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THEY CAN'T DO THAT, CAN THEY? CONSTITUTIONAL LIMITATIONS ON THE SEIZURE OF UNDERWATER MORTGAGES

This *Commentary* discusses a proposal, referred to below as "the property seizure program," whereby state and local governments would use their eminent domain power to "condemn" underwater mortgages—that is, mortgages under which the outstanding amount of the debt exceeds the market value of the underlying real property. The property seizure program appears to have generated some momentum over the last few months, collecting the endorsement of both legal scholars and politicians.[1] *The L.A. Times* recently reported that the Board of Supervisors of San Bernardino County unanimously approved a program to use eminent domain to seize mortgages and restructure them for underwater homeowners stuck in their properties.[2]

Under the property seizure program, private investors would supply state and local governments with capital to provide compensation, at current market value, to banks, lenders, securitization trusts, and other holders of mortgages. Once the mortgages have been condemned, the governments would transfer mortgage rights to the private investors on the condition that they restructure the mortgages to account for the current market value of the underlying real property. The private investors could then retain and service the resulting new mortgages, or sell the new mortgages, presumably at a profit, to another investor.

The property seizure program creates serious concerns for holders of mortgage-backed securities, the vast majority of which are securitization trusts to which those mortgages were transferred. If underwater mortgages were condemned at a steep discount to their face value, these securitization trusts and the holders of mortgage-backed securities issued by such trusts could face significant losses. In addition, uncertainty regarding further governmental action relating to mortgages could result in decreased demand for mortgage-backed securities at a time when investor confidence is only just starting to recover.

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This *Commentary* discusses two potential constitutional impediments to the property seizure program. First, there is a plausible argument that the property seizure program violates the Fifth Amendment's Takings Clause because it accomplishes a taking not for public use. Second, there is a plausible argument that the property seizure program substantially and unjustifiably impairs private contract rights in violation of the Constitution's Contract Clause.

TAKINGS CLAUSE

For a taking to be permissible under the Fifth Amendment to the U.S. Constitution, it "must be for a 'public use' and 'just compensation' must be paid to the owner."[3] There is a strong argument that the property seizure program constitutes a taking within the meaning of the Takings Clause, and there are plausible arguments that the program fails the "public use" test.

The Program Constitutes a "Taking." Contracts constitute property within the meaning of the Fifth Amendment and are susceptible to a "taking" within the meaning of the Takings Clause.[4] To determine whether a contract right has been taken, courts apply either a categorical test or, more commonly, the fact-dependent analysis employed in regulatory takings cases. There are strong arguments that the property seizure program is a taking under either approach.

When the categorical takings analysis is applied in physical takings cases, courts ask whether a physical invasion has occurred, as well as whether the government's regulation has denied all economically productive or beneficial uses of the seized property. While physical invasion is impossible in a contractual case—a consideration that has prompted some courts to question whether a categorical contractual taking is possible—the property seizure program would appear to satisfy the "no beneficial use" criterion for a categorical taking.

The same conclusion would follow from the more commonly applied regulatory takings analysis. Under that approach, courts assess the extent to which a challenged governmental action: (i) interferes with investment-backed expectations, (ii) has an adverse economic impact on the claimant, and (iii) is in character akin to regulation of a nuisance.[5] There are strong arguments that the first two factors are satisfied here, since the government's reassignment of contractual rights currently held by lenders would both eradicate the lenders' expectations of receiving mortgage payments and have a significant negative economic effect on claimants.

The government might respond that regulatory effects on contracts do not give rise to takings when those regulations are foreseeable, such as in areas where similar regulation is commonplace.[6] But the unprecedented nature of the property seizure program undermines that argument. Mortgage holders could not reasonably have anticipated that local governments would exercise eminent domain in the unprecedented way envisioned by the property seizure program. As for the third taking factor, which goes to the character of the government action, the government might argue that its program alleviates liquidity problems in the housing market. But it would be difficult for the government to analogize underwater mortgages to conventional public nuisances, particularly because underwater mortgages are a commonplace feature of modern economic life. The property seizure program might aspire to improve economic conditions, but it does so by taking private property put to conventional, nonharmful uses.

