SUBPRIME SOLUTIONS TO THE HOUSING CRISIS: CONSTITUTIONAL PROBLEMS WITH THE HELPING FAMILIES SAVE THEIR HOMES ACT OF 2009

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INTRODUCTION

In seventeenth-century Holland, tulip mania grasped the country, and prices for the bulbs skyrocketed to the point where the Dutch traded such personal belongings as furniture, jewels, and even land to acquire the most highly sought after tulips.[1] This price inflation is generally accepted as the first known asset bubble, the collapse of which devastated Dutch investors and spurred the government to attempt to intervene.[2] Since then, modern economies have seen the rise and fall of numerous asset bubbles.[3] The recent collapse of the American housing market is thus not unique.[4] There was a nationwide collapse in housing prices during the Great Depression, and more recently in the early 1990s, national housing prices declined as the Savings and Loan ("S&L") crisis unfolded.[5] Some experts have argued that the origins of the recent bubble can be traced back to the moral hazard created by the government's bailout of financial institutions during the S&L crisis and of Long Term Capital Management in 1998, as well as two decades of the Federal Reserve's loose monetary policy.[6]

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1 ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 177-79 (2000).

2 BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 35-36 (1999).

3 *Id.*

4 *See id.*

5 *See* Bob Ivry & Brian Louis, *U.S. Home Construction Bust May Last Until 2011*, BLOOMBERG, May 29, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aKQoeHb1MraI; *S&P/Case-Shiller Home Price Indices*, STANDARD & POOR'S (Sept. 29, 2009), www2.standardandpoors.com/spf/pdf/index/CSHomePrice_History_092955.xls.

6 *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 230 (2000); Stephen Spruiell, *Blame Not the Deregulator: It Was Market Distortions That Created the Bubble*, NAT'L REV., July 6, 2009, http://nrd.nationalreview.com/article/?q=ZjJhNzUxNTZhYTA0MDA4M2E3ZjZmMGMzMzk2NDgzNjY=; Eric Weiner, *Subprime Bailout: Good Idea or 'Moral Hazard?'*, NPR, Nov. 29, 2007, http://www.npr.org/templates/story/story.php?storyId=16734629.

Under both the Bush and Obama administrations,[7] the federal government's response to the current crisis has been broad and varied.[8] However, as often happens during crises, in the haste of formulating a response, the prudence and legality of some of the policies, legislation, and programs have not been adequately scrutinized by legislators, policy makers, and scholars.[9] One such piece of legislation is the Helping Families Save Their Homes Act of 2009 ("Homes Act"), signed into law on May 20, 2009.[10] The Homes Act revises the Consumer Credit Protection section of the United States Code, which deals with the duties of servicers of residential mortgage loans.[11] This Comment evaluates this specific provision of the Homes Act, which has the goal of reducing home foreclosures by encouraging mortgage loan servicers to modify applicable mortgage loans.[12] Because the vast majority of mortgage loans are held by investors in mortgage loan securitization trusts, and because these investors have certain contractual and property rights to those securitized mortgage loans, the Homes Act also provides mortgage lenders that modify mortgage loans with a safe harbor from potential litigation by such investors.[13] The safe harbor provision functions by statutorily providing that mortgage servicers will not be liable or subject to injunction, stay, or any other equitable relief when a servicer undertakes a "qualified loss mitigation plan" with respect to a residential mortgage loan on a primary residence.[14]

As with any new piece of legislation that modifies and affects individual contractual and property rights, three pertinent questions should be asked: (1) whether the legislation is constitutional; (2) whether the legislation will actually cure the problem it seeks to address; and (3) whether the legislation will have any detrimental ancillary effects.[15] With the goal of

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7 Jeff Zeleny, *Obama Weighs Quick Undoing of Bush Policy*, N.Y. TIMES, Nov. 9, 2008, *available at* http://www.nytimes.com/2008/11/10/us/politics/10obama.html.

8 *See generally* Anna T. Pinedo & Amy Moorhus Baumgardner, *Federal Mortgage Modification and Foreclosure Prevention Efforts*, 41 UCC L.J. 319, 320-22 (2009) (outlining the federal government's legislative, policy, and program responses to the housing crisis); *infra* note 15.

9 *See infra* note 15.

10 Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1632 (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.). For the specific language of the Homes Act, see *infra* Part I.B.3.

11 *Id.* (amending 15 U.S.C. § 1639a (2009)).

12 *Id.*

13 15 U.S.C. § 1639a.

14 *Id.* For a definition of "qualified loss mitigation plan," see *infra* note 134.

15 In the fallout from the housing crisis, the Homes Act has not been the only crisis-related governmental response to present constitutional concerns. Under the Troubled Asset Relief Program ("TARP"), created as part of the Emergency Economic Stabilization Act of 2008, the Secretary of the Treasury is authorized to require recipients of TARP funds to meet certain executive compensation requirements. Michael W. McConnell, *The Pay Czar Is Unconstitutional: Kenneth Feinberg Hasn't Been Confirmed by the U.S. Senate*, WALL ST. J., Oct. 29, 2009, http://online.wsj.com/article/SB10001424052748703574604574499953992328762.html. In late October

answering these questions about the Homes Act,[16] Part I of this Comment discusses the background of mortgage-backed securitization and the collapse of the housing market in an effort to better understand what type of corrective legislation is needed to achieve an effective response to the problem. Part II provides background on regulatory takings law. In light of that background, Part II then analyzes the constitutionality of the Homes Act under the Takings Clause of the Fifth Amendment, concluding that the Act raises serious constitutional concerns. Part III addresses the effectiveness of the Homes Act thus far, looking specifically at the only federal cases that have addressed the Act,[17] and concludes that the Homes Act will not effectively alter mortgage lenders' incentives to modify loans to the extent necessary to stave off a significant number of foreclosures. Finally, Part III looks for better solutions to achieve the desired outcome of the Home Act's safe harbor provisions, suggesting that certain Bankruptcy Code amendments originally proposed as part of the Homes Act might better effect the result sought by Congress, though not without raising similar constitutional concerns.[18]

2009, the so-called "Pay Czar" appointed by the Treasury Secretary cut—by approximately half—the salaries of executives at various banks receiving TARP funds. *Id.* Legal scholars have seriously questioned the constitutionality of these acts on different levels, including whether such a "Pay Czar" is required to be confirmed by the Senate. *Id.*

16 It should be noted that as a part of the recent North Carolina Banking Institute Symposium on the Foreclosure Crisis, a student note was published addressing the same issues presented by this Comment. Leila A. Hicks, Note, *The North Carolina Banking Institute Symposium on the Foreclosure Crisis: The Unintended and Unconstitutional Consequences of the Helping Families Save Their Homes Act*, 14 N.C. BANKING INST. 237 (2010).

17 Greenwich Fin. Servs. Distressed Mortgage Fund 3, LLC v. Countrywide Fin. Corp., 654 F. Supp. 2d 192 (S.D.N.Y. 2009), *appeal dismissed*, 603 F.3d 23 (2d Cir. 2010); Jones v. Premier One Funding, Inc., No. C-09-3858 SC, 2010 WL 841277 (N.D. Cal. Mar. 10, 2010); IndyMac Fed. Bank, F.S.B. v. Ocampo, No. EDCV 09-02337 PA (DTBX), 2010 WL 234828 (C.D. Cal. Jan. 13, 2010). These have been the only cases yet concerning mortgage modifications and the Homes Act's safe harbor provision. Two of the cases were remanded to state court for jurisdictional deficiencies and did not reach any decision on the merits of the safe harbor defense. However, the court in *Jones* directly addressed 15 U.S.C. § 1639a and concluded that the section does not require loan servicers to modify loans, but that it does "protect[] loan servicers who engage in modification activities from liability." *Jones*, 2010 WL 841277, at *3 (citing 15 U.S.C. § 1639a(b)). For a discussion of these cases, see *infra* Part III.A.

18 155 CONG. REC. S4915-38, S4943-53 (daily ed. Apr. 30, 2009), 2009 WL 1161264, at *D477 (voting down 51 to 45 Durbin Amendment No. 1014, which would have amended anti-modification provisions of the Bankruptcy Code to allow bankruptcy judges to modify the terms of mortgage loans on primary residences which otherwise are protected secured interests); *see* Elizabeth Williamson, *Plan to Let Judges Alter Loans Stalls*, WALL ST. J., Mar. 20, 2009, http://online.wsj.com/article/SB123749731025388627.html.

I. BACKGROUND: THE COLLAPSE OF THE HOUSING MARKET AND THE FEDERAL RESPONSE

A. *Mortgage-Backed Securitization Primer*

Securitization generally functions by pooling assets in a special purpose vehicle ("SPV"), usually structured as a trust, and then issuing securities through the SPV that are backed by those assets.[19] The process usually begins when a financial institution purchases (or originates itself) the assets that will eventually be securitized.[20] The financial institution, sometimes called the originator, then conveys or sells the assets to the SPV.[21] Once assets are pooled in a trust fund, the SPV then issues any number of securities, backed by those pooled assets, with different payment characteristics and priorities, a financial structuring technique called tranching.[22] For example, so-called senior securities have priority in receiving payments of principal and interest from the streams of payments on the underlying assets and thus receive the lowest interest rate, whereas the junior securities suffer losses on the assets first.[23] Thus, junior security investors receive a higher interest rate to compensate for their greater risk of not receiving the full return on their investment.[24] Payments on pooled assets like mortgage loans—both residential and commercial—are collected by the trust fund, and then the trustee makes periodic payments out of the trust fund to the security holders (investors) who are entitled to those payments by ownership of the security and by the terms of the transaction documents.[25] This process is economically valuable because it converts a large number of illiquid assets into a liquid financial instrument that can be marketed and

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[19] Leon T. Kendall, *Securitization: A New Era in American Finance*, *in* A PRIMER ON SECURITIZATION 1, 1-2 (Leon T. Kendall & Michael J. Fishman eds., 2000). Securities can be either bonds representing debt of the trust or certificates representing an undivided ownership interest in the assets of the trust fund. *See id.*

[20] Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1081-83 (2009).

[21] *Id.*

[22] The payment characteristics and priorities of the individual securities within the ordinary mortgage-backed securitization trust are very diverse. *See* Kendall, *supra* note 19, at 9-11. Certain securities can be structured to receive only interest or only principal payments or just the prepayment penalties from mortgage loans in the pool, for example. *Id.* The securities are almost always tranched with different payment priorities, creating various levels of bonds, classified generally as either senior or junior bonds. *Id.* The senior bonds have priority over the junior bonds in receiving payments from the trust fund. *Id.* When the trust fund sustains losses on the trust fund assets, these losses are usually assessed to the junior bonds first. *Id.* For an example of how this works, see *infra* note 305 and accompanying text.

[23] Robert Dean Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights*, 24 J. CORP. L. 295, 301 (1999).

[24] *See id.*

[25] *See* Kendall, *supra* note 19, at 1-2.

traded.[26] The investors that purchase the securities are integral in the development of the structure of the securities because the product that they will eventually hold must meet their risk appetite, interest rate requirements, payment needs, and short-term or long-term liability requirements.[27]

The first mortgage-backed securitizations were done by the Government National Mortgage Association ("Ginnie Mae") in 1970.[28] The industry in America subsequently expanded until 2007, in which year companies issued a total of $2.146 trillion in mortgage-backed securities, both residential and commercial ("RMBS" and "CMBS," respectively, and "MBS," collectively).[29] Fourth quarter statistics for 2009 show $9.188 trillion of MBS still outstanding.[30] This incredible growth in the MBS market has been invaluable in financing America's housing boom over the past three decades.[31] Mortgage-backed securitization is credited specifically with the continued availability of financing for housing after the failure of the thrifts during the S&L crisis of the late 1980s and early 1990s.[32] The MBS market has been able to finance America's homeowners because it attracts private capital, creates competition, which decreases the cost of credit, and generally provides stability to the mortgage lending market.[33]

Investors in these financial products during the boom years were not just Wall Street investment banks like Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley.[34] Such investment banks played an

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26 *Id.* at 2.

27 *Id.* at 5; *see generally* Laurence D. Fink, *The Role of Pension Funds and Other Investors in Securitized Debt Markets*, *in* A PRIMER ON SECURITIZATION, *supra* note 19, at 117-27.

28 STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE FUNDAMENTALS OF ASSET SECURITIZATION 3-4 (1990); *see* THOMAS H. STANTON, A STATE OF RISK: WILL GOVERNMENT-SPONSORED ENTERPRISES BE THE NEXT FINANCIAL CRISIS? 21-22 (1991). Salomon Brothers, an investment bank, improved upon the original design and issued a much more marketable mortgage-backed security in 1977, which spurred the growth of the S&L industry and concomitantly the U.S. housing market. Lewis S. Ranieri, *The Origins of Securitization, Sources of Its Growth, and Its Future Potential*, *in* A PRIMER ON SECURITIZATION, *supra* note 19, at 31, 31-33.

29 SIFMA Research & Statistics, *U.S. Mortgage-Related Securities Issuance*, SEC. INDUS. & FIN. MARKETS ASS'N, http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USMortgageRelatedIssuance.xls (last visited July 24, 2010). These statistics include both agency (government sponsored issuers, e.g., Ginnie Mae, Freddie Mac, and Fannie Mae) and non-agency (private issuers, e.g., Goldman Sachs) numbers for both RMBS and CMBS.

30 SIFMA Research & Statistics, *U.S. Mortgage-Related Securities Outstanding*, SEC. INDUS. & FIN. MARKETS ASS'N, http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USMortgageRelatedOutstanding.pdf (last visited July 24, 2010) (including both agency and non-agency RMBS and CMBS).

31 Leland C. Brendsel, *Securitization's Role in Housing Finance: The Special Contributions of the Government-Sponsored Enterprises*, *in* A PRIMER ON SECURITIZATION, *supra* note 19, at 17, 22.

32 *Id.* at 22-25.

33 *Id.* at 22.

34 *See* Brent J. Horton, *In Defense of Private-Label Mortgage-Backed Securities*, 61 FLA. L. REV. 827, 870 (2009).

integral role in issuing and underwriting MBS and, unfortunately for them, ended up holding the riskier junior bonds of the MBS products that they issued and underwrote.[35] However, the largest class of purchasers of the AAA-rated[36] MBS products were actually pension funds and other large institutional investors such as insurance companies and mutual funds.[37]

To put the securitization process and the effects of modifications of securitized mortgage loans in perspective, consider John Q. Homeowner, a life-long employee of Company Y. Company Y has provided him with a generous life insurance policy and pension plan for his retirement. When John takes out a typical thirty-year mortgage loan[38] from a bank against the house he is purchasing, he gets the title to the property.[39] However, at the same time, a lien is created against the property, which attaches to the title to benefit the creditor bank in the event that John defaults on his monthly

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35 *See id.* at 872.

36 Many institutional investors, such as pension funds and insurance firms, are restricted in the type of securities they can purchase and hold by the Banking Act of 1935. Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1117 (2009). Such investors may only purchase securities that receive a top credit rating from the credit rating agencies. *Id.* Credit ratings assess the risk of default of a particular security or debt instrument with "AAA" indicating the least likelihood of default. *Id.* at 1116. For example, according to Standard & Poor's, one of the industry's leading credit rating agencies:

> Credit ratings are opinions about credit risk published by a rating agency. They express opinions about the ability and willingness of an issuer, such as a corporation, state or city government, to meet its financial obligations in accordance with the terms of those obligations. Credit ratings are also opinions about the credit quality of an issue, such as a bond or other debt obligation, and the relative likelihood that it may default. Ratings should not be viewed as assurances of credit quality or exact measures of the likelihood of default. Rather, ratings denote a relative level of credit risk that reflects a rating agency's carefully considered and analytically informed opinion as to the creditworthiness of an issuer or the credit quality of a particular debt issue . . . . Standard & Poor's uses 'AAA', 'BB', or 'CC' to communicate relative credit risk, with 'AAA' denoting the strongest creditworthiness and 'C' or 'D' denoting the weakest, or that a default has occurred.

