

**Private-label Residential Mortgage  
Securitization: Recording Innovations and  
Bankruptcy Remoteness**

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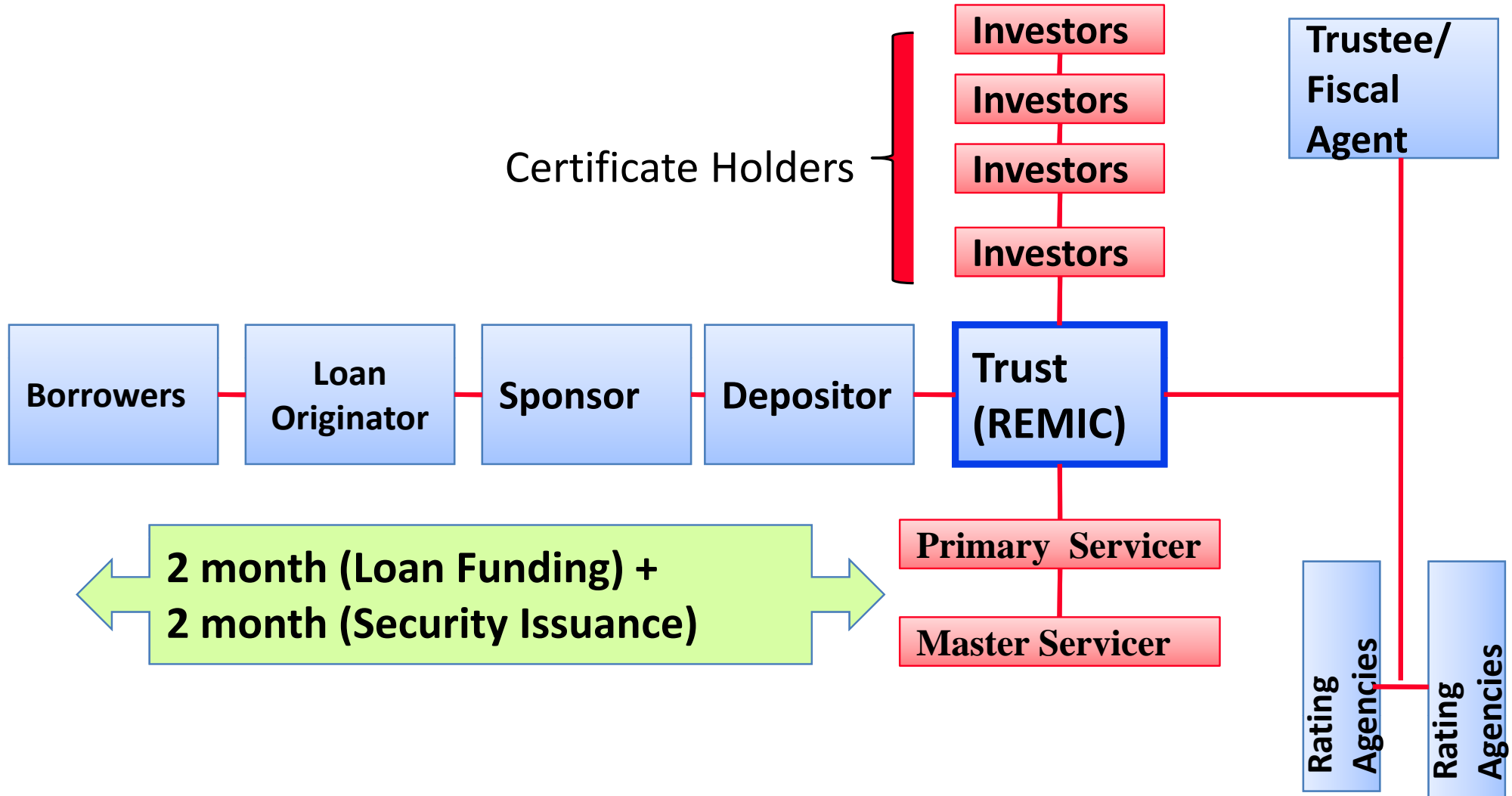
## Introduction

