See *infra*, next several paragraphs. See generally Hockett, *Six Years On and Still Counting*, *supra* note 3.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* See also Office of the Comptroller of the Currency, Office of Thrift Supervision, Mortgage Metric Report for Third Quarter 2008 (2009); Office of the Comptroller of the Currency, Office of Thrift Supervision, Mortgage Metric Report for Fourth Quarter 2008 (2009); Office of the Comptroller of the Currency, Office of Thrift Supervision, Mortgage Metrics Report for First Quarter 2009 (2009). These and additional reports are available at <http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/index-mortgage-metrics.html>. See also Tomasz Piskorski et al, *Securitization and Distressed Loan Negotiation: Evidence from the Subprime Mortgage Crisis* (2010), Chicago Booth School of Business Research Paper, No. 09-02, available at

with collective agency to act on behalf of our fragmented creditors and their financial wellbeing is contractually impeded from taking the one action that is most needful right now for the creditors themselves – expected value (EV) maximizing principal reduction.

A distinct but related obstacle here is that PSAs also determine the compensation arrangements pursuant to which servicers are paid. And these arrangements, made during the boom years with no evident thought that a property price bubble, bust, or consequent default and foreclosure tsunami might occur, overwhelmingly place servicer compensation incentives at variance with lenders' and borrowers' value-preserving loan modification interests.<sup>81</sup>

In the vicinity of borrower insolvency, RMBS servicer fees generally are independent of borrower payments. The upshot is that servicers often fare better financially over a 12 to 18 month period of borrower default than over any comparable period of debt renegotiation, restructuring, and payment resumption. Meanwhile, (1) the aforementioned fragmentation of securitized residential mortgage investors, and (2) counterpart dispersion, accompanied by missing information, demoralization, and weak bargaining power on the part of borrowers, conspire to impede any spontaneous development of more incentive-aligning servicer compensation arrangements.<sup>82</sup>

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[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1321646](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646); John P. Hunt, *What Do Subprime Securitization Contracts Actually Say About Loan Modification? Preliminary Results and Implications*, March 25, 2009, working paper, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1369286](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1369286); and Credit Suisse, *The Day After Tomorrow: Payment Shocks and Loan Modifications* (2007).

<sup>80</sup> Id. Hence, incidentally, one of the attractions of legally mandated sale – compensated taking under eminent domain authority – as proposed *infra*, Section III.

<sup>81</sup> See, e.g., sources cited *supra*, note 79. See also Larry Cordell et al, *The Incentives of Mortgage Servicers: Myths and Realities*, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., No. 2008-46 (2008), available at <http://www.federalreserve.gov/pubs/feds/2008/200846/revision/200846pap.pdf>; and Sarah Bloom Raskin, "Putting the Low Road Behind Us, Remarks at the Midwinter Housing Finance Conference," Park City, Utah, February 11, 2011, available at [http://www.google.com/imgres?imgurl=http://www.federalreserve.gov/aboutthefed/bios/board/bloom\\_raskin\\_sarah\\_web.jpg&imgrefurl=http://www.federalreserve.gov/aboutthefed/bios/board/raskin.htm&h=201&w=176&sz=57&tbnid=sicY7NccRVY5gM:&tbnh=104&tbnw=91&prev=/search%3Fq%3DSarah%2BBloom%2BRaskin%26tbm%3Disch%26tbo%3Du&zoom=1&q=Sarah+Bloom+Raskin&hl=en&usq=Jt7XFwpo3QK80uc0jC3\\_8dHDcP0=&sa=X&ei=70QfTtbPFsnb0QGInpS1Aw&ved=0CDUQ9QEwAw](http://www.google.com/imgres?imgurl=http://www.federalreserve.gov/aboutthefed/bios/board/bloom_raskin_sarah_web.jpg&imgrefurl=http://www.federalreserve.gov/aboutthefed/bios/board/raskin.htm&h=201&w=176&sz=57&tbnid=sicY7NccRVY5gM:&tbnh=104&tbnw=91&prev=/search%3Fq%3DSarah%2BBloom%2BRaskin%26tbm%3Disch%26tbo%3Du&zoom=1&q=Sarah+Bloom+Raskin&hl=en&usq=Jt7XFwpo3QK80uc0jC3_8dHDcP0=&sa=X&ei=70QfTtbPFsnb0QGInpS1Aw&ved=0CDUQ9QEwAw).

<sup>82</sup> See sources cited *id.*, as well as Hockett, *Six Years On and Still Counting*, *supra* note 3. It is interesting to note, by way of contrast, that in the securitized *commercial* real estate mortgage market the sizes of individual loans in the pools appear to have rendered lenders and borrowers more active in negotiating more incentive-aligning servicer compensation arrangements. Here securitized commercial loan servicers divide into two specialties – transaction processors and loss mitigators, with delinquent loan payments triggering shifts in responsibility from the former to the latter. The latter, in turn, are paid in proportion to restructured loan performance, rather than in the form of fees that are independent of such performance. See again Hockett, *Six Years On and Still Counting*, *supra* note 3.

Another distinct but related point is that the residential real estate loan servicing industry, whose personnel, practices, and technologies also were retained during times when the prospect of system-wide bust and foreclosure were not contemplated, has simply been overwhelmed by the sheer magnitude of the bust. Neither the numbers and specializations of personnel, nor the technologies by which documents are maintained and retrieved, have been equipped to respond to the scale of the problem we're now living with.

This is so whether the scale in question be measured in numbers of loans, amounts owed on loans, or numbers of heterogeneous PSAs carrying distinct sets of terms and requirements with which servicers must comply. It is ultimately this circumstance that accounts both the aforementioned "robo-signing" scandals of two years ago, and the recommendation of "sub-servicer" arrangements for still troubled loans in the recently proposed settlement between Bank of America and a number of institutional investors.<sup>83</sup>

The third additional impediment to plenary loan modification stems from a surprising turn taken by the familiar divergence of interest between first and second lienholders on mortgage loans. It turns out that seconds possess significant "holdup" power over would-be value-preserving modification arrangements between borrowers and firsts, *notwithstanding their subordinate status* to those firsts. This power operates through another power that seconds in turn hold over borrowers.

In essence, the problem emerges from two conjoined facts.<sup>84</sup> The first is that firsts – even when able to act in concert, or when not having to do so because holding single portfolio loans – do not benefit by loan modification unless seconds modify too. This is simply a consequence of the familiar observation, sometimes made in connection with "tranch warfare" situations of the sort mentioned above, that creditors in the "first loss" position likewise are first to benefit by principal reduction. The second operative fact is that *seconds* reap greater benefit by *not* agreeing to modifications, thanks to a power they hold over distressed mortgagors in virtue of the latter's liquidity needs when financially strapped.<sup>85</sup>

A squeezed borrower who cannot afford to make all payments required of her in a given month, and who must accordingly fall behind on something, will typically fall behind first on her

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<sup>83</sup> See, e.g., Goodman, *supra* note 61, for more on the bust's overwhelming of servicers. Also Hockett, *Six Years on and Still Counting*, *supra* note 3. Note, in addition in this connection, the contrast with servicing arrangements in the commercial real estate mortgage markets, as described *supra*, note 82. The Bank of America settlement is available at <http://www.cwrmbssettlement.com/docs/Exh%20B.pdf>.

<sup>84</sup> See Alpert, Hockett, & Roubini, *The Way Forward*, *supra* note 22. Also Hockett, *Six Years On and Still Counting*, *supra* note 3.

<sup>85</sup> See source cited *supra*, note 83.

*first* rather than her *second* mortgage loan. The reason is that default on the latter – typically a home equity line of credit (HELOC) – means loss of capacity to pay for anything else, including the things she must purchase to live and to work while endeavoring to dig herself out of debt. Default on the former, by contrast, triggers a lengthy foreclosure process that affords “breathing room” in which to attempt to put life back in order.<sup>86</sup> Hence seconds have both holdup power and incentive to exercise it, while firsts and their borrowers are unable to benefit by the modification that both need and want until seconds stop wielding that power.

What is legally perverse here, of course, is that second lienholders in effect can use power they hold over mortgagors to seize priority status from prior mortgagees – first lienholders. In so doing they can prevent value-preserving loan modifications even by *portfolio* lenders who are *not* faced with the extra coordination challenges, described just above, that *RMBS* investors face.

Since some \$873 billion in second lien term mortgages and HELOC mortgage loans, most of them seconds, weigh on a large portion of the most deeply underwater first mortgage loans nationwide, this impediment is particularly costly.<sup>87</sup> In our sample representative County, moreover, this problem, like most of the state’s and the nation’s mortgage-related problems, is proportionally worse. HELOCs in San Bernardino amount to significant portion of mortgage debt.<sup>88</sup>

But there is more here. Ironically, the *servicer incentive problem* mentioned a moment ago *dovetails* with the HELOC holdup problem. Why? Because in many cases the servicer itself is the HELOC second lien holder!<sup>89</sup> There is accordingly a conflict of interest to buttress the aforementioned PSA, compensation, and “overwhelmedness” impediments to servicers’ agreeing to loan sales or principal reductions. Against this backdrop, the lack of plenary principal reductions of the sort that would end our ongoing and still self-worsening mortgage crisis could hardly be less surprising.

But wait, one might now interject, what about the federal Home Affordable Mortgage Program (HAMP) and the Home Affordable Refinance Program (HARP)? And how about the loans held by the government sponsored entities (GSEs) Fannie Mae and Freddie Mac – and the MBS held by the Federal Reserve System through, for example, the New York Fed’s Maiden Lane funds? Are these not significant sites of potentially helpful *federal* intervention through

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<sup>86</sup> See source cited *supra*, note 83.

<sup>87</sup> See Alpert, Hockett, & Roubini, *The Way Forward*, *supra* note 22.

<sup>88</sup> Figures to come.

<sup>89</sup> See Goodman, sources cited *supra*, note 61.

which principal might be widely writ-down? Can the federal government not act, by dint of its multiple concentrated ownership stakes, as that collective agent which is evidently required to solve that thus far intractable collective action problem which is our ongoing and still self-worsening mortgage crisis?

Alas, it seems not – at least not to the requisite degree. The reasons are once again many. The most tenacious is probably the ideologically divided U.S. Congress,<sup>90</sup> combined with the fact that the first costs and immediate urgency of our nation’s self-worsening mortgage crisis are experienced more directly by the localities in which mortgaged property is located than by the more remotely located federal government.<sup>91</sup> These facts alone render the federal government unlikely to purchase possession of mortgage loans outright with a view to restructuring or refinancing them, or even to refinance those they already hold. But there is yet more to the story.

It is true that some federal instrumentalities already possess large pools of mortgage loans or associated securities in such manner as might help enable restructuring. The aforementioned Fed funds of course hold some. But these represent only a fraction of all such outstanding and have in any event been held from the start with a view not to holding them indefinitely, but instead for the short term until markets recover. The purpose from the outset has been to address liquidity crises faced by a number of large financial intermediaries whose balance sheets were widely believed to hold unsustainable quantities of “toxic” assets in 2008. That limited purpose in turn limited the kind and quantity of assets purchased, and of course also is why the Fed now is selling them off at a profit.

Fannie and Freddie could have been – and still might turn out be – a somewhat different story. The GSEs do hold significant numbers of loans for which they could in theory write down principal. The principal holdups in this case appear to be three, two of them apparently rooted in one source. The first is that Fannie and Freddie themselves use thousands of distinct servicers to service the loans that they hold, meaning that the “overwhelmed servicer”

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<sup>90</sup> One might partly pun here by saying that there is yet another “collective action problem” in this case, since the deeply divided Congress is simultaneously (a) evenly divided and (b) operating in its Senate subject to supermajority voting requirements – the classic recipe for “gridlock.”

