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Constitutional Issues Relating to Proposals for Legislation to Impose an Interest Rate Freeze/Reduction on Existing Mortgages

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Summary

As a way to slow the decline in the U.S. housing market, some in Congress have suggested passing legislation that would impose a temporary reduction or freeze in the interest rates of certain mortgages in order to give mortgage market participants, such as borrowers, servicers, lenders, and investors, time to refinance or otherwise adjust the mortgage terms of borrowers who would not likely be able to keep up with their scheduled payments. Such a measure would modify existing contracts, which would result in the loss of property rights of some individuals in the mortgage market. For this reason, this type of legislation raises some constitutional issues.

This report presents an overview of Congress's authority to pass laws pertaining to mortgages, and reviews the Contract Clause, Takings Clause, and Substantive Due Process jurisprudence. After explaining why Contract Clause and Substantive Due Process claims appear less relevant to the question, the report considers the test a court would likely use in assessing whether a federal interest rate freeze/reduction would offend the Takings Clause. It suggests that the application of such a proposal to tranches of mortgage-backed securitized trusts, in a minority of instances, could potentially be considered "takings" requiring just compensation for the purpose of the Fifth Amendment. However, the number of likely successful claims and the overall potential liability of the federal government for those claims (and the litigation costs of unsuccessful claims) are not possible to assess, at least within the scope of this report.

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Constitutional Issues Relating to Proposals for Legislation to Impose an Interest Rate Freeze/Reduction on Existing Mortgages

Introduction and Background

The U.S. housing market began to slow in early 2006. This downturn has likely played a role in the rise of late mortgage payments and foreclosures occurring across the country over the past year.[1] Many believe that the problem will get worse. The Joint Economic Committee estimates that around 2 million foreclosures of subprime mortgages will occur from the beginning of 2007 to the end of 2009.[2]

As a way to slow the decline, some in Congress have suggested passing legislation that would impose a temporary reduction or freeze in the interest rates of certain mortgages in order to give mortgage market participants, such as borrowers, servicers, lenders, and investors, time to refinance, or otherwise adjust the mortgage terms of borrowers who would not likely be able to keep up with their scheduled payments. Such a measure would modify existing contracts, which would result in the loss of property rights of some individuals in the mortgage market. For this reason, this type of legislation raises some constitutional issues.

This report addresses the possible constitutional implications, most notably regarding the Fifth Amendment's Takings Clause, of a temporary interest rate freeze/reduction as it would relate to investors in mortgage-backed securities (MBSs). MBS investors are chosen for analysis in this report because they likely would be impacted more by such a measure than other potential claimants. However, this is not to suggest that other mortgage market participants could not or would not raise claims, such as a Takings Clause violation, because of an interest rate freeze.

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[1] *See* CRS Report RL33930, *Subprime Mortgages: Primer on Current Lending and Foreclosure Issues*, by Edward Vincent Murphy, and CRS Report RS22511, *Preliminary Observations on the Impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8)*, by Brian Cashell, Mark Jickling, and Heather D. Negley. *See also*, Joint Economic Committee, "Mortgage Woes Weigh on Financial Markets," September 11, 2007, available at [http://www.house.gov/jec/Economic%20Update/RED%20September%2011.pdf].

[2] Joint Economic Committee, "The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here," October 2007, available at [http://jec.senate.gov/Documents/Reports/10.25.07OctoberSubprimeReport.pdf].

This report begins with an overview of Congress's authority to pass laws pertaining to mortgages, and a review of Takings Clause, the Contract Clause, and Substantive Due Process jurisprudence. After explaining why the Contract Clause and Substantive Due Process claims appear less relevant to the question, this report considers the test a court would likely use in assessing whether a federal interest rate freeze/reduction would offend the Takings Clause. It suggests that the application of such a proposal to tranches of mortgage-backed securitized trusts, in a minority of instances, could potentially be considered "takings" requiring just compensation for the purpose of the Fifth Amendment. However, the number of likely successful claims and the overall potential liability of the federal government for those claims (and the litigation costs of unsuccessful claims) is not possible to assess, at least within the scope of this report.[3]

Legislative Authority to Pass an Interest Rate Freeze/Reduction

The constitutionality of legislation that imposes an interest rate freeze/reduction on mortgages may be affected by the context in which it is raised, and by extension the authority by which Congress passes such a statute. Two possible sources of authority are the Commerce Clause and the Bankruptcy Clause, which will be addressed in turn.

