Cornell Law Library
Scholarship@Cornell Law: A Digital Repository

Cornell Law Faculty Publications | Faculty Scholarship

4-1-2013

Accidental Suicide Pacts and Creditor Collective Action Problems: The Mortgage Mess, the Deadweight Loss, and How to Get the Value Back

Robert C. Hockett
Cornell Law School, rch37@cornell.edu

Follow this and additional works at: http://scholarship.law.cornell.edu/facpub

Part of the Property Law and Real Estate Commons, Securities Law Commons, and the Torts Commons

Recommended Citation

Hockett, Robert C., "Accidental Suicide Pacts and Creditor Collective Action Problems: The Mortgage Mess, the Deadweight Loss, and How to Get the Value Back" (2013). *Cornell Law Faculty Publications.* Paper 640.
http://scholarship.law.cornell.edu/facpub/640

This Article is brought to you for free and open access by the Faculty Scholarship at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Faculty Publications by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

ACCIDENTAL SUICIDE PACTS AND CREDITOR COLLECTIVE ACTION PROBLEMS: THE MORTGAGE MESS, THE DEADWEIGHT LOSS, AND HOW TO GET THE VALUE BACK

Robert Hockett†

INTRODUCTION: THE MORTGAGE MESS IS STILL THE PROBLEM

For six years now, the nation has been struggling with the fallout of a residential real estate bubble and bust. From their 2006 highs, housing prices are down nationally by 26.4%.[1] In harder hit communities, the figure is significantly higher. In Nevada, for example, house prices remain 51.6% below their 2006 peak levels.[2] This is notwithstanding continuing cyclical fluctuations pursuant to which prices routinely rise in the summer only to plummet again

† Robert Hockett is Professor of Financial and International Economic Law at Cornell Law School, Consulting Counsel at the International Monetary Fund, and recent Resident Consultant at the Federal Reserve Bank of New York. He is also a Fellow of The Century Foundation; commissioned author for the New America Foundation; regular consultant to a number of domestic and international financial regulators and advocacy groups, including Americans for Financial Reform; and occasional consultant to Mortgage Resolution Partners, LLP, which is advancing a version of the plan advocated herein, which Mr. Hockett has been pushing since mid-2008.

Thanks to Tobias Adrian, Mike Campbell, Bill Frey, Laurie Goodman, Howell Jackson, Darius Kingsley, Chris Mayer, Jamie McAndrews, Meg McConnell, Rep. Brad Miller, Sen. Don Riegle, Larry Rufrano, Bob Shiller, Joe Tracy, and other colleagues at the Federal Reserve Board, the Federal Reserve Bank of New York, the Department of Treasury, the Federal Deposit Insurance Corporation, and the Department of Housing and Urban Development for helpful comments in connection with this Essay. The views here expressed are nevertheless solely my own and not attributable without confirmation to anyone else named herein.

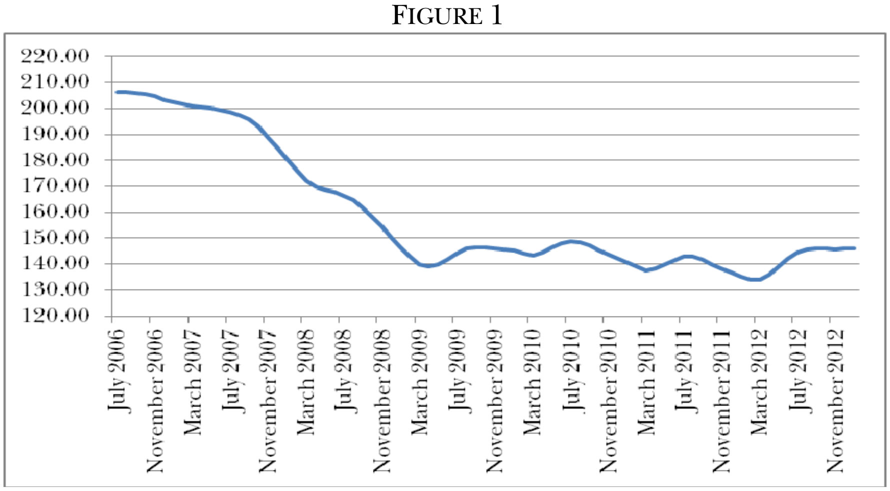
1 CORELOGIC, CORELOGIC HOME PRICE INDEX RISES BY ALMOST 10 PERCENT YEAR OVER YEAR IN JANUARY 2 (2013), *available at* http://www.corelogic.com/research/hpi/january-2013-home-price-index-report.pdf.

2 *Id.*

between annual 'peaks.'[3]

The cyclical character of post-bust housing prices undercuts occasional suggestions that the housing markets are 'recovering.' Non-seasonably adjusted Case-Shiller 20-city composite housing price data compiled since July 2006 and represented below in Figure 1, for example, indicate that the highest post-bubble price peak prior to this past summer came not last year or the year before that, but in July of 2010, while early 2012 saw the deepest post-bubble trough since January 2009.[4] After the recent 2012 seasonal peak, in turn, prices again dropped in October and November. They then recovered some of that loss in December and January, but remained below their September seasonal peak.[5] The point, then, should be plain: short-term cyclical gains do not constitute 'turnarounds.' Long-term trajectories, which we can predict only partly by reference to recent trends, while also by reference to causally relevant conditions, are what matter. Millions of deeply underwater and accordingly at-risk mortgage loans are as causally relevant as can be. We would be foolish, then, to view any one season's price rises as indicia of 'final recovery,' just as we would be to view one cooler summer as 'disproof' of climate change.

FIGURE 1



The numbers on the y-axis indicate S&P/Case-Schiller home price index levels.

---

3 *S&P/Case-Shiller Home Price Index Levels*, S&P/CASE-SHILLER HOME PRICE INDICES (Standard & Poor's, Americas), Mar. 26, 2013, *available at* http://www.standardandpoors.com/indices/articles/en/us/?articleType=XLS&assetID=1221192472066 (providing non-seasonably adjusted 20-city composite data); *infra* Figure 1 (presenting in graphical form the non-seasonably adjusted Case-Shiller Home Price Index 20-city composite data from July 2006 to January 2013).

4 *See S&P/Case-Shiller Home Price Index Levels*, *supra* note 3.

5 *See id.*

Yet while inherently variable home equity values have fallen and remain stubbornly low in relation to longer term trend, the fixed *debt* obligations incurred by so many American homeowners during the bubble years to buy homes—obligations that price-taking mortgagors *had* to take on to *afford* home ownership under bubble conditions—have of course not.[6] The consequence is that nearly eleven million mortgaged homes are now 'underwater,' market-valued at less than the debts they secure.[7] That is nearly a *quarter* of all American homes with mortgages outstanding.[8] Of these mortgaged homes, in turn, upward of three million are already in default, in foreclosure, or foreclosed and awaiting liquidation.[9] Over two million Americans are twelve months or more behind on their mortgages, meaning that they are so delinquent as to be unlikely ever to catch up.[10]

The upshot of all of these figures, where public policy is concerned, is that *fewer than half* of underwater home mortgage loans are now *current*,[11] while more go delinquent each month.[12] Together with loans that are already defaulted or delinquent, most housing analysts expect between *7.5 million and 9.5 million additional homes* to go into liquidation over the next several years absent serious remedial action.[13] These homes would liquidate into an already depressed market and would in turn create a backlog totaling approximately 200% of all annual existing home sales in the U.S. at current sales paces.[14] And we are not even halfway through our post-2006 housing

---

6 *See Strengthening the Housing Market and Minimizing Losses to Taxpayers: Hearing Before the S. Subcomm. on Hous., Transp. and Cmty. Dev.*, 112th Cong. 1 (2012) (statement of Laurie S. Goodman, Senior Managing Director, Amherst Secs. Grp.), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0f96e0ff-8500-41a5-a0f2-0139d0df2e07 (estimating that between 7.4 and 9.3 million borrowers had yet to face foreclosure and eventual liquidation, including between 2.4 and 3.3 million borrowers with excellent payment history but underwater mortgages) [hereinafter *Goodman Testimony*].

