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## DISAPPEARING NEIGHBORS

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Responding to Richard C. Schragger, *Mobile Capital, Local Economic Regulation, and the Democratic City*, 123 HARV. L. REV. 482 (2009).

### INTRODUCTION

Professor Richard Schragger's article, *Mobile Capital, Local Economic Regulation, and the Democratic City*,<sup>1</sup> raises significant questions in our pursuit of a workable understanding of city power — especially because his thesis on new problems of mobile capital is linked with the old problem of racial segregation and its accompanying patterns of economic marginalization. The influx of mortgage capital into cities from a host of lenders and intermediaries over the last decade has provided a real-world test of his ideas about city-business relationships. Specifically, what cities can and cannot do to address the growing mortgage foreclosure crisis in their midst illustrates the promise and pitfalls of relying on local regulation.

Schragger argues that limitations on city power are more a matter of reacting to “[t]he political pathologies [that arise from] the city-capital relationship” than a result of the relationship between states and cities.<sup>2</sup> The pathologies owe a lot to the city's need to attract and to retain capital investment. Recently, cities have shown a greater willingness to act more aggressively against capitalist investors — more than in the past, and more than most scholars were willing to assume cities could, given the preemptive power of federal and state agencies to regulate capital. He asserts that common techniques fall under the categories of either exploitation or giveaways. Attempts to exercise “economic localism,” however, are emerging along three lines of city leverage: the control, redistribution, or exclusion of capital.

Schragger's examples help to illustrate how the scheme of authority interests in cities confounds the use of terms like “localities” in much the way that the city's previous (and, I would argue, current) identification with business transcended the public/private distinction. If translocal groups — as Schragger calls them — effectively alter the terms of capital investment in ways that benefit and give cover to local officials, there is no clear divide between government and nongovern-

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<sup>1</sup> Richard C. Schragger, *Mobile Capital, Local Economic Regulation, and the Democratic City*, 123 HARV. L. REV. 482 (2009).

<sup>2</sup> *Id.* at 487.

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ment actors. Yet that is what Schragger argues occurs in the case of “living wage” laws or community benefits agreements. In one, local unions exercise great power to control and redistribute capital investment. In the other, local interest groups constrain and regulate capital investment.

But his most provocative claim is that the “localist economic project” is underway “to assert community control over global capital.”<sup>3</sup> Schragger wants to explore a kind of mid-range local governmental activism between “the usual attraction, displacement, and retention strategies, but which fall[s] short of government or collective ownership of productive assets.”<sup>4</sup> The techniques he discusses seek to make global capital “accountab[le].”<sup>5</sup> The problem, as I view it, is that the current foreclosure crisis originated with the discrimination that produced redlining and the chronic market failures that produced predatory lending — the first an example of prohibited capital and disinvestment, the latter an example of opportunism at the margins. As the case of Newark, New Jersey, will show, however, cities (along with states and federal government programs) often welcomed the investment of mobile capital — banks, brokers and other lenders selling securitized debt — as a means of increasing both tax bases and resident stakeholderhood — only to see well-established trends in predatory lending plunge cities into fiscal disaster as the fate of mobile capital met the plight of global capitalism in the current recession. After looking at that phenomenon, I discuss the difficulties cities have in exercising any independent power to avert such catastrophes.

#### I. DYNAMICS OF THE FORECLOSURE CRISIS IN NEWARK AND ELSEWHERE

Much of our understanding of the mortgage crisis is rooted either in an evaluation of subprime borrowers’ and lenders’ place in the context of global capitalism or racial segregation — or both. But for our purposes, it may be more instructive to begin with the work of Professor Kathe Newman, a political scientist who asserts that specific processes of deregulation and government participation helped turn the subprime mortgage into a kind of “post-industrial widget.”<sup>6</sup> As others have noted, both municipalities and individual households increasingly bought into the idea of real estate investment as the city’s fiscal savior, first during the period of banking deregulation under Ronald Reagan

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<sup>3</sup> *Id.* at 506.

<sup>4</sup> *Id.* at 508.

<sup>5</sup> *Id.*

<sup>6</sup> Kathe Newman, *Post-Industrial Widgets: Capital Flows and the Production of the Urban*, 33.2 INT’L J. URB. & REGIONAL RES. 314, 314 (2009).

