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MEMORANDUM ADDRESSING THE CONSTITUTIONALITY OF FEDERAL LEGISLATION REQUIRING NON-VOLUNTARY AMENDMENTS TO EXISTING MORTGAGE CONTRACTS

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EXECUTIVE SUMMARY

Introduction

Congress has the constitutional authority to impose reasonable restrictions on existing mortgage contracts, even if those restrictions are mandatory rather than voluntary. The legislation contemplated below would fall well within the power granted Congress by the Commerce Clause and would in no way implicate the Contract Clause, which applies only to state governments. The only feasible challenges to such legislation would come from the Takings Clause and the Due Process Clause. As this memo will explain, all the measures contemplated below would almost certainly survive judicial review.

Assumptions

For the purposes of this paper, we assume that the proposed legislation will consist of some combination of the following provisions:

- Freezes, caps, or reductions of interest rates
- Extension of repayment periods
- Waiver of modification fees
- Reductions of the mortgage principal to the property's fair market value

Commerce Clause

Federal legislation amending existing mortgage contracts would fall well within the power granted Congress by the Commerce Clause. Congress has broad powers with which to regulate interstate commerce and, given the recent economic crisis, there can be little doubt that the terms of mortgage agreements have a substantial impact on commerce that go well beyond the bounds of any one state. The Supreme Court rarely invalidates

federal legislation due to a lack of authority under the Commerce Clause, and decisions that do so only cover a limited range of non-economic (and often criminal) conduct.[1]

Takings Clause

It is extremely unlikely that any court would sustain a challenge to the contemplated legislation under the Takings Clause of the Fifth Amendment and require the government to pay just compensation to mortgage holders who were compelled to amend the terms of existing mortgage contracts. Courts broadly characterize potential takings as either "categorical" takings or takings that fall under a balancing test. Potential takings are "categorical" if they involve either a "permanent physical invasion"[2] or they deprive the interest holder of "all economically beneficial use of their property."[3] Otherwise, they are considered under the balancing test of Penn Central.[4]

Courts grappling with potential takings consider the permanent invasion of a piece of property to be a categorical taking and will require just compensation for that portion of property [5] Other restrictions, however, such as temporary invasions[6] or restrictions on the right to exclude individuals,[7] do not implicate the categorical takings doctrine. The legislation contemplated in this memorandum does not go even as far as those examples – it merely regulates the relationship between borrower and mortgage holder and does not fundamentally alter the mortgage holder's interest in the property (or any discrete portion of it). The Supreme Court has consistently affirmed that the government has broad

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[1] See, e.g., United States v. Morrison, 529 U.S. 598 (2000).
[2] See Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982) (discussing permanent physical invasions).
[3] See Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992) (discussing the deprivation of all economically beneficial uses).
[4] Penn Cent. Transp. Co. v. New York City, 438 U.S. 104 (1978) (hereinafter "Penn Central").
[5] See Loretto, 458 U.S. at 419. (requiring just compensation for space on a roof for a cable box).
[6] Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency, 535 U.S. 302, 321 (2002).
[7] See Heart of Atlanta Motel, Inc. v. United States, 379 U.S.241 (1964).

power to regulate housing conditions without paying compensation,[8] and has declined to consider even substantially more severe restrictions on property rights, like rent control regimes, to be categorical takings.[9] The contemplated legislation does not purport to extinguish mortgage holders' interests in the mortgage notes or the properties themselves, and allows mortgage holders to retain considerable economic benefit. The legislation proposed here, like the vast majority of government regulation, will fall under the Penn Central balancing test,[10] not the categorical takings doctrine.

It is extremely likely that legislation requiring mortgage holders to amend existing mortgage contracts or placing restrictions on existing mortgages would pass the Penn Central balancing test, which courts use to assess the effect of government regulations on property.[11] Under the balancing test, courts consider "[t]he economic impact of the regulation," the extent to which the regulation "interfered with distinct investment-backed expectations," and the character of the regulation.[12] The heavily regulated nature of the mortgage industry means that any reasonable investor was or should have been aware the regulations governing these instruments could change in time of crisis, and the widespread nature of the foreclosure crisis points to legislation which simply "adjusts the benefits and burdens of public life."[13] In addition, because the contemplated legislation would help reduce the current avalanche of foreclosures and may stabilize property values across the nation, its ultimate economic effect on mortgage holders would likely be limited.

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[8] E.g., Yee v. City of Escondido, 503 U.S. 519 (1992).
[9] See Block v. Hirsch, 256 U.S. 135 (1921); Pennell v. City of San Jose, 485 U.S. 1 (1988); Yee, 503 U.S. at 519.
[10] See Penn Central, 438 U.S. at 104.
[11] Courts also use the "unconstitutional conditions" balancing test, but only in the exactions context. For the leading case on this doctrine, see Nolan v. California Costal Comm'n, 483 U.S. 825 (1987).
[12] Penn Central, 438 U.S. at 124.
[13] Id.

At base, the Penn Central test measures whether the proposed government action "force[s] some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[14] Because the current crisis has numerous deleterious effects on the public – ranging from the blight created in many communities by numerous foreclosures to threats to the financial system of this nation –and because these effects resulted in large part from the economic activity engaged in by those the contemplated legislation would regulate, it is both just and fair for those mortgage holders to bear the costs of attempts to remedy the situation.

Due Process Clause and the Contract Clause

The Federal Government's ability to modify existing contract rights is somewhat restrained by the Due Process clause of the Fifth Amendment.[15] However, the substantially more restrictive conditions imposed on States by the Contract Clause do not apply to federal legislation.[16]

Under the doctrine of substantive due process there is a "clear federal power to retroactively alter private contractual rights."[17] The party challenging the constitutionality of the act must demonstrate "first, that the statute alters contractual rights or obligations" and then "that the impairment is of constitutional dimension."[18] If the first two parts of that test are met the complaining party must "overcome a presumption of constitutionality and 'establish that the legislature has acted in an arbitrary and irrational way.'"[19] In cases of private contracts allegedly impaired by

[14] Armstrong v. United States, 364 U.S. 40, 49 (1960).
[15] National R.R. Passenger Corp. v Atchinson, Topeka & Santa Fe R.R. Co., 470 U.S. 451, 472 (1985).
[16] See Pension Ben. Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 733 (1984).
[17] U.S. Const. art 1 §10, cl. 1; Parker Motor Freight, Inc. v. Fifth Third Bank, 116 F.3d 1137, 1142 (6th Cir. 1997) *citing* Pension Ben. Guar. Corp, 467 U.S. at 732.
[18] National R.R. Passenger Corp. 470 U.S. at 472 (1985).
[19] Id. *citing* Pension Ben. Guar. Corp, 467 U.S. at 729.

federal statutes the third step “is especially limited, and the judicial scrutiny quite minimal.”[20] It is almost certain that any legislation along the lines discussed above would be considered constitutional under this test.

Equal Protection

Even if the relief offered treated homeowners or mortgage holders differently based on their circumstances (e.g. by the type of mortgage affecting them), such a statute would survive a challenge on equal protection grounds.[21] As a matter of “social and economic policy,” the contemplated legislation would be reviewed using a “rational basis” test. Under that standard, a statute “must be upheld against equal protection challenge if there is any reasonably conceivable state of facts that could provide a rational basis for the classification.”[22] Those challenging a statute have “to negative every conceivable basis which may support it.”[23] So long as the policy enacted has any plausible justification for treating different groups differently it is likely to be well insulated from constitutional challenge.

Brief Conclusion

As the body of this memorandum explains in much greater detail, none of the Constitutional provisions discussed here present a significant barrier to federal legislation designed to modify the terms of existing mortgages to provide relief to homeowners and their communities. Such action falls squarely within the bounds of Congressional power under the Commerce Clause. It is extremely unlikely that the Takings Clause of the Fifth

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[20] Id.
[21] The Equal Protection Clause of the Fourteenth Amendment does not apply to the Federal Government. However, the same protections and standards apply under to the Federal Government under the Due Process Clause of the Fifth Amendment. Adarand Constructors v. Pena, 515 U.S. 200, 217 – 218 (1995).
[22] F.C.C. v. Beach Communications, 508 U.S. 307, 313 (1993) (internal citations omitted).
[23] Id. at 315.

Amendment would require just compensation to be paid to affected mortgage holders, provided the law stayed within the very broad bounds contemplated in this memo. Furthermore, given the highly deferential standards of review which would apply to both substantive due process and equal protection challenges brought under the Fifth Amendment, such challenges will almost certainly fail. Modern constitutional law indicates that neither the Fifth Amendment nor any other provision bars the Federal Government from offering homeowners and communities relief they both need and deserve.

Section One: Introduction, Assumptions, And Congressional Authority

I. Introduction

Modern constitutional law poses no serious barrier to federal legislation providing relief to homeowners and communities by modifying the terms of existing mortgages. Laws dealing with mortgages fall well within the power granted Congress by the Commerce Clause. Congress has broad power to regulate interstate commerce, and given the recent economic crisis, there is little doubt that the terms of mortgage agreements have a substantial impact well beyond the bounds of any one state.

It is extremely unlikely that any court would sustain a challenge to the contemplated legislation under the Takings Clause of the Fifth Amendment and require the government to pay just compensation to mortgage holders who were compelled to amend the terms of existing mortgage contracts. The legislation proposed here, like the vast majority of government regulation, will fall under the Penn Central balancing test rather than the categorical takings doctrine. At base, the Penn Central test measures whether the proposed government action unjustly forces some alone to bear burdens that should be fairly distributed to the public at large. Because the current crisis has numerous deleterious effects on the public – ranging from the blight created in many communities by numerous foreclosures to threats to the financial system of this nation – and because these effects resulted in large part from the economic activity engaged in by those the contemplated legislation would regulate, is both just and fair for those mortgage holders to bear the costs of attempts to remedy the situation.

Nor would the Contract Clause or Due Process Clause pose a serious threat to such legislation. The Contract Clause only restricts the power of the states, it has no bearing or affect on federal legislation. The Federal Government's ability to alter contracts made by private parties is only minimally restricted by the Due Process Clause of the Fifth Amendment. Judicial review of federal legislation modifying private contracts is reviewed with an extremely deferential standard and upheld unless "arbitrary and irrational."[24] Given the effects foreclosures have on individuals, communities, and the national economy as a whole it is almost certain that a court would not view attempts to assist homeowners and communities as so irrational as to override the presumption in favor of the validity of Congressional action. Should the relief offered classify borrowers or mortgage holders into different categories, equal protection concerns may be implicated. However, as a statute with an economic and social purpose (that does not use suspect classifications, such as race), it would be reviewed using a deferential rational basis standard. There is little doubt that relief for homeowners and communities would have a plausible justification and withstand rational basis scrutiny.

In sum, modern constitutional law poses no serious barriers to federal legislation modifying the terms of mortgages to provide relief to homeowners and communities. Such action falls well within the bounds of Congressional power under the Commerce Clause. It is extremely unlikely that the Takings Clause of the Fifth Amendment would require just compensation be paid to affected mortgage holders, provided the law stayed within the broad bounds contemplated in this memo. Furthermore, courts will almost certainly uphold such legislation due to the extreme deference accorded to Congress under the standards of review governing both substantive due process and equal

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[24] Pension Ben. Guar. Corp, 467 U.S. 717, 729 (1984).

protection challenges brought under the Fifth Amendment. Congress has the constitutional authority to grant American homeowners and communities the relief they both need and deserve.