7 CORELOGIC, CORELOGIC REPORTS 1.4 MILLION BORROWERS RETURNED TO "POSITIVE EQUITY" YEAR TO DATE THROUGH THE END OF THE THIRD QUARTER 2012 1 (2013), *available at* http://www.corelogic.com/research/negative-equity/corelogic-q3-2012-negative-equity-report.pdf ("10.7 million, or 22 percent, of all residential properties with a mortgage were in negative equity at the end of the third quarter of 2012.").

8 *Id.*

9 *See Goodman Testimony*, *supra* note 6, at 1; Barry Ritholtz, *Fascinating Mortgage & Housing Data Points*, THE BIG PICTURE (June 17, 2012, 9:38 AM), http://www.ritholtz.com/blog/2012/06/fascinating-mortgage-housing-data-points/.

10 *See* Ritholtz, *supra* note 9.

11 *See Goodman Testimony*, *supra* note 6, at 1.

12 *See id.*

13 *See, e.g.*, *id.* (estimating that there are between 7.4 and 9.3 million borrowers who have "yet to face foreclosure and eventual liquidation.").

14 *See* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 2 fig.1 (2012), *available at* http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2012.pdf (estimating only about 4 million existing home sales in 2012).

'correction.'

The flesh and blood fallout effects of these arid numbers are devastating. Communities see their residents rendered homeless and their property tax bases destroyed—ironically, just as abatement costs wrought by foreclosed or abandoned properties skyrocket.[15] Homeowners who are able to stay in their homes, for their part, not only lose neighbors and endure all the blight and lost value associated with empty and unmaintained neighboring homes but also see essential services cut, school districts retrenching, and economies shrinking—an aggregate monetized loss that is now estimated at $2 trillion.[16] Against this backdrop, it is hardly surprising that municipalities throughout the country—particularly those at the core of our recent mortgage loan bubble and bust—are now filing for bankruptcy.[17]

It is likewise unsurprising that the macroeconomy continues to linger near Fisher-style, debt-deflationary slump—an economic rendition of chronic fatigue syndrome with no resolution in sight. As a recent Federal Reserve Board white paper and other sources abundantly document, foreclosures and consequent slump in the housing markets feed back into the broader economy by diminishing wealth and consumer spending.[18] That in turn lowers macroeconomic growth and employment—bad enough in themselves, yet also drawing more mortgages into the wave of

15 *See* Robert Hockett, *It Takes a Village: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Local Economic Recovery*, 18 STAN. J.L. BUS. & FIN. 121, 133–34 (2012).

16 *See id.* at 150; John W. Schoen, *Foreclosure Fallout Cost Nearby Homeowners $2 Trillion, Report Finds*, NBCNEWS.COM: ECONOMY WATCH (Oct. 24, 2012), *available at* http://www.nbcnews.com/business/economywatch/foreclosure-fallout-cost-nearby-homeowners-2-trillion-report-finds-1C6663420.

17 *See, e.g.*, Steven Church, Dawn McCarty & Michael Bathon, *San Bernardino, California, Files Chapter 9 Bankruptcy*, BLOOMBERG.COM (Aug. 2, 2012, 7:38 PM), *available at* http://www.bloomberg.com/news/2012-08-02/san-bernardino-california-files-for-bankruptcy-protection-2-.html. The municipalities mentioned in this Essay, San Bernardino County, California and Wayne County, Michigan, will figure prominently below as exemplars of American municipalities hit hard by the recent mortgage price bubble and bust. *See infra* Part IV.

18 *See, e.g.*, FED. RESERVE BD., THE U.S. HOUSING MARKET: CURRENT CONDITIONS AND POLICY CONSIDERATIONS 3–4 (2012), *available at* http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf (showing that decreases in home equity has significantly weakened household spending and consumer confidence) [hereinafter U.S. HOUSING MARKET]; William C. Dudley, Housing and the Economic Recovery, Remarks at the New Jersey Bankers Association Economic Forum (Jan. 6, 2012), *available at* http://www.newyorkfed.org/newsevents/speeches/2012/dud120106.html (explaining that the decline in housing prices has created greater weakness in consumption and a decreased ability to refinance which traditionally provided an important channel for consumer spending).

delinquency and default.[19] Hence the familiar self-worsening 'downward spiral' or 'holding pattern' of high underwater loan and foreclosure rates, which cause low growth and employment, which in turn cause yet more default and foreclosure, and so on.[20]

Not all currently troubled mortgages, of course, are troubled by virtue of their underwater status. Some homeowners, for example, face difficulty keeping current on monthly mortgage payments simply for reasons of temporary unemployment or underemployment, stemming as radial effects from the broader underwater-mortgage-induced slump.[21] For this class of mortgagor, the author and several New York Fed colleagues 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.[22] A draft bill instituting the program, co-authored by the present author and one of the aforementioned New York Fed colleagues, is happily now under consideration in the state of New York.[23]

But even assuming successful enactment of the author's draft statute in New York and in other states, the nation's far larger problem will remain unaddressed. Temporary payment difficulties associated with above-water mortgage loans are, after all, but a miniscule part of the national mortgage problem.[24] The key driver of

---

19 *See* Dudley, *supra* note 18; Hockett, *supra* note 15, at 134–35; Robert Hockett, *Six Years On and Still Counting: Sifting Through the Mortgage Mess*, 9 HASTINGS BUS. L. J. 373, 374–75 (2013) .

20 *See* Hockett, *supra* note 19, at 374–75; *see also* Robert Hockett, *Recursive Collective Action Problems*, J. APPLIED ECON. (forthcoming) (manuscript at 13–15), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239849 (discussing credit-fueled asset price busts and resulting debt deflation).

21 *See* James Orr et al., *Help for Unemployed Borrowers: Lessons from the Pennsylvania Home Owners' Emergency Mortgage Assistance Program*, CURRENT ISSUES IN ECON. & FIN., April 2011, at 1, *available at* http://newyorkfed.org/research/current_issues/ci172.pdfhttp://newyorkfed.org/research/current_issues/ci17-2.html.

22 *See id.* at 2–9 (detailing and explaining the mortgage bridge loan assistance programs).

23 *See* NEW YORK CITY BAR COMMITTEE ON BANKING LAW, PROPOSAL TO ADOPT THE HOME MORTGAGE BRIDGE LOAN PROGRAM 16–28 (2012), *available at* http://www2.nycbar.org/pdf/report/uploads/9_20072233-BridgeLoanAssistanceProgram.pdf (urging adoption of the Act and reproducing the text of the Act in its entirety).

24 *Cf.* Michael V. Campbell & Robert C. Hockett, *Some Homeowners Need Just Temporary Aid*, AMERICAN BANKER (May 24, 2012, 10:59AM), http://www.americanbanker.com/bankthink/Mortgage-bridge-loan-New-York-City-Bar-1049605-1.html (noting that although some mortgages are in default due to temporary slump-induced unemployment, others are simply poorly underwritten and structured loans); Robert Hockett & Michael V. Campbell, *A Bridge to Viable Mortgages*, TIMESUNION.COM (June 14, 2012, 8:36PM), http://www.timesunion.com/opinion/article/A-bridge-to-viable-mortgages-3635265.php (arguing that mortgage problems caused by temporary causes have gotten little attention because many distressed mortgages are structurally unsound, not just temporarily

that story, again, is the large class of *underwater* mortgage loans singled out above.