About Credit Ratings, STANDARD & POOR'S, http://www2.standardandpoors.com/aboutcreditratings/RatingsManual_PrintGuide.html (last visited July 4, 2010).

37 *See generally* Fink, *supra* note 27, at 117-27; Horton, *supra* note 34, at 873.

38 The typical thirty-year mortgage functions in this manner:

> [T]he typical residential mortgage loan has been a thirty-year fixed-rate loan requiring a level monthly payment of principal and interest. The payment amount is determined mathematically to ensure that the principal is fully paid by the maturity date. Accordingly, each monthly payment includes a principal payment, in an amount that initially is small but that grows gradually, and an interest payment, in an amount that initially is large but that declines gradually.

Thomas E. Plank, *Regulation and Reform of the Mortgage Market and the Nature of Mortgage Loans: Lessons from Fannie Mae and Freddie Mac*, 60 S.C. L. REV. 779, 784-85 (2009).

39 Julia Patterson Forrester, *Still Crazy After All These Years: The Absolute Assignment of Rents in Mortgage Loan Transactions*, 59 FLA. L. REV. 487, 493-94 (2007).

loan payments.[40] John uses the monthly salary he receives from Company Y to make the monthly interest and principal payments on the mortgage loan.

After the mortgage loan is originated, the mortgage lender sells the loan to an investment bank, which then securitizes it with thousands of other similar loans.[41] The investment bank, making a healthy profit in the process, issues securities backed by those pooled mortgage loans (including John's loan) and sells some of those securities to various investors.[42] One of those investors buying the securities backed by John's home mortgage is the pension fund that manages Company Y's pension plans.[43] Another is the insurance firm that provides John with his life insurance policy.[44] When John later defaults on his mortgage loan and the mortgage loan servicer reworks the terms of the loan, the security holders—Company Y's pension fund and the insurance firm—could very likely see a diminished stream of payments on the securities they hold.[45] While John might now have more manageable monthly payments on his mortgage loan, the loan modification could very well also indirectly affect John's future pension plan payments and his life insurance premium.[46]

If a significant number of mortgage loans are modified—as the government programs' supporters advocate in order to stem foreclosure rates—the collective effect on pension funds and insurance firms, which have heavily invested in RMBS, could be severe.[47] Besides seeing a reduction in payments on the securities they hold, these big institutional investors could suffer other adverse effects. Most notably, modifications of mortgages in a securitized mortgage loan pool would very likely result in downgrading of

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40 The creditor has a right, if John defaults on his mortgage payments, to foreclose on the property and seek to settle the outstanding balance on the mortgage loan with the proceeds from the sale of the property. *Id.* at 493-94. There are generally two theories of mortgage loans: title theory and lien theory. *Id.* Under title theory, the mortgage is viewed as transferring title of the property to the lender along with the right to possess the property in the event the borrower defaults. *Id.* Lien theory, which is now the majority theory, holds that a mortgage provides the lender with a lien on the property along with the right to the proceeds from the sale of the property in the event of foreclosure. *Id.* This Comment follows the lien theory for purposes of its analysis.

41 *See supra* note 19.

42 *See supra* note 22.

43 *See* Fink, *supra* note 27.

44 *See id.*

45 *See* Lesley Mitchell, *Need Help Lifting a Mortgage Burden?*, SALT LAKE TRIB., Mar. 20, 2010, http://www.sltrib.com/realestate/ci_14701076. For a more detailed explanation of the mechanics of loss attribution in an MBS trust, see *infra* note 305 and accompanying text.

46 Gretchen Morgenson, *A Reality Check on Mortgage Modification*, N.Y. TIMES, Apr. 25, 2009, http://www.nytimes.com/2009/04/26/business/26gret.html.

47 *See id.*; *Mortgage Investors Getting Protection from Obama's Housing Bill*, DAILY HEALTH CARE TIPS (Dec. 25, 2009), http://www.dailyhealthcaretips.com/health-care/mortgage-investors-getting-protection-from-obamas-housing-bill.html.

the RMBS's credit rating.[48] Because institutional investors like pension funds and insurance firms have certain federally-mandated rating requirements on the types of assets they may hold, such downgrades would trigger capital requirements necessitating that the institutions raise funds.[49] This in turn could adversely affect John's insurance policies and pension benefits.[50] In today's financial world, where markets are inextricably tied together, mortgage loan modification cannot be considered a zero-sum game. John might benefit by having a reduced mortgage loan payment in the short term, but he would also suffer in the long term with a reduction in the financial security of his pension fund and an increased premium on his life insurance policy.

The legal aspects of MBS can be quite complicated because of the sequencing of the multiple transactions, the legal structuring of the products, and the sheer volume of documentation.[51] Many different parties are involved in a securitization transaction, and their rights and obligations are usually defined in what is called a pooling and servicing agreement ("PSA").[52] A PSA governs the collection of mortgage payments from mortgagors and the eventual distribution of the funds to the security holders.[53] It also states the rights and protections of the investors who, by holding the security, are holders of an undivided ownership interest in the pool of mortgage loans.[54] Pursuant to the provisions of the PSA, a mortgage loan servicer is hired for the purpose of collecting payments from the mortgagors and depositing them into the trust.[55] A servicer's ability to modify mortgage loans is typically severely restrained under the terms of the PSA.[56] Modifications by the servicer may be limited to only a small number of loans in the pool, permitted only when default by the borrower is imminent, or may often only be allowed with the approval of the security holders.[57]

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48 *See, e.g.*, *Moody's Takes Action on $6B of Wells Fargo-Issued Jumbo RMBS*, STRUCTURED FIN. NEWS (Apr. 5, 2010), http://www.structuredfinancenews.com/news/-204756-1.html.

49 For an explanation of credit ratings, see *supra* note 36.

50 *See Mortgage Investors Getting Protection from Obama's Housing Bill*, *supra* note 47.

51 *See generally* SCHWARCZ, *supra* note 28. For an amusing yet informative and largely accurate cartoon explanation of the subprime crisis, see *The Subprime Primer*, http://docs.google.com/present/view?skipauth=true&id=ddp4zq7n_0cdjsr4fn (last visited July 4, 2010).

52 *See* Pinedo & Baumgardner, *supra* note 8, at 320-22.

53 *Id.*

54 *Id.*

55 *Id.*

56 *Id.*

57 *Id.* For example, the terms of one prospectus for an MBS offering, whose provisions are also memorialized in the transaction's PSA, provide:

> The Servicers may waive, modify or vary any term of any Mortgage Loan or consent to the postponement of strict compliance with any term of any Mortgage Loan so long as that waiver, modification or postponement is not materially adverse to the Trust Fund; *provided, however,* that unless the applicable Servicer has received the prior written consent of the Master Servicer[,] . . . the applicable Servicer may not permit any modification for any Mortgage Loan that would change the Mortgage Rate, defer or forgive the payment of prin-

Because the normal mortgage loan trust issuance is tranched into a large number of securities that are eventually held by multiple, different investors, obtaining approval could be burdensome, if not effectively impossible.[58] To ensure that ownership interests of security holders in the pooled assets are protected in the event of bankruptcy proceedings against the originator of the assets, the PSA also provides that the trustee will obtain a perfected security interest in the pooled mortgage loans.[59] This means that in the event of a bankruptcy proceeding against the originator, any investor holding a security issued by the SPV will have priority over a bankruptcy trustee or any third party in its interest in the SPV's assets.[60]

The sections of PSAs that deal with servicing of the pooled mortgage loans can vary among different MBS products and transactions, but analysis of a boilerplate sample is helpful to show how the terms are generally drafted.[61] A servicer's primary duty is to service and administer the mortgage loans, which primarily involves collecting monthly payments and depositing them into a bank account for the benefit of the trustee.[62] In carrying out this duty, servicers are generally allowed to "do any and all things which it may deem necessary or desirable in connection with such servicing and administration, . . . subject to the terms of this [PSA]."[63] This broad description of a servicer's power is usually qualified by reference to general mortgage loan servicing practices and is further limited by clauses that restrict the servicer to act only in a manner consistent with the interests of the trustee and investors: "the [servicer] shall take no action which is inconsistent with or prejudices the interest of the Trustee or the [investors] in any Mortgage Loan or the rights and interest of the Trustee or the [investors] under this [PSA]."[64] Servicers also have a duty under most PSAs to fore-

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> cipal or interest, reduce or increase the outstanding Scheduled Principal Balance (except for actual payments of principal) or change the final maturity date on that Mortgage Loan. In the event of any such modification that permits the deferral of interest or principal payments on any Mortgage Loan, the related Servicer must make an Advance. However, the related Servicer may not make or permit any modification, waiver or amendment of any term of any Mortgage Loan that would cause any REMIC created under the Trust Agreement to fail to qualify as a REMIC or result in the imposition of any tax.

Structured Asset Sec. Corp., Prospectus Supplement (Form 424B5), at 90 (Nov. 30, 2006).

58 Pinedo & Baumgardner, *supra* note 8.

59 SCHWARCZ, *supra* note 28, at 25-27.

60 *Id.* The elaborate structuring of asset-backed securities is largely driven by this need to create the SPV in such a manner that the assets it holds are "bankruptcy remote," i.e., safe from any bankruptcy proceeding initiated against the originator of the pooled assets. *See* STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION § 3:1 (3d ed. 2009).

61 *See* 7D CLARK A. NICHOLS, NICHOLS CYCLOPEDIA OF LEGAL FORMS ANNOTATED § 181:34 (2006).

62 *Id.* ¶¶ 3.01, 3.07.

63 *Id.* ¶ 3.01.

64 *Id.*

close on the properties of delinquent mortgage borrowers and distribute the proceeds to the trust account.[65]

Because modifications ultimately affect how securities pay out—which is an investor's primary concern—each PSA contains a section specifying how mortgage loan modifications may be carried out.[66] In collecting payments from mortgagors, servicers are allowed to utilize any method that they would normally use in collecting payments for mortgages held in their own portfolios.[67] For example, a servicer may be allowed to waive certain fees or extend due dates for payments.[68] However, when a servicer takes such an action, the modification section of the PSA will usually stipulate that the servicer must either advance funds equal to the amount of the waived fees or advance funds to the trust account to cover the extended payment due dates.[69] If there is a significant modification to a mortgage loan (or modifications to a significant number of mortgage loans), the servicer could be obligated to buy that mortgage loan out of the pool for the value of all outstanding principal and interest payments remaining on the mortgage or to substitute a similarly-structured mortgage loan back into the pool.[70]

Though many MBS were stamped AAA by rating agencies,[71] the credit rating agencies' formulas did not account for the effect of the stress of a nationwide drop in housing prices on the performance of the securities.[72] Yet, just like previous asset bubbles, the housing bubble burst, and America saw the first significant nationwide decrease in housing prices since the Great Depression.[73]

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65 *Id.* ¶ 3.14.

66 *See id.* ¶¶ 3.01, 3.07.

67 *See supra*, note 61, ¶ 3.07.

68 *Id.*

69 *Id.* ("In the event of any such arrangement, the [servicer] shall make timely advances on the related Mortgage Loan during the scheduled period in accordance with the amortization schedule of such Mortgage Loan without modification of it by reason of such arrangements.").

70 *See id.*

71 For an explanation of credit agency ratings, see *supra* note 36.

72 Felix Salmon, *Recipe for Disaster: The Formula That Killed Wall Street*, WIRED, Feb. 23, 2009, *available at* http://www.wired.com/techbiz/it/magazine/17-03/wp_quant; *Number-Crunchers Crunched*, ECONOMIST, Feb. 13, 2010, at 6.

73 *See* Henry Blodget, *Shiller: House Price Drop Could Be Worse Than the Great Depression*, BUS. INSIDER (Sept. 5, 2008), http://www.businessinsider.com/2008/9/shiller-house-price-drop-could-be-worse-than-the-great-depression. For a good explanation of the various causes of the housing crash, see Jason Kravitt, *Foreword* to CREDIT MARKET AND SUBPRIME DISTRESS: RESPONDING TO LEGAL ISSUES xlix, lvii-lxxi (J. Paul Forrester & John D. Van Gorp eds., 2009).

B. *Federal Response to the Housing Crisis*

1. Overview of Federal Government Responses

As the magnitude of the housing crisis became apparent, federal lawmakers progressively rolled out a broad range of responses, including voluntary, market-based federal agency programs, federal funding of local government and mortgage agency programs, and legislative acts.[74] These measures have generally been corrective, seeking to address the current collapse of the American housing market, but there have also been a number of proposals to reform the financial system and prevent future collapses.[75]

As the housing market began to collapse and delinquencies increased in late 2007, the federal government's first responses were voluntary and market-based. The Bush administration first implemented Hope Now, which sought to give subprime borrowers who were current on their mortgage payments, but who faced higher adjustable rates, the opportunity to refinance into lower-cost Federal Housing Administration ("FHA")[76] loans.[77] Due to strict eligibility requirements and the limited practical ability of the program to actually work out refinancings, Hope Now has failed to reach a significant number of borrowers and stem foreclosure rates.[78] The Bush administration implemented other voluntary programs, such as

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[74] *See generally* Pinedo & Baumgardner, *supra* note 8, at 322-25; Rachel D. Godsil & David V. Simunovich, *Protecting Status: The Mortgage Crisis, Eminent Domain, and the Ethic of Homeownership*, 77 FORDHAM L. REV. 949, 986-95 (2008); R. Travis Santos, Comment, *The Legal Way to Defeat Optimus Sub-Prime*, 25 EMORY BANKR. DEV. J. 285, 313-29 (2008).

[75] Of course, there have also been legislative proposals aimed at preventing the recurrence of another housing bubble, but this Part focuses on summarizing some of the federal government's major efforts at stabilizing housing prices and stemming foreclosure rates. *See, e.g.*, Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008). The Housing and Economic Recovery Act was omnibus legislation that included a number of regulatory reforms, such as creating the Federal Housing Finance Agency to oversee Fannie Mae and Freddie Mac and modernizing the FHA's lending standards. *Id.*; *see also* Pinedo & Baumgardner, *supra* note 8, at 322-23. Congress is also working on reforming the federal government's financial regulatory scheme through the Wall Street Reform and Consumer Protection Act of 2009, which passed the House on December 11, 2009. H.R. 4173, 111th Cong. (2009). Senator Christopher Dodd introduced similar legislation, the Restoring American Financial Stability Act of 2010, in the Senate on April 15, 2010. S. 3217, 111th Cong. (2010).

[76] The FHA insures certain home mortgage loans, which are originated with very small down payments to encourage home ownership. *See The Federal Housing Administration*, U.S. DEP'T OF HOUS. & URBAN DEV., http://www.hud.gov/offices/hsg/fhahistory.cfm (last visited July 21, 2010).

[77] Godsil & Simunovich, *supra* note 7474, at 986-87; Press Release, Hope Now, Hope Now Alliance Created to Help Distressed Homeowners (Oct. 10, 2007), *available at* http://www.fsround.org/media/pdfs/AllianceRelease.pdf.

[78] Ruth Simon & Tom McGinty, *Earlier Subprime Rescue Falters*: *December Plan Has Done Little to Help Borrowers in Dire Circumstances*, WALL ST. J., Feb. 13, 2008, http://online.wsj.com/article/SB120285480915463431.html.

