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The Foreclosure Crisis and the Anti-Fragmentation Principle in State Property Law

David A. Dana

One 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. Moreover, one in five homeowners in the United States will likely to be "under water" before housing prices bottom -- that is, the market value of the home will be less than the amount borrowed with the house as collateral. These foreclosures, in turn, are wreaking havoc even on neighbors whose mortgages are not in default, just as fire in a 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 from the dislocation of families from their homes.

The measures that state 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 and/or did not understand the risks they were assuming. As have states in past credit crises, states have also looked to foreclosure moratoria as a means of slowing dislocations and encouraging loan modifications. Neither of these measures will yield much more than publicity for the plight of communities engulfed in foreclosures.

To effectively address the foreclosure crisis, legislation is needed that will 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 a some kind of "right" and/or economic stake in the secured credit on any given home. These parties have conflicting interests, and as a result servicers are unwilling or unable to re-work loans in cases where borrowers can and would make reasonable payments

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1 Professor of Law and Associate Dean for Faculty Research, Northwestern University School of Law. Many thanks for helpful comments to Susan Koniak, Adam Levitin, Claire Priest, Jacob Sagi and [ ].


3 Id.
(that is, payments that take some account of the dramatic drop in housing values). In effect, "we" -- our society, that is -- has 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."4

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 anti-fragmentation-of-interest 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 anti-fragmentation principle as well. The property law tradition of legal interventions to combat excessive fragmentation also bolsters the argument that federal legislation transferring servicing of mortgages would not be a taking under the Fifth Amendment of the United States Constitution.

This Article is organized as follows. Part One briefly evaluates public nuisance litigation as a response to the foreclosure crisis, and temporary mortgage moratoria. Part Two explains how the changes in the mortgage industry have impeded significant efforts to modify loans in a way that actually would leave borrowers able and willing to maintain payments on the modified loans, rather than simply re-defaulting. It also outlines the proposal to re-structure the servicing of troubled loans by making modification decisions replicate what one might expect to be the decisions that would be made in the absence of excessive fragmentation. Part Three develops the argument that Anglo-American property law reflects an anti-fragmentation principle. Part Four 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. The most immediate problem for these lawsuits is that they lack a workable legal theory. It appears there was some actionable fraud in mortgage origination in Cleveland and elsewhere, 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 able to be legally responsible for fraudulent representations made to mortgage applicants. As a result, Cleveland has grounded its suit in public nuisance, a category of tort for which no showing of intent is required.

Characterizing the origination, securitization, and investment in mortgages as public nuisance, however, stretches "public nuisance" beyond what 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 re-cast products liability law as a form of public nuisance law, and for the same reason they would be reluctant to re-cast consumer fraud and securities fraud as a form of public nuisance. Federal preemption is also a problem for these public nuisance claims against national or 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 multi-factored. 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 a 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. In both cases, the states opted for temporary moratoria on mortgage foreclosures, and sometimes they instituted successive moratoria.

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

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6 For example, the Rhode Island Supreme recently rejected efforts to characterize lead paint in homes as a public nuisance, see Rhode Island v. Lead Industries et al, ___ A2d ____ (RI 2008).
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 principal.7

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 more and/or 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.8 The California legislation specifically states that California is not seeking to exercise oversight or inspection authority over national banks or affiliates, but pressuring banks to engage in loan modifications may be categorized 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 Ass'n v Blaisdell, 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.9 And much more recently, the Court upheld a temporary moratorium on construction in the Lake Tahoe region on the theory that local regulators needed flexibility in developing the best means of reconciling private property owners' interests and the need to prevent environmental degradation.10 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 semi-permanent.

