

# The Foreclosure Crisis and the Antifragmentation Principle in State Property Law

David A. Dana<sup>†</sup>

*This Article explains how excessive fragmentation of property interests in mortgages has prevented reasonable modifications in loan terms and helped to create the current foreclosure crisis. The Article argues that Anglo-American property law reflects an antifragmentation principle. This principle offers historical grounding for and constitutional legitimacy to proposals to restructure the servicing of troubled loans so as to produce loan modifications when doing so would produce more net economic value than foreclosure. The Article also considers some reforms that could be adopted to prevent future cycles of excessive fragmentation of property interests in mortgages.*

## INTRODUCTION

One out of every ten houses in the United States is likely to burn down. Figuratively, that is. These houses are “owned” by someone who has been or is at real risk of being foreclosed upon by the servicer of a mortgage on his home.<sup>1</sup> Moreover, one in five homeowners in the United States will likely be “underwater” before housing prices bottom—that is, the market value of the home will be less than the amount borrowed with the house as collateral.<sup>2</sup> These foreclosures, in turn, are wreaking havoc even on neighbors whose mortgages are not in default, just as fire in one house can easily damage the house next door. Foreclosures are driving down housing prices for non-foreclosed-upon properties, and leaving unoccupied, uncared-for properties that invite vandalism and criminal activity. And, of course, there are very high social costs that arise from the dislocation of families from their homes.

The measures that states and localities have so far tried to stem the foreclosure crisis are very unlikely to work. Cities have threatened to bring or have brought public nuisance claims against lenders who allegedly made loans to borrowers they knew could not pay, did not

---

<sup>†</sup> Professor of Law and Associate Dean for Faculty Research, Northwestern University School of Law.

Many thanks to Lee Fennell, Susan Koniak, Adam Levitin, Claire Priest, Julie Roin, and Jacob Sagi.

<sup>1</sup> Congressional Oversight Panel, *Foreclosure Crisis: Working toward a Solution, March Oversight Report 1* (Mar 6, 2009) (“Oversight Report”), online at <http://cop.senate.gov/documents/cop-030609-report.pdf> (visited Aug 31, 2009) (“Over the next few years, an estimated one in every nine homeowners is likely to be in foreclosure.”).

<sup>2</sup> *Id.* (“[O]ne in five [homeowners] will likely have a mortgage that is higher than their house is worth, making default a financially rational alternative.”).

understand the risks, or both.<sup>3</sup> States have also looked to foreclosure moratoria as a means of slowing dislocations and encouraging loan modifications.<sup>4</sup> Neither of these measures will yield much more than publicity for the plight of communities engulfed in foreclosures.

To deal effectively with the foreclosure crisis, legislation is needed to address a major reason that servicers have resisted making effective loan modifications that could keep at least some struggling borrowers in their homes. That reason is the excessive legal fragmentation of individual mortgages. By virtue of the revolution in the mortgage industry and mortgage markets in just the last few decades, a range of parties often have some kind of “right” or economic stake in the secured credit on any given home. These parties often have conflicting interests, and as a result, servicers are unwilling or unable to rework loans in cases where borrowers can and would make reasonable payments (that is, payments that take some account of the dramatic drop in housing values). In effect, “we”—our society, that is—have made with mortgages the same mistake that feudal society made with respect to property in land: allowing private parties to divide up a key kind of property in so many ways and so intricately that the transaction costs are just too high for rational, timely decisions to be made about the property when conditions change. The current mortgage crisis is an incarnation of what might be called “the feudal mistake.”<sup>5</sup>

There is a possible solution, and it necessarily must be both legislative and federal. Congress should enact legislation that removes the loan modification process from the current servicers and vests it in neutral, economically disinterested agents who will make loan modification decisions as if—using the criteria that would be used if—they owned *all* the interests in the individual mortgages at risk. The states cannot undertake this reform, but state law, and in particular the common law of property, can provide historical legitimacy for any such federal effort. State law reflects an antifragmentation principle in the form of the rule against perpetuities and in other rules of deed and will construction. State oil and gas field unitization laws have operated in accord with such an antifragmentation principle as well. The prop-

---

<sup>3</sup> See notes 6–8 and accompanying text.

<sup>4</sup> See, for example, California Foreclosure Prevention Act, Cal Civil Code §§ 2923.52–2923.53 (West) (mandating a foreclosure delay of ninety days unless certain loan modification measures are taken).

<sup>5</sup> See David Dana, *The Feudal Mistake*, Huffington Post (Dec 8, 2008), online at [http://www.huffingtonpost.com/david-dana/the-feudal-mistake\\_b\\_149377.html](http://www.huffingtonpost.com/david-dana/the-feudal-mistake_b_149377.html) (visited Oct 17, 2009) (describing the myriad of interests in and divisions of property during feudal times that made the property useless to all).

erty law tradition of legal intervention to combat excessive fragmentation bolsters the argument that federal legislation transferring the servicing of mortgages would not be a taking under the Fifth Amendment to the United States Constitution.

This Article is organized as follows. Part I briefly evaluates public nuisance litigation and temporary mortgage moratoria as responses to the foreclosure crisis. Part II explains how changes in the mortgage industry have impeded significant efforts to modify loans in a way that would actually leave borrowers able and willing to maintain payments on the modified loans, rather than simply redefaulting. It also outlines a proposal to restructure the servicing of troubled loans by making modification decisions replicate those that would be made in the absence of excessive fragmentation. Part III develops the argument that Anglo-American property law reflects an antifragmentation principle. Part IV outlines the argument that dramatic federal intervention to address excessive fragmentation of property in mortgages would not constitute a regulatory taking.

## I. STATE MEASURES THAT WILL NOT WORK

### A. Public Nuisance Suits

One possible response to the foreclosure crisis would be for hard-hit cities and states to seek financial recovery from the originators, securitizers, and investors in mortgages and then use the recovered money to help homeowners and others, as well as to meet the property tax shortfall and other budgetary problems arising from the housing crisis. Cleveland is pursuing this strategy aggressively.<sup>6</sup> The most immediate problem for these lawsuits is that they lack a workable legal theory. It appears there has been some actionable fraud in mortgage origination in Cleveland and elsewhere,<sup>7</sup> but fraud is hard to prove and many of the deepest pockets in these lawsuits are far too removed from the mortgage brokers and originators to be legally responsible

---

<sup>6</sup> For a description of the lawsuit, see Richard O. Faulk, John S. Gray, and Diana P. Larson, *A Sub-prime Tort? Public Nuisance an Unfit Tool for Lending Regulation* \*5-7 (Washington Legal Foundation Working Paper No 158, Aug 2008), online at [http://www.gardere.com/Content/hubbard/tbl\\_s31Publications/FileUpload137/2084/Faulk\\_Gray\\_Larson\\_Sub\\_Prime.pdf](http://www.gardere.com/Content/hubbard/tbl_s31Publications/FileUpload137/2084/Faulk_Gray_Larson_Sub_Prime.pdf) (visited Oct 26, 2009). For a description of another major effort to stretch the traditional boundaries of public nuisance, see David A. Dana, *The Mismatch between Public Nuisance Law and Global Warming* \*5-11 (Northwestern Public Law Research Paper No 08-16, May 2008), online at <http://ssrn.com/abstract=1129838> (visited Oct 17, 2009) (questioning whether the political question doctrine should bar courts from using public nuisance to address climate change issues).