- ▶ A central tenet of asset securitization in the United States is that securitized assets are bankruptcy remote from their sponsors
  - (i.e.) the bankruptcy of the sponsor does not give the sponsor's creditors recourse to the assets held in the trust, or vice versa.
- ▶ Currently, there are two dominant methods used to record priority for the transfer of residential home loans from sponsors to the securitization trusts?
  - Public recording at the County Recorders Office, or Registrar of Deeds.
  - Mortgage Electronic Registration System (MERS) – 60% of all U.S. mortgages.
- ▶ Question whether MERS achieves either recorded priority or bankruptcy remoteness of the mortgage transfer?

## Refresher on Mortgage Loans: Two Legal Documents

- 1. Promissory Note** – Contractual promise made by the borrower to the lender to pay a defined principal amount at a specified contract interest rate, payment structure, and maturity.
  - ▶ States do not require the promissory note to be recorded for it to be enforceable.
- 2. Mortgage, or Trust Deed** – Grant of a lien or other security interest in the borrower's real property to the lender (or the trustee, for the lender's benefit) to secure the contractual obligations of the promissory note.
  - ▶ State foreclosure laws govern how mortgages enforce notes.
  - ▶ States do not require the mortgage to be recorded for it to be enforceable.
  - ▶ States use mortgage recording to establish the **priority** of the mortgage relative to other possible legal claims.

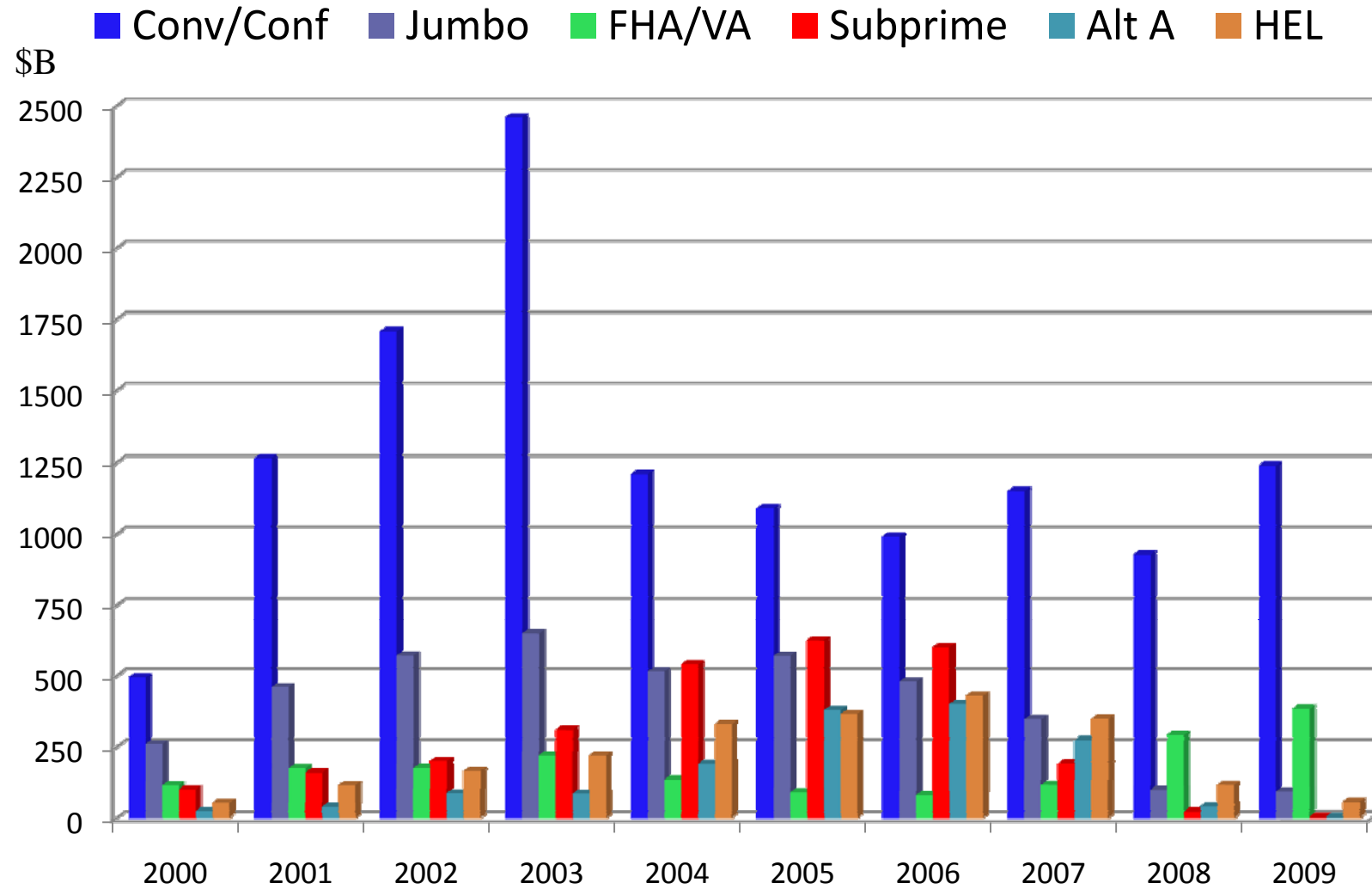
# Transfers in Securitization: Mortgage Loans to the Trust