It is not hard to see why underwater mortgage loans would account for the greater part of our troubles. Wrought by the long, bubble-associated rise in housing prices that ended in 2006, the so-called 'wealth effect' supported growth-and-employment-maintaining consumer demand even when wages and salaries rose only slightly or stagnated.[25] But the 'effect' runs both ways: homeowners with 'negative equity' after the bust cut their spending the most, even before defaulting and foreclosing.[26] Even tax cuts, rather than flowing mainly toward employment-supportive consumer expenditures, go largely toward trimming back overhung debt for this class of mortgagor.[27] That might explain why the 2009 fiscal stimulus, tax-cut-laden as it was, did less than was hoped.[28]

Now matters appear to be bound to continue as they are—worryingly reminiscent of Japan's two (and still counting) post-crash 'lost decades'—until mortgage debt overhang is pared back.[29] Interest-reduction and term-extension will not suffice; the overhang is the problem.[30] But overhang can be trimmed in only one or both of two ways: (1) inducing a rise in home prices back toward their bubble year highs, and (2) writing-down debts toward their associated post-bust collateral values. Since a return to bubble era home prices seems neither feasible nor desirable, debt-reduction will have to be part of any bona fide move forward.

I
PRINCIPAL WRITE-DOWNS ARE STILL THE SOLUTION

In light of the foregoing facts, it is now widely appreciated that

troubled).

25 *See* Dudley, *supra* note 18 (describing the ways in which a strong housing market supports economic growth); Hockett, *supra* note 15, at 127–36.

26 *See* Hockett, *supra* note 15, at 134–35. *But see* Jennifer Robison, *Local Spending is Up, May Be Linked to Mortgage Delinquencies*, LAS VEGAS REV.-J. (Oct. 21, 2012, 7:53AM), http://www.lvrj.com/business/local-spending-is-up-may-be-linked-to-mortgage-delinquencies-175130981.html (documenting consumer expenditure boosts once mortgage payments drop).

27 *See* Robert Hockett et al., *The Way Forward: Moving from the Post-Bubble, Post-Bust Economy to Renewed Growth and Competitiveness* 16 (Cornell Legal Studies, Research Paper No. 12-01, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1987139.

28 *See* Michael Grabell, Op-Ed., *How Not to Revive an Economy*, N.Y. TIMES, Feb. 12, 2012, at SR8, *available at* http://www.nytimes.com/2012/02/12/opinion/sunday/how-the-stimulus-fell-short.html?pagewanted=all&_r=0.

29 *See* ROBERT KUTTNER, A PRESIDENCY IN PERIL 66–68 (2010) (describing Japan's folly in the 1980s).

30 *See* Hockett et al., *supra* note 27, at 4. *See also Goodman Testimony*, *supra* note 6, at 1 (advocating for principal reduction modification as a means of reducing debt and strengthening the housing market).

principal write-downs must be done on a broad swath of underwater mortgage loans.[31] *Debt* loss will have to be formally recognized in a manner commensurate with fair-value-accounted *equity* loss. Even many creditors—the prospective first bearers of write-down-wrought losses—understand and embrace this hard truth.[32] Write-downs are, after all, preferable to defaults, which plague underwater mortgages at ominously high rates—rates we will soon see in more numbers. Indeed, for much underwater mortgage debt, principal write-downs actually *maximize value*.[33] We find evidence for this in the rates at which portfolio mortgage loan holders, as distinguished crucially—in ways the author will explain—from securitization trusts, write down debt.[34]

Write-downs, then, will have to be done—both to salvage value for creditors and to trim macroeconomy-crippling mortgage debt overhang for homeowners and their communities. The only question is how. The answer at present, alas, depends tragically upon whether the loans in question are held in bank portfolios or by securitization trusts. In the former case, write-downs are already occurring at significant and still increasing rates, while in the latter they are not.[35]

Why? Because bank officers *know* that underwater loans default at high rates, meaning that the expected values of such loans fall needlessly far short of their face values.[36] It is accordingly rational for banks to write down such loans. In so doing, the banks benefit not only themselves but also their debtors and the communities in which those debtors reside. It is a case of convergent interests —of 'win-win-win'—though even here we can 'win' a lot more.[37]

II
WHY WRITE-DOWNS REMAIN RARE: SUICIDE PACT CONTRACTS AND CREDITOR COLLECTIVE ACTION PROBLEMS

What about securitized mortgage loans? How and why do they

31 *See* Hockett et al., *supra* note 27, at 4–7; U.S. HOUSING MARKET, *supra* note 18, at 17, 20–21.

32 *See Goodman Testimony*, *supra* note 6, at 4–7.

33 *Id.*

34 *See infra* Part II.

35 *See* Dawn Kopecki & Michael J. Moore, *JPMorgan, Wells Fargo Write Down Home-Equity Loans*, BLOOMBERG (Oct. 12, 2011), http://www.bloomberg.com/news/2012-10-12/occ-forced-jpmorgan-wells-fargo-to-write-down-home-equity-loans.html; David Streitfeld, *Big Banks Easing Terms on Loans Deemed as Risks*, N.Y. TIMES, July 3, 2011, at A1, *available at* http://www.nytimes.com/2011/07/03/business/03loans.html?_r=0.

36 *See* Kopecki & Moore, *supra* note 35.

37 *See infra* Parts V–VI. This is true because, as we shall see, the externalities connected with price races give rise to a 'last mover advantage,' so that even portfolio loans are modified at suboptimally low rates, with many banks waiting for others to modify—or for some other price-raising 'miracle'—to occur first. *See* Hockett, *supra* note 15, at 138–49.

differ from portfolio loans? Unfortunately, a host of classic collective action problems stand in the way of the win-win solution in this case.[38]

For one thing, there is a last-mover advantage where write-downs are concerned, owing to the positive externalities on later loans wrought by most write-downs on earlier loans.[39] Of course, this particular challenge confronts portfolio loans too and therefore keeps modification rates lower than they likely would otherwise be even among banks.[40] A battery of additional challenges in the case of securitized loans, however, reinforces portfolio loans' relative advantage.

Most decisive among the additional challenges facing securitized loans is contract rigidity. The problem is that many of the pooling and servicing agreements (PSAs) pursuant to which most loans are securitized, drafted during the bubble years when few foresaw the prospect of an economy-wide housing price crash and many rushed to push or to purchase exotic new mortgage products, require unanimity or supermajority assent among mortgage-backed securities (MBS) holders before loans can be modified within or sold out of trusts.[41] The problem that this poses is that fragmented owners of MBS cannot even find one another, much less negotiate with borrowers or would-be buyers and then reach agreement on what is best for all. Making matters yet worse, the same agreements likewise prohibit or otherwise prevent even trustees and loan servicers, who are duty-bound to act on behalf of the MBS holders and hence could in theory address the owners' collective action problems, from modifying or selling bad loans in sufficient numbers.[42]

But there is more. Many underwater homes also are subject to second liens that secure home equity lines of credit (HELOCs), taken out by mortgagors to supplement stagnating incomes during the housing boom years. First lienholders do not benefit from

---

38 *See* Hockett, *supra* note 15, at 138–40 (providing background and more detail regarding the phenomena discussed in the following paragraphs); *see also* Robert J. Shiller, *Reviving Real Estate Requires Collective Action*, N.Y. TIMES, June 24, 2012, at BU6, *available at* http://www.nytimes.com/2012/06/24/business/economy/real-estates-collective-action-problem.html (endorsing the analysis and plan presented in Hockett, *supra* note 15).

39 *See* Hockett, *supra* note 15, at 138–42.

40 *See id.* at 142. The solution offered here might also be put to good use in connection with some portfolio loans even though it is most dramatically called for in the case of PLS loans. *See infra* Parts V–VI.

41 *See* Hockett, *supra* note 15, at 139–40.