<sup>91</sup> “First” costs, “immediate” urgency, and “more directly” because the first costs are the foreclosures, attendant evictions, property value and attendant revenue base declines, and like harms elaborated more fully infra, Sections III and V, which affected localities experience unmediated – a fact which will figure into the justification of recourse to municipal eminent domain infra. Later costs experienced by the nation at large are “mediated” and “less direct” because they involve radial effects of mortgage debt overhang and foreclosure on consumer spending, growth, and employment in the macroeconomy – costs which some members of Congress evidently do not realize stem more from the ongoing mortgage crisis than, say, from women’s use of contraceptives or the President’s birth certificate.

impediment mentioned above could prove operative here too. But this is the least serious of the GSE holdups.

The second holdup is that many underwater GSE loans – somewhere on the order of 50% – are subject also to second liens, meaning that Fannie and Freddie also face the HELOC obstacle noted above. Were they or their regulator and, for the time being, conservator – the Federal Housing Finance Authority (FHFA) – to “play hardball” with the second lien holders, principal write downs might be somewhat more common. But the current acting director of the agency seems, for the time being at least, to be rather reluctant to “strong arm” the banking institutions that hold these second liens.<sup>92</sup>

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<sup>92</sup> There are some very tentative signs that this could change, in light of the present acting director’s recent remarks made at the Brookings Institution and his January letter to Congressman Cummings cited immediately below, to the effect that FHFA is assessing the prospect of principal reduction. Were such change to occur, Fannie and Freddie could possibly prove to be helpful federal complements to the municipalities on whose behalfs I am here arguing by doing with the loans that they hold something like what Section III prescribes that the municipalities do with the loans they purchase through condemnation from private label securitization trusts. More on this infra. It also bears noting here that Professor Jackson’s proposal, *supra* note 11, and the author’s 2008 proposal noted in the same place, would have amounted to means very similar to these for achieving much the same end. Insofar as the current acting director of FHFA changes his mode of thinking here, then, he will be moving in the 2008 Jackson and Hockett directions.

It is also important to note, however, that the prospective principal reductions now being assessed by FHFA would operate in tandem with HAMP, meaning that they would require significant “incentive” payments by Treasury. That means both (1) that current FHFA thinking on principal reduction, were it to issue in actual such reduction, would also entail significant expense to the public fisc, and (2) that the EV calculation by reference to which the decision is to be made is stacked against FHFA approval of principal reduction. In fact, in FHFA’s current calculations, as registered at pp. 18-19 of the Brookings address cited immediately below, HAMP-required servicer incentive payments made by Treasury (\$3.9 billion) would be more than double the EV gain enjoyed by Fannie and Freddie (\$1.7 billion). All of this, if accurate, suggests both that the publicly cost-less Plan outlined below in Section III is both (1) just about infinitely more dollarwise efficient than HAMP-hampered principal reduction as currently contemplated by FHFA, and (2) infinitely more likely to occur as well.

For the Brookings remarks, see Edward DeMarco, *Addressing the Weak Housing Market: Is Principal Reduction the Answer?*, Remarks Delivered at the Brookings Institution, April 10, 2012, available at [http://www.brookings.edu/events/2012/0410\\_housing\\_demarco.aspx](http://www.brookings.edu/events/2012/0410_housing_demarco.aspx). For the mentioned letter, see Letter from Edward DeMarco, Acting Director of the Federal Housing Finance Agency to Congressman Elijah Cummings, Ranking Member, Committee on Oversight and Government Reform, January 20, 2012, available at [http://www.google.com/url?sa=t&rct=j&q=fhfa%20letter%20to%20cummings&source=web&cd=2&ved=0CDIQFjAB&url=http%3A%2F%2Fwww.fhfa.gov%2Fwebfiles%2F23056%2FPrincipalForgivenessltr12312.pdf&ei=xap\\_T8TCGJPh0wH7\\_rT4Bw&usg=AFQjCNF958kOhIVkOCBFW3rKmicBnBvd1g](http://www.google.com/url?sa=t&rct=j&q=fhfa%20letter%20to%20cummings&source=web&cd=2&ved=0CDIQFjAB&url=http%3A%2F%2Fwww.fhfa.gov%2Fwebfiles%2F23056%2FPrincipalForgivenessltr12312.pdf&ei=xap_T8TCGJPh0wH7_rT4Bw&usg=AFQjCNF958kOhIVkOCBFW3rKmicBnBvd1g).

Note finally that Alpert, Hockett, & Roubini, *The Way Forward*, *supra* note 22, and Laurie Goodman, sources cited *supra* note 61, offer helpful means of avoiding any risk of principal-reduction-induced moral hazard of the sort with which FHFA might be concerned. (See, e.g., concerns noted at page 19 of the Brookings Remarks.) The Federal Reserve and FRBNY President Bill Dudley, *supra* note 8, also endorse such readily available means of hazard mitigation. Finally, see also HUD Secretary Donovan’s recent interventions on this subject, e.g., *Housing Secretary Pushes Mortgage Write-Downs*, REUTERS, April 6, 2012, available at <http://www.reuters.com/article/2012/04/06/us-usa-housing-idUSBRE8350MS20120406>.

The third reason that Fannie and Freddie do not, at least yet, engage in significant principal write downs likewise takes root in the present way of thinking of the current acting director of FHFA. The thinking in this case is apparently that, because FHFA as public conservator of the GSEs must safeguard their assets to safeguard the fisc, writing down principal on GSE-held loans would compromise its statutory duty.

This is of course sound thinking only if writing down principal on underwater loans either lowers the EVs of the loans, or entails costs that exceed EV benefits. If, by contrast, writing down principal significantly lowers default risk – which it does – and thereby increases EVs by more than what ever administrative or other costs would be entailed by the write downs, the long term fisc-preservation mission is actually better effected by writing down principal. That opens an interesting door.

It should be noted at this juncture that the likelihood of principal write downs’ increasing the EVs of particular loans increases with the aggregate number of written down loans – a compositional corollary of the first, “deep structural” collective action impediment to privately managed principal write downs noted above.<sup>93</sup> But this means that the acting FHFA director’s present way of thinking is more sound insofar as the GSEs and any entities that might coordinate with them collectively hold fewer loans, and less sound insofar as the GSEs and any entities that might coordinate with them collectively hold more loans. Such coordinating entities might include, of course, municipalities.

The current acting director’s recent acknowledgement that principal write downs at least *might* ultimately prove to be in the public’s interest, as noted above in note 92, is accordingly very welcome. For it signals that municipalities’ efforts pursuant to the Plan we elaborate below in Section III might ultimately be enhanced by diminished GSE passivity. The GSEs’ coordinating with municipalities, or even conveying their underwater mortgages to them for fair market value, would effectively magnify the degree of collective agency exercisable by government instrumentalities in modifying underwater mortgage loans. That would in turn maximize system-wide EVs and minimize, if not indeed eliminate, cost to the fisc.

It will be helpful, then, as suggested above in introducing this Memorandum and as we shall see more fully verified presently, to think of the GSEs as potential *complements* to state

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<sup>93</sup> As noted above, the last to write down principal has least reason to write down principal owing to the appreciation of home prices in response to the lessened default risk system-wide wrought by others’ principal write downs. This is a compositional – “whole greater than the sum of its parts” – phenomenon, more extreme versions of which are those market-wide aggregate overvaluations known as bubbles and market-wide aggregate undervaluations known as busts. See again Hockett, *A Fixer-Upper for Finance*, supra note 5; Hockett, *Recursive Collective Action Problems*; supra note 6; and Hockett, *Bailouts, Buy-Ins, and Ballyhoo*, supra note 72.

municipalities in solving that ongoing collective action problem which is the self-worsening mortgage crisis. For when the municipalities begin temporarily purchasing mortgage loans and writing down principal per the Municipal Plan elaborated below, total public holdings of underwater mortgage loans will be all the greater.

The acting FHFA director will then have little remaining reason to suppose that the GSEs' joining in to write down principal will have any but salutary effects on the fisc. Indeed he might wish to convey GSE-held loans to the municipalities themselves as suggested above, in view of the Municipal Plan's avoidance of any public expenditure – a feature that even GSE writedowns under the current regime would not have in operating in tandem with HAMP, to which we turn next.

How about HAMP and HARP, then? Are they not programs that involve collective agency at the federal level, such as can solve those collective action challenges that underwrite our ongoing and self-worsening mortgage market slump? Alas, not really. Here we are back to impediments that sound less in deep-structural challenge to collective action and more in contractual and political such challenges, along with certain programmatic limitations.

To begin with HARP, here the principal problem takes the form of programmatic limitation. HARP simply is not there for principal reduction. It's an interest-reduction program for GSE-held loans. That can be helpful, of course, just as can bridge loan assistance of the sort mentioned earlier. But it is not designed to address the core problem – which is, again, the urgent need of principal reduction.

HAMP for its part encourages some principal modification and, more so, less ambitious forms of loan modification. This it does pursuant to the so-called “waterfall” sequencing, which relies first on interest reduction, then on term extension, then on principal forbearance, and as a last resort on principal forgiveness. HAMP has, moreover, even come increasingly to contemplate principal reduction since 2010 – through the then-introduced Principal Reduction Alternative (PRA) for which Treasury recently has announced an intention to triple incentive payments made to creditors who opt for it.

The problem, however, is that because HAMP does not involve any collective agent's actually *taking possession* of loans, it continues to be hampered, if one might be pardoned a pun, by the last several impediments listed above. It also occasions costs to the fisc that are not only regrettable in themselves if avoidable, but also problematic for purposes of GSE-sought principal reduction. Again, in other words, we see interlocking and mutual reinforcing among the many impediments we must catalogue. We sketch the problems in turn.

First, then, HAMP cannot bring fragmented parties in interest together any more than those parties themselves can find one another and surmount their conflicts of interest. Second, it cannot readily undo PSA unanimity or supermajority requirements where those are present. Third, it cannot readily undo contractual limitations on servicers' writing down principal or selling off loans. And fourth, it cannot seem to handle the second lien problem, particularly in view of the favorable treatment that HAMP's Second Lien Modification Program (2MP) affords seconds at the effective expense of firsts. In these senses, HAMP suffers all the impediments to *parties' themselves* writing down principal catalogued above.

What *can* HAMP do well, then? All it can do well is to address one of the servicer incentive problems noted above. That is helpful, of course, only for loans that do not suffer the aforementioned contractual prohibitions. Moreover, and more damning, the only method that HAMP has to address the servicer incentive problem is to *bribe the servicers*. This it does in the form of payments of the PRA sort noted above.

In other words, HAMP works, when it works at all, through means that involve significant public expenditure – which, again as we shall see below, the Plan we propose here does not. And this will *remain* the case even should *GSEs* begin writing down principal in conjunction with HAMP as noted above and in note 92. That might afford yet more reason for *GSEs* themselves to go the route of the Plan we propose here in Section III, by conveying their underwater loans to municipalities for fair market value, and perhaps even participating in the financing of these acquisitions, like *PLSTs* and investors themselves as described below.

None of this is to denigrate HAMP or HARP, which have enjoyed notable successes and even have marginally increased the rate at which they are managing to secure principal reductions on troubled loans in the case of HAMP, and marginal foreclosure prevention through refinance in the case of HARP. It is only to say that these programs are unnecessarily costly and inherently limited by the baroque methodologies they employ or programmatic restrictions to which they are subject where addressing the underwater mortgage crisis is concerned.