<sup>7</sup> See Faulk, *A Sub-prime Tort?* at \*6 (cited in note 6).

for fraudulent representations made to mortgage applicants. As a result, Cleveland has grounded its suit in public nuisance,<sup>8</sup> a category of tort for which no showing of intent is required.<sup>9</sup>

Characterizing the mortgage origination, securitization, and investment as a public nuisance, however, stretches “public nuisance” beyond even what a sympathetic court would (or I think, should) allow. Because public nuisance is a strict liability tort, in the sense that it does not require a showing of bad intent or lack of due care, courts have resisted efforts to recast products liability law as a form of public nuisance law,<sup>10</sup> and for the same reason they would be reluctant to recast consumer fraud and securities fraud as a form of public nuisance. Federal preemption is also a problem for these public nuisance claims against federal or international financial actors. Finally, even public nuisance claims necessitate a showing of causation, and the causes of mortgage defaults and foreclosures are certainly multiple. The common law places on the plaintiff in a public nuisance suit the very daunting burden of showing that the mortgage originator, servicer, or investor is the but-for cause of the default and foreclosure.

## B. Mortgage Moratoria

States traditionally have set the procedures and substantive standards regarding mortgage foreclosure as part of their general role as the source of real property law. For example, state law governs how foreclosure sales must be conducted, how much time a defaulting borrower has to repurchase his foreclosed-upon home as a matter of right after the foreclosure sale, and to what extent defaulting homeowners can be held liable for deficiencies between the outstanding principal owed and the foreclosure proceeds.

Building on this traditional role, states have sometimes responded to economic crises by attempting to alter the foreclosure rules and standards to help borrowers in trouble. Prior to the current foreclosure crisis, the two most notable waves of state law foreclosure relief occurred during the Great Depression and the farm crisis of the 1980s.

---

<sup>8</sup> *Id.* at \*5.

<sup>9</sup> See Restatement (Second) of Torts § 821B, comment d (1979).

<sup>10</sup> For example, the Rhode Island Supreme Court recently rejected efforts to characterize lead paint in homes as a public nuisance. See *State v. Lead Industries Association, Inc.*, 951 A2d 428, 435 (RI 2008) (“[D]efendants were not in control of any lead [paint] at the time the lead caused harm . . . , [which made] defendants unable to abate the alleged nuisance, the standard remedy in a public nuisance action.”).

In both cases, the states opted for temporary moratoria on mortgage foreclosures, and sometimes they instituted successive moratoria.<sup>11</sup>

States have responded to the current foreclosure crisis with moratoria, and, as is often true, California has been at the vanguard. California adopted a statute that uses the stick of a moratorium to incentivize banks to modify loans. Under the California Foreclosure Prevention Act, banks are required to delay foreclosure actions by ninety days unless they adopt a comprehensive loan modification program that includes such measures as interest rate reductions and deferral or reduction of the principal.<sup>12</sup>

The states, however, face substantial legal obstacles in pursuing a strategy of increasing the costs of foreclosure as a means of pressuring lenders to engage in additional, more generous loan modification. For one thing, states are preempted from regulating national banks or their affiliates, and a large share of the mortgages in every state have been originated or partly held or serviced by such institutions.<sup>13</sup> By pressuring banks to engage in loan modification, the California legislation would seem to qualify more as loan and capital regulation (the exclusive domain of the federal government with respect to national banks and their affiliates) than property law and contract law (traditionally, and still largely, the domain of the states even with respect to national banks and their affiliates).

The federal Constitution also poses a potential obstacle to state moratoria. In *Home Building & Loan Association v Blaisdell*,<sup>14</sup> the United States Supreme Court upheld a foreclosure relief statute enacted by Minnesota against constitutional challenge under the Contracts Clause, explaining that the protections afforded defaulting homeowners were temporary and justified by an economic emergency.<sup>15</sup> And

---

<sup>11</sup> See Robert M. Lawless, *The American Response to Farm Crises: Procedural Debtor Relief*, 1988 U Ill L Rev 1037, 1041–43, 1049–60.

<sup>12</sup> See California Foreclosure Prevention Act, Cal Civil Code §§ 2923.52–2923.53. See also 10 CCR §§ 2031.1–2031.10 (clarifying the application of Cal Civil Code §§ 2923.52–2923.53 through elaboration of the minimum requirements for a comprehensive loan modification program under Cal Civil Code § 2923.53).

<sup>13</sup> For the United States Supreme Court’s most recent preemption decision in the banking area, which embraces an expansive vision of the scope for federal preemption, see *Watters v Wachovia Bank*, 550 US 1, 21 (2007) (concluding that the National Bank Act “protect[s] from state hindrance a national bank’s engagement in the ‘business of banking’ whether conducted by the bank itself or by an operating subsidiary”). But see *Cuomo v Clearing House Association*, 129 S Ct 2710, 2721 (2009) (concluding that the National Bank Act preempts a state’s visitatorial powers but not its power to prosecute enforcement actions in state courts).

<sup>14</sup> 290 US 398 (1934).

<sup>15</sup> *Id.* at 444–48 (“We are of the opinion that the Minnesota statute as here applied does not violate the contract clause of the Federal Constitution.”). For a summary of the relevant state and federal case law, see generally *Mortgage Foreclosure Forbearance Statutes—Modern Status*, 83 ALR

much more recently, the Court upheld a temporary moratorium on construction in the Lake Tahoe region on the theory that local regulators needed flexibility to develop the best means of reconciling private property owners' interests and the need to prevent environmental degradation.<sup>16</sup> These precedents might suggest that California and other states have leeway under the federal Constitution to institute temporary moratoria as long as such moratoria are styled as temporary and do not de facto become long-term or semipermanent.

But that is exactly the problem: truly temporary moratoria will accomplish nothing or next to nothing. Of course, moratoria could sometimes be helpful while other significant reforms are being put in place.<sup>17</sup> However, the pressure and costs of delay in foreclosure due to moratoria, by themselves, are not enough to overcome the obstacles to meaningful loan modifications, including the conflicting interests among interest holders in mortgages. And, at the end of the moratoria, borrowers, therefore, will likely just face more late payments and penalties than before the moratoria. As a result, we are likely to observe a wave of foreclosures once state moratoria end.<sup>18</sup>

## II. EXCESSIVE FRAGMENTATION AS A CAUSE OF THE MORTGAGE CRISIS AND WHAT TO DO ABOUT IT

### A. Too Many Players, Too Many Conflicts

In the "old days" of residential mortgage financing, the relevant players with respect to the secured credit on a home were simply "the bank" and "the borrower." The bank originated the mortgage, serviced it, and owned it. The borrower paid principal and interest to the bank, and that was that. In this regime, the bank would modify a troubled loan if it could reasonably predict that the stream of payments the borrower could make under a modified loan would yield more net profit (or less net loss) than would result from foreclosure. The bank rationally would agree to significant loan modification, even principal

---

4th 243 (1991). See also Roland C. Amundson and Lewis J. Rotman, *Depression Jurisprudence Revisited: Minnesota's Moratorium on Mortgage Foreclosure*, 10 Wm Mitchell L Rev 805, 821–26 (1984).

<sup>16</sup> See *Tahoe-Sierra Preservation Council, Inc v Tahoe Regional Planning Agency*, 535 US 302, 334–36 (2002) (concluding that a rule prohibiting moratoria "would render routine government processes prohibitively expensive or encourage hasty decisionmaking").