42 *See id.* In some cases, for example, PSAs allow no more that 5% of loans in the pool to be modified—a percentage that both reflects how little anticipation there was of across-the-board crash and has long since been reached in the case of most loan pools. *See id.*; Patricia A. McCoy, *Barriers to Federal Home Mortgage Modification Efforts During the Financial Crisis* 22–23 (Harvard University Joint Center for Hous. Studies, Working Paper MF10-6, 2010).

modifications unless second lienholders modify, and hence are pecuniarily disinclined to modify on their own. But many second lienholders, for their part, feel less pressure to modify. The reason is that borrowers in need of liquidity after the bust tend to 'prioritize' their sole remaining sources of revolving credit—their HELOCs—and accordingly pay their second lienholders first. These payments effectively reverse the legal order of creditor priorities between firsts and seconds.[43] To add insult to injury, the second lienholders also quite often are banks—the same banks that service the first-lien-secured loans. This arrangement of course poses a formidable conflict of interest that further obstructs value-salvaging agreements among creditors.[44]

There are additional obstacles to creditor-benefiting coordination. Among them are bankruptcy law inapplicability as well as Internal Revenue Code and Trust Indenture Act uncertainties.[45] But the impediments already mentioned are enough to indicate how forbidding the obstacles to voluntary principal write-downs that would benefit creditors, debtors, and communities can be—particularly for loans held in private label securitization (PLS) trusts, which do not benefit from any explicit or implicit federal guarantee.

III
COLLECTIVE AGENCY FOR COLLECTIVE ACTION, TAKE ONE: FEDERAL FAILURES

What then to do? Well, to solve a collective action problem or cluster of the same, we require a collective agent.[46] PLS trustees and loan servicers of the sort we just noted typically play this role. But as discussed above, in the case of most PLS loans, these individuals are all either hand-tied, conflicted, or both. Who then is left to act for the creditors and, by extension, the homeowners and spillover victims of local foreclosures and national slump?

As it happens, governments and their instrumentalities are collective agents too.[47] And in this context they are collective actions *par excellence*. For governments are the sole entities capable of sidestepping PSA contract rigidities of the sort that now stand in the way of broad principal write-downs for PLS loans. But *which*

43 *See* Hockett, *supra* note 15, at 142. *But see* Donghoon Lee et al., *A New Look at Second Liens*, 569 FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS 1 (2012), *available at* http://www.newyorkfed.org/research/staff_reports/sr569.html (indicating that the second-mortgage-secured HELOC problem might not be as significant, empirically, as one might expect it in theory to be).

44 *See Goodman Testimony*, *supra* note 6, at 3.

45 *See* Hockett, *supra* note 19, at 391–93.

46 *See* Hockett, *supra* note 20 (manuscript at 15–16).

47 *See id.* at 15.

government should take up this mantle. Should we be focusing on federal, state, or local governmental units?

In 2008, this author and two other academics separately advocated federal action under a specific legal authority to which we shall presently turn.[48] In 2010, higher-profile policy advocates, members of Congress, and other government figures added their voices to the call.[49] But for a number of reasons, our federal government does not seem to be up to the task, nor does it appear likely to reach that point anytime soon.

For one thing, the flagship federal Home Affordable Mortgage Program (HAMP) does not prioritize write-downs, and neither the present Congress nor any foreseeable future Congress are likely to change this.[50] When HAMP *is* used for write-downs, moreover, it operates simply by paying the servicers, just as it does for all forms of modification. It seeks to 'bribe' servicers with taxpayer money, in other words, paying creditors to do what already creates value for those creditors.[51] More importantly, it offers *no means of getting round PSA-rooted restrictions* on servicer action.[52] These issues render HAMP both irrelevant to PSA-hamstrung servicers and needlessly costly to public coffers—all while 'austerity hawks' and others constantly remind us that we live in tight times.

The government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac—are for their parts steered clear of loan write-downs by their regulator and current conservator, the Federal Housing Finance Agency (FHFA).[53] The latter is, thanks to its current acting director, hostile to principal reduction as a matter of (as it happens, inapplicable) principle and would in any event write down principal at unnecessary cost through HAMP even if its acting director did not oppose the idea. Indeed, the acting director of

---

48 *See* Robert C. Hockett, *Bailouts, Buy-ins, and Ballyhoo*, 52 CHALLENGE 36, 36–37 (2009) (elaborating more fully on this argument and proposals made by the author in several op-eds over the autumn of 2008); Howell E. Jackson, *Build a Better Bailout*, CHRISTIAN SCI. MONITOR (Sept. 25, 2008), *available at* http://www.csmonitor.com/Commentary/Opinion/2008/0925/p09s02-coop.html (arguing for alternatives such as the government purchasing actual loans); Lauren E. Willis, *Stabilize Home Mortgage Borrowers, and the Financial System Will Follow* 1–2 (Loyola-LA Legal Studies, Working Paper No. 2008-28, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1273268 (discussing government action such as eminent domain to solve issues with the current financial system).

49 *See* KUTTNER, *supra* note 29, at 55–87; Brad Miller, *UnHAMPered*, NEW REPUBLIC, Feb. 24, 2010, *available at* http://www.tnr.com/article/unhampered#.

50 *See* Hockett, *supra* note 15, at 143–45.

51 *Id.* at 146–47.

52 *See id.*

53 *See* Binyamin Appelbaum, *U.S. Agency Bars a Plan to Reduce Home Debt*, N.Y. TIMES, Aug. 1, 2012, at B1, *available at* http://www.nytimes.com/2012/08/01/business/us-agency-bars-fannie-and-freddie-from-reducing-principal.html.

FHFA factors HAMP fees into his cost-benefit analysis of possible GSE write-downs, thereby stacking the deck further against forward movement involving GSE-held mortgage loans.[54]

Finally, because Congress has twice attempted and failed to include mortgaged homes in the Bankruptcy Code, bankruptcy judges are unable to employ their equitable powers to salvage value among home mortgagors and mortgagees—unless, perhaps, millions of underwater homeowners take up a 'lease swap' proposal made by the present author in 2011, which does not look likely.[55] Again, then, neither this federal failure nor similar failures with respect to any other hypothetical legislation is likely to be reversed in the foreseeable future given the state of continuing paralysis in our divided federal government. So no federal instrumentality appears presently equipped to do sorely needed, value-recouping write-downs on mortgage loan debt or apt to become thus equipped in the near future.

What are the consequences of these failures? In the year from September 30, 2011 to September 30, 2012, during which rates of principal reduction were increasing, only 58,549 underwater home mortgage loans saw principal write-downs.[56] From the beginning of 2008 through the end of the second quarter of 2012, moreover, only about 2.7 million loans were modified in *any* way by their servicers,[57] while approximately 40% of these modifications reduced monthly payments by less than 10%.[58] All of this is the case notwithstanding abundant evidence, derived from portfolio loan-holders, that sizeable

---

54 *See* Edward DeMarco, Remarks at the Brookings Institution: Addressing the Weak Housing Market: Is Principal Reduction the Answer? 17 (Apr. 10, 2012), *available at* http://www.brookings.edu/events/2012/0410_housing_demarco.aspx; Letter from Edward DeMarco, Acting Director of the Federal Housing Finance Agency, to Congressman Elijah Cummings, Ranking Member, Committee on Oversight and Government Reform (Jan. 20, 2012) (on file with author).