The Constitution grants Congress vast authority to enact laws involving interstate commerce. Article I, § 8, clause 3 of the U.S. Constitution states: "Congress shall have the Power To ... regulate Commerce with foreign Nations and among the several States ...." Commerce "among the several States" must, by "necessity" include commerce "between the states."[4] The power extends beyond the borders of individual states because it would not be possible for Congress to regulate commerce that takes place exclusively on states' borders.

While there was a time when the courts interpreted the Commerce Clause more restrictively, the melding of 50 different economies into a single national economy has played a significant role in its expansion.[5] Indeed, the U.S. Supreme Court has only twice since the 1930s invalidated federal legislation because Congress had

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[3] Quantifying the potential liability would require details of all, or a representative subsection of, the tranches of mortgage-backed securitized trusts. Because investors of these securities are largely unregulated, this information may not exist at all. If it does exist, the information is likely proprietary.

[4] Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 196 (1824); Stoutenburgh v. Hennick, 129 U.S. 141 (1889); Atlantic Cleaners & Dyers v. United States, 286 U.S. 427 (1932); In re Bryant, 4 Fed. Cas. 514 (No. 2067) (D. Oreg. 1865); Hanley v. Kansas City Southern Ry. Co., 187 U.S. 617 (1903); Western Union Tel. Co. v. Speight, 254 U.S. 17 (1920).

[5] New York v. United States, 505 U.S. 144, 158 (1992) ("The volume of interstate commerce and the range of commonly accepted objects of government regulation have ... expanded considerably in the last 200 years, and the regulatory authority of Congress has expanded along with them. As interstate commerce has become ubiquitous, activities once considered purely local have come to have effects on the national economy, and have accordingly come within the scope of Congress' commerce power.").

exceeded its Commerce Clause power. In both of those cases, the Court held that the statute being challenged was not economic in nature, and therefore, did not have a substantial effect on interstate commerce.[6]

As the Court stated in *Lopez*:

> [the] criminal statute [] by its own terms has nothing to do with commerce or any sort of economic enterprise ... and it not an essential part of a larger regulation of economic activity, in which the regulatory scheme could be undercut unless the intrastate activity were regulated. It cannot, therefore, be sustained under our cases upholding regulations of activities that arise out of or are connected with a commercial transaction, which viewed in the aggregate, substantially affect interstate commerce.[7]

The Court has said that statutes that regulate one of three categories of commercial activities are within congressional authority:

> First, Congress may regulate the use of the channels of interstate commerce. Second, Congress is empowered to regulate and protect the instrumentalities of interstate commerce, or persons or things in interstate commerce, even though the threat may come only from intrastate activities. Finally, Congress' commerce authority includes the power to regulate those activities having a substantial relation to interstate commerce, i.e., those activities that substantially affect interstate commerce.[8]

The last of these categories allows courts to examine the cumulative effect of a commercial activity on the economy as a whole. This is the category into which an interest rate freeze/reduction would likely fall.

A federally mandated interest rate freeze/reduction designed to reduce the effects of a slowing national housing market seems to pertain to financial transactions that, "viewed in the aggregate, substantially affect interstate commerce."[9] Even if viewed as entirely intrastate, such a law also would likely be considered "part of a larger regulation of economic activity, in which the regulatory scheme could be undercut unless the intrastate activity were regulated" due to the fact that the secondary market links local real property into a national market.[10] Although not beyond debate, it seems likely that a court would find a statute imposing an interest rate freeze/reduction to be within Congress's constitutional authority.

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[6] United States v. Lopez, 514 U.S. 549, 549 (1995); United States v. Morrison, 529 U.S. 598, 617 (2000).

[7] *Lopez*, 514 U.S., at 561.

[8] *Id*. at 558-59 (citations omitted).

[9] *Id.* at 561.

[10] *Quoting, id.* at 549.

Congress also has broad authority, concurrent with its authority under the Commerce Clause, to enact "uniform laws on the subject of Bankruptcies."[11] The Supreme Court has approved of Congress's use of this authority to impair contracts and even to avoid liens.[12] For this reason, it appears likely that Congress has authority pursuant to the Bankruptcy Clause to impose an interest rate freeze/reduction. Regardless of which of these two sources of authority are applied, the legislative proposal in question would still be subject to the protections provided by the Contract Clause and the Fifth Amendment's Due Process and Takings Clauses.

