American
SECURITIZATION
FORUM®

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Via Electronic Submission

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San Bernardino County Board of Supervisors
385 N. Arrowhead Avenue, 5th Floor
San Bernardino, CA 92415-0110

RE: Joint Exercise of Powers Agreement

Ladies and Gentlemen:

The American Securitization Forum ("ASF")[1] writes on behalf of our members to express our strong objections to the proposed use of eminent domain to acquire mortgage loans as part of a Homeownership Protection Program ("Program") pursuant to the First Amended and Restated Joint Exercise of Powers Agreement ("Agreement") among the County of San Bernardino (the "County") and Cities of Fontana and Ontario (collectively, "Members of the Joint Powers Authority", or "JPA" or "Authority").

We recognize and appreciate the serious challenges associated with the current housing market, and our members continue to improve methods to help borrowers that are in distress find ways to retain their homes. Millions of mortgage loan modifications have been conducted across the country to help borrowers in distress meet their mortgage payments. Certainly, in a severe economic downturn marked by high unemployment, all parts of the country are facing economic challenges.

But even in the most challenging of economic times, poor policy solutions such as the proposal to seize mortgage loans through eminent domain are not productive or legal answers. We understand that the eminent domain proposal was developed and brought to you by a private entity called Mortgage Resolution Partners LLC ("MRP") and, from your public comments, that you have not yet decided whether eminent domain should be a part of the Program. While

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF has over 330 member firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

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MRP's proposal initially may seem like an attractive method to assist borrowers in challenging economic times, the proposal, as a policy matter, would be short-sighted and ultimately be counterproductive for the residents of San Bernardino County. Moreover, it would violate both the United States and California Constitutions.

Notably, the proposal is not set up to help borrowers who are having difficulties with paying their mortgages. Servicing standards and all major modification protocols to date have been established to help borrowers who are challenged economically to make their monthly mortgage payments (that is, those who are in default or otherwise face reasonably foreseeable default), rather than those who have the ability to pay their mortgage and, as such, are current on their payments. By targeting this latter group, the plan seeks to seize assets that would be most profitable for MRP rather than address a public purpose to aid the housing market. Not only would such a proposal fail to help those most at risk, it would undermine the national market as a whole, making credit less accessible for homeowners and devaluing the investments of pension funds, mutual funds and other entities that hold mortgage-backed securities.

In the enclosed letter, we provide:

(1) a brief description of the facts of the plan as we presently understand them;

(2) an explanation of why MRP's proposal will not serve the JPA's interests and would be harmful from a policy perspective; and

(3) a summary of the legal defects associated with the contemplated use of eminent domain for such purposes.

Our members would welcome the opportunity to explore ways in which the Program could be crafted so that the JPA can participate in and foster market-based solutions to the current housing woes. Neither the Members nor constituents of the JPA, however, would be served by following an unlawful plan that would only profit a select group of private investors, while doing little to address the stated public purposes.

We very much appreciate the opportunity to provide these concerns regarding the Program and look forward to assisting in any way that we can. Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact me at 212.412.7107 or via email at tdeutsch@americansecuritization.com.

Sincerely,

Tom Deutsch

Tom Deutsch
Executive Director
American Securitization Forum

Factual Background

The following are the facts as we understand them based on our review of the Agreement, press accounts, and certain publicly available documents describing the details of MRP's plan, including a Memorandum by Cornell Law School professor Robert C. Hockett,[2] who we also understand has been employed as a consultant to MRP.

On June 19, 2012, the County adopted a resolution to approve the Agreement among it, the City of Ontario, and the City of Fontana. The Agreement establishes the JPA pursuant to Section 6500 et seq. of the California Government Code to explore and implement options for the Program. According to the Agreement, the "Program may include the Authority's acquisition of underwater residential mortgage loans by voluntary purchase or eminent domain and the restructuring of these loans," but it "expressly excludes the power to acquire homes by eminent domain." See Agreement, Recital (C), ¶¶ 4, 8.