(when federal aid to cities was sharply curtailed), and later under the homeownership-promoting policies of the Clinton Administration.<sup>7</sup> Before the housing boom that just imploded, however, new mortgages became increasingly scarce. The incentive for subprime lending, therefore, began with the need for new borrowers, including those who had been routinely left out of the lending system by redlining. Creating that market, Newman argues, required solving problems of fixity and liquidity.<sup>8</sup> Fixity problems involve the trouble of valuing properties based on location and local knowledge, which policy changes helped to resolve.<sup>9</sup> Liquidity problems were mainly solved by expansion of the secondary market through federal government encouragement (legislation) or direct participation (via government-sponsored enterprises) in ways that dramatically reduced investor risk.<sup>10</sup> Real estate was commodified as a result.

Not only did these larger processes of what Newman calls financialization weaken federal regulation of the mortgage industry, but they also enlarged regulatory blindspots in the credit markets in minority neighborhoods, exacerbating the problems of redlining and fair access to affordable credit and capital. More numerous types of lenders took advantage of under-penetrated housing markets, including nonbank lenders, mortgage brokers, and other intermediaries — even home repair contractors connected to subprime lenders.<sup>11</sup> These lenders operated in what might be called regulatory antimarkets, beyond the reach of federal and state regulators and without the safeguards protecting capital investment in what became “prime” neighborhoods. Financialization also produced less effective state regulation.<sup>12</sup> The internet provided many more opportunities to reach potential borrowers (both current and prospective homeowners) through direct marketing.<sup>13</sup> The combination of loosely regulated forces disproportionately affected black and Hispanic borrowers in cities, whose substantial personal losses have had clear and disastrous implications for those cities themselves.

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<sup>7</sup> See, e.g., ALYSSA KATZ, *OUR LOT: HOW REAL ESTATE CAME TO OWN US* (2009).

<sup>8</sup> Newman, *supra* note 6, at 317.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 317–18. Examples include the Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (codified as amended in scattered sections of 12 and 15 U.S.C.), the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 101 Stat. 183 (codified as amended in scattered sections of 12, 18, and 31 U.S.C.), and the deduction rules in the Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 131–135, 100 Stat. 2085, 2113–16 (codified as amended in scattered sections of 26 U.S.C.). See Newman, *supra* note 6, at 317–18.

<sup>11</sup> Newman, *supra* note 6, at 318.

<sup>12</sup> See *id.* at 319.

<sup>13</sup> See *id.*

Why would subprime lending affect blacks and Hispanics in such disproportionate ways if it merely reflected an expansion — perhaps even an evolution — of the postmodern mortgage market? Because this less-regulated, sometimes explicitly predatory mode of financialization was compounded by another feature of urban residential organization: racial and economic segregation. Numerous researchers have shown the correlation between race and ethnicity in the market for high-cost or subprime loans that cannot be explained by income or credit histories alone.<sup>14</sup> Nationally, black and Hispanic borrowers received subprime loans at a rate that was three times and two-and-a-half times more than whites, respectively, in 2006.<sup>15</sup> Moreover, taking both borrower and metropolitan area segregation characteristics into account, Professor Vicki Been, Professor Ingrid Ellen, and Josiah Madar found that the racial disparities apparent at the national level are most pronounced in regions with high rates of segregation (as measured by dissimilarity).<sup>16</sup> These effects are then further compounded by neighborhood data: “As the percentage of minorities in the neighborhood increases, whites, blacks and Hispanics all have a higher probability of receiving high-cost loans.”<sup>17</sup> For example, a Hispanic borrower seeking a mortgage in a neighborhood with a low percentage of non-white residents had a fourteen percent chance of receiving a subprime loan, while that probability more than doubled to thirty-one percent in a neighborhood with a high concentration of non-whites.<sup>18</sup>

In smaller, struggling, predominantly minority central cities like Newark, New Jersey, these dynamics pose a monumental challenge to the city’s economic prospects. Without a substantial middle class and not encircled by suburbs whose commuting residents might help sustain the city’s economic life, cities like Newark are constantly trying to retain the relatively scarce capital they have and to attract more. Like so many cities in the last twenty years, it has staked its “renaissance” on the combination of splashy cultural institutions (e.g., the New Jersey Performing Arts Center and Prudential Arena) and homeownership opportunities that are far more affordable than much of the region. Newark, in particular, contends with a notorious history of racial division, high rates of family and neighborhood poverty, the statewide middle-class preference for nonurban living, and the com-

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<sup>14</sup> See, e.g., Michael Powell & Janet Roberts, *Minorities Hit Hardest as New York Foreclosures Rise*, N.Y. TIMES, May 16, 2009, at A1 (including a map of foreclosures by race and ethnicity throughout the New York region); see also Vicki Been, Ingrid Ellen & Josiah Madar, *The High Cost of Segregation: Exploring Racial Disparities in High Cost Lending*, 36 FORDHAM URB. L.J. 361 (2009).