They can help significantly – albeit at taxpayer expense – with mortgages that are not underwater. And HAMP for its part can even induce principal reductions – at yet heftier taxpayer expense – in those relatively few cases where PSAs and servicer conflicts do not stand in the way. But in these capacities they are at best marginal complements to a bona fide principal-focused strategy. We shall see shortly that only municipalities are well situated to embark on that strategy.

These, then, are the principal impediments that have stood in the way, and still stand in the way, of senior and junior first lien holders, second lien holders, borrowers and even servicers who might otherwise have acted in concert by now to modify mortgage loans so as to render them payable, eliminate debt overhang, and maximize salvageable post-bubble mortgage and collateral value for all. There have, to be sure, been additional potential impediments. These include provisions promulgated under the Internal Revenue Code (I.R.C.) until 2009,<sup>94</sup> accounting standards promulgated by the Financial Accounting Standards Board (FASB) as of 2008,<sup>95</sup> and possibly the Trust Indenture Act (TIA) of 1939, although the latter has not been litigated.<sup>96</sup> But because all of these would have served solely as “fallback”

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<sup>94</sup> Sections 860A through 860G of the IRC, as interpreted by the Internal Revenue Service (IRS) under its Revenue Procedures and Treasury Regulations at least until September 2009, conditioned the pass-through tax treatment of those Real Estate Mortgage Investment Conduits (REMICs) that hold securitized mortgages upon strict passivity. Modifications of underlying mortgage loans, for their part, were treated until recently as *departures* from the required passivity. Hence securitized mortgage obligations up to that point could be modified only on pain of significant back-tax penalty. Changes made by the IRS to the text of its Revenue Procedures (see Rev. Proc. 2009-45) and Treasury Regulations (see Section 1.860G-2) in mid-September of 2009, however, which apply retroactively to early 2008, have arguably removed this erstwhile impediment to loan modification. That was the intention, at any rate. See Hockett, *Six Years On and Still Counting*, supra note 3. In the absence of any real capacity on the part of MBS holders actually to find one another and work together with mortgagors to modify underlying loans, however, this salutary change to the tax rules is for present purposes unhelpful. See Hockett, *Six Years On and Still Counting*, supra note 3.

<sup>95</sup> For a loan originator, who typically continues on as a servicer, to realize a gain on the sale of a loan to a REMIC trust and remove the loan from its balance sheet as it aims to do, the trust to which it sells the loan must be “qualified” under the accounting standards as promulgated by the Financial Accounting Standards Board (FASB) and employed by the SEC in its regulatory roles. This in turn legally requires that the originator retain no “control” over the assets. See *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, Statement of Fin. Accounting Standards No. 140, Paras. 8-13 (Financial Accounting Standard Board 2008).

Although (a) the standards do not elaborate on what counts as “control,” and (b) some SEC staff have opined that modifications of imminently defaulting loans probably would *not* count as “control” of the sort that would shift assets back to originator/servicer balance sheets (see Letter from Christopher Cox, SEC Chairman, to Rep. Barney Frank, Chairman of Comm. on Fin. Servs., US House of Representatives (July 24, 2007)), there is sufficient uncertainty on the matter as to render the avoidance of modification prudent in the eyes of cautious originator/servicers. As in the case of the tax provisions discussed supra, note 94, however, it is not clear that this source of uncertainty is decisive, given the already formidable task would-be loan modifying principals would face in attempting to find one another and then act in concert with mortgagors to restructure underlying loans. See again Hockett, *Six Years On and Still Counting*, supra note 3.

<sup>96</sup> Though the question does not appear ever to have been litigated, the terms of the Trust Indenture Act of 1939, 15 U.S.C. Sec. 77aaa-77bbb (TIA), which apply to all corporate bonds including residential mortgage backed securities (RMBS), would seem to require unanimous consent among bondholders before rights to receive principal and interest payments on the securities could be altered. That in turn could be expected to operate as an impediment to modifying the terms of underlying mortgage loans – assuming, as seems plausible enough, that such alterations would result in alterations to payments into the legal entity on whose behalf the servicer collects on underlying mortgages before distributing proceeds to RMBS holders.

This would be so even were modifications to underlying loans *demonstrably to improve expected value*. For the TIA’s requirements are categorical, while actually securing the categorically required express unanimity among thousands or millions of RMBS holders worldwide is so highly improbable as to amount to impossibility. While it is not clear to what extent, if any, the TIA currently figures into the thinking of servicers and trust

impediments behind the more fundamental and more direct obstacles to joint coordination just catalogued,<sup>97</sup> any plan that might *substitute* for interested party coordination will effectively sidestep *all* impediments to loan modification and revaluation. That is precisely what the Municipal Plan does.

### ***III. The Municipal Plan – Structure and Operational Details***

We now turn to the main event – the combined condemnation, compensation, and mortgage loan modification Plan best able to end the still dragging, self-worsening mortgage foreclosure crisis laid out and structurally characterized above. This Section lays out the Plan’s fundamental attributes and financial features. The following Section lays out its legal contours and constitutional underpinnings.

The Municipal Plan is designed specifically to *sidestep* all of the unnecessary impediments that presently block meaningful debt revaluation and attendant value maximization. It does so by forthrightly recognizing the challenge for what it is, then addressing it accordingly.

The challenge, again, is effectively an enormous coordination problem faced by literally hundreds of thousands, if not indeed millions, of dispersed interested parties. Each of these parties acting individually has good reason to wait for the others to act, and so the group as a whole fails to act. Further, even such parties as might nevertheless *wish* to act would be unable to *find* one another to act. Contract rigidities and incentives that trustees, servicers and second lien holders face drive the final nails in the coffin.

There is no one as yet who has proved willing and able to act in a manner that benefits all of these fragmented parties in interest. No federal programs or instrumentalities are properly equipped, let alone carefully aimed at the core problem.

Enter the one instrumentality that has *not* been considered. We refer to the states and their municipalities – townships, cities, counties, and kindred units of local government. By

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administrators intrigued by the prospect of value-salvaging mortgage modifications, given the many more conspicuous factors already cited that serve to dissuade modification, it surely could present an obstacle were those other obstacles to be removed. See Hockett, *Six Years On and Still Counting*, supra note 3. This of course affords yet more reason to act pursuant to the Plan elaborated next, in Section III of this Memorandum.

<sup>97</sup> See Hockett, *Six Years On and Still Counting*, supra note 3, for a complete catalogue of all impediments, as well as “flowchart”-form tracing of their multiple mutual interactions. Also Alpert, Hockett, & Roubini, *The Way Forward*, supra note 22.

acting in the name of its residents, their safety and wellbeing, and its own economic necessity – as well as in a manner that collaterally benefits all dispersed creditors who would rather be paid than foreclose – the American municipality is ideally positioned to solve that still worsening, value-destructive coordination problem we face in our mortgage markets. For the problem itself is essentially, in its first instance, local in character.

It is a *real estate* crisis we are living with. And it has been all along. That means it is a local crisis before it's a national one. Main Street's woes are the ultimate source both of Wall Street's and of the wider economy's woes.

It is *cities* that must watch their residents being evicted, their homes being emptied, their houses deteriorating, their property values plummeting, their tax bases dwindling, their services retrenching, their crime levels spiking, and so on and on. But they don't have to lie back and watch. They can act, and act now. They *exist* to address problems like these. Protecting the citizenry and heading off blight is what municipal *eminent domain* authority is for. It's why we have it. And it's why municipalities, rather than states directly or the federal government, are those entities that most often employ it.

The Plan grows from this simple fact. It is accordingly for municipalities, or joint powers authorities (JPAs) that they or their states establish to enable coordination among multiple municipalities, to discharge their legally appointed function by customary, legally familiar means. And it is for them to do so in partnership with private investors who effectively render the Plan publicly costless – just as we've done since the earliest days of our republic in carrying out and financing local projects.

Here is how it works. We begin schematically, then steadily fill in detail.

For purposes of exposition we shall again assume a particular municipality. Again that will be the California county of San Bernardino, or a Joint Powers Authority ("Authority") that San Bernardino or California establishes to facilitate collaboration among multiple municipalities. Now, in partnership with lending institutions and employing its traditional eminent domain power, the County or Authority will purchase, at fair market value, temporary possession of carefully selected underwater mortgage loans and liens on properties located within its jurisdiction – to facilitate refinance the same.<sup>98</sup>

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<sup>98</sup> For reminder of why San Bernardino, California makes for an illustrative case study, please see *supra*, note 54 and accompanying text. We say that possession of the purchased mortgages is, for the most part, "temporary" in two senses. First, the purchased mortgage note obligations and attendant mortgages securing them are discharged and extinguished upon repayment. Second, most of the new loans and attendant mortgages that replace the antecedent ones are conveyed to new trusts that become the new mortgagees. The municipalities, in

Once it has purchased possession, the County or Authority will work directly with each willing mortgagor within its jurisdiction to accept a “short” – that is, discounted – repayment of that mortgagor’s obligations. It will do so in an amount corresponding to the level at which the mortgagor can obtain new financing in the current mortgage loan market.

As mentioned, municipalities or authorities, financed by private investors, will pay just compensation to current loan and lien holders in purchasing the select loans and liens, as required by both state and federal law.<sup>99</sup> Applicable California law, which defines the eminent domain authority somewhat more narrowly than does the U.S. Constitution,<sup>100</sup> pegs just compensation at what it terms “fair market value.” This it defines as a price apt to be reached by counterparties bargaining at arm’s length under orderly market conditions.<sup>101</sup>

Municipalities or authorities acting on the Plan in California and counterpart states might accordingly sometimes be paying more for the affected loans and liens even than many private market participants themselves would now value them, under those still self-worsening

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other words, do not simply become permanent state-level counterparts to the GSEs. A partial exception to the general case here is the case of any borrower who might ultimately prove non-refinancable, in whose case the municipality or joint powers authority will sell the loan on the whole loan market in states that permit this, while holding them in states that do not. (California permits its municipalities such sales, Florida and Nevada at present do not.) Investors collaborating with the municipality or joint powers authority bear the risk in all cases, which, for reasons elaborated throughout this Memorandum and further substantiated in Appendix A, is significantly lower than is the risk of widespread default and attendant value loss in connection with non-refinanced underwater mortgages.

The bases on which mortgages are selected for acquisition is more fully elaborated below. The short-playing version is that the first selected mortgagors must be current on their obligations – hence good credit risks – and owe on significantly underwater mortgage obligations – hence strapped by severe post-bubble conditions that they had no more reason than did lenders to anticipate. Some communities might of course subsequently select mortgages pursuant to broader criteria, as determined per their own legislative judgment. The Plan is, in other words, sufficiently adaptable as to be fine-tuned from community to community in manners responsive to those communities’ particular needs. It should also be noted, if only in passing, that most mortgages securing real property debts in our sample state of California are actually “deeds of trust.” For present purposes, however – or for most any other purpose, for that matter – no practical difference is introduced by this distinction. See generally 4 WITKIN, SUMMARY OF CALIFORNIA LAW: SECURITY TRANSACTIONS IN REAL PROPERTY, § 5 at 795 (10<sup>th</sup> ed. 2005).

<sup>99</sup> “Fair market value,” which is California’s legally mandated understanding of just compensation, might even exceed current market value in view of the ongoing and still self-worsening slump whose structural dynamics we have characterized above in Sections I and II. This is one sense in which creditors themselves benefit by the Plan. See *infra*, notes 101-104, and associated text for more on this matter. Also *infra*, Section IV.

<sup>100</sup> Cites.

