



To: Interested Parties

From: The Center for Popular Democracy and American Civil Liberties Union of New Jersey

Re: The Power of New Jersey Municipalities to Purchase Underwater Mortgages Pursuant to New Jersey's Eminent Domain Law

I. Question Presented

May New Jersey municipalities purchase mortgages using their powers of eminent domain in order to write down the mortgage principals, prevent foreclosures, and inject cash into local economies?

II. Short Answer

Yes. New Jersey state law empowers cities to use eminent domain to purchase mortgages through their eminent domain authority. Two recent decisions by the New Jersey Supreme Court make clear that property characterized by “diversity of ownership” that negatively affects surrounding properties – which almost certainly includes underwater securitized mortgages – constitutes a quintessential example of property that may be properly purchased through eminent domain.

III. Background

New Jersey has the second highest rate of foreclosures in the country, almost twice the national average.¹ All over the state, families continue to navigate the burdens of rising bills and plummeting home values. Although the housing crisis seems to be finally relenting in some parts of the country, the opposite is true in New Jersey.

In order to help suffering families, cities across the country are considering writing down the principals on underwater mortgages after purchasing them through their power of eminent domain. By using eminent domain to purchase underwater mortgages, municipalities can help their residents lower mortgage debt, reduce default risk, and increase the value of their homes. The private sector has failed to implement widespread mortgage principal reduction for securitized mortgages because of high transaction costs, conflicts of interest, and collective action problems: precisely the age-old issues that justify the use of eminent domain to build railroad tracks, highways, or public schools.

The use of eminent domain has been rooted in our legal system since this country was founded and the Supreme Court has repeatedly affirmed the right of states to formulate local eminent domain policy within constitutional boundaries. Although eminent domain more familiarly

involves compulsory purchases of physical property, it has also long been used to purchase intangible property like leaseholds, rights-of-way, contracts, and other financial instruments.² The only notable aspect of the current proposals is that the property being purchased is a mortgage. But that fact does not make it legally suspect. On the contrary, New Jersey law *explicitly* defines real property to include mortgages and the New Jersey Supreme Court has recently highlighted the appropriateness of using eminent domain in situations when the diversity of ownership creates blight.

IV. Discussion

A. New Jersey Law Authorizes Cities to Condemn Mortgages Through Eminent Domain

As the New Jersey Supreme Court recently reiterated, “[t]he concept of eminent domain dates back to the Magna Carta. It is deeply rooted in our own jurisprudence, having first been declared in the 1776 New Jersey Constitution.”³

A municipality “may exercise its eminent domain power so long as it adheres to the [Constitution’s] Eminent Domain Clause and any applicable statutory requirements.”⁴ The statutory requirements governing the use of eminent domain for redevelopment are embodied in New Jersey’s Local Redevelopment and Housing Law (“LRHL”).⁵ The law establishes the procedure that cities must follow if they wish to condemn property for the purpose of development: the city must conduct an investigation to determine whether the property is in need of redevelopment (including for the reason of addressing or preventing blight), hold a public hearing, make recommendations, accept public comment, and consider objections. Ultimately, after complying with the statutory procedures, “the municipal governing body may adopt a resolution determining that the delineated area, or any part thereof, is a redevelopment area.”⁶ Once the city makes that determination and adopts a redevelopment plan for the area, the “the municipality is authorized to utilize all those powers provided in [N.J. Stat. Ann. 40A:12A-8].”⁷

N.J. Stat. Ann. 40A:12A-8 grants municipalities the authority to “[a]cquire, by condemnation, any land or building which is necessary for the redevelopment project, pursuant to the provisions of the ‘Eminent Domain Act of 1971’ [N.J. Stat. Ann. 20:3-1].” That text, however, grants cities the power to condemn “any land or building.” May cities use this authorization to condemn mortgages?