The Taking Is Not for "Public Use." The Supreme Court has taken a broad view of the "public use" requirement. Instead of requiring that taken properties are actually "used" by the public, the Takings Clause has been construed to require that the government engage in takings only when motivated by a "public purpose." In its most recent decision in this vein, the Court held by a vote of 5 to 4 that the Takings Clause allowed Connecticut and the City of New London to seize a private home and transfer it to private developers. The purpose of this transfer was to establish a private research facility whose development might stimulate the depressed local economy. Still, the Court's decision in *Kelo v. New London*—along with Justice Kennedy's critical fifth-vote concurrence—emphasized that the "public use" requirement does place real limits on the government's Takings Clause authority.[7] Two of those limits are particularly relevant here.

First, the Court has repeatedly stated that a taking is not for "public use" when it is "for the purpose of conferring a

private benefit on a particular private party."[8] Although recognizing that "the government's pursuit of a public purpose will often benefit individual private parties," *Kelo* made clear that courts should scrutinize the "actual purpose" motivating the taking of private property and check for impermissible "pretext." In *Kelo* itself, Justice Kennedy particularly underscored that "[t]he identities of most of the private beneficiaries were unknown at the time the city formulated its plans." The property seizure program, by contrast, was originally conceived by private investors driven by a profit motive. Indeed, the program can function as envisioned only if the private investors are able to extract value from the mortgages in excess of the money provided to their original owners. Thus, it is at least plausible that a court would find that the program's "primary motivation" is to enrich private investors, such that any public benefits would be incidental.[9]

Second, *Kelo* reserved the issue of whether a taking is for "public use" when it is an isolated transfer "executed outside the confines of an integrated development plan."[10] Writing separately, Justice Kennedy further drew attention to this point, noting that the taking at issue in *Kelo* had "occurred in the context of a comprehensive development plan."[11] Justice Kennedy further emphasized that the city had complied "with elaborate procedural requirements that facilitate review of the record."[12] In part, these remarks simply reinforced the Court's earlier observation that the taking at issue in *Kelo* should be evaluated "in light of the entire [redevelopment] plan" put forward by the government.[13] But they also emphasized the wholesale nature of the redevelopment program at issue in *Kelo*, which involved the planned reallocation of 90 acres' worth of land selected by the government through a single process. By contrast, the property seizure program would necessarily proceed on a house-by-house basis, involving a presently unspecifiable number of distinct and factually nuanced determinations, depending on how the program is administered. This piecemeal approach may frustrate effective judicial review of the government's program, making it sufficiently "prone to abuse" to justify an especially high level of judicial scrutiny.[14]

State constitutions can be even more favorable to a constitutional challenge. For example, the California Constitution in some respects imposes more stringent takings protections than the United States Constitution. Under *Kelo*, as noted above, the federal Takings Clause permits takings for redevelopment purposes. The California Constitution, by contrast, specifically states that "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."[15] More generally, the California provision demonstrates that the U.S. Supreme Court's broad view of permissible "public use" does not necessarily carry over to California or other state courts.

CONTRACT CLAUSE

The Contract Clause forbids state and local governments from impairing contract rights, regardless of whether the contract is between private parties or involves a government.[16] So, even if the property seizure program does not involve constitutionally infirm takings, there is a plausible argument that the program impermissibly impairs mortgage-based contract rights.

Contract Clause analysis proceeds in two steps. "The threshold inquiry is 'whether state law has, in fact, operated as a substantial impairment of a contractual relationship.'"[17] At the second step, courts apply a level of scrutiny proportional to the magnitude of the contractual burden identified at the first step. "If the state regulation constitutes a substantial impairment, the State, in justification, must have a significant and legitimate public purpose behind the regulation."[18]

For much the same reason that the property seizure program likely constitutes a taking of contractual property, it also substantially impairs contract rights. Because the property seizure program would obliterate the contract rights originally held by mortgage-owning entities, there is a strong argument that it would substantially impair contract rights. Furthermore, the property seizure program would radically transform, if not eliminate, the returns on mortgage-backed securities whose terms are predicated on the current face value of existing mortgages. By comparison, the Supreme Court has viewed the mere addition of a contract obligation to a preexisting private contract as an impermissible impairment.

The government may respond that the program should be viewed as both the transfer of contract rights and the

provision of market-based compensation, such that the program simply "restricts" a given mortgage holder "to gains it reasonably expected from the contract."[19] On that view, the program would "not necessarily constitute a substantial impairment."[20] Still, "[t]otal destruction of contractual expectations is not necessary,"[21] and the original lenders would have entirely lost their expected stream of mortgage payments. Further, and as in the takings context, it is relevant that the mortgage plan is unprecedented, even though the mortgage industry has otherwise been subject to governmental regulation.