<sup>101</sup> See Cal. Civ. Pr. §§ 1263.310 and 1263.320(a). See *infra*, Section IV, for full text. Fair market value would accordingly be higher for, say, a property just outside the zone of danger deemed by authorities to surround Three Mile Island than could likely be had in the actual market for such properties post-1978. By the same token it would be lower for, say, the last property sold on the outskirts of territory recently announced to be slated for a new Vandenberg Air Force Base than the actual market assigned to such property immediately following that 1950s-era announcement. More on these matters *infra*, Section IV.

market conditions outlined and quantified above throughout Sections I and II. For these, recall, are conditions that, again for the reasons elaborated in Section II, bear no inherent tendency to change. Indeed they'll continue to worsen unless and until municipalities or joint powers authorities act per the Plan we elaborate.<sup>102</sup>

It is precisely this fact – the fact that concerted action taken by the municipalities will, in solving the collective action problems that underwrite all of the ongoing ill health that we find in our mortgage markets – which accounts for private market participants' willingness to finance the condemnations in the manner next to be described. More, then, on that.

Municipalities or authorities acting on the Plan will pay for the mortgage-associated loans and liens of which they take legal possession with funds supplied by the aforementioned private sector investing institutions.<sup>103</sup> Among these investing institutions – which, notably, may include current loan and lien holders themselves, indirectly through MBS<sup>104</sup> – will be one or more of the following: public and private pension funds, insurance companies, mutual funds and other investment firms.<sup>105</sup>

Investors apt to be attracted by the Plan include in particular such as might wish to replace presently troubled and default-prone mortgage loans with safer assets, either in their own portfolios or in the portfolios they manage for others in fiduciary capacities. As suggested above in Section II, that might mean even the GSEs – Fannie and Freddie, who by participating in the Plan can maximize portfolio value and facilitate principal write downs in the public interest without having to make hefty HAMP PRA “incentive” payments to servicers.

Now to the condemnation process itself.

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<sup>102</sup> Precisely because current conditions are rooted in coordination impasse as elaborated in Sections I and II. See in particular, in this connection, the statistics elaborated in Section II.

<sup>103</sup> While the private sector investors will initially be acting as lenders of a joint powers authority or other off-balance-sheet entity established by the municipalities to receive the condemned mortgage loans/liens, the transaction constitutes part of a forward purchase by those investors of new mortgage securities that will come forth pursuant to the Plan's execution. There is a sense here in which investors are effectively partnering with municipalities. They are doing so pursuant to an arrangement in which the municipalities now act in the name of all interested parties, per the terms of Sections I and II above, as that one collective agent which is able to solve the collective action problems that all mortgage securities investors and their obligors currently face when contemplating the desirable prospect of value-salvaging loan restructuring.

<sup>104</sup> This should not be surprising, given the rootedness of current market-undervaluation of these institutions' mortgage loan and lien holdings in impassible coordination problems that they face and the municipalities now solves in their name.

<sup>105</sup> Please see *supra*, notes 101-104. Also *infra*, Section IV.

At the commencement of planned condemnation proceedings, the municipalities or authorities will deposit the mentioned investor-supplied funds, as required by states' eminent domain statutes, in state-administered escrow accounts maintained for the purpose. The deposited amount in each particular case will, again as mandated by law, be set equal to the probable just compensation ultimately to be paid for the mortgage loans and liens that the given municipality condemns.

Under "quick take" eminent domain procedures such as apply in California and many other states, probable just compensation is determined up front via municipality-procured appraisals. Funds then are deposited into the aforementioned escrow accounts at the time that the condemnation motions are filed. Once final compensation amounts have been subsequently determined by loan and lien holders and the condemning municipality – either with or without court assistance – any overage left in the escrow accounts will be equitably distributed among loan and lien holders, donated to qualified housing charities through a program administered by a respected national eleemosynary foundation, or both.

Once underwater loans are acquired, each municipality or authority will, in cooperation with the consortium of designated participants in the financial services industry who supply the upfront funding, ultimately accept discounted repayment of the loans from qualifying mortgagors who have opted in to the Plan. Repayment of the acquired loans is effected by re-underwriting and refinancing participating mortgagors pursuant to criteria commonly employed by ordinary market lenders and guarantors like the Federal Housing Administration (FHA). This way the Plan ensures that the new loans are particularly safe and sound.<sup>106</sup>

Additional substantive eligibility criteria, at least in the Plan's early stages when erring on the side of caution is prudent, are as follows.

First, the Plan will apply only to single family, owner-occupied residences within each municipality's jurisdiction. Second, all existing qualifying first lien mortgage loans will have loan to value ratios (LTVs) greater than 100%. Third, the aggregate fair market value of loans or liens secured by any qualifying home is to total to 85% or less of the value of the home itself, as determined by quantitative valuation methods developed by the municipalities' in partnership with qualified mortgage finance professionals.<sup>107</sup>

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<sup>106</sup> Departure from traditional, and historically highly successful, FHA underwriting criteria was a hallmark, of course, of the notorious nonprime loans that grew popular during the final phase of the bubble. See Hockett, *Bailouts, Buy-Ins, and Ballyhoo*, supra note 72; also MORRIS, supra note 52.

<sup>107</sup> Please see Appendix A, below, for technical specifications.

Finally fourth, the value of qualifying homes will not exceed 105.3% of FHA approved loan amounts – thus permitting a 95% new loan to value ratio.<sup>108</sup> As it happens, our sample state of California is the *situs* of just under 1.5 million mortgage loans meeting these categorical criteria.<sup>109</sup>

Other states and municipalities will of course be the *situs* of different numbers of mortgage loans meeting the criteria, and all states over time will presumably adjust the criteria in keeping with their own local needs and legislative judgments. This responsiveness to specific state and local conditions is indeed one of the particular strengths of the Plan. Rather than requiring one or two entities with national scope to deal in “one size fits all” terms with thousands of servicers, per the concerns expressed by FHFA as noted above in note 92, the Plan enables localities flexibly to tailor criteria to varying local circumstances, as well as to deal with much smaller numbers of trustees and servicers, more on which momentarily.

Along with the categorical criteria just elaborated, the Plan contemplates possible use of several additional, somewhat more open-ended substantive criteria in “prioritizing” mortgagors. First, priority will likely be given at first to those homeowners who appear, on the basis of existing loan level information including credit history and the mortgaged property itself, to qualify for refinancing into new FHA first mortgage loans of 95% LTV. That is again an “err on the side of caution” principle, based on the high success rates of FHA-conforming mortgage loans over the past 80 years.

Second, priority will preliminarily be given to first mortgage loans held in private label securitization trusts (PLSTs), as well as associated second mortgage liens. This is in order to minimize the number of parties with whom municipalities must negotiate in purchasing qualifying loans and repayment rights – thereby preventing replication of the coordination challenges that necessitate local action in the first place.

Once the Plan is fully underway, municipalities or authorities will presumably conduct further iterations in which non-PLST-held loans likewise are purchased and refinanced in cooperation with obligors. It appears that California is the *situs* of approximately 565,700 mortgage loans – 38% of all underwater such loans – held in PLSTs.<sup>110</sup>

A particular municipality such as San Bernardino County might reasonably anticipate that some 6,000 homeowners, with mortgage loans held by some 4,000 PLSTs managed by

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<sup>108</sup> See again *infra*, Appendix A, for fuller technical explication, explanation, and justification of these criteria.

<sup>109</sup> Cite forthcoming.

<sup>110</sup> Basis forthcoming.

merely twelve trustees, will complete the opt-in process during the first phase of its use of the Plan after acquiring the qualifying mortgage loans. These loans might just as reasonably be expected to possess an average fair market value, as this term of art is defined under California law, of somewhere in the neighborhood of \$150,000.<sup>111</sup> The County, in turn, might determine to err on the side of caution by placing, say, \$1 billion into the aforementioned state-managed escrow account on behalf of the PLSTs from which it will purchase the loans.

The County or Authority in most cases also will treat together all loans in connection with which any specific trustee acts on behalf of some PLST presently holding the loans. That again enables a county like San Bernardino effectively to eliminate the coordination challenges that have blocked loan restructuring thus far among its first 6,000 qualifying residents and many thousands – if not millions – of dispersed PLST bondholders. For it will now be negotiating with a mere twelve trustees. The new, refinanced loans that replace the old, underwater loans will then ultimately be grouped together again, with the partnering institutions that finance the municipalities' purchases holding the resultant bonds.

In effect, each municipality or authority that adopts and acts on the Plan will be taking possession of mortgage loans to resolve and refinance them – in short, to negotiate EV-maximizing principal write downs that lenders and borrowers alike wish to see but cannot separately negotiate in light of the impediments catalogued in Section II. In so doing it will also be accepting discounted repayment in the form of proceeds from new mortgage loans. These latter in turn are originated specifically for the purpose of conveyance to participating private investors, as repayment in kind of the moneys that the investors lend the municipality upfront to finance the condemnation award.<sup>112</sup>

In operating pursuant to the Plan, each municipality will have preserved neighborhood integrity, property values, and the revenue base from which it funds services. It will have kept its own residents in their own homes – still owning and paying on them rather than falling into default and foreclosure that harms lenders nearly as much as it does borrowers. It will also have enabled residents to get out from under the debt overhang that for six years and counting has increasingly to imperiled not only them, but their lenders, their neighbors, and the state, local, and national economies to boot.

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<sup>111</sup> See *infra*, note 142, and associated text for more on the technical meaning of “fair market value” under California law. The dollar figure is from DQ NEWS.

<sup>112</sup> As noted *supra*, note 98, there might be a small cohort of mortgage loans that, for one reason or other, ultimately prove not to be refinancable. Such loans of this description as might emerge will be sold by municipalities in the “whole loan” market for cash, which cash will then also be returned to investors.

In short, the Municipal Plan is an efficient and Solomonic solution that treats everyone fairly and protects countless third parties against the immensely destructive spillover consequences of mass foreclosure as well. There has never been a more fitting use of the states' traditional eminent domain authority.

#### ***IV. The Plan's Constitutional Basis and Legal-Procedural Details***

The Municipal Plan makes essential use of the states' and their instrumentalities' traditional eminent domain authority. It will accordingly be helpful now to lay out the broad contours of this authority and its applicability to the purposes pursuant to which the Plan employs it. That way we lay out the structure of this, legal "layer" of the Plan just as Section III has laid out the structure of its financial "layer."<sup>113</sup>

The two layers together constitute the entirety of the Plan much as a contour map captures a salient entirety of a geographical region. In an important sense, however, the legal layer is more "fundamental." For the states can act only in keeping with their legal authority, Plan or no Plan. On, then, to this authority on the basis of which the Plan envisages states and municipalities acting.

The eminent domain authority is of longstanding in both the civil and common law traditions. Even as early an articulation of the authority as that found in Grotius's *De Jure Belli et Pacis* reads strikingly like contemporary articulations.<sup>114</sup> The guiding idea behind eminent domain might be better conveyed in contemporary terms by substituting the now more familiar "preeminent" and "dominion" for the more archaic "eminent" and "domain."

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<sup>113</sup> Because this Memorandum is meant to be intelligible to non-lawyers, there is more in the way of background explanation, and somewhat less in the way of luxuriant citation to authority, here than there would in an appellate brief of the sort that the author is accustomed to penning. A sample such brief, formatted and citing as such briefs themselves do, appears as Appendix B – the legal counterpart to that sample financial term sheet that appears as Appendix A. All constitutional, statutory, and case-legal authority relied upon in this Section, however, still is cited in full. There simply will not be citations for literally every sentence as is generally the case in briefs filed in court.

