

Concurrent Session

Part II: The Mortgage
Financial Crisis
Macro Legal and
Economic Issues Raised
by the Enforceability of
Residential Mortgages
in Consumer Cases

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TO: Interested Parties
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RE: Fixing “Foreclosure-gate”

Late last week, Massachusetts’ highest state court upheld a lower court ruling invalidating two foreclosures due to improper paperwork by banks.¹ In its decision, the Massachusetts Supreme Judicial Court ruled that U.S. Bancorp and Wells Fargo had failed to prove they owned the mortgages when they foreclosed on two homes.

While consumer advocates are hailing the decision as a victory for borrowers, homeowners are more likely to suffer the downsides—not the benefits—from the Massachusetts ruling. This case is certain to set off a massive wave of litigation by borrowers and lawyers eager to challenge a pending foreclosure. This in turn will create tremendous uncertainty in the still-wobbly housing market: Will homebuyers who bought a home out of foreclosure worry that their purchase will be invalidated? Will prospective homebuyers get too nervous to come off the sidelines, thereby driving up inventory and driving down home values? Will some homeowners be encouraged to “strategically default” in the hopes of winning a “free house” from technically faulty paperwork?

Before “foreclosure-gate” opens the floodgates for both litigation and greater market uncertainty, policymakers need to step in with a common sense solution. As egregious as the paperwork failures were in the Massachusetts case, it would be far more damaging to the American economy if every foreclosure and every securitization were suddenly open to question.

This memo outlines a set of solutions aimed at ending the potential crisis touched off by the Massachusetts ruling. In particular, this memo proposes a series of policy ideas to achieve the following three goals:

1. Protecting injured homeowners.

Homeowners who were genuinely damaged by paperwork failures deserve a fair remedy. For example, with regard to earlier controversies over “robo-signing” and other faulty practices, borrowers who were robo-signed for foreclosure despite a pending request for a modification or short sale should have their foreclosure proceedings suspended. These homeowners should instead receive an expedited review of their modification or short sale application, to be completed within 30 days. Banks should also refund any fees or other penalties levied as part of a genuinely erroneous foreclosure and be barred from seeking deficiency judgments.

2. Keeping the housing market moving.

As devastating as the foreclosure crisis has been, the vast majority of Americans are facing a different kind of dilemma: how to restore the nearly \$7 trillion in housing wealth they've lost since the crisis began.² To help homeowners regain their wealth, policymakers must keep the housing market moving—including preventing unnecessary litigation that adds to borrower and investor uncertainty.

The Massachusetts decision shouldn't justify the creation of a cottage legal industry aimed at stalling inevitable foreclosures. Creating a limited safe harbor from paperwork-related litigation for pending foreclosures on abandoned or severely delinquent properties would provide more certainty to the housing market and help triage potentially successful modifications from inevitable foreclosures. In addition, a one-year statute of limitations on paperwork-related lawsuits would ensure litigation doesn't drag on for years.

3. Preventing future failures.

As a result of ongoing criminal and other investigations by state attorneys' general, banks and the lawyers they worked with are likely to pay the price for their transgressions. Equally important, however, is creating safeguard to prevent future abuses. The newly-created Consumer Financial Protection Bureau (CFPB) should take the lead in creating compliance procedures and an audit system to regulate the processing of foreclosure paperwork in order to prevent widespread documentary failures.

When the paper trail matters

The Massachusetts ruling is only the latest chapter in an ongoing saga involving paperwork failures and mortgages. Late last year, the controversy began with reports of so-called "robo-signing" by banks.

In a legal deposition that has become the smoking gun for the robo-signing phenomenon, an employee of a "foreclosure mill" in Florida admitted under oath that he signed hundreds of affidavits a day to process pending foreclosures without actually having read or checked the documents. It later came to light that this employee was not alone, and in the 23 states that require a court to approve a foreclosure, thousands of foreclosures are now potentially under question.

Without doubt, robo-signing and similar practices are sloppy, negligent and egregious. But what robo-signing and other documentary failures do *not* do—despite what some advocates claim—is nullify the right *by someone* to foreclose on a defaulted mortgage. Lenders don't forfeit their right to collect on a loan just because of faulty paperwork. If a robo-signing lender "cures" these defects, an otherwise legitimate foreclosure will proceed.

There are, in fact, two important limitations to the Massachusetts ruling that potential litigants should heed:

The Massachusetts court did not nullify the underlying mortgage debt owed by the homeowners.

The court simply ruled that the particular foreclosing banks did not adequately show they had the contractual right to enforce the loan. The court did not foreclose the possibility of another party being able to collect on the debt if it can show it has the right to do so.

Here's a common sense version of what this means: Say that John lends Jane \$100 and writes an IOU to that effect. If John loses the IOU, Jane still owes \$100—she doesn't get to keep the cash for free. Now say that John moves to Australia and hires Bob to collect the \$100 for him. While Jane may protest that Bob lacks the legal authority to collect the loan on John's behalf, the underlying obligation still stands—she owes someone \$100. Moreover, Bob does not need to produce the original IOU to prove that he's entitled to collect on John's behalf. All he needs is a signed agreement with John "assigning" John's right to collect to Bob.

This hypothetical is actually not that different from what happened in the Massachusetts case. The banks were the equivalent of "Bob" in the preceding example, except that they did not fulfill the legal requirements necessary to act as if they had stepped into the shoes of the original lender. But nothing changes the fact that a borrower still owes the original loan, and by defaulting on a mortgage, borrowers are in breach of their original contracts. The Massachusetts case does not mean that homeowners are now entitled to a free ride on their loans.

The Massachusetts court did not question the validity of the securitization process.

While the court questioned whether the mortgages involved in the case had been validly assigned to a securitization trust (apparently the mortgages were not included on the list of securitized loans), the court did not challenge the process of securitization itself.

Thus, the Massachusetts ruling does not validate the so-called "produce the note" phenomenon now gaining favor among some advocates, in which homeowners challenge foreclosures on the grounds that "those initiating foreclosure proceedings on behalf of securitized pools of mortgage loans had no right to do so, because they couldn't prove they actually owned the debt."³

According to *The Huffington Post*, lawyers pursuing this tactic have helped some homeowners stay in their homes for as long as five years after foreclosure proceedings have begun.⁴ As a result, there are even analyses circulating inside the financial services industry that "in order for the mortgage note to be sold or transferred to someone else (and therefore turned into a mortgage-backed security), this document has to be physically endorsed to the next person."⁵

Securitization is a practice that began in 1970⁶ when the first mortgage-backed securities were issued.* It is also specifically sanctioned under the Uniform Commercial Code (UCC), which has been adopted by all 50 states and which governs all commercial transactions including real estate. In fact, states adopted a series of revisions to the Uniform Commercial Code in 2001 precisely to clarify the legal issues surrounding the securitization of mortgage loans.⁷ Under the UCC, physical possession of the note and the mortgage⁸ are *not required* to enforce the loan.[†]

Three steps to fixing “Foreclosure-gate”

Despite the limitations of the Massachusetts ruling, it’s nevertheless likely that this decision will be construed far more broadly than it should be and could potentially encourage needless litigation on foreclosures that should not be challenged.

To date, there’s been no evidence that lenders have been initiating en masse foreclosure proceedings against borrowers who are not delinquent or in default. According to Bank of America’s CEO Brian Moynihan, as many as 80% of foreclosure sales in the second quarter of 2010 involved borrowers who had not made a payment in a year.⁹

As the law makes clear, if a foreclosure proceeding is otherwise justified (i.e. the borrower isn’t paying the loan), documentary failures don’t nullify a lender’s underlying right to a remedy. (This is why a blanket foreclosure moratorium is needless as well as harmful.)

Nevertheless, there have been reports of legitimate cases where a borrower in the process of a modification or short sale found that process short-circuited by a rubberstamped, robo-signed foreclosure—resulting in genuine harm to the borrower. Moreover, banks have undeniably engaged in irresponsible, if not reprehensible behavior, and should be held to account.