Contract Clause and Substantive Due Process

Article I, § 10, clause 1 of the U.S. Constitution states: "No State shall ... pass any ... Law impairing the Obligation of Contracts...." This clause prohibits states from passing legislation that changes the terms of existing contracts. The language of the Contract Clause is expressly limited to the states. Additionally, the Court has held that the principles of the Contract Clause are not incorporated against the federal government by the Fifth Amendment's Due Process Cause.[13] The Court explained:

> We have never held ... that the principles embodied in the Fifth Amendment's Due Process Clause are coextensive with provisions existing against state impairments of pre-existing contracts.... [Rather,] we have contrasted the limitations imposed on States by the Contract Clause with the less searching standards imposed on economic legislation by the Due Process Clauses.[14]

Therefore, the Contract Clause does not apply to federal legislation.

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[11] U.S. CONST art. I, § 8, cl. 4. One important difference between the Commerce Clause and the Bankruptcy Clause, is that laws passed under by the Bankruptcy Clause must be uniform. Railway Labor Executives' Assn. v. Gibbons, 455 U.S. 457, 465 (1981). The Court in *Gibbons* held that a bankruptcy statute that applied to only one debtor was not uniform. *Id.* at 471. The court also explained the difficulty in:

> [d]istinguishing a congressional exercise of power under the Commerce Clause from an exercise under the Bankruptcy clause ... Although we have noted that the subject of bankruptcies is incapable of final definition, we have previously defined "bankruptcy" as the subject of the relations between an insolvent or nonpaying or fraudulent debtor and his creditors, extending to his and their relief. Congress' power under the Bankruptcy Clause contemplates an adjustment of a failing debtor's obligations This power extends to all cases where the law causes to be distributed, the property of the debtors among his creditors. It includes the power to discharge the debtor from his contracts and legal liabilities, as well as to distribute this property. The grant to Congress involves the power to impair the obligation of contracts, and this the States were forbidden to do.

Id. at 466 (internal citations and quotations omitted).

[12] Hanover Nat'l Bank v. Moyses, 186 U.S. 181 (1938); *In re* Klein, 42 U.S. (1 How) 277 (1843).

[13] PBGC v. R.A. Gray & Co., 467 U.S. 717, 733 (1984). *Accord,* United States v. Winstar Corp., 518 U.S. 839, 875-76 (1996).

[14] PBGC, 467 U.S. at 733.

Federal legislation, on the other hand, is subject to the protections of substantive due process. Substantive due process "prevents government power from being used for purposes of oppression, or abuse of government power that shocks the conscience, or action that is legally irrational in that it is not sufficiently keyed to any legitimate government purpose."[15] An interest rate freeze/reduction that is implemented for the purpose of providing lenders and servicers time to initiate loan modifications and loss mitigation in order to strengthen an ailing market would not likely be violative of substantive due process in light of the vast deference courts provide the government in the context of economic regulation.[16] Consequently, this report focuses on takings law analysis.[17]

Overview of Takings Clause Jurisprudence

The Fifth Amendment concludes with the words "nor shall private property be taken for public use, without just compensation." The Takings Clause requires striking a balance between the government's public goals and the burdens suffered by private property owners as the government takes measures to meet its goals. The courts have recognized relatively few governmental infringements of private citizens' property as constitutional "takings" where no outright seizure or permanent physical occupation of the property occurs. The infringement must rise to a certain severity or be of a particular kind before courts will say a "taking" has occurred. Only then must the government provide "just compensation" to the property owner.[18] The courts have developed an array of tests, rules, and factors to determine what does and does not constitute a "taking."

Four Types of Takings. The proper test to apply depends on the type of governmental action involved. There are four broad categories of takings recognized by the Supreme Court.[19] Two of these tests are clearly not applicable to an interest rate freeze/reduction. One is a land-use exaction taking, such as a mandatory set aside

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[15] Torromeo v. Town of Fremont, N.H., 438 F.3d 113, 118 (1st Cir. 2006). Prior to 2005, there was a great deal of confusion among courts in how to properly delineate between takings law and substantive due process analysis, which was partially alleviated by the Supreme Court's 2005 *Lingle v. Chevron U.S.A. Inc.* decision. 544 U.S. 528 (2005). *See, e.g.*, Agins v. City of Tiburon, 447 U.S. 255 (1980); Kavanau v. Santa Monica Rent Control Bd., 941 P.2d 851 (Cal. 1997). While some confusion remains, the Court has clarified that substantive due process and takings law address unique concerns.