<sup>15</sup> See Been, Ellen & Madar, *supra* note 14, at 385 tbl.1.

<sup>16</sup> *Id.* at 380–81.

<sup>17</sup> *Id.* at 384.

<sup>18</sup> *Id.* at 30 tbl.10.

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parative attractiveness of a truly global city — New York — only a dozen miles away.

Newman analyzed pre-foreclosure data for Newark in 2004 (more recent data was not yet available as of this writing), and found vast destabilization in just those neighborhoods cities count on for retaining capital and a robust tax base. Foreclosures primarily affected not renters in poor neighborhoods, but rather those in lower-middle- and solidly middle-class areas like Vailsburg (and adjacent older suburbs).<sup>19</sup> Unlike the neighborhoods that saw waves of disruption because of urban renewal, public housing or highway construction, these are older, more settled neighborhoods of low-rise dwellings. In accord with the findings of Been, Ellen, and Madar, and others, the vast majority of homeowners are African American and Latino. “Foreclosures are concentrated in the majority-minority low-rise residential neighborhoods, many of which have been the target of focused community development efforts, receiving governmental, private foundation and bank resources.”<sup>20</sup> In addition to disproportionately higher rates of foreclosure in these neighborhoods, Newman also found evidence of deliberate targeting of these neighborhoods by many of the same subprime lenders.<sup>21</sup> In 2003, most of the loans in some neighborhoods were not regulated by one of the four federal regulatory agencies that regulate prime lenders.<sup>22</sup>

The resulting destabilization flips the calculus for cities trying to overcome concentrated ghetto poverty. Neighborhoods like Vailsburg — not in, but near, ghetto neighborhoods — are often seen as the front for advancing economic stability into ghetto areas. Instead, the targeted collapse of once-stable neighborhoods like Vailsburg makes them the likely extension of a widening ghetto.

For the city of Newark as a whole, the foreclosure crisis continues to inflict manifold actual and lost-chance damage. This is evident at several levels. For homeowners, there is the loss of an asset and its accompanying wealth-building potential, the risk of displacement, ruined credit, lowered property values for neighbors, and a potential for diminished appetite in wealth accumulation among populations that were new to it. But for the city itself, there are distinct costs, including lost tax capacity of foreclosed homeowners, additional social services burdens caused by households under financial stress, increased police presence necessary to combat increased crime in areas of aban-

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<sup>19</sup> See Newman, *supra* note 6, at 322.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 324 (“The top ten originators of loans in pre-foreclosure in 2004 account for one-quarter of foreclosure starts.”).

<sup>22</sup> *Id.* at 325. These are the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Company, and the Office of Thrift Supervision.

doned property, the city's reputation among prospective migrants and employers, and the overall pull against the prospects for economic development.

## II. WHAT CITIES CAN'T DO ABOUT IT

The foreclosure crisis, therefore, presents an up-to-the-minute case of the city-business power imbalance in the age of especially mobile capital. In describing what he regards as the emerging "economic localism," Schragger argues that "[c]ities . . . need at the least to strike better deals with mobile capital."<sup>23</sup> Though predatory lending was a problem known to urban neighborhoods for decades, cities had not done much to condition, exclude, or redistribute lending in minority and moderate-income areas.<sup>24</sup> Perhaps because this kind of dealmaking would have required some form of regulation of capital, cities attempting to regulate predatory lending on their own tend to founder either on preemption grounds where the state has already acted or because they reach the allowable extent of home authority over police power matters.<sup>25</sup> It is perhaps the best indication yet that "regulatory localism" — much as it may be needed — has not reached some of the most potentially destabilizing forms of mobile capital.