55 *See* Hockett, *supra* note 19, at 391–92. For a description of the 'lease swap' proposal, see Robert Hockett, *How About Home Lease Swapping as a Mortgage Market Cure?*, BENZINGA FIN. NEWS (Oct. 14, 2011, 3:01 PM), http://www.benzinga.com/news/11/10/1987688/how-about-home-lease-swapping-as-a-mortgage-market-cure; Robert Hockett, *Post by Bob Hockett: 'Lease Swaps' as Mortgage Market Cure*, DORF ON LAW (Oct. 16, 2011), http://www.dorfonlaw.org/2011/10/post-by-bob-hockett-lease-swaps-as.html. For a defense of Robert Hockett's lease swap proposal, see Lynn M. LoPucki, *House Swaps: A Strategic Bankruptcy Solution to the Foreclosure Crisis*, 112 U. MICH. L. REV. (forthcoming Mar. 2014) (manuscript at 17–52), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2230117##).

56 OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC MORTGAGE METRICS REPORT: DISCLOSURE OF NATIONAL BANK AND FEDERAL SAVINGS ASSOCIATION MORTGAGE LOAN DATA, THIRD QUARTER 25 tbl.17 (2012), *available at* http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2012/mortgage-metrics-q3-2012.pdf.

57 *See id.* at 6 tbl.2.

58 *See id.*

write-downs do salvage sizeable value.[59] And it is notwithstanding equally compelling evidence, found in the GSEs' SEC filings, that underwater PLS loans that are *not* written down *will default at remarkably high rates.* For 2006 vintage loans, for example, approximately 71% of subprimes, 70% of option ARMs, 58% of variable rate loans, and a surprising 40% even of garden variety fixed rate mortgage loans will default.[60]

IV
COLLECTIVE AGENCY FOR COLLECTIVE ACTION, TAKE TWO: THE MUNICIPAL EMINENT DOMAIN PLAN

If it is not trustees, servicers, or federal government instrumentalities, then who *is* the proper collective agent equipped to address the collective action problems that now prevent principal write-downs? The answer has been right before our noses all along: it is *state and municipal governments*, which (a) face the brunt of mass foreclosure and all of the ills that these mass foreclosures bring more directly than the federal government;[61] and (b) have readily available authority, under both state and federal statutory and constitutional law, to address these emergencies just as directly. We shall turn to the 'how' in due course, but first we shall elaborate somewhat on both (a) and (b).

To start with the first point, although the underwater mortgage debt overhang crisis is crippling our entire nation's economy, the *worst* of the problem is significantly *localized* in character. There are some communities, for example, in which *more than 80%* of mortgage loans are underwater.[62] In some, moreover, the *degree* to which the affected loans are underwater—or the quantum of 'negative equity'—is nothing short of remarkable. There are communities that have a significant number of underwater mortgages with loan to value (LTV) ratios greater than 200%.[63] This figure is historically unprecedented and affords at least some hint as to why some affected

---

59 *See Goodman Testimony*, *supra* note 6, at 4–6.

60 *See* FED. NAT'L MORTG. ASS'N, QUARTERLY REPORT (Form 10-Q) 111 (June 30, 2012), *available at* http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/q22012.pdf.

61 It is well known that Fannie and Freddie hold significant numbers of underwater loans in their portfolios and would benefit by writing them down for reasons given *infra* Part V, notwithstanding the misguided arguments to the contrary referenced *supra* in note 54.

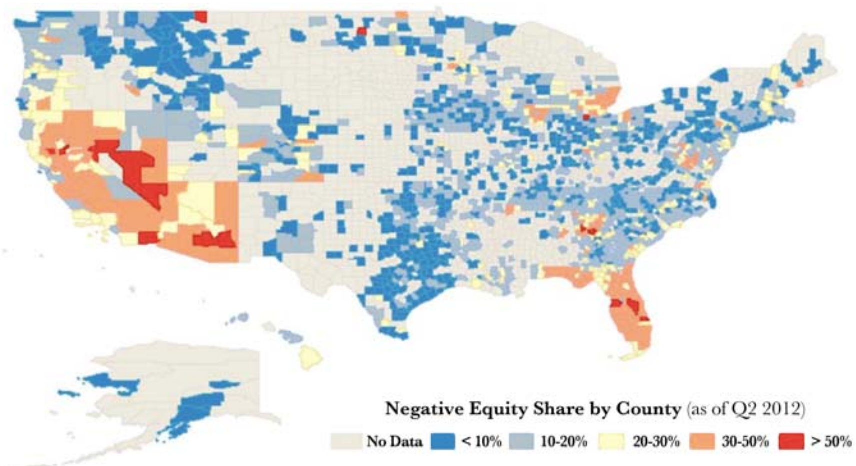
62 *See, e.g.*, *The U.S. Housing Crisis: Where are Home Loans Underwater?*, ZILLOW, http://www.zillow.com/visuals/negative-equity (last visited Apr. 15, 2013) (inputting area code 30294 on March 17, 2013, indicates 81% of homes are underwater in that area code).

63 *See, e.g.*, *id.* (inputting area code 30294 on March 17, 2013, indicates that there are significantly more mortgages with LTV ratios higher than 200% than there are mortgages at any other individual level of LTV displayed by Zillow).

communities are willing to act even before the nation as a whole might see fit to do so.

The following county-by-county map affords a telling, if understated,[64] summary overview of how localized the worst of the nation's underwater mortgage loan problem actually is:[65]

FIGURE 2
CoreLogic Negative Equity: Negative Equity Share by County



Source: CoreLogic Negative Equity Report, Q2 2012, Negative Equity Share

If for the sake of illustrative case study we now concentrate our attention on two counties in two states that (a) appear to have been targeted with particular intensity by subprime lenders during the bubble years; and (b) have suffered accordingly since the bubble's burst—San Bernardino in California and Wayne County in Michigan—the underwater figures and associated measures of poor economic health are remarkably high.

In California, the figure is approximately two million underwater homes, representing 29% of the total statewide.[66] Housing prices have decreased significantly over the past five years—27.3% for California as a whole[67] and 41.34% for the Riverside-San Bernardino-

64 The chart covers all underwater loans, hence it does not reflect distinctions between high LTV and lower LTV ratios on such loans.

65 CORELOGIC, CORELOGIC REPORTS NUMBER OF RESIDENTIAL PROPERTIES IN NEGATIVE EQUITY DECREASES AGAIN IN SECOND QUARTER OF 2012 5 (2012), *available at* http://www.corelogic.com/about-us/researchtrends/asset_upload_file355_20017.pdf [hereinafter *2012 Q2 Negative Equity Report*].

66 *Id.* at 6.

67 *Change in FHFA State House Price Indexes (Seasonally Adjusted, Purchase-Only Index, 2012Q4)*, FEDERAL HOUSING FINANCE AGENCY, http://www.fhfa.gov/Default.aspx?Page=215&Type=summary (Mar. 17, 2013, 5:30 PM).

Ontario area specifically.[68] Unsurprisingly, San Bernardino also has significantly higher unemployment and poverty rates than does the nation as a whole. Its unemployment rate stands at 11.9% compared to a national figure of 7.9%,[69] while its estimated poverty rate stands at 19.3% compared to a national figure of 15.9%.[70] Scarce wonder, then, that it is among the first municipalities in the nation to consider a plan like the one on which we shall shortly elaborate.

Turning to Wayne County, Michigan—where Detroit is located—the figures are again telling. Approximately 450,000 homes, representing a remarkable 32.8% of the total statewide, are under water in Michigan.[71] Home prices statewide are down 12.6% over the past five years,[72] while in Wayne County's Detroit-Livonia-Dearborn area the figure is 26.61%.[73] As with San Bernardino, Wayne County also shows similar disparities concerning indicators of economic health: its unemployment rate is 11% compared to the nation's 7.9%,[74] while its estimated poverty rate is 25.9% compared to the nation's 15.9%.[75]

Yet as worrisome as all of these figures are, they are anything but fully contained within these two illustrative counties. The cyclical *patterns* we noted earlier for the nation as a whole carry over to our worst hit states and their subdivisions as well.[76] Meanwhile, a backlog of over 195,000 homes in California, with approximately 17,300 in San Bernardino alone, and over 60,000 homes in Michigan, with

68 *Change in FHFA Metropolitan Area House Price Indexes (All Transactions Index, 2012Q4)*, FEDERAL HOUSING FINANCE AGENCY, http://www.fhfa.gov/Default.aspx?Page=216&Type=summary (Mar. 17, 2013, 5:30 PM).