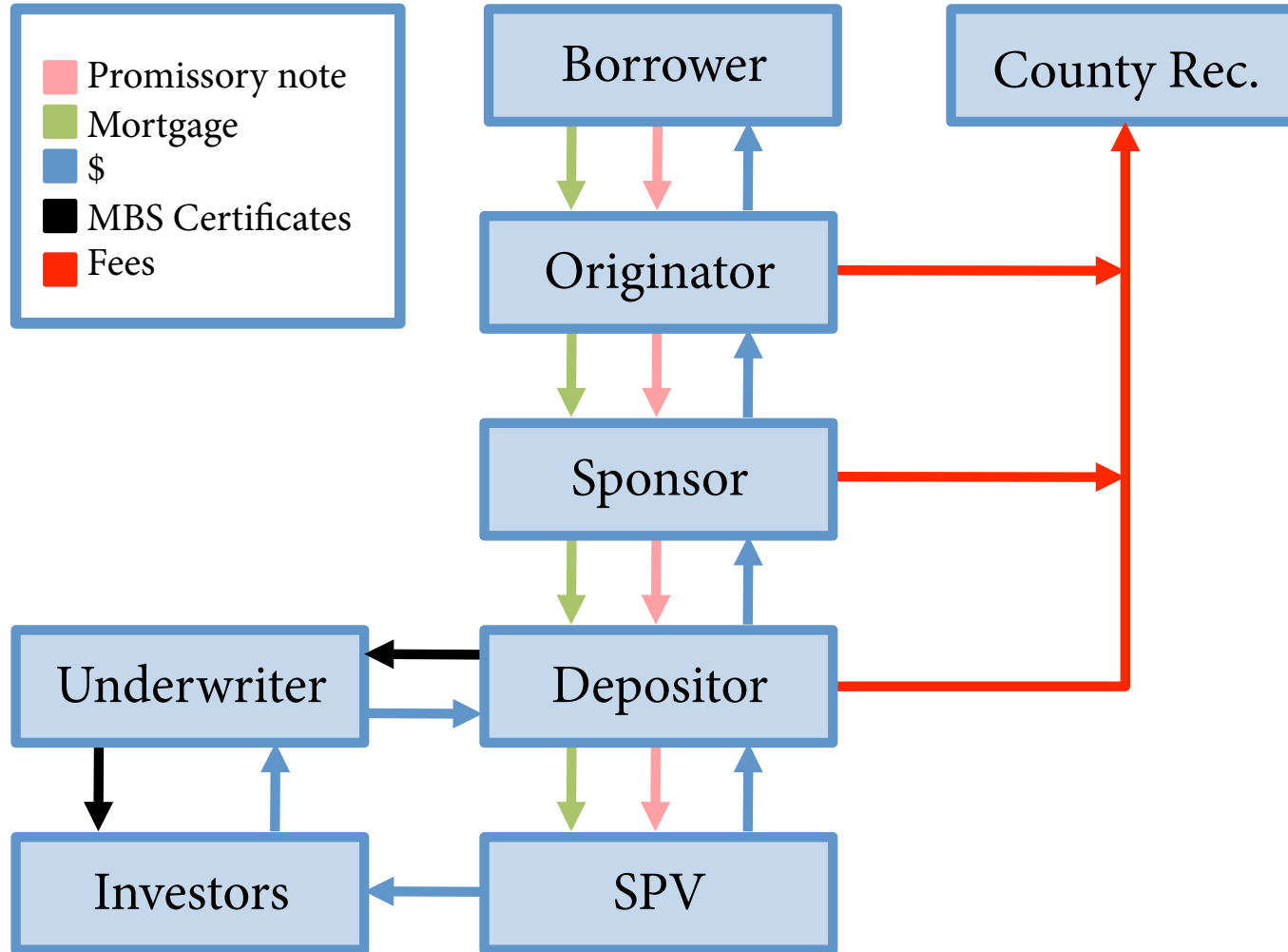
## Economic Efficiency: Predicated on the Existence of Bankruptcy Remoteness