<sup>114</sup> Here is Grotius: "The property of subjects is under the eminent domain of the state, so that the state or he who acts for it may use and even alienate and destroy such property, not only in the case of extreme necessity, . . . but for ends of public utility, to which ends . . . private ends should give way. But it is to be added that when this is done the state is bound to make good the loss to those who lose their property." See HUIJ DE GROOT ("Grotius"), *DE JURE BELLI ET PACIS* ("The Law of War and Peace") (1625), available online at <http://www.lonang.com/exlibris/grotius/index.html>. (For more on Grotius, see ROBERT HOCKETT, *THE LITTLE BOOK OF BIG IDEAS: LAW* (2009).) Contemporary articulations of the eminent domain authority to follow.

The gist of “preeminent dominion” is that any sovereign authority – the nation, a state, or some other fundamental unit of government – so long as it acts on behalf and in the name of the people, holds a dominion over property within its jurisdiction that is implicitly prior to that of any particular individual. This it may sparingly exercise as against any subordinate private dominion over the property in question, when and only when necessary for the good of all, provided it pay just compensation when so doing.

Because this authority is as plenary as the sovereign’s jurisdiction itself and accordingly operates, like the relevant unit of government itself, in the name of the sovereign public or people as a whole, it is applicable to all forms of property – real or personal, tangible or intangible, integral or fragmentary. A unit of government that can exercise personal jurisdiction and thereby “haul you into court,” try you, condemn you, imprison or even execute you, unsurprisingly, can exercise *in rem* jurisdiction over and “condemn” your inanimate possessions as well. The question’s not whether, but how – within what limitations.

The only inherent limitations on the eminent domain authority are already implicit in the characterizations just given. As it is ultimately the public’s or people’s authority – in the U.S., the authority of that “We, the people,” who speak in the Preamble to the Constitution – it can only be exercised for a *purpose* of the people: a public purpose. And, presumably because a guiding principle of that social contractarian legal and political ideal that has been part of the American ethos since at least the time of that favorite of the American Founders, John Locke, has been that citizens should not be made worse off for being members of a polity than they would have been in a “state of nature,” the public holds itself bound also to *compensate* any of its members against whose privately held property it *exercises* its eminent domain authority.

These are the apposite “first principles,” which antedate the American founding and find their way into American law via the British common law that we adopted, then adapted, from the colonial era on down to the present. An additional wrinkle is introduced in the American case, however, by the federal system of government that we also embraced with our Constitution. Pursuant to the “dual sovereignty” exercised by state and federal governments alike under our system, both sites of sovereignty hold powers of eminent domain. All that differs between them, in essence, is the identity of the relevant “public” – or, in the terms of Sections I through III above, the relevant “collectivity” – on whose behalf each government acts as collective agent.

To remain with our earlier, not quite randomly selected example, then, California’s state government exercises its eminent domain authority in the name of and on behalf of Californians as residents of California. The federal government exercises its counterpart

eminent domain authority in the name of and on behalf of Americans as citizens of the U.S. Of course this means also that California's exercise of its eminent domain authority will be conducted pursuant to a "public purpose" understood in reference to the public of *California* – the Californian citizenry – while the federal government's such exercises are symmetrically taken for purposes of the full U.S. citizenry.

Exercises of the eminent domain or any other authority by these distinct sovereigns may collaterally benefit other "publics" that they do not represent, of course. U.S. clean air standards presumably benefit many outside of the U.S. just as surely as U.S. carbon emissions might induce acid rain elsewhere, for example. But the exercise of authority must always be capable of being justified by reference to that public which actually authorizes the government in question to act in its name.

It is also the case, of course, that citizens of California are likewise citizens of the U.S., meaning that there is overlap among the "publics" who are implicated by the U.S. and Californian "public purposes" for which U.S. and Californian eminent domain authority might be exercised. How then are those purposes distinguished? Here it is helpful to recur once again to the notion of a collective action problem of the sort that figures prominently in Sections I through III. In essence, our constitutional arrangement is such as to observe principles of what in other parts of the world are called "subsidiarity."

The basic subsidiarian idea, which the U.S. honors under several distinct terminologies – one such of course being "federalism" – boils down to this: Where satisfaction of some particular interest requires addressing a collective action challenge that afflicts some group of  $n$  persons and no more, in general the smallest unit of government with jurisdiction over those  $n$  persons should be charged with satisfying that interest.

The interest of national defense, for example, and the collective-action-redolent "free rider problem" that imperils it, is inherently national in scope in the sense that national forces are needed and all national citizens must be taxed to finance them, even when there are or have been state National Guard units or militias. The interest of policing a neighborhood, by contrast, and the free rider problem that imperils it, is straightforwardly local and can be handled and tax-financed accordingly.<sup>115</sup>

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<sup>115</sup> Unless of course there is a national interest in rough equality of service quality nationwide, which as an inherently national interest would in some circumstances bring federal subsidies to underserved localities, financed via federal revenues. Counterpart remarks hold for education, water quality, etc., many of which implicate either the Equal Protection Clause of the 14<sup>th</sup> Amendment to the U.S. Constitution or political and hence legislative values that find partial expression therein. Of course where schooling is concerned, the Clause itself has been held to require very little, alas. See *San Antonio Ind. Sch. Dist. v. Rodriguez*, 411 U.S. 1 (1973).

In between these two “highest” and “lowest” levels of government, national subdivisions like states, or coalitions thereof, will be best suited to handling certain matters that affect multiple cities or townships within their jurisdictions while not affecting any outside of them – matters concerning the management of certain shared rivers or lakes, for example.

An important feature of the American rendition of subsidiarity for present purposes is its vesting jurisdiction over matters of real property, trust and estates, contract, and commercial law – the stuff of housing, home-ownership, real estate and mortgage finance – almost exclusively with the states.<sup>116</sup> Legal-doctrinally speaking, that vesting takes the form of states’ reservation, via the Constitution’s 10<sup>th</sup> Amendment, of what is known as a residual “police power” over matters not expressly or impliedly placed under immediate or optional federal jurisdiction by other provisions of the Constitution.

“Police” here, importantly, is to be understood in the sense of “policy” rather than “constable,” though the term definitely embraces the notion of states’ roles as *protectors* of their citizens, and in that sense as regulators of activities that can harm or pose significant risks to them. This is, again, a residual *plenary* authority, understood as that fundamental baseline from which the federal constitution’s so-called “enumerated powers” constitute only discrete, limited, conditional exceptions.

States’ or their instrumentalities’ roles as collective agents in this context, then, as suggested in introducing this Section above, can be viewed as occupying a “contract-and-property-legal layer” over which their roles as collective agents as suggested in Section III serve as a “mortgage-financial overlay.” Fundamentally, state governments exercise their police powers, of which the eminent domain power is but one, both in the name of and on behalf of the collectivity of their citizens – most of whom are home owners and neighborhood dwellers, and many of whom are borrowers and lenders.

Collaterally, though, in some cases of so doing they will also be assisting their citizens in the resolution of collective action problems that these citizens face in conjunction with out-of-

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<sup>116</sup> Hence all states have their own property codes, and nearly all have their own versions of the Uniform Commercial Code (UCC), Article 2 of which covers commercial contracts, Article 9 of which covers secured transactions including mortgage-secured such transactions, and Article 3 of which covers negotiable instruments including promissory notes of the sort mortgagors convey to mortgagees. Significantly, there is no “national” property code, nor is there any national commercial code, the “uniformity” of the UCC signifying an aspiration of the drafters and Permanent Editorial Board (PEB) that states voluntarily harmonize precisely because there is no *federally* imposed uniformity. See generally Hockett, *Six Years On and Still Counting*, supra note 3.

state others to whom they relate in contract, so as effectively to benefit all. This is, of course, what we have found in connection with the Municipal Plan elaborated above in Section III.

In the just mentioned interstate contracting connection it of course bears noting that it is a commonplace of the American constitutional order that jurisdiction over matters concerning inherently or undeniably *interstate* commerce can be exercised by the federal legislature. It is not quite as commonplace, but at least is notorious to many a law student past the first year, that some such matters are thought to be so *essentially* interstate in character as to count as implicitly required to be kept uniform across states even when Congress has not affirmatively acted so to require.<sup>117</sup>

But what is most striking against this backdrop is how much our constitutional order nevertheless reserves to the states – and, in particular, how matters of contract, commercial, and especially property law continue to be almost *entirely* matters of state law under that order. We really do remain, in a significant sense, a sort of “compact of states.”

One more wrinkle important to note in connection with both our federated form of subsidiarity and the place of the eminent domain authority in American law comes with the role of *municipalities* in our system. Because the federal Constitution was historically a compact entered into by what were viewed as thirteen antecedently sovereign states, states are effectively viewed as being among the original delegators of authority in our system.

The federal government’s being a creature of “the People” independently of the states, as suggested by the Preamble to the Constitution, finds expression, legislatively speaking, in the House of Representatives, wherein states are represented in proportion to their populations. But the federal government’s being also and simultaneously a creature of the states also finds expression in our national legislature – in this case via the Senate, wherein each state is represented, *as a state*, by the same number of Senators.

If states *share* their delegation of authority with “the people” of the nation as a whole where federal governance is concerned, however, they are the *sole* delegators of authority to their own municipalities. They are not viewed under our law as “compacts” or “federations” of

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<sup>117</sup> This is the domain of the so-called “dormant,” or “implicit” Commerce Clause, essentially interpreted as a prohibition on protectionism on the part of states of firms located within them at the expense of competing firms located in other states – a sort of GATT or WTO of the states. Notorious examples include South Carolina’s once prohibiting delivery trucks of a particular size from using its highways, widely recognized as a means of protecting local producers against imports from neighboring-state competitors. People who fret over “judicial activism” are among those who most loathe the notion of a “dormant” Commerce Clause. If it’s asleep, let it lie until Congress expressly awakens it, they in effect complain.

their cities and towns, in other words, as the federal government is viewed as a federation of “united” “states.” Instead the term that the law uses in this context is “creatures.” Municipalities are “creatures of state law,” just as are trusts, corporations, and other legal entities. Indeed, in most states, municipalities are in fact legally known as “municipal corporations,” from whence derives the notion of “incorporating” a town.

The significance of this relation between state and municipality for present purposes is twofold. First, even when employed by municipalities, as it typically is pursuant to state delegation under “home rule” or cognate statutes, the eminent domain authority is state authority. In that sense it is located at the very core of our federal system of government – a species of authority that belongs to the states quite as fully, if not indeed more so, as it does to the federal government.

Second, in delegating the eminent domain power to their municipalities as states generally do, they are delegating it to entities that are in a certain sense “on a level” with other organized entities created under state law – even private such entities such as trusts. Hence it is unsurprising that municipalities often work in partnership with other entities in pursuing public purposes through use of the eminent domain power – as the Municipal Plan itself envisages. This has been the way of eminent domain since the earliest days of our republic.

That takes us on to the Municipal Plan in particular and its status as a familiar and altogether orthodox exercise of the eminent domain power. For expository purposes noted above in note 54 and the text that accompanies it, we shall once again assume use of the Plan in a particular state: California. For the same purposes we shall also assume the same county as before: San Bernardino.

Taking some other state or municipality for our illustrative example might affect the analysis we shall now undertake at the margin, but only at the margin. That is because all of the states’ eminent domain regimes are quite similar. All one would have to do to apply the forthcoming analysis to a different state and municipality would be to cite distinct state constitutional, statutory, and municipal provisions as well as judicial constructions thereof, and then accommodate such minor terminological wrinkles as these variations would introduce.