The New Jersey Supreme Court recently addressed a nearly identical question. The Town of Keany sought to condemn through eminent domain a leasehold interest. The Court concluded that the municipality “is empowered to condemn a leasehold interest, separate and apart from, and without the condemnation of, the fee simple.”⁸

To reach that conclusion, the Supreme Court referenced the state’s Eminent Domain Act, which explicitly states that if a municipality “shall specify a lesser title [than a fee simple], the lesser title so specified shall be the title condemned and acquired.”⁹ This statutory language

“anticipates a situation in which a leasehold or an easement is the only condemned property interest.”¹⁰ Crucially, the Court explained, this “interpretation gels with the language the Legislature used to define ‘real property’ and ‘property’ in the LRHL and the Eminent Domain Act which cross-reference each other and require cognate interpretations.”¹¹

This analysis applies *precisely* to mortgages as well as to leaseholds because mortgages, like leaseholds, are included in the definition of real property in the LRHL. The LRHL defines real property as

all lands, including improvements and fixtures thereon, and *property of any nature appurtenant thereto* or used in connection therewith, and every estate, interest and right, legal or equitable, therein, including terms for years and *liens by way of judgment, mortgage or otherwise*, and indebtedness secured by such liens.¹²

Thus, just as cities are empowered by the LRHL to condemn leasehold interests (*i.e.*, “terms for years”), they are entitled to condemn mortgages (*i.e.*, “liens by way of . . . mortgage”).

Similarly, as the Court explained, the Eminent Domain Act defines property as “land, or *any interest in land*.”¹³ New Jersey courts have long held that mortgages constitute “interests in land”¹⁴ and that understanding matches the fundamental notion that a mortgage grants the lender a security interest in the land if the loan is not repaid. As the Restatement of Property observes, “[a] mortgage creates . . . a security interest in real estate.”¹⁵

The New Jersey courts have explained that the LRHL and the Eminent Domain Act must be read in conjunction with one another. The text of the LRHL explicitly defines real property to include mortgages and the Supreme Court held only two years ago that this definition governs the types of property that municipalities may seize. There can be little doubt, therefore, that New Jersey cities have the power to condemn mortgages.¹⁶

B. According to the New Jersey Supreme Court, Securitized Mortgages Are Precisely the Type of Property That May Be Seized

In a 2007 case, *Gallenthin Realty Development Inc. v. Borough of Paulsboro* (“*Gallenthin*”), the New Jersey Supreme Court narrowed the scope of municipalities’ eminent domain authority.¹⁷ The Court held that the Borough of Paulsboro was not authorized to classify certain wetlands as “in need of redevelopment” (and therefore subject to taking via eminent domain). The Court explained that the Local Redevelopment and Housing Law was not intended “to apply in circumstances where the sole basis for redevelopment is that the property is ‘not fully productive.’”¹⁸ Instead, it explained, the act “N.J.S.A. 40A:12A–5(e) applies only to property that has become stagnant and unproductive because of issues of title, diversity of ownership, or other conditions of the same kind.”¹⁹

Diversity of ownership is the central feature of a securitized mortgage: the lender has effectively sliced and diced the mortgage and sold it in various tranches to multiple bondholders. It is precisely this securitization and diversity of ownership that prevents the private parties from reducing the mortgage principal. Principal reduction of deeply underwater mortgages *increases* the value of the mortgages to the lender because it significantly reduces the risk of default and relieves the lender of the costs of foreclosure. This is why lenders who own entire mortgages have written down thousands of them in recent years – it serves their interests.²⁰

However, when mortgages are securitized and sold to diffuse bondholders, numerous and complicated contractual and collective action problems prevent mortgage principal reduction.²¹ Furthermore, the servicers who ostensibly act in the interest of the bondholders have interests that often conflict with the bondholders: their compensation is set as a percentage of the outstanding debt (which discourages reducing principal) and they are reimbursed the costs of foreclosure but are not reimbursed the costs of principal reduction. Thus, the central feature of mortgage securitization – diversity of ownership – is precisely the characteristic that is preventing principal reduction.