<sup>17</sup> See *Oversight Report* at 61–63 (cited in note 1).

<sup>18</sup> See, for example, Alan Zibel, *US Foreclosures up 24 Percent in 1st Quarter*, USA Today (Apr 16, 2009), online at <http://content.usatoday.net/dist/custom/gci/InsidePage.aspx?cId=dailytribune&sParam=30561303.story> (visited Oct 1, 2009).

reduction, in order to avoid foreclosure where housing prices had dropped substantially since the origination of the mortgage.

That has all changed. Now, with respect to the secured credit on a single home, there are a host of actors with an economic interest in whether or how the loan is paid back, modified, or both. Mortgages now are most often serviced by an entity that holds no direct or indirect interest in the mortgage or mortgages on the property. Moreover, a large percentage of first mortgages in the United States in recent years have been pooled, and each pool has been securitized. The securities in each pool have been divided into different “tranches” with different credit-risk ratings and different rights to payments from the borrowers. Tranching has occurred in a dizzying variety of approaches, but typically, for each pool, there are senior, intermediate or mezzanine, and junior tranches. The lower tranches, moreover, typically have been resecuritized through the use of collateralized mortgage obligations (CMOs) or collateralized debt obligations (CDOs). CMOs and CDOs then often have been tranced and securitized in the form of a CMO<sup>2</sup> or CDO<sup>2</sup>, and then sometimes these instruments in turn have been tranced and securitized, and on and on.<sup>19</sup> By virtue of the financial alchemy of Wall Street, a single mortgage could be—and often has been—transformed into tens or hundreds or even thousands of distinct investment interests.

Still, there are even more interest holders to consider. At least in theory, in some cases there could be a surplus value after all the various bondholders in a pool have been paid off. This residual interest was also carved out and sold to yet another set of entities, called residual claimants or holders of Net Interest Margin (NIM). And on top of all of this, Wall Street created a layer of credit default swaps, which are insurance bet investments based on mortgage pool investments.

Finally, for many properties, a second mortgage was originated at the same time as the first mortgage in order to allow the borrower to avoid mortgage insurance requirements. (Second mortgages were also originated at a later date, often part of a home equity line.) These second mortgages became much more common in mortgages originated after 2002; by 2006, more than half of Alt-A mortgage originations also included a second mortgage.<sup>20</sup> These second mortgages often are held by

---

<sup>19</sup> See *Oversight Report* at 43–44 (cited in note 1); Anna Gelpern and Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities* \*24–28 (Georgetown Public Law & Legal Theory Working Paper No 1323546, May 2009), online at <http://ssrn.com/abstract=1323546> (visited Oct 26, 2009); Joshua D. Coval, Jacob Jurek, and Erik Stafford, *The Economics of Structured Finance* \*10–15 (Harvard Business School Working Paper No 09-060, 2008), online at <http://www.hbs.edu/research/pdf/09-060.pdf> (visited Oct 26, 2009).

<sup>20</sup> See *Oversight Report* at 41 (cited in note 1).

parties other than those who hold first mortgages or interests in the securitized or multiply securitized pools containing the first mortgage. And to make matters all the more difficult, second mortgages are often securitized and resecuritized in the same iterative process as first mortgages.

This incredible fragmentation of the secured credit in individual homes impedes effective loan modification for three basic reasons: (1) servicers have distinctive economic interests regarding the mortgages they service that make them resist effective modifications; (2) even when servicers would pursue an effective modification of a mortgage that is part of a securitized pool, they cannot obtain the necessary agreement of all of the owners of a direct or indirect interest in the mortgage; and (3) even when servicers would pursue an effective modification of a first mortgage that is part of a securitized pool and can obtain the consent of everyone who has an interest in that mortgage, they cannot coordinate the necessary subordination of the second mortgage on the property.

Servicers service mortgages contained in a securitized pool by virtue of contracts known as Pooling and Servicing Agreements (PSAs).<sup>21</sup> Because the servicer of a mortgage does not own any part of the mortgages it services, its only source of revenue related to the mortgages is a fee it obtains from investors in the pool of securitized mortgages, and these fees are generally based on the principal of the serviced mortgages. Servicers thus have a strong interest in not modifying loans in such a way as to reduce principal and hence reduce fees, even when doing so might be the only way to avoid foreclosures and might be exactly what economically rational servicers would do if they also owned the mortgages they serviced.<sup>22</sup> Because PSA contracts also generally provide that servicers must cover payments to investors in the mortgage pool after the mortgages go into default and up until the properties are foreclosed upon,<sup>23</sup> cash-strapped servicers also have an incentive to push mortgages in default to foreclosure. The fact that servicers are compensated for

---

<sup>21</sup> Larry Cordell, et al, *The Incentives of Mortgage Servicers: Myths and Realities*, 41 UCC L J 4 Art 2, § 3 (2009).

<sup>22</sup> See John D. Geanakoplos, *Why President Obama's Plan Will Not Work and What Will* \*6-7 (Mar 19, 2009) (testimony before the House Subcommittee on Housing and Community Opportunity, a subset of the House Financial Services Committee), online at [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/geanakoplos\\_testimony\\_-\\_all.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/geanakoplos_testimony_-_all.pdf) (visited Aug 31, 2009) (“Servicers are paid a percentage of principal for each house that is not defaulting. That means reducing interest costs them nothing and gains them much, at least in the short term” and “all servicers are driven by their immediate needs.”).

<sup>23</sup> *Id.* at \*7, 8.



all expenses of foreclosure, including whatever various fees they tack on, also may lead them to proceed readily to foreclosure.<sup>24</sup>

Even when servicers want to aggressively pursue meaningful loan modifications, including ones involving principal, the inability to coordinate and obtain consent from all the relevant investors may result in paralysis or at best halfway measures. Many PSA contracts require a supermajority or even unanimous consent of all interest holders in a mortgage in order to allow a modification of the loan.<sup>25</sup> Even when that is not the case, servicers reasonably may fear liability if they act without broad consent. Investors in senior-most tranches have no reason to support loan modification because they have priority and will recover on their investment even with foreclosure, while those in the most junior tranches have no reason to support modification because they will receive nothing once a schedule of significantly reduced payments is in place. Of course, some “in the middle” investors may benefit from meaningful modifications but that hardly makes for unanimity or a supermajority of investors.<sup>26</sup>

Reworking the first mortgage, moreover, will not happen (and cannot prevent foreclosures) if all of the benefits of the reworking accrue to second mortgage holders, rather than borrowers. As the Congressional Oversight Panel’s report on the foreclosure crisis explained,

Unless a junior mortgagee consents to subordination, the junior mortgage moves up in seniority upon refinancing. Out of the money junior mortgagees will consent to subordination only if they are paid. Thus, junior mortgages pose a serious holdup for refinancings, demanding a ransom in order to permit a refinancing to proceed.<sup>27</sup>

Where the second mortgage has been securitized, gaining consent for refinancing may mean in effect gaining the consent of hundreds or thousands of investors in a pool that contains the second or junior mortgage.