The three-step solution described below is one possible way to address genuine grievances by homeowners and bring lenders into compliance, while at the same time promoting more certainty in the markets.

* A related set of misunderstandings underlies the problem with MERS, the electronic mortgage registry that has also come under question complicating the question of legal title. This is a separate issue that will be addressed in a later memo.

† In legalese, Section 309(4) of Article 9 of the UCC provides that in the case of sales of promissory notes, the security interest in those notes is automatically “perfected” upon “attachment.” This means that the execution of a valid sales agreement to sell the note is all that’s needed to transfer the obligation—the buyer of the notes doesn’t also need to gain possession of the notes to “perfect” a security interest (i.e. make it enforceable). Nor does the buyer of a note need to gain possession of the underlying mortgage to have an enforceable obligation. Under Section 203(b) of the UCC, whomever holds an interest in the note also essentially holds the mortgage (a doctrine called “the mortgage follows the note”).

Step 1: Protecting injured homeowners

Rather than a blanket moratorium, we propose a “surgical intervention” aimed specifically at five categories of borrowers who suffered real harm from a robo-signed or slipshod foreclosure:

- **Mistaken foreclosures.** These are borrowers who have been current on their mortgage payments and against whom a foreclosure proceeding should never have been filed.
- **Pending modifications.** These are borrowers who had previously requested a modification but essentially lost their chance at a modification because of a robo-signed foreclosure.
- **Pending short sales.** These are borrowers who were in the process of having a short sale of their home approved but lost their chance at an approval because of a robo-signed foreclosure. In most cases, when presented with the option of approving a short sale or going through with foreclosure proceedings, time and costs would dictate the former be the most logical outcome.
- **Borrowers catching up.** These are borrowers who may have been delinquent on their mortgage but who made a payment and were foreclosed on anyway because of a faulty process that failed to take that payment into account.

These aggrieved borrowers should be entitled to four things: (1) the immediate suspension of foreclosure proceedings; (2) the right to sue for actual damages caused by a wrongful signed foreclosure; (3) access to a 30-day expedited application process for loan modification if they have an application pending (but without a guarantee the modification will be granted); and (4) a refund of any fees and charges assessed by the bank, as well as protection from any deficiency judgments (if a borrower was seeking a modification or short sale).

Ideally, banks should step up to deliver the remedies described above in (1), (3) and (4). But in the absence of proactive action by the banks, the newly created Consumer Financial Protection Bureau (CFPB), together with the Federal Housing Administration and HUD, might be well-suited to take on the task of regulating and enforcing this expedited review process.[‡]

Step 2: Keeping the housing market moving

The potential existence of thousands of foreclosures with faulty paperwork could prove to be a litigation bonanza—but one that in many cases only forestalls the inevitable while creating continued uncertainty for buyers and investors. In fact, the threat of continued litigation could hamper the housing market significantly:

[‡] As a future paper will address, this process could provide a new model for standardizing and “triaging” candidates for modification so that borrowers with the best chance of a successful modification move quickly through the process

- Buyers may be reluctant to buy a foreclosed property if they are concerned the foreclosure could be challenged and their purchase nullified;
- Title insurers may refuse to issue policies or raise their premiums if they are concerned that a challenged foreclosure could cloud the title on a future sale; and
- Investors in mortgage-backed securities may demand higher premiums (which will eventually result in higher interest rates for borrowers) to compensate for the risk of litigation.

To bring clarity and certainty to the market, Congress should enact the following: (1) a “safe harbor” barring paperwork-related litigation on certain foreclosures; and (2) a statute of limitations to limit the time period in which suits can be brought.

Safe Harbor

This proposal would be similar to that offered up by Federal Deposit Insurance Corporation (FDIC) Chair Sheila Bair, who recently proposed the notion of a safe harbor. Specifically, Bair proposed that foreclosures be allowed to proceed “if the property is vacant or if the lender/servicer offered a meaningful payment reduction — say a minimum of 25%—and the borrower could still not perform on the loan.”¹⁰ Following similar reasoning, Congress could enact a safe harbor barring lawsuits to challenge foreclosures in two circumstances where a delay would be especially fruitless—in the case of vacant or abandoned homes, and in the case of loans that have been in default for 18 months or more.

No foreclosure challenges on vacant or abandoned homes. According to news reports, one in three homes in the process of foreclosure is vacant.¹¹ Processing foreclosures on vacant homes is essential to restoring the housing market. In the second quarter of 2010, as many as 18.9 million homes stood vacant.¹²

Vacant homes are not only drains on local municipalities such as police and fire resources while offering no tax revenue to the burdened communities; they attract crime and depreciate home values via urban blight. As housing expert Allan Mallach notes, “...it is critical to understand that even one vacant, boarded-up property can undermine the vitality of an entire city block.”¹³ One study found, for example, that “the presence of an abandoned house on a block reduces the value of all the other property by an average of \$6,720.”¹⁴ (This study, however, was in 2001, and it’s likely that the damage done today by a vacant home in the neighborhood far exceeds that amount.)

Borrowers on vacant homes (many of whom have likely “strategically defaulted” and walked away) should not be allowed to challenge a foreclosure so that a vacant home stays vacant still longer and can’t be returned to the available housing stock.

No foreclosure challenges on severely defaulted loans. Borrowers who defaulted 18 months ago and have not cured are people who will likely never catch up on their mortgage. These borrowers might be facing a payment that they simply cannot afford under any circumstances, or they may be suffering from a prolonged bout of unemployment. They may also have opted for a strategic default. These borrowers also belong in the category of an “inevitable” foreclosure that a lawsuit will not ultimately prevent.

Statute of Limitations

In addition to the safe harbor, Congress should enact a 12-month statute of limitations⁵ for when a paperwork-related lawsuit can be filed. (In the 23 states where a court must approve a foreclosure, the “clock” on the statute of limitations would begin to run from the date that a homeowner received notice of an approved foreclosure proceeding.)

This time period is long enough both to provide ample opportunity for injured parties to file legitimate lawsuits against the banks while also giving investors and buyers a deadline for certainty. It is also long enough to give banks enough time to accommodate modifications and approve short sales but not so short that banks can simply wait out the problem and fail to act on improving their procedures.

Step 3: Preventing future failures

A limited safe harbor provision, subject to the conditions mentioned, is both necessary and justified to prevent unnecessary litigation from bringing the housing market to a halt.

What it emphatically does *not* do is shield bad actors from the consequences of their behavior. A safe harbor and statute of limitations will do nothing to protect banks and their lawyers from the investigations currently underway by state attorneys’ general across the country.¹⁵ Nor will it prevent disbarment and other consequences that are likely to be suffered by lawyers at the “foreclosure mills” at the heart of the robo-signing scandal. The now infamous firm headed by David J. Stern in Florida, for example, “has seen its fortunes plummet, with major clients, like Fannie Mae, Freddie Mac, and Citigroup, cutting ties to Stern. Stern’s operation has also laid off hundreds of employees in recent weeks.”¹⁶

While regulators ensure that bad actors get their just desserts, they should also focus on improving future paperwork compliance. The CFPB, for example, should consider creating standardized guidelines for ensuring “due diligence” in the foreclosure process that comports with state-specific requirements. Such standardization may actually benefit the banks by making foreclosures proceed more smoothly. By ensuring that the paperwork was right the first time, foreclosures will be less likely to be challenged or challenged successfully.

Conclusion

Banks, investors, homebuyers and regulators all bear some share of the blame for the circumstances that created the housing bubble to begin with and that led to the

⁵ Precedents for a one-year statute of limitations include Section 13 of the Securities Act of 1933, which limits civil claims brought under Sections 11 and 12(a)(2) to one year after the discovery of a false or misleading statement in a prospectus. Given the acute amount of scrutiny that robo-signing is receiving, it’s unlikely that a currently delinquent homeowner in the process of foreclosure would wait a year to challenge the paperwork.

eventual crisis. The current controversy over paperwork is likely only the beginning of the eventual problems the housing industry will face as it “deleverages” the excesses of the bubble years.