69 *See Unemployment Rate by County*, WASH. POST, http://www.washingtonpost.com/wp-srv/special/nation/unemployment-by-county/ (last visited Feb. 25, 2013) (containing interactive map that displays unemployment statistics for a county as selected by the user) [hereinafter *Unemployment Rate Chart*].

70 *See* UNITED STATES CENSUS BUREAU, POVERTY STATUS IN THE PAST 12 MONTHS: 2011 AMERICAN COMMUNITY SURVEY 1-YEAR ESTIMATES, *available at* http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ACS_11_1YR_S1701&prodType=table (allowing user to display reports on the national poverty rate and poverty rates by county) (national and San Bernardino County reports on file with author) [hereinafter *Census Poverty Estimates*].

71 *See 2012 Q2 Negative Equity Report*, *supra* note 65, at 6.

72 *See Change in FHFA State House Price Indexes (Seasonally Adjusted, Purchase-Only Index, 2012Q4)*, *supra* note 67.

73 *See Change in FHFA Metropolitan Area House Price Indexes (All Transactions Index, 2012Q4)*, *supra* note 68.

74 *See Unemployment Rate Chart*, *supra* note 69.

75 *See Census Poverty Estimates*, *supra* note 70 (national and Wayne County reports on file with author).

76 *See, e.g.*, U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF TREASURY, SPOTLIGHT ON THE HOUSING MARKET IN DETROIT-WARREN-LIVONIA, MICHIGAN MSA 2 (Jan. 2013), *available at* http://portal.hud.gov/hudportal/documents/huddoc?id=HUDJanRegSCSL_Detroit.pdf (showing cyclical home price fluctuations for Detroit-Warren-Livonia, Michigan MSA).

approximately 14,700 in Wayne County alone, are now either in default, held in bank real estate owned (REO) portfolios or up for post-foreclosure auction.[77]

So localities in many instances have significant incentives to address the underwater mortgage loan problem in a decisive manner. Under what authority, then, might they do so?

Here too the answer lies right under our noses, though lawyers are apt to be first to detect it: using their traditional *eminent domain* powers—a legal authority enshrined in our state and federal constitutions for precisely such public exigencies as those that the foreclosure crisis presents[78]—states or their counties can simply purchase underwater mortgage loans from their holders at fair value, sidestepping PSA contract rigidities in order to do what too many PSAs presently prevent the loanholders and their fiduciaries from doing. That is, again, to modify loans to render them payable. The states or counties in question can then write down the loans to just under the values of the underlying homes, bringing the homes at last back above water. And voilà, the problem is solved in one elegant stroke.[79]

If necessary, the same authority can also be used to take second-lien-secured loans at fair value, or even the liens that secure them while leaving the notes with their holders, effectively converting the latter into unsecured consumer debt. That prospect could do wonders in bringing recalcitrant seconds to the table with firsts. Eminent domain alone makes this approach possible—again, because contract and holdup rigidities of this sort are precisely what inherently flexible eminent domain authority is for. Eminent domain enables political units to break through periodically emergent, market-paralyzing contract rigidities or holdout abuses in the name

---

77 *California Real Estate Trends*, REALTYTRAC, http://www.realtytrac.com/trendcenter/default.aspx?address=CA&parsed=1&stc=ca (last visited Feb. 25, 2013) (showing foreclosure trend data for the State of California); *San Bernardino County, CA Real Estate Trends*, REALTYTRAC, http://www.realtytrac.com/trendcenter/default.aspx?address=San%20Bernardino%20county%2C%20CA&parsed=1&cn=san%20bernardino%20county&stc=ca (last visited Feb. 25, 2013) (showing foreclosure trend data for San Bernardino County); *Michigan Real Estate Trends*, REALTYTRAC, http://www.realtytrac.com/trendcenter/default.aspx?address=MI&parsed=1&stc=mi (last visited Feb. 25, 2013) (displaying foreclosure trend data for State of Michigan); *Wayne County, MI Real Estate Trends*, REALTYTRAC, http://www.realtytrac.com/trendcenter/default.aspx?address=Wayne%20county%2C%20MI&parsed=1&cn=wayne%20county&stc=mi (last visited Feb. 25, 2013) (displaying foreclosure trend data for Wayne County).

78 *See* U.S. CONST. amend. V, cl. 4 (providing the federal constitutional basis for eminent domain in stating "nor shall private property be taken for public use, without just compensation").

79 *See* Hockett, *supra* note 15, at 162–70 (providing a fuller schematization of this plan).

of us all.

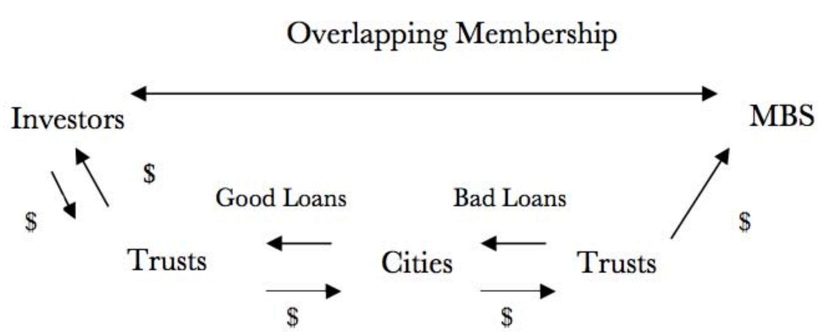
But how are municipalities to *purchase* the loans or the liens, given that states and their subdivisions are even more strapped for cash these days than the federal government? Here too the answer is simple. Municipalities can finance the purchases with monies supplied by private sector investors, thereby avoiding all cost to the public fisc. Investors can then be repaid from the proceeds of refinanced loans, or in the form of bonds issued against pools of the new, modified, and accordingly more valuable loans. In this connection, crucially, the mentioned investors can and indeed should include *current bondholders themselves*, who can receive rights of first refusal to participate before any other investors are invited in. This inclusion will underscore the sense in which the eminent domain plan is meant simply to solve a collective action problem that dysfunctional PSAs now prevent trustees and servicers from solving themselves on behalf of their bondholding PLS trust beneficiaries.

It is instructive to note that by working with the municipalities in the described manner, current bondholders will in effect piggyback on governmental authority to sidestep market-failure-causing dysfunctional contracts (the PSAs), and in so doing will at last get past those contract rigidities that currently prevent them from writing down principal and maximizing value on significantly underwater loans, just as the portfolio loan holders, unhampered by dysfunctional PSAs, are doing.

To note that bondholders will effectively be 'paying themselves' less than face value for their loans is just a roundabout way of saying that they will be writing down principal. Again, that is something which value-maximizing investors or their fiduciaries would do on their own if PSAs did not render such action legally impossible absent governmental exercise of contract-rescission authority through its eminent domain power. Write-downs on deeply underwater loans boost the values of those loans by eliminating most of the very high default risk that otherwise afflicts them.

In sum, then, the plan as schematically rendered looks like the figure below (single-headed arrows should be followed counterclockwise beginning at the upper left; double-headed arrow symbolizes identity or overlap between linked classes):

FIGURE 3



Investors, including current bondholders, convey funds to trusts or accounts organized and maintained by municipalities. The latter then use the funds to purchase deeply underwater loans with high default risk from current PLS trusts while continuing to pay out to their bondholder beneficiaries. The municipalities then work with homeowners to modify the bad loans on which they owe and that the municipalities now hold. Once the modifications are completed, the new loans are conveyed to the first-mentioned trusts, which convey resultant funds to the first-mentioned investors just as the PLS trusts do to their own beneficiaries. This is the plan in broad outline.