---

<sup>24</sup> *Oversight Report* at 45 (cited in note 1). For an analysis of how servicers’ financial interests diverge from those of investors in mortgages and result in foreclosures where loan modification would yield greater revenue, see Larry Cordell, et al, *The Incentives of Mortgage Servicers: Myths and Realities* \*17–19 (Finance and Economics Discussion Series working paper 2008–46, Sept 8, 2008), online at <http://www.federalreserve.gov/pubs/feds/2008/200846/200846pap.pdf> (visited Sept 3, 2009).

<sup>25</sup> *Oversight Report* at 43 (cited in note 1).

<sup>26</sup> See Gelpert and Levitin, *Rewriting Frankenstein Contracts* at \*25 (cited in note 19) (“All the benefit [of modification] accrues to the ‘fulcrum’ tranche that is in the money if there is a modification, and out of the money in a foreclosure.”).

<sup>27</sup> *Oversight Report* at 35 (cited in note 1).

The fragmentation of the secured credit interest in real property described above is, to be sure, not the only impediment to meaningful and expeditious loan modifications. There are many other reasons, ranging from widespread job losses to concerns of publically traded financial institutions about booking losses when principal is reduced to the sheer number of mortgages in default or facing default.<sup>28</sup> But fragmentation appears to be an important enough part of the story that addressing it must be part of the solution.

### B. Putting the Pieces Back Together

Government-provided financial incentives for servicers to modify loans, in theory, could operate to counteract their financial incentives not to engage in meaningful principal reductions, to press for mortgages in default to go into foreclosure, or both. But such incentives would need to be structured and calibrated properly for each major servicer, and so far there is no evidence yet that government actors have the information, political ability, or desire to provide the needed incentives. Loan modifications have increased somewhat with the federal incentives for servicers that have been instituted, but the available evidence suggests that many of these modifications are “bad” ones that result in the servicers receiving incentive payments without modifying the loans in such a way that borrowers can (or, as a matter of pure self-interest, should) continue to make payments rather than redefaulting and walking away from their mortgages in the relatively near term.<sup>29</sup> Moreover, giving incentive payments to servicers will not correct the barriers to meaningful reworking of mortgages that are rooted in the difficulty of coordinating and obtaining consent from the multiple investors who have conflicting stakes in particular properties that have been subject to a securitized first mortgage and (often) also a second junior mortgage or mortgages.

---

<sup>28</sup> Id at 30–40.

<sup>29</sup> See Office of the Comptroller of the Currency and Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, Fourth Quarter 2008* 6 (Apr 2009), online at <http://files.ots.treas.gov/4820362.pdf> (visited Aug 31, 2009) (finding that the majority of loan modifications did not decrease borrower’s monthly payments, and 32 percent increased monthly payments). The report also found that modifications that left payments the same or increased them were associated with redefault rates that were double those associated with modifications that reduced monthly payments. Id at 6–8 (noting that loan modifications that decreased monthly payments by more than 10 percent resulted in a 22.7 percent delinquency rate compared to delinquency rates of 50.6 percent and 45.8 percent for modifications that left payments unchanged and increased payments, respectively).

Lauren Willis and Howell Jackson, writing separately, have suggested that the federal government cut through the mortgage securitization morass by condemning all the interests in securitized mortgages.<sup>30</sup> Such a vast exercise of the eminent domain power could easily be tied up in the courts, with the salient questions being what just compensation was at the time of condemnation and whether it was paid. Moreover, as the party bringing the condemnation actions, the government would bear the burden of proving that it paid just compensation; given the uncertainties of valuation, it matters a great deal which party has the burden of proof. Even if there were no legal challenges, moreover, the federal government could not plausibly attempt valuations and hence pursue condemnations until it had assembled information about each mortgage, borrower, and mortgage pool, which is something that would require changes to federal law. As discussed below, once so much information has been gathered, effective reforms could be undertaken without the further step of actual condemnation of mortgages and interests in mortgages. Further, wholesale condemnation of mortgages and interests in mortgage pools would mean that the federal government effectively would own the mortgages on a huge number of homes and either would remain the nation's largest mortgagee or would have to undertake the enormous task of remarketing mortgages in a way that did not unduly benefit some private parties or otherwise delegitimize the government. Our politics and political culture would almost certainly make such a massive federal intervention in the market impossible, and we need not go to that extreme in order to address the excessive fragmentation in mortgages.

A better approach has been outlined by John Geanakoplos and Susan Koniak.<sup>31</sup> In this approach, the servicing of securitized first

---

<sup>30</sup> See Lauren E. Willis, *Stabilize Home Mortgage Borrowers, and the Financial System Will Follow* \*2 (Loyola Law School Legal Studies Paper No 2008-28, Sept 2008), online at <http://ssrn.com/abstract=1273268> (visited Aug 31, 2009) (arguing that, after selling homes seized through eminent domain back to the homeowner, “[l]enders and investors would receive the lesser of the mortgage balance or the amount paid by the government as just compensation”); Howell E. Jackson, *Build a Better Bailout*, *Christian Sci Monitor* 9 (Sept 25, 2008) (“With congressional authorization, the Treasury could force the purchase of these assets through eminent domain and make an immediate payment of an estimate of the loans’ current fair value, which would then be later reviewed for adequacy by a judicial forum.”).

<sup>31</sup> See John D. Geanakoplos and Susan P. Koniak, *Mortgage Justice Is Blind*, *NY Times* A39 (Oct 29, 2008) (“[W]e propose legislation that moves the reworking function from the paralyzed master servicers and transfers it to community-based, government-appointed trustees. . . . [T]he blind trustees would consider, loan by loan, whether a reworking would bring in more money than a foreclosure.”). See also John D. Geanakoplos and Susan P. Koniak, *Matters of Principal*, *NY Times* A31 (Mar 4, 2009). I also rely on an outline of a “Mortgage and Securities Stabilization, Recovery and Modification Program Act of 2009” based on the Geanakoplos and Koniak

mortgages on homes would be transferred to government-appointed trustees who would be empowered to obtain, for each mortgage, the necessary information to determine whether the mortgage was at risk of foreclosure absent modification of the loan terms. In cases where the answer is found to be yes, the trustees could modify the loan (including via principal reductions), but only if doing so would reasonably be expected to yield more revenue than foreclosure. A homeowner would need to be able to demonstrate that he or she could reasonably be expected to make and sustain the payments on the modified loan. Mortgages that did not meet the test for modification would be allowed to proceed to foreclosure.<sup>32</sup>

In order to capitalize on the traditional knowledge that informed lending and loan modifications before the dawning of the age of excessive fragmentation in property in mortgages, the plan would employ community bankers in a decentralized, regional approach. While the community-based bankers would be sighted with respect to local economic conditions and borrowers' personal profiles and histories, they would be "blind" as to who or what institutions held interests in any of the mortgages they were reviewing. After the blind review, mortgages that have not been reworked and those that have would be returned to the original servicers. Throughout this process, investors in mortgage pools would be paid as before, except that their payments might be adjusted or even terminated on mortgages that had been modified.<sup>33</sup>

---

proposal and authored by them as well as George Cohen. See Geanakoplos, *Why President Obama's Plan Will Not Work and What Will* at \*20–28 (cited in note 22) (including a bill attached to the testimony that proposes "a program for nonconforming securitized mortgages . . . that transfers responsibility for mortgage modifications and foreclosure decisions from servicers to government-designated, community-based trustees").