II. Assumptions Regarding Potential Legislation

Congressionally mandated mortgage loan modifications could include many types of provisions. Among these are freezes, caps or reductions of interest rates, waiving of modification fees, and extension of repayment terms.

In theory, excessive contract changes more drastic than those proposed below could so dramatically alter property and contract rights as to be unconstitutional. For example, legislation that simply transferred the entire property to the borrower would at least require just compensation be paid to the mortgage holder. However, for the purposes of this paper, we will assume that the proposed legislation does not include such extreme measures and instead consists of some combination of the following provisions:

- Freezes, caps, or reductions of interest rates
- Extension of repayment periods
- Waiver of modification fees
- Reductions in mortgage principal down to the current fair market value of the property

Mandating any of these changes either through Congressional stipulation of terms or required modifications would fall squarely within the power granted Congress by the Commerce Clause under the United States Constitution and would almost certainly not run afoul of any constitutional protections.

III. Presumption of Constitutionality

A party that seeks to challenge a Congressional statute must overcome a strong presumption of its constitutionality.[25] Parties who seek to challenge the legislation on its face would need to surmount an especially difficult hurdle. The Supreme Court has held that "a facial challenge to a legislative Act is, of course, the most difficult challenge to mount successfully, since the challenger must establish that no set of circumstances exists under which the Act would be valid."[26]

Economic and remedial statutes are accorded a high degree of deference even when they create legislative classifications. Considerations such as whether the law is efficient or convenient are not the concern of the Court.[27] When interpreting a statute that may or may not be ambiguous, the Court follows the "elementary rule" that "every reasonable construction must be resorted to, in order to save a statute from unconstitutionality."[28]

IV. Commerce Clause Authority

Congress has the power under the Commerce Clause to regulate all activities that have a substantial relation to interstate commerce. For many years, the Supreme Court essentially refused to define the outer contours of the Commerce Clause authority and stated its belief that the "built in-restraints" of federalism would ensure laws that unduly burden the states would not be promulgated.[29] In recent years, the Court has reversed course and has struck down federal laws on Commerce Clause grounds in certain

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[25] Immig. and Naturalization Service v. Chadha, 462 U.S. 919, 944 (1983).
[26] United States v. Salerno, 481 U.S. 739, 745 (1987).
[27] Id.
[28] Edward J. DeBartolo Corp. v. Florida Gulf Coast Bldg. & Constr. Trades Council, 485 U.S. 568, 575 (1988).
[29] E.g., Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528 (1985).

circumstances.[30] These decisions, however, only cover a limited range of actions and the Court has repeatedly noted that "the non-economic, criminal nature of the conduct" at issue in those cases was central to its rulings.[31]

The Court's view of what constitutes "economic" conduct and what conduct affects interstate commerce is still quite expansive. Restrictions on mortgages fall clearly within the power granted to Congress by the Commerce Clause.[32] Given the monumental effect that the recent mortgage lending crisis has had on the U.S. financial markets and overall economy, it is hard to imagine an activity *more* central to interstate commerce than the creation, amendment, and termination of mortgage contracts. Even if a mortgage contract was made by a mortgage holder in the same state as the borrower, and there was no intention of selling the debt, the Federal Government would still have the ability to pass legislation affecting it. The Court demonstrated as much in Gonzales v. Raich, where it upheld a federal law banning the cultivation and use of marijuana even though the marijuana in question was grown and consumed in the same state and did not cross any borders. The Court justified its decision in part on the grounds that Congress has the "power to regulate purely local activities that are part of an economic class of activities that have a substantial effect on interstate commerce."[33] The Commerce Clause thus grants the federal government the power to amend, or to require mortgage holders to amend, the terms of existing mortgage contracts.

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[30] See, e.g., United States v. Lopez, 514 U.S. 549 (1995) (holding that the federal government had no authority to regulate possession of firearms in school zones).
[31] United States v. Morrison, 529 U.S. 598 (2000).
[32] See Stone v. Mehlberg, 728 F.Supp.1341, 1350 (1989) *citing* Mourning v. Family Publication Services, Inc., 411 U.S. 356, 377 – 378 (1973) (holding that the Truth in Lending Act is "within the power granted to Congress under the Commerce Clause.")
[33] Gonalez v. Raich, 545 U.S. 1, 17 (2005) (internal quotations omitted).

SECTION TWO: TAKINGS CLAUSE ANALYSIS

I. Introduction to Takings Analysis

A federal statute or regulation that would require mortgage holders to amend the terms of existing mortgage contracts would very likely not constitute an unconstitutional taking without just compensation. It is extremely unlikely that any of the many lines of Takings Clause jurisprudence would require the federal government to compensate mortgage holders due to the legislation discussed here.

The text of the Takings Clause focuses on physical takings – commonly described as eminent domain. This clause requires the federal government, and state governments,[34] to provide just compensation "whenever the government acquires private property for a public purpose."[35] Property for purposes of the Fifth Amendment includes not only "real property" like fees simple and leaseholds, but a number of other tangible and intangible items such as Indian artifacts,[36] trade secrets,[37] mortgage liens,[38] and possibly certain "valid contracts."[39] Even though courts will consider mortgage liens as property under the Fifth Amendment, this does not mean that regulations requiring reasonable modifications to the underlying contracts would constitute an unjustifiable and compensable taking.

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[34] For many years, the Takings Clause limited only the federal government. Over a hundred years ago, however, the Supreme Court applied the Takings Clause to the states through the Fourteenth Amendment's Due Process Clause. Chicago B. & Q. R. Co. v. City of Chicago, 166 U.S. 226 (1897). It is well-settled law that "the restraints imposed by the national government in this regard by the *Fifth Amendment* are no greater than those imposed on the States by the Fourteenth." Bowles v. Willingham, 321 U.S. 503 (1944) *citing* Hamilton v. Kentucky Distilleries Co., 272 U.S. 146, 157 (1926).

[35] Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency*,* 535 U.S. 302, 321 (2002).

[36] See Andrus v. Allard, 444 U.S. 51 (1979) (Indian artifacts containing eagle feathers regulated under the Endangered Species Act).

[37] Ruckelshaus v. Monsanto Co., 467 U.S. 986 (1984).

[38] Louisville Joint Stock Land Bank v. Radford, 925 U.S. 555 (1935) (mortgage lien).

[39] Lynch v. United States, 292 U.S. 571, 579 (1934) ("valid contracts are property, whether the obligor be a private individual, a municipality, a state, or the United States.") In a Part II, Section V, this memo will discuss the contours of this doctrine.

Courts divide takings cases into two broad categories: physical takings (such as condemnations) and regulatory takings. Even though the Constitution does not explicitly contemplate the impact of government regulations on private property, the Supreme Court has long since recognized that "government regulation of private property may, in some instances, be so onerous that its effect is tantamount to a direct appropriation" compensable under the Fifth Amendment.[40] Courts would almost certainly consider the legislation contemplated in this memo as regulatory rather than physical in nature (unless the government decided to, for example, seize all control over the mortgage note in question).

Unlike physical takings jurisprudence,[41] regulatory takings jurisprudence is extremely complex and consists of numerous lines, some of which depend on *per se* rules and others which apply broad based standards. It is extremely unlikely, however, that any of these lines would require the government to pay just compensation for mortgage holders who were compelled to amend the terms of existing mortgage contracts.

II. Permanent Physical Invasions

FEDERAL LEGISLATION MODIFYING EXISTING MORTGAGE CONTRACTS WOULD NOT CAUSE MORTGAGE HOLDERS TO SUFFER A "PERMANENT PHYSICAL INVASION."

In some situations, none of which apply to the legislation contemplated in this memo, courts have recognized that the government may physically invade a particular piece of property through regulation by requiring a holder of property rights to accept the

[40] Lingle v. Chevron U.S.A. Inc., 544 U.S. 528 (2005) (tracing that development of the regulatory takings doctrine back to Pennsylvania Coal v. Mahon, 260 U.S. 393 (1922)).
[41] The jurisprudence of condemnations and physical takings for the most part "involves the straightforward application of *per se* rules" and requires compensation regardless of whether a government seizes all or only part of a property. Tahoe-Sierra, 535 U.S. at 322.

physical presence of someone or something on that property.[42] If that physical presence is permanent, a court will consider the government action a "categorical taking" and will require the government to pay the property owner just compensation.[43] Because the Supreme Court has limited this doctrine to a unique subset of regulatory actions, the "permanent physical invasion" doctrine will not apply to any of the measures discussed in the "Assumptions" section of this memo.

The Court developed the "permanent physical invasion" doctrine in Loretto v. Teleprompter Manhattan CATV Corp., which dealt with a New York State statute that required landlords to allow the cable company to install CATV facilities on their properties for their tenants.[44] The lead plaintiff in Loretto brought, and won, a class action based on the Takings Clause after purchasing a property with previously installed CATV facilities.[45] The Court in Loretto focused on the uniquely invasive nature of the government action at issue, noting that "a physical invasion is a government intrusion of an unusually serious character."[46] The Court distinguished the CATV installation from other government regulations that physically impact property rights, such as requirements to install smoke detectors, because the cable company, not the plaintiff, literally owned the wire that snaked through the plaintiff's building.[47] Notably, the Court in Loretto did not depart from its traditional practice of analyzing a regulation's effect on the owner's

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[42] See, e.g., Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982).

[43] Before Lingle, the Supreme Court did not explicitly classify "permanent physical invasion" regulatory cases in the manner presented in this memo and essentially considered "deprivation of value" cases as the only type categorical regulatory takings. In fact, previous Supreme Court cases seem to have, perhaps unintentionally, placed Loretto and similar cases in with the traditional "physical takings" doctrine rather than the "regulatory takings" doctrine. See Tahoe-Sierra, 535 U.S. at 322, 323. Despite this confusion, it is clear that the current Court both considers cases like Loretto to be regulatory cases and places these cases in a distinct line from Lucas cases.

[44] Loretto, 458 U.S. at 419.

[45] Id. at 424.

[46] Id. at 433.

