Eminently Reasonable

David J Reiss, Brooklyn Law School

Available at: https://works.bepress.com/david_reiss/55/
Eminently Reasonable

David Reiss

Local governments across the country are considering an innovative use of eminent domain. They propose to condemn underwater mortgages in their communities and restructure them so that homeowners can afford their payments as well as ensuring that the new mortgage is for less than the fair market value of the property. If this proposal is implemented, the local government will pay the owner of mortgages of “underwater” homes the fair market value for the mortgages. The local government will then restructure the mortgage by reducing the principal amount owed to be in line with a mortgage that would be appropriate for the fair market value of the home. This will result in lower monthly payments. It will also result in a sustainable transaction, one in which homeowners can imagine ultimately paying off their mortgages, the American Dream of owning one’s home free and clear. The financial industry is up in arms against this proposal, claiming that the sky will fall if it is implemented. But this proposal is constitutional, beneficial, and administratively feasible. Local governments should give it a try as they seek to stabilize their communities.

Eminent domain is an ancient prerogative of sovereign governments. Federal and state governments have limited that power by requiring that a government use eminent domain to achieve a public purpose and pay just compensation upon its exercise.1 The Supreme Court has taken an expansive view of the “public purpose” requirement, holding that use of eminent domain to achieve economic development is a legitimate exercise of government power even when it involves taking land from one private party and giving it

---

to another. Indeed, a New Deal-era Supreme Court case even contemplated this proposal, merely stating what should be obvious to us today: “If the public interest requires, and permits, the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain; so that, through taxation, the burden of the relief afforded in the public interest may be borne by the public.”

The bottom line is that preventing mass foreclosures, with its implications for halting blight, healthy property tax collections and keeping communities vibrant, are obviously legitimate public purposes that are consistent with the relevant Supreme Court precedent.

Predictably, the financial industry has argued that this use of eminent domain is first and foremost downright un-American and will also, by the way, cause losses for investors. That is not right. The exercise of eminent domain will have a concomitant payment of just compensation to the owner of the mortgage. This just compensation will be the fair market value of the condemned mortgage. What is likely of greater concern to those opposing the use of eminent domain in this context is that it will force them to “mark to market,” such that their losses will be realized for accounting purposes. In other words, eminent domain will not cause losses. It will cause already existing losses to be realized. While this has great import for investors, it is not relevant for purposes of evaluating the constitutionality of the use of eminent domain in this context.

A common argument by the investing community is that pro-borrower developments will destroy the credit markets. This argument has been used in the

---

context of municipalities filing for bankruptcy, sovereign nations defaulting on bonds and pro-debtor changes to the bankruptcy laws. This long term chilling of the credit markets has never actually happened. If lenders and investors think they can make money in a market, they will return to it like bears to honey.

The rule of law must of course be respected, or else lenders will not believe that they can make money and they will flee that particular market. But eminent domain has long been part of the legal framework of the housing market, referenced in standard mortgage documents. While its large-scale use is an unexpected application, we are in extraordinary times. And given the federal government’s failure to implement a solution to the problems communities face, it is utterly appropriate for local governments to use their intrinsic powers to address this crisis. Really, the worst case scenario for future residential borrowers is that mortgages may be priced slightly higher to address the remote possibility that a government will use its power of eminent domain during some future crisis.

The federal government’s responses to the current crisis in the housing markets have been at cross purposes, half-hearted and self-defeating. So it is not surprising that local governments are attempting to fashion solutions to the problem with the tools at their disposal. Courts should, and likely will, give these democratically-implemented and constitutionally-sound solutions a wide berth as our ship of state tries to right itself after being swamped by a tidal wave of mortgage defaults.

*David Reiss is a professor at Brooklyn Law School. He writes about housing policy and the mortgage markets.*