[16] *See, e.g.*, Eastern Enterprises v. Apfel, 524 U.S. 498 (1998).

[17] It also is possible for one to claim an Equal Protection Clause violation, especially if the claimant believes that she was treated unequally. *See, e.g.*, Village of Willowbrook v. Olech, 528 U.S. 562 (2000). An Equal Protection Clause violation is not likely to result from an interest rate freeze/reduction that is not limited to members of a protected class, such as race or ethnicity.

[18] Mortgages and the contract rights to mortgage-backed securities investments are private property for the purpose of Fifth Amendment protections.

[19] *Lingle*, 544 U.S. at 538.

for a certain portion of a new housing development to be green space.[20] The other is a type of regulatory taking, as described in *Lucas v. South Carolina Coastal Council*,[21] where the government "deprive[s] an owner of all economically beneficial use of her property." This type of infringement is considered a per se taking and is commonly referred to as a *Lucas* "total taking."[22] Most courts agree that *Lucas* total takings only apply to land, not personal property such as contract rights.[23] An interest rate freeze/reduction could be assessed pursuant to one of the other two tests. One is a "physical taking" or "appropriation" where the "government requires an owner to suffer permanent physical invasion of her property."[24] The final test is for all regulatory takings other than total takings, which are analyzed pursuant to the test originally set out in *Penn Central Transp. Co. v. City of New York*.[25]

Physical Taking/Appropriation vs. Regulatory Taking. Plaintiffs would likely argue that legislation imposing an interest rate freeze/reduction resulted in a "permanent physical occupation" of their property, as these are considered per se takings, warranting just compensation. While on the contrary, the government would likely argue that this type of legislation should be analyzed under *Penn Central*, where the government usually wins. One takings law commentator explains:

> The Court's decisions using per se physical taking analysis ... typically involve physical invasions in the literal sense — invasions by aircraft, flood waters, the boating public, government personnel, cable boxes, and mobile-home-park tenants. But in some factual contexts ... physical and regulatory takings have proved difficult to keep separate.
>
> The tendency to blur the two is enhanced by the powerful incentives plaintiffs have to urge a physical, versus regulatory, theory in a case. First, there is the lesser showing needed for plaintiff to win on a permanent physical occupation claim.... Second, ... [is] the extremely narrow range of application for the ... total taking test, leaving the physical occupation rule as the only per se rule left to plaintiff in many cases.... [One example of where this line is blurred is where a] government program causes no physical invasion, but affects the property owner in a way more or less akin to an appropriation. Here, the takings analysis may go either way — regulatory or physical. The issue played out at length in cases involving state demands that small interest amounts on lawyers' trust accounts

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[20] *Id.*

[21] 506 U.S. 1003 (1992).

[22] *Lingle*, 544 U.S. at 538.

[23] *See, e.g.*, Hawkeye Commodity Promotions, Inc. v. Vilsack, 486 F.3d 430, 441 (8th Cir. 2007) ("it appears that *Lucas*[' total takings test] protects real property only"). However, at least one Federal Circuit case has applied total takings analysis to personal property, though it did not find a taking had occurred. Maritrans v. United States, 342 F.3d 1344 (Fed. Cir. 2003).

[24] *Lingle*, 544 U.S. at 538.

[25] 438 U.S. 104 (1978) (the Court found no taking where New York City, pursuant to a historic preservation ordinance, prevented a property owner from developing the air rights over a historic landmark). *See also*, *Lingle* 544 U.S. at 538-39.