<sup>32</sup> Another possible federal reform would be an amendment to federal bankruptcy statutes to allow homeowners to write down the principal on their mortgages to current values as part of Chapter 13 bankruptcy. For an extended argument on behalf of this approach, see Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 Wis L Rev 565, 571–78, 647–48 (outlining the argument and concluding that bankruptcy modification "offers immediate relief, . . . spreads burdens [to all involved], and avoids both the costs and moral hazard of a government bailout"). There are great social costs, however, in not providing mortgage relief until homeowners are in such bad financial straits that they would be eligible and willing to file for bankruptcy; moreover, filing for bankruptcy itself is costly and hence beyond the ability of some homeowners who are already deeply in debt. Finally, the bankruptcy courts and bankruptcy judges do not have the institutional capacity to handle a huge wave of bankruptcy filings. Indeed, the bankruptcy courts probably could handle such a wave only if something like a system of government-employed trustees with backgrounds in community banking were set up at the same time. See Alan Schwartz, *Don't Let Judges Fix Loans*, NY Times A27 (Feb 27, 2009) (arguing that the bankruptcy solution would "swamp bankruptcy courts," disappoint debtors, and "worsen[] economic uncertainty").

<sup>33</sup> In the Geanakoplos and Koniak plan, holders of second mortgages would take away nothing when the blind trustee decides that the first mortgage is so troubled that a modification

The blind trustee plan, in the case of any given mortgage, might result in some unhappy investors. But under this plan, the federal government would not need to institute condemnation suits and calculate and defend particular just compensation payments: Investors would need to file inverse condemnation or regulatory takings suits and would have the burden of overcoming the ripeness requirements for regulatory takings challenges before even being able to address and argue the merits that regulatory takings had occurred.<sup>34</sup> And (as discussed below) with certain modifications, the plan would very likely survive any regulatory takings challenges, such that the thorny issue of just compensation could be avoided completely.

### III. THE ANTIFRAGMENTATION PRINCIPLE IN ANGLO-AMERICAN LAW AND ITS SIGNIFICANCE FOR FEDERAL LEGISLATIVE REFORM

A plan to transfer the servicing of securitized mortgages to blind government trustees would represent a very significant alteration by the federal government of a private ordering through the means of property and contract law. But significant alterations are not without precedent. Perhaps most notably, President Franklin Roosevelt removed the United States from the gold standard during the Great Depression and in effect altered thousands of contracts based on the premise of a gold standard; the United States Supreme Court, apparently without effort or reservation, accepted that elimination of the gold standard was constitutional.<sup>35</sup> But the gold standard example has nothing to do with excessive fragmentation; it is not evidence of our legal culture's willingness to affirm public reorderings of private orderings so as to reduce or eliminate the negative effects of excessive fragmentation. In the following discussion I focus on examples that do suggest an antifragmentation principle or tradition in our property law.<sup>36</sup>

---

is required. See Geanakoplos, *Why President Obama's Plan Will Not Work and What Will* at \*11 (cited in note 22). I suggest a different approach to this issue below.

<sup>34</sup> As-applied regulatory takings challenges require a final decision by the relevant regulators regarding the property interest at issue on the theory that the diminution in value borne by the property owner cannot be ascertained until there has been a final decision. See, for example, *Suitum v Tahoe Regional Planning Agency*, 520 US 725, 733–39 (1997).

<sup>35</sup> See *Nortz v United States*, 294 US 317, 328 (1935) (“Congress has complete authority to regulate the currency system of the country,” including the “power to appropriate unto the Government outstanding gold bullion, gold coin and gold certificates.”) (quotation marks omitted). For a discussion of this case, see Gelpert and Levitin, *Rewriting Frankenstein Contracts* at \*54–56 (cited in note 19) (noting that Chief Justice Charles Evans Hughes “specifically refused to characterize the gold measure as a constitutional emergency, which might have fixed its duration”).

<sup>36</sup> For an extended, thoughtful account of increasing fragmentation (without using the word as such) of property in our law in arenas other than mortgages, see Michael Heller, *The*

### A. The Law of Estates in Land

The disposition of property through wills is a regime of private ordering, but the law has trumped or constrained private ordering to prevent excessive fragmentation of property interests in land by means of wills or other grants. There is no “antifragmentation principle” as such in our estate law tradition, but there are a number of doctrines that have been justified on the basis of enhancing the alienability and especially the efficient market alienability of land. These doctrines enhance alienability precisely by limiting fragmentation of interests in land. The implicit premise of these doctrines—as they have come to be justified, however obscure and contested their historical origins may be—is that private actors may not splinter property into so many fragments that they preclude value-maximizing decisionmaking regarding the use and disposition of land.

The first such doctrine is that ambiguous grants or devises should be read as creating a fee simple in land. The fee simple is the least fragmented of the recognized English (and later American) estates in land, because it combines all current possessory rights in land with all future rights; as the least fragmented estate in land, the fee simple is the estate in land that most facilitates investment in and market alienability of property in land. The fee simple developed out of far more temporally fragmented interests by the fourteenth century, but the presumption with respect to ambiguous grants was that a life estate rather than a fee simple was what the grantor or testator intended to create. In the United States, in the nineteenth century, the presumption was changed by statute so that ambiguous grants would be construed as creating not a life estate, but the less fragmented, more alienable fee simple.<sup>37</sup> The preference for a fee simple can also be seen in the adoption of statutes in many of the states (beginning in the Revolutionary era) that abolished the fee tail—an interest where land is tied up along lines of biological issue or “heirs of my body”—and that rewrote grants containing traditional fee tail language as creating fee simples.<sup>38</sup>

---

*Gridlock Economy: How Too Much Ownership Wrecks Markets, Stops Innovation, and Costs Lives* xiv (Basic Books 2008). (Heller does briefly mention mortgages in the preface, however.)

<sup>37</sup> See, for example, *White v Brown*, 559 SW2d 938, 939–40 (Tenn 1977) (discussing how a statute in 1851 switched the presumption under Tennessee law).

<sup>38</sup> See Jesse Dukeminier, et al, *Property* 188–89 (Aspen 6th ed 2006). Where the fee tail was reformed rather than abolished, it was done to improve transparency as to who held an interest in the property and hence enhance alienability. For an extended treatment of these issues, see Claire Priest, *Understanding the End of Entail: Information, Institutions, and Slavery in the American Revolutionary Period* \*3–4 (unpublished draft, 2008), online at

Another doctrine that is consistent with an antifragmentation principle is the doctrine of worthier title. This doctrine addresses situations where a grantor during his or her life gives property to someone for life (a life estate) and then to the grantor's legal heirs in succession (who would not be known necessarily at the time of the grant). Such grants fragment the interest in land over time, creating many possible interest holders, and make market alienation and investment in the land difficult.<sup>39</sup> Under the doctrine of worthier title, the grants are rewritten to provide that the life tenant has possessory rights of the land during his or her life, but after death all the rights in the land revert back to the grantor, and he or she has a fee simple. By facilitating the reconsolidation of the land into a fee simple held by the grantor or the grantor's estate, the doctrine decreases fragmentation and increases market alienability. Although the doctrine of worthier title is now understood as a doctrine of interpretation where the grantor's intent is ambiguous, it was initially adopted and followed in this country as a mandatory rule that applied even when it contradicted the clear intent of the grantor.<sup>40</sup>

The final estate doctrine that advances an antifragmentation principle is the common law rule against perpetuities. This rule operates to override even a clear expression of intent on the part of the grantor when the grant fragments the interest in property so as to create distant, uncertain contingent remainders. Interests that violate the rule are simply "crossed out," with the result that the overall fragmentation of property in land is reduced and alienability increased. As John Chipman Gray explained in a classic treatise, "The principal object of the Rule against Perpetuities is to prevent, except within certain limits, restraints upon the alienation of property by the owner of the present interest."<sup>41</sup>

## B. Statutory Unitization of Underground Oil and Gas Fields

State property law, via statutes, has expressed an antifragmentation principle most clearly in the context of oil and gas field development. Indeed, in this arena the law has overridden firm property rights

---

[http://www.law.columbia.edu/null/Priest++Entail\\_Columbia?exclusive=filemgr.download&file\\_id=15107&showthumb=0](http://www.law.columbia.edu/null/Priest++Entail_Columbia?exclusive=filemgr.download&file_id=15107&showthumb=0) (visited Oct 5, 2009).

