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The Fight Over the Use of Eminent Domain to Seize Underwater Mortgages: Recent Updates

The latest developments in the fight over the use of eminent domain to seize underwater mortgages in California and elsewhere have important implications for lenders nationwide.

The debate over the use of eminent domain for this purpose stems from plans raised by some municipalities to take title to underwater mortgages secured by real property within their jurisdictions and to pay the mortgage holders “fair market value” as the just compensation required by the Fifth Amendment of the U.S. Constitution. Municipalities and private investors would then issue new mortgages to the homeowners and write down the principal balance of their loan.¹ This would serve the dual goals of allowing the homeowners to build equity and reduce their monthly payments, and hopefully restoring some vitality to the local housing market. The restructured mortgages would then be sold to third-party investors.²

Unsurprisingly, the mortgage lender community has been outraged by these proposals, and numerous market participants and observers

have called for restraint and thorough consideration of the likely consequences before any program is put in place. Recently, some new voices have joined the chorus on both sides of the proposals.

California Lieutenant Governor’s Letter in Support of Eminent Domain Programs

California’s Lieutenant Governor, Gavin Newsom, recently sent a letter to United States Attorney General Eric Holder in favor of the proposed action. While he noted his concerns about the struggles facing underwater homeowners and the need for local government action in lieu of federal government action, the letter was most notable for his criticism of the opponents of eminent domain proposals. Specifically, the letter accused investors in private label securitization trusts, the Securities Industry and Financial Markets Association (SIFMA), members of SIFMA and even potentially Fannie Mae, Freddie Mac and Ginnie Mae of restraint of trade, collusion and retaliation against program participants. He asserted that such collusion would be the cause of an increased price of credit in participating municipalities, and would be primarily targeted at discouraging municipalities from participating in such programs.

¹ By one account, investors have already pledged as much as \$500 million to a mortgage-modification plan that would entail the use of eminent domain to seize loans. See *Eminent Domain Plan Draws Backers*, Asset-Backed Alert, Sep. 21, 2012, at 3.

² For our initial discussion of the proposal to use eminent domain to seize underwater mortgages, as well as some of the initial issues that were raised including some under the U.S. Constitution and under California Law, see *California County Considers Using Eminent Domain to Seize Underwater Mortgages*, July 2012 *DechertOnPoint*.

Lieutenant Governor Newsom's other main accusation was that these same lending entities were violating consumer protection regulations by "redlining" certain geographic areas where municipalities were participating in eminent domain programs. He also characterized this as a restraint of trade. His letter concluded with a plea to the Department of Justice to investigate this situation and to take action against the mortgage industry and certain federal government agencies if needed.

Congressional Action Opposing Eminent Domain Programs

The U.S. House of Representatives was the scene of the other recent development in the fight over the use of eminent domain. Representative John Campbell (R-Cal.) introduced the "Defending American Taxpayers from Abusive Government Takings Act," the goal of which is to prohibit the government from backing mortgages in areas where underwater loans are seized through eminent domain. This bill would amend the charters of Fannie Mae and Freddie Mac to forbid financing loans in municipalities that had approved such eminent domain plans in the previous ten years. It would also prevent the Federal Housing Authority and the Department of Veterans Affairs from insuring mortgages in those areas.

This legislation is aimed at prohibiting any use of eminent domain to seize underwater mortgages. Because these

government-sponsored entities hold such a large chunk of the market share in home loans, municipalities that enact such programs would effectively be cutting off a major source of financing for homes within their borders. Given the reactions of the mortgage industry to these programs, it seems unlikely that any new market players would come forward to fill that need. Such a move would likely only cause housing prices in those areas to fall further, exacerbating the situation that caused the municipality to consider such a program in the first place.

Conclusion

It is too soon to predict the fate of the calls for seizing underwater mortgages through eminent domain, but due to the national scope of residential mortgage securitization and policy, the actions of any one program will have ripple effects on all mortgage borrowers and lenders throughout the country. The only thing that seems likely at this point is that litigation will ensue regardless of which side initially prevails.



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