Alternatively, cities could sue predatory lenders for the costs they inflict on the city as a whole. After all, in most cases the city has been targeted as a uniquely attractive market for certain kinds of high-risk loans, often solicited through deliberately misleading, if not fraudulent, lending practices. What makes communities vulnerable to targeting by predatory lenders could make such communities especially susceptible to damage from increased use of city resources and a diminished tax base when default risks materialize. Successful litigation against mobile capital entities that harm city interests would condition the future terms of fair dealing by residential lenders in that city.

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<sup>23</sup> Schragger, *supra* note 1, at 535.

<sup>24</sup> Of course, local groups and public interest organizations have sought to increase the terms and availability of lending to redlined neighborhoods through vehicles such as the Community Reinvestment Act for many years. See Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1463 (1994).

<sup>25</sup> See *Am. Fin. Servs. Ass'n v. City of Oakland*, 104 P.3d 813 (Cal. 2005); *Mayor of N.Y. v. Council of N.Y.*, 780 N.Y.S.2d 266 (N.Y. Sup. Ct. 2004). *But see* *Am. Fin. Servs. Ass'n v. City of Toledo*, 161 Ohio App.3d 477, 2005-Ohio-2943, 830 N.E.2d 1233 (allowing a city ordinance regulating predatory lending and rejecting an express state law preemption provision as an unconstitutional violation of home rule powers). For a more complete discussion of the unsettled nature of municipal predatory lending ordinances in Ohio, see Jonathan L. Entin and Shadya Y. Yazback, *City Governments and Predatory Lending*, 34 FORDHAM URB. L.J. 757, 775–80 (2007). See generally Kimm Tynan, Note, *Pennsylvania Welcomes Predatory Lenders: Pennsylvania's Act 55 Preempts Philadelphia's Tough Ordinance but Provides Little Protection for Vulnerable Borrowers*, 34 RUTGERS L.J. 837 (2003).

Yet even a city's power to sue for those collective harms is minimal and often subordinate to state enforcement by attorneys general. Cities suing lenders in their own capacities face federal standing hurdles on *parens patriae* grounds<sup>26</sup> and, in state courts, their standing is dependent upon home rule provisions and the extent of Dillon's Rule observance.<sup>27</sup> Where states grant cities the right to sue as quasi-sovereigns suing in the interests of their residents, cities may bring claims subject to the Supreme Court's tests for numerosity and a distinct injury beyond that of a private party.<sup>28</sup> There is little case law on cities suing as quasi-sovereigns; however, it's clear that the problem of city-capital powerlessness starts to look a lot like the problem of city-state powerlessness argued by scholars like Professor Jerry Frug<sup>29</sup> but considered "beside the point" by Schragger.<sup>30</sup>

Although cities are often denied standing to sue in federal court, the Supreme Court last term permitted a state claim against lenders despite asserted federal preemption of "oversight" functions by a federal agency, specifically the Comptroller of the Currency. The Court ruled that the National Bank Act does not preempt a state attorney general's suit to enforce state lending laws against a national bank.<sup>31</sup> The decision signals that states may sue lenders for direct violations of state banking laws under certain circumstances (states often sue under their own consumer protection or unfair trade practices laws),<sup>32</sup> but still leaves open the question of what power cities have to sue in their own name.

Cities are also suing subprime lenders for predatory economic behavior, typically based on violations of civil rights laws. For instance, the City of Baltimore has survived an early motion to dismiss its suit against Wells Fargo Bank for underwriting subprime loans in predom-

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<sup>26</sup> Kathleen C. Engel, *Do Cities Have Standing? Redressing the Externalities of Predatory Lending*, 38 CONN. L. REV. 355, 365–66 (2006).

<sup>27</sup> *Id.* at 367.

<sup>28</sup> *Id.* at 371. See also Alfred L. Snapp & Son, Inc. v. Puerto Rico, 458 U.S. 592, 607 (1982) (explaining that cities may champion such interests as the health, safety, welfare, and economic and physical well-being of their populace).

<sup>29</sup> See, e.g., Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1057 (1980).

<sup>30</sup> Schragger, *supra* note 1, at 536. I generally agree with Schragger that too much discussion on city powerlessness tends to focus on questions of relative powers between levels of government, but the regulation of mobile capital is clearly an example where a focus on relativism is most manifest. Often the relative powerlessness of cities is not due to their constitutional relationship to the state, but rather their competitive position relative to other municipalities in the region. On this, Schragger and I apparently agree. "This nascent localization of economic policy coincides with the rise of the region as an important economic unit and the relative decline of the nation-state as a central regulator of economic life." *Id.* at 533.