FHASecure and the Hope for Homeowners program, which similarly attempted to get borrowers out of risky adjustable-rate mortgage loans and refinance them with FHA loans.[79]

Under the Housing and Economic Recovery Act of 2008, the federal government has also responded by opening its purse and directly funding a variety of state and local programs for mortgage counseling, purchasing of abandoned properties, and general financing for struggling homeowners.[80] This legislation also sought to prop up housing prices by encouraging housing sales through a tax credit for first-time home buyers.[81]These recent programs and policies, however, have not been without their own pitfalls and roadblocks. Significantly, the Obama administration, in deploying its loan modification incentive plans, has warned borrowers seeking modifications to be wary of putative "consultants" seeking to advise lenders—for a fee of course—on the modification process.[82]

In addition to these agency programs, there have also been legislative responses aimed at encouraging debt forgiveness for troubled homeowners. For example, the Internal Revenue Code was modified by the Mortgage Forgiveness Debt Relief Act of 2007, allowing taxpayers to exclude cancelled mortgage debt on a principal residence from their gross income for a period of three years.[83] The IRS has also provided protection for the tax exempt vehicles associated with the mortgage loan trusts, called real estate mortgage investment conduits ("REMIC"), which might otherwise lose their tax exempt status when mortgage loans in the trust fund are modified.[84] Yet, despite these efforts of the Treasury Department and the IRS,

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[79] Godsil & Simunovich, *supra* note 74, at 987-88; Press Release, U.S. Dep't of Hous. & Urban Dev., Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes: FHA to Implement New "FHASecure" Refinancing Product (Aug. 31, 2007), *available at* http://archives.hud.gov/news/2007/pr07-123.cfm; *HOPE for Homeowners*, U.S. DEP'T OF HOUS. & URBAN DEV., http://www.hud.gov/hopeforhomeowners/index.cfm (last visited July 21, 2010).

[80] Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008).

[81] *Id.* The legislation allows for an $8,000 tax credit for first-time home buyers. *Id.* § 3011. Originally set to expire at the end of 2009, the credit was extended by the Worker, Homeownership, and Business Act of 2009. Pub. L. No. 111-92, 123 Stat. 2984 (2009). According to Ron Phipps, Vice President of the National Association of Realtors, who testified before Congress in support of extending the tax credit, since the credit took effect, housing sales have increased by 600,000. *State of the Nation's Housing Market Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 2 (2009) (statement of Ron Phipps, Vice President, Nat'l Ass'n of Realtors), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=dc269554-093d-470a-a39e-d545f3f561ae&Witness_ID=b10a2a78-fd3e-43ac-8922-c4309e71c909.

[82] Edmund L. Andrews, *Mortgage Plan Targets up to Four Million Homeowners*, N.Y. TIMES, Mar. 5, 2009, http://www.nytimes.com/2009/03/05/business/economy/05loan.html; Jose A. Mendoza & Cassandra E. Hooks, *California Foreclosure Intervention: The Good, the Bad and the Ugly*, *in* CALIFORNIA FORECLOSURE: WHAT YOU NEED TO KNOW NOW 1, 5 (2009).

[83] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 121 Stat. 1803 (2007) (amending 26 U.S.C § 108(h) (2006)).

[84] Rev. Proc. 2007-72, 2007-52 I.R.B. 1257; Rev. Proc. 2008-47, 2008-31 I.R.B. 272.

serious tax considerations regarding the effect of modifications on securitization vehicles remain.[85]

Perhaps the most controversial legislation yet created is the Emergency Economic Stabilization Act of 2008 ("EESA") which began as the Treasury Department's $700 billion, three-page outline plan to purchase troubled assets from financial institutions.[86] Congress gradually amended and expanded the plan to include mortgage modification and foreclosure provisions, enacting it on October 3, 2008.[87] During deliberations on the bill, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs Christopher Dodd noted that home ownership was a priority of the legislation: "This is not an ancillary objective; it is inherent, in my view, to our efforts to resolve this economic crisis."[88] The approximately $700 billion Troubled Asset Relief Program ("TARP") created by the EESA was made available for use by the Treasury Department to purchase "troubled assets."[89] The foreclosure mitigation provisions of EESA also give the Treasury authority to manage and modify all of the mortgage-related assets that it purchases with TARP funds.[90]

When President Obama took office, his administration refocused the Treasury Department's use of the funds by pledging to use no less than $50 billion of the EESA funds on foreclosure prevention plans.[91] These funds, as outlined in Obama's Financial Stability Plan,[92] are channeled through three programs: (1) the Making Home Affordable program allows Freddie Mac and Fannie Mae to modify mortgage products they own or insure with

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85 *See* Pinedo & Baumgardner, *supra* note 8, at 321, 334-35.

86 Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

87 *Id.*

88 154 CONG. REC. S10,224 (daily ed. Oct. 1, 2008), 2008 WL 4425677, at *S10,224 (statement of Sen. Dodd).

89 "Troubled Assets" (also called toxic assets or toxic securities) are defined by the Congressional Budget Office as:

> (A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and (B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.

CONG. BUDGET OFFICE, THE TROUBLED ASSET RELIEF PROGRAM: REPORT ON TRANSACTIONS TROUGH DECEMBER 31, 2008 1 (2009), *available at* http://www.cbo.gov/ftpdocs/99xx/doc9961/01-16-TARP.pdf.

90 Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 109, 122 Stat. 3765, 3774-75 (2008).

91 Letter from Lawrence H. Summers, Director-Designate, Nat'l Econ. Counsel, to Rep. Nancy Pelosi, Speaker, U.S. House of Representatives, Rep. John Boehner, Republican Leader, U.S. House of Representatives, Sen. Harry Reid, Majority Leader, U.S. Senate, & Sen. Mitch McConnell, Republican Leader, U.S. Senate (Jan. 15, 2009), *available at* http://financialservices.house.gov/summers011509.pdf.

92 *See generally* U.S Dep't of the Treasury, *Financial Stability Plan Fact Sheet*, FIN. STABILITY, http://www.financialstability.gov/docs/fact-sheet.pdf (last visited July 23, 2010) (outlining the administration's plan and where the funds are channeled).

fewer restrictions on the types of loans that may be modified than under previous programs;[93] (2) the Home Affordable Modification Program provides standardized guidelines[94] for modifying mortgage loans and includes incentives for servicers, lenders, and investors to pursue modifications in the form of $1,000-per modification payments;[95] and (3) a number of spending measures strive to build confidence in Freddie Mac and Fannie Mae, such as by purchasing MBS issued by the two government-sponsored entities.[96]

However, some of these programs, including the Making Home Affordable program and the Home Affordable Modification Program, have turned out to be ineffective.[97] In fact, some critics suggest that the programs have actually hurt homeowners by falsely leading them to believe that they can afford to own homes, even with modified mortgage loans, when in fact they still cannot afford homes at the lower rates.[98] Legislators have advocated for more exacting legislation and more aggressive action by federal agencies. For example, U.S. Representative Maxine Waters of California, Chairwoman of the Financial Services Subcommittee on Housing and Community Opportunity, recently advocated that the Attorneys General from all fifty states coordinate the filing of a class action lawsuit against the nation's mortgage lenders in an effort to force them to engage in more mortgage loan modifications to stave off foreclosures.[99]

Interestingly, one thing that the TARP funds have not really been used for is the purchase of "troubled assets," the very purpose for which the

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[93] U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE: SUMMARY OF GUIDELINES (2009), *available at* http://www.treas.gov/press/releases/reports/guidelines_summary.pdf.

[94] Importantly, the guidelines require that any modification comply with the contractual provisions of the PSA for any securitized mortgage loan. U.S. DEP'T OF THE TREASURY, HOME AFFORDABLE MODIFICATION PROGRAM GUIDELINES 1 (2009), *available at* http://www.treas.gov/press/releases/reports/modification_program_guidelines.pdf.

[95] *Id.*

[96] Press Release, U.S. Dep't of the Treasury, Statement by Secretary Tim Geithner on Treasury's Commitment to Fannie Mae and Freddie Mac (Feb. 18, 2009), *available at* http://www.financialstability.gov/latest/tg32.html.

[97] Peter S. Goodman, *U.S. Loan Effort Is Seen as Adding to Housing Woes*, N.Y. TIMES, Jan. 2, 2010, at A1; James R. Hagerty, *Mortgage-Rescue Program Benefits More Homeowners*, WALL ST. J., Mar. 13, 2010 , at A2 (reporting that although the program continues to take on more homeowners, approximately 90,000 have already dropped out because they were unable meet the decreased monthly payments).

[98] *See* David Streitfeld, *Defaults Rise in Loan Modification Program*, N.Y. TIMES, Apr. 14, 2010, at B1; Jonathan Hoenig, *The Plan to Stop Foreclosures Has Failed*, SMARTMONEY (Feb. 18, 2010), http://www.smartmoney.com/investing/economy/the-plan-to-stop-foreclosures-has-failed.

[99] Press Release, Maxine Waters, U.S. Representative, Congresswoman Maxine Waters Calls for More Class Action Lawsuits to Prevent Foreclosures (Oct. 19, 2009), *available at* http://www.house.gov/apps/list/press/ca35_waters/PR091019_lawsuits.html.

funds were originally allocated.[100] Instead, a vast majority of the funds have been used to purchase stock in struggling financial institutions like American International Group ("AIG").[101] Undoubtedly, the landscape of legislative and executive action will continue to change as foreclosures rise and the housing crisis continues to unfold.[102]

2. Proposed Amendments to the Bankruptcy Code

Another major aspect of the federal response has been various attempts to revise the Bankruptcy Code.[103] Because homeowners who are facing foreclosure are often not far removed from potential bankruptcy proceedings,[104] Congress has focused particularly on amending the Bankruptcy Code.[105] Before looking at the amendments that are currently being contemplated by Congress, a brief review of the history of the current form of the Bankruptcy Code is necessary.

When the Bankruptcy Code was enacted in 1978, it included a safe harbor provision for Chapter 13 bankruptcy[106] meant to protect mortgages on a debtor's principal residence from modification.[107] Under federal bankruptcy law prior to the Code's enactment, all secured creditors had to confirm a bankruptcy payment plan.[108] Originally, the U.S. House of Representatives' version of the 1978 amendments allowed Chapter 13 bankruptcy

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100 *See* CONG. BUDGET OFFICE, THE TROUBLED ASSET RELIEF PROGRAM: REPORT ON TRANSACTIONS THROUGH JUNE 17, 2009 2 (2009), *available at* http://www.cbo.gov/ftpdocs/|100xx/doc10056/06-29-TARP.pdf.

101 *See id.*

102 *See, e.g.*, Joshua Ruby, Note, *Sound and Fury, Confused Alarms, and Oversight: Congress, Delegation, and Effective Responses to Financial Crises*, 47 HARV. J. ON LEGIS. 209 (2010).

103 Ryan Grim, *Cramdown Is Back: Banks Against Homeowners, Round 2*, HUFFINGTON POST (Sept. 8, 2009), http://www.huffingtonpost.com/2009/09/08/cramdown-is-back-banks-v_n_280126.html.

104 FRANK S. ALEXANDER, GEORGIA REAL ESTATE FINANCE AND FORECLOSURE LAW § 12:5 (2009-10 ed., Thomson-West 2009).

105 For a good discussion of recent efforts to amend the Bankruptcy Code to ease the modification of mortgage loans, see Santos, *supra* note 74, at 286-88.

106 Whereas Chapter 7 governs the liquidation of a debtor in bankruptcy, both Chapters 11 and 13 govern debtor reorganizations. *See* 11 U.S.C. §§ 701-784 (2006). Chapter 11 covers the reorganizations of businesses, and Chapter 13 deals with the reorganization of individual debtors. 11 U.S.C. §§ 1101-1174 (2006); 11 U.S.C. §§ 1301-1330 (2006).

107 Robert M. Zinman & Novica Petrovski, *The Home Mortgage and Chapter 13: An Essay on Unintended Consequences*, 17 AM. BANKR. INST. L. REV. 133, 135 & n.9 (2009) (citing Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (enacting Title 11 of the United States Code governing bankruptcy proceedings)). The specific safe harbor provision can be found at 11 U.S.C. § 1322(b)(2) (2006).

108 Zinman & Petrovski, *supra* note 107, at 135; 11 U.S.C. § 1052(1) (1976) (originally enacted as 13 U.S.C. § 652(1)).

plans to modify the rights of any holder of a secured or unsecured claim.[109] However, the Senate objected, seeking protection for claims secured by mortgages on real property.[110] The Senate had been swayed by arguments made by representatives of the mortgage banking industry that the House bill, if adopted, would "cause residential mortgage lenders to be extraordinarily conservative in making loans in cases where the general financial resources of the individual borrower are not particularly strong," thereby constricting the flow of credit to the mortgage market.[111] The House and Senate ultimately compromised with a bill allowing modification of secured and unsecured claims, but providing a safe harbor from modification for claims "secured only by a security interest in real property that is the debtor's principal residence."[112] This compromise, it would seem, was not just a protection for mortgage lenders, but also a positive legislative effort to encourage home ownership.[113]

Since the fall of 2007, Congress has made various attempts to amend this safe harbor provision and allow the terms of mortgage loans on debtors' principal residences to be reworked in bankruptcy.[114] The Durbin Amendment, named after its sponsor Senator Richard Durbin and originally part of the Homes Act, would have allowed bankruptcy judges to modify the terms of certain mortgage loans on primary residences (colloquially called "cramdown" because judges can force new mortgage loan terms on lenders).[115] The Durbin Amendment did not attempt to permanently modify the language of 11 U.S.C. § 1322(b)(2)—the Bankruptcy Code's safe harbor provision for primary residential homes—but rather would have allowed the modification of mortgage loans that were originated before the passage of the legislation and were currently facing foreclosure (i.e., more than sixty days delinquent).[116] Permissible mortgage modifications would have included extending the term of payment, lowering the interest rate, or

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109 Zinman & Petrovski, *supra* note 107, at 136 & n.12.

110 *Id.* at 136 & n.13.

111 *Id.* at 136-37 (quoting *Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the Comm. on the Judiciary*, 95th Cong. 702-21 (1977) (statement of Edward J. Kulik, Senior Vice President of Real Estate Div., Mass. Mutual Life Ins. Co.)) (internal quotation marks omitted).

112 11 U.S.C. § 1322(b)(2); Zinman & Petrovski, *supra* note 107, at 136. For a discussion of the only Supreme Court case to rule on § 1322(b)(2), see *infra* notes 274-84 and accompanying text.

113 *See* Zinman & Petrovski, *supra* note 107, at 138 (suggesting that the 11 U.S.C. § 1322(b)(2) safe harbor "was in large measure an experiment in social engineering through the Bankruptcy Code, an experiment that had unintended consequences for the lenders, borrowers and the national economy").

114 153 CONG. REC. S12,533 (daily ed. Oct. 3, 2007), 2007 WL 2872598, at *S12,533-38 (introducing Senator Richard Durbin's Helping Families Save Their Homes Act of 2007, S. 2136, 110th Cong. (2007), which would have permitted bankruptcy plans to modify certain mortgage loans when debtors had insufficient funds to satisfy their mortgage payments).

115 155 CONG. REC. S4980 (daily ed. Apr. 30, 2009), 2009 WL 1161161, at *4980-81 (introducing Durbin Amendment No. 1014 to S. 896, 111th Cong.).