> be paid to a state-run program funding legal services for the poor, and was ultimately resolved as a physical-type taking.[26]

It is possible that a court would consider an interest rate freeze/reduction a physical taking or an appropriation of an MBS investor's rights to the income stream lost due to the legislation, and therefore, a per se taking. This argument would likely be given some credence because the focus of the proposals being considered for legislation, interest payments, is such a central element of a mortgage. What might be fundamental to a court's inquiry is whether the interest rate modification would have been allowed under the Pooling and Servicing Agreement (PSA). PSAs are the contracts for mortgage-backed securitized trusts that govern the legal relationship between MBS trustees, MBS investors, and servicers of the mortgages comprising these trusts. While not all PSAs are exactly alike, one relevant feature of typical agreements is the scope of the permission of servicers to perform loss mitigation and loan modification for borrowers. In instances where a mortgage would qualify for an interest rate freeze/reduction under federal legislation, but where the borrower would not have qualified for a modification under the PSA, finding a physical taking would be more likely. The more tailored the scope of any legislation to the situations in which servicers have authority to adjust mortgage interest rates pursuant to governing PSAs, the less likely a court would find a physical taking.[27]

A more probable scenario, especially in light of the fact that the income lost as a result of an interest rate freeze/reduction would not directly accrue to the government as was the case with the interest from the lawyer's trust accounts, is that a court would consider such a statute as a possible regulatory taking, to be analyzed pursuant to *Penn Central*.[28]

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[26] Robert Meltz, *Takings Law Today: A Primer for the Perplexed*, 34 Ecology L.Q. 307, 364-65 (2007).

[27] For more information regarding the securitization process and provisions of typical PSAs, *see* CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward Vincent Murphy, and CRS Report RL34372, *The HOPE NOW Alliance/American Securitization Forum (ASF) Plan to Freeze Certain Mortgage Interest Rates*, by David H. Carpenter and Edward Vincent Murphy.

[28] A plaintiff might argue a taking under the rationale provided in Louisville Joint Stock Bank v. Radford, 295 U.S. 555 (1934). The Supreme Court in *Radford* held the Frazier-Lemke Act of 1934, which provided farmers a five-year mortgage foreclosure moratorium, allowed farmers to keep possession of real property for a reasonable rent, and allowed them to pay a judicially appraised purchase value at the end of the five years, in violation of the Fifth Amendment, and thus unconstitutional. *Id.* at 589-90. However, this decision was called into question in a Supreme Court decision just three years later in which a slightly modified version of the Frazier-Lemke Act was deemed in accordance with the Fifth Amendment. Wright v. Vinton Branch of the Mountain Trust Bank of Roanoke, 300 U.S. 440 (1937). Additionally, *Radford* was handed down prior to the seminal *Penn Central* decision. As one court explained: "whether or not *Lousiville Joint Stock Land Bank v. Radford* has any current value as precedent is subject to reasonable doubt. Times have changed, and a review of its progeny discloses a constant and steady erosion of its vitality." In re Pommerer, 10 B.R. 935, 945 (Bankr. Ct. D. Minn. 1981). For these reasons, *Radford* is not likely to affect a takings analysis.

Application of *Penn Central* to an Interest Rate Freeze/Reduction

***Penn Central* Overview.** Before beginning any analysis, it should be noted that Takings Clause jurisprudence is a highly amorphous and an ever-evolving area of the law. Additionally, the question of whether a statutorily imposed interest rate freeze/reduction violated the Takings Clause has never been addressed directly by a court. The *Penn Central* test is, as the Supreme Court has stated, an "essentially ad hoc and factual inquir[y]."[29] Finally, the mortgage-backed securities industry is a highly complex, yet largely unregulated industry, which makes garnering specific information about the tranches of each mortgage-backed securitized trust very difficult. All of these factors make analysis of how a court might rule on a takings issue quite difficult even where all facts are known. With those caveats in mind, the following analysis informs on how courts have assessed each of the three *Penn Central* factors and highlights certain contexts or facts that courts emphasize as triggering Takings Clause protection that may be implicated by such legislation.

Legislation targeting private contracts usually survives takings attacks under *Penn Central* analysis.[30] However, this does not mean that a court could not find a takings under certain circumstances, nor does it mean that secondary market investors would not bring suits claiming takings had occurred, which comes with its own costs to the government. It seems plausible, as discussed in greater detail below, that a statute imposing an interest rate freeze/reduction could have a significant enough effect on a minority of MBS tranches as to rise to the level of a taking.

The *Penn Central* test consists of three factors that are designed to determine whether the government regulatory action has resulted in the deprivation of a property right sufficient to violate the Takings Clause. The three factors are: (1) the economic impact of the government action; (2) the "extent to which the regulation has interfered with distinct investment-backed expectations"; and (3) the character of the government action.[31] The Supreme Court has shed little light on the content of

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[29] *Penn Central*, 438 U.S. at 124.