[47] Id. at 440, fn. 19.

entire interest in the property rather than one particular piece;[48] rather, it noted that in unique context of permanent physical invasions "the government does not simply take a single 'strand' from the 'bundle' of property rights: it chops through the bundle, taking a slice from every strand."[49]

Due to the limited nature of this doctrine and the sharp contextual distinction between the full owner of an apartment complex and the holder of a mortgage note, only the most extreme regulations would implicate the "permanent physical invasion" rule. A regulation that permanently eliminated a mortgage holder's ability to foreclose on a particular property would run afoul of this test.[50] A regulation that literally seized part of a payment already received by a mortgage holder from the mortgage holder's bank account would also constitute a categorical taking.[51] But an incredibly wide array of other measures would not implicate this doctrine. In particular, none of the measures discussed in the "Assumptions" section of this memorandum would have any physical impact on the mortgage holder's interest in the property under either a "title theory" or a "lien theory" of borrower-mortgage holder relations.[52] It would be impossible to argue

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[48] E.g., Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency, 535 U.S. 302, 327 (2002) (noting that "in regulatory takings cases we must focus on 'the parcel as a whole' and rejecting the plaintiff's attempt to divide the property rights into temporal sections) *citing* Penn Central Transportation Co v. New York City, 438 U.S. 104 (1978); Concrete Pipe & Products of Cal., Inc. v. Construction Laborers Pension Trust for South Cal., 508 U.S. 602 (1993).
[49] Loretto, 458 U.S. at 435.
[50] Similarly, regulations that did not directly extinguish a mortgage holder's interest in a property but were so onerous that they in essence eliminated its ability to obtain possession would probably constitute a taking. See W. B. Worthen Co. v. Thomas, 292 U.S. 426 (1934) (striking down a state law that sheltered life insurance payments from creditors and thus completely eliminated a creditor's ability to collect on a debt). The legislation contemplated in this memo, however, would neither legally or practically eliminate a mortgage holder's ability to foreclose and would thus not implicate this doctrine.
[51] See Brown v. Legal Foundation of Washington, 538 U.S. 216 (2003) (noting that the transfer of interest income from IOLTA accounts to the Washington Legal Foundation seems more akin to Loretto than Penn Central). Of course, one could easily structure a tax that would have an identical impact but would raise no constitutional concerns.
[52] Under the title theory, the law views the mortgage contract as a transfer of title from the borrower to the mortgage holder until the mortgage loan is paid off. Under the lien theory, the borrower holds full equitable and legal title and transfers only a future interest, which takes the form a lien. The lien is

that legislation that simply capped mortgage interest payments at a certain rate, for example, created a "permanent physical invasion." The homeowner would simply abide by the terms of the amended agreement and retain full right to possession of property or he would not abide by the agreement and the mortgage holder would exercise its right to take possession.[53] At worst, the required modification of the contract would simply delay the mortgage holder's ability to gain control of the premises. This temporary delay would not the rule requiring a *permanent* physical invasion.

Even if a homeowner at risk of foreclosure fulfilled all of her obligations under the modified agreement and ultimately kept possession of her property, the mortgage holder could still not successfully argue that its inability to obtain possession resulted in a categorical physical taking. A mortgage holder's right to obtain possession depends entirely on a borrower's failure to fulfill the obligations of the contract. The mortgage holder's right to possession cannot be infringed upon before default, because the mortgage holder has no right to possession. One cannot invade a non-existent right. The legislation considered in this memo would not allow homeowners to remain in place after the mortgage holder gained a right to possession. As a result, it does not fundamentally alter the nature of the mortgage holder's property right, but merely regulates the relationship between the parties.[54] A Congressional decision to cap interest rates or reduce mortgage principal, for example, would function like a rent control statute by

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removed once loan payments are complete. For more information, see DAVID A. SCHMUDD, A PRACTICAL GUIDE TO MORTGAGES AND LIENS (ALI-ABA 2004). The vast majority of U.S. states follow the lien theory.

[53] This analysis is complicated somewhat by the differences between title theory states and lien theory states. Mortgage holders in title states would have a stronger takings argument than those in lien states, but the effect on the overall analysis would be slight. Regardless of the theory, borrowers hold full legal right to possession of the property as long as they abide by the terms of the contract, and they eventually obtain an unencumbered fee simple once the mortgage is fully paid off.

[54] The Supreme Court similarly characterizes landlord-tenant laws as a "regulating a relationship" and not as altering property rights. See, e.g., Yee v. City of Escondido, 503 U.S. 519, 528 (1992).

placing a ceiling on a borrower's payments just as a rent control statute places a ceiling on a tenant's rent payments. The Supreme Court upheld rent control laws as early as 1921[55] and has repeatedly affirmed that decision.[56]

In fact, one could pass legislation with a much greater physical impact on property rights without implicating Loretto. Rent control regimes, for example, not only cap rental rates but also reduce or eliminate the ability of landlords to retake possession from compliant tenants.[57] Unlike mortgage holders, who generally have only conditional rights to title,[58] landlords hold definite rights of reversion that rent control laws clearly weaken and delay. The Supreme Court has refused to find categorical takings in a number of similar circumstances, such as federal legislation denying certain property owners the right to exclude customers based on race,[59] state constitutional provisions denying certain property owners the right to exclude peaceful protesters,[60] and municipal ordinances depriving certain property owners the ability to choose their incoming mobile home tenants.[61] The Court has consistently affirmed that the government has broad

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[55] Block v. Hirsch, 256 U.S. 135 (1921).

[56] E.g., Pennell v. City of San Jose, 485 U.S. 1, 12, n. 6 (1988) (declining to reconsider the constitutionality to rent control); Yee, 503 U.S. at 520-21 (1992).

[57] The rent control regime the Supreme Court upheld in Block, for example, allowed compliant tenants to maintain essentially perpetual control over their apartments. In particular, the ordinance only allowed a landlord to terminate a tenancy if the tenant did not comply with the rent control regime or the landlord wanted the property "for actual and bona fide occupancy" by himself or members of his family. Block, 256 U.S. at 154. In rejecting the Takings Clause challenge, the Court noted in particular the necessity of restricting the landlord's power to regain possession. "If the tenant remained subject to the landlord's power to evict, the attempt to limit the landlord's demands would fail." Id. at 157.

[58] Even in title theory states, the mortgage holder's interest in the property is significantly weaker than a typical landlord. A landlord will generally have the ability to obtain no-fault eviction after a term of years lease expires, while a mortgage holder has no ability to gain possession in the absence of a default by the borrower.

[59] See Heart of Atlanta Motel, Inc. v. United States, 379 U.S.241 (1964).

[60] See PruneYard Shopping Center v. Robbins, 447 U.S. 74 (1980).

[61] See Yee, 503 U.S. at 519. The Court noted in that case that landlords who "voluntarily open their property to occupation by others ... cannot assert a *per se* right to compensation based on their inability to exclude particular individuals." Id. at 531. If a mobile home park owner does not have a *per se* right in the context of *new* tenants, mortgage holders almost certainly do not have *per se* rights to compensation based on an inability to exclude existing borrowers who comply with the amended mortgage contract.

power to regulate housing conditions without paying compensation,[62] that depriving property owners of "one strand" of a bundle of rights will not constitute a categorical taking,[63] and that all but the most invasive governmental regulation falls under the Penn Central, not Loretto test.[64]

Any attempt to apply to analogize the "partial takings" aspect of Loretto to the mortgage context would fail. The Supreme Court in Loretto did recognize that the law requires just compensation for a physical appropriation of even a minor piece of a property, no matter how small.[65] The Court has noted, however, that actual physical appropriations are both "relatively rare" and "easily identified" and has refused to find partial takings outside of that context.[66] In Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency, for example, the Court refused to subdivide a developer's property interest into time-bound parcels and noted that takings jurisprudence "does not divide a single parcel into discrete segments and attempt to determine whether rights in a particular segment have been entirely abrogated."[67] Rather, courts analyze a regulation's effect on the property as a whole.[68] Because of this strong precedent, a mortgage holder could not plausibly argue that a government regulation which reduced the principal owed on a mortgage note from $500,000 to $400,000 constituted a "categorical taking" of

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[62] E.g., Yee, 503 U.S. at 528; Pennell, 485 U.S. at 12, n. 6.
[63] "Where an owner posses a full 'bundle' of property rights, the destruction of one 'strand' of the bundle is not a taking." E.g., Andrus v. Allard, 444 U.S. 51, 65-66 (1979); Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency, 535 U.S. 302, 327 (2002).
[64] E.g., Yee, 503 U.S. at 529 ("Such regulations are analyzed by engaging in the 'essentially ad hoc, factual inquiries' necessary to determine whether a regulatory taking has occurred.")
[65] See Tahoe-Sierra, 535 U.S. at 322 (classifying Loretto as a categorical taking).
[66] Id. at 324.
[67] Id. at 329.
[68] Id. at 327. See also Penn Central Transportation Co v. New York City, 438 U.S. 104 (1978); Concrete Pipe & Products of Cal., Inc. v. Construction Laborers Pension Trust for South Cal., 508 U.S. 602 (1993).

$100,000 worth of property.[69] The contemplated legislation falls outside of Loretto's special context, and attempts to reason from it by analogy will fail.

III. Deprivations of All Economically Beneficial Uses

FEDERAL LEGISLATION MODIFYING EXISTING MORTGAGE CONTRACTS WOULD NOT DEPRIVE MORTGAGE HOLDERS OF *ALL* ECONOMICALLY BENEFICIAL USE OF THEIR PROPERTY.

The Supreme Court has identified only one other situation in which a regulatory taking is "categorical" and necessarily compels compensation. In Lucas v. South Carolina Coastal Council, the Supreme Court held that where regulations prohibit all economically viable use of land, the landowner is entitled to compensation.[70] In his majority opinion in that case, Justice Scalia noted that a landowner who suffered a 95% deprivation in value would not benefit from this categorical rule.[71] None of the measures contemplated in this memorandum would deprive mortgage holders of anywhere close to 95% of the current value of their mortgage note and none would constitute a taking under Lucas. In fact, it is probable that only a regulation completely and permanently extinguishing a mortgage holder's ability to obtain possession of the property under any circumstance would run afoul of Lucas. Laws that mandate reductions in interest rates or that fix mortgage payments to the current appraisal value of the underlying properties rather than the face value on the mortgage notes, for example, would still provide a steady income stream to mortgage holders and would still allow them to obtain

[69] As the Supreme Court has expressly stated changing the relative economic welfare of the parties does not "convert regulation into a physical invasion." Yee, 503 US at 529-30.
[70] Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992),
[71] Lucas, 505 U.S. at 1019, fn. 8. See also Tahoe-Sierra, 535 U.S. at 329.

possession if a borrower defaulted. Simply put, none of the contemplated measures would constitute a categorical taking under Lucas.[72]

IV. The Penn Central Balancing Test

IT IS EXTREMELY LIKELY THAT FEDERAL LEGISLATION MODIFYING EXISTING MORTGAGE CONTRACTS WOULD PASS THE PENN CENTRAL BALANCING TEST GENERALLY USED TO ASSESS GOVERNMENT REGULATIONS ON PROPERTY.

Courts typically use the broad-based Penn Central balancing test to determine whether a government action caused a regulatory taking.[73] In the seminal case on regulatory takings, Penn Central Transportation Co. v. New York City, the Supreme Court identified several factors that have "particular significance" to these "ad hoc, factual inquiries."[74] Courts undertaking a Penn Central analysis focus in particular on the following three considerations:[75] (1) "[t]he economic impact of the regulation," (2) "the

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[72] In fact, even a complete moratorium on foreclosures would not implicate Lucas as long as it contained a sunset clause that limited the moratorium's duration. In East N.Y. Savings Bank v. Hahn, the Supreme Court upheld New York State's moratorium on foreclosures enacted during the Great Depression. In 1933, the State disallowed foreclosures as long as the borrower paid taxes, insurance, and interest (but not principal). The State repeatedly extended the moratorium and courts upheld the extensions against every challenge. See East New York Sav. Bank v. Hahn, 326 U.S. 230 (1945).

[73] The Penn Central balancing test is not the only balancing test used in regulatory takings analysis. Courts will apply the "unconstitutional conditions" doctrine in the context of land use exactions. Exaction cases arise when a local government demands that a developer dedicate an easement allowing public access to part of his or her property as a condition of obtaining a development permit. This memo will not address the "unconstitutional conditions" doctrine as the Supreme Court has expressly refused to expand it beyond the exactions context. See City of Monterey v. Del Monte Dunes at Monterey, Ltd., 526 U.S. 687, 702 (1999); See also McClung v. City of Sumner, No. 07-35231, slip op. at 13744-45 (9th Cir. Sep. 25, 2008) (holding that even legislative, generally applicable development restraints do not implicate the unconstitutional conditions doctrine). Regardless, it is hard to imagine that the unconstitutional conditions balancing test would produce different results from the Penn Central test in this context.