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.11 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 just face more

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7 The Act originated as Assembly Bill 7 and was signed into law on February 20, 2009, and is codified at [ ].
8 For the United State'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 U.S. 1 (2007).
11 See Oversight Report, at 61-63 (outlining possible benefits of moratoria).
late payments and penalties than before the moratoria. As a result, we are likely to observe a wave of foreclosures once state moratoria end.12

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 loan in trouble if it reasonably could 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. In this regime, a bank rationally would agree to significant loan modification, even principal 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 is a host of actors with an economic interest in whether or how the loan is paid back and/or modified. 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 re-securitized through the use of collateralized mortgage obligations (CMOs) and/or collateralized debt obligations (CDOs). CMOs and CDOs then often have been tranched and securitized in the form of CMO2s or CDO2s, and then sometimes these instruments in turn have been tranched and securitized, and on and on.13 By virtue of the financial alchemy of Wall Street, a single mortgage could -- and often has been -- transformed into tens or hundred 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 of holders of Net Interest Margin or NIM. And on top of all of

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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 borrowers to avoid mortgage insurance requirements. (Second mortgages also often are originated at a later date, often as part of a home equity line.) These second mortgages have become much more common in mortgages originated after 2002; by 2006, more than half of Alt-A mortgage originations also included a second mortgage. These second mortgages often are held by 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 re-securitized 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 makes 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 Pooled Servicer Agreements (PSAs). 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 an economically rational servicer would do if they also owned the mortgages they serviced. 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, cash-strapped servicers also have an incentive to push mortgages in default to foreclosure. The fact that servicers are compensated for all expenses of foreclosure, including whatever various fees they tack on, also may lead them to proceed readily to foreclosure.

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14 Oversight Report, at 41.
15 See Testimony of John D. Geanakoplos, Presented to the House Subcommittee on Housing and Community Development House Financial Services Committee, March 19, 2009 (on file with the author).
16 Oversight Report, at 45. 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*, Sept. 8, 2008 (on file with the author).
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 contract require a supermajority or even unanimous consent of all interest holders in a mortgage in order to allow a modification of the loan. 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 payment 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.17

Re-working the first mortgage, moreover, will not happen (and cannot prevent foreclosures) if all of the benefits of the re-working accrue to second mortgage holders, rather than borrowers. As the Congressional Oversight Panel's Report on the Foreclosure Crisis explained, "Unless a junior mortgage consents to subordination, the junior mortgage moves up in seniority upon refinancing. Out of money junior mortgagees will consent to subordination only if they are paid. Thus, junior mortgages pose a serious holdup for refinancing, demanding a ransom in order to permit a refinancing to proceed."18 Where the second mortgage has been securitized, gaining consent to securitization may mean in effect gaining the consent of hundred or thousands of investors in a pool that contains the second or junior mortgage.

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 numbers of mortgages in default or facing default.19 But fragmentation appears to be an important enough part of the story that addressing fragmentation 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 and/or to press for mortgages in default to go into foreclosure. 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 or 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

17 See Gelpert & Levitan, supra note [ ] at 23 ("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").
18 Oversight Panel, at 43.
19 Oversight Panel, at 30-40.
result in the servicers receiving incentive payments but that do not modify the loans in such a way that borrowers can (or, as a matter of pure self-interest should) continue to make payments rather than re-defaulting and walking away from their mortgages in the relatively near term.\textsuperscript{20} Moreover, giving servicers incentive payments will not correct the barriers to meaningful re-working 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.

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.\textsuperscript{21} 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 and borrower and mortgage pool, which is something that would require changes in federal law. As discussed below, once so much information had 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 interest in mortgage pools would mean that the federal government effectively owned 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 re-marketing mortgages in a way that did not unduly benefit some private parties or otherwise de-legitimize 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 property in mortgages.

A better approach has been outlined by John Geneakoplos and Susan Koniak.\textsuperscript{22} In this approach, the servicing of securitized first 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

\textsuperscript{20} See OCC and OTS Mortgage Metrics Report, Fourth Quarter 2008, at 6 (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 re-default rates that were double that associated with modifications that reduced monthly payments. Id, at 6-7.