The three-step solution above attempts to fairly allocate responsibility among all parties while advocating pragmatic steps that will move the housing market back to health as quickly as possible.

Endnotes

¹ See, for example, Thom Weidlich, "Banks Lose Pivotal Foreclosure Case in Massachusetts High Court," *Bloomberg*, January 7, 2011, Accessed January 10, 2011. Available at: <http://www.bloomberg.com/news/2011-01-07/us-bancorp-wells-fargo-lose-pivotal-massachusetts-foreclosure-case.html>.

² Rex Nutting, "Housing is the forgotten crisis", *MarketWatch*, December 15, 2010, Accessed January 10, 2011. Available at: <http://www.marketwatch.com/story/housing-is-the-forgotten-crisis-2010-12-15>.

³ Shahien Nashiripour and Ryan Grim, "Who Owns Your Mortgage? 'Produce the Note' Movement Helps Stall Foreclosures," *The Huffington Post*, June 17, 2010, Accessed October 29, 2010. Available at: http://www.huffingtonpost.com/2009/09/22/whos-got-the-mortgage-pro_n_294169.html.

⁴ *Ibid.*

⁵ This quote was taken from the text of an email forwarded to the authors that has received wide circulation inside the financial services industry. The original author is unknown.

⁶ United States, Congress, House of Representatives, Subcommittee on Housing and Community Opportunity, Subcommittee on Financial Institutions and Consumer Credit, "Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit," Statement of Cameron Cowan on behalf of the American Securitization Forum, 108th Congress, 1st Session, November 5, 2003, Accessed January 10, 2011. Available at: <http://www.riskcenter.com.tr/risknews/risknewsfiles/gls14.pdf>.

⁷ Lech Kalembka, "Revised Article 9 of the Uniform Commercial Code: An Introduction," Cadwalader, Wickersham & Taft LLP, 2000, Accessed January 10, 2011. Available at: <http://library.findlaw.com/2000/Apr/1/129031.html>.

⁸ For a primer on title law, see for example, Karen Gelernt, "Viewpoint: Title Transfer Law 101," *American Banker*, October, 19, 2010, Accessed January 10, 2011. Available at: <http://www.cadwalader.com/assets/article/101910GelerntAmericanBanker.pdf>.

⁹ "On the Call: Bank of America CEO Bryan Moynihan," *Associated Press*, October 19, 2010, Accessed November 1, 2010. Available at: <http://abcnews.go.com/Business/wireStory?id=10397888>.

¹⁰ Ronald D. Orol, "Bair backs "safe harbor" plan on foreclosures," *The Wall Street Journal*, Market Watch, October 25, 2010, Accessed November 2, 2010. Available at: <http://www.marketwatch.com/story/bair-backs-safe-harbor-plan-on-foreclosures-2010-10-25>.

¹¹ Stephen Meister, "Foreclosure-Gate is Quickly Spinning out of Control," *Real Clear Markets*, October 22, 2010, Accessed November 1, 2010. Available at: <http://www.realeclearmarkets.com/articles/2010/10/22/foreclosure-gate-is-quickly-spinning-out-of-control.html>.

¹² United States, Department of Commerce, Census Bureau, "Residential Vacancies and Homeownership in the Second Quarter 2010," *U.S. Census Bureau News*, July 27, 2010, Accessed October 14, 2010. Available at: <http://www.census.gov/hhes/www/housing/hvs/qtr210/files/q210press.pdf>.

¹³ Alan Mallach, "How to Spend \$3.92 Billion: Stabilizing Neighborhoods by Addressing Foreclosed and Abandoned Properties," *Discussion Papers*, Federal Reserve Bank of Philadelphia, October 2008, Accessed November 2, 2010. Available at: http://philadelphiafed.org/community-development/publications/discussion-papers/DiscussionPapers_Mallach_10_08_final.pdf.

¹⁴ "Blight Free Philadelphia: A Public-Private Strategy to Create and Enhance Neighborhood Value," Executive Summary, Eastern Pennsylvania Organizing Project and The Temple University Center for Public Policy, October 2001, p. iv, Accessed November 2, 2010. Available at: <http://astro.temple.edu/~ashlay/blight.pdf>.

¹⁵ Dawn Wotapka, "UPDATE:50 State Attys General Investigate Mortgage Servicers," *The Wall Street Journal*, Dow Jones Newswires, October 13, 2010, Accessed January 11, 2011. Available at: <http://online.wsj.com/article/BT-CO-20101013-710815.html>.

¹⁶ Andy Kroll, "Inside Foreclosure King David Stern's Downfall," *Mother Jones*, November 4, 2010, Accessed January 10, 2011. Available at: <http://motherjones.com/mojo/2010/11/david-stern-foreclosure-djsp-enterprises>.

Mortgage Loan Modification: Promises and Pitfalls

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I. INTRODUCTION

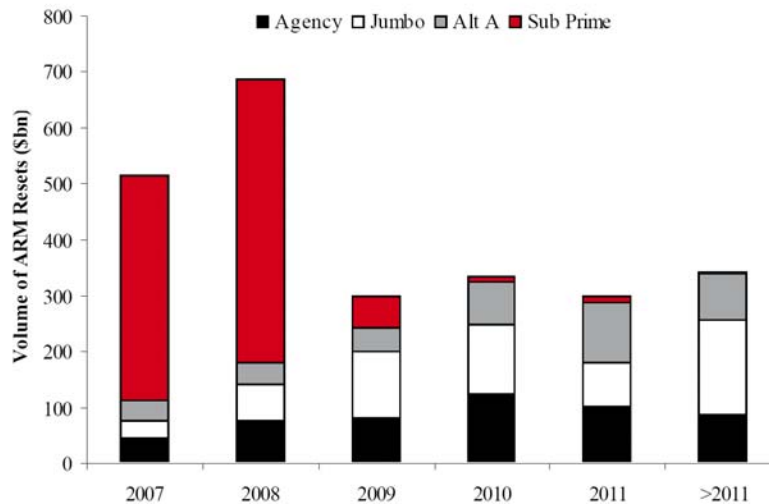
Problems in the US mortgage industry have led many disparate authorities to consider numerous ways to insulate borrowers from the effects of their loan payments, and therefore ameliorate the short-term economic impact of the current market crisis.

Clearly the problem is large. Leaving the alt-A and jumbo sectors aside, subprime mortgages alone currently amount to about 13% of total mortgage loans outstanding, or about \$1.2 trillion. It is estimated that in 2007 alone, about \$400 million in subprime loans will face adjustable-rate interest increases, which in some cases can result in payment increases of 150 percent or more and borrower pre-tax debt-to-income ratios of up to 65 percent (it is common to consider a debt-to-income ratio of 40 percent or below as prudent). As Figure 1 shows, 2008 is expected to be worse.

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FIGURE 1: SUBPRIME MORTGAGE RESETS IN 2007 AND THE FUTURE

Significant Subprime Reset in '07 and '08



Source: Bloomberg, FactSet.

Source: Bank of America, "Subprime Mortgage Finance Weekly: Subprime Loan Modifications – not a Panacea," May 25, 2007.

The current subprime delinquency ratio is about 15 percent (\$180 billion) of outstanding subprime mortgages, a 14-year high. Even if all subprime mortgage loans currently in delinquency do not go into foreclosure, it is easy to imagine the ratio rising further to create a crisis on par with the thrift crisis of the late 1980s, which is equal to about \$150 billion in inflation-adjusted terms.¹

Each delinquency and foreclosure is costly to administer. The cost of a typical foreclosure has been estimated to be about \$60,000, or about 20-25 percent of the loan balance (legal fees alone can cost \$4,000), and those costs are expected to be higher in times of home price depreciation.² Hence, it is logical for lenders to try to avoid foreclosures through loan modification.