[74] Penn Cent. Transp. Co. v. New York City, 438 U.S. 104 (1978). See also Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922); Keystone Bituminous Coal Assn. v. DeBenedictis, 480 U.S. 470 (1987).

[75] One should note that for many years, courts also considered an additional, stand-alone factor in regulatory takings cases which was completely independent of either Penn Central or any other takings test: whether the statue or regulation "substantially advanced" a state interest. See Agins v. City of Tiburon, 447 U.S. 255 (1980) (announcing the "substantially advance" test). In Lingle v. Chevron U.S.A. Inc, the Court finally addressed this incongruous additional element and held that "this formula prescribes an inquiry in the nature of due process" and "has no proper place in our takings jurisprudence." Lingle v. Chevron U.S.A. Inc., 544 U.S. 528 (2005).

extent to which the regulation interfered with distinct investment-backed expectations," and (3) the character of the regulation.[76]

Courts have developed a few rules of thumb to help guide the Penn Central analysis. First, Federal Circuit cases interpreting the economic impact prong have held that "a regulatory taking does not occur unless there are serious financial consequences."[77] Second, the Penn Central test is the same for both permanent and temporary regulations,[78] although in the latter situation courts must carefully consider the duration of the restriction under the economic impact prong.[79] Third, the "character of the regulation" test examines the nature of the government's action, not its efficacy. The Penn Central Court explained that a taking "may more readily be found when the interference with property can be characterized as a physical invasion by government than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good."[80] Courts have struggled with the obtuse nature of this third prong, but many commentators liken it to a fairness analysis,[81] asking if the legislation merely adjusts the benefits and burdens of economic life in a reasonable way. All in all, commentators consider the Penn Central test a "very deferential test" that benefits the government.[82] The Supreme Court itself has stated numerous times that "a party challenging a governmental action as an unconstitutional

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[76] Id.
[77] E.g., Cienega Gardens v. United States, 503 F.3d 1266, 1282 (Fed. Cir. 2007) (hereinafter "Cienaga X"); Loveladies Harbor, Inc. v. United States, 28 F.3d 1171 (Fed Cir. 1994).
[78] See Tahoe-Sierra, 535 U.S. at 302.
[79] See, e.g., Cienega X, 503 F.3d at 1282 (explaining the two approaches to measure economic impact and modifying one of those approaches, the return on equity approach, in order to better reflect the economic realities associated with a temporary taking).
[80] Penn Central, 438 U.S. at 124.
[81] See, e.g., Steven J. Eagle, *Property Tests, Due Process Tests and Regulatory Takings Jurisprudence*, 2007 B.Y.U. L. REV. 899 (2007); John D. Echeverria, *Making Sense of Penn Central*, 23 UCLA J. ENVTL. L. & POL'Y 171 (2005).
[82] See, e.g., Eagle, *supra* note 78 at 911.

taking bears a substantial burden."[83] It is extremely unlikely that a party challenging a statute or regulation that required mortgage holders to amend existing mortgage contracts would meet this burden.

Extent of the Economic Impact

When analyzing the economic impact of a regulation, courts will pay close attention to a regulation's effect on the fair market value of a property; some courts will also consider whether the regulation diminishes the property holder's return on equity.[84] The Federal Circuit, which has exclusive jurisdiction over appeals arising out of non-tort monetary claims against the federal government (such as takings cases),[85] has given the government considerable latitude when considering a regulation's effect on fair market values. In Cienega Gardens v. United States, the Federal Circuit noted that "[w]hat has evolved in the caselaw is a general requirement that plaintiffs show 'serious financial loss' from the regulatory imposition in order to merit compensation."[86] Both the

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[83] E.g., United States v. Sperry Corp., 493 U.S. 52, 60 (1989); Eastern Enterprises v. Apfel, 524 U.S. 498, 522 (1998).

[84] The difference is largelly irrelevant here as the fair market value of a mortgage note is derived from its risk adjusted expected return on investment. However, it is worth noting that the Circuits disagree about the centrality of the fair market value of the property to the economic impact prong. The Federal Circuit suggests that courts can determine the extent of the economic impact by examining either the diminution in total property values or the decrease in return on equity (or both). See Rose Acre Farms, Inc. v. United States, 373 F.3d 1177, 1184-90 (Fed. Cir. 2004); Cienega X, 503 F.2d at 1280-82 (modifying the return on equity prong for a temporary restriction). The Second Circuit, however, rejected the return on equity approach, noting that the key question for takings purposes is "not whether the regulation allows operation of the property as a profitable enterprise for the owners, but whether others might be interested in purchasing all or part of the land." Park Avenue Tower Associates v. City of New York, 746 F.2d 135, 139 (1984) (internal quotations omitted). See also Federal Home Mortgage Corp. v. New York State Div. of Housing & Communitiy Renewal, 83 F.3d 45, 48 (1996) (citing Park Avenue approvingly and noting that the property owners are not guaranteed a reasonable return on their investment).

[85] For a good overview of the Federal Circuit's jurisdiction, see James L. Huffman, *Judge Plager's "Sea Change" in Regulatory Takings Law*, 6 FORDHAM ENVTL. L. J. 597 (1995).

[86] Cienega X, 503 F.3d at 1282. See also Loveladies, 28 F.3d at 1171. In Cienega X, the court reversed a lower court ruling finding a compensable taking when Congress passed legislation that interfered with the property rights of landlords who participated in an affordable housing program. The legislation at issue altered a "Regulatory Agreement" signed by the government agency and the landlords and further limited the landlords' rights to sell their properties and prepay their mortgages. In remanding the case and requiring the lower court to apply different standards and consider additional evidence, the court cast

Supreme Court and the Federal Circuit, however, have refused to identify threshold percentage diminutions in value that will trigger the Takings Clause. In Yancey v. United States, the Circuit affirmed a lower court decision that found a compensable taking due to a 77% diminution in value.[87] The Circuit rejected the government's contention that a 77% reduction was not substantial enough to constitute a taking.[88] The court stated that the government relied erroneously on past Supreme Court cases that rejected claims for compensation despite greater diminutions in value and held, "we do not read these early precedents as creating an automatic numerical barrier preventing compensation, as a matter of law, in cases involving a smaller percentage diminution in value."[89] In a later case, the Circuit reiterated this holding, noting "the modern Penn Central approach" requires a balancing of "all the relevant considerations."[90]

The legislation contemplated in this memorandum would not cause a significant economic impairment of a mortgage holder's property right, let alone result in a serious financial loss on the property. Many current mortgage holders are falling behind on their

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serious doubt on the continuing validity of its previous decision in Cienega VIII, in which it found that those same regulations did result in a compensable taking of the property rights of four "model plaintiffs." Cienega Gardens v. United States, 331 F.3d 1319 (2003). In any case, the Penn Central analysis in Cienega VIII relies on a unique factual scenario that does not impact the legislation contemplated in this memo. First, the Cienega VIII court characterized the government's action as "physical" because the government "eviscerated" the landlords' unconditional right to exclude low-rent tenancies after twenty years. Id. at 1338. Mortgage holders do *not* have an unconditional right to exclude and can only gain possession after a default by the borrower. Notably, the contemplated legislation does not "eviscerate" this already conditional right but merely regulates the existing relationship between the parties by modifying the future income stream under the mortgage contract. Second, the court noted that the entire burden was placed on a small number of individuals and did not "affect all landlords." Id. at 1339. Third, the court specifically distinguished the development industry from the banking industry, which it considered "an extreme field" due to the long history of "consistent, intrusive, and changing government regulation" in the banking industry. Id. at 1350. Most importantly, the government provided these rights as a "material inducement" for landlords to enter a contractual relationship with the government. The court held that the model plaintiffs had "every indication from HUD" that the regulations granting these rights would "continue to control the duration of the Regulatory Agreement." Id. at 1349.

[87] Yancey v. United States, 915 F.2d 1534 (1990).

[88] Id. at 1541

[89] Id. The government relied in particular on Euclid v. Amber Realty Co., 272 U.S. 365 (1926); Hadacheck v. Sebastian, 239 U.S. 394 (1915).

[90] Rose Acre Farms, 373 F.3d at 1187.

payments and more will fail to keep up if contracts are not amended to provide relief.[91] As borrowers begin to fear foreclosure, their incentive to continue making payments and to engage in general upkeep of their properties declines.[92] As a result, even before foreclosure proceedings commence mortgage holders both lose a stream of income[93] and incur significant repair costs.[94] At the same time, mortgage holders face significant costs in gaining full possession of the property. Foreclosure is a lengthy and expensive process not only for homeowners and but also for mortgage holders as well. Mortgage holders must absorb the costs of foreclosure which "include legal fees, brokers' property management fees, and other holding costs."[95] The Chairperson of the Federal Deposit Insurance corporation recently testified before Congress that "[t]hese costs can total up to forty percent or more of the market value of the property."[96] Mortgage holders also face costs in attempting to dispose of the property, such as commissions paid to brokers or auctioneers and transfer taxes.[97] While there are a range of estimates regarding the total

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[91] Matthew L. Jacobs et al, Insurance Coverage and the Subprime Crisis: A Broad Overview, ALI-ABA COURSE OF STUDY MATERIALS, in THE SUBPRIME MORTGAGE CRISIS: FROM A-Z (ALI-ABA COURSE OF STUDY, SEPTEMBER 18-19, 2008 (noting that projections indicate "as many as half of the borrowers whose adjustable rates were due to reset in the first three months of 2008 eventually would lose their homes to foreclosure.")

[92] Amy Crews Cutts and Richard K. Green, *Innovate Servicing Technology: Smart Enough to Keep People in Their Houses*, Freddie Mac Working Paper #04-03, 5 (July 2004) (For a lender, costs accumulate as the seriousness of the contractual failure increases. These costs include the opportunity cost of principal and income not yet received . . .")

[93] Roberto G. Quercia et al., *The Cost-Effectiveness of Community-Based Foreclosure Prevention*, Joint Center for Housing Studies at Harvard University, BABC 04-18, 13 (February 2004) ("Once borrowers realize they will lose their house to foreclosure, they often cease performing needed maintenance on the house. Properties may be vacant for months before the lender can obtain title. Therefore, repairs are usually required before the house can be resold.")

[94] Id.

[95] Sheila C. Bair, Testimony before the Financial Services Committee U.S. House of Representatives (September 17, 2008), available at: http://www.fdic.gov/news/news/speeches/chairman/spsep1708.html.

[96] Id.