Of course, as the words 'schematic' and 'broad outline' suggest, this diagram shows only the basic structure of the plan. More detail will have to be supplied, on a locality-by-locality basis, to render such a plan operational in any particular community. Among the required further detail will be (a) selecting and preliminarily valuing the appropriate underwater loans; (b) approaching and securing the involvement of the investors; (c) commencing and conducting the legal proceedings pursuant to which eminent domain authority is actually exercised; (d) actually restructuring and perhaps resecuritizing the loans once they are purchased; (e) working with homeowners in connection with the foregoing; and (f) ultimately compensating the investors once the process is completed, among other things. Moreover, effective discharge of these functions will require significant legal, financial, and counseling expertise. Yet this can all be had and done, as the author has detailed elsewhere and as municipalities are already considering.[80]

V
THE PLAN IS LEGAL: FAIR VALUE AND PUBLIC PURPOSE

But *does* this sort of thing actually occur, legally speaking? In other words, does the government really use eminent domain for more than just compulsory land purchases for the building of public infrastructure?

Once again, the answer is straight-forwardly yes.[81] Although non-lawyers are not as immediately aware of the fact as are lawyers, cities compulsorily purchase property for public use at fair market value all of the time, and they do so with *all manner* of property—tangible and

---

80 *See, e.g.*, Eleazar David Melendez, *Brockton, Massachusetts, Considers Eminent Domain to Address Foreclosures*, HUFFINGTON POST (Jan. 15, 2013, 2:19 PM), http://www.huffingtonpost.com/2013/01/11/brockton-eminent-domain-foreclosure_n_2458369.html (last updated Jan. 15, 2013). The author is also serving as a consultant for a number of cities considering the plan, but those cities' identities are presently confidential.

81 *See* Hockett, *supra* note 15, at 157–70 (providing a more thorough legal analysis than the necessarily abbreviated one laid out in this Essay).

intangible, contractual and real-estate-related alike.

Forms of intangible property analogous to mortgage loans that have been purchased under eminent domain authority by states or municipalities include bond tax exemption covenants,[82] contract rights,[83] insurance policies,[84] corporate equities,[85] businesses as going concerns,[86] hunting rights,[87] rights of way,[88] and all manner of additional intangible property—even sports franchises.[89] Given that the law does not distinguish between kinds of property that can be compulsorily purchased in eminent domain proceedings, it should come as no surprise that loans and liens in particular, as merely one form of contractual obligation among many, all of which can be condemned in eminent domain, are regularly condemned.[90] Among those liens are mortgage loans and liens, as the U.S. Supreme Court and other state courts have long recognized.[91]

The question, then, is not what kinds of property can be taken, but only whether the government pays fair value and whether a proper public purpose justifies the forced sale. Preventing a self-

---

82 *See* CONN. GEN. STAT. §§ 12-242ee–12-424yy (2011), *available at* http://www.cga.ct.gov/2011/pub/chap208b.htm (containing innovative statutory provision enacted to prevent bond covenants from draining revenues from the fisc of the State of Connecticut by utilizing the State's eminent domain power).

83 *See, e.g.*, U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 19 n.16 (1977) ("Contract rights are a form of property and as such may be taken for a public purpose provided that just compensation is paid.").

84 *See, e.g.*, Lynch v. United States, 292 U.S. 571, 577–79 (1934) ("Valid contracts are property, whether the obligor be a private individual, a municipality, a State or the United States.").

85 *See, e.g.*, Offield v. N.Y., New Haven & Hartford R.R. Co., 203 U.S. 372, 375–77 (1906) (holding condemnation of shares of railway stock valid under state statute).

86 *See, e.g.*, Kimball Laundry Co. v. United States, 338 U.S. 1, 3–4, 7–8 (1949) (holding that use of eminent domain where United States government sought to acquire right to temporary use and occupancy of defendant's laundry to provide laundry and dry cleaning service for members of the armed forces was justified).

87 *See, e.g.*, Swan Lake Hunting Club v. United States, 381 F.2d 238, 240–41 (5th Cir. 1967) (allowing condemnation of hunting rights via eminent domain).

88 *See, e.g.*, City of Cincinnati v. Louisville & Nashville R.R. Co., 223 U.S. 390, 407 (1912) (permitting condemnation of right of way for public use).

89 *See* City of Oakland v. Oakland Raiders, 646 P.2d 835, 837 (Cal. 1982) (reversing the lower court's grant of summary judgment against the city's action to acquire by eminent domain the property rights of a professional football team).

90 *See, e.g.*, Phillips v. Wash. Legal Found., 524 U.S. 156, 172 (1998) (holding that interest income generated by certain account funds is private property belonging to the owner of the principal for Takings Clause purposes); Armstrong v. United States, 364 U.S. 40, 48–49 (1960) (taking of materialman's lien); Legal Tender Cases, 79 U.S. 457, 551–53 (1870).

91 *See, e.g.*, Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 596 (1935) ("If a part of the mortgaged property were taken by eminent domain a mortgagee would receive payment on a similar basis."); W. Fertilizer & Cordage Co. v. City of Alliance, 504 N.W.2d 808, 816 (Neb. 1993) (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").

amplifying tsunami of additional foreclosures, mass homelessness, blighted property, lost revenue base, and ultimate retraction of essential city services—in short, urban blight on a disastrous scale as is now seen in San Bernardino, Detroit, and all too many additional American cities—is widely recognized in the courts as the most compelling of public purposes justifying use of eminent domain authority.[92]

What about valuation then? How is 'fair value' determined? Would municipalities have to purchase underwater loans at *less* than fair market value in order to recoup sufficient margin to compensate the investors—including the current bondholders themselves—who put up the purchase money? The answers are again rather simple. Let us address the two questions in turn.

As for how valuation would be managed, there is nothing particularly recondite or mysterious here. For one thing, where MBS associated with a particular pool of loans or with analogous pools trade on public markets at a discount, imputation of counterpart discounts to the underlying loans is arithmetically straightforward. And let there be no mistake: PLS bonds are trading at *very* steep discounts.[93] Where the mentioned imputation methods are not available owing to missing markets, orthodox discounted cashflow methods are perfectly serviceable. As noted above, for example, Fannie and Freddie, among other entities, publish expected default rates for various classes of underwater PLS mortgage each year in their SEC 10-Q filings.[94] Recall that the default rate for 2006 vintage subprimes is about 70%, while the default rate for even relatively safe fixed-rates is 40%.[95]

Other loan types show default rates between these extremes.[96] From such default rates—along with loan terms, recovery rates, and discount rates—the calculation of net present values (NPVs) is a straightforward exercise. Our courts, which routinely hear arguments about valuation in multiple contexts and can always

---

92 *See, e.g.*, Kelo v. City of New London, 545 U.S. 469, 473, 478–79 (2005). The *Kelo* decision makes for a particularly interesting comparison. There, the U.S. Supreme Court upheld a taking of actual homes at fair market value from predominantly elderly residents with significant non-monetizable sentimental attachments to the homes, then conveyed them to Pfizer in the name of a particularly speculative claim that this would economically revitalize the city of New London, Connecticut. *Id.* What is contemplated here, by contrast, is a taking of underwater mortgage loans with no sentimental significance at truly fair value, in the name of a much more plausible claim that this will, by addressing a market failure, bring value to bondholders, homeowners, and wider communities alike.

93 *See Current Markit ABX.HE Indicies*, MARKIT (Mar. 25, 2013), http://www.markit.com/en/products/data/indices/structured-finance-indices/abx/abx-prices.page.