116 *Id.* § 503.

writing down the principal balance to the fair market value of the property.[117] These are the same types of modifications expressly prohibited by most PSAs.[118] On April 30, 2009, the Senate rejected the Durbin Amendment in the face of strong opposition from the financial services industry and both Democratic and Republican senators.[119] Subsequently, the Homes Act passed on May 20, 2009 without any of the so-called bankruptcy "cramdown" provisions.[120]

However, as evidenced by the lengthy time period over which the bankruptcy amendments have been considered and the number of different legislative proposals that have been discussed by Congress, it is not surprising that legislators continue to consider revising the Bankruptcy Code to include some sort of cramdown provision.[121] Though House Financial Services Committee Chairman Barney Frank stated that the same cramdown legislation dropped from the Homes Act would be incorporated in the financial regulatory reform bill currently being considered by Congress,[122] the House version of the regulatory bill, which passed on December 11, 2009, does not include any modifications to the bankruptcy code.[123] While the House considered the bill, Representative John Conyers introduced an amendment nearly identical to the Durbin Amendment, but, as was the case with the Senate bill, the House rejected it.[124] The financial services industry again lobbied strongly against the inclusion of cramdown legislation, and won.[125]

The advantages and disadvantages of the Bankruptcy Code's safe harbor provision, or alternately, cramdown, have been long and vigorously debated.[126] The financial services industry came down firmly on the side of

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[117] *Id.*

[118] *See supra* note 57 and accompanying text.

[119] 155 CONG. REC. S4915-38, S4943-53, *supra* note 18 (voting down 51-45 Durbin Amendment No. 1014); Williamson, *supra* note 18; Press Release, Am. Bankers Ass'n, ABA Statement in Opposition to Agreement on Mortgage Cram-down Legislation (Jan. 9, 2009), *available at* http://www.aba.com/Press+Room/010909MortgageCramDownLegislation.htm; Press Release, Mortgage Bankers Ass'n, Courson and Kittle React to Mortgage Cramdown Deal (Jan. 8, 2009), *available at* http://www.mbaa.org/NewsandMedia/PressCenter/67030.htm.

[120] *See* Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1632 (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

[121] *See* Santos, *supra* note 74, at 317-28.

[122] Grim, *supra* note 103.

[123] *See* Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009); 155 CONG. REC. H14,762-63 (daily ed. Dec. 11, 2009), 2009 WL 4729870, at *D1451-52 (failing by a vote of 188-241).

[124] 155 CONG. REC. H14,762-63, *supra* note 123.

[125] *Congress Rejects Measure to Help Struggling Families Amid Shower of Special Interest Money*, PR NEWSWIRE (Dec. 16, 2009), http://www.prnewswire.com/news-releases/congress-rejects-measure-to-help-struggling-families-amid-shower-of-special-interest-money-79415147.html.

[126] *See supra* Part I.B.2; *see also* Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565 (2009); Julia Patterson Forrester, *Bankruptcy*

the safe harbor provision in 1978 when the Bankruptcy Code was being enacted, and the industry has again come to its defense during the current crisis.[127] Interestingly, as the case dealing with the Homes Act demonstrates, financial industry participants have also come down against the provision of the Homes Act protecting mortgage loan servicers that modify mortgage loans from litigation.[128]

3. The Homes Act

After passing the House on March 5, 2009,[129] the Homes Act was introduced on the Senate floor on April 24, 2009.[130] The original text of the Homes Act already included the servicer safe harbor provision for mortgage loan modifications under section 201.[131] It is unclear from the congressional record what Congress's exact reasoning was behind its inclusion of the provision. However, because the provision was already part of the text of the legislation before the Durbin Amendment was introduced and voted down, it can be said that that the safe harbor provision was not originally intended to serve as a substitute for cramdown. Regardless of the motive behind section 201, it still has the potential to produce the same result as cramdown if given effect by courts, and thus raises similar constitutional concerns.[132] This Comment will thus draw analogies to the cramdown amendments in order to make observations about the implications of section 201 of the Homes Act.

The final version of section 201 of the Homes Act amended the language of 15 U.S.C. § 1639a—which deals with the duties of residential mortgage loan servicers—to read as follows:

Takings, 51 FLA. L. REV. 851 (1999); James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973 (1983). *Compare* Gelpern & Levitin, *supra* note 20, at 1149-52 (arguing that the rigidity of PSAs is halting housing recovery and that bankruptcy courts should be allowed to rework them), *with* Mark S. Scarberry, *A Critique of Congressional Proposals to Permit Modification of Home Mortgages in Chapter 13 Bankruptcy*, 37 PEPP. L. REV. 635, 641-44 (2010) (arguing that the proposed amendments to the bankruptcy code would have substantial negative effects on future mortgage interest rates and mortgage availability and refuting Levitin's empirical evidence to the contrary).

127 *See supra* Part I.B.2.

128 *See infra* Part III.A.

129 H.R. 1106, 111th Cong., 155 CONG. REC. H2986, H2994 (daily ed. Mar. 5, 2009), 2009 WL 562368, at *H2986, *H2994 (enacted by a vote of 239-181).

130 S. 896, 111th Cong., 155 CONG. REC. S4721 (daily ed. Apr. 24, 2009), 2009 WL 1103579, at *S4721.

131 Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, div. A, tit. II, § 201, 123 Stat. 1632, 1638-40 (2009).

132 *See infra* Part II.

> (a) *In General* . . . [W]henever a servicer of residential mortgages agrees to enter into a qualified loss mitigation plan with respect to 1 or more residential mortgages originated before May 20, 2009, including mortgages held in a securitization or other investment vehicle-- (1) to the extent that the servicer owes a duty to investors or other parties to maximize the net present value of such mortgages, the duty shall be construed to apply to all such investors and parties, and not to any individual party or group of parties; . . . (b) *No liability*[.] A servicer that is deemed to be acting in the best interests of all investors or other parties under this section shall not be liable to any party who is owed a duty under subsection (a)(1), and shall not be subject to any injunction, stay, or other equitable relief to such party, based solely upon the implementation by the servicer of a qualified loss mitigation plan . . . . (d) *Scope of safe harbor*[.] Any person, including a trustee, issuer, and loan originator, shall not be liable for monetary damages or be subject to an injunction, stay, or other equitable relief, based solely upon the cooperation of such person with a servicer when such cooperation is necessary for the servicer to implement a qualified loss mitigation plan that meets the requirements of subsection (a).[133]

Section 1639a provides that when a servicer of residential mortgage loans enters a qualified loss mitigation plan,[134] "to the extent that the servicer owes a duty to investors or other parties to maximize the net present value of such mortgages, the duty shall be construed to apply to all such investors and parties, and not to any individual party or group of parties."[135] The purpose of the this sub-article is to overcome the problem of dealing with value maximization calculations that would be prohibitively difficult due to the fact that the different pieces of any one mortgage-backed security, all of which could be held by different investors, can have vastly different payment characteristics.[136] Thus, it would be immensely difficult to perform modifications that would maximize the value of each of the diverse securities.

The clause begins by stating that the servicer might owe a duty to maximize the "net present value"[137] of the mortgage loans in the pool,[138] but it is uncertain from where such a duty arises unless the duty is imposed by the Homes Act itself.[139] Certain PSA provisions make strict and clear re-

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133 15 U.S.C. § 1639a(a), (b), (d); Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, div. A, tit. II, § 201(b), 123 Stat. 1632, 1638-40 (2009).

134 "Qualified loss mitigation plan" under this section of the Housing Act means:

> (A) a residential loan modification, workout, or other loss mitigation plan, including to the extent that the Secretary of the Treasury determines appropriate, a loan sale, real property disposition, trial modification, pre-foreclosure sale, and deed in lieu of foreclosure, that is described or authorized in guidelines issued by the Secretary of the Treasury or his designee under the Emergency Economic Stabilization Act of 2008; and (B) a refinancing of a mortgage under the Hope for Homeowners program . . . .

15 U.S.C. § 1639a(f)(1)(A)-(B).

135 15 U.S.C. § 1639a(a)(1).

136 *See supra* note 22 and accompanying text.

137 The Homes Act does not clearly define "net present value." *See* 15 U.S.C. § 1639a.

138 "[T]o the extent that the servicer owes a duty to investors or other parties to maximize the net present value of such mortgages, the duty shall be construed to apply to all such investors and parties, and not to any individual party or group of parties . . . ." 15 U.S.C. § 1639a(a)(1).

139 15 U.S.C. § 1639a, *amended by* Pub. L. No. 111-22, div. A, tit. II, § 201(b), 123 Stat. 1632, 1638-40 (2009).

strictions on the modifications that are permissible by mortgage servicers and do not generally prescribe a present value-maximization rubric.[140] Prior to the enactment of the Homes Act, 15 U.S.C. § 1639a was titled "Fiduciary duty of servicers of pooled residential mortgages," but the current version omits the term "fiduciary."[141] What was the meaning of this change? Was it purposeful? Was its prior inclusion erroneous? The congressional record is not helpful in clarifying this change. Even if servicers owe a fiduciary duty[142] to investors, either individually or collectively with regards to the entire mortgage loan trust, that duty could only be carried out properly by the servicer compensating the trust fund with funds equal to the amount of the deficiency in funds created by any mortgage loan modification (as measured by the difference between the value to maturity of the mortgage loans before and after modification).[143]

Because this provision of the Homes Act attempts to preclude MBS investors from suing servicers when they modify mortgage loans through the creation of the safe harbor, and because the PSA sections generally require a servicer that modifies a mortgage loan to buy that modified mortgage loan out of the pool in an amount equal to the sum of the loan's outstanding principal balance and the remaining interest payments thereon,[144] section 201 of the Homes Act can effectively abrogate the investors' contractual rights and result in a regulatory taking of their property.[145] A trio of Columbia University scholars[146] advocating a similar proposal recognized that such proposals present legitimate constitutional concerns.[147] However, their cursory constitutional analysis concluded that such an abrogation of rights would not be unconstitutional, either as a regulatory taking under the Fifth Amendment or as a violation of the Due Process Clause.[148] Specifically with regard to regulatory takings, the scholars argued that a takings issue would not arise because the government does not directly benefit from the modified contractual rights.[149] Rather, "homeowners, investors, and

140 *See supra* notes 61-70 and accompanying text.

141 15 U.S.C. § 1639a, *amended by* Pub. L. No. 111-22, div. A, tit. II, § 201(b), 123 Stat. 1632, 1638-40 (2009).

142 A fiduciary is "[a] person who is required to act for the benefit of another person on all matters within the scope of their relationship" or "[o]ne who must exercise a high standard of care in managing another's money or property." BLACK'S LAW DICTIONARY 658 (8th ed. 2004).

143 *See supra* notes 61-70 and accompanying text.

144 *See id.*

145 *See id.*

146 Christopher Mayer, Senior Vice Dean and Paul Milstein Professor of Real Estate, Columbia Business School; Edward Morrison, Professor of Law, Columbia Law School; and Thomasz Piskorski, Assistant Professor of Finance and Economics, Columbia Business School.

147 Christopher Mayer et al., *A New Proposal for Loan Modifications*, 26 YALE J. ON REG. 417, 424-25 (2009).

148 *Id.* (finding proposal to allow mortgage loan modifications not to be in violation of the Fifth Amendment takings clause).

149 *Id.* at 425.

servicers" would benefit from the modification of mortgage loans.[150] As the following analysis of regulatory takings and its application to the Homes Act safe harbor will demonstrate, this is not correct.

II. ANALYSIS OF THE CONSTITUTIONALITY OF THE ACT

This Comment will now outline regulatory takings jurisprudence and then apply it to the Homes Act safe harbor provision to determine the validity of a constitutional challenge to the new legislation.

A. *Regulatory Takings Jurisprudence*

It has long been accepted in Anglo-Saxon law that private property rights must at times yield to the superior right of the sovereign to condemn privately-held land and use it for the general public welfare.[151] The sovereign's power over the domain (or "eminent domain") was not originally granted in written constitutions, but rather presumed as an inherent power of the sovereign.[152] English barons eventually explicitly restricted this power by forcing King John to sign the Magna Carta in 1215.[153] The specific clause stated: "No Freeman shall be taken, or imprisoned, or be disseized of his Freehold . . . but by lawful Judgement [sic] of his Peers, or by the Law of the Land."[154] Such early constitutional provisions, which generally required that any exercise of eminent domain be carried out under a lawful judgment, did not explicitly require compensation when the sovereign exercised its inherent power.[155] However, just compensation gradually became the standard legal practice whenever the state exercised its eminent domain power.[156]

America subsequently inherited England's body of eminent domain law.[157] While it was assumed that the individual states were able to exercise eminent domain over their respective state lands,[158] in 1875 the U.S. Supreme Court firmly established in *Kohl v. United States*[159] that the federal government could exercise the power of eminent domain over all American

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150 *Id.*

151 ELLEN FRANKEL PAUL, PROPERTY RIGHTS AND EMINENT DOMAIN 72 (1987).

152 *Id.* at 74.

153 *Id.* at 72.

154 *Id.* (quoting MAGNA CARTA art. 29 (1297) (c. 9)) (internal quotation marks omitted).

155 *Id.* at 72-73.

156 *Id.* at 73.

157 *See* PAUL, *supra* note 151, at 72-73.

158 Kohl v. United States, 91 U.S. 367, 371 (1875).

159 91 U.S. 367 (1875).

land.[160] The Court derived this power from the text of the Constitution's Fifth Amendment.[161]

At the same time, the Fifth Amendment constrains the federal government's eminent domain power: "[N]or shall private property be taken for public use, without just compensation."[162] The purpose of the "Takings Clause," as it is known, is in part to protect citizens from the government confiscating their property and giving it to others,[163] and also in part to ensure that if the government does take private property to benefit society's general welfare, then the loss suffered by the individual property owner is shared by society.[164] The Supreme Court has emphasized that the "Just Compensation Clause" "was designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[165] Thus, the Court's takings jurisprudence has sought to "prevent[] the public from loading upon one individual more than his just share of the burdens of government."[166]

Parsing out the elements of the Takings Clause, the first question is what constitutes a taking? The Supreme Court has established three rather clear categorical rules for determining whether or not a taking exists.[167] The first category encompasses government action that directly appropriates property or functions as a practical ouster of the owner from possession of his property (e.g., taking private real estate for the development of a federal highway).[168] The second category holds that a taking has occurred when

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160 *Id.* at 371 ("The powers vested by the Constitution in the general government demand for their exercise the acquisition of lands in all the States.").

161 PAUL, *supra* note 151, at 73. The Supreme Court derived this power as an implied right stemming from the Fifth Amendment, which states "nor shall private property be taken for public use without just compensation." U.S. CONST. amend. V; *see also Kohl*, 91 U.S. at 372-73. For a more thorough analysis of the evolution of eminent domain law in America, see JACQUES B. GELIN & DAVID W. MILLER, THE FEDERAL LAW OF EMINENT DOMAIN (1982).

162 U.S. CONST. amend. V. Although both federal and state governments may exercise the power of eminent domain, only the federal government's power is of interest for purposes of this Comment. ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES § 8.4.1, at 639 (3d ed. 2006). Article I, § 10 of the Constitution, which states that "No State shall . . . pass any . . . law impairing the Obligation of Contracts," may seem relevant to this Comment's analysis, but it is firmly established that the Contracts Clause only applies to state and local governments, not to the federal government, and thus would not be involved in a constitutional analysis of recent federal legislation. *Id.* § 8.3.1, at 629.

163 CHEMERINSKY, *supra* note 162, § 8.4.1, at 640.

164 *Id.* at 640-41 (citing Armstrong v. United States, 364 U.S. 40, 49 (1960)).

165 *Armstrong*, 364 U.S. at 49.