Fitch Ratings recently suggested that as many as two-thirds of existing delinquencies can be expected to be modified over the next 12-18 months. Among such loans, modification might be the *only* viable alternative to foreclosure for as many as 50% of the loans in default or facing a default scenario.³

There are three major problems with this strategy. First, a modification effort of this magnitude is far beyond the existing modification capacity of the industry. Most servicers currently modify less than 1 percent of their loans, so increasing to 10 or 20 percent represents growth of 1,000- 2,000 percent. Second, while

1. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007. I derive this figure using \$100 billion and adjusting for inflation from 1991-2006 with CPI.

2. *Id.*

3. Gabrielle Stein, *Loan Modifications Pick Up Pace Despite Speed Bumps*. ASSET SECURITIZATION REPORT, Jun. 18, 2007.

modification may be less costly than foreclosure (although this is far from certain), the difference could well be negligible. Third, the authorities calling for massive modification efforts must realize that, “Payment deferral will not help people who inflated incomes or recklessly bought properties they could not afford.” Since, by some estimates, borrowers inflated their stated income by 50 percent or more in 70 percent of loans, it could be that few of the loans currently experiencing difficulties can benefit from modifications that would preserve any reasonably economic lending arrangement for borrower and lender alike.⁴

If modifications are given to borrowers that are not well suited for homeownership in the long term the loan modification only serves to delay the inevitable while keeping the borrower in a (somewhat milder) state of financial distress. In such cases, the borrower may be better off moving to more affordable housing today rather than continuing to pressure their finances chasing the unobtainable chimera of “homeownership.” Furthermore, modifications granted to unsuitable borrowers may be considered predatory. On top of all this, thin preliminary data (provided by those with successful modification programs) suggest that modified loans experience a 35-40 percent redefault rate over the following two years. Hence, predatory or not, relatively few loan modifications “work,” that is, help the borrower ultimately afford the home.

It appears, therefore, that the main purpose of loan modification is to skew financial reporting of delinquencies. In other words, modifying loans helps borrowers to make a few payments, allowing lenders to aggressively reage the accounts and classify them as “current,” instead of “delinquent.” Such practices appear to have been a key mechanism in supporting paper earnings of many failed subprime lenders prior to bankruptcy. Hence, without regulatory oversight or increased transparency, it is hard to imagine that borrowers will benefit from modification in the long run.

The report that follows looks at the promises and pitfalls of loan modification. Section II illustrates the costs and benefits of modification. As stated above, while delinquencies and foreclosures are long and costly to the servicer, industry inexperience with modification, the potential lack of suitable loans for modification efforts, and the sheer cost of the efforts may limit the usefulness of the approach to a level far below that which can cushion the harmful economic effects precipitated by the current crisis. Section III shows that predatory servicing has been a problem in the recent past and modification, too, can be predatory if it does not truly help borrowers afford homes in any meaningful sense. Redefault rates from modifications are high, and modification has been misused in the past, in conjunction with reaging, to skew financial performance. With no regulatory authority to oversee modification and reaging policies and little transparency with respect to those arrangements, it is quite possible that extensive modification will hurt consumers and investors alike. Again.

4. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007 at 4.

II. THE COSTS AND BENEFITS OF MODIFICATION ARE NOT CLEAR

Loan modification is used to avoid defaults, which are costly to servicers. Mortgage loan servicers are typically remunerated on the basis of a servicing fee of between 12.5 and 50 basis points of the outstanding principal balance. The flat servicing fee can be augmented with equity incentives, residual first-loss investment stakes that give the servicer an incentive to maximize cash flow from the loans. The total value of the direct fees and equity incentives are included on servicers' balance sheets as mortgage servicing rights (MSRs). MSRs are the net present value of the series of uncertain direct service fee payments. MSRs are difficult to value with any degree of certainty and the valuations that result can be very volatile to actual conditions realized in the servicing pool.⁵

Default costs create not only large direct costs – in terms of increased telephone call, mailing, legal, and administrative costs – but also substantial cash flow difficulties. Cash flow difficulties arise because the legal and other costs related to foreclosing upon and selling repossessed real estate, while ultimately reimbursable from the trust, are only reimbursed when the collateral is sold. “Advancing” funds in such circumstances can substantially disrupt the cash flows of the servicing entity. If the servicer does not have cash on hand to cover the cash flows those advances must be funded in the interim through borrowings, and while the direct costs of the disposition are reimbursed, the funding costs are not. Advances can remain outstanding for a long time because the foreclosure process itself is lengthy, *averaging* almost a year-and-a-half from missed payment to sale of the property in a healthy market.⁶

Servicers, therefore, engage a variety of different strategies to avoid the costs of default, but modification incurs other, new, costs. Modification strategies in the most general sense include a wide range of proactive loss mitigation tools like payment plans⁷ and loan modifications.⁸ Loan modifications may include a permanent reduction in rates, extending the term of the loan to reduce monthly payments, deferring prior missed payments and adding them to the principal balance, and reset shock modification where the terms of the loan are adjusted to mitigate the payment shock.⁹

5. The vast majority of bank failures since 1992 have involved substantial issues of MSR and residual valuations. Nonetheless, many of the top mortgage servicers derive a great deal of their value from equity incentives and MSRs. WaMu's MSRs amount to 23 percent of their capital, IndyMac's amount to 90 percent of their capital, and Countrywide's amount to 115 percent of their capital. Having MSRs worth more than the value of capital creates a high risk that valuation difficulties can wipe out a substantial portion of a firm's underlying capital with the stroke of a pen.

6. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

7. In the case of temporary financial hardship, servicers often put borrowers on repayment or forbearance plans to make up missed payments over a short period of time. These plans do not change the contractual obligations of the original loan terms.

8. Loan modifications are designed to assist borrowers in financial distress who are unable to meet their mortgage obligation under the existing contractual terms of the loan by providing more favorable terms which will enable the borrower to make monthly payments to stay current or cure the loan.

9. Merrill Lynch, *Mortgage Credit Losses: How Much, Where, and When?*, Jul. 20, 2007. See also Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

Each of those choices effectively reduces the borrower’s loan payment, but not necessarily the total price paid by the borrower over the life of the loan. From the servicer’s perspective, therefore, each alters cash flow expectations arising from the loan, therefore altering MSR and residual valuations.

The present section examines the magnitude of the cash flow disruptions that occur from default management and relate those to the potential for loan modification programs.

A. Servicers are Using Modification in Attempts to Avoid Costly Defaults, Foreclosures, and Advances

Figure 2 illustrates the default, foreclosure, and disposition process whose costs servicers attempt to avoid through modification. Note first that the process is lengthy, as mentioned above, taking an average year-and-a-half to complete in a healthy economic and real estate market environment. Note further that the servicer must not only advance legal fees, property taxes, maintenance fees (12 percent of principal balance), and transaction and broker fees during the process, but also maintain coupon payments to mortgage-backed securities investors until the process is complete, the losses can be properly accounted for.

FIGURE 2: MORTGAGE DELINQUENCY AND FORECLOSURE TIMELINE



Source: Bank of America, *The Hidden Credit Costs of Mortgage Servicers*, Specialty and Mortgage Finance Weekly Mar. 23, 2007.

Adding just the cost of temporarily *funding* those reimbursable default costs into Bank of America’s servicing costs estimate raises the annual cost of servicing delinquent loans to over 2,000 percent the cost of servicing current loans and the cost of servicing foreclosed loans to 4,000 percent the level for current loans, or 20 to 40 times normal servicing costs. Bank of America gives the example of a \$144,000 mortgage with a fixed interest rate of 7.5 percent. The servicer earns a fixed servicing fee of 35 basis points. The results of the exercise are illustrated in Figure 3.

FIGURE 3: TOTAL ANNUALIZED SERVICING COST PER MORTGAGE LOAN

	Delinquent	Foreclosure	Performing Loan
Servicing Costs	\$51	\$51	\$51
Non-reimbursable	\$316	\$316	
Funding Costs for reimbursable expenses	\$659	\$1,086	
Reduction to MSR Fair Value		\$662	
Total Annualized Cost Per Loan	\$1,026	\$2,115	\$51

Source: Bank of America, *The Hidden Credit Costs of Mortgage Servicers*, Specialty and Mortgage Finance Weekly Mar. 23, 2007 at 7-8.