94 *See supra* note 60 and accompanying text.

95 *See id.*

96 *See id.*

impanel experts in such cases, will be equipped to oversee all that transpires as required by law, ensuring procedural and substantive fairness to all parties.

What about the putative need to bilk current investors to compensate new ones? Would that not be unfair and undercut claims of public purpose? This false concern is intimately bound up with another canard, widely propagated by certain participants in the securitization industry whose interests appear now to conflict with those of bondholders, homeowners, and their communities alike, to the effect that someone must 'lose' under the eminent domain plan if anyone is to 'win.' Must we rob Peter to pay Paul?

The answer is once again no. The charge that eminent domain proceedings must always represent a 'zero sum game' is simply false. Literally everyone can win under the eminent domain solution if the actual stakeholders think for themselves, examine the numbers, and do not squander resources—as certain participants in the securitization industry have (bluffingly) threatened will happen since the summer of 2012[97]—on pointless litigation, lobbying, or strong-arming efforts.[98]

Key to understanding why the eminent domain solution can benefit everyone is the notion, discussed above, of a needlessly wasteful collective action problem.[99] The solutions to such market failures, by definition, recoup needless losses that can then be distributed Solomonically over all stakeholders.

To elaborate briefly, collective action problems characterize situations in which everyone experiences avoidable loss even when each person acts rationally, precisely because of the ways in which even rational actions can aggregate into dysfunctional outcomes when not orchestrated through coordinating instrumentalities like governments. Credit-fueled asset price bubbles and busts are classic cases in point,[100] as are monetary inflations,[101] debt deflations,[102] 'bums' rushes,'[103] and 'commons tragedies.'[104] Indeed, so was the aforementioned credit-fueled housing price hyperinflation itself,

97 *See* Ben Hallman, *San Bernardino Eminent Domain Fight Closely Watched by Other Struggling Communities*, HUFFINGTON POST (Sept. 25, 2012, 3:29 PM), http://www.huffingtonpost.com/2012/09/01/eminent-domain-mortgages_n_1836710.html.

98 The author passionately believes these opposing claims to be bluffs. *See infra* Part VI.

99 *See supra* Parts II–III.

100 *See* Hockett, *supra* note 15, at 138–42; Hockett, *supra* note 20 (manuscript at 12–14).

101 *See* Hockett, *supra* note 20 (manuscript at 11–12).

102 *See id.* (manuscript at 14–15).

103 *See id.* (manuscript at 10–11).

104 *See id.* (manuscript at 2).

which is why individuals like the present acting director of FHFA are so terribly wrong in believing that 'moral hazard' is anything more than a *de minimis* policy interest where our ongoing underwater mortgage loan crisis is concerned.[105]

As noted above, the nation's ongoing mortgage and hence broader economic troubles are rooted in problems of precisely this collective action variety. Indeed, they just *are* the bondholder collective action problems described earlier. This is precisely where the eminent domain solution enters the picture in a way that can benefit literally everyone. Its *sole significance* is its enabling of a collective agent *other* than the trustee or servicer, whom we found earlier to be hamstrung, to sidestep those market-paralyzing securitization contracts that private parties cannot sidestep. Eminent domain then allows refinancing of debt so that markets can return to doing what they normally do best: price goods efficiently and recoup otherwise lost value. This recouped value—the surplus we gain by surmounting those market failures that our collective action problems and PSAs jointly constitute— then can benefit literally everyone.

VI
THE PLAN IS WIN-WIN-. . . WIN: OF SURPLUS AND STAKEHOLDERS

Everyone? Yes—literally everyone can win if we do the thing right. Consider the stakeholders class by class. Under the eminent domain plan, current *first lienholders* receive fair market value for presently illiquid, unmarketable assets. Insofar as they are among the investors who finance the compulsory purchases and receive refinanced and accordingly more valuable loans in return, they get a desired outcome that dysfunctional PSA contracts now prevent. That is, of course, higher valued mortgage loan assets brought higher by modifications that PSAs presently prevent.[106] They are also spared the significant litigation and liquidation costs associated with foreclosure.

Next, consider *investors in the written-down loans* as a class, irrespective of whether they themselves are participating current bondholders. These people for their part get modest returns on the funds that they lend to pay first-lien-holding trusts.[107] Those returns

---

105 *See* DeMarco, *supra* note 54 (detailing Acting FHFA Director Edward DeMarco's observations on the "moral hazard" issue)*; see also* Hockett, *supra* note 15, at 142–49 (arguing for how readily principal-reduction plans can avoid "moral hazard" issues).

106 *See supra* Part III.

107 It is instructive to note how the two step process under the eminent domain plan, pursuant to which an MBS holder first 'pays herself' for her loans and then holds more valuable, modified loans, simply simulates in two steps the one step act, commonly taken by portfolio loan holding banks, of writing down principal to increase a loan's value. The

stem from the value that is added by modification and consequent default-risk-reduction. Since this value-addition is made possible by eminent domain and the private funds used to pay the required condemnation awards, it is fair and equitable for both to receive a part of the surplus that is generated. And so they shall under optimal renditions of the eminent domain plan.

Now consider the underwater *homeowners*, who had no choice but to pay bubble-determined prices for their homes during the bubble years and are no more responsible for the bust or for failure to foresee the bust than the lenders and securitizers—indeed they are likely less responsible. This constituency now will receive an increment of positive home equity and sustainable debt loads, their piece of the refinance-generated surplus. They will also be enabled to stay in their homes, which is itself ultimately an incalculable benefit.

It should also be noted that *neighbors and municipalities* will finally stop losing home values and revenue bases, and *everyone now suffering related forms of spillover loss* thanks to our ongoing balance sheet recession will finally see real recovery. That will be these constituencies' piece of the surplus—or perhaps better put, this will be the *positive* externality that at last reverses the currently negative externalities that afflict them.

Finally, consider the *second lienholders*. *Even they* can benefit if paid sweeteners out of the value recouped by the write-downs effected through eminent domain, since in foreclosure—which, again, is overwhelmingly likely where mortgage debt is severely underwater—they get nothing. Through the eminent domain plan, by contrast, all that the seconds stand to lose is the holdup power that some of them wield illegitimately owing to mortgagor liquidity needs—a power that, again, harms those first lienholders who legally stand ahead of them in the bankruptcy queue.[108] This 'loss' is no more a policy-cognizable loss than any other loss of an ill-gotten, illegitimate gain.

In the end, then, literally everyone can win under the eminent domain solution because it recoups presently lost value that can be equitably distributed.

CONCLUSION: IT TAKES A VILLAGE

It is to be hoped, then, in light of the foregoing, that all might help all now by acting to salvage lost value. As elaborated above, our

reason for the second step in the PLS case is the PSAs, in which contracts require the interpolation of a step taken by government—the sole entity able to abrogate contracts—in order to effect what could otherwise be done in one step by a private party.

108 *See supra* notes 43–44 and accompanying text.

continuing mortgage debt crisis is enormous in magnitude. Many millions are directly affected, and scores of millions more suffer the ravages of that broader slump which the mortgage mess underwrites. Tragically, all of this is *completely unnecessary*, the product of no more than a structural problem that blocks us from doing what is best for everyone.

What is best for everyone at this point is for creditors and debtors in the securitized residential real estate market to write down debt as those in the non-securitized market do. All that stands in their way are certain improvidently formulated contracts drafted when few thought a nationwide real estate crash possible. Only the public at large, through its governments, is legally able to get past those contracts. And as this author hopes to have made plain, the governments best situated to do that at present, it seems, are the local ones.

Here, as in so much else, then, it takes something other than individuals or federal agencies to break a tragic impasse. It takes collective action at that level of government where the pain is felt most. It takes, then, a village.