Given the existence of a substantial impairment of contract rights, the government would argue that the property seizure program nonetheless has a "significant and legitimate public purpose" in that it remedies "a broad and general social or economic problem"—namely, the provision of relief to persons suffering from underwater mortgages.[22] That conclusion finds some support in the famous Depression-era decision in *Home Building & Association v. Blaisdell*,[23] in which a state law extended the period of time for redeeming real property from foreclosure and sale under existing mortgages. The government might further observe that courts typically defer to legislative assessments in this area when the government's own contracts are not at issue.

Yet these precedents can be distinguished. Unlike in *Blaisdell* and its progeny, the property seizure program entirely eliminates all contract rights, is permanent as opposed to merely temporary, and is designed in large part to be a profitable venture for investors. Moreover, the property seizure program does not operate by way of a "generally applicable," prospective state regulation on business operations.[24] If the government could eliminate contract rights in this way, then it would be hard to imagine what contracts could not be set aside in the name of market efficiency.

CONCLUSION

The property seizure program currently garnering so much attention poses significant constitutional questions. It arguably violates the Takings Clause because it was designed by third-party investors for the express purpose of creating profits for those investors, and not primarily for a public purpose. And the program arguably violates the Contract Clause because it entirely obliterates mortgage-based contract rights, including in connection with mortgage-backed securities.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Jayant W. Tambe
New York
+1.212.326.3604
jtambe@jonesday.com

Katherine S. Ritchey
San Francisco
+1.415.875.5728
ksritchey@jonesday.com

Brian J. Murray
Chicago
+1.312.269.1570
bjmurray@jonesday.com

Christopher Lovrien
Los Angeles
+1.213.243.2316
cjlovrien@jonesday.com

Michael A. Carvin
Washington
+1.202.879.7643
macarvin@jonesday.com

Robert J. Graves
Chicago
+1.312.269.4356
rjgraves@jonesday.com

Antonio F. Dias
Washington / Pittsburgh
+1.202.879.3624 / +1.412.394.7240
afdias@jonesday.com

ENDNOTES

1 *See* http://www.ft.com/cms/s/0/8017cf44-b309-11e1-83a9-00144feabdc0.html#axzz1z3s1Fgyv; http://papers.ssrn.com/sol3/papers.cfm?abstract__id=2038029.
2 *See* www.latimes.com/business/money/la-fi-mo-eminent-domain-20120620,0,4970444.story.
3 *Brown v. Legal Foundation of Washington*, 538 U.S. 216, 231-32 (2003).
4 *See Lynch v. United States*, 292 U. S. 571, 579 (1934) ("The Fifth Amendment commands that property be not taken without making just compensation. Valid contracts are property, whether the obligor be a private individual, a municipality, a State or the United States."); *see also Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1003 (1984) (noting the range of "intangible interests," including contracts, that are "property for purposes of the Fifth Amendment's Takings Clause").
5 *See Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978); *Pennsylvania Coal v. Mahon*, 260 U.S. 393, 415 (1922) ("The general rule at least is, that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking.").
6 *See Connolly v. Pension Benefit Guaranty Co*., 475 U.S. 211, 225-28 (1986).
7 *See Kelo v. New London*, 545 U.S. 569 (2005).
8 545 U.S. at 477.
9 *Id*. at 493 (Kennedy, J., concurring) (relying on lower court's finding, based on a review of the factual record, that "the primary motivation or effect of this development plan" was to benefit the public, and not to advance private interests).
10 *Id*. at 487.
11 *Id*. at 493 (Kennedy, J., concurring).
12 *Id*.
13 *Id*. at 484.
14 *Id*. at 493 (Kennedy, J., concurring).
15 Cal. Const. art. I § 19(b).
16 *See Southern California Gas Co. v. City of Santa Ana*, 336 F.3d 885, 886-87 (9th Cir. 2002) ("The right of a party not to have a State, or a political subdivision thereof, impair its obligations of contract is a right secured by the first article of the United States Constitution.").
17 *Energy Reserves Group, Inc. v. Kansas Power & Light Co*., 459 U.S. 400, 411 (1983).
18 *See Energy Reserves*, 459 U.S. at 411 ("The severity of the impairment is said to increase the level of scrutiny.").
19 *Energy Reserves*, 459 U.S. at 411.
20 *Id*.
21 *Id*.
22 *Energy Reserves*, 459 U.S. at 411-12.
23 290 U.S. 398 (1934).
24 *Allied Structural Steel*, 438 U.S. at 249.

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