Underwater securitized mortgages that are at risk of foreclosure are therefore the quintessential form of “property that has become stagnant and unproductive because of issues of title, *diversity of ownership*, or other conditions of the same kind.”²²

C. Neighborhoods With High Numbers of Underwater Homes Are “Blighted” and Eligible for Redevelopment

The Supreme Court of New Jersey has held that only property that is blighted, or becoming blighted, can be purchased by municipalities.²³ In *Gallenthin*, it explained that the “essential characteristic” of blight is “deterioration or stagnation that negatively affects surrounding properties.”²⁴

While the definition of blighted neighborhoods was once more limited, the New Jersey Supreme Court has expanded this definition in recent decades. Under the current definition, blight includes those properties that have “reached a stage of stagnation and unproductiveness.”²⁵ The court has expressed its approval of municipal intervention for blighted areas, stating that “community redevelopment [is] a means of removing the decadent effect...on neighboring property values,”²⁶ and that “blighted property presents a real hindrance to the development of the city [which] cannot be eliminated or improved without public assistance.”²⁷

There is indisputable evidence that foreclosures lead to declining property values for neighbors.²⁸ And there is similarly strong evidence that falling prices put families under water, which leads to foreclosure.²⁹ Because of this vicious cycle, neighborhoods with high rates of foreclosure and underwater mortgages are neighborhoods whose property is continually

sinking in value. By definition, these neighborhoods are blighted. Municipalities may therefore designate them as redevelopment zones for which the use of eminent domain is appropriate.

The housing crisis has resulted in billions of dollars in neighborhood loss, including for faultless homeowners who have always kept up with their mortgages. In New Jersey, areas with a significant number of homes that are underwater meet the legal standard for blight, as these mortgages cause entire neighborhoods to deteriorate in value. Some neighborhoods certainly suffer from worse blight than others, but the essential point remains: many neighborhoods with a significant number of underwater mortgages are in, or headed toward, blight.

V. Conclusion

The underwater mortgage crisis has persisted for six years and counting because the private sector *cannot* solve the collective action and transaction cost problems on its own. Underwater securitized mortgages are a significant burden on municipal development and recovery. Public solutions, in the form of using long-established eminent domain powers to purchase underwater mortgages and readjust them to current market value, can finally help alleviate this burden.

New Jersey law permits municipalities to condemn mortgages and the New Jersey Supreme Court has recently emphasized that, although the power of eminent domain is not unlimited, it is appropriate specifically when the diffusion of property ownership leads to stagnant and unproductive use of land.

¹ Orlando Rodriguez, *New York, New Jersey emerge as foreclosure leaders*, Real Estate Weekly (June 26, 2013).

² “The U.S. Supreme Court and the Courts of Appeals have regularly held that the [eminent domain] authority extends, for example, to contract rights, insurance policies, shares of stock, businesses as going concerns, hunting rights, rights of way, and all manner of additional intangible. U.S. states follow the same longstanding common law tradition as does federal law in this connection.” Robert Hockett, *It Takes a Village: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Local Economic Recovery*, Stanford Journal of Law, Business, and Finance, Vol. 18, No. 121, 2013 at 43.

³ *Town of Kearny v. Discount City of Old Bridge, Inc.*, 205 N.J. 386, 399 (2011) (“In contour, the doctrine recognizes “the rightful authority which exists in every sovereignty to control rights of a public nature which pertain to its citizens in common and to appropriate and control property for the public benefit as the public safety, necessity, convenience, or welfare may demand.” (citations omitted)).

⁴ *Id.* at 400.

⁵ “The statutory requirements governing blight and redevelopment are embodied in the LRHL which was enacted to ‘revise [], consolidate [] and clarif [y] the various statutes related to the exercise of redevelopment and housing powers by local governments into a modern and comprehensive statute,’” *Town of Kearny*, 205 N.J. at 400 (quoting Assemb. 1138 (Assembly Housing Committee), 205th Leg., 1992 N.J. ALS 79 (N.J. 1992)).