Based on material prepared by MRP and Professor Hockett's Memorandum, we understand that MRP is proposing to manage and facilitate the eminent domain and loan restructuring process, including: (a) raising funds for the Program; (b) identifying properties to be acquired by eminent domain proceedings; and (c) arranging for the loan refinancing. MRP's targets are mortgage loans that are part of the pool of assets backing "private-label" residential mortgage-backed securities ("RMBS"). Such "private-label" securitizations are legal entities that are not sponsored by federal government arms such as Fannie Mae, Freddie Mac or Ginnie Mae and are generally located outside of California.

In particular, MRP intends to target loans that are "underwater" (the home value is less than the amount of the loan), but are currently performing, in that the borrowers are continuing to honor their contractual obligations by making their payments as scheduled.[3] While such loans could potentially be at a higher risk of default compared to certain properties with positive equity, they are not currently delinquent, and are not required to be identified as being on the road to foreclosure or even likely to default.[4] In fact, some of these loans may have already been modified to help the borrower achieve a reasonable ability to repay. MRP purports to seek to acquire the loans at "fair market value" but makes clear that it intends to pay only 75-80% of the value of the property based on a "foreclosure discount." In other words, MRP seeks to value

[2] See, e.g., Nick Timiraos, Cities Consider Seizing Mortgages, WSJ.com, July 4, 2012, http://online.wsj.com/article/SB10001424052702303933404577505013392791018.html. The Wall Street Journal online article includes links to (a) a Powerpoint presentation prepared by MRP on the Program ("MRP Presentation"), (b) a "Frequently Asked Questions" information sheet prepared by MRP ("MRP FAQ"), (c) the Memorandum written by Professor Hockett, "Breaking the Mortgage Debt Impasse: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Local Economic Recovery," Cornell Law School Research Paper No. 12-12; and (d) the Agreement.

[3] See MRP Presentation at p. 9; MRP FAQ No. 17; see also Mortgage Resolution Partners website, http://mortgageresolutionpartners.com/ (explaining their plan of "[c]hoosing only performing mortgages").

[4] For example, researchers estimate that prime loans with a 120% loan-to-value ratio, which appear to be encompassed within MRP's proposal, currently have only around an 8.4-8.8% chance to default. See "Global Securitized Products Weekly," Credit Suisse, July 12, 2012 at p. 8. http://www.americansecuritization.com/uploadedFiles/CS_Eminent_Domain_20120711.pdf.

loans that are not in default, and are likely to never be in default, by treating them as if default is imminent.[5]

These two components – hand-selecting the best borrowers among those with underwater loans and paying significantly less than the price of the property – appear critical to MRP's plan, which would result in MRP reaping substantial profits for itself and its investors. The plan appears to seek to refinance the loans into federal government-backed FHA loans, which will then be re-securitized into a new pool of Ginnie Mae mortgage-backed securities. See supra note 2.[6] All in all, MRP and its partners would earn returns in the neighborhood of 20-30% of each home's value by merely flipping the loan, which is the strongest signal possible that just compensation would not be paid by the JPA to the securitization trusts through eminent domain.

MRP's Eminent Domain Plan Would Not Remedy the Stated Problem and Would Have Unintended Consequences

For several reasons, MRP's eminent domain proposal would not actually achieve the goals of the JPA and would have negative unintended consequences for its Members and their constituents. Adopting what MRP calls its "business model" is, quite simply, poor public policy.

First, MRP's plan addresses the wrong mortgage loans for the stated public purpose of the program—that is, to reduce foreclosures. Rather than targeting loans that are currently in default and on the road to foreclosure – i.e., those that present an immediate danger to the San Bernardino County housing market – MRP's proposal only targets performing mortgage loans. It is impossible to identify particular performing loans that will end up in foreclosure proceedings, and most probably will not end up in default. Indeed, these are the borrowers who remained current through the economic crisis, shunned the opportunity for strategic default, and continue to honor their contractual obligations well after their loans went "underwater." It seems quite strange to formulate a proposal for preventing foreclosure and remedying blight that neither seeks to prevent imminent foreclosures nor directly addresses current blight. But defaulted mortgage loans are not nearly as valuable as performing mortgage loans, and therefore, not part of MRP's business model. Although we think that the use of eminent domain by the Authority to acquire delinquent loans would also have negative consequences, the use of eminent domain to acquire performing loans is particularly egregious.