[97] See Quercia, *supra* note 93 at 13.

costs faced by mortgage holders,[98] it is well established that going through the full formal foreclosure process is extremely expensive and time consuming.[99] Given the costs associated with foreclosures and the likely decrease in the number of foreclosures that would accompany any requirement to amend existing mortgage contracts, the contemplated legislation would have only a limited economic impact on a mortgage holder's property rights.[100] The reduction in defaults and resultant decrease in costs would likely offset, or at least mitigate, the decreased streams of income from the mortgage notes themselves. Government agencies have recognized the strength of this effect. Recently, the Federal Deposit Insurance Corporation (FDIC) decided to modify delinquent loans it holds as a result of its takeover of Indymac, in part because it believed that the program would "increase the value of distressed mortgages by rehabilitating them into performing loans."[101]

In addition, a regulation with only temporary restrictions would present an even more clear-cut case. Consider a regulation that only capped interest payments for a certain number of years or simply extended the repayment time beyond a certain date. The Supreme Court's rulings in cases like Tahoe-Sierra indicate that courts should

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[98] Zhenguo Lin et al., *Spillover Effects of Foreclosures on Neighborhood Property Values*, 38 J. Real Estate Fin. & Econ. (Forthcoming May 2009) (noting that estimates of the total cost run from several thousand dollars to well into the tens of thousands).

[99] See e.g., Cutts and Green, *supra* note 92 at 5, *citing* Craig Focardi, *Servicing Default Management: An Overview of the Process and Underlying Technology*, TowerGroup Research Note, No. 033-13C (November 15, 2002) (estimating "that for a sample of loans that went through the full formal foreclosure process, the total cost, including lost interest during delinquency, foreclosure costs, and disposition of the foreclosed property ran $58,759 and took an average of 18 months to resolve.")

[100] In fact, even if the contemplated legislation *did* result in a significant economic impairment, it is likely that the other two prongs of the analysis would overcome that economic effect.

[101] Federal Deposit Insurance Corporation, Loan Modification Program for Distressed Indymac Mortgage Loans (August 20, 2008), http://www.fdic.gov/consumers/loans/modification/indymac.html.

carefully consider time-limited regulations such as these for duration.[102] It is unlikely that a temporary restriction of this sort would substantially impact the long-term fair market value of a mortgage holder's interest in a property.

Investment-Backed Expectations

The second prong of the Penn Central balancing test focuses on whether the government action interferes with "reasonable investment-backed expectations."[103] A recent Federal Circuit decision further explains this prong of Penn Central by breaking it down into three inquiries: (1) whether the plaintiff operates in a "highly regulated industry," (2) whether the plaintiff was aware of the problem that spawned the regulation at the time it purchased the property, and (3) whether the plaintiff could have "reasonably anticipated" the possibility of such regulation in light of the "regulatory environment" at the time of purchase.[104] An application of these inquiries to the context of the mortgage industry reveals that the contemplated legislation would not interfere with reasonable investment backed expectations.

First, despite the relatively weak oversight in recent years, mortgage bankers have always operated in one of the most highly regulated industries in the nation. In fact, as recently as 1996, the Supreme Court reiterated the longstanding recognition that "banking is one of the longest regulated and most closely supervised of public callings."[105] Most mortgage holders that did not originate the loans they currently hold are sophisticated investors that understood or should have understood the highly regulated nature of this

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[102] Tahoe-Sierra, 535 U.S. at 342 ("[T]he duration of the restriction is one of the important factors that a court must consider in the appraisal of a regulatory takings claim.") For analogous circuit court precedent, see Rose Acre Farms, Inc. v. United States, 373 F.3d 1177, 1195 (Fed. Cir. 2004).
[103] E.g., Palazzolo v. Rhode Island, 533 U.S. 606, 617 (2001) (stating that a claimant's investment-backed expectations must be reasonable).
[104] Appolo Fuels, Inc. v. United States, 381 F.3d 1338, 1349 (Fed. Cir. 2004).
[105] United States v. Winstar Corp., 518 U.S. 839, 843 (1996) *citing* Fahey v. Mallonee, 332 U.S. 245, 250 (1947).

industry. Additionally, many mortgage holders that did not originate their currently held loans either originated other loans which they then swapped or had financial and legal ties to a broader corporate entity that originated those or similar mortgage loans. As the Federal Circuit has recognized, "investment-backed expectations are 'greatly reduced in a highly regulated field.'"[106]

Second, although lenders and mortgage holders did not fully comprehend the ramifications their actions would have on the U.S. economy, they assumed the risk of adverse effects. Mortgage holders were, or should have been, aware that many subprime and Alt-A borrowers would not be able to pay their mortgages. Lenders had advance access to the "poor past payment history" of many such borrowers from credit bureau histories and scores used in the underwriting process. Thus, "[i]t should have come as no surprise when subprime borrowers became delinquent."[107] Lenders and mortgage holders hoped that the derivative products created at Wall Street firms would provide them with the opportunity to seek high returns with minimal risk[108] by allowing them to take advantage of mortgage backed securities characterized by "higher returns due to the high adjustable and the fact that many of the underlying loans carried prepayment penalties that were intended to ensure longer payback periods."[109] While the market may have "underestimated the likelihood of default by many subprime borrowers,"[110] mortgage holders, like other investors, knowingly assumed the risk that the assets they purchased would lose value. By embedding those securities and related instruments into

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[106] Cienega VII, 331 F.3d at 1350 *citing* Branch ex. rel. Marine National Branch v. United States, 69 F.3d 1571, 1581 (Fed. Cir. 1995).
[107] Dennis R. Capozza and Thomas Thomson, *Subprime Transitions: Lingering or Malingering in Default?*, 33 J. Real Estate Fin & Econ. 241, 243 (2006).
[108] See Jacobs, *supra* note 91.
[109] Id.
[110] Id.

key institutions and a central place in the world financial markets, however, they made the general public subject to those risks.

Finally, the mortgage holders took those risks knowing that eventually, if many subprime and Alt-A borrowers did default, concerned citizens and public officials would target the mortgage industry for reforms in response. Loan products with no down payment, teaser rates, and balloon payments have long come under public scrutiny,[111] and "the history of federal and state policy is full of precedent for protecting vulnerable citizens in economic transactions, especially ones as important as mortgage loans."[112]

Character of the Government Regulation

Like the economic impact and investment-backed expectation prong, the "character" prong weighs heavily in favor of the proposed regulations. Courts consider the following factors in this analysis: (1) whether the purported taking should be "characterized as a physical invasion by government," (2) if it arises "from some public program adjusting the benefits and rights of economic life to promote the common good,"[113] (3) if the government benefits from the taking,[114] (4) if the action "singles out" a particular individual to suffer any burden,[115] and (5) if there is an "average reciprocity

[111] See, e.g., Vincent D. Rougeau, *Rediscovering Usury: An Argument for Legal Controls on Credit Card Interest Rates*, 67 U. COLO. L. REV. 1, 3 (1996) (arguing that the absence of interest rate controls "has allowed the law to become a tool of the special interests that benefit from the promotion of high consumer debt and consumption"); Elizabeth Warren, *The Bankruptcy Crisis*, 73 INDIANA LAW JOURNAL 1079, 1083 (1998) ("When the cards are highly profitable, credit card issuers have a strong incentive to distribute them to marginal borrowers and to borrowers already loaded with debts, which increases both the issuer's profits and its loan defaults.")

[112] Dan Immergluck and Geoff Smith, *The External Costs of Foreclosures: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 Housing Policy Debate 57, 75 (2006).

[113] Penn Central, 438 U.S. at 124.

[114] Connolly v. Pension Ben. Guar. Corp., 475 US 211, 225.

[115] Tahoe-Sierra Pres. Council v. Tahoe Reg'l Planning Agency, 535 U.S. 302, 341 (2002)

of advantage" by which the burdened party also receives some benefit from the legislation.[116]

First, the proposed regulations do not resemble a temporary physical taking even if they do allow borrowers a better chance to stay in their home. The mortgage holder does not have physical possession of the property until foreclosure, and the contemplated legislation would only regulate the property pre-foreclosure. It would not restrict the ability of mortgage holders to take legal action against those in default. Before foreclosure, the mortgage holder has no right to possession, nor any present interest in the property aside from the borrower's compliance with the mortgage.

Second, the regulations simply adjust the benefits and burdens of economic life. The only thing regulated is the entirely economic relationship between a borrower and mortgage holder, and the only thing changed is some portion of the future income stream which, if the homeowner did not default, would accrue to the mortgage holder. The benefits conferred on the public and communities result from the change in that relationship, and include avoidance of ills tied to economic malaise such as increased homelessness, eviction of tenants who are fully in compliance with leases but reside at foreclosed upon properties,[117] significantly decreased public revenues,[118] and decreased

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[116] Id. at 133-5.

[117] See, e.g., Jennifer B. McKim, *Students Take to the Street to Aid Displaced Tenants*, BOSTON GLOBE, October 18, 2008 at a9.

[118] Dan Immergluck and Geoff Smith, *The Impact of Single-family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUDIES 851, 853 (2006) *citing* Ana B. Moreno, *The Cost-Effectiveness of Mortgage Foreclosure Prevention* (Minneapolis: Family Housing Fund 1995) ("Cities, counties and school districts may lose tax revenue from abandoned homes. In examining FHA foreclosures, for example, Moreno estimated average city costs of $27,000 and neighborhood costs of $10,000." Those estimates are per foreclosed property.)

property values.[119] Third, the government does not receive any portion of the property regulated by the contemplated legislation.[120] Fourth, the contemplated legislation would apply to all similarly situated mortgage holders, no single individual or entity would be singled out.

There would be "an average reciprocity of advantage" because the contemplated legislation would benefit mortgage holders as well.[121] Easing the financial burden on borrowers will allow more homeowners to pay off their mortgages and avoid foreclosure. Several recent empirical studies have concluded that foreclosed property drags down the value of neighboring properties.[122] This increases the number of homeowners who have negative equity in their homes. Negative equity is generally considered to be a necessary,

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[119] E.g., Immergluck and Smith, *Property Value, supra* note 112; John P. Harding et al., *The Contagion Effect of Foreclosed Properties* (July 15, 2008) (working paper) available at: http://ssrn.com/abstract=1160354; Lin, *supra* note 98.

[120] It is conceivable that borrowers subject to these mortgages would be deemed to receive taxable cancellation of debt income. However, that would not be a taking of property from the mortgage holders but rather a tax incurred by homeowners. It is extremely unlikely that courts would consider a tax incurred by homeowners relevant to an inquiry regarding any purported taking of a mortgage holder's property. Even if were the case, it would not change the analysis under this factor. Any benefit the government could be deemed to receive would be, at most, ancillary to the contemplated regulation. The purpose of this factor is to assess if the government is acting unfairly in its own self interest; taxable cancellation of debt income received by homeowners could not reasonably be used to infer that it was. See Robert Meltz, *Symposium: Litigating Takings: Primer*, 34 ECOLOGY LAW QUARTERLY 307, 345 (2007).

[121] The consideration of whether a property regulation has "an average reciprocity of advantage" stems from Justice Holmes's opinion in Pennsylvania Coal v. Mahon, 260 U.S. 393 (1922). The Court originally used the "average reciprocity" rule to determine whether a state had actual police power authority for a certain action, but over time the Court folded the test into the Takings Clause analysis itself. See Lynda Oswald, *Role of the "Harm/Benefit" and "Average Reciprocity of Advantage" Rules in a Comprehensive Takings Analysis*, 50 VAND. L. REV. 1447 (1997) (tracing the development of the "average reciprocity" rule over time). Average reciprocity of advantage does not mean each specific individual must gain a net benefit. Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470, 492 (1987) ("The Takings Clause has never been read to require the States or the courts to calculate whether a specific individual has suffered burdens under this generic rule in excess of the benefits received.")