Back to California and San Bernardino, then, for purposes of the present hypothetical legal analysis. The Municipal Plan’s use of eminent domain authority will be subject both to the federal and to the state constitutions – first the latter, then the former as a final check on the latter. The California provision on point is article I, Section 19 of the state’s Constitution. Subsection (a) thereof reads

*Private property may be taken or damaged for a public use and only when just compensation, ascertained by a jury unless waived, has first been paid to, or into court for, the owner. The Legislature may provide for possession by the condemnor following commencement of eminent domain proceedings upon deposit in court and prompt release to the owner of money determined by the court to be the probable amount of just compensation.*<sup>118</sup>

The “public use” and “just compensation” limitations are of course common – so much so that the introductory discussion above, it might have been noted, employed the same terminology without reference to any particular state or federal constitutional provision. The referenced requirement to place potential condemnation award moneys – the prospective just compensation – in escrow is likewise common, and is of course one reason for provision to do so in the Municipal Plan as laid out above in Section III.

The applicable federal constitutional provision on point, the so-called “Takings Clause” of the Fifth Amendment, is no more restrictive than the California provision.<sup>119</sup> Indeed if anything, it is less so. For the U.S. Supreme Court notoriously has interpreted the provision to allow government condemnation of private residences for purposes of conveying them to private parties in the name of economic development.<sup>120</sup> California, by contrast, is more arguably solicitous of homeowners’ interest in remaining in their homes. Hence it purports to forbid *Kelo*-style taking in subsection (b) of the aforesaid Section 19.<sup>121</sup> In general, however, the U.S. and California provisions are sufficiently in agreement as to underwrite California courts’ regularly citing to both state and federal decisions in cases involving the exercise of eminent domain in the state.<sup>122</sup>

Next, as noted above, eminent domain authority is exercisable over all forms of property – real or personal, simple or fragmentary, tangible or intangible. That, again, is the

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<sup>118</sup> Cal. Const. art. I, § 19 (a).

<sup>119</sup> U.S. Const., amend. V (“... nor shall private property be taken for public use, without just compensation.”). What is perhaps most noteworthy about this clause is the fact that it presupposes that private property regularly is, and accordingly may, be taken for public use, with the clause purporting to restrict the common practice only by reiterating that just compensation is to be paid.

<sup>120</sup> *Kelo v. City of New London*, 545 U.S. 469 (2005).

<sup>121</sup> 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.”). It should perhaps be noted, if only in passing, that subsections (c) and (d) go on to limit subsection (b) itself somewhat, in the form of familiar exceptions for public health or public works projects.

<sup>122</sup> See *County of Ventura v. Channel Islands Marina, Inc.*, 159 Cal. App. 4th 615 (2008). Given the post-*Kelo* date of this cited decision, on the one hand, and the exceptions to subsection (b) of the section 19 of the California Constitution’s article I cited in the previous note, there might be some reason to question whether California takings law is indeed more restrictive than federal takings law under *Kelo*, as I suggested above.

case everywhere that eminent domain authority is recognized, be it in civil or common law jurisdictions.

Under the federal rendition of this authority, for its part, the U.S. Supreme Court and the Courts of Appeals have regularly held that the authority extends, for example, to contract rights,<sup>123</sup> insurance policies,<sup>124</sup> shares of stock,<sup>125</sup> businesses as going concerns,<sup>126</sup> hunting rights,<sup>127</sup> rights of way,<sup>128</sup> and all manner of additional intangible. U.S. states follow the same longstanding common law tradition as does federal law in this connection.<sup>129</sup> California's Supreme Court, for example, long has explicitly recognized that "[the state's] eminent domain law authorizes the taking of intangible property."<sup>130</sup>

In view of the law's drawing no distinctions between kinds of property that can be condemned in eminent domain proceedings, it should come as no surprise that liens in particular, as merely one form of contractual obligation among many, all of which can be condemned, are themselves regularly condemned.<sup>131</sup> Among those liens are, of course, mortgage loans and liens, as the U.S. Supreme Court and other state courts have recognized.<sup>132</sup> Hence, again, the explicit recognition by the California Supreme Court, too, that "[n]o constitutional restriction, federal or state, purports to limit the nature of the property that may be taken by eminent domain."<sup>133</sup>

The only complication at all that is introduced into eminent domain analysis by intangible property has to do with the effect that intangibility has on state courts' jurisdiction, since intangibles cannot be literally, spatially "located." The law has long been aware of the

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<sup>123</sup> See, e.g., *United States Trust Company of New York v. New Jersey*, 431 U.S. 1, 19 (1977).

<sup>124</sup> See, e.g., *Lynch v. United States*, 292 U.S. 571, 577-79 (1934).

<sup>125</sup> See, e.g., *Offield v. New York, New Haven & Hartford R.R. Co.*, 203 U.S. 372 (1906).

<sup>126</sup> See, e.g., *Kimball Laundry Co. v. United States*, 338 U.S. 1 (1949).

<sup>127</sup> See, e.g., *Swan Lake Hunting Club v. United States*, 381 F.2d 238 (5th Cir. 1967).

<sup>128</sup> See, e.g., *City of Cincinnati v. Louisville & Nashville Railroad Co.*, 223 U.S. 390 (1912).

<sup>129</sup> See, e.g., *New York, N.H. & H.R. Co. v. Offield*, 59 A. 510 (Conn. 1904) (Connecticut, condemning stock); *Spencer v. Seaboard Air Line Ry. Co.*, 49 S.E. 96 (N.C. 1904) (North Carolina, condemning stock).

<sup>130</sup> *City of Oakland v. Oakland Raiders*, 32 Cal.3d 60, 68 (2008) (condemning a sports franchise).

<sup>131</sup> See, e.g., *Phillips v. Washington Legal Foundation*, 524 U.S. 156 (1998) (accrued interest on account funds); *Armstrong v. United States*, 364 U.S. 40 (1960) (materialman's lien); and the iconic *Legal Tender Cases*, 79 U.S. (12 Wall.) 457 (1870).

<sup>132</sup> See, e.g., *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 602 ("If the public interest requires . . . the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain."); *W. Fertilizer & Cordage Co. v. City of Alliance*, 504 N.W.2d 808, 816 (Neb. 1993) (Nebraska Supreme Court holding that "a mortgagee's lien on real estate is an interest that may be subjected to a taking for a public purpose and, therefore, may be the subject of an eminent domain proceeding.").

<sup>133</sup> *Oakland Raiders*, supra note 130, 32 Cal.3d at 67.

fact that intangibles are not tangible and accordingly not spatially located, however, and its doctrines have responded accordingly.

Because the doctrines of due process, *in personam*, *in rem*, territorial and subject matter jurisdiction through which it does so are particularly complex and technical both in themselves and in their interactions, though, it will be well to defer fuller technical treatment to the technical-legal appendix that is Appendix B.<sup>134</sup> For present purposes it will suffice to observe that in general, courts find the *situs* of a debt instrument to be in the domiciliary state of the debtor,<sup>135</sup> and the *situs* of real estate mortgage debt in particular to be the state in which the mortgaged property is itself located.<sup>136</sup>

It will be noted that where the mortgage debtor is domiciled in the mortgaged home itself, as is in fact required to qualify for loan modification under the Municipal Plan as elaborated in Section III, both of the aforementioned grounds of state jurisdiction converge. This entails that the state enjoys both *in rem* jurisdiction over the debt and the property securing it, and due process-consistent *in personam* jurisdiction over the creditor/mortgagee, both of these ultimately in virtue of the territorial jurisdiction it has over the space in which the mortgagee and her home are respectively domiciled and located. Subject matter jurisdiction, for its part, is here a matter of traditional state authority delegated to municipalities, more on which presently.

Federal and state constitutional authority to exercise the eminent domain power over intangibles like mortgage notes as contemplated by the Municipal Plan, then, is secure. The same holds of power to transfer acquired such property – tangible as well as intangible – to private entities. In the case of federal law, of course, the latest and most oft-cited word on the matter is the U.S. Supreme Court’s 2005 *Kelo* decision mentioned above. California, as also noted above, is sufficiently solicitous of the interest of homeowners in staying in their homes as to limit condemnation of residences for purposes of transfer to private entities. That is of

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<sup>134</sup> The author taught Civil Procedure I and Civil Procedure II in the legal academy during his final year as a doctoral student. The first of those courses is in its entirety devoted to the subject of jurisdiction, which involves not only codes of procedure, but such constitutional interests as due process. He trusts that the reader would rather this full semester course be summarized in an appendix than over multiple pages within the present text.

<sup>135</sup> See, e.g., the old chestnuts, beloved of all professors and students of Civil Procedure, *Harris v. Balk*, 198 U.S. 215 (1905); and *Chicago, Rock Isl. & Pac. Ry. Co. v. Sturm*, 174 U.S. 710 (1899). In California in particular, see *Waite v. Waite*, 6 Cal.3d 461 (1972).

<sup>136</sup> Here the jurisdiction is mediated by the unseverable link between mortgage and note. See *Carpenter v. Longan*, 83 U.S. 271, 274 (“The note and the mortgage are inseparable.”); and *Hyde v. Mangan*, 88 Cal. 319, 327 (1891) (“The debt and security are inseparable; the mortgage alone is not a subject of transfer.”). For more on this matter, and its consequent wedding of inherently state-centric property and commercial law, see Hockett, *Six Years On and Still Counting*, supra note 3.

course good news for the constitutionality of the Municipal Plan, a principal purpose of which is precisely to prevent foreclosures, evictions, and expropriation of homeowners.

Also good news is the fact that California is as open as is the U.S. Supreme Court to transfer of condemned *intangibles*, as likewise contemplated in the Municipal Plan. The only restriction in this case is the earlier discussed public purpose requirement that is at the heart of the eminent domain power, to the precise contours of which under U.S. and California law we shall turn in due course. California's authorization of the transfer of condemned intangibles is found in its Code of Civil Procedure,<sup>137</sup> and is well recognized by the state's Supreme Court.<sup>138</sup>

The next thing to note is that, as suggested by the citation just made to California's Code of Civil Procedure, *statutory* law promulgated by state legislatures affords further guidance to use of the eminent domain authority. To keep with our sample state – California – then, the applicable law is, as just effectively noted, found in the state's Code of Civil Procedure, Sections 1230.010-1273.050, known as the state's Eminent Domain Law.

This Law, for its part, first requires that express statutory authority authorize any particular government instrumentality's use of the eminent domain power.<sup>139</sup> As for the question of what such instrumentalities might do so, California conforms to the general observations made above that (1) municipalities and joint powers authorities themselves exercise these powers only insofar as states delegate them to them, while (2) most states do in fact thus delegate them. Hence in California, municipalities and joint powers authorities (1) exercise eminent domain authority "only when expressly authorized by law,"<sup>140</sup> while (2) they *are* in fact expressly authorized by law to exercise this authority.<sup>141</sup>

As in other states, statutory guidance also further contours the determination of what counts as "just compensation" in California – that which must, again under both the Takings Clause of the 5<sup>th</sup> Amendment to the U.S. Constitution and under Section 19 of Article I of the California Constitution, be paid those whose property is condemned under the eminent domain

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<sup>137</sup> See Cal. Civ. Proc. § 1240.120(b) (property condemnable "with the intent to sell, lease, exchange, or otherwise dispose of [the same]. . .").

<sup>138</sup> *Oakland Raiders*, supra note 130, 32 Cal.3d at 681-82 ("So long as adequate controls are imposed [to ensure transfer to private entity itself furthers public purpose], there is no reason why the 'public purpose' which justifies a taking may not be so served and protected.").

<sup>139</sup> See Section 1240.020 ("The power of eminent domain may be exercised to acquire property for a particular use only by a person authorized by statute to exercise the power of eminent domain to acquire such property for that use.").

<sup>140</sup> *Oakland Raiders*, supra note 124, 32 Cal.3d at 64. Also Civ. Proc. § 1240.020(b) (power exercisable "only by a person authorized by statute to exercise [it].").