166 Monongahela Navigation Co. v. United States, 148 U.S. 312, 325 (1893).

167 Lucas v. S.C. Coastal Council, 505 U.S. 1003, 1014-17, 1029-30 (1992).

168 *Id.* at 1014; *see also* Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982) (finding that a New York law requiring landlords to permit cable companies to place television cable equipment on their buildings was such a physical taking).

regulation "denies all economically beneficial or productive use of land."[169] The third categorical rule is referred to as the nuisance exception.[170] It holds that when a law regulates something that under general legal principles would be considered a nuisance, and at the same time renders land valueless to the property owner, such a regulation is categorically *not* a taking because it does not prohibit a use of the land which would generally be permissible.[171] For example, a law that prohibits a landowner from constructing a nuclear power plant along an earthquake fault line would constitute a typical nuisance law, and thus would not constitute a taking because the landowner would never have been permitted to build on the land even absent the regulation.[172]

If the putative taking does not clearly fall within one of these three categories, a less precise multi-factor balancing test is employed.[173] As Professor Erwin Chemerinsky notes in his treatise on constitutional law, "[n]o bright-line test ever has been, or likely ever will be, formulated to determine when government actions that decrease the value of property become a taking."[174] Thus, there is a large body of case law on the issue, with each case being decided on the basis of unique factual circumstances.[175] *Pennsylvania Coal Co. v. Mahon*[176] was a landmark 1922 case in which the Supreme Court held that a state statute restricting the amount of coal mining on private property constituted a regulatory taking.[177] The Court cautioned that "[w]e are in danger of forgetting that a strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying for the change."[178] Trying to draw some line to demark a taking, the Court found that "while property

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169 *Lucas*, 505 U.S. at 1016; *see also id.* at 1017 ("[T]otal deprivation of beneficial use is, from the landowner's point of view, the equivalent of a physical appropriation."); *id.* at 1017-18 ("Surely, at least, in the extraordinary circumstance when *no* productive or economically beneficial use of land is permitted, it is less realistic to indulge our usual assumption that the legislature is simply 'adjusting the benefits and burdens of economic life,' . . . in a manner that secures an 'average reciprocity of advantage' to everyone concerned." (quoting Penn Cent. Transp. Co. v. City of New York, 438 U.S. 104, 124, 140 (1978))).

170 *Id.* at 1029-30 ("Such regulatory action may well have the effect of eliminating the land's only economically productive use, but it does not proscribe a productive use that was previously permissible under relevant property and nuisance principles.").

171 *Id.*

172 *Id.*

173 *See* Pa. Coal Co. v. Mahon, 260 U.S. 393, 413 (1922).

174 CHEMERINSKY, *supra* note 162, § 8.4.1, at 641.

175 *Id.*; *see, e.g.*, PruneYard Shopping Ctr. v. Robins, 447 U.S. 74, 83 (1980) (weighing "such factors as the character of the government action, its economic impact, and its interference with reasonable investment-backed expectations" and finding that a state's mandating public access to a shopping center for free speech purposes was not a taking).

176 260 U.S. 393 (1922).

177 *Id.* at 414-15.

178 *Id.* at 416.

may be regulated to a certain extent, if regulation goes *too far* it will be recognized as a taking."[179]

The question for the courts in determining whether there has been a regulatory taking has thus become what is *too far*? Chemerinsky concludes that, very generally, "the Court has not found a taking so long as the government regulation met a rational basis test and so long as the regulation did not prevent almost all economically viable use of the property."[180] Though there is no clear-cut rule, the Supreme Court in *Penn Central Transportation Co. v. City of New York*[181] laid out a three-factor balancing test to determine whether a regulation goes so far as to constitute a taking.[182] When determining what constitutes a taking, the Court weighs the following three factors: "(1) 'the economic impact of the regulation on the claimant'; (2) 'the extent to which the regulation has interfered with investment-backed expectations'; and (3) 'the character of the governmental action.'"[183]

The economic value aspect is important. Yet there must be more than diminished economic value to create a taking; the government regulation must leave the property with *no* reasonable economic value.[184] Also critical to the evaluation is the property owner's investment-backed expectations.[185] The property value lost as a result of the regulation must be considered in light of the property owner's expectations.[186] The test of whether the regulation has gone too far, thereby depriving the property owner of so much economic value in his land that the regulation amounts to a taking, "must be whether the deprivation is contrary to reasonable, investment-backed expectations."[187]

The third prong of the *Penn Central* multi-factor test concerns the character of the governmental action.[188] The more a regulation can be characterized as a physical invasion by the government, the more likely it is to be declared a taking.[189] Conversely, a regulation is less likely to amount to a taking "when interference arises from some public program adjusting the

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179 *Id.* at 415 (emphasis added).

180 CHEMERINSKY, *supra* note 162, § 8.4.2, at 658.

181 Penn Cent. Transp. Co. v. City of New York, 438 U.S. 104 (1978).

182 *Id.* at 124.

183 Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211, 225 (1986) (quoting *Penn Cent. Transp. Co.*, 438 U.S. at 124); *see also* PruneYard Shopping Ctr. v. Robins, 447 U.S. 74, 83 (1980).

184 CHEMERINSKY, *supra* note 162, §8.4.2, at 647. *Compare* Lucas v. S.C. Coastal Council, 505 U.S. 1003 (1992) (finding that government coastal protection plan which prevented owner from building on coastal property was a taking because the property was rendered valueless), *with Penn Cent. Transp. Co.*, 438 U.S. 104 (finding government historical landmark status that restricted the height of a building was not a taking because it did not take all economic value).

185 CHEMERINSKY, *supra* note 162, §8.4.2, at 648.

186 *Penn Cent. Transp. Co.*, 438 U.S. at 124-25.

187 *Lucas*, 505 U.S. at 1034 (Kennedy, J., concurring).

188 *Penn Cent. Transp. Co.*, 438 U.S. at 124.

189 *Id.* at 124 ("A 'taking' may more readily be found when the interference with property can be characterized as a physical invasion by government . . . .").

benefits and burdens of economic life to promote the common good."[190] One context in which regulation would not amount to a taking is taxation.[191] Another context is regulation that causes economic harm to the owner's property, but has not yet interfered with the reasonable, investment-backed expectations.[192] Finally, a third context in which a regulation is not likely to be classified as a taking is where the regulation's character is similar to nuisance law.[193] This is essentially the nuisance exception. However, "[e]ven where the government prohibits a noninjurious use, the [Supreme] Court has ruled that a taking does not take place if the prohibition applies over a broad cross section of land and thereby 'secure[s] an average reciprocity of advantage.'"[194]

A second question is what property does the Takings Clause protect? The Supreme Court has generally defined property broadly as the "entire 'group of rights inhering in the citizen's [ownership].'"[195] For example, the Court found in *Webb's Fabulous Pharmacies, Inc. v. Beckwith*[196] that interest earned in an interpleader account on sums deposited by the litigating parties constituted property protected under the Takings Clause.[197] The Supreme Court, analogizing to traditional features of property such as assignablility, has even held that trade secrets qualify as property under the Takings Clause.[198] Considering this broad range, an MBS would certainly be considered property for purposes of the Takings Clause.

The third element of the Takings Clause—public use—has also been read broadly by the Supreme Court.[199] Though the Court has said that there are some restraints on the breadth of "public use,"[200] the Court generally finds a taking to be for public use as long as it falls within the state's police power.[201] This means that the Court will apply a rational basis test to deter-

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190 *Id.*

191 *Id.*

192 *Id.* at 124-25.

193 *Id.* at 125 ("[I]n instances in which a state tribunal reasonably concluded that 'the health, safety, morals, or general welfare' would be promoted by prohibiting particular contemplated uses of land, this Court has upheld land-use regulations that destroyed or adversely affected recognized real property interests.").

194 *Penn Cent. Transp. Co.*, at 147 (Rehnquist, J., dissenting) (quoting Pa. Coal Co. v. Mahon, 260 U.S. 393, 415 (1922)).

195 CHEMERINSKY, *supra* note 162, §8.4.3, at 658 (alteration in original) (quoting United States v. Gen. Motors Corp., 323 U.S. 373 (1945)).

196 449 U.S. 155 (1980).

197 *Id.* at 161.

198 Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1002-04 (1984).

199 CHEMERINSKY, *supra* note 162, §8.4.4, at 662.

200 Thompson v. Consol. Gas Utils. Corp., 300 U.S. 55, 80 (1937) ("[O]ne person's property may not be taken for the benefit of another private person without a justifying public purpose, even though compensation be paid.").

201 CHEMERINSKY, *supra* note 162, §8.4.4, at 662; *see also* Joseph Sax, *Takings and the Police Power*, 74 YALE L.J. 36 (1964).

mine whether there is a reasonable belief that the taking is for a public purpose and that it will benefit the public.[202] The case of *Kelo v. City of New London*[203] is the most recent Supreme Court case on the issue. There, the Supreme Court affirmed its line of public use cases deferring to the state's police power and found constitutional the taking of private property for the purposes of an economic development project that the state reasonably believed would create over 1,000 new jobs and spur economic growth.[204] While Justice O'Connor, writing in dissent, cautioned that the Court's holding would open the door for the government to take private property in order to put it to a more economically valuable use,[205] Justice Thomas, writing separately in dissent, went so far as to urge a major change in the law.[206] Specifically, Justice Thomas argued that under a true interpretation of the meaning of "public use," a constitutional taking requires that the government actually be the ultimate holder and user of any private property taken.[207]

Finally, the fourth element of the Takings Clause is just compensation.[208] When the government does take property that is deemed to be for public use, it must "justly compensate" the private property owner for the value of what he has lost.[209] When a private property owner believes that the government has taken his property, his usual action against the government is an "inverse condemnation suit" for just compensation for the property

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202 CHEMERINSKY, *supra* note 162, §8.4.4, at 662; *see also* Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 240 (1984) (finding that the "public use requirement is thus coterminous with the scope of a sovereign's police powers"); *id.* at 241 ("[W]here the exercise of the eminent domain power is rationally related to a conceivable public purpose, the Court has never held a compensated taking to be proscribed by the Public Use Clause.").

203 545 U.S. 469 (2005).

204 *Id.*

205 *Id.* at 494 (O'Connor, J., dissenting).

206 *Id.* at 506 (Thomas, J., dissenting).

207 *Id.* at 508 (Thomas, J., dissenting); *cf.* Matthew P. Harrington, *"Public Use" and the Original Understanding of the So-Called "Takings" Clause*, 53 HASTINGS L.J. 1245, 1249 (2002) (arguing "that the term 'public use' as used in the Fifth Amendment was meant to be descriptive, rather than proscriptive, and that the term was not intended to operate as a substantive limitation on Congress' power to expropriate property").

208 U.S. CONST. amend. V. For a good discussion of just compensation and alternative measurement schemes, see Godsil & Simunovich, *supra* note 74, at 975-83. For a good discussion of the economic approach to the compensation aspect of takings, see Thomas J. Miceli & Kathleen Segerson, *Compensation for Regulatory Takings: An Economic Analysis with Applications*, *in* 1 THE ECONOMICS OF LEGAL RELATIONSHIPS 1 (Nicholas Mercuro ed., 1996).

209 *See* CHEMERINSKY, *supra* note 162, §8.4.5, at 664; *see also* Bos. Chamber of Commerce v. City of Bos., 217 U.S. 189, 195 (1910) (measuring loss as "What has the owner lost? not, [sic] What has the taker gained?").

taken.[210] Just compensation is a judicial question, meaning that it is reviewable by courts and is generally equated to "fair market value."[211]

Determination of fair market value and market risk in the context of an inverse condemnation suit or bankruptcy proceeding is difficult. In a recent case, *Till v. SCS Credit Corp.*,[212] the Supreme Court was confronted with the problem of determining the interest rate to be used for a bankruptcy debtor's installment payments to a creditor.[213] Rejecting the secured creditor's argument that the interest rate should be set at the 21 percent rate stipulated in the original contract, the Court held that an interest rate calculated at the prime rate plus a certain percentage determined by a bankruptcy court-approved formula would be sufficient to satisfy the creditor's risk of not receiving all the installment payments.[214] Writing in dissent, Justice Scalia argued that the so-called "prime plus" formula, as opposed to the rate stipulated in the contract, unfairly shifted risk of default to the secured creditor and was unlikely to adequately protect his interests.[215]

Partial regulatory takings and the conceptual partitioning of property have recently become the most important—and least clear—legal aspects of regulatory rakings law.[216] In *Lucas v. South Carolina Coastal Council*,[217] the Supreme Court found that a government coastal protection plan that prevented an owner from building on his coastal property was a taking because it rendered the property valueless.[218] The state's actions constituted a "total taking" that denied the owner of "all economically beneficial use" of the land.[219] In holding that the state regulations constituted a total taking, the Court applied the *Penn Central* test.[220] The decision in *Lucas* raised the question as to what might constitute a partial taking and whether the *Penn Central* test might be applied to determine whether a partial taking has occurred.[221]

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210 *See, e.g.*, Kirby Forest Indus., Inc. v. United States, 467 U.S. 1, 5 (1984) (quotation omitted).

211 *See id.* at 10; *see also* PAUL, *supra* note 151, at 81.

212 541 U.S. 465 (2004).

213 *Id.* at 465.

214 *Id.*

215 *Id.* at 491-92 (Scalia, J., dissenting); *see also* Laura H. Burney, *Just Compensation and the Condemnation of Future Interests: Empirical Evidence of the Failure of Fair Market Value*, 1989 BYU L. REV. 789, 791 (1989) (arguing that it is inappropriate to adhere to "one predetermined standard in compensating owners whose property has been taken").

216 *See, e.g.*, John D. Echeverria, *Do Partial Regulatory Takings Exist?*, *in* TAKING SIDES ON TAKINGS ISSUES: PUBLIC AND PRIVATE PERSPECTIVES 219, 220 (Thomas E. Roberts ed., 2002).

217 505 U.S. 1003 (1992).

218 *Id.* at 1019.

219 *Id.* at 1029, 1030.

220 *Id.* at 1015.

221 Echeverria, *supra* note 216, at 220.

The Supreme Court acknowledged, but did not fully resolve, this issue in its recent and convoluted opinion in *Palazzolo v. Rhode Island*.[222] In *Palazzolo*, a state law restricting construction on wetlands prevented the owner of a parcel of coastal wetlands from developing his property, so the owner initiated an inverse condemnation suit, claiming that the law effected a regulatory taking without just compensation.[223] The Supreme Court found that because the property owner had the opportunity to build a single-family house on a smaller uplands portion of his land at a value of $200,000, the state law did not leave the land "economically idle" and thus did not effect a total regulatory taking.[224] Therefore, the Court held that *Lucas* was inapplicable.[225] In a concurring opinion, Justice O'Connor argued that a *Penn Central* analysis of investment-backed expectations was the proper test for evaluating partial regulatory takings: "Our polestar instead remains the principles set forth in *Penn Central* itself and our other cases that govern partial regulatory takings. Under these cases, interference with investment-backed expectations is one of a number of factors that a court must examine."[226] Unfortunately, the question of what exactly constitutes "reasonable investment-backed expectations" remains unanswered.[227]

Importantly, however, the Court acknowledged the property owner's alternative argument that the upland and wetland portions of his land were distinct tracts of land and should be considered so for purposes of the takings analysis.[228] He argued that because the two land tracts were distinct, the wetlands portion should be conceptually partitioned from the rest of the land and considered independently of the upland parcel, which the Court had determined not to have been deprived of all economic value.[229] The Court noted that it has "at times expressed discomfort with the logic" of the rule that "regulatory action is measured against the value of the parcel as a whole," as opposed to distinct partitions of a parcel.[230] Unfortunately, how-

222 533 U.S. 606 (2001); *see also* Gregory M. Stein, *The Effect of* Palazzolo v. Rhode Island *on the Role of Reasonable Investment-Backed Expectations*, *in* TAKING SIDES ON TAKINGS ISSUES: PUBLIC AND PRIVATE PERSPECTIVES, *supra* note 216, at 41, 41 (concluding that the long-term effect of *Palazzolo* on takings law is likely to be minimal).