[122] E.g., Immergluck and Smith, *Property Value*, *supra* note 112; Harding *supra* note 119; Lin, *supra* note 98. Note that Harding uses a different means of statistical analysis than the other two studies listed here, but all conclude that "foreclosures have a statistically and economically significant effect on [nearby] property values." Immergluck and Smith, *Property Value*, *supra* note 112 at 75.

though not sufficient, prerequisite before a foreclosure will take place.[123] This may lead to a spiraling effect: foreclosures reduce property value, which increases number of foreclosures of nearby properties, which, in turn, further reduce property value.

A reduction in foreclosures will benefit all property owners in a given area. Mortgage holders will also gain from stabilization in property values as the value of their mortgage contracts depends in large part on how many of their borrowers are "underwater" in their contracts.[124] On a nationwide level, a policy that reduces foreclosures might halt the decline in housing prices in many areas, which would benefit communities, borrowers and mortgage holders alike. In fact, the reluctance of individual mortgage holders to adopting these proposed measures voluntarily may stem from a collective action problem. Each mortgage holder might benefit if *all* mortgage holders capped interest rates or even reduced mortgage principals, but if one mortgage holder undertakes a program without a coordinated effort by the others, it will suffer. A financial institution that held many mortgages and implemented such a policy might initially benefit as a decrease in defaults and foreclosures counterbalanced a reduction in income from principal and interest payments. In the long term, however, the underlying value of its own borrowers' properties would continue to erode as more neighboring properties were foreclosed on by other mortgage holders still trying to collect on the face value of their notes. Because of this continued price decline, many of its borrowers

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[123] Christopher J. Foote et al., *Negative Equity and Foreclosure: Theory and Evidence*, 64 J. URB. ECON. 234, 245 (2008) (noting "the necessity of negative equity for foreclosures – borrowers with positive equity will sell if they need to move.")

[124] "Home price declines can cause foreclosures by decreasing the equity homeowners have in their properties. Borrowers are much more likely to default on their loans if the current value of their property falls below the outstanding loan balance... Declines in home prices will increase the frequency with which homeowners ... "walk away" from the property and the mortgage." Press Release, Office of Federal Housing Enterprise Oversight, House Prices Weaken Further in Most Recent Quarter (Nov. 29, 2007), available at http://www.ofheo.gov/media/pdf/3q07hpi.pdf.

would again fall "underwater" in their modified loans and its foreclosure rate would again rise, ultimately increasing the likelihood that the reduction in receipts would cause a net economic loss.

Policies Behind Penn Central – Justice and Fairness

In evaluating the merits of the Penn Central balancing test, the most insightful approach is to focus on what the Court has identified as the broad policy reasons that underlie its approach to regulatory takings. Quite simply, the Court has stated that the Fifth Amendment's guarantee of just compensation is "designed to bar the 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."[125] The mortgage crisis and the concurrent financial and economic crises were caused in large part by the profit seeking activities of mortgage holders that the government now purports to regulate. The public has been exposed to harms ranging from a general threat to the welfare of the American financial system to decreased property values[126] to funding for public services,[127] and increased rates of violent crime in areas where foreclosures are concentrated.[128] It is impossible to say that "fairness and justice" prevent mortgage holders from bearing at least some of the burdens associated with protecting our homeowners, our communities, and our economy from the worst effects of this crisis. The Court in Penn Central recognized that there is no "'set formula' for determining when 'justice and fairness' require that economic injuries caused by public action be compensated by the government, rather than remain

[125] Armstrong v. United States, 364 U.S. 40, 49 (1960); Eastern Enterprises, 524 U.S. at 522.
[126] See *supra* note 122 and surrounding text.
[127] See Immergluck and Smith, *Crime*, *supra* note 118.
[128] Id. at 863 (concluding that the rate of foreclosures in a given area is a "statistically significant determinant of violent crime" even after other factors are controlled for).

disproportionately concentrated on a few persons."[129] Here, given the burdens that the public has already borne due to irresponsible lending practices, it would strain credulity to suggest that taxpayers must also bear the costs of this type of regulation.

V. Takings Analysis and Contractual Rights

THE CONTRACTUAL NATURE OF THE MORTGAGE NOTE FURTHER BOLSTERS THE ARGUMENT THAT THE PROPOSED ACTIONS WOULD NOT RESULT IN COMPENSABLE TAKINGS.

The analysis in Part II, Section IV assumed that courts would analyze a mortgage holder's entire interest a mortgage note and concluded that even under those assumptions it is extremely likely that the contemplated legislation would pass the Penn Central balancing test. In reality, it is possible that a court may refuse to consider a mortgage holder's entire interest in a mortgage note to be property for purposes of the Fifth Amendment. In particular, a court may recognize that the mortgage note includes not only a mortgage lien, which is a property interest, but also some solely contractual rights that are independent from that lien and do not implicate the Takings Clause.[130] A court that viewed the nature of the mortgage holder's property interest in this more restricted manner would limit its Penn Central analysis to the specific, previously recognized property interests in the lien itself. This narrower analysis would weigh even more strongly in favor of the government's action.

As explained in Part II, Section I, some precedent suggests that the Takings Clause provides protection to certain "valid contracts."[131] This contentious doctrine has

[129] Penn Central, 483 U.S. at 124.
[130] This same analysis could apply to a mortgage holder in a title theory state, but this memo will primarily address the lien theory, which the vast majority of states follow. See SCHMUDD, *supra* note 49.
[131] Lynch v. United States, 292 U.S. 571, 579 (1934). For more recent cases on this subject, see Connolly v. Pension Ben. Gaur. Corp., 475 U.S. 211 (1986) (casting doubt on the Lynch doctrine but ultimately

come under attack repeatedly, and courts have struggled to determine which contractual rights also implicate property rights and to what extent.[132] Consider Eastern Enterprises v. Apfel, the Supreme Court's most recent decision addressing this issue directly.[133] In that case, a coal company that had not mined since 1965 contested a 1992 law that required signatories to collective bargaining pension plan agreements to fund lifetime benefits to widows of deceased miners. The company had last signed a pension plan agreement in 1950. Despite the conflict between the 1992 law and the 1950 contract, a majority of justices refused to hold that the law had implicated a "specific property interest" and denied the coal company's claim.[134]

Past Supreme Court cases have recognized that a lien,[135] including a mortgage lien,[136] "'fits but awkwardly into the analytic framework' of our regulatory takings analysis."[137] The "awkward" nature of this situation stems from "the nature of the property interest at stake, which resembles a contractual obligation."[138] The Supreme Court's hesitance with analyzing mortgage liens under the regulatory takings analysis suggests that courts should explicitly recognize that a mortgage note is a primarily

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analyzing contract rights under Penn Central). See also Concrete Pipe & Products of Cal., Inc. v. Construction Laborers Pension Trust for South Cal., 508 U.S. 602 (1993).

[132] The Second Circuit notes, for example, that the Lynch decision "is neither a blanket nor absolute rule" and that it "has been called into question" by other Supreme Court cases. See Buffalo Teachers Federation v. Tobe, 464 F.3d 362, 374-5 (2006).

[133] Eastern Enterprises v. Apfel, 524 U.S. 498, 522 (1998).

[134] Id. at 543, 550. Interestingly, a separate majority of justices did hold that the law as written violated the Constitution; four justices employed Penn Central, while Justice Kennedy used the Due Process Clause of the Fifth Amendment. On the takings issue, however, Justice Kennedy unambiguously sided with the four dissenters, noting that "the existing category of cases involving specific property interest ought not to be obliterated by extending regulatory takings analysis to the amorphous class of cases embraced by the plurality's opinion today." Id. at 542. (Kennedy, D., concurring in the judgment and dissenting in part).

[135] United States v. Security Industrial Bank, 459 U.S. 70 (1982) (affirming a creditor's lien as property under the Fifth Amendment).

[136] Radford, 925 U.S. at 555.

[137] Eastern Enterprises, 524 U.S. at 542 (Kennedy, J., concurring in the judgment and dissenting in part) *citing* Security Industrial Bank, 459 U.S. at 103.

[138] Id.

contractual obligation that includes both a specific property interest – a mortgage lien – and other independent rights, such as the right to collect loan repayment income from the borrower.[139] Notably, dividing the mortgage note in this way would not implicate Tahoe-Sierra. Tahoe-Sierra standards for the proposition that one should conceptually sever specific, Fifth Amendment property interests into numerous, compensable rights.[140] The division suggested here would simply recognize that not all of the contractual provisions in the mortgage note implicate a specific property interest and thus that only a portion of the mortgage note itself falls under the Takings Clause rubric.

Past precedent, particularly the depression-era Supreme Court case of Wright v. Vinton Branch of Mountain Trust Bank of Roanoke, Va., supports this theory.[141] In that case, the Court defined the boundaries of a lien holder's property rights (which were subject to the reasonable discretion of the court):[142]

1. The right to retain the lien until the indebtedness thereby secured is paid;
2. The right to realize upon the security by a judicial public sale;
3. The right to determine when such a sale shall be held;
4. The right to protect its interest in the property by bidding at such sale whenever held; and
5. The right to control the property during the period of default.

Notably, those identified rights did not include all of the rights of the mortgage contract itself. In particular, the Supreme Court excluded from that "bundle" the right to collect on the entire value of the underlying mortgage note. In that era, like today, the face value

[139] This argument primarily focuses on lien states but can be applied to title states as well. Although courts would never analyze an unencumbered fee simple through this rubric (by separating the right to live on a piece of property from its fair market value, for example), one might distinguish those traditional title holders from mortgage holders by noting how few of the "bundle of sticks" mortgage holders possess to begin with. Notably, the Supreme Court in Wright v. Vinton Branch of Mountain Trust Bank of Roanoke, Va., 330 U.S. 440 (1937), upheld federal legislation that provided similar relief to borrowers without even addressing the difference between the two theories.
[140] Tahoe-Sierra, 535 U.S. at 302.
[141] Vinton Branch, 330 U.S. at 440.
[142] Id. at 457.

of many mortgage notes exceeded the value of the underlying property; as a result, the lien only secured the fair market value of the property, not the entire debt. By excluding that unsecured potion of the debt, the court implicitly recognized that the Takings Clause only covered the lien itself, not the entire mortgage note. Ultimately, the Vinton Branch Court upheld sweeping federal legislation that allowed courts to stay the foreclosure sale for up to three years, gave borrowers the right to remain in the property and pay "reasonable rent" during the stay, and granted borrowers the option to purchase property free of any liens or accrued taxes at any point during the three years by paying the lienholder the appraised value of the property.[143]

The legislation contemplated in this memorandum is less sweeping than the provision at issue in Vinton Branch and would not substantially impact any of the rights recognized in that case. Capping interest rates or extending repayment periods, for example, would not jeopardize the mortgage holder's ability to exercise its right to foreclose if necessary. If the borrower did not comply with the modified arrangement, the mortgage holder could still exercise its right to take possession of the property. Even reducing the principal on the mortgage note to the fair market value of the property is the functional equivalent of allowing the mortgage holders in Vinton Branch to purchase the property at fair market value.