<sup>141</sup> See Cal. Govt. Code § 37350.5.

authority. California’s Eminent Domain Law provides that guidance in its Sections 1263.310 and 1263.320(a).

As mentioned above in Section III, the first stipulates that “fair market value” be paid for the property taken. Also as mentioned above, the second unpacks “fair market value” essentially as the highest price apt to be reached by willing counterparties bargaining under conditions of unforced sale.<sup>142</sup> There will be more to say on this in Appendix A, which treats of valuation matters in greater technical detail.

The final limitation upon the eminent domain authority about which a bit more should be said is the “public purpose” requirement mentioned above with our first, preliminary characterization of the authority. While the requirement has always been implicit in the doctrine of eminent domain itself – since well before anyone knew there would one day be a United States of America – the requirement finds more specific expression, again, in specific provisions of federal and state law.

The applicable federal law is simply the Supreme Court’s elaboration of the public use requirement implicit in the aforementioned Takings Clause. The applicable state law comprises (1) the aforementioned Section 19 of Article I of the state’s Constitution, (2) California statutory provisions to be considered presently, and (3) state judicial constructions of (1) and (2).

The basic grounding of state and municipal exercises of eminent domain authority amounts to a kind of combined subject matter, personal, and territorial jurisdiction. It is the “police power” mentioned above in preliminarily characterizing the doctrine of eminent domain generally. The U.S. Constitution’s 10<sup>th</sup> Amendment specifically reserves this power to the states, and most of the states in turn delegate portions of this power to their municipalities along more or less subsidiarist lines as elaborated above. California does this through its constitution’s article XI, Section 7, which provides that “[a] county or city may make and enforce within its [territorial] limits all local, police, sanitary, and other ordinances and regulations not in conflict with general laws.”

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<sup>142</sup> The statutory language reads thus: Fair market value is “the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, nor obliged to sell, and a buyer, being ready, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available.” Further guidance is provided in the form of a stipulation that existing comparable markets can be used in ascertaining the mentioned counterfactual “would.” Absent some such comparable market, the Eminent Domain Law permits determination of “fair market value” as determined by any method of valuation that is “just and equitable.” See Civ. Proc. § 1263.320(b). The discussion over Sections I through III above, as well as that over Section IV below, would seem to have some bearing on what is just and equitable here.

As the catch-all “other ordinances” suggests, the police power is very broad – indeed a “plenary authority to govern, subject only to the limitation that [the municipalities exercising the power] exercise [it] within their territorial limits and subordinate to state law.”<sup>143</sup> Hence it permits municipalities authority “to enact laws to promote public health, safety, morals and general welfare.”<sup>144</sup>

Presumably because (1) states and municipalities employ eminent domain authority in exercising their police powers, while (2) these powers are themselves very broad per the federal Constitution’s 10<sup>th</sup> Amendment, the U.S. Supreme Court’s construction of the eminent domain public purpose requirement is very deferential to state and municipal legislative judgments of public purpose. The best known exemplar is again the Court’s widely discussed *Kelo* decision of 2005, in which the city of New London, Connecticut’s condemnation of homes with relatively low market value for purposes of making land available to private developers was upheld. The proffered public purpose in this case was economic development, which the city thought a likely collateral benefit of the developers’ proposed facility. The Court for its part recognized the interest in economic development as a legitimate “public use” for purposes of the eminent domain authority.

Two other public purposes commonly recognized both by the Supreme Court and all other courts in the U.S. are particularly apposite to the Municipal Plan. One is the long recognized public interest in reversing or preventing *blight*. So venerable is this particular purpose that the City of New London itself appealed to it in justifying the action mentioned above.

More common appeals to the blight reversal or prevention interest ground themselves in actual abandoned or decaying homes, emptying neighborhoods, overgrowing lawns, crumbling roads and other infrastructure, and the like.<sup>145</sup> Again, not only reversal, but also prevention of developments such as these – both of which the Municipal Plan by its terms aims to effect – counts as a public use *par excellence* for purposes of justifying exercise of the

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<sup>143</sup> *Suter v. City of Lafayette*, 57 Cal.App.4<sup>th</sup> 1109, 1118 (1997). Note that, structurally and functionally speaking, the municipal/state relation is being characterized as analogous to the state/federal relation. All that differs is the putative font of the authority in question, the conceit in the state/federal case being that the states confer, along with “the People,” authority upon the “higher level” federal government, while in the municipal/state case the conceit is the reverse, with the state delegating authority to the “lower level” municipal governments. As mentioned earlier in this Section, however, the conceit is important, in that it imparts to our federalism a tendency to treat states and their eminent domain as in a certain sense as or more “fundamental” as/than the federal government and its eminent domain power. This might account for the high degree of U.S. Supreme Court deference to state and local exercises of eminent domain, as discussed presently.

<sup>144</sup> *Community Memorial Hosp. v. County of Ventura*, 50 Cal.App.4<sup>th</sup> 199, 206 (1996).

<sup>145</sup> Here the chestnut case is *Berman v. Parker*, 348 U.S. 26 (1954).

eminent domain authority.<sup>146</sup> Section V of this Memorandum, to which we proceed presently, accordingly documents in detail the blight – indeed, blight that is unprecedented in magnitude – now being wrought in multiple U.S. municipalities by the ongoing mortgage foreclosure crisis.

The second public purpose routinely upheld as legitimate in challenges to eminent domain exercise is the interest in eliminating dislocations in local housing markets stemming from lienholders’, servicers’, and other parties’ unwillingness to consent to short sales, deeds in lieu of foreclosure, and the like – as well as counterpart inability of mortgagors to sell at current market value or otherwise transfer property in satisfaction of mortgage debt. Like the blight reversal and prevention interest, so is this one straightforwardly applicable to cases in which the Municipal Plan will be pursued.

Here the best known U.S. Supreme Court decision is that handed down in the case of *Hawaii Housing Authority v. Midkiff*,<sup>147</sup> in which the Court found sufficient public interest in the State of Hawaii’s wholesale condemnation of landlords’ ownership interests in real property in order to convey the property to tenants. The purpose of the condemnation and transfer was to “reduce the concentration of ownership of fees simple in the State,” which Hawaii had found “responsible for skewing the State’s residential fee simple market, inflating land prices, and injuring the public tranquility and welfare.”<sup>148</sup>

Against the backdrop of *Midkiff*, it is difficult to imagine anyone’s finding the Municipal Plan’s purposes anything other than fully public. The “landlords” in the present case, after all, themselves overwhelmingly wish to write-down principal but are prevented from doing so by the collective action challenges catalogued in Section II. They also, of course, hold property rights that are much more attenuated than those of literal landlords, owning as they do only repayment rights and security interests.

Current securitized mortgagees likewise are immeasurably more “absentee” than the most absent of literal landlords, the form of their “absence” in this case – fragmented and scattered all over the world as they are, knowing only their bond instruments, not the properties that secure them – being precisely what stands in the way of their coming together to write down principal as they would if they could. And finally, as noted above they are free and invited in any event, per the terms of the Plan, to *continue* as owners by participating in the investment that funds the Municipal Plan itself, the funders of which become the ultimate resultant creditors.

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<sup>146</sup>

Id.

<sup>147</sup>

467 U.S. 229 (1984).

<sup>148</sup>

*Midkiff*, id. at 232.

So much for the federal construal of public purpose. As noted above, California’s understanding of “public use” tracks that of the federal courts.<sup>149</sup> There is accordingly little to add in respect of its case law on point. It is worth noting, however, that the State’s Eminent Domain Law (which we shall now label “EDL”) adds further statutory guidance, including with respect to procedure. First, then, the EDL repeats the State’s constitutional requirement of “public use.”<sup>150</sup> Next, the EDL requires that any municipality or other State instrumentality such as a JPA authorized to employ the authority adopt, before doing so, a “resolution of necessity” that explains the public use for which property is being condemned.<sup>151</sup>

The resolution for its part is adopted in an open legislative session, after a public hearing on the question of necessity in which reasons for condemnation are proffered, debated, and assessed. These familiar legislative procedural requirements are of course meant to ensure full transparency, reasoned democratic deliberation, and fair access to all who might wish to take part in those community proceedings in which municipalities contemplate use of their eminent domain authority.

If and when a resolution of necessity is then adopted, the municipality obtains an appraisal of the condemnable property as described above in Section III, places the appraised amount in escrow, and files a condemnation action in California Superior Court.<sup>152</sup> The Municipal Plan can of course be adapted to incorporate within it all such procedural steps as might be prescribed by any other participating state’s and municipality’s eminent domain statutes and ordinances.

But who will these participating states and municipalities be, and why might they participate? This question takes us straight to our final Section – which, by describing more fully the imminent consequences of continued delay in implementing some variant of the Municipal Plan in cities still at the core of our ongoing mortgage foreclosure crisis, both (1) implicitly identifies municipalities that should find the Plan most attractive, while (2) rendering clear just how urgent the public purpose these cities will have for pursuing the Plan will be.

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<sup>149</sup> See, again, *County of Ventura v. Channel Islands Marina, Inc.*, 159 Cal.App.4<sup>th</sup> 615, 624 (2008) (apart from the aforementioned protection of residences from *Kelo*-style taking with a view to transferring to other private parties, “California courts have construed the [counterpart federal and state takings provisions] congruently [and] have analyzed takings claims under decisions of both the California and United States Supreme Courts.”).

<sup>150</sup> See Civ. Proc. § 1240.010.

<sup>151</sup> See Civ. Proc. § 1245.230. If the State Legislature has provided explicitly by statute that some particular “use, purpose, object or function” is “one for which the power of eminent domain may be exercised,” then the action is deemed to be a declaration by the Legislature itself that the use, purpose, object or function in question is indeed a public use. See *id.*, § 1240.010.

<sup>152</sup> See Civ. Proc. § 1250.110.

## V. The Plan's Manifest Public Purpose and Urgent Necessity

We complete this Memorandum by discussing in a bit more detail what is currently underway in those municipalities located at the center of our ongoing and self-worsening mortgage foreclosure crisis. Specifically, we note the remarkable toll in family and neighborhood suffering, ongoing and self-worsening value and revenue loss, and consequent blight that rolling foreclosures are now actively bringing in their wake.

Closing on this note serves two critical purposes. One is to illustrate how squarely the public purpose requirement, under which condemnation proceedings always proceed, is met by the purposes that prompt the Municipal Plan laid out and legally analyzed in Sections III and IV. Indeed, we shall see, we have here what amounts to a “textbook case” – and then some.

The other purpose we serve is empirically to substantiate, and afford more appreciation of the true costs occasioned by, that financial and economic dynamic elaborated over the course of Sections I and II. In effect, then, in this Section we further support both the legal and financial cases for the Plan, bind all the foregoing Sections more fully together, and while at it flesh out their full human and economic significance “on the ground.”

The first thing to note “on the ground,” then, is the great rise in home vacancy rates in states hit most hard by the mortgage foreclosure crisis to date. U.S. Census Bureau data indicate that nonseasonal vacant properties have increased 51% nationally from under 7 million in 2000 to over 10 million in early 2010.<sup>153</sup> Ten states in particular – including California, in keeping with our case study methodology – saw increases of 70% or more.<sup>154</sup> Other “sunbelt” and “sand” states – Arizona, Nevada, and Florida, for example – saw these larger increases as well. The overwhelmingly greater part of the spike in all places, moreover, has occurred since 2006, when the bubble peaked and then plunged.<sup>155</sup>

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<sup>153</sup> See Government Accountability Office, *Vacant Properties: Growing Number Increases Communities' Costs and Challenges*, Report to the Ranking Member, Subcommittee on Regulatory Affairs, Stimulus Oversight, and Government Spending, Committee on Oversight and Government Reform, House of Representatives, November 2011 (hereinafter “GAO Report”). Also Federal Reserve Board, *supra* note 8; Dudley, *supra* note 8; and Alpert, Hockett, & Roubini, *The Way Forward*, *supra* note 22.