223 *Palazzolo*, 533 U.S. at 611-16.

224 *Id.* at 630-32.

225 *Id.*

226 *Id.* at 633 (O'Connor, J., concurring).

227 *See* Stein, *supra* note 222, at 49-50 ("[T]he Court still views as viable *Penn Central*'s emphasis on examining reasonable investment-backed expectations as a critical component of the ad hoc analysis appropriate for most regulatory takings cases . . . [, but *Palazzolo*] leaves open many key questions, including the precise definition of 'reasonable investment-backed expectations.'").

228 *Palazzolo*, 533 U.S. at 631.

229 *Id.*

230 *Id.*

ever, the Court did not clearly resolve the issue and has not done so as of the time of this Comment's writing.[231]

B. *Regulatory Takings During Past Crises*

1. The New Deal Era

During the 1930s, when America suffered a nationwide decline in housing values similar to the current crisis,[232] the federal government responded with a variety of legislation aimed at halting the crisis and stemming the tide of foreclosures.[233] Also like recent experience, this legislation was hastily passed in the face of the crisis, raising constitutional concerns that were eventually evaluated by the Supreme Court.[234] This Comment will now examine some of those cases to shed light on how the current Court might handle a constitutional challenge to the Homes Act safe harbor provision.

Congress passed the first Frazier-Lemke Act ("First Act") in 1934 to amend the bankruptcy law in order to relieve the agricultural sector of the economy, which suffered severely from the effects of the Great Depression.[235] The First Act allowed debtor farmers to write down their mortgages to the obviously depressed market value and then acquire full title to the property from their creditor at that value.[236] The constitutionality of this law was immediately challenged in 1935 in *Louisville Joint Stock Land Bank v. Radford*.[237] In a unanimous decision, the Supreme Court held that the First Act violated the Takings Clause and was thus unconstitutional.[238] The Supreme Court found that the First Act deprived mortgagees of five substantive rights:

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231 *Id.* ("Whatever the merits of [conceptual partitioning], we will not explore the point here."). It should be noted that the Supreme Court recently heard oral argument on the case of *Walton County v. Stop Beach Renourishment, Inc.*, 998 So. 2d 1102 (Fla. 2008), *cert. granted sub. nom. Stop Beach Renourishment, Inc. v. Fla. Dep't of Envtl. Prot.*, 129 S. Ct. 2792 (2009), which deals with whether or not Florida's efforts to create a buffer against erosion by modifying beach fronts amounts to a taking. The resolution of the case could very likely have an effect on the Supreme Court's takings jurisprudence.

232 Ivry & Louis, *supra* note 5.

233 For a discussion of the Great Depression, see generally JOHN KENNETH GALBRAITH, THE GREAT CRASH: 1929 (1954); ESSAYS ON THE GREAT DEPRESSION (Ben S. Bernanke ed., 2000).

234 *See, e.g.*, Wright v. Union Cent. Life Ins. Co. 311 U.S. 273 (1940); Wright v. Vinton Branch of Mountain Trust Bank of Roanoke, 300 U.S. 440 (1937); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935).

235 Frazier-Lemke Act of 1934, ch. 869, 48 Stat. 1289 (codified as amended at 11 U.S.C. § 203(s) (1934)).

236 *Id.*

237 295 U.S. 555 (1935).

238 *Id.* at 601-02.

> (1) The right to retain the lien until the indebtedness thereby secured is paid[;] (2) [t]he right to realize upon the security by a judicial public sale[;] (3) [t]he right to determine when such sale shall be held, subject only to the discretion of the court[;] (4) [t]he right to protect its interest in the property by bidding at such sale whenever held . . . [; and] (5) [t]he right to control meanwhile the property during the period of default . . . .[239]

In response to the Supreme Court's invalidation of the First Act, Congress passed the second Frazier-Lemke Act ("Second Act") in 1935.[240] The Second Act aimed to address the Court's concerns about the mortgagee's substantive rights.[241] In *Wright v. Vinton Branch of Mountain Trust Bank*,[242] the Supreme Court, in another unanimous decision, held that the Second Act did not violate the Takings Clause and was constitutional.[243] However, the Second Act did not restore all of the mortgagee's rights that the Court in *Radford* said had been violated.[244] The Court held that this was not required by *Radford*, but rather that the "effect of the [First Act] in its entirety was to deprive the mortgagee of his property without due process of law."[245] Altogether, the changes to the Second Act made "no unreasonable modification of the mortgagee's rights[,] and hence [was] valid."[246]

Commentators have struggled to reconcile *Vinton Branch* with *Radford*, and there does not seem to be much consensus.[247] Perhaps the best argument has been put forth by Patrick A. Murphy: "No later opinion has substantially contradicted the basic holding of *Radford* that a significant infringement of a substantive property right held by a secured creditor constitutes an uncompensated 'taking' within the meaning of the final clause of the fifth amendment . . . ."[248] This would seem to make sense considering Justice Brandeis's efforts in *Vinton Branch* to reconcile the ruling on the Second Act with the Court's stance in *Radford*.[249]

The Second Act also contained a conflict between the right of the debtor to have the value of the property fixed for redemption and the right

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239 *Id.* at 594-95. However, the Court also found that the mortgagee's right to payment of its claim on the property equal to its present value was protected under the Act. *Id.*

240 Act of Aug. 28, 1935, ch. 792, 49 Stat. 942, 943-45 (codified as amended at 11 U.S.C. § 203(s) (1935)).

241 79 CONG. REC. 13,632 (1935) (statement of Sen. Borah).

242 300 U.S. 440 (1937).

243 *Id.* at 470.

244 *Id.* at 457.

245 *Id.* Interestingly, though Justice Brandeis based his rationale in *Radford* on analysis of the Takings Clause in *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 594-95 (1935), in *Vinton Branch* he implicated the Fifth Amendment Due Process Clause in his analysis. *Vinton Branch*, 300 U.S. at 470.

246 *Vinton Branch*, 300 U.S. at 470.

247 *See* Zinman & Petrovski, *supra* note 107, at 151 n.71.

248 Patrick A. Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW 15, 26 (1974).

249 *Vinton Branch*, 300 U.S. at 470.

of the creditor to have the property sold at a public sale.[250] The Supreme Court addressed the issue in 1940 in *Wright v. Union Central Life Insurance Co.*[251] and held that although the creditor's right to a judicially ordered sale was still protected, "the debtor's request for redemption . . . cannot be defeated by a request of a secured creditor for a public sale."[252] This was so because the secured creditor's rights to the value of the property were otherwise protected by the statute.[253] The Court went on to define exactly what constitutional rights secured creditors have:

> Safeguards were provided to protect the rights of secured creditors, throughout the proceedings, *to the extent of the value of the property*. There is no constitutional claim of the creditor to more than that. And so long as that right is protected the creditor certainly is in no position to insist that doubts or ambiguities in the Act be resolved in its favor . . . . Under our construction, . . . the creditor will not be deprived of the assurance that the value of the property will be devoted to the payment of its claim.[254]

The important phrase from this quote is "to the extent of the value of the property."[255] *Union Central* established that the Constitution guarantees a secured creditor the value of the collateral in which he owns an interest.[256] Importantly, this guarantee to the creditor of the value of the property means that the payment is to be made by the debtor in cash.[257] One commentator has suggested that leaving creditors with stripped-down mortgages as opposed to the actual value of their collateral in cash, as the proposed bankruptcy amendments would do, could very likely violate the Takings Clause under *Union Central*.[258] By analogy, because the Homes Act could achieve the same effective result through both its safe harbor provision and the proposed bankruptcy amendments, the Homes Act raises the same constitutional concerns.

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250 Act of Aug. 28, 1935, ch. 792, 49 Stat. 942, 944 (codified as amended at 11 U.S.C. § 203(s) (1935)).

251 311 U.S. 273 (1940).

252 *Id.* at 279.

253 *Id.*

254 *Id.* at 278-79 (emphasis added) (citations omitted).

255 *Id.*

256 *Id.*

257 Wright v. Union Cent. Life Ins. Co., 311 U.S. 273, 278-79 (1940); *see* Zinman & Petrovski, *supra* note 107, at 153.

258 *See* Zinman & Petrovski, *supra* note 107, at 153 ("[T]he [Bankruptcy Code] amendments, if enacted, could become the unintended catalyst that will result in a new sober look at whether chapter 13 can function as constitutionally mandated.").

2. The Savings and Loan Crisis

In the end, these New Deal-era cases established that, even in the realm of bankruptcy, property rights are still subject to Fifth Amendment protections.[259] America faced another nationwide drop in housing prices during the S&L crisis in the late 1980s and early 1990s.[260] The federal government again responded with legislation to prevent the failure of the S&L institutions (also called thrifts), which were saddled with bad mortgage debt.[261] As it did during the Great Depression, such proposed legislation eventually precipitated litigation over the purported abrogation by the government of the vested rights of private citizens.

United States v. Winstar Corp.[262], the major case stemming from the federal government's regulatory response to the S&L crisis, highlights the importance of evaluating the future legal (especially constitutional) issues of current legislative actions, particularly the Homes Act safe harbor provision. More importantly, the *Winstar* case demonstrates that the Supreme Court has not shied away from invalidating federal government actions taken in the name of some greater public purpose, such as resolving a housing crisis, when the legal rights of private citizens have been abridged.

As the S&L crisis unfolded, American housing prices fell and many thrifts failed as a result.[263] One of the federal government's responses was to encourage solvent thrifts to acquire failing thrifts.[264] The thrift regulators would allow acquiring thrifts to amortize this "goodwill asset"—the failed thrift that they purchased—over a long period of time, which, from an accounting standpoint, functioned to increase the profits of the acquiring thrifts.[265] However, the S&L crisis deepened, and in an effort to reform the thrift industry, Congress passed the Financial Institutions Reform, Recov-

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[259] Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935) ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment."); *see also* United States v. Sec. Indus. Bank, 459 U.S. 70, 75 (1982) ("The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation.").

[260] *See S&P/Case-Shiller Home Price Indices*, *supra* note 5.

[261] *See* Anchor Sav. Bank, FSB v. United States, 81 Fed. Cl. 1, 12-15 (2008) (discussing the history of the federal government's response to the S&L crisis), *aff'd in part, remanded in part* 597 F.3d 1356 (Fed. Cir. 2010).

[262] 518 U.S. 839 (1996). For a good discussion of the *Winstar* case and its historical background, see Rodger D. Citron, *Lessons from the Damages Decisions Following* United States v. Winstar Corp., 32 PUB. CONT. L.J. 1 (2002). *See also* Mark T. Cramer, *Contracts Written in Stone: An Examination of* United States v. Winstar Corp., 25 PEPP. L. REV. 567 (1997).

[263] Thrifts, also known as savings and loan banks, are a type of financial institution whose general function is to take deposits and issue mortgage loans. The thrift industry is regulated by the federal government. 1 BAXTER DUNAWAY ET AL., FIRREA: LAW AND PRACTICE § 3.01, at 3 n.2 (1994).

[264] *Winstar Corp.*, 518 U.S. at 847.

[265] *Id.* at 852.

ery, and Enforcement Act of 1989 ("FIRREA").[266] Among other things, FIRREA revised the thrift capital requirements to disallow the counting of goodwill assets toward core capital.[267] This had the effect of rendering many formerly solvent thrifts insolvent.[268]

A number of thrifts, including Winstar Corporation, which had acquired failing thrifts under the presumption that they could use the goodwill asset accounting, filed suit against the United States in the Court of Federal Claims, claiming damages on both contractual and constitutional theories.[269] The Supreme Court held that despite the regulatory changes of FIRREA, the United States was contractually obligated to permit the thrifts to maintain the goodwill asset accounting standards to which they had previously agreed, and, therefore, that the United States was liable for breach of contract.[270]

Even though it has been nearly two decades since the passage of FIRREA and another housing bubble has since grown and burst, the actual damage awards from the line of *Winstar* cases is still being resolved in federal courts.[271] In one such case, *Anchor Savings Bank, FSB v. United States*,[272] the Court of Federal Claims held that Anchor Savings Bank, a thrift during the S&L crisis, was entitled to lost profits in the amount of $111.6 million as a result of FIRREA legislation having caused it to miss opportunities presented by the MBS market of the late 1990s and early 2000s.[273] In other words, the Court awarded damages to Anchor because the financial setback to the company caused by having to adopt FIRREA accounting standards twenty years ago forced it to avoid the subprime MBS market that recently collapsed.

The S&L crisis also spawned litigation by private homeowners who had been adversely affected by the downturn. The 1993 Supreme Court case of *Nobelman v. American Savings Bank*[274] is the first and only Supreme Court decision addressing 11 U.S.C. § 1322(b)(2)[275] of the Bankruptcy Code, which exempts from modification secured interests in a

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266 Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989).

267 *Winstar Corp.*, 518 U.S. at 856-57.

268 *Id.* at 857-58.

269 *Id.* at 858-59.

270 *Id.* at 907-910.

271 Citron, *supra* note 262, at 3-6.

272 Anchor Sav. Bank, FSB v. United States, 81 Fed. Cl. 1 (2008), *aff'd in part, remanded in part* 597 F.3d 1356 (Fed. Cir. 2010).

273 *See id.* at 122.

274 508 U.S. 324 (1993).

275 "Subject to subsections (a) and (c) of this section, the plan may . . . (2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims." 11 U.S.C. § 1322(b)(2) (2006).

debtor's principal residence during bankruptcy proceedings.[276] In *Nobelman*, the debtors filed for Chapter 13 bankruptcy[277] and proposed a bankruptcy plan to bifurcate the creditor bank's claim on their principal residence into both a secured and unsecured component.[278] This was an attempt by the debtors to adjust payments on the unsecured component of the mortgage.[279] Both the creditor bank, which held the debtor's mortgage, and the Chapter 13 bankruptcy trustee objected to the plan.[280]

A unanimous Supreme Court held that the bifurcation was prohibited by the anti-modification provision of 11 U.S.C. § 1322(b)(2).[281] The Court found that the anti-modification provision could not be circumvented in this manner in an attempt to reduce the mortgage to the home's depressed fair market value.[282] Importantly, in remanding the case, the Court ordered that section 1322(b)(2) be applied literally.[283] The Supreme Court's decision seems to clearly indicate that creditors holding secured claims on a debtor's principal residence will be afforded an absolute protection from any form of modification during bankruptcy.[284]

In light of this background of case law, this Comment will now explore how the Homes Act's safe harbor provision could violate the Takings Clause.[285]

C. *The Homes Act Could Effect a Regulatory Taking*

The proposal of the trio of Columbia University scholars who sought to encourage more mortgage loan modifications was similar to what was eventually enacted by the Homes Act, though it went even further in that it encouraged Congress to enact legislation that would explicitly abrogate

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276 Santos, *supra* note 74, at 300. For a discussion of the history of the enactment of 11 U.S.C. § 1322(b)(2), see *supra* notes 107-13107113 and accompanying text .

277 Chapter 13 bankruptcy allows individuals to adjust their debts, rather than liquidate them, and develop a plan to make installment payments to their creditors over a period of three to five years. For a good background discussion of Chapter 13 bankruptcy, see M. Jonathan Hayes & James T. King, *A Chapter 13 Primer for Non-Chapter 13 Bankruptcy Attorneys*, 30 CAL. BANKR. J. 41 (2009).