[30] It should be noted that the Supreme Court has indicated that government actions that are implemented for a public benefit and only incidentally interfere with the performance of private contracts constitute only a frustration, not a taking, of contract rights. Omnia Commercial Co. v. United States, 261 U.S. 502 (1923). The legislative issue this report is addressing, on the other hand, would *directly target* private mortgage contracts, as opposed to incidentally interfering with the contracts. When legislation specifically targets an existing contract or a class of contracts, the courts have found that *Omnia* does not apply, and instead have applied *Penn Central's* balancing test. *See*, Cienega Gardens v. United States, 331 F.3d. 1319, 1335 (Fed. Cir. 2003) ("Omnia ... refers to legislation targeted at some public benefit, which incidentally affects contract rights, not ... legislation aimed at the contract rights themselves in order to nullify them.").

[31] *Penn Central*, 438 U.S. at 124-28; Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 415 (1922); Nollan v. California Coastal Comm'n, 483 U.S. 825, 834 (1985).

these three factors or on how to balance them, and each factor raises "vexing subsidiary questions."[32]

Economic Impact. The *Penn Central* inquiry "turns in large part, albeit not exclusively" on the economic impact factor.[33] In assessing the economic impact, courts evaluate the proportion of the loss caused by the regulation to the "parcel as a whole."[34] This means that, in weighing the economic impact, the courts look at entire property, rather than exclusively at the portion of the real property affected by the legislation in isolation. The Supreme Court explained it this way:

> a claimant's parcel of property could not first be divided into what was taken and what was left for the purpose of demonstrating the taking of the former to be complete and hence compensable. To the extent that any portion of property is taken, that portion is always taken in its entirety; the relevant question, however, is whether the property taken is all, or only a portion of, the parcel in question.[35]

The "parcel as a whole" concept has three different dimensions: physical/spatial, functional, and temporal. In the context of a takings claim raised by investors of MBSs, the tranches of each securitized trust, as opposed to the whole trust or the individual mortgages comprising the trust that are affected by an interest rate freeze/reduction, would likely be considered the physical "parcel" because the tranches represent each individuals' investment.[36] To address the functional dimension, courts would look to how the governmental interference affects the entire "bundle of rights," as opposed to a single right within the bundle.[37] In the MBS context, an investor's bundle of rights would include everything provided in the governing PSA, including rights to a certain income stream and contract claims for violations of the PSA. The temporal dimension requires an assessment of the physical parcel for the entire time period during which the plaintiff has an interest in that property.[38] For example, if an investor owned a tranche that consisted of the 12-month income stream, from both principal and interest payments, of a group of mortgages, and a six-month interest rate freeze was imposed in the middle of that

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[32] *Lingle*, 544 U.S. at 539.

[33] *Lingle*, 544 U.S. at 540.

[34] The parcel as a whole concept was originally established, as was most of Takings Clause jurisprudence, for land-use takings claims. The courts have extended the parcel as a whole concept to contexts other than land-use, such as employee pension plans, Concrete Pipe & Products, Inc. v. Construction Laborers Pension Trust, 508 U.S. 602, 644 (1993), and mortgage restrictions on low-income housing projects, Cienega Gardens v. United States, 503 F.3d 1266 (Fed. Cir. 2007).

[35] *Concrete Pipe*, 508 U.S. at 644.

[36] It is also possible that courts could consider individual mortgages or whole trusts to be the "parcel." Such a conclusion would make a successful takings claim less likely than if tranches were deemed the "parcel." This report focuses on the tranches as the "parcel" interpretation.

[37] Andrus v. Allard, 444 U.S. 51, 66 (1979), *cited in* Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency, 535 U.S. 302, 327 (2002).

[38] *Tahoe-Sierra*, 535 U.S. at 331-32.

period, the court would analyze the economic impact to that investor in relation to the whole 12 months, not just the six months of the freeze (temporal dimension) and in relation to the income from both principal and interest, not just the interest payments changed by the freeze (functional).

Courts vary in how they determine the economic loss caused by regulations. Most courts look to either the property's "diminution in value" or "diminution in return" caused by the regulation.[39] Under both, courts are in agreement that the loss must be significant. The Supreme Court has in past cases found diminutions in property upwards of 75% to not, by themselves, be enough to be considered a "taking."[40] Determining the severity of the lost value or return caused by the legislation in question would be an entirely fact-specific inquiry.