<sup>154</sup> GAO Report, *id.*

<sup>155</sup> *Id.*

Unsurprisingly, high foreclosure rates closely correlate with the growing vacancy rates in question, accounting in many cases for as much as three-fourths of the increase.<sup>156</sup> So too, then, do high underwater mortgage rates, since these themselves correlate overwhelmingly with foreclosures as noted above in Sections I and II.<sup>157</sup> This is not only because people ultimately leave foreclosed homes. It is also because the foreclosure process itself is a drawn out affair, meaning that foreclosers are unable to place properties back on the market quickly even where there might be demand.<sup>158</sup> As it happens, however, there is little demand either – another source of the spike in vacancy rates.<sup>159</sup> All in all, then, these factors slow the rate at which homes that are left come to be reoccupied, which of course adds up to spiking vacancy rates.

Associated unemployment, in some cases responsible for foreclosures themselves while in other cases attendant on economic slump that both reinforces and is reinforced by mass foreclosure, is another source of spiking vacancy rates.<sup>160</sup> A tertiary cause appears to be migration from hard hit cities that is itself a response to declining employment opportunities which themselves interact symbiotically with foreclosure rates per the feedback effects discussed above throughout Sections I and II.<sup>161</sup> There are straightforward feedback effects between these phenomena and spiking vacancy rates.<sup>162</sup>

Growing home vacancy rates of course represent considerable individual and familial trauma. Involuntarily uprooted families are at least temporarily deprived of the most basic of human needs – the need of shelter, a “home base,” a place to conduct stable family life. There are countless studies documenting the incalculable psychological and physical toll on children, in particular, wrought by foreclosure and eviction.<sup>163</sup> The toll taken on adults is immense as well. As a qualitative matter, this all perhaps goes without saying. As a quantitative matter, a 70% spike in home vacancy rates is of course much more than a 70% spike in rates of the mentioned traumas. For prior to the spike, what vacancies there are will be less the result of foreclosure than they are or regular economically induced migration.

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<sup>156</sup> See sources *supra*, note 153.

<sup>157</sup> See *supra*, Sections I and II, and sources there cited.

<sup>158</sup> See notes 156 and 157.

<sup>159</sup> GAO Report, *supra* note 153.

<sup>160</sup> See sources cited *supra*, note 153, as well as *supra*, Sections I and II and sources cited therein.

<sup>161</sup> GAO Report, *supra* note 153.

<sup>162</sup> *Id.*

<sup>163</sup> See, e.g., Janet Currie & Erdal Tekin, *Is the Foreclosure Crisis Making Us Sick?*, NBER Working Paper No. 17310, August 2011, available at <http://www.nber.org/papers/w17310>; G.T. Kingsley et al., *The Impacts of Foreclosures on Families and Communities*, White Paper, The Urban Institute, May, 2009, available at [http://www.urban.org/UploadedPDF/411909\\_impact\\_of\\_forclosures.pdf](http://www.urban.org/UploadedPDF/411909_impact_of_forclosures.pdf).

Growing home vacancy rates also impose great pecuniary and other costs upon municipalities.<sup>164</sup> Although most if not all counties have on their books legal requirements that owners before and after foreclosure maintain their properties, as a practical matter this doesn't tend to happen.<sup>165</sup> Parties on either end of foreclosures have other things on their minds: The foreclosed party, where to go next; the foreclosing party, how in heaven's name to process all the remaining foreclosures that impend.

The consequence is that municipalities themselves must maintain or demolish the properties in question.<sup>166</sup> Simply boarding up abandoned properties typically costs hundreds to thousands of dollars per structure.<sup>167</sup> Cutting grass, draining swimming pools, or removing debris entails similar costs, some of them repeated regularly for each property.<sup>168</sup> Demolition ultimately proves necessary for many properties, and entails costs well into the thousands of dollars – even double digit thousands – for each property demolished.<sup>169</sup> Some of these costs are occasioned by the physical process itself, others by the administrative and judicial requirements that have to be met before absentee mortgagee-owned property can be simply destroyed.<sup>170</sup>

Before abandoned properties are properly sealed off or demolished, they also impose significant safety costs on communities.<sup>171</sup> Many of them act as “attractive nuisances,” to employ the familiar tort law term, to minors and others. Others attract criminals and crime, including not only drug-dealing and prostitution, but materials-stripping, vandalism and arson.<sup>172</sup> These represent not only costs in themselves, but also costs in the form of increased law enforcement expenditure on the part of affected municipalities.

Abandoned properties also, of course – partly in virtue of the tendencies just noted but also of themselves – reduce the value of surrounding properties, often thus leading to further desertion and migration: yet another self-worsening feedback or “snowball” effect once a critical mass of abandoned properties is reached.<sup>173</sup> The numbers are often impressive. One

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<sup>164</sup> See sources cited supra, notes 153 and 163.

<sup>165</sup> GAO Report, supra note 153.

<sup>166</sup> Id.

<sup>167</sup> Id.

<sup>168</sup> Id.

<sup>169</sup> See sources cited supra, notes 153 and 163.

<sup>170</sup> GAO Report, supra note 153.

<sup>171</sup> See sources cited supra, notes 153 and 163.

<sup>172</sup> Id.

<sup>173</sup> See sources cited supra, notes 153 and 163.

study has found that even a single foreclosed home depresses prices of nearby homes from just under one to as high as 8.7 percent.<sup>174</sup>

Again, this is just one foreclosed home. Another study found that one demolished home reduced the values of 13 surrounding properties by \$17,000 per.<sup>175</sup> Yet another study found that a single foreclosed, vacant home reduces the value of neighboring properties by 10 percent, and all homes within 500 feet of it by an average of .7%.<sup>176</sup> One could proliferate references to studies of this sort with abandon,<sup>177</sup> but the point is presumably made, and is at all events hardly surprising.

Also hardly surprising is that all of this foreclosure, abandonment, and consequent value loss results in municipal revenue loss.<sup>178</sup> Municipalities in America overwhelmingly finance their operations through property tax assessments.<sup>179</sup> Lose property dwellers, lose property values, and you lose funding – all while needing more such funding to handle the costs wrought by the abandoned homes themselves as elaborated above. And this is so notwithstanding loan servicers’ being required to keep up property tax payments during foreclosure proceedings.<sup>180</sup>

Of course, some *federal* programs are aimed at assisting hard hit localities in handling the growing costs despite dwindling revenues.<sup>181</sup> But these do not appear to be functioning well and in any event simply represent shifts of the costs to the federal budget, rather than eliminating the source of those costs.<sup>182</sup> Why on earth would this be preferred to municipalities’ taking charge of and reversing their own declines on behalf of their citizens by pursuing the Municipal Plan sketched in Section III?

The costs run through thus far all are attendant on actual foreclosure and actual vacancy. But there are additional costs wrought by what might be called “shadow” vacancy, if one might be forgiven for coining another neologism.<sup>183</sup> Here we refer to the much lower

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<sup>174</sup> GAO Report, supra note 153.

<sup>175</sup> Id.

<sup>176</sup> Id.

<sup>177</sup> They are cited with abandon (pun intended) in the GAO Report, supra note 153.

<sup>178</sup> See sources cited supra, notes 153 and 163.

<sup>179</sup> Id.

<sup>180</sup> GAO Report, supra note 153.

<sup>181</sup> As discussed supra, Section II.

<sup>182</sup> Id.

<sup>183</sup> By analogy to “shadow inventory” and “shadow banking.”

investments of moneys and labor in home improvement or home maintenance that underwater mortgagors make.<sup>184</sup>

The reasons are not hard to find. For one thing these mortgagors, strapped as they are, are apt to be out of the house more either working extra hours or seeking such work. For another thing, insofar as their underwater status induces uncertainty concerning how much longer they are likely to be able to hold on, it likewise induces a search for alternative residence and livelihood.

Finally, of course, it would simply not seem to be consistent with “human nature” to invest one’s care and concern in a home that one senses s/he might very soon lose. For all of these reasons, underwater mortgaged homes deteriorate much more rapidly than do other homes even well *before* foreclosure. These homes are in a certain sense “vacant already,” in that the owners in many cases will have psychologically detached themselves from them. Heightened degrees of this same form of detachment of course bring on “walkaway” and “strategic default” in some cases. It is, after all, financially rational to default on an underwater mortgage, since one thereby “pays” with the lower-valued asset rather than the higher-valued principal amount.<sup>185</sup>

This of course leads straight to the costs that foreclosure and “shadow” foreclosure impose upon lenders themselves. Lenders naturally are well aware of these costs, and for that very reason are apt to favor principal writedowns. The problem is that they cannot coordinate to secure them, for reasons comprehensively adduced above in Section II. Insofar as some of these lenders themselves reside in the municipalities in question, counties that exercise their eminent domain authority pursuant to the Municipal Plan act authoritatively on their behalves too. And this is of course not to mention the sense in which these municipalities will act collaterally, in effect, to the benefit of all others who wish to see principal writedowns as well.

All of the foregoing are widely appreciated, well documented and well quantified tendencies nationwide in the midst of our ongoing and self-worsening mortgage foreclosure crisis. All of them likewise serve to underwrite an obvious and indeed exigent public purpose on the basis of which municipalities can exercise their traditional eminent domain authority pursuant to the Plan that is the subject of this Memorandum. To sharpen things once more

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<sup>184</sup> See sources cited supra, notes 153 and 163. Also Goodman, sources cited supra, note 61; and Brian T. Meltzer, *Mortgage Debt Overhang: Reduced Investment by Homeowners with Negative Equity* (August 2010) (working paper, on file with the author).

<sup>185</sup> Indeed, “efficient breach” theories of contract reneging such as have proliferated in conservative, “law and economics” approaches to contract in such schools as the University of Chicago have it that forgoing strategic default is irrational.

with a specific case study, however, it might be well also to supply some of the applicable numbers for our previously selected illustrative sample state, California, and our sample county therein, San Bernardino.<sup>186</sup> Here are a few of the numbers in question.<sup>187</sup>

### *Conclusion: What's Next*

We have covered a good bit of ground here. But much more remains to be done. Presumably the financial and legal cases for municipalities' and cognate authorities' embracing and acting upon plans like the Municipal Plan have been fully made. What remains is for specific municipalities now to begin doing so. That is apt to begin very soon. For there are financial planners and investor coalitions ready to begin partnering with the hardest hit counties. Once these counties and their private partners commence proceedings, and once they start succeeding, and once word gets out, others will surely be quick to follow. For it is the solution that all of them have quite literally been waiting for.

In closing, perhaps the following observation will be in order. "We" might not have turned out to be "the ones we've been waiting for" if the "we" in question is our presently "operationally challenged" federal government. But "we" indeed are the ones we've been waiting for if "we" be our own towns and neighborhoods – if "we" be "the people" in that much more concrete and visceral, rather than diffuse and abstract, sense that a great observer of American life once suggested. The observer in question was Alexis de Tocqueville, who said, in effect – well before a quotable former First Lady did – that in America, it takes a village. It would seem he was right.

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<sup>186</sup> For reminder of why San Bernardino, California makes for an illustrative case study, please see supra, note 54, and accompanying text.

<sup>187</sup> Figures forthcoming.

**Technical Appendix A: Mortgage Selection and Fair Valuation Methodologies**

**Technical Appendix B: Further Jurisdictional and Other Legal Details**