When the loan goes into default, the servicer has to advance coupon payments of \$10,798 per annum to investors and does not earn the annual servicing fee of \$504. Both will be reimbursed when (if) the loans becomes current, but in the meantime the servicer incurs \$659 annual funding costs at LIBOR plus 50 basis points. In foreclosure, the servicer also pays taxes and legal fees of \$5,759 annually and a 12 percent standard annual maintenance fee (to keep the house in marketable condition) of \$17,277. Funding those fees in addition to the coupon and servicing fee amounts to \$1,086 per annum at a rate of LIBOR plus 50 basis points.

Matters are further exacerbated by the effect of defaulted and foreclosed loans on MSR values, a significant source of servicer enterprise value. In each case, a loan did not remain in the performing pool, so the servicing fee revenue ended. If the servicing fee cash flow ends before originally expected, the MSR must be written down to reflect the decreased value of the servicing contract. Assuming that the average life of the loan in the previous example is six years, if the loan goes immediately into delinquency followed by default two years later, that represents roughly 4 years of foregone servicing fees. Bank of America calculates the average annual cost for a simulated sample of foreclosed loans as a function of the MSR portfolio to be 0.46 percent (based on an assumed fair value as percentage of MSR portfolio of 1.38 percent). That equates to a cost of \$662 per loan in foreclosure based on the example loan's unpaid balance of \$144,000. The results are also presented in Figure 3.

In summary, servicers' contractual funding needs can cause the cash costs for defaulted loans to swell significantly for about a year-and-a-half, until the servicer can complete the foreclosure and recovery process and obtain reimbursement. Since those costs can be expected to be higher and the process longer in poor economic and real estate market conditions, servicers should expect to endure substantial earnings pressure as they are squeezed between market conditions and funding needs.

B. ...but Modification, itself, is Expensive and the Benefits, for both Servicers and Borrowers, are Highly Uncertain

While most servicers claim that a well-managed loan modification program can save money over servicing through what has been illustrated above as an extremely costly delinquency and foreclosure process, loan modification is a relatively new function and, like the subprime mortgages that necessitate it, is untested in an economic downturn.

At Fitch's RMBS Servicer Workshop, held in May 2007, almost all servicers said that they "had not used modifications extensively as a loss mitigation tool in the past." And while "most indicated that they are preparing for significant increases in modification volume," the volume of modification necessary to address current market difficulties is unprecedented. Later Fitch Ratings reports that subprime servicers plan to resolve as many as 50-75 percent of defaults using various modification tools.¹⁰

Furthermore, not all borrowers will qualify for loan modifications. While the decision to modify a loan is not subject to oversight as is the decision to make the initial loan, modifications only make sense for a certain set of re-underwriting criteria. Moody's explains that servicers will have to, "...review the borrower's current financial situation and re-qualify the loan. It is not advantageous to modify a loan without knowing if the borrower can afford the modified obligations." Moody's also states that, "This will be particularly important for the large number of loans originated in recent years that were made to borrowers who merely stated their income and asset information instead of providing documented proof (so called "limited documentation" loans)."¹¹

Even with income and qualifications, loan modifications will not be applicable to all problematic borrowers. Loans originated with little documentation of income, where borrowers still cannot document sufficient income to qualify under today's tighter credit standards are poor candidates for modification. Borrowers with no equity in their home are also poor candidates for modification, as decreasing home values may lead them to default notwithstanding the level of their loan payment. Interest only and other extremely low payment loan borrowers probably cannot support an amortizing obligation regardless of interest rate, and are, again, poor candidates for modification, as are borrowers who have 40- and 50-year mortgages that are already stretching out payments for a longer period of time.¹²

As Mark Adelson, formerly of Nomura, stated, "...modifying loans for distressed borrowers is a labor-intensive process because the servicer must carefully evaluate each borrower's capacity to pay. The full cost of processing a loan modification can be in the range of \$500 to \$600. It is often necessary to visit the subject property and to interact with the borrower face-to-face."¹³ Because of the high cost involved, Litton Loan Servicing Vice President Shane Ross equates modification to "doubling-down" your bet: a highly risky proposition that you should not undertake without a full understanding of the risks. Ross points out that dramatic increases in loan modification work necessitate increasing, "your loss mitigation staff, your collections staff, your customer service staff,...your foreclosure staff," all at a time when servicing

10. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007; Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007; Fitch Ratings, *Changing Loss Mitigation Strategies for U.S. RMBS*, Jun. 4, 2007.

11. Moody's, *US Subprime Mortgage Market Update*, Apr. 2007.

12. Moody's, *Challenging Times for the US Subprime Mortgage Market*, Mar. 7, 2007.

13. Nomura, *Securitization & Real Estate Update*, May 18, 2007.

costs are skyrocketing and cash advance and funding needs are spiking. A highly risky business proposition.¹⁴

Legislative or regulatory intervention can easily upset the balance of discretion in loan modifications, imposing high costs on that already risky proposition. According to Chris Flanagan, managing director and head of global research at JPMorgan Securities, the whole premise of loan modifications is to allow the servicer to exercise independent discretion and evaluate borrowers individually to determine appropriate options available to them. If legislators or regulators require modifications to some group of borrowers regardless of their fundamental ability to make the loan payments successfully well into the future, that balance will be upset.¹⁵

At the end of the day, however, even a successful loan modification is harmful to lenders. Loan modifications reduce yields and the yield reduction will negatively impact residual valuations due to lower cash flow accrued to the trust. Since the servicer often owns an equity stake in the trust, the servicer is bound to lose.¹⁶

III. SINCE MODIFICATION IN AN UNREGULATED ENVIRONMENT CAUSED THE PRESENT DIFFICULTIES, IT DOES NOT MAKE SENSE TO ENCOURAGE MORE

The servicing industry has experienced problems in the past that should make those pressing for greater use of loan modifications generally wary. First, not too long ago, the industry was battling allegations of predatory servicing, or foreclosing on one class of borrowers more aggressively than others. If some classes of borrowers are more likely to receive loan modifications than others with equal credit characteristics, loan modifications may contain a predatory component as well.

Second, a sizeable proportion of modification agreements fail, in the sense that the borrower redefaults within 24 months. In such cases, the servicer spends the greater costs of default and foreclosure on top of the costs of earlier modification. Furthermore, the servicer may recover far less from the collateral due the extended period of borrower difficulties. On net, therefore, even existing modification efforts may not provide servicer cost savings. Extending a losing business proposition will require massive government subsidies now and in the future.

Third, in the late 1990s many segments of the consumer credit industry were found to be reaging loans aggressively to mask delinquencies. It seems that many failed non-bank subprime mortgage lenders have similarly used modification in conjunction with aggressive reaging to support portfolio performance more recently.

Last, it is important for proponents of widespread modification to understand that the practice lies outside fair lending laws, and there are no regulatory monitoring or enforcement authorities prepared to guard against predatory

14. Amilda Dymi, *Need for Loan Mods Will Persist*, NATIONAL MORTGAGE NEWS, May 28, 2007.

15. Karen Sibayan, *Panelists Reject Mandatory Loan Modifications*, ASSET SECURITIZATION REPORT, May 21, 2007.

16. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007.

modification, ensure prudent redefault rates, and impose reporting rules promoting transparency on reaging policy. Given that none of these risks are new, advocates would be wise to propose a more prudent measured expansion, and only after thorough and thoughtful consideration of the promises and the risks of widespread loan modification.