- ▶ We assume that bankruptcy remoteness is assured through the alchemy of **lawyers** and **accountants**!
- ▶ Conditional on bankruptcy remoteness the efficiency gains from asset securitization are achieved through:
  - Skarabot (2002) and Gorton and Souleles (2005) – reduction in bankruptcy costs due to the transparency of the trusts; prohibitions on asset substitutions between equity and debt-holders of the trust; and the impossibility of bankruptcy for properly structured trusts.
  - Leland (2007) – advantages of dual limited liability and the additional leverage permissible on low-risk assets.
  - DeMarzo (2005) – tranching as an optimal solution to asymmetric information in asset sales.
  - Hartman-Glaser (2010) – optimal contracting structure in a dynamic setting with asymmetric information and reputation concerns.

## Private-label Securitization Trends: 2000 - 2009



# Mortgage Transfers with Recording



## Creation of MERSCORP

### ▶ Background:

- Uniform Electronic Transactions Act (UETA) – negotiations in late 1990s National Conference of Commissioners on Uniform State Laws, to rationalize state laws on legal status of electronic records and signatures.
- Electronic Signatures in Global and National Commerce (E-SIGN) – passed by Congress in 2000.

### ▶ MERSCORP, Inc. – incorporated in 1995.

- Privately held corporation owned by 28 (now 25) mortgage industry companies: Mortgage Bankers Association, Fannie Mae, Freddie Mac, Bank of America, Wells Fargo Bank, Washing Mutual, Chase, Citimortgage, First American Title Insurance Corporation, among others.