⁶ N.J. Stat. Ann. 40A:12A-6(b)(5).

⁷ N.J. Stat. Ann. 40A:12A-6(c).

⁸ *Town of Kearny*, 205 N.J. at 405.

⁹ “The title to property condemned and acquired by the condemnor hereunder, shall be a title in fee simple, free and discharged of all right, title, interest and liens of all condemnees, and shall include all the right, title and interest of each condemnee therein, provided, however, that *if the complaint or any amendment thereof shall*

specify a lesser title, the lesser title so specified shall be the title condemned and acquired.” *Town of Kearny*, 205 N.J. at 405 (quoting N.J. Stat. Ann. 20:3–20) (emphasis the Court’s).

¹⁰ *Id.*

¹¹ *Id.*

¹² N.J. Stat. Ann. § 40A:12A-3 (emphasis added).

¹³ N.J. Stat. Ann. § 20:3–2(d) (emphasis added).

¹⁴ *Joseph S. Naame Co. v. Louis Satanov Real Estate & Mortgage Corp.*, 2 Backes 386, 390 (N.J. Ch. 1928)

(examining statute of frauds and noting that “[t]here can be no doubt that a mortgage is such an interest in land as the statute requires to be in writing”).

¹⁵ Restatement (Third) of Property: Mortgages 4.1 (“A mortgage creates only a security interest in real estate and confers no right to possession of that real estate on the mortgagee”).

¹⁶ The definitions in the LRHL and the Eminent Domain Act are re-enforced by that in the Local Lands and Building Laws (“LLBL”). The LLBL says that “[a]ny county or municipality may acquire: (a) Any real property . . . or any interest or estate whatsoever therein” (N.J. Stat. Ann. 40A:12-4., entitled “Further acquisitions authorized.”) and it defines property to include “the usual connotations thereof,” which New Jersey courts have advised are “extremely broad.” See *Township of Hillsborough v. Robertson*, 260 N.J. Super. 37, 44 (App. Div. 1992) (noting that “[t]he definition of ‘real property’ provided in N.J.S.A. 40A:12-2(g) is extremely broad and includes ‘the usual connotations of real property’” in finding that the Legislature intended to enable the acquisition by municipalities of easements).

¹⁷ *Gallenthin Realty Dev., Inc. v. Borough of Paulsboro*, 191 N.J. 344 (2007).

¹⁸ *Id.* at 348.

¹⁹ *Id.* at 373.

²⁰ See 3/15/2012 Testimony of Laurie S. Goodman to the U.S. Senate Subcommittee on Housing, Transportation and Community Development, available at

www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0f96e0ff-8500-41a5-a0f2-0139d0df2e07; Robert Hockett, *Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt*, Federal Reserve Bank of New York, (2013); David Streitfeld, *Big Banks Easing Terms on Loans Deemed as Risks*, NY Times (July 2, 2011).

²¹ See generally Robert Hockett, *It Takes a Village: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Local Economic Recovery* at 43; Diane E. Thompson, *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior: Servicer Compensation and its Consequences* (2009).

²² *Gallenthin Realty Dev.*, 191 N.J. at 373 (2007).

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 363.

²⁶ *Id.*

²⁷ *Gallenthin*, quoting *Sweetwater Valley Civic Ass'n v. City of National City*, 18 Cal.3d 270 (1976).

²⁸ See *Dan Immergluck and Geoff Smith, The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*.

²⁹ See Stan Liebowitz, *New Evidence on the Foreclosure Crisis*, Wall Street Journal (July 3, 2009) (“What is really behind the mushrooming rate of mortgage foreclosures since 2007? The evidence from a huge national database containing millions of individual loans strongly suggests that the single most important factor is whether the homeowner has negative equity in a house – that is, the balance of the mortgage is greater than the value of the house.”)