A. Predatory Servicing can be Extended to Modification

Predatory servicing was a common concern among regulatory officials and servicers in 2003 and 2004. In November 2003, Select Portfolio Servicing, Inc. (formerly Fairbanks Capital Corp.) signed a consent order with the Federal Trade Commission and the Department of Housing and Urban Development due to predatory servicing concerns. In April 2004, Ocwen Federal Bank FSB reached a supervisory agreement with the Office of Thrift Supervision (OTS) based on similar concerns. Soon after that, Ocwen Financial Corporation, Ocwen Federal Bank FSB's parent company, filed an Application for Voluntary Dissolution with the OTS in November 2004 to explore the possibility of the bank terminating its status as a federal savings bank under OTS and Federal Deposit Insurance Corporation supervision.¹⁷

Following those regulatory actions, many servicers re-evaluated their operations to identify potential exposure to predatory servicing concerns. Servicers implemented 100 percent call recording, itemized monthly statements, and issued paper notification to borrowers when fees are charged. Servicers added transparency to force-placed insurance programs (hazard insurance coverage that is assigned to mortgaged property when the borrower fails to maintain his or her own coverage) and reduced or eliminated ancillary fees.

One big concern of consumer advocates with respect to predatory servicing was quick foreclosure, particularly for lenders that refer loans to foreclosure in a 60 to 75 day timeframe following delinquency. In response to concerns that early foreclosures were not warranted, servicers added pre-foreclosure activities to ensure that collection and loss mitigation attempts on a loan were thorough and that proper notices were provided to the borrower. Loans were also reviewed pre-foreclosure for potential legal issues and headline risk that could be associated with a foreclosure action. Foreclosure referrals are now more common beginning after the 90th day of delinquency. But the new pre-foreclosure activities also paved the way for servicers to make more detailed loan-level decisions, including using more loan modifications.¹⁸

The fact that the opportunities for more loan modification originated from attempts to more thoroughly investigate loans prior to foreclosure to avoid predatory servicing concerns should not be a source of comfort. Rather, that means the processes surrounding modification are still new enough that they can be mis-applied to consumers' detriment.

The decision to modify a loan is identical to a decision to refinance a loan, but the modification decision is not currently treated as a new loan decision. That means that the modification proposal and acceptance by the consumer are not required to generate any of the records, disclosures, and restrictions placed upon

17. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

18. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

the new loan process. Therefore modifications can impose exorbitant fees or back-end payments or other conditions upon consumers without adequate record-keeping to pursue even a legal remedy.

The reason for concern lies in the fact that major industry groups and regulatory officials, having characterized the conditions for a successful modification as raising the net present value of the loan, have effectively advocated maximizing income to the lender as the primary goal of modification. Fitch Ratings reports that servicers express, "the belief that that ultimate loss to the transaction should be the only consideration in determining the execution of the best loss mitigation strategy."¹⁹

Even Moody's recognizes, however, that if borrowers cannot meaningfully qualify for a modified loan under transparent and duly reported and defensible underwriting guidelines, the modification may, "simply serve to postpone an eventual foreclosure and increase, rather than decrease, the ultimate loss on the loan."²⁰ Work by JP Morgan prior to the present market difficulties illustrates that the kinds of flags that can indicate predatory modification are, "...liberal repayment terms with extended amortizations, moving accounts from one workout program to another, multiple re-aging and poor monitoring of performance. *Principal reduction should be the main goal of workout programs, not maximizing income recognition* [emphasis added]." Servicing that does not promote principal reduction can therefore be considered predatory.²¹

B. Significant Borrower Redefaults Hurt both Lenders and Homeowners

Modification does not always work. Fitch Ratings reports that a good modification program has only a 60-65 percent success rate. That means that some 35-40 percent of borrowers redefault on their loans within 12-24 months. Furthermore, as of June 2007, many servicers reported to Fitch Ratings that repayment and forbearance plan effectiveness is decreasing and that modification is not, "...expected to work for borrowers facing ARM resets, as many of the borrowers are expected to default upon reset because they will not be able to afford the new monthly payments."²²

Figure 4 shows that the type of success illustrated by respondents to Fitch Ratings may be optimistic or unrepresentative. Moody's reports that strong servicers can achieve success rates of 52 percent or more following modification, but that average servicers only achieved a 31-40 percent success rate. Participants at a May 2007 American Securitization Forum panel on servicing opined that, "It seems reasonable to expect that a company of merely average abilities and operating during stressful times would experience a somewhat higher rate of re-defaults. Also, ... a typical servicer does not have the incentive of first-loss credit exposure on the loans (i.e., no "skin in the game") and gets paid the same fee regardless of the effort and expense of servicing a loan. The \$64,000 question is

19. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

20. Moody's, *US Subprime Mortgage Market Update*, Apr. 2007.

21. JP Morgan, *ABS Monitor 2003 Year Ahead Outlook*, Dec. 23, 2003.

22. Fitch Ratings, *Changing Loss Mitigation Strategies for U.S. RMBS*, Jun. 4, 2007.

whether the higher re-default rate would be just a little higher than 35 percent (e.g. 40 percent) or much, much higher (e.g., 65 percent). Only time will tell.”²³

FIGURE 4: 12-MONTH LOAN RESOLUTION PERFORMANCE INDICATORS FOR SUBPRIME LOANS

	Total Cure and Cash Flowing	Losses with Loss Mitigation
Strong	> 52%	> 23%
Above Average	41% - 51%	19% - 22%
Average	31% - 40%	9% - 18%

Note 1: The population of loans was seasoned between two and five years.

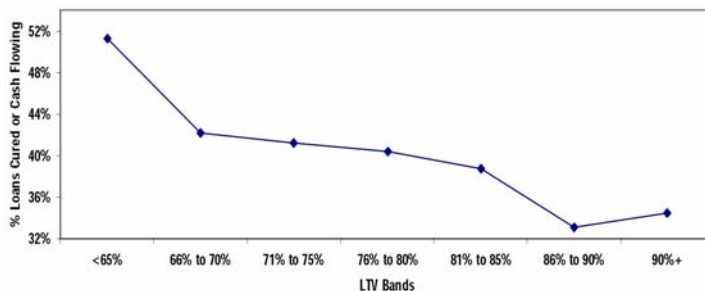
Note 2: "Total Cure and Cash Flowing" includes the percentage of loans that began a 12-month static pool analysis as 90+ days delinquent, in foreclosure, or in bankruptcy which were fully paid-off, current, performing on a forbearance plan, modified, 30 days delinquent, 60 days delinquent, or current on a bankruptcy plan at the end of the static pool period.

Note 3: "Losses With Loss Mitigation" includes the percentage of loans that were resolved from a short sale, short payoff, deed-in-lieu, or third-party sale as a percentage of total losses.

Source: Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

Figure 5 shows that success varies significantly with the type of loan modified. Figure 5 shows that the highest success rates lie with loans below 66 percent LTV, hardly the borrowers most in need. Hence, the modification decision, like the original loan underwriting decision, is a complex multidimensional decision that needs to be made according to a set of transparent consistently-applied underwriting criteria.

FIGURE 5: AVERAGE 12-MONTH TOTAL CURE AND CASH FLOW RATES, BY LTV BAND

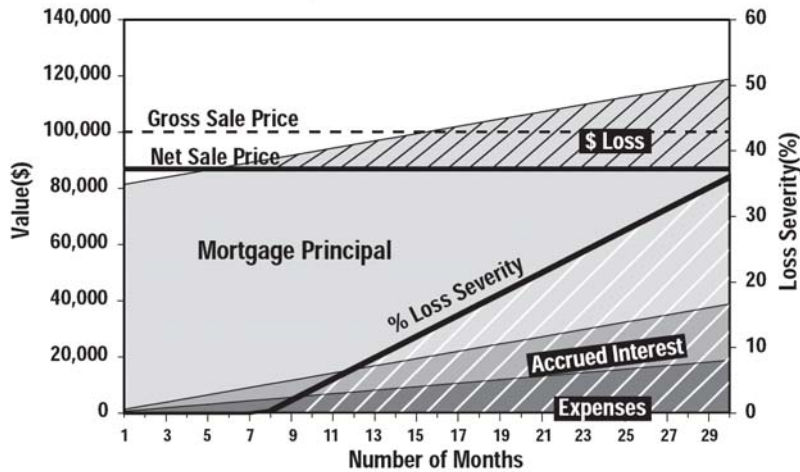


Source: Moody's, *2005 Review and 2006 Outlook: US Servicer Ratings*, Jan. 24, 2006.