## Creation of Mortgage Electronic Registration System

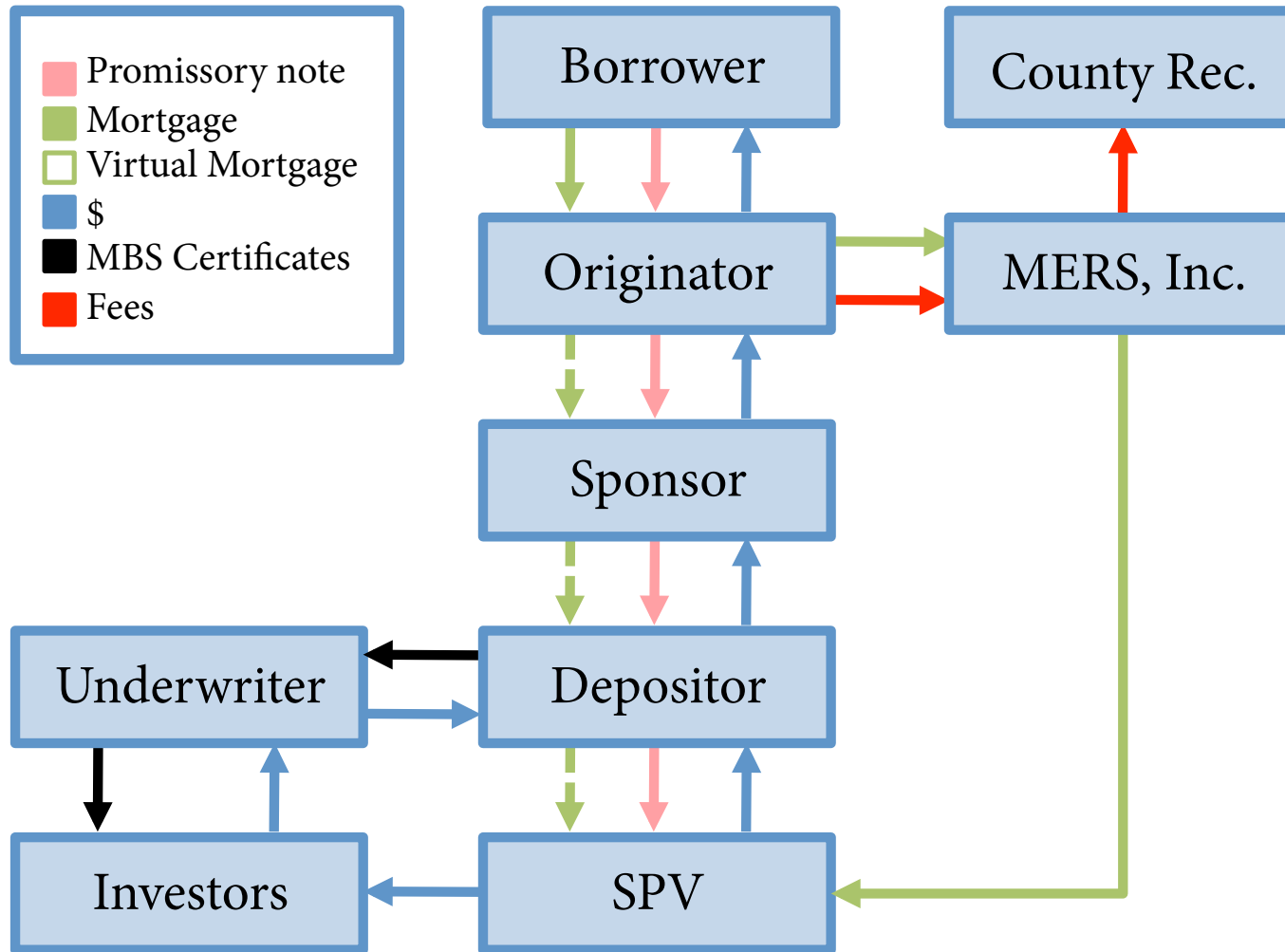
- ▶ Incorporated 1998.
  - Bankruptcy-remote subsidiary of MERSCORP, Inc.
  - Purpose to serve as the "mortgagee" in the land records for loans registered on the MERs System. – **"Every Loan Needs a MOM"** (MERS as Original Mortgagee)
  - Currently on land records for 64 million mortgages.
- ▶ Two ways for MERS to become mortgagee:
  1. Use Deeds of Trust or Mortgages with MERS as Original Beneficiary, or Mortgagee, using standard language approved by Fannie Mae, Freddie Mac, FHA, and VA.
  2. Assignment to MERS.
- ▶ All transfers of the mortgage within the MERS membership list require no further recording – MERS remains the owner of record.

