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Calif. County's Halted Mortgage Seizure Plan May Deter Others

By **Erin Coe**

San Bernardino County, Calif., on Thursday abandoned a bold proposal to ease the foreclosure crisis by using eminent domain to take over houses with underwater mortgages, a retreat experts say will likely make other municipalities in California and beyond think twice about adopting a strategy certain to face drawn-out legal challenges from the banking industry.

The Homeownership Protection Program Joint Powers Authority board, which is made up of the county and two of its cities, Ontario and Fontana, voted unanimously to discontinue a plan aiming to use private investors' money to buy underwater mortgages through the eminent domain process and in effect write new, lower-cost mortgages for existing homeowners. The board said the proposal had drawn little public support and raised concerns that it could destabilize an already weak local housing market.

Government agencies traditionally use eminent domain to seize property for public purposes like parks and highways, and using it to take over troubled mortgages is a new concept. San Bernardino County began considering the strategy last year after it was proposed by San Francisco-based Mortgage Resolution Partners, which is in active talks with two dozen municipalities in California and other states to provide the money for the mortgages and eventually take ownership of them. Berkeley, Oakland and Sacramento have reportedly engaged in preliminary discussions with the company.

San Bernardino has been viewed as the focal point for the proposal, and its unanimous rejection of the idea could slow down any other municipalities in California or elsewhere that have been contemplating condemnation of underwater mortgages, according to Rick Rayl, chair of Nossaman LLP’s eminent domain practice.

“I would not be surprised to see any or all of these other municipalities make statements rejecting the proposal now that San Bernardino has done so,” he said. “While this decision has no direct impact on any communities other than those involved in the JPA, with the tremendous focus placed on San Bernardino, the decision could have a chilling effect elsewhere in California and across the country."

San Bernardino County officials said about half of the county's 300,000 mortgages were underwater in July, a month before its largest city filed for Chapter 9 bankruptcy, and Mortgage Resolution has likely shopped the eminent domain proposal around to municipalities that have been hit hardest by the foreclosure crisis, according to Hill Farrer & Burrill LLP partner Kevin Brogan.

"The places that probably were the most desperate were looked at first," he said. "And if the proposal didn't fly [in San Bernardino], it's not going to fly in those places that are in better financial shape."

Under the proposal, municipalities would use eminent domain to buy up underwater mortgages where the homeowners have not missed a payment. The plan would only apply to private-label, securitized mortgages, not those held by banks, Fannie Mae or Freddie Mac.

But JPA Board Chairman Greg Devereaux said Thursday that continuing to consider the possibility of eminent domain would interfere with efforts to work with the banking, mortgage, real estate and investment communities to make various forms of assistance available to homeowners.

"It's wrong to impose that risk on the community without support from the community, and that level of support has not materialized," Devereaux said. "We don't want to do more harm than good in what we choose to do."

Like San Bernardino, other cash-strapped municipalities are likely to reject the eminent domain proposal because they don't want to go through a long and costly legal battle with banks, particularly when they are looking for immediate foreclosure relief, according to David Min, a real estate finance professor at University of California, Irvine, School of Law.

"If any town tries to claim eminent domain over mortgages, there will be intense litigation," he said. "Who wants to engage in litigation that could go all the way up to the U.S. Supreme Court and entail high costs to try to get this? It's probably the reason why San Bernardino dropped the plan and why others may drop it as well.”

The plan would essentially require holders of mortgage-backed securities to take a massive haircut, with municipalities paying the current real value of the home to the trusts controlling the bonds rather than the face value of the mortgage.

If a municipality does try to adopt a mortgage seizure proposal, banks are likely to bring suits claiming it can’t exert eminent domain on mortgages because they are not real property. And even if they lose on that argument, they are likely to assert that the plan is unconstitutional because they are not receiving just compensation for the mortgages, according to Min.

“I don’t think a small town is going to have the deep pockets to fight the banks, which are going to fight tooth and nail because if they lose on one proposal, other cities could adopt this strategy,” he said.

While Mortgage Resolution has offered to put up funds to provide fair value for the home loans, it’s not going to cover the litigation costs, and a lot of uncertainty remains over whether the eminent domain strategy would work, he said.

“The cost-benefit for towns is not there to justify adopting the proposal,” he said. “There are no certain benefits and definitely certain costs.”

The fact that San Bernardino even considered the eminent domain strategy signals the county’s frustration with the federal government and private sector's ability to meaningfully address the foreclosure problem, according to Min.

“It is frustrated like much of America that it is not seeing effective policies coming out of Washington, D.C., and the banking industry,” he said. “The fact that it considered this as a solution shows it doesn’t have good options right now.”

Not everyone in the county is willing to write off the eminent domain option, however, as Fontana Mayor Acquanetta Warren signaled the city might continue to review the eminent domain strategy independent of the JPA.

"We continue to believe that it would be irresponsible for the city of Fontana to not examine all options available to strengthen our community by helping our underwater homeowners," Warren said. "It is our intention to go forth aggressively to help find local solutions to Fontana's mortgage and foreclosure crisis."

Meanwhile, Mortgage Resolution President Steven Gluckstern said the board's decision was a letdown, but the company would focus on engaging other municipalities in California and other states.

"We are disappointed that the JPA in San Bernardino chose not to explore all options to prevent mortgage foreclosures in their jurisdiction, a jurisdiction where roughly two thirds of the [mortgage holders with private-label mortgage-backed securities] are currently underwater and some one-third is already in default," he said.

Although there is not likely to be any large-scale implementation of the eminent domain proposal anytime soon, Mortgage Resolution is going to continue to present this strategy to other municipalities, experts said. In San Bernardino County alone, if the company was able to effectuate the condemnation of the estimated 42,000 eligible loans, it would stand to make nearly $190 million, at a fee of $4,500 per loan, according to Rayl.

"I do not think this proposal is dead," Rayl said. "There is too much money to be made if the plan proceeds."

--Additional reporting by Evan Weinberger. Editing by Elizabeth Bowen.