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.\textsuperscript{23}

In order to capitalize on the traditional knowledge that informed lending and loan modifications before the dawn of the age of excessive fragmentation in property in mortgages, the plan would employ community bankers on a de-centralized, 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 re-worked 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.\textsuperscript{24}

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 condemnations 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.\textsuperscript{25} 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.

\textsuperscript{23} 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, \textit{Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy}, 2009 WISC L REV 565 (2009). 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 background in community banking were set up at the same time. See Alan Schwartz, Don't Let Judges Fix Loans, NY Times, Feb. 27, 2009, at [    ].

\textsuperscript{24} 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 is required. I suggest a different approach on this issue below.

\textsuperscript{25} As-applied regulatory takings challenges require a final decision by the relevant regulators regarding the property interest at issue, see, e.g., Suits v Tahoe Regional Planning Ass'n, 520 U.S. 725, 733-39 (1997), on the theory that the diminution in value borne by the property owner cannot be ascertained until heir is a final decision.
III. The Anti-Fragmentation 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. But significant alterations are not without precedent. Perhaps most notably, President Roosevelt removed the United 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 as constitutional. 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 re-orderings 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 anti-fragmentation principle or tradition in our property law.

The Law of Estates in Land

The disposition of property through wills is a regime of private ordering, but the law has trumped and/or constrained private ordering to prevent excessive fragmentation of property interests in land by means of wills or other grants. There is no "anti-fragmentation 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 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 decision-making 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 had 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 simply was what the grantor/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. The preference for a fee simple can also be seen

26 See Nortz v. United States, 294 U.S. 317 (1935); for a discussion of this case, see Gelpert & Levitan, supra note [ ] at 45-47.
27 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, GRIDLOCK ECONOMY (2008). (Heller does briefly mention mortgages in the preface, however).
28 See, e.g., White v. Brown, 559 S.W.2d 938, [ ] (1977) (discussing how a statute in 1851 switched the presumption under Tennessee law).
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 re-wrote grants containing traditional fee tail language as creating fee simples.  

Another doctrine that is consistent with an anti-fragmentation 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. Under the doctrine of worthier title, the grants are re-written 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 re-consolidation of the land into a fee simple held by the grantor or the grantor's estate, the doctrine decreased fragmentation and increased 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.

The final estate doctrine that advances an anti-fragmentation 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 Gary 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."

**Statutory Unitization of Underground Oil and Gas Fields**

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

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29 Dukeminier & Krier, PROPERTY, 6th ed, at 188-189. Where the fee tail was reformed rather abolished, it was done so to improve transparency as to who held an interest and 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 (on file with the author).

30 Dukeminier & Krier, PROPERTY, 6th ed, at 244 ("The reasons for this doctrine are obscure, but probably it was motivated by [the idea that] [t]he doctrine furthers alienability").

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.

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) led the state legislature and/or an authorized state agency to adopt some scheme of mandatory oil and/or natural gas field unitization. The typical unitization scheme overrode any previous contractual arrangements between some or all of the neighboring landowners and/or 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.

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 private contracts. These challenges all failed: 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, the Oklahoma Supreme Court upheld a unitization statute that allowed for mandatory unitization when the holders of fifty 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." 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

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33 See E.H. Schopler, 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 (Originally published in 1954) Sec 2 (reviewing the case law).

among landholders of the migratory oil and gas under their land, fairly distributing among them the costs of production and of apportionment. 35

Mortgages and mortgage pools and mortgage pool-insurance instruments are not the same thing as wills or oil or gas fields; the analogy between the anti-fragmentation 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 inefficiencies 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. But even so, the courts ultimately could be faced with a large number of ripe taking 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. 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 uncompensated regulation that "picks on" a single or few 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 and/or viable use of the property at issue.\textsuperscript{36}

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 interest 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 interest in land in the same emotional and cultural way as the interest of the homeowners in \textit{Nollan} and or the hardware store owner in \textit{Dolan} or the would-be homeowner and developer in \textit{Lucas}.\textsuperscript{37} 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 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.\textsuperscript{38}