278 *Nobleman*, 508 U.S. at 326.

279 *Id.* at 326-27.

280 *Id.*

281 *Id.* at 331.

282 *Id.*

283 *Id.* at 332.

284 It should be noted, however, that some commentators have argued that lower courts have found flexibility in the language of section 1322(b)(2) and that the *Nobelman* decision could support other legal outcomes. *See* Santos, *supra* note 74, at 301-10. Such a discussion, however, is outside the scope of this Comment.

285 *See* Mayer et al., *supra* note 147, at 424-25 (finding proposals to allow mortgage loan modifications not to be in violation of the Fifth Amendment takings clause); Zinman & Petrovski, *supra* note 107, 149-53 ("[T]he issue . . . may spark another Supreme Court review . . . .").

PSA provisions prohibiting mortgage loan modifications.[286] Similarly to the safe harbor provision enacted by the Homes Act, the scholars also proposed a litigation safe harbor as an affirmative defense for servicers "provided they modify loans . . . in a reasonable, good faith belief that they are acting in the best interests of investors as a group."[287] Significantly, the scholars acknowledged that their proposals raised constitutional questions.[288]

The Columbia scholars' constitutional analysis concluded that their loan modification proposal would not violate the Takings or Due Process Clauses of the Fifth Amendment.[289] Though they did not actually address whether their proposal would be a taking, the scholars argued that their plan "is not an unconstitutional taking because investors are compensated, in kind, for the legislative interference."[290] By "in kind" they likely meant that investors are compensated by having the original mortgage loan replaced with a stripped-down mortgage loan that reflects something approaching the current fair market value of the collateral. Regardless of whether the modified mortgage loan would accurately reflect the fair market value of the collateral, *Union Central* demonstrates that such "in kind" compensation should not be the standard in takings cases.[291] The Supreme Court in *Union Central* held that a creditor is entitled to the value of the collateral in cash, not in kind.[292] Thus, if a taking were truly established, it would be difficult to conclude that the investors had received "just compensation" in light of the Court's jurisprudence on the issue.

In terms of the value of the collateral after modification, the scholars argued that, relative to foreclosure, modifications under their plan would increase the value of investors' securities.[293] A simple question must be

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[286] Mayer et al., *supra* note 147, at 422-27. In fact, such a provision was originally included in the House version of the Homes Act, but it did not survive the final vote. Section 124 of the proposed bill provided that:

> No provision in any investment contract between a servicer and a securitization vehicle or investor in effect as of the date of enactment of this Act that requires excess bankruptcy losses that exceed a certain dollar amount on residential mortgages to be borne by classes of certificates on a pro rata basis that refers to types of bankruptcy losses that could not have been incurred under the law in effect at the time such contract was entered into shall be enforceable, as such provision shall be contrary to public policy. Notwithstanding this section, such reference to types of bankruptcy losses that could have been incurred under the law in effect at the time such contract was entered into shall be enforceable.

H.R. 1106, 111th Cong. § 124, 155 CONG. REC. H2997, H2999 (daily ed. Mar. 5, 2009), 2009 WL 562376, at *H2997, *H2999.

[287] Mayer et al., *supra* note 147, at 422.

[288] *Id.* at 424-26 ("But because the legislation alters the terms of existing contracts, it raises other constitutional concerns. The most important is that our proposal might violate the Takings and Due Process Clauses . . . ." (footnotes omitted)).

[289] *Id.* at 424-25.

[290] *Id.* at 424.

[291] Wright v. Union Cent. Life Ins. Co., 311 U.S. 273, 278-79 (1940).

[292] *Id.*

[293] Mayer et al., *supra* note 147, at 424.

asked in evaluating the validity of this conclusion. If it is true, as they assert, that their legislative proposal would increase the value of the investors' MBS, why would such sophisticated investors so strenuously object to mortgage loan modifications?[294] An interest-based analysis shows that the investors' objections are valid. It is clear that the clauses in PSAs that prohibit mortgage loan modifications were negotiated in the interest of the investors guaranteeing the characteristics of the stream of payments they receive from the mortgage loan trust. It is also evident that investors are concerned that modifications will actually decrease the value of their securities in light of recent litigation in which investors sought an injunction enforcing anti-modification provisions in MBS PSAs.[295] Moreover, if fair market value is the measurement used to gauge what would be "just compensation," it seems as if investors would be put at a great disadvantage by an inverse condemnation scenario. In such a situation, the investors would be forced to take the value of the securities at current fair market value, which will almost certainly turn out to be undervalued as compared to the value of the security if the mortgage loans were not written down and the security were held to maturity.[296]

Because the housing market (and the economy in general) is cyclical with a positive long-term trend, the value of the properties for which any mortgage is modified will likely rise, along with the debtor's ability to pay.[297] Yet the mortgagee/investor does not have any recourse in any of the proposed legislation to recoup this increase in value to the mortgage/security if he earlier suffered a loss. This could hardly, then, be considered "just compensation," and it highlights the point Justice Scalia made in his *Till* dissent that "prime-plus" interest rate formulas do not adequately compensate creditors for the risk over the term of a debtor's bankruptcy plan.[298] Moreover, because of the way junior bonds in a mortgage securitization function, it would be very difficult to provide for "just compensation" now in the likely scenario where debtors receiving a reworked mortgage eventually do become able to pay and the value of their home increases. Junior bonds first take losses on principal and interest in the mort-

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[294] *See infra* Part III.A.

[295] *See* Greenwich Fin. Servs. Distressed Mortgage Fund 3, LLC v. Countrywide Fin. Corp., 654 F. Supp. 2d 192 (S.D.N.Y. 2009), *appeal dismissed*, 603 F.3d 23 (2d Cir. 2010). For a discussion of the case, see *infra* Part III.A.

[296] *See* Brett Arends, *Should You Invest in Toxic Assets?*, WALL ST. J., July 29, 2009, http://online.wsj.com/article/SB10001424052970203609204574316610509900476.html; Alexandra Zendrian, *Invest in . . . Mortgage-Backed Securities?*, FORBES (Sept. 9, 2009), http://www.forbes.com/2009/09/08/mortgage-backed-securities-intelligent-investing-spreads.html.

[297] *See* Zinman & Petrovski, *supra* note 107, at 162.

[298] Till v. SCS Credit Corp., 541 U.S. 465, 491-92 (2004) (Scalia, J., dissenting); *see also* Burney, *supra* note 215, at 791 (arguing that it is inappropriate to adhere to "one predetermined standard in compensating owners whose property has been taken").

gage loan trust's payment waterfall.[299] As such, whenever any initial modifications to mortgage loans are made, those bonds could lose all of their value and become worthless.[300]

The scholars also acknowledged the problem presented by junior bond holders,[301] but too quickly dismissed the takings issue as it applies to them. They apparently misunderstood the full implications of the MBS transaction structure on the likelihood that junior bond holders will receive payments after a significant number of modifications are made.[302] They stated that junior bond holders are usually entitled to "a share of coupon payments" during foreclosure and that though they would be deprived of these payments when loan modifications are made to avoid foreclosure, this does not constitute a taking.[303] This is so, the argument goes, because "[i]nvestors are losing contractual rights—a share of coupon payments, set by contract—not real property rights. Different rules ('regulatory takings') apply to the former rights."[304]

However, this argument misses the true effect of mortgage modifications on junior bond holders. When the principal balance on a securitized mortgage loan is written down to its fair market value, this loss of principal is applied to the principal value of the junior bonds first.[305] Thus, junior bond holders will not just be losing the "coupon payments" from foreclo-

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299 *See infra* note 305 and accompanying text.

300 *See* Morgenson, *supra* note 46.

301 Mayer et al., *supra* note 147, at 424-25.

302 *Id.*

303 *Id.*

304 *Id.*

305 For example, the following is a typical allocation of losses to the junior bonds of an MBS offering:

> As described in this prospectus supplement, amounts representing losses on the mortgage loans . . . will be applied to reduce the principal amount of the subordinate class of certificates still outstanding that has the lowest payment priority, until the principal amount of that class of certificates has been reduced to zero. For example, losses in excess of overcollateralization and excess cashflow will first be allocated in reduction of the principal amount of the Class B Certificates, until it is reduced to zero, then in reduction of the principal amount of the Class M9 Certificates until it is reduced to zero, then in reduction of the principal amount of the Class M8 Certificates until it is reduced to zero . . . . *If a loss has been allocated to reduce the principal amount of a subordinate certificate, it is unlikely that investors will receive any payment in respect of that reduction*. Amounts representing losses on the mortgage loans will not be applied to the senior certificates; however, if the applicable subordination is insufficient to absorb losses, then holders of senior certificates may incur losses and may never receive all of their principal payments.

Structured Asset Sec. Corp., *supra* note 57, at 10-11 (emphasis added). In a bankruptcy scenario, however, the result would be different. Most PSAs, according to a study by Standard & Poor's, have special provisions for payment distributions when mortgages are in bankruptcy. Todd J. Zywicki, *Don't Let Judges Tear Up Mortgage Contracts*, WALL ST. J., Feb. 13, 2009, http://online.wsj.com/article/SB123449016984380499.html. In such a scenario, bankruptcy losses that rise above a certain threshold established by the PSA are assessed pro rata across all classes of securities. *Id.* Thus, senior bond holders would be assessed the same losses as riskier junior bond holders, which is not the normal result when the mortgage pool otherwise suffers losses.

sure that the Columbia scholars described, but also the principal balance of the bonds they hold, which would also adversely affect all subsequent interest payments and overall yield.[306] In fact, the loss of principal could be so great as to render the most junior bonds valueless.[307] If a court would recognize partial regulatory takings as the Supreme Court suggested in *Lucas*,[308] an investor holding both senior and junior bonds might succeed in an argument that the modifications protected by the Homes Act safe harbor effected a taking of their junior bond. In situations where an investor holds only junior bonds, it seems that no such partial regulatory takings analysis would be necessary, but rather that such an investor would be faced with a total taking as the entire value of his security would have been destroyed.

While the law of partial regulatory takings is unsettled,[309] it is still relevant in analyzing whether modifications of mortgages in a mortgage loan trust that decrease (or destroy) the value of certain bonds issued by that trust constitute a partial regulatory taking of only those bonds. Like the property owner in *Palazzolo*, could investors argue that though their senior bonds might still hold some economic value, the junior bonds that they also hold should be viewed distinctly and that their total loss of economic value should be treated as a partial regulatory taking of the mortgage loan trust? This unsettled area of law does not lend itself to a clear answer.

A partial takings scenario would also create valuation problems. Should the court compare the regulated value of the asset (i.e., the value of a bond after mortgages have been modified) against either the original value of the investment (i.e., the bond's projected yield at issuance) or the present unregulated value of the bond (i.e., the fair market value of the bond)? The latter measurement would be quite difficult considering that the MBS market has yet to be effectively resuscitated and the only real purchaser currently is the federal government.[310] One would be hard-pressed to consider such a "market" value fair, especially in light of Justice Scalia's arguments made in his *Till* dissent.[311]

Moreover, the statement that investors would not be losing real property rights is disingenuous. An investor in an MBS has an undivided interest in the assets of the mortgage loan trust.[312] The assets of the trust are mortgage loans, and thus investors, having an ownership interest in the mortgage loans, have certain rights in the real property on which the mort-

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306 *See* Structured Asset Sec. Corp., *supra* note 57, at 10.

307 *See* Morgenson, *supra* note 46.

308 *See supra* notes 216-21 and accompanying text.

309 John D. Echeverria, *supra* note 216, at 226-30 (arguing that the origins of the idea of "partial takings" was more inadvertent than intentional and can be traced to dicta in *Lucas* that inferred the existence of partial takings by creating the category of "total takings").

310 *See* Arends, *supra* note 296.

311 *See* Till v. SCS Credit Corp., 541 U.S. 465, 491-92 (2004) (Scalia, J., dissenting); *supra* notes 212-15 and accompanying text.

312 *See* Pinedo & Baumgardner, *supra* note 8, at 320-22.

gage provides a lien.[313] Also, contractual rights under the PSA guarantee the investor certain payments from those mortgage assets.[314] Thus, investors have both contractual and property rights.

The Columbia scholars also touched on the issue of investment-backed expectations when they said that "any party to a contract is or should be aware that future government regulation could reduce the value of contractual rights,"[315] citing *Lucas* in support.[316] Though *Lucas* did hold that property owners ought to be aware that regulations might render property worthless, the Court was referring to circumstances in which "the property's only economically productive use is sale or manufacture for sale."[317] That is not the case with MBS investors who gain "economically productive use" of their securities by holding the bonds to maturity and collecting payments on them. Significantly, the "Risk Factors" section of an ordinary MBS prospectus does not state that prospective government laws and regulations are risks borne by investors purchasing MBS.[318]

Finally, the Columbia scholars also made the argument that their proposal would not cause an unconstitutional taking because it nullifies rights for the benefit of the public ("homeowners, investors, and servicers") and not the federal government.[319] However, there is no clear empirical evidence to support this proposition. As the interest-based analysis above showed, modifications do not work to the benefit of investors holding MBS.[320] Similarly, servicers have not been modifying mortgages at a significant rate, which is strong evidence that modifications do not benefit servicers.[321] A recent working paper of the Federal Reserve Bank of Boston shows that since 2007, only 3 percent of seriously delinquent loans (greater than sixty

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313 Black's Law Dictionary defines a lien as "[a] legal right or interest that a creditor has in another's property, lasting usu[ally] until a debt or duty that it secures is satisfied. Typically, the creditor does not take possession of the property on which the lien has been obtained." BLACK'S LAW DICTIONARY 941 (8th ed. 2004).

314 *See* Kendall, *supra* note 19, at 1-2, 5.

315 Mayer et al., *supra* note 147, at 425.

316 *Id.* at 425 n.20; *see* Lucas v. S.C. Coastal Council, 505 U.S. 1003 (1992).

317 *Lucas*, 505 U.S. at 1027-28. The Court went on to say that "[i]n the case of land, however, we think the notion . . . that title is somehow held subject to the 'implied limitation' that the State may subsequently eliminate all economically valuable use is inconsistent with the historical compact recorded in the Takings Clause that has become part of our constitutional culture." *Id.* at 1028.

318 *See, e.g.*, Structured Asset Sec. Corp., *supra* note 57. The Risk Factor section does, however, list risks resulting from current regulations, e.g., "Environmental Risks," "Originators and Servicers May Be Subject to Litigation or Governmental Proceedings," and "Violation of Various Federal, State and Local Laws May Result in Losses on the Mortgage Loans." *Id.* at 19-20, 28-29, 32.

319 Mayer et al., *supra* note 147, at 425.

320 *See supra* notes 293-96 and accompanying text.

321 *See* Manuel Adelino et al., *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* 3-4 (Fed. Reserve Bank of Bos., Pub. Policy Discussion Papers, Working Paper No. 09-4, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf.

days delinquent) have been modified.[322] The authors argue that securitization, contrary to popular opinion, does not actually impede servicers from modifying delinquent loans.[323] Modification is only beneficial to servicers if the reduction in the value of the mortgage loan is less than the loss the servicer would sustain by foreclosing, and this does not appear to be the case based on the empirical data available.[324]

With homeowners, the question of whether or not they actually benefit from modifications is not easy to measure empirically. Some scholars have argued that many of the "homeowners" facing foreclosure do not really "own" their homes, but are in fact effectively renters.[325] The point is that many people who purchased homes with the aid of exotic mortgage products (e.g., adjustable-rate, negative amortization, and interest-only loans)[326] could not originally afford them and likely still cannot afford them, even at depressed values and with modified mortgages.[327] Moreover, the goal of universal homeownership, which Congress professed in enacting the Homes Act,[328] is not necessarily an intrinsically positive goal for society or without downfalls.[329] The fact that supporters of legislation like the Homes Act cannot convincingly demonstrate that the legislation will actually be effective and support the general welfare works strongly against the constitutionality of the legislation because it ultimately could not pass the public use requirement of a regulatory taking.[330]

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322 *Id.* at 3.