<sup>39</sup> See Dukeminier, et al, *Property* at 244 (cited in note 38) ("The reasons for this doctrine are obscure, but probably it was motivated by . . . [the idea that] [t]he doctrine furthers alienability.").

<sup>40</sup> See, for example, *Doctor v Hughes*, 225 NY 305, 311–12 (NY 1919) (explaining that the worthier title doctrine does not "survive[] as an absolute prohibition limiting the power of a grantor . . . . [T]o transform into a remainder what would ordinarily be a reversion, the intention to work the transformation must be clearly expressed").

<sup>41</sup> John Chipman Gray, *The Rule against Perpetuities* 495 (Little, Brown 4th ed 1942) (Roland Gray, eds).

expectations and contracts in the name of preventing a socially important asset from being inefficiently developed. The state and federal courts, in this context, have accepted that where existing property rights rules and private ordering result in too many parties with an interest in the same resource, the law has a legitimate role in coercing the multiple interest holders to act in a more unified, and hence (from an overall return on private investment perspective) rational, manner.

Oil and gas fields are underground resources that typically can be drained from any of a number of surface wells. Where the surface area is held by multiple landowners, the physical reality of oil and gas—that it flows and hence can be forced to migrate in one direction or another with enough technological investment—creates a dynamic where neighboring landowners engage in a race to drain the entire field, each acting out of fear that delay may result in his neighbors getting all the oil or gas. Under the traditional rule of capture, as embodied in state statutes and common law precedents, each surface owner owned whatever oil or gas he or she managed to withdraw.<sup>42</sup>

In every major oil and natural gas producing state in the United States except Texas, the overinvestment in drilling equipment and surface storage of oil (rather than conservation by means of leaving it underground)<sup>43</sup> led the state legislature or an authorized state agency to adopt some scheme of mandatory oil or natural gas field unitization. The typical unitization scheme overrode any previous contractual arrangements between some or all of the neighboring landowners and lessees, and required that the field be managed as a single unit and that the costs and profits from the development of the unitary field be distributed to individual surface landowners in proportion to the size of their surface land holding.<sup>44</sup>

Aggrieved landowners brought many constitutional challenges to state oil and gas field unitization statutes, arguing that they effected unconstitutional takings of private property rights and impairments of

---

<sup>42</sup> See *Westmoreland & Cambria National Gas Co v DeWitt*, 18 A 724, 725 (Pa 1889) (“If an adjoining, or even a distant, owner, drills his own land, and taps your gas, so that it comes into his well and under his control, it is no longer yours, but his.”).

<sup>43</sup> For a good discussion of the various inefficiencies associated with competition among surface landholders, see Gary D. Libecap, *Unitization*, in Peter Newman, ed, 3 *The New Palgrave Dictionary of Economics and the Law* 641, 641 (Macmillan 1998) (arguing that “[t]he most complete solution to the common-pool problem in oil and gas reservoirs is unitization”).

<sup>44</sup> See *id.* at 642.



private contracts. These challenges all failed:<sup>45</sup> The state courts repeatedly affirmed unitization as a rational state response to the wasting of the value of the oil and gas resource. For example, in *Palmer Oil Corporation v Phillips Petroleum Company*,<sup>46</sup> the Oklahoma Supreme Court upheld a unitization statute that allowed for mandatory unitization when the holders of 50 percent or more of the surface area of the field petitioned for compulsory unitization. The statute was based on a legislative finding that

it is desirable and necessary . . . to authorize and provide for unitized management, operation and further development of [oil and gas field properties] . . . to the end that a greater ultimate recovery of oil and gas may be had therefrom, waste prevented, and the correlative rights of the owners in a fuller and more beneficial enjoyment of the oil and gas rights, protected.<sup>47</sup>

The United States Supreme Court has also rejected constitutional challenges to unitization, explaining that “a state has constitutional power to regulate production of oil and gas so as to prevent waste and to secure equitable apportionment among landholders of the migratory gas and oil underlying their land, fairly distributing among them the costs of production and of the apportionment.”<sup>48</sup>

Mortgages, mortgage pools, and mortgage-pool insurance instruments are not the same thing as wills, or oil or gas fields; the analogy between the antifragmentation precedents in the law of estates in land, and in oil and gas unitization can only be taken so far. Indeed, one could read the estate law examples as artifacts of a particular concern with avoiding family dynasties and the oil and gas precedents as a manifestation of an undercurrent in American law that key natural resources can be privately held but also are a subject of distinctive public interest and control.

Law, however, evolves based on analogies, and analogies are never perfect. In the estates-in-land examples and in field unitization, fragmentation of property interests was viewed as causing inefficien-

---

<sup>45</sup> See *Validity of Compulsory Pooling or Unitization Statute or Ordinance Requiring Owners or Lessees of Oil and Gas Lands to Develop Their Holdings as a Single Drilling Unit and the Like*, 37 ALR 2d 434, 435–40 (1954) (reviewing the case law).

<sup>46</sup> 231 P2d 997 (Okla 1951).

<sup>47</sup> *Id.* at 1000 (quoting the Oklahoma statute) (quotation marks omitted). The United States Supreme Court dismissed an appeal of the Oklahoma Supreme Court decision on the grounds that it “failed to raise any substantial federal questions.” *Palmer Oil Corp v Amerada Petroleum Corp*, 343 US 390, 391 (1952) (per curiam).

<sup>48</sup> *Hunter Co v McHugh*, 320 US 222, 227 (1943) (per curiam).

cies and waste, and the law was applied to reduce fragmentation, despite that doing so disrupted private ordering and despite the fact that there were some relative winners and losers after the law addressed the problem of fragmentation. One could argue that all the private interests in oil and gas fields benefit from unitization in the very long run, but we would not have witnessed repeated litigation challenges if that view were shared by all the affected interest holders. Viewed at a significant but reasonable level of abstraction, the estate-in-land and field unitization examples provide precedential support for the sort of federal legislation that would be needed to mandate transfers of servicing of mortgages to government trustees.

#### IV. WOULD OVERCOMING EXCESSIVE FRAGMENTATION BY TRANSFERRING SERVICING BE A TAKING?

If the federal government were to require that servicing of mortgages be transferred to blind trustees and some such mortgages consequently modified, would the government be held liable for having taken private property without just compensation? Under the applicable ripeness rules, as-applied regulatory takings challenges could only be brought by particular interest holders once it was clear how the government program had treated or disposed of their interests.<sup>49</sup> But even so, the courts ultimately could be faced with a large number of ripe takings challenges. What would the result be?