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. Moreover, there is precedent for recognizing the legitimate role of the federal government in providing foreclosure relief during times of economic upheaval.\textsuperscript{39} 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-servicing program cannot be understood as picking favorites or otherwise raising the equal protection concerns that seem to underlie

\textsuperscript{36} This list of factors is based on my distillation of the Supreme Court case law, a body of law that has been and remain subject to a dizzying array of interpretations. For an extended discussion, see David A. Dana and Thomas Merrill, \textit{TAKINGS} (2002).


\textsuperscript{38} Servicers presumably would argue that blind government trustee review and modifications nullifies and hence takes their contractual rights under PSAs, requiring the payment of just compensation.

\textsuperscript{39} See \textit{Wright v. Vinton Branch of Mountain Trust Bank of Roanoke}, 300 U.S. 440, 460-464 (1937) (upholding federal legislation that allowed for up to three year stay of foreclosure and eviction of defaulting farmers).
much of the judicial and academic discourse regarding the law of regulatory takings.\textsuperscript{40} The government trustee program is closer to broad-based consumer banking regulation or income tax regulation -- kinds of regulation that has 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 sub-set of mortgages within the pool for which the loan terms are modified,\textsuperscript{41} it seems likely that the 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 default 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 \textit{Penn Central}.\textsuperscript{42} 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 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 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

\textsuperscript{40} See Lucas, 505 U.S. at [      ] (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); \textit{Penn Central}, 438 U.S. at [      ] (explaining that the landmark designation process burdened not just Penn Central but a significant number of properties throughout the city).

\textsuperscript{41} See Palazzolo v. Rhode Island, 533 U.S. 606 (2001) (apparently 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).

\textsuperscript{42} \textit{Penn Central Transportation Co. v, City of New York}, 438 U.S. 104, [      ] (1978).
interest holders and/or holders of second mortgages. For example, a flat one percent of savings-over-foreclosure could be reserved for second mortgagees.43

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 will label: better contracts, fighting fragmentation with more fragmentation, and reducing 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 and that specifically authorizes or even requires principal modifications under certain specified circumstances where they would be sensible -- that is, when there have been widespread and substantial reductions in housing values. A model agreements also could include fee structures that did 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 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 fight-fragmentation-with-fragmentation strategy builds on a recognition that the division between mortgage servicing and ownership creates a strong possibility of divergence 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 a portion or stake in the individual mortgages they originate, and servicers would be required to retain or acquire a portion or stake in the mortgages they service. This strategy entails (possibly) more fragmentation because in add yet another class or classes of entities with fragments of ownership in particular mortgages, and hence adds addition unwanted complexity to a market already overwhelmed by complexity. And it may be difficult to calibrate what percentage or amount of ownership on the part of originators and servicers would be

43 The Supreme Court has never resolved whether cash payment or substitute development rights figure into the analysis of whether the relevant property interest had been wiped out or whether they only figure into the analysis whether just compensation had been paid for a regulatory taking. At least on current Justice clearly favors the latter view. See Suitum v. Tahoe Regional Planning Agency, 520 U.S. 725, 747-748 (1997) (Scalia, J., concurring).
required to significantly align their incentives with that of the other investors in mortgages.

The final strategy entails reducing the legally permissible fragmentation in the mortgage market. One relatively easy way to do this would be to discourage the creation of second mortgages at the time of the original financing of the house purchase by prohibiting borrowers to avoid mortgage insurance requirements by means of taking out a second mortgage. Other restriction 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. Any of these actions would make financing real estate purchases more expensive, and it would be hard to know ex ante whether the benefits of these would outweigh the costs. But one thing is certain: we should be thinking about these tradeoffs and the best institutional design now, rather than waiting passively for the next housing crisis.

VI. Conclusion

Secured credit in homes has been divided and over-divided 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 anti-fragmentation 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.