A narrower Penn Central analysis that limited itself to the mortgage holder's specific property interest in the lien would weigh even more strongly in favor of the

[143] Id. at 460. Through this decision, the Court implicitly overruled Radford, which had held that "[t]his right of the mortgage holder to insist upon full payment before giving up his security has been deemed the essence of a mortgage" and had found a taking when examining a virtually identical five year stay provision. See Radford, 925 U.S. at 580. Six years later, the Court explicitly recognized that Vinton Branch overruled Radford. Helvering v. Griffiths, 318 U.S. 371, 401, n. 52 (1943). See also In re Ye, 219 Br. 395, 401 (E.D. Va. 1998) (noting in a different context that Radford "was all but overruled" by Vinton Branch and that the case has "fallen into disrepute").

government's action than the Penn Central analysis above. In fact, the Supreme Court in Vinton Branch noted that even the complete deprivation of one of these rights might not render the act invalid and that the analysis depended on the legislation's effect on the property as a whole.[144] Regardless of how the court framed the issue, courts have repeatedly upheld legislation that impacts contractual rights. The Supreme Court has noted multiple times that "[c]ontracts, however express, cannot fetter the constitutional authority of Congress."[145] Moreover, even those justices who hold an expansive view of the Takings Clause agree that "Congress has considerable leeway to fashion economic legislation, including power to affect contractual commitments between private parties, without effecting an unconstitutional taking."[146]

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[144] Vinton Branch, 300 U.S. at 457. This reasoning comports with later cases that held "where an owner posses a full 'bundle' of property rights, the destruction of one 'strand' of the bundle is not a taking." E.g., Andrus v. Allard, 444 U.S. 51, 65-66 (1979); Tahoe-Sierra, 535 U.S. at 327. All of these cases further support the argument that courts should, and will, review the contemplated legislation under Penn Central rather than Loretto.

[145] E.g., Connolly v. Pension Ben. Gaur. Corp., 475 U.S. 211, 223-224 (1986); Norman v. Baltimore Ohio R. Co., 294 U.S. 240, 307-308 (1935); Eastern Enterprises, 524 U.S. at 525.

[146] E.g., Eastern Enterprises, 524 U.S. at 527.

Section Three: Contract Clause and Due Process Clause Analysis

I. *Contract Clause and Substantive Due Process Analysis*

A Federal Law Requiring Mortgage holders to Modify the Terms of Mortgage Contracts Could Not Be a Violation of the "Contract Clause," and Will Not Be considered a Violation of the Due Process Clause.

The Contract Clause does not does restrict the Federal Government.[147] While the States are bound by a constitutional prohibition stating that "No State shall . . . pass any. . . Law impairing the Obligation of Contracts,"[148] no legislation passed by Congress altering the terms of existing mortgages can violate the Contract Clause. There is a "clear federal power to retroactively alter private contractual rights."[149]

Nor would the legislation herein contemplated be likely to violate the Due Process Clause of the Fifth Amendment.[150] The Federal Government's power to modify private

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[147] E.g, Pension Ben. Guar. Corp., 467 U.S. at 733 ("It could not justifiably be claimed that the Contract Clause applies, either by its own terms or by convincing historical evidence, to the actions of the National Government.").

[148] U.S. Const. art 1 §10, cl. 1.

[149] Parker Motor Freight, Inc. v. Fifth Third Bank, 116 F.3d 1137, 1142 (6th Cir. 1997) *citing* Pension Ben. Guar. Corp., 467 U.S. at 732; Fleming v. Rhodes, 331 U.S. 100, 107 (1947) ("Federal regulation of future action based upon rights previously acquired by the person regulated is not prohibited by the Constitution. So long as the Constitution authorizes the subsequently enacted legislation, the fact that its provisions limit or interfere with previously acquired rights does not condemn it.") There is also a clear and broad federal power to impose reasonable restraints on the freedom to contract without violating the Due Process Clause. E.g., West Coast Hotel Co. v. Parrish, 300 U.S. 379, 392-3 (1937) *citing* Chicago, Burlington & Quincy R. Co. v. McGuire, 219 U.S. 549, 565 (1911) ("The guaranty of liberty does not withdraw from legislative supervision that wide department of activity which consists of the making of contracts, or deny to government the power to provide restrictive safeguards. Liberty implies the absence of arbitrary restraint, not immunity from reasonable regulations and prohibitions imposed in the interests of the community.")

[150] This is not to say that any legislation other than that considered here which offers relief for homeowners would be likely to be held constitutional under the Due Process Clause. For example, legislation which had the effect of reopening or revising final judgments, meaning those for which "the availability of appeal is exhausted," issued by courts may be held unconstitutional under the "Vested Rights Doctrine." Johnston v. Cigna Corp., 14 F.3d 486, 490-7 (10th Cir. 1993). However, none of the policies considered here would run afoul of that prohibition.

contracts is somewhat constrained by the Due Process Clause and ideas of substantive due process.[151] However, those constraints are not "coextensive with prohibitions existing against state impairments of pre-existing contracts."[152] Judicial scrutiny over such legislation is minimal.[153] The Supreme Court has promulgated a three part test. The party challenging the constitutionality of the act must demonstrate "first, that the statute alters contractual rights or obligations" and then "that the impairment is of constitutional dimension."[154] Finally, if the first two parts of the test are met, the complaining party must "overcome a presumption of constitutionality and 'establish that the legislature has

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[151] National Wildlife Federation v. Interstate Commerce Com., 271 U.S. App. D.C. 1, n.12 (D.C. Cir. 1988) ("Any claim that federal legislation unlawfully impairs existing contracts falls under the *due process clause of the Fifth Amendment*") (emphasis in original). Concerns regarding procedural due process would not threaten legislation amending mortgages. Gillespie v. City of Indianapolis, 13 F. Supp. 2d 811, 825 (S.D. Ind. 1998) quoting Brown v. Retirement Comm., 797 F.2d 521, 527 (7th Cir. 1986) ("when the legislature passes a law which affects a general class of persons, those persons have all received procedural due process -- the legislative process.")

[152] Pension Ben. Guar. Corp, 467 U.S. at 732.

[153] See National R.R. Passenger Corp. v Atchinson, Topeka and & Santa Fe R.R. Co., 470 U.S. 451, 472 (1985). If the proposed legislation were enacted, entities which may be considered part of the Federal Government (e.g. Fannie Mae and Freddie Mac) would have their contracts modified (it is not certain if the Federal Government would be considered a party to those contracts.) The standard for modifications of contracts to which the Federal Government is a party may be somewhat more stringent. E.g., Alpine Ridge Group v. Kemp, 955 F.2d 1382, 1387 (9th Cir. 1992); Gavin v. Branstad, 122 F.3d 1081, 1091 (8th Cir. 1997); Sheridan Square Partnership v. United States, 66 F.3d 1105, 1109 ("we review economic legislation with particular scrutiny when a government attempts to redefine or abrogate its own contractual relationships.") Courts have not discussed the actual content of that standard at any length. In Sheridan Square the Tenth Circuit upheld modification of a contract to which the Federal Government was a party because it was "eminently reasonable and fair." Id. at 1108-9. In such cases the Court can exercise more scrutiny because the "State's self interest is at stake" which creates an inherent conflict. U.S. Trust Co. of New York v. New Jersey, 431 U.S. 1, 26 (1977). There is a direct relationship between the extent of the government's self-interest and the amount of scrutiny which will be applied. United States v. Winstar Corp., 518 U.S. 839, 898 (1996) ("The greater the Government's self-interest, however, the more suspect becomes the claim that its private contracting partners ought to bear the financial burden of the Government's own improvidence, and where a substantial part of the impact of the Government's action rendering performance impossible falls on its own contractual obligations, the defense will be unavailable"); Harmelin v. Michigan, 501 U.S. 957, 978 (U.S. 1991) ("it makes sense to scrutinize governmental action more closely when the State stands to benefit.") However, since such changes would not be to the detriment of the Government's counterparties and would reduce the amount owed to those entities, it is unlikely any concerns regarding self-dealing would be a serious obstacle to the constitutionality of this legislation. Indeed, the Federal Deposit Insurance Corporation has recently begun modifying loans owned or securitized and serviced by IndyMac to provide relief to homeowners. See Federal Deposit Insurance Corporation, Loan Modification Program for Distressed Indymac Mortgage Loans (August 20, 2008), http://www.fdic.gov/consumers/loans/modification/indymac.html.

[154] National R.R. Passenger Corp., 470 U.S. at 472.

acted in an arbitrary and irrational way.'"[155] In cases of private contracts allegedly impaired by federal statutes this third step "is especially limited, and the judicial scrutiny quite minimal."[156]

Whether the first two prongs of the test described above would be met depends a on the specific provisions of the legislation passed. However, it is often the final part of the analysis that is controlling. Indeed, it is not uncommon for courts to simply assert without argument or explanation that there is an impairment of contract and then "assum[e] for the sake of argument that the statute's interference . . . is, in fact, a substantial constitutional impairment."[157]

The third part of this test calls for use of a highly deferential standard in assessing a statute which affects existing contract or other economic rights.[158] The Supreme Court has "expressed concerns about using the Due Process Clause to invalidate economic legislation."[159] Generally, for the past seventy plus years the Supreme Court's "posture

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[155] Id. *citing* Pension Ben. Guar. Corp., 467 U.S. at 729. This is the general standard applied to retroactive economic legislation when reviewed under the Due Process clause. United States v. Carlton, 512 U.S. 26, 28 (1994) (internal citations omitted). In other contexts the Supreme Court has used a different formulation of this standard, asking if relevant legislation was "harsh and oppressive." However, the Supreme Court has interpreted that standard as one that does "not differ from the prohibition against arbitrary and irrational legislation that applies generally to enactments in the sphere economic policy." Id. The fact that legislation may be applied retroactively does not change this analysis. The Supreme Court, in a unanimous decision, held that all that need be shown is "that the retroactive application of the legislation is itself justified by a rational legislative purpose." United States v. Sperry Corp., 493 U.S. 52, 63 (1989) (internal quotations omitted). However, if a statute has both retrospective and retrospective effects, while the test under the Due Process Clause is the same, "the justifications for latter may not suffice for the former." Id.; Davon, Inc. v. Shalala, 75 F.3d 1114, 1123 (7th Cir. 1996) ("Congress must have an independent rational basis for making a law retroactive, even where the prospective aspects of the legislation are plainly rational"). However, that does not change the general rule that "*constitutional* impediments to retroactive civil legislation are now modest." Landgraf v. Usi Film Prods., 511 U.S. 244, 272 (U.S. 1994) (emphasis in original).

[156] Id.

[157] See Gillepsie v. City of Indianapolis, 13 F.Supp.2d 811, 828 (S.D. Ind. 1998); Glosemeyer, 879. 2d at 321; James v. Lash, 965 F.Supp. 1190, 1199 (N.D. Ind. 1997); Consolidated Rail Corp. v. Metro-North Commuter R. Co., 638 F. Supp. 350, 357-8 (Regional Rail Reorg. Ct. 1986) (the first two prongs of the test were not contested); Gavin, 122 F.3d at 1091.

[158] National R.R. Passenger Corp. 470 U.S. at 472.