One significant risk with respect to redefaults is that the eventual recovery rates of redefaulted modified loans will be far less than loans foreclosed immediately, without modification attempts. Figure 6 reflects the accepted wisdom that it is wisest to seize the collateral as soon as possible so that the collateral does not deteriorate unduly in the hands of a borrower who foresees the inevitable foreclosure. Hence, typical industry research like that by Moody's presented in Figure 6 shows that loss severity rises with time in distress.

23. Nomura, *Securitization & Real Estate Update*, May 18, 2007.

FIGURE 6: LOSS SEVERITY INCREASES WITH TIME: EXAMPLE WITH AN 80% LTV LOAN



Source: Moody's, *Special Servicing and Default Management in the Subprime Mortgage Market: The Loan Doctors*, April 1999.

Modification willingly gives up that extra time. If the redefault rate is 50 percent, but ultimate losses are twice as large, the financial effects of modification to the servicer are moot. Hence, the logic of modification flies in the face of traditional banking thought. It is not surprising that some servicers participating in Fitch's RMBS Servicer Workshop remain unconvinced by contemporary claims about modification, expressing concerns that, "redefaults for modified loans, ... could result in higher ultimate losses to the trust."²⁴

C. *Modification and Reaging Work together to Skew Reported Delinquencies*

Reaging policy has to do with when it is prudent to consider a once-delinquent borrower current again. Reage is defined to mean "returning a delinquent, open-end account to current status without collecting the total amount of principal, interest, and fees that are contractually due."²⁵ In prime loan portfolios with few delinquencies reaging policy has little effect on reported financial performance. But in subprime loan portfolios with large delinquencies reaging is a powerful tool to skew reported financial performance.

Before the advent of subprime lending, servicers typically had wide discretion to set and disclose aggressive or conservative reaging policies. Reaging is problematic because a lender that requires three consecutive on-time payments in order to reclassify borrowers as current will carry a lot more delinquencies on its books than a lender that requires only one on-time payment in order to reclassify borrowers as current. Modification policies can help pull delinquencies down even further by assisting the borrower in making that one on-time payment necessary to reclassify the loan under the aggressive reaging policy. Hence, it is not surprising that reaging policy remains of great concern to investors throughout the mortgage industry, including mortgage lenders, servicers, and MBS.

24. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

25. *Notices*, 65 FEDERAL REGISTER 113, Jun. 12, 2000 at 36905-6.

Reaging policy was once an arcane backwater concern of a small segment of the industry that dealt with applying special servicing policies to defaulted loans. But that sector of the industry began to grow fast with the evolution of subprime home equity lending in the late 1990s and subprime first-lien lending more recently. According to Nomura, in 1998, there was already about \$1 billion of RMBS issuance backed by “scratch and dent” mortgage loans (including re-performing, non-performing, sub-performing, out of guideline, and document deficient loans). By 2002, the sector had grown to about \$9 billion of issuance, or about 5 percent of the subprime universe. Spreads on triple-A tranches can be from 10 bp to 50 bp wider than spreads on regular sub-prime RMBS, reflecting the greater risk involved.²⁶

Early on in the development of subprime lending, it was commonly known that one way to spruce up scratch and dent pools was through aggressive reaging, which can skew financial ratios and mask true pool performance. After much regulatory wrangling with the problem, in 2000, regulators established reaging standards for federally-supervised financial institutions.²⁷

Those regulations, however, did not affect non-bank mortgage lenders, non-bank servicers, or securitization trusts, which all lay outside federal regulatory authority and, we have recently learned, have underwritten the majority of recent subprime mortgages. They also did not alleviate the problem of interpreting delinquency levels among *federally-regulated* institutions, leading to a December 2005 rulemaking announcement that stipulated, “Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk.”²⁸

Re-Aging, Extensions, Deferrals, Renewals, and Rewrites³

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-aging, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution’s management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution’s personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
- Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained

26. Nomura Fixed Income Research, *Report from Arizona: Coverage of Selected Sessions of the February 2003 Securitization Conferences*, Feb. 18, 2003.

27. *Notices*, 65 FEDERAL REGISTER 113, Jun. 12, 2000 at 36905-6.

28. *Notices*, 70 FEDERAL REGISTER 249, Dec. 29, 2005 at 77257.

The problem is still a widespread industry concern, among both federally-regulated and non-federally regulated institutions. In 2003, well after the Federal regulatory rules, Nomura wrote that a key, "...problem for the sub-prime mortgage sector in general is that some servicers and special servicers characterize loans as 30-days delinquent when in fact they should be classified in more severe delinquency categories. The problem stems from lenders "re-aging" loans in forbearance and loans subject to payment plans or bankruptcy plans."²⁹

Little has changed since 2003. In May 2007, Bank of America recently wrote, "...even in the case of successful workouts... true credit exposure will be masked because worked out loans are considered performing and will no longer be disclosed once they are disseminated into the performing loan pools. The credit ratios going forward should be distorted and are no longer reflecting the real credit exposure. For these reasons, going forward, we believe investors should focus on static pool yield changes, instead of credit ratios, as a credit performance indicator of the existing loan portfolios and static securitization pools."³⁰

Nomura expressed similar concerns as early as 1997, in particular noting the incentive problems for servicers who may hold residual equity incentives. Nomura points out that, "...modifications favor the interests of subordinate and residual classes by delaying the recognition of losses and the writedown of those classes." Nomura notes further that, "...the treatment of modified loans under performance covenants (trigger tests) that allow the release of principal to subordinate and residual classes. If modified loans are treated as 'current,' a substantial amount of cash flow may be released to subordinate and residual classes while the risk to the senior classes rises. We think that the better approach is to treat modified loans as delinquent for purposes of trigger tests. We also think that this is the area that is most likely to spawn litigation, both between investors and servicers and among competing classes of investors."³¹

In summary, "The shortcomings of ABS/MBS disclosure have long been recognized. For example, in January 1996, Moody's emphasized the issue of ABS disclosure as a key challenge for the market."³² In the eleven years since Moody's published that opinion, few of those concerns have been addressed. Modification has already been used in conjunction with reaging to mask financial condition and it is already an active concern for market participants, notwithstanding the small amount of modifications being used in today's marketplace. Hence, expanding modification efforts to ten or twenty times their existing level runs the risk of confusing MBS and mortgage lender investors even more, which will cause them to pull back from the marketplace even more dramatically than has already occurred.

29. Nomura Fixed Income *Research, Report from Arizona: Coverage of Selected Sessions of the February 2003 Securitization Conferences*, Feb, 18, 2003.

30. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007. See also Moody's, *Alternative Financial Ratios for the Effects of Securitization: Tools for Analysis*, Sep. 19, 1997..

31. Nomura, *Securitization & Real Estate Update*, May 18, 1997.

32. Moody's, *Challenges to the Asset-Backed Market in 1996...A Call for More Transparency*, Jan. 19, 1996.

D. There is No Monitoring or Enforcement to Guard against Adverse use of Modification

Like securitization, modification has evolved in a regulatory vacuum. Like securitization, the problem is not the lack of existing strictures that can be brought to bear on the practices, but that new business practices have evolved out of sight of regulatory and legislative authorities. Hence, little thought has been given to what can go wrong and how that can be most effectively dealt with (for example, transparency, functional regulation, or some other means). The servicing industry and, therefore modification practices, are touched by at least three existing monitoring authorities: the ratings agencies; the Securities and Exchange Commission's Regulation AB; and the Sarbanes-Oxley Act of 2002. None of those systematically monitors modification efforts on behalf of consumers, creating potentially big problems if modification efforts are rapidly expanded to ten to twenty times current industry levels.

Credit ratings agencies currently rate servicing quality for major mortgage servicers. Historically, credit rating agencies typically monitored operational cash flow considerations of servicers to better ensure remittances to investors over other factors. More recently, servicers have expanded their considerations to, "how effective a servicer is at preventing defaults and maximizing recoveries to a transaction when defaults occur."³³ Such monitoring, however, is still akin to judging modifications on the basis of maximizing cash flow to the servicer, rather than ability to reduce principal on behalf of the borrower, as explained above, and therefore is a poor means of addressing whether modification programs are built upon safe and sound business practices and satisfy potential predatory concerns.