The United States Supreme Court would be the ultimate decisionmaker, and, formal doctrinal tests aside, four factors appear to drive the Court's regulatory takings outcomes.<sup>50</sup> First, the Court is far less deferential to uncompensated regulation in the context of real property regulation than it is in the context of personal property regulation. Second, the Court seems to be guided in regulatory takings cases by how important it considers the purpose and content of the regulation at issue, and whether the regulation reasonably addresses what the Court understands as a kind of public harm (as opposed to public benefit). Third, the Court seems more concerned about uncom-

---

<sup>49</sup> See, for example, *Williamson County Regional Planning Commission v Hamilton Bank of Johnson City*, 473 US 172, 186 (1985) (holding the takings claim premature “[b]ecause the respondent had yet to obtain a final decision regarding the application of the [ordinance and regulations] to its property”). See also Gregory M. Stein, *Regulatory Takings and Ripeness in the Federal Courts*, 48 Vand L Rev 1, 16–26 (1995) (discussing ripeness challenges faced by plaintiffs alleging a taking in related regulatory takings contexts).

<sup>50</sup> This list of factors is based on my distillation of the Supreme Court case law, a body of law that has been and remains subject to a dizzying array of interpretations. For an extended discussion, see generally David A. Dana and Thomas Merrill, *Property: Takings* (Foundation 2002).

pensated regulation that “picks on” a single or small group of property owners, as opposed to a relatively broad class of citizens. Finally, the Court appears to be willing to find a regulatory taking only when there has been an interference with the right to exclude from real property, or when the regulation wipes out the economic value or viable use of the property at issue.

All of these factors suggest that the mandatory transfer of servicing of mortgages to government trustees would not be deemed to effect regulatory takings—particularly, if some minimal payment were made to any interests formally cancelled or terminated as a result of loan modifications. Consider the first factor—whether the affected interests are real property interests. Mortgages and even securities or insurance on securities based on a pool of mortgages in a sense relate to individual pieces of land. But these interests are not interests in land in the same emotional and cultural way as the interest of the homeowners in *Nollan v California Coastal Commission*<sup>51</sup> or the hardware store owner in *Dolan v City of Tigard*<sup>52</sup> or the would-be homeowner and developer in *Lucas v South Carolina Coastal Council*.<sup>53</sup> If it makes any sense at all to privilege property in land for purposes of regulatory takings analysis, it is because we think “owning” a home or a farm or a small store involves special values and deserves special protection: when we think of such owning, we do not think of owning financial instruments such as derivatives. And, of course, private servicers (mostly banks)—the group that might complain the most about the transfer of servicing to government trustees—have no ownership interest in the underlying parcels of land that would be at issue.<sup>54</sup>

Saving people’s homes from foreclosure that should be—and, but for excessive fragmentation, would be—saved through reasonable modifications is an important public purpose. Certainly, it is not hard to document that foreclosures have adverse impacts on whole communities and not just defaulting mortgagors.<sup>55</sup> Moreover, there is

---

<sup>51</sup> 483 US 825, 827 (1987) (holding that a lateral easement condition for a building permit for private home renovation violated the Takings Clause).

<sup>52</sup> 512 US 374, 379 (1994) (holding that a bicycle path condition for a small, family-owned hardware store expansion violated the Takings Clause).

<sup>53</sup> 505 US 1003, 1007 (1992) (holding that a prohibition on building of homes on two beachfront lots likely violated the Taking Clause, unless building would constitute a common law nuisance under state law).

<sup>54</sup> Servicers presumably would argue that blind government trustee review and modifications nullify and hence take their contractual rights under PSAs, requiring the payment of just compensation.

<sup>55</sup> See, for example, Hearings on Utilizing Technology to Improve TARP and Financial Oversight before the Subcommittee on Oversight and Investigations, 111th Cong, 2d Sess 1

precedent for recognizing the legitimate role of the federal government in providing foreclosure relief during times of economic upheaval.<sup>56</sup> And, as discussed above, there are precedents for legal interventions to prevent inefficiencies that would result from excessive fragmentation of property interests.

Third, as a broad-based program that applies the same review and procedure to all mortgages and that (one would guess) will result in a significant number of loan modifications, a government-trustee-as-service program cannot be understood as picking favorites or otherwise raising the equal protection concerns that seem to underlie much of the judicial and academic discourse regarding the law of regulatory takings.<sup>57</sup> The government trustee program is closer to broad-based consumer banking regulation or income tax regulation—kinds of regulation that have never been held to effect regulatory takings—than it is to the kind of narrowly focused land use prohibitions that have resulted in findings of regulatory takings.

Fourth, the program would not result in wipeouts. To be sure, when loans are modified to reduce principal and interest, junior tranche interest holders in first mortgage securitized pools may be left without any possibility that they will receive revenue on the basis of the modified loans. But if a given mortgage in a pool is troubled enough to meet the test for modification, the junior tranche interest holders should have no reasonable expectation of actually collecting any revenue even before the loan is modified. Moreover, if the relevant property interest for constitutional purposes is deemed to be the mortgage pool and not the particular subset of mortgages within the pool for which the loan terms are modified,<sup>58</sup> it seems likely that the

---

(Sept 17, 2009) (statement of Susan Marlow on behalf of the Management Association for Private Photogrammetric Surveyors), online at [http://www.house.gov/apps/list/hearing/financial\\_svcs\\_dem/marlow\\_testimony.pdf](http://www.house.gov/apps/list/hearing/financial_svcs_dem/marlow_testimony.pdf) (visited Oct 17, 2009) (“Foreclosures . . . adversely affect neighborhoods and communities through a rise in crime, theft, and vandalism, blight, and unsafe health conditions.”).

<sup>56</sup> See *Wright v Vinton Branch of Mountain Trust Bank of Roanoke, Va.*, 300 US 440, 460–64 (1937) (upholding federal legislation that allowed for up to a three-year stay of foreclosure and eviction of defaulting farmers).

<sup>57</sup> See *Lucas*, 505 US at 1025 n 11 (emphasizing that the building restrictions did not apply to existing homeowners and imposed hardship only on new purchasers of land where houses had not yet been built); *Penn Central Transportation Co v City of New York*, 438 US 104, 133–35 (1978) (explaining that the landmark designation process burdened not just Penn Central but a significant number of properties throughout the city).

<sup>58</sup> See *Palazzolo v Rhode Island*, 533 US 606, 631–32 (2001) (rejecting “conceptual severance” of property into parts affected by regulation and parts unaffected, but also noting expressions of discomfort with this approach and relying upon the fact that the petitioner had framed the relevant property interest as the parcel as a whole).

investor in even very junior tranches will not be deprived of the entire value of his or her property interest.

In addition, by stabilizing the residential real estate market generally, the government trustee plan would benefit junior tranche investors by reducing the likelihood of future defaults on other mortgages in the pool. The government trustee program thus offers even junior tranche investors something akin to the “average reciprocity of advantage” the Supreme Court invoked in *Penn Central Transportation Co v City of New York*.<sup>59</sup> Second mortgage holders also should benefit from the stabilization of the housing market, inasmuch as they have a strong stake in preventing current mortgages from entering default and being foreclosed upon (in which case they very likely recover nothing, given the drop already experienced in housing prices).