<sup>31</sup> *Cuomo v. Clearing House Ass'n*, 129 S.Ct. 2710 (2009).

<sup>32</sup> See, e.g., Engel, *supra* note 26, at 380–81.

inantly African-American neighborhoods.<sup>33</sup> The United States District Court for the District of Maryland defined three criteria that supported granting Baltimore standing to bring suit: that the lender singled out blacks and black neighborhoods for oppressive loans; that the oppressive loans caused foreclosures and vacancies in those neighborhoods; and that the foreclosures and vacancies harmed the city in some quantifiable way.<sup>34</sup> This precedent shows a promising opening, but there is a long way to go before cities are powerful enough to govern the destructive effects of capital disasters without waiting for state or federal enforcement of their interests.

### III. THE PROBLEM GOING FORWARD

The foregoing analysis demonstrates at least three consequences of cities' powerlessness relative to mobile capital. The first is that the foreclosure has acted like a grand exposé of the structural vulnerabilities of cities caused by persistent segregated housing patterns within cities and their suburbs. So long as racially homogenous neighborhoods can be so easily targeted by unscrupulous lenders and their agents, cities will always face the potential for crippling macroeconomic crises despite any other efforts they make to attract, control, or exclude capital. Cities, therefore, have to focus city power as much on eliminating the conditions that make predatory investment possible as on making those interests accountable for such predatory investment once they have already come (and gone).

Second, cities face a host of new survival risks associated with a new economy of globalized capital of various types. The "middle range" examples of mobile capital that Schragger uses — community benefits agreements over development projects, living wage laws for certain sectors doing business in the city and exclusion of big box retailers — illustrate a different kind of capital mobility than mortgages (and their global financialization) do. The latter kind of capital mobility is much harder to impact, is subject to more individual distinctions in kind, is more private in origin, and has more numerous market actors involved. The capital that finally came to redlined neighborhoods did not arrive as a single entity with global branches, nor did it invest in job-creating developments. Instead, it was disaggregated and hyper-mobile, in the form of high-cost credit, aggressively marketed and sold to local consumers who then reinvested their own scarce capital at tremendous risk. These characteristics frustrate the capacity for cities to build a "localist regulatory order" that reaches the larger

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<sup>33</sup> *Mayor of Balt. v. Wells Fargo Bank, N.A.*, Civil No. L-08-62, 2009 U.S. Dist. LEXIS 68268 (D. Md. Aug. 5, 2009).

<sup>34</sup> *Id.* at \*1-3.



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transactions that profoundly affect resident welfare. They also demonstrate the relative powerlessness of cities to defend themselves against the local effects of the next global economic bubble.

Finally, the difficulties are problems for a city's democratic interests as well as a city's economy. The economic localism Schragger describes is based on the importance of city residents' empowerment activity in giving voice to basic needs such as available wages and labor participation.<sup>35</sup> It is a political instrument of organized citizenship pursuing welfare-enhancing aims. As homeownership is a supposed feature of citizenship, democratic participation and voice are the very heart of a stable democratic public. The inability of cities to avert foreclosure crises through the imposition of constraints on mortgage lending is therefore a significant impediment to city's democracy-reinforcing functions. The disappearance of stakeholders in the form of foreclosure evicted neighbors places stress on resident organizations at all levels of the city and impoverishes city life.

#### CONCLUSION

Schragger's goal was to expose a less obvious dynamic in city power — cities' relationship to mobile capital and the aggressive regulatory changes occurring under the banner of economic localism. This is a worthy and helpful endeavor, with many novel and useful insights. He recognizes the limits of city power and the importance of neutrality: "Once the city is understood as a neutral framework for private economic activity," Schragger writes, "the two — state and market — should operate in relatively separate spheres. But they do not. The city's neutrality has to be constantly reaffirmed and maintained through legal rules."<sup>36</sup> However, as the case of mobile mortgage financing suggests, perhaps too much legal reaffirmation of cities' neutrality has put them at systemic risk — now and in the increasingly global economic future.

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<sup>35</sup> Schragger, *supra* note 1 at 530.

<sup>36</sup> *Id.* at 536.