The complexity of the secondary market coupled with its lack of governmental oversight, hamper the ability to fully assess how many, and to what extent, tranches of mortgage-backed securitized trusts would be affected by a statutorily imposed interest rate freeze/reduction of certain mortgages. When mortgages are sold in the secondary market, they are often lumped in trust and then separated into tranches on the basis of certain common characteristics. Mortgages can be left intact or they can be diced into pieces. For example, a tranche could consist entirely of 30-year, fixed, prime rate mortgages that do not include prepayment penalties. Or, a tranche could consist of only the income stream from the interest payments of subprime mortgages with two-year ARMs. Or, a tranche could be comprised of 25% of the first group and 75% of the second group. There are virtually no limits to what can comprise a tranche. It is conceivable that there are or would be tranches that represent, in whole or in part, the income from the planned interest rate adjustment that is eliminated or significantly reduced by a federal interest rate freeze or reduction. In these cases, legislation could result in up to a 100% diminution in value or diminution in return of the tranches. Where a tranche lost its entire value due to federal legislation, a taking has likely occurred. It is unclear where a court would draw the line in cases where some, but less than a 100% loss results, though almost certainly, the percentage would be quite high. For intermediate percentages, the other two prongs of the *Penn Central* test are likely to be of importance.

Impairment of Contracts. When examining whether congressional impairment of private contracts interferes with investment-backed expectations, courts have typically focused on whether it was reasonable for the harmed party to assume that the impairment would not occur.[41] "The critical question is whether

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[39] Rose Acre Farm, Inc. v. United States, 75 Fed. Cl. 527, 532 (2007). Other courts have looked to whether only a small number of many contractual rights are affected by the regulation. *See*, McAndrews v. Fleet Bank of Massachusetts, 989 F.2d 13, 18-19 (1st Cir. 1993). However, this type of analysis would not fit well in the context of a takings claim raised by an investor of MBSs.

[40] *See*, *Concrete Pipe*, 508 U.S. at 645.

[41] *See, e.g.*, Appolo Fuels, Inc. v. United States, 381 F.3d 1338 (Fed. Cir. 2004). For this purpose, the courts examine the regulations in place before the plaintiff acquired the property in question.

extension of existing law could be foreseen as reasonably possible."[42] To do so, courts generally look to the type and level of regulation the claimant faced prior to implementation of the regulation in question. If, for instance, the subject of the regulation was part of a "heavily regulated field" prior to the additional legislative impairment, then additional regulation is more likely to have been "foreseeable" to the harmed party. The courts have concluded, for example, that national banks[43] and employee pension plans[44] are in heavily regulated fields.[45] However, low-income housing is not.[46]

Proposals for legislation addressed in this report would regulate the mortgage lending, mortgage servicing, and mortgage-backed securities investing industries. The mortgage lending industry would likely be considered "heavily regulated." However, credible arguments could be made that the other two, especially, the MBSs industry, are not heavily regulated, which would strengthen the argument that a taking has occurred. Yet, secondary market investors understand that each mortgage they invest in could end up in default, and this possibility is accounted for in the PSAs governing when and how servicers may modify these loans. While a government imposed modification of the interest rates of certain mortgages arguably would be a departure from the norm of servicers modifying mortgages in accordance with the terms of PSAs, the more important question would seem to be whether the statutorily imposed modification would have been allowed pursuant to the governing PSA. A MBS investor could make a stronger argument that the legislation in question was not reasonably foreseeable where the statutorily imposed interest rate freeze/reduction would not have been allowed under the governing PSA. The more tailored the application of any interest rate freeze/reduction was to those borrowers who would qualify for such a loan modification pursuant to the governing PSA, the fewer MBS investors that would have stronger arguments under this prong. Consequently, the scope of legislation might play an important role in a court's analysis under the investment-backed expectations prong of the *Penn Central* test.

Character of the Government Action. The third factor, the character of the government action, is arguably of diminished importance in light of the Supreme Court's *Lingle v. Chevron USA Inc.* decision, where the Court stated unequivocally that inquiry into whether a regulation advances some public purpose is not relevant to the question of whether a taking occurred for Fifth Amendment purposes.[47] The

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[42] *Cienega Gardens*, 503 F.3d at 1289.