[159] Eastern Enterprises v. Apfel, 524 U.S. 498, 522 (1998).

has been one of deference to Congress' economic policy prerogatives."[160] The Seventh Circuit has stated that "it may be right that merely economic regulations can never flunk the test of rationality."[161]

Courts have interpreted this standard as very similar to, and in many cases explicitly stated it to be the same as, the standard for rational basis review.[162] Under rational basis review, a statute cannot be invalided "solely because it upsets otherwise settled expectations."[163] A constitutional plan need not be that which "a court would later find to be fairest, but simply one that is rational and not arbitrary."[164] A challenging party's "burden of establishing such unreasonableness as to deny due process of law is not easily met. For the last half-century, courts have upheld challenged governmental acts unless no reasonably *conceivable* set of facts could establish a rational relationship between the regulation and the government's legitimate ends."[165] Wide ranging relief issued by the Federal Government during times of economic malaise, such as a ninety

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[160] In re Chateaugay, 53 F.3d at 487.
[161] Central States, 181 F.3d at 806 (internal quotations omitted).
[162] Inmates of Suffolk County Jail v. Rouse, 129 F.3d 649, 659 (1st Cir. Mass. 1997); Moss v. Clark, 886 F.2d 686, 692 (4th Cir. 1989) ("As in equal protection analysis, substantive due process requires only that legislation be rationally related to a legitimate end of government") citing National R.R. Passenger Co., 470 U.S. at 476-7; In Re Chateaugay Corp., 53 F.3d 478, 486 - 487 (2nd Cir. 1995) ("Substantive due process requires only that economic legislation be 'supported by a legitimate legislative purpose furthered by rational means" citing Pension Ben. Guar. Corp., 467 U.S. at 729; Central States, Southeast & Southwest Areas Pension Fund v. Midwest Motor Express, Inc., 181 F.3d 799 (7th Cir. Ill. 1999); Jensen v. County of Lake, 958 F. Supp. 397, 405 (N.D. Ind. 1997) (expressly using the same reasoning to support a statute surviving challenge under both the rational basis test and the above test); Bellaire Corp. v. Shalala, 995 F.Supp.125, 132 (D.D.C. 1997) ("Economic legislation comports with due process if it bears a rational relation to a legitimate governmental purpose."); Lindsey Coal Mining Co. Liquidating Trust v. Shalala, 901 F. Supp. 959, 967 (W.D. Pa. 1995) ("a statute will stand if it bears a rational relationship to a legitimate government purpose") (internal quotations omitted).
[163] Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 16 (U.S. 1976); Central States, Southeast & Southwest Areas Pension Fund v. Midwest Motor Express, Inc., 999 F. Supp. 1153, 1165 (N.D. Ill. 1998) ("It is well settled that whether or to what extent a particular piece of legislation dashes a parties' economic expectations' generally poses no constitutional impediment since all economic legislation--whether labeled prospective or retroactive--inherently disrupts someone's financial expectations") (internal quotations omitted).
[164] National R.R. Passenger Co., 470 U.S. at 477.
[165] Tenoco Oil Co. v. Department of Consumer Affairs, 876 F.2d 1013, 1022 (1st Cir. 1989).

day freeze on rents, has been upheld against challenges under the Due Process Clause after being subjected to rational basis scrutiny.[166] Due process challenges to legislation intended to assist homeowners and their communities in times of economic crisis have failed in the past. In East New York Savings Bank v. Hahn,[167] the Supreme Court upheld a one year moratorium on foreclosures, which had been renewed for ten consecutive years, protecting borrowers who paid “taxes, insurance and interest,” and in later years a low rate of amortization on the principle owed (1 – 3%). The appellant urged the Court to find violations of the Due Process Clause of the Fourteenth Amendment,[168] but the Court stated that the Fourteenth Amendment challenge was “too feeble to merit consideration.”[169]

Cases invalidating statutes regarding economic policy on substantive due process grounds have been largely nonexistent in recent decades.[170] While overturning such statutes was a more common practice during the Lochner Era, which spanned from around 1890 to 1937, at least three circuits and various other courts have “expressed doubts” about the “continuing validity” of older cases which employ “intrusive judicial

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[166] United States v. Lieb, 462 F.2d 1161, 1168 (Temp. Emer. Ct. App. 1972).
[167] 326 U.S. at 234-5.
[168] Brief of Petitioner-Appellant at 3, East New York, 326 U.S. at 230. While the 5th amendment would control federal legislation, the language of the due process clause in each is effectively identical and has the same meaning. See Malinski v. New York, 324 U.S. 401, 415 (1945) (Cardozo, J. concurring) (“To suppose that 'due process of law' meant one thing in the Fifth Amendment and another in the Fourteenth is too frivolous to require elaborate rejection.”) An equal protection challenge under the 14th amendment was also raised. Brief for Savings Banks Association of the State of New York as Amicus Curiae Supporting Appellants, East New York, 326 U.S. at 230. Justice Frankfurter appears to be referring to both challenges in his brief statement dismissing them.
[169] East New York, 326 U.S. at 231.
[170] Central States, 181 F.3d at 806 (“The Supreme Court has not invalidated any economic regulation on substantive due process grounds since 1938”); In re Chateaygay, 53 F.3d at 487 (“We are aware of no post-1935 cases in which the Supreme Court invalidated an economic regulation on due process grounds.”) While there appears to be some disagreement amongst the Circuit Courts as to when the Supreme Court last invalidated an economic statute on substantive due process grounds, it is clear that it has not been a common practice in recent decades.

scrutiny of economic legislation under the rubric of substantive due process."[171] Justice Souter has indicated that he concurs in that assessment; in Washington v. Glucksberg, he argued that the line of cases which commonly overturned statutes based on ideas of "economic due process had been repudiated."[172]

In recent years only one Justice has attempted to invalidate a statute on substantive due process grounds, and even then he only did so under what he considered to be "the most egregious of circumstances."[173] In Eastern Enterprises v. Apfel, Justice Kennedy, writing only for himself in a concurrence, attempted to invalidate a statute on that basis.[174] Even in that case, however, he described the standard as "permissive" and stated that cases would only be invalidated on substantive due process grounds in "rare instances" and "only under the most egregious of circumstances."[175] Justice Kennedy would have invalidated the statute because he felt that (1) "the degree of retroactive effect is a significant determinant in the constitutionality of a statute," (2) that the statute at hand had "a retroactive effect of unprecedented scope" because it created liability for events that took place thirty-five years earlier, and (3) that the statute bore "no legitimate relation to the interest which the Government asserts in support of the statute."[176] The

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[171] In re Chateaygay, 53 F.3d at 487; Bellaire Corp., 995 F.Supp. at 136.
[172] Wash. v. Glucksberg, 521 U.S. 702, 761 (1997) (Souter, J. concurring).
[173] Eastern Enterprises, 524 U.S. at 549-50 (Kennedy, J. concurring). This opinion is unlikely to be at all applicable to the contemplated legislation. In that case the statute Justice Kennedy criticized the statute as "severely retroactive" because it imposed liability for things which had taken place decades earlier. The Federal Circuit, while noting that Justice Kennedy's opinion does not create binding law, indicated that the threshold question for even entering into Justice Kennedy's form of analysis would be whether there were "severe retroactive obligations" imposed. Commonwealth Edison Co. v. United States, 271 F.3d 1327, 1345 – 1346 (2001). The legislation contemplated here imposes no new obligations or liabilities on mortgage holders – it merely regulates the future stream of income they may receive from existing mortgage notes.
[174] Id. The plurality in that case did not address that issue. Id., at 537-8. Justice Breyer, dissenting with three other justices, did reach the issue of substantive due process and held that the statute was constitutional. Id. at 550-68.
[175] Id. at 488.
[176] Id. at 549.

potential legislation described above would not run afoul of that standard so long as any relief offered that was retroactive in nature was rationally related to a legitimate governmental interest.

Legislation offering relief to homeowners and their communities would satisfy a any number of legitimate ends by helping avoid the ills caused by large numbers of foreclosures. Regulating mortgage notes is clearly rationally related to that objective. For example, the Supreme Court has expressly stated that "the protection of consumer welfare" is considered a legitimate end and that "price or rate regulation" may be used to achieve that goal.[177] Amending the terms of mortgages to assist homeowners and their communities will almost certainly not be invalidated by the doctrine of substantive due process.

II. Equal Protection

It is possible the relief offered may treat homeowners or mortgage holders differently based on their circumstances (e.g. giving different relief to borrowers with traditional mortgages at subprime rates than those at prime rates or with Alt-A mortgages, or treating various types of mortgage holders differently.[178]) Such a statute could be challenged on equal protection grounds,[179] but would almost certainly be held

[177] Pennell, 401 U.S at 14 (upholding a city rent control ordinance which restricted landlord's ability to raise rents for reasons including hardship faced by the tenant in part because it "represents a rational attempt to accommodate the conflicting interests of protecting tenants from burdensome rent increases while at the same time ensuring that landlords are guaranteed a fair return on their investment.") See, *supra*, Section III, Part II for a more extensive discussion of legitimate ends which could be served by this legislation. Note that the Court will hesitate to uphold retroactive legislation if it is for the purpose of "deterrence" or "blameworthiness." Usery, 428 U.S. at 18 (1976) (internal quotations omitted). However, spreading costs incurred by those harmed by an action to those who benefited is an acceptable end. See id.

[178] This issue was raised in the Brief for Savings Banks Association of the State of New York as Amicus Curiae Supporting Appellants 17 - 30, East New York, 326 U.S. at 230. See *supra* notes 168- 169 and surrounding text.

[179] The Equal Protection Clause of the Fourteenth Amendment does not apply to the Federal Government. However, the same protections and standards apply to the Federal Government under the Due Process Clause of the Fifth Amendment. Adarand Constructors v. Pena, 515 U.S. 200, 217-8 (1995).

constitutional. As a matter of "social and economic policy" it would be reviewed using a "rational basis" test. Under that standard, a statute "must be upheld against equal protection challenge if there is any reasonably conceivable state of facts that could provide a rational basis for the classification."[180] Justice Thomas describes rational basis review as "a paradigm of judicial restraint."[181] Those challenging a statute have "to 'negative every conceivable basis which may support it.'"[182] So long as the policy enacted has a plausible justification for treating different groups differently it will survive any equal protection challenge.

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[180] F.C.C. v. Beach Communications, 508 U.S. 307, 313 (1993). This assumes the statute would not utilize a suspect classification, such as if it was directed at "particular religious . .. or national . . .or racial minorities . . . " See Beach Communications, 508 US at 313; United States v. Carolene Products, 304 U.S. 144, n. 4 (1938). Rational basis scrutiny is also inappropriate if a classification "infringes fundamental constitutional rights." Beach Communications, 508 US at 313. Here no such right is at issue. See Donald T. Kramer, American Jurisprudence § 816 (2d ed. 2008) (listing rights typically considered to be "fundamental" for equal protection purposes).

[181] Id.

[182] Id. at 315.

SECTION FOUR: CONCLUSION

Modern constitutional law poses no serious barriers to federal legislation providing relief to homeowners and communities by modifying the terms of existing mortgages. It is extremely unlikely that any court would sustain a challenge to the contemplated legislation under the Takings Clause of the Fifth Amendment and require the government to pay just compensation to affected mortgage holders, provided the law stayed within the very broad bounds described in this memo. The constitutional prohibition against impairing the obligations of contracts is limited to the States and inapplicable to the Federal Government. The legislation discussed in this memorandum would meet the requirements of the Due Process Clause of the Fifth Amendment regarding both substantive due process and equal protection – such relief is not irrational or arbitrary and there is a plausible justification for such help being offered. Modern constitutional law indicates that neither the Fifth Amendment nor any other provision bars the Federal Government from offering homeowners and communities relief they both need and deserve.