Second, there is little logic to why MRP's plan targets only "private-label" securitized mortgage loans. The plan purportedly seeks to solve a "collective action problem" that limits loan modifications, but we are unaware of any prudent lending standards that would call for principal reduction for performing loans. To the extent loans are in default or are reasonably

[5] Although valuations will differ by loan, it is clear that MRP would not be paying anywhere near "fair market value" of the loan. By way of reference, researchers have estimated that the "fair market value" for a loan with a 660 FICO, 140 LTV, and 3.7% gross weighted average coupon would be at least 96% of the current market value of the property. This fact pattern is especially concerning when you consider that MRP would like to refinance the loan into an FHA loan that would price closer to 107% of par value. Id. at 12.

[6] See also, e.g., Debra Cassens Weiss, Local California Officials Consider Using Eminent Domain to Restructure Underwater Mortgages, ABA Journal (online), July 5, 2012, http://www.abajournal.com/news/article/local_california_officials_consider_using_eminent_domain_to_restructure_und/.

foreseeable to go into default, the vast majority of securitization contracts give the mortgage loan servicer significant discretion to engage in loss mitigation, including making various kinds of loan modifications.[7] Regardless, it is not clear why MRP would target only securitized loans, except based on an expectation that it is easier to proceed legally against out-of-state trusts managing the interests of a diverse group of investors, as compared to banks or the FHFA as conservator of Fannie Mae and Freddie Mac (which, notably, preclude principal reduction as a permitted form of loan modification). As a policy matter, many borrowers whose loans are held in a government security or a bank portfolio will get radically disparate treatment and not have their loan written down.

Third, MRP's plan threatens to restrict the availability of mortgage loans to potential homeowners in the San Bernardino housing market. As set forth in the June 28, 2012 letter[8] from ASF and numerous other organizations, MRP's plan would harm current mortgage loan investors, as it would compel the liquidation of performing loans at a "foreclosure discount," even though the loans are continuing to generate cash flow for their investors and are likely to eventually be paid off.[9] If the government reserves such power, the market would have to respond to this new risk. For example, most lenders in San Bernardino County will likely require substantially lower loan-to-value ratios and corresponding increases in down payments to guard against loans going "underwater," or take other measures that would reduce the pool of eligible borrowers able to buy homes. No lender will want to bear the risk that if the loan goes underwater, the city will seize the loan and flip it at the expense of the original lender and to the profit of MRP. Other lenders may simply choose not to serve San Bernardino County due to the potential risks associated with government intervention through eminent domain or otherwise. In addition, investors in mortgage loans (including investors in RMBS) may refuse to invest in mortgage loans that could be acquired through the Authority's exercise of eminent domain, which would ultimately reduce the availability of mortgage loans for borrowers in the San Bernardino market.

We note that actions are already being considered that could impair credit availability in San Bernardino County, including a potential decision to disqualify County loans from being included in the "to be announced" ("TBA") market.[10] The TBA market facilitates the bulk of trading of Fannie Mae and Freddie Mac loan pools and is the nation's preeminent source of mortgage credit. Constriction of credit for new borrowers is the opposite of what San Bernardino County needs. It means less ability for new borrowers to buy homes, resulting in reduced demand and the continued build-up of housing stock, thus reducing market values for all homes in the area. In fact, in the most recent minutes of the Federal Reserve Board of Governors

[7] See ASF's "Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans," June 2007, http://www.americansecuritization.com/uploadedfiles/asf%20subprime%20loan%20modification%20principles_060107.pdf.

[8] Available at: http://www.americansecuritization.com/uploadedFiles/Joint_Letter_on_JPA-San_Bernardino_6_28_12.pdf.

[9] It has been estimated that investors could be faced with loan loss severities in the neighborhood of 43% as a result. See "Global Securitized Products Weekly," Credit Suisse, July 12, 2012 at p. 8.

[10] See Nick Timiraos, Investor Group Fights Proposed Loan Seizures, WSJ.com, July 12, 2012, http://online.wsj.com/article/SB10001424052702304373804577523201696362254.html?KEYWORDS=investor+group+fights+proposed+loan.

Open Market Committee, the Committee cited tight lending standards as a primary cause for the slow housing recovery.[11] Finally, a further reduction in home prices could result in more underwater borrowers, and thus more seizures under MRP's proposal— a disastrous cycle.