The argument that the government trustee program would not effect total wipeouts, however, would be strengthened if there were some mechanism by which the junior tranche interest holders and the holders of second mortgages would receive some payout when loans are modified. To return to oil and gas field unitization, even holders of a small surface area who likely could not have out-drilled their neighbors do receive a proportionate share of proceeds from the field once it is managed as a single production unit. Following this analogy, a government servicing program might provide as follows: when government trustees modify loans, they must try to quantify the expected gain in doing so as compared to allowing foreclosure to continue, and then they must direct a small percentage of the gain (set by a statutory or regulatory formula) to junior tranche interest holders or holders of second mortgages. For example, a flat 1 percent of savings over foreclosure could be reserved for second mortgagees.<sup>60</sup>

---

<sup>59</sup> 438 US 104, 140 (1978) (Rehnquist dissenting) (noting that “average reciprocity of advantage” is achieved when “all [in the same position] are placed under the same restrictions . . . for the benefit of [society as a whole and] for the common benefit of one another”), quoting *Pennsylvania Coal Co v Mahon*, 260 US 393, 415 (1922).

<sup>60</sup> The Supreme Court has never resolved if cash payments or substitute development rights figure into the analysis of whether the relevant property interest had been wiped out or if they only figure into the analysis as to whether just compensation had been paid for a regulatory taking. At least one current justice clearly favors the latter view. See *Suitum v Tahoe Regional Planning Agency*, 520 US 725, 747–48 (1997) (Scalia concurring) (noting that “[i]f money that the government-regulator gives to the landowner can be counted on the question of whether there is a taking . . . rather than on the question of whether the compensation for the taking is adequate, the government can get away with paying much less”).

## V. GOING FORWARD

Whatever is done or not done about the crisis related to current mortgages, the question remains what, if anything, should be done to avoid another round of over-fragmentation of mortgages in the future? How can we avoid another foreclosure crisis prompted or at least lengthened and deepened by such over-fragmentation? There are at least three general strategies that might be pursued, which I label: better contracts, different fragmentation, and less fragmentation.

The “better contracts” strategy refers to PSA contracts. One could imagine a model contract or agreement that allows loan modifications even without any explicit investor consent if certain conditions are met, and that specifically authorizes or even requires principal modifications when there have been widespread and substantial reductions in housing values. A model agreement also could include fee structures that do not create incentives (or as great incentives, at least) for servicers to either allow foreclosure where foreclosure could and should be avoided and to avoid principal-reduction modifications when those would be the only modifications that plausibly could succeed. Use of the model PSA could be mandated as a matter of state or federal statute, although it is unclear, to say the least, whether state statutory requirements would withstand federal preemption challenges. One immediate objection to such a strategy is that it might make investment in mortgage pools less attractive to investors, and hence might increase the cost of capital for financing mortgages. But if recent experience has taught us anything, it would seem to be that barriers to loan modifications can accentuate and prolong a decline in housing value and in that sense, they create much more economic risk for investors (and all of us) than they prevent.

The “different fragmentation” strategy builds on a recognition that the division between mortgage servicing and ownership creates a strong possibility of divergences of interests between servicers and investors in mortgages however much PSA contracts are drafted to align the interests of servicers and investors. As part of this strategy, mortgage originators might be required to retain an ownership fragment in the individual mortgages they originate, and servicers would be required to retain an ownership fragment in the mortgages they service. This strategy entails not more or less fragmentation, as the mortgages would still be divided up, but a statute that would constrain who would hold fragments and how they would be held, in the interest of avoiding some of the problems underlying our current foreclosure crisis. The different fragmentation strategy, however, raises the question of how much and what kind of a stake must originators and ser-

vicers retain in individual mortgages such that they would have an interest in reasonable, net-social-wealth-maximizing loan modifications when housing prices drop. For example, if originators and servicers only retain the top or highest-quality (AAA-rated) tranche of the mortgages, the retention of that ownership fragment may not incentivize them to avoid foreclosures inasmuch as their retained tranche would be first to be paid off in full using the foreclosure proceeds.

The final strategy entails reducing the legally permissible fragmentation in the mortgage market. A great advantage of this strategy is that it would reduce the complexity and complexity-related costs that fragmentation creates. One relatively easy way to reduce fragmentation would be to discourage the creation of second mortgages at the time of the original financing of the house purchase by prohibiting borrowers from avoiding mortgage insurance requirements by means of taking out a second mortgage. Other restrictions on second mortgages also might be possible. In addition, financial institutions that originate mortgages could be limited as to the percentage of those they securitize, and securitization of mortgages itself could be regulated to limit the degree of tranching and hence the degree of conflicts between investors in different tranches. An even more drastic solution would be the adoption by the United States and other countries of the Danish system, whereby mortgage originators retain servicing of the mortgages and ownership of the rights to any foreclosure proceeds and the risk that foreclosure proceeds will not cover the outstanding principal, and mortgage-backed bonds are issued solely in standardized form and solely as an investment in interest rate risk (rather than creditworthiness).<sup>61</sup>

In theory, reducing the legally permissible degree of fragmentation could make financing real estate purchases more expensive, if we believe that fragmentation attracts investors and hence increases the overall pool available for financing mortgage borrowing. But, again,

---

<sup>61</sup> See George Soros, *Denmark Offers a Model Mortgage Market*, Wall St J A15 (Oct 10, 2008) (explaining that in Denmark “mortgage originators are required to retain credit risk and to perform the servicing functions, thereby properly aligning the incentives”); Karen Dubas, *Can Elements of the Danish Mortgage System Fix Mortgage Securitization in the United States?* (Mar 26, 2009) (summary of a convention of the American Enterprise Institute for Public Policy Research), online at <http://www.aei.org/EMStaticPage/100028?page=Summary> (visited Sept 4, 2009):

In Denmark, the credit risk of a loan is required to remain with the brokers or mortgage bankers who originated the debt. Unlike in the current U.S. model, Danish mortgage originators are now invested in the credit worthiness of the loan; their interests become “perpetually aligned” with the borrowers, and they become de facto “liability advisers.” The interest-rate risk in the loan is sold to bond holders.

by reducing uncertainty and confusion and the possibility of housing implosions, less fragmentation may have benefits that outweigh its costs: less fragmentation may result in equal or even lower borrowing costs in the housing market. Denmark may have unique qualities in terms of its housing market, politics, and culture, but it bears note that the costs of borrowing in Denmark, where fragmentation is minimal, are quite competitive with those in the United States and other countries that allow tremendous fragmentation.<sup>62</sup> In any case, one thing is certain: we should be thinking about possible tradeoffs and the best institutional design now, rather than waiting passively for the next housing crisis.

#### CONCLUSION

Secured credit in homes has been divided and subdivided and spun into so many separate interests that economically rational, socially beneficial modifications of loans are impossible. The mortgage story is a new one but the excessive fragmentation of property and the creation of waste and inefficiency is not new. And our legal tradition has an answer in the form of an antifracturing principle. Consistent with this principle, government trustees should be authorized to review mortgages and, where modification would yield greater total return than foreclosure, modify the loans. Blind trustee review, moreover, can be achieved without formal condemnations of property interests or the creation of government liability for regulatory takings.

---

<sup>62</sup> See Soros, *Denmark Offers a Model Mortgage Market*, Wall St J at A15 (cited in note 61) (discussing the “large and liquid market” for mortgage financing in Denmark).