[43] Branch v. U.S., 69 F.3d 1571, 1581 (Fed. Cir. 1995).

[44] *Concrete Pipe*, 508 U.S. at 645-46.

[45] Other "heavily regulated fields include: railroad labor disputes (Burlington N.R.R. Co. v. United Transp. Union, 822 F. Supp. 797, 802 (D.D.C. 1991)); coal mining (*Appolo Fuels*, 381 F.3d, at 1349); liquor stores (People's Super Liquor Stores, Inc. v. Jenkins, 432 F. Supp.2d 200, 215 (D. Mass. 2006)); gambling (*Hawkeye Commodity Promotions*, 486 F.3d at 440); and adult entertainment establishments (McCrothers Corp. v. City of Mandan, 728 N.W.2d 124, 141 (N.D. 2007)).

[46] *Cienega Gardens*, 503 F.3d, at 1289.

[47] 544 U.S. at 542 ("The 'substantially advances' formula suggests a means-ends test: It (continued...)

effect *Lingle* will have on how future courts will apply the "nature of the government action" factor is unclear. Historically, courts used this factor to assess whether a regulation that impaired private contracts directly benefited the government; disproportionately imposed the costs of a public benefit on a small class; or was somehow the result of governmental bad faith.[48] It is doubtful that a legislatively imposed interest rate freeze/reduction would take rights from investors and appropriate them to the government or would be enacted as a result of bad faith. Rather, such legislation likely would be an attempt to help stem the current housing downturn that is affecting the entire market. In the absence of specific legislative language to delineate which mortgages would be covered by an interest rate freeze/reduction, it is unclear if such legislation would impose a disproportionate amount of liability on a small number of investors. The nature of the government action authorized by the proposals in question would not appear to greatly augment a takings claim, but more information would be needed to know for sure.

Conclusion

In sum, it is unlikely, but possible that a court would assess an interest rate freeze/reduction as a physical taking or an appropriation, which would be a per se taking requiring just compensation. Courts would be more likely to assess such legislation as a regulatory taking under *Penn Central*. If analyzed as a regulatory taking, it is unclear how a court would decide an as-applied takings claim, especially without specific facts that would allow an assessment of the severity of the regulation's economic impact on an individual investor's property rights, which seems to be the most important *Penn Central* factor.[49] However, due to the great diversity of investments in the mortgage securities market, it is not difficult to envision some tranches being significantly diminished in value, if not entirely eradicated by an interest rate freeze/reduction. The economic effect in some of these situations could be substantial enough to be considered a regulatory taking. It is impossible to predict at what level of economic impact a court would hold that a taking has occurred, though in the past, it has almost always been quite high. The strength of an impairment of investment-backed expectations argument would likely turn on the scope of the legislation and how that coincides with the loan modification authority provided by the governing PSA. The nature of the government action, does not appear to warrant takings concerns on its own. If a taking were found, then the government would be required to provide just compensation. There is no way to

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[47] (...continued)
suggests, in essence, whether a regulation of private property is *effective* in achieving some legitimate public purpose. An inquiry of this nature has some logic in the context of a due process challenge . . . But such a test is not a valid method of discerning whether private property has been "taken" for purposes of the Fifth Amendment.") (emphasis in original).

[48] *See, e.g.*, Tahoe-Sierra Preservation Council, Inc. v. Tahoe Regional Planning Agency, 535 U.S. at 333 (were it not for findings that the agency acted in good faith, the Court "might have concluded the agency was stalling" and found a taking).

[49] A facial challenge would not succeed under *Penn Central* because the particular facts of each tranche would be pivotal to a regulatory takings analysis. A facial challenge would be possible if the court found an interest rate freeze/reduction to be a physical taking. *See*, the "Physical Taking/Appropriation vs. Regulatory Taking" section of this report.

predict how much, if any, the government would be liable for in just compensation claims, but in an industry valued at more than $1 trillion in 2006, the potential liability could be large.[50] Additionally, investors who lost large sums of money due to an interest rate freeze/reduction could sue the government, and regardless of the outcome of these cases, the litigation itself would likely be costly.

[50] The value of securitized mortgages was around $2 trillion in 2006. *See*, CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward Vincent Murphy.