Fourth, not only would MRP's proposal harm the San Bernardino housing market, it may also result in reduced property tax revenues for San Bernardino County. The tax assessment for a particular property is based on the "market value" of that property. Under the plan, a court would determine the fair market value of a mortgage loan based on the value of the underlying property, which would likely be lower than the assessed value for property tax assessment purposes. That would give the homeowner a legitimate basis to lower the property assessment, reducing the revenue that San Bernardino has available to provide municipal services that help support property values in the area.[12]

At base, MRP's plan rests on the premise that a private investment group can use governmental power to expropriate selected assets of other investors for its own use, and then flip them into government guaranteed FHA loans on the other bookend to earn substantial profits. That would be a dangerous and untenable national precedent, regardless of the public purpose asserted. But here, MRP's plan would not actually fulfill the JPA's objectives and instead would negatively impact the communities the JPA seeks to serve.

<u>The Plan to Use Eminent Domain to Acquire Mortgage Loans Is Legally Improper</u>

In addition to the proposal being ill-conceived as a policy matter, the eminent domain proposal raises numerous, fundamental legal issues. Press accounts have widely observed that the idea of using eminent domain to acquire mortgage loans is "unusual," but it is much more than that—the plan would be unlawful and unconstitutional as a matter of both state and federal law.

A. The Plan Is Not a Legitimate "Public Use" Under State or Federal Standards

Both the California Constitution and the U.S. Constitution allow takings only for a "public use." U.S. Const. amend. V; Cal. Const. art. I, § 19. Even in its broadest formulation, "public use" has never encompassed the situation envisioned here, where a private entity seeks to use a governmental agency as a vehicle to seize property for its direct use and profit.

Unsurprisingly, Professor Hockett cites to the U.S. Supreme Court's 5-4 decision in Kelo v. City of New London, 545 U.S. 469 (2005), but Kelo does <u>not</u> support the plan proposed here. In Kelo, the majority affirmed the city's power to take property for a comprehensive economic development of a "riverwalk" and marina area that involved converting the property for a variety of commercial, residential, and public recreational uses. Even the four-justice majority opinion and Justice Kennedy's concurring opinion were careful to distinguish that kind of comprehensive development project from a one-to-one taking of property to be given to another private party.

[11] See page 7 at: http://www.federalreserve.gov/newsevents/press/monetary/fomcminutes20120620.pdf.

[12] We note Tuesday's decision by San Bernardino city to seek bankruptcy protections. See Phil Willon, San Bernardino Seeks Bankruptcy Protection, Los Angeles Times (online), July 10, 2012, http://www.latimes.com/news/local/la-me-0711-san-bernardino-20120711,0,5646419.story.

The problem identified in City of Oakland arises here with equal, if not greater, force. MRP's proposal specifically targets mortgage loans that have been securitized in out-of-state transactions to back securities traded in interstate commerce. Indeed, a principal purpose and justification of the proposal is to remove individual mortgage loans from securitized "pools" and avoid contractual restrictions put in place by RMBS investors and servicers. Those contractual restrictions are a direct requirement of IRS REMIC regulations that ultimately regulate securitization trusts nationally. Such a proposal would undermine the securities backed by those loans and the applicable federal rules governing these transactions, thereby disrupting the securitization market as a whole, especially if it were adopted in multiple jurisdictions. The effect and burden on interstate commerce would be intentional and direct, rather than only "incidental" or "indirect," and would interfere with Congress's role in regulating the nationwide market.

For similar reasons, the eminent domain proposal would likely violate the U.S. Constitution's "Contracts Clause," which prohibits laws impairing the obligations of contracts. U.S. Const. art I, § 10; see also Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411-12 (1983). The Contracts Clause has frequently been applied to state action that limits creditors' rights or materially changes the nature of their security. See, e.g., U.S. Trust Co. of New York v. New Jersey, 431 U.S. 1 (1977) (violated Contracts Clause to repeal, in contract between two states, covenant that provided important protection to bondholders); Los Angeles v. Rockhold, 3 Cal. 2d 192 (1935) (act that materially changed security interests for bondholders and landowners declared invalid). Here, among other things, exercising eminent domain to compel a "foreclosure" sale of currently performing loans would impair RMBS investors' contractual rights to future cash flows and the value of their securities.