## Mortgage Electronic Registration System, Inc.

### ▶ Governing Documents:

- Originators enter into a membership agreement with MERS – **member agrees that MERS shall serve as their nominee as the mortgagee in the land records in exchange for the Member registering the mortgage on the MERS system.**
- ▶ Two part member tariff system: (Borrower pays recording fee)
1. Annual membership fee (5,643 members currently).
  2. Pay for each mortgage "e-registry" (\$6.95) and mortgage transfer (\$2.00).

# Mortgage Transfers with MERS



## Appropriate Transfer for Securitized Promissary Notes?

- ▶ Sale via contract of sale, governed by the common law of contracts.
- ▶ American Securitization Forum (2010) – Promissary Note is a negotiable instrument that can be transferred via endorsement and delivery under Article (3) of the Uniform Commercial Code (UCC).
- ▶ Covington & Burling (2004) – Note can be converted into an electronic note and transferred according to the provisions of the federal E-SIGN Act.
- ▶ American Securitization Form (2010) – Promissary Note could be sold under Article 9 of the UCC, if there exists an authenticated agreement, a value given, and the seller has rights in the property being transferred.

## Appropriate Transfer for Securitized Mortgages?

- ▶ Mortgage could be assigned through traditional common law practice. This would require a document of assignment.
- ▶ American Securitization Forum (2010) – “Mortgage follows the Note,” per common law and as codified in the (UCC §9 – 203 cmt. 9) “a transfer of an obligation secured by a security interest or other lien on personal or real property also transfers the security interest or lien.”
  - MOM splits the note and the mortgage. MERS has no claim to the Note, however, it claims that it is the mortgagee. Thus, the mortgage does not follow the note.
- ▶ Levitan (2010) – Private contract law in combination with Trust Law establishes more rigid set of transfer requirements that must be scrupulously followed.
  - Pooling and Servicing Agreements (PSA) in Prospectuses for Trusts constitute “variations by agreement from the UCC.”
  - The securitization trusts are usually New York Common law trusts – “New York law requires that any transfer in contravention of the trust documents is void.”

## Pooling and Servicing Agreements define Transfer?

- ▶ **Non-MERS** loans: require a delivery to the trustee for every mortgage loan in the deal showing a complete chain of endorsements from the originator to the last endorsee. (See, GSAMP TRUST 2005-HE4)
- ▶ **MERS Loans:** “MERS will serve as mortgagee of record solely as nominee in an administrative capacity on behalf of the trustee and will not have any interest in such mortgage loans.” (See, BSABSs 2005-HE11)
- ▶ More recent deals add new risk disclaimers: “The Recording of the Mortgages in the Name of MERS May Affect the Yield on the Certificates, ... , a Florida court recently ruled that MERS lacked standing to pursue foreclosure proceedings on behalf of the beneficial owners of several mortgage notes who were not named parties to the proceedings.” (See, GSAMP Trust 2006-HE3)

## United State Bankruptcy Court Eastern District of New York v. Ferrel L. Agard (2/10/2011)

- ▶ “MERS also relies on its rules of membership as evidence of the agency relationship. However the rules lack any specific mention of an agency relationship, and do not bestow upon MERS any authority to act. Rather the rules are ambiguous as to MERS’s authority to affirmative actions with respect to mortgages registered on its system.” (p. 34-35).
- ▶ “Aside from the inappropriate reliance upon the statutory definition of “mortgagee,” MERS’s position that it can be both the mortgagee and an agent of the mortgagee is absurd, at best.” (p. 35)
- ▶ “...this Court finds that MERS did not have authority, as “nominee” or agent, to assign the Mortgage absent a showing that it was given specific written directions by its principal.” (p. 36)
- ▶ “This Court finds that MERS’s theory that it can act as a “common agent” for undisclosed principals is not support [sic] by law.” (p. 36)

## Summary and Conclusions

- ▶ Asset securitization requires bankruptcy remoteness, implying that the Mortgages and Notes must be properly transferred to the Trusts.
- ▶ If proper transfer cannot be established, then it is possible that investors would have a claim for rescission of the securitization – repayment at par by the sponsor.
- ▶ This could have devastating effects on the sponsors of private-label securitizations.