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THE WALL STREET JOURNAL.
WSJ.com

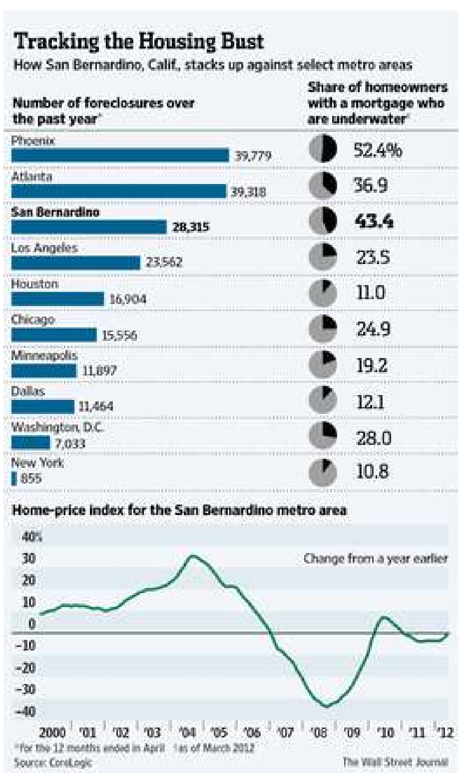
ECONOMY | July 4, 2012, 7:58 p.m. ET

Cities Consider Seizing Mortgages

By NICK TIMIRAOS

A handful of local officials in California who say the housing bust is a public blight on their cities may invoke their eminent-domain powers to restructure mortgages as a way to help some borrowers who owe more than their homes are worth.

Investors holding the current mortgages predict the move will backfire by driving up borrowing costs and further depress property values. "I don't see how you could find it anything other than appalling," said Scott Simon, a managing director at Pacific Investment Management Co., or Pimco, a unit of Allianz SE.



Eminent domain allows a government to forcibly acquire property that is then reused in a way considered good for the public—new housing, roads, shopping centers and the like. Owners of the properties are entitled to compensation, which is usually determined by a court.

But instead of tearing down property, California's San Bernardino County and two of its largest cities, Ontario and Fontana, want to put eminent domain to a highly unorthodox use to keep people in their homes.

The municipalities, about 45 minutes east of Los Angeles, would acquire underwater mortgages from investors and cut the loan principal to match the current property value. Then, they would resell the reduced mortgages to new investors.

The eminent-domain gambit is the brainchild of San Francisco-based venture-capital firm Mortgage Resolution Partners, which has hired investment banks Evercore Partners and Westwood Capital to raise funds from private investors. The company's chief executive, Graham Williams, is a mortgage-industry veteran who helped pioneer lending programs for low-income borrowers at Bank of America Corp. in the early 1990s. Its chairman, Steven Gluckstern, is an entrepreneur who once owned the New York Islanders hockey franchise. Evercore's founder and co-chairman, Roger Altman, served in the Clinton administration and is raising funds for President Barack Obama's re-election effort.

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For a home with an existing $300,000 mortgage that now has a market value of $150,000, Mortgage Resolution Partners might argue the loan is worth only $120,000. If a judge agreed, the program's private financiers would fund the city's seizure of the loan, paying the current loan investors that reduced amount. Then, they could offer to help the homeowner refinance into a new $145,000 30-year mortgage backed by the Federal Housing Administration, which has a program allowing borrowers to have as little as 2.25% in equity. That would leave $25,000 in profit, minus the origination costs, to be divided between the city, Mortgage Resolution Partners and its investors.

Proponents say this would help residents shed debt loads that are restraining economic growth, while preventing foreclosures that are eroding the tax base. But unlike the beneficiaries of most recent mortgage-modification efforts, who must show hardship, these borrowers would have to be current on their payments to participate. And the program initially would focus only on mortgage-backed securities that aren't federally guaranteed—about 10% of all outstanding U.S. mortgages.

The move is yet another sign of the desperate measures taken by cities still reeling from the effects of the housing bust. Several have declared bankruptcy.

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"A number of cities, mayors, city managers have come to me and said, 'How soon can we get in?' " said Greg Devereaux, San Bernardino County's chief executive. He said he learned of the program last year from a California state official. He said county officials haven't yet made a firm decision on whether to proceed. "We think it would be irresponsible, given the size of the problem in our county, not to at least explore it," he said.

Unemployment in San Bernardino County, the nation's 12th-most-populous county, is among the nation's highest and tops 30% in some parts. More than two in five borrowers with a mortgage owed more than their homes were worth at the end of March.

The seizure of home-mortgage liens, but not the underlying homes, hasn't ever been conducted through eminent domain, as far as the group's principals can tell. And while they believe they have a strong legal case, they expect loan owners to sue.

"California legal precedent and political posture favor the program and constitute an ideal proving ground," Mortgage Resolution Partners said in a presentation to investors reviewed by The Wall Street Journal.

The document said it would begin with a $5 billion effort in California that could grow to three million mortgages as part of a $500 billion multistate effort.

Several states have authorized the taking of other intangible property, such as insurance policies, shares of stock or rights of way, according to Robert Hockett, a Cornell University professor of law and adviser to Mortgage Resolution Partners.

In 1984, the U.S. Supreme Court upheld the state of Hawaii's use of eminent domain to transfer residential tracts of land to renters to break up a landownership oligopoly and stabilize home prices. In 2005, the court affirmed the right of a Connecticut town to use eminent domain to transfer non-blighted homes to a private developer to spur redevelopment. That spurred several states to pass laws restricting such powers.

REUTERS

A house for sale in Fontana, San Bernardino County, Calif., in 2009.

The three local California governments have created joint powers authorities that don't need permission from their city councils or board of supervisors to move forward unless they need public money. That means if the agencies back proposals that are privately financed, the plans could only be stopped from moving forward in court.

Mortgage-bond investors—who are the property owners, for eminent-domain purposes—say the program would do nothing to deal with the biggest problems—borrowers already in default. "Shouldn't that be the first priority?" said Laurie Goodman, senior managing director at broker-dealer Amherst Securities Group LP.

A letter sent last week to city leaders from 18 trade associations, led by the Securities Industry and Financial Markets Association, warned that such a move "could actually serve to further depress housing values" by making banks less willing to lend. The plan's backers are unfazed. "The exact opposite is true. There's no private market right now," said Mr. Gluckstern of Mortgage Resolution Partners. "Until you clear out this problem [of underwater loans], private lending will not come back."

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