C. The Authority Cannot Assert Eminent Domain over Property Outside the County

Local agencies have the power of eminent domain only to the extent authorized by statute, see Cal. Code Civ. Proc. ("CCP") § 1240.020, and by statute, "[a] local public entity may acquire by eminent domain only property within its territorial limits," subject to exceptions not applicable here. CCP § 1240.050. "Statutory language defining eminent domain powers is strictly construed and any reasonable doubt concerning the existence of the power is resolved against the entity." Kenneth Mebane Ranches v. Superior Court, 10 Cal. App. 4th 276, 282-83 (1992) (rejecting extraterritorial exercise of eminent domain). Moreover, because eminent domain arises out of the power of the State as sovereign, see People v. Chevalier, 52 Cal. 2d 299, 304 (1959), the State lacks power to authorize the taking of property outside its boundaries. See Mayor & City Council of Baltimore v. Baltimore Football Club, Inc., 624 F. Supp. 278 (D. Md. 1986) (rejecting attempt to condemn football franchise that had moved out of state).

Here, MRP's proposal is to seize, not real property located in the County, but mortgage loans held by securitization trusts. In many, if not most, cases the trusts and notes evidencing the loans will be located outside the County and indeed the State. The "situs" for such rights typically is where the written instrument evidencing the rights (i.e., the note) is held or at the owner's domicile or business situs under the principle mobilia sequuntur personam ("the chattel follows the person"). See, e.g., Texas v. New Jersey, 379 U.S. 674 (1965) (adopting version of mobilia sequuntur personam principle for escheat determinations); S. Pac. v. McColgan, 68 Cal. App. 2d 48 (1945) (explaining "situs" of intangible property for tax purposes); Restatement

<u>Using Eminent Domain Will Also Involve Substantial and Costly Procedural Hurdles</u>

The foregoing discussion merely illustrates some of the legal issues that we have observed from our preliminary review; it is not an exhaustive list of the legal authority or arguments that can or would be raised against the eminent domain proposal. We expect in the coming weeks to continue our review of the legal and procedural infirmities of these proposals and will continue to convey those findings in a timely manner. Aside from these substantive issues, there are numerous procedural hurdles to implementing such a plan.

First, prior to initiating any eminent domain proceeding, the JPA will have to (a) notify the holder of each mortgage loan; (b) hold a hearing in which interested parties are given the opportunity to be heard; and (c) adopt a "resolution of necessity." See CCP §§ 1245.230, 1245.235.

Second, if eminent domain proceedings are commenced, defendants may seek to transfer venue to a neutral County and would have a right to do so if any defendants are not residents of, or doing business in, the County. See CCP § 1245.010; see also CCP §§ 394, 397. Regardless, interested parties will be able to challenge in court the Authority's right to take the property and will be able to conduct full discovery. See CCP §§ 1250.350-.360, 1258.010.

Third, while MRP's materials and Professor Hockett's Memorandum suggest that the JPA could use a "quick take" procedure, that is highly unlikely. The right to take will be disputed, and the JPA will not be able to make the requisite showings – including, for example, that there is an "overriding need" to take the property before final adjudication, and that absent immediate possession of the property the JPA will suffer a "substantial hardship" that outweighs the hardship to defendants. See CCP § 1255.410(d)(2).

Fourth, the substantial legal questions around the novel use of eminent domain in the proposal would certainly generate time-consuming litigation at the trial level, and if not struck down immediately at the trial level, would likely be appealed to the California and/or U.S. Supreme Courts. If the JPA does not prevail on the right-to-take issue, the JPA, and ultimately each Member of the JPA jointly and severally, will be liable for attorneys' fees, in addition to any other damage caused by any pre-condemnation activity. The tens of millions of dollars in litigation losses may push more cities in the County, or the entire County itself, into bankruptcy.

For these reasons, in addition to the policy issues and substantive legal problems, we urge that the JPA not include the use of eminent domain in the Program. There are far more reasonable ways for the JPA to pursue its goals than to follow an unprecedented, burdensome proposal that is legally unsupportable and, even if implemented, would do more harm than good for the San Bernardino County community.