323 *Id.* at 4-5.

324 *Id.* at 2.

325 *See, e.g.*, *Proposed Mortgage Modification in Bankruptcy Code: Hearing on H.R. 200 and H.R. 225 Before the S. Comm. on Commercial & Admin. Law of the H. Comm. on the Judiciary*, 111th Cong. 148-49 (2009) (statement of Todd J. Zywicki, Professor, George Mason University School of Law), *available at* http://www.mercatus.org/PublicationDetails.aspx?id=25932 ("[M]any homeowners had minimal equity in their homes. As a result, they bore little cost from permitting default and foreclosure on these homes—in short, they were functionally the same as renters, not homeowners.").

326 For a description of different types of mortgage products, see Santos, *supra* note 74, at 289-90.

327 *See id.* at 291.

328 Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, div. A, tit. II, § 201(a), 123 Stat. 1632, 1638 (2009) (stating in the congressional findings that the purpose to the Homes Act and the safe harbor provision is to stem foreclosures, keep people in their homes, and stabilize housing prices).

329 *See* A. Mechele Dickerson, *The Myth of Home Ownership and Why Home Ownership Is Not Always a Good Thing*, 84 IND. L.J. 189 (2009).

330 For an explanation of regulatory takings law, see *supra* notes 199-207 and accompanying text.

III. ANALYSIS OF THE HOMES ACT'S EFFECTS AND OTHER POSSIBLE SOLUTIONS

A. *Prospects for Mortgage Lenders Modifying a Significant Number of Mortgage Loans*

This Comment will now address the effects of the Homes Act safe harbor provision by looking at the only cases yet to deal with the provision. In October 2008, Countrywide Financial settled lawsuits with the Attorneys General of eleven states who had alleged that the mortgage lender engaged in predatory lending practices.[331] Without admitting any wrongdoing, Countrywide was required to provide $8.4 billion in relief to troubled mortgage borrowers under the settlement, largely through loan modifications.[332] Such modifications could involve a reduction in the principal balance of the loans, a cut in the interest rate, or a combination of the two.[333] However, the modification program has been criticized as ineffective, and Bank of America, which acquired Countrywide last year,[334] has refused to disclose statistics regarding the program.[335]

A number of the loans that Countrywide had agreed to modify under the settlement had previously been securitized into MBS purchased by certain investors.[336] Countrywide was continuing to service these loans on behalf of the investors who had ownership interests in those mortgage trusts.[337] In response to the multistate settlement, several of those investors holding certificates issued by the Greenwich Financial Services Distressed Mortgage Fund 3, LLC ("Fund"), which was composed of Countrywide loans, filed a putative class action lawsuit against Countrywide.[338] The investors sought a declaratory judgment that under the terms of the Fund's PSA, Countrywide was obligated to buy out of the mortgage loan pool any loans it modified at a price equal to the unpaid principal balance of such loans plus any accrued interest thereon.[339] The specific terms of the PSA

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331 Gretchen Morgenson, *Countrywide to Set Aside $8.4 Billion in Loan Aid*, N.Y. TIMES, Oct. 6, 2008, http://www.nytimes.com/2008/10/06/business/06countrywide.html.

332 *Id.*

333 *Id.*

334 Gretchen Morgenson, *Bank of America Is Firm on Countrywide Buyout*, N.Y. TIMES, June 8, 2008, http://www.nytimes.com/2008/06/08/business/worldbusiness/08iht-08country.13548957.html.

335 Monica Hatcher, *Countrywide's Promised Loan Relief Falling Short for Many*, MIAMI HERALD, July 29, 2009, http://www.miamiherald.com/2009/07/29/1161676/countrywides-promised-loan-relief.html.

336 Greenwich Fin. Servs. Distressed Mortgage Fund 3, LLC v. Countrywide Fin. Corp., 654 F. Supp. 2d 192, 193-194 (S.D.N.Y. 2009), *appeal dismissed*, 603 F.3d 23 (2d Cir. 2010).

337 *Id.* at 194.

338 *Id.* at 193-94.

339 *Id.*

stated that "Countrywide may agree to a modification of any Mortgage Loan (the 'Modified Mortgage Loan') if . . . Countrywide purchases the Modified Mortgage Loan from the Trust Fund . . . ."[340]

Countrywide quickly removed the suit from state court to the Southern District of New York.[341] Judge Richard J. Howell addressed whether the case presented a federal question sufficient to give the court subject matter jurisdiction and concluded that Countrywide's argument that it was protected from suit by virtue of the safe harbor provision of 15 U.S.C. § 1639a was not sufficient to give the court subject matter jurisdiction because "[a] federal defense has never been sufficient for federal question jurisdiction."[342]

There has not yet been a disposition of the case in state court, but the federal court's analysis of contractual provisions of the PSA and how they relate to 15 U.S.C. § 1639a is interesting and could provide an idea of how federal judges might read the mortgage loan modification provisions of other PSAs in future litigation. The court agreed with Countrywide's argument that the investors bear the burden of showing that the PSA "as a whole" requires Countrywide to purchase out of the mortgage loan pool any loans that it modifies.[343] Though the court did cite sources supporting this form of contract interpretation,[344] the task of reading a PSA—which usually incorporates by reference sub-servicing agreements and a number of other ancillary transaction documents—as a whole is certainly a difficult one.[345] In the first place, it seems strange that the court would seek to read the PSA "as a whole" when the issue involved—mortgage loan modification—is expressly addressed in one section of the PSA relating to those very rights and duties of a servicer.

Judge Howell quoted the specific language from section 3.11 of the Fund's PSA that addressed mortgage loan modifications: "'The Master Servicer may agree to a modification of any Mortgage Loan . . . if (i) the modification is in lieu of a refinancing . . . and (iii) the Master Servicer purchases the Modified Mortgage Loan from the Trust Fund . . . .'"[346] This provision was the basis for the investors' argument that a declaratory judgment should issue affirming their right under the PSA to have Countrywide buy out of the mortgage loan pool loans that it might modify pursuant to its settlement with the States' Attorneys General.[347] Curiously, the judge attached great value to the "in lieu of a refinancing" phrase, and determined

340 *Id.* (internal quotation marks omitted).
341 *Id.*
342 *Greenwich*, 654 F. Supp. 2d at 203.
343 *Id.* at 202.
344 *Id.*
345 For a discussion of the servicing and mortgage loan modification sections of PSAs, see *supra* Part I.A.
346 *Greenwich*, 654 F. Supp. 2d at 201.
347 *Id.* at 194.

that section 3.11 of the PSA only applied to modifications made in lieu of refinancing.[348] Thus, if a modification were not in lieu of refinancing—as almost all modifications for delinquent borrowers would be—the court reasoned that modifications would be permissible under section 3.11 without any buy-out requirement.[349]

The court also found that other sections of the PSA could authorize mortgage loan modifications without such buy-out requirements.[350] The judge found such language in section 3.01, which discussed Countrywide's rights and duties generally.[351] Section 3.01 described actions that the servicer could take with regard to the mortgage loans it serviced so long as those actions conformed with "[c]ustomary and usual standards of practice of prudent mortgage loan servicers."[352] Thus, Judge Howell concluded that determining which section governs "is a matter of contract construction."[353]

It would likely be easy for a mortgage servicer and mortgage borrower—at least in the case of the particular phrasing of this PSA—to avoid falling into a buy-out requirement by defining the modification as not in lieu of a refinancing. However, it seems that a clearer and more realistic reading of section 3.11 is to see it as the only scenario under which a mortgage servicer would be permitted to modify a loan (i.e., only when a modification is made in lieu of a refinancing and the mortgage loan is purchased out of the pool may a mortgage lender modify mortgage loans). Furthermore, the current practice of the vast majority of mortgage loan servicers is not to modify mortgage loans held in pooled securitizations.[354] Whether this is due more to cost and administrative difficulties on the part of mortgage lenders or their concern about lawsuits from investors, it would seem that these current customs and practices would (or at least should) have some influence on how courts interpret such sections of PSAs.[355]

In a similar and more recent California case, *IndyMac Federal Bank, F.S.B. v. Ocampo*,[356] the United States District Court for the Central District of California also remanded a state proceeding back to state court for lack of federal subject matter jurisdiction.[357] However, in remanding the case, the court did not discuss the Homes Act to any significant extent.[358] The plaintiffs in another recent California case, *Jones v. Premier One Funding,*

348 *Id.* at 201-02.

349 *Id.*

350 *Id.*

351 *Id.*

352 *Greenwich*, 654 F. Supp. 2d at 202 (internal quotation marks omitted).

353 *Id.*

354 *See supra* notes 321-24 and accompanying text.

355 *See id.*

356 IndyMac Fed. Bank, F.S.B. v. Ocampo, No. EDCV 09-2337 PA (DTBX), 2010 WL 234828 (C.D. Cal. Jan. 13, 2010).

357 *Id.* at *2.

358 *See id.*

Inc.,[359] argued that the Homes Act placed an affirmative duty on mortgage loan servicers to modify the terms of borrowers' mortgage loans, but the United States District Court for the Northern District of California concluded that the Homes Act did not place any such affirmative duty on mortgage loan servicers.[360] Importantly, the Court cited 15 U.S.C. § 1639a(b) and stated that the Homes Act "protects loan servicers who engage in modification activities from liability."[361] The lack of any further case law leaves in question the extent to which this dicta might be applied in the future; however, it does demonstrate that courts—at least in the Ninth Circuit—could give effect to the letter of the Homes Act safe harbor provision.

B. *Other Possible Solutions*

Though legal academics sit on either side of the line of whether cramdown is constitutional or advisable from a policy standpoint,[362] the law should, in either case, be clear. If legislators determine that policy considerations demand that such an option be made available to encourage mortgage modifications, it should be a clear legal rule that investors, mortgage lenders, and potential homeowners can rely on. As it stands now, the Homes Act's safe harbor provision does not meet these qualifications. In fact, if given effect by courts, it seems that it could serve as an end-run around the defeated bankruptcy amendments and thus present the same constitutional concerns.

In line with Justice Thomas's dissent in *Kelo*,[363] the federal government should use the TARP funds for their original and intended purpose of purchasing troubled assets.[364] Once the government purchases the MBS products, its mortgage modification programs would be far more effective, as mortgage lenders could modify loans without concern over litigation from investors because the government would be the ultimate holder. This would also eliminate questions about the constitutionality of the Homes Act safe harbor provision. Of course, for any losses suffered on the value of the securities purchased by the Treasury Department, the taxpayer would ultimately be responsible, but that would be a political issue—not a legal issue.

If mortgage modifications must be carried out in order to save the American housing market, which is not necessarily self-evident as scholars and this Comment have suggested,[365] cramdown may be the least objection-

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[359] Jones v. Premier One Funding, Inc., No. C-09-3858 SC, 2010 WL 841277 (N.D. Cal. Mar. 10, 2010).

[360] *Id.* at *3.

[361] *Id.*

[362] *See supra* Part I.B.

[363] Kelo v. City of New London, 545 U.S. 469, 505-23 (2005) (Thomas, J., dissenting).

[364] *See supra* note 89 and accompanying text.

[365] *See supra* notes 319-30 and accompanying text.

able alternative. However, all parties involved (the federal government, the financial services industry, homeowners, etc.) must acknowledge the consequences and effects of such legislation—namely, that cramdown could disincentivize future mortgage lenders from providing financing for homeowners, as lenders will no longer be able to rely on their secured interest in the property during bankruptcy proceedings.[366] Aside from increasing lender risk, cramdown legislation would have the effect of raising interest rates and clogging courts with bankruptcy suits by homeowners seeking to have the terms of their mortgages rewritten.[367] Though the Durbin Amendment would not have changed the actual language of 15 U.S.C. § 1322(b)(2)[368]— rather, it would have provided a temporary exception to its restrictions in order to allow cramdown while the nation is facing increasing foreclosure rates—this change could still have long-term effects on the expectations of players in the housing market.[369] Significantly, it could discourage the revival of the MBS market.[370] It is unnecessary to restate the failures of the financial product, but the ability of securitization to create liquidity and enable a great deal more homeownership than would otherwise be possible cannot be ignored.[371] These effects stand in stark contrast to the government's supposed goals in enacting the Homes Act and other such legislation in response to the housing crisis.[372] Furthermore, encouraging mortgage modifications through cramdown or the Homes Act would serve as a penalty to homeowners who remain current on their mortgage payments but do not benefit from the chance to secure more favorable mortgage loan terms.

One benefit of cramdown legislation over the Homes Act's safe harbor provision is that, in bankruptcy, judges can add a risk premium for secured creditors that have had their secured interests reworked.[373] As has been noted, attaching a risk premium in the bankruptcy context for mortgage loans would be difficult.[374] Under the Homes Act, there is no such allowance for a risk premium on reworked mortgage loans. Considering this fact alone, cramdown may be preferable for investors if given the choice, and

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366 *See* Zywicki, *supra* note 305. *But cf.* Levitin, *supra* note 126, at 578 (arguing that cramdown would have little or no effect on the cost or availability of credit).

367 Williamson, *supra* note 18.

368 *See supra* notes 115-16.

369 *See* Zywicki, *supra* note 305.

370 *Id.*

371 *See supra* notes 32-33.

372 Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, div. A, tit. II, § 201(a), 123 Stat. 1632, 1638 (2009) (stating in the congressional findings that the purpose to the Homes Act and the safe harbor provision is to stem foreclosures, keep people in their homes, and stabilize housing prices).

373 *See supra* notes 213-15.

374 Zywicki, *supra* note 305.

especially if the concerns expressed in Justice Scalia's *Till* dissent are heeded.[375]

CONCLUSION

Though Congress did not adopt the proposed Durbin Amendment to the Homes Act that would have allowed judges to rework the terms of mortgages in bankruptcy, the Homes Act's safe harbor provisions could accomplish essentially the same result. The only case on record, *Greenwich Financial Services v. Countrywide Financial Corp.*, indicates that this safe harbor provision is unlikely to encourage the significant number of mortgage loan modifications that its drafters envisioned. But the serious constitutional concerns raised by the provision cannot be overlooked. If given effect by courts, the safe harbor provision would amount to a regulatory taking and would function as an end-run around the rejected amendments to the Bankruptcy Code. The uncertainty in contractual rights that this legislation could create in the long term would be as detrimental to the functioning of the housing industry—and the economy in general—as the failure to respond to the increase in foreclosures.

If policy makers and legislators determine that cramdown is necessary in order to stave off more foreclosures and prop up the housing market, it is in the interests of that market, the economy, and the sanctity of property and contract rights in general that the rules be certain so that all players can best formulate their expectations and determine their actions. Reintroducing the Durbin Amendment may be the best way to do this, but that would still not conclusively solve the takings issues that the legislation presents or perhaps even the foreclosure crisis. Like the New Deal-era legislation, it seems inevitable that at least some of the new legislation on the books will be scrutinized by the courts, and the Homes Act safe harbor provision is a prime candidate.

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[375] Till v. SCS Credit Corp., 541 U.S. 465, 491-92 (2004) (Scalia, J., dissenting); *see also supra* notes 212-15.