In 2004, the Securities and Exchange Commission introduced Regulation AB, which includes enhanced reporting requirements for ABS issuers and servicers. In particular, Reg AB sets forth a new set of "best practices" servicing criteria, improving on the Uniform Single Attestation Program for Mortgage Bankers (USAP).³⁴ Like early ratings agency surveillance, however, that portion of Regulation AB focused primarily on investor remittance and reporting, rather than safe and sound business practices and potential predatory concerns.³⁵

Regulation AB also imposed rules that, in the eyes of many investors, "represent historic steps in the evolution of financial regulation in the U.S. Under the new rules, investors will receive static pool data similar to what the rating agencies have received for years." The problem is that the new rules only went into effect in 2006, and markets will not see even the beginnings of their full impact until several years later, when static pool data will count as part of registration statements for liability purposes. In the mean time, the SEC still needs to improve its electronic filing system to replace "incorporation by reference to issuer web sites" as the vehicle for disclosure of static pool performance data. Even with improved SEC reporting, collateral-level data required under Regulation AB may still be available only at exorbitant expense from Loan Performance Corporation, which refuses to sell access to the "public"

33. Moody's, *Housing Research*, Sep. 1, 2007.

34. See <http://www.campusmba.org/pdf/usap.pdf>.

35. Moody's, *2005 Review and 2006 Outlook: US Servicer Ratings*, Jan. 24, 2006.

data to academic researchers or even bank regulatory authorities. Hence, although Regulation AB showed great promise, it has not been extended to modification issues and does not adequately provide for public reporting.³⁶

The Sarbanes-Oxley Act of 2002, "...requires the management of publicly-owned companies to assess the effectiveness of internal controls over financial reporting. Because of the increased focus on maintaining strong internal controls, Moody's believes that Sarbanes-Oxley should have a meaningful impact on servicing stability. This will be true both for publicly-owned servicers as well private servicers that voluntarily take similar steps." Originators and servicers are very concerned about material disclosure provisions being applied to reaging and modification programs that may not have been properly disclosed in recent years.³⁷ Nonetheless, Sarbanes-Oxley has yet to be applied to reporting modification and reaging, which have certainly been material concerns.

FIGURE 7: FITCH'S SAMPLE OF NECESSARY STATISTICS TO BE REQUESTED FROM SERVICERS USING MODIFICATION AS A LOSS MITIGATION TOOL

Performing Modifications							
Months Since Mod	Loan Count	Principal Balance at Mod	Projected Loss without Mod	Cost to Trust of Mod	Cash Collected at/after Mod	Net Value to Trust after Mod	
< 3							
3-6							
6-12							
> 12							
Totals							

Redefaulted Modifications							
Months Since Mod	Loan Count	Principal Balance at Mod	Projected Loss without Mod	Cost to Trust of Mod	Cash Collected at/after Mod	Value of Lost Time to Liquidate	Net Value to Trust after Mod
< 3							
3-6							
6-12							
> 12							
Totals							

Note: Statistics should indicate all mods since program began for RMBS. Tables should be developed by product and transaction

Source: Fitch Ratings, *Changing Loss Mitigation Strategies for U.S. RMBS*, Jun 4, 2007

In summary, since relatively few loan modifications took place prior to 2007, "...typical transaction documentation does not include standard or robust reporting language regarding loan modifications." Therefore, reporting varies significantly from transaction to transaction, even for the same issuer or servicer. Sometimes a loan being modified will continue to be reported as delinquent, based on its pre-modification terms. Other times, a delinquent loan that is modified will be reported immediately as "current." In addition, reporting mechanisms for modifications may or may not track the cumulative level of modifications. Industry participants like Moody's Investors Service advocate "...enhanced transparency in both loan-level reporting of modifications as well

36. Nomura, *ABS/MBS Disclosure Update #6: 24 Steps to Tighter ABS – Regulation AB*, Dec. 27, 2006)

37. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

as the cumulative impact of modifications on securitizations.”³⁸ Fitch suggests a reporting format like that in Figure 7. Unfortunately, contemporary advocates from both the industry and politics, alike, are ignoring the practical realities of modification and pushing for the expansion of highly risky practices in an environment of little consumer protection and opaque financial reporting, precisely the conditions that are causing the current market crisis.

IV. CONCLUSIONS AND POLICY RECOMMENDATIONS

Servicing is costly, and increasing loan modifications increases the costs of servicing. While the practice of modifying loans shows promise, the practice is highly risky, both to the consumer and the lender, and substantially unproven. Moreover, there are currently no industry standards for modification and financial reporting, and no consumer safeguards to monitor or prohibit predatory practices.

Modification will not be suited to helping avoid the massive defaults expected as a result of ARM interest rate resets, which account for the majority of the industry's problems into 2008. Legislative pushes to mis-apply the practice to those ends will substantially worsen industry performance.

One of the key reasons loan modification has grown has been to skew financial reporting of delinquencies, modifying loans to help borrowers make a few payments and then aggressively reaging the accounts to classify them as “current,” instead of “delinquent.” Such practices appear to have been a key mechanism in supporting the paper earnings of many failed subprime lenders prior to bankruptcy.

Regulators can already require modified loans to be reported as material considerations under Sarbanes-Oxley with standardized reporting practices promulgated by the Financial Accounting Standards Board and Regulation AB. Without applying even existing regulations toward regulatory oversight or transparency in loan modification practices, however, it is hard to imagine long-term positive benefits for borrowers.

It does not make sense, therefore, to push a broad unmonitored application of loan modification onto the industry or the public without serious consideration. Doing so runs a substantial risk of consumers being used to prop up the mortgage industry in the short term by keeping financially-strapped consumers in homes they cannot hope to afford.

It does make sense, however, to apply limited modification programs to appropriately-selected consumers while helping to smooth the transition to smaller homes or rentals for others. Regulators need to be aware that appropriately selecting borrowers for modification is an underwriting decision, which needs to be monitored for safe and sound underwriting practices. Regulators can monitor modification programs for predatory behavior and abuse by simply classifying a modification as a new loan, which subjects the practice to all the disclosure and record-collection requirements for other new loans. Hence, regulators can use existing regulations to monitor modification outcomes so that

38. Moody's Investors Service, *Loan Modifications in U.S. RMBS: Frequently Asked Questions*, Jun. 6, 2007.

lenders who use modification for short-term gain solely at the expense of consumers can be identified and censured.

With no regulatory authority to oversee modification and reaging policies and little transparency with respect to those arrangements, however, there is a distinct possibility that extensive modification will hurt consumers and investors alike. Again.

APPENDIX: THE BUSINESS OF LOAN SERVICING

Servicing is often viewed as the key element to loan value.³⁹ Poor servicing can result in uncollected payments from borrowers and missed payments to investors. Poor servicing may also result in unpaid property taxes and mortgage insurance premia, placing collateral at risk. Figure A1 lists the largest mortgage services as of 2006. These servicers are the companies that will be most affected by modification policy.

FIGURE A1: TOP 15 MORTGAGE SERVICERS, 2006

Top 15 Servicers - (\$ in millions)					
Rank	2006	YoY Change	2005		
1	Wells Fargo Home Mortgage	\$1,341,870	33.5%	1 Countrywide Financial Corp.	\$1,111,090
2	Countrywide Financial Corp.	\$1,298,394	16.9%	2 Wells Fargo Home Mortgage	\$1,005,410
3	Washington Mutual	\$710,797	-4.8%	3 Washington Mutual	\$746,759
4	JPM	\$674,057	11.6%	4 JPM	\$604,170
5	Citi	\$521,509	17.6%	5 Citi	\$443,510
6	GMAC	\$456,150	16.1%	6 GMAC	\$392,929
7	Bank of America	\$419,497	13.9%	7 Bank of America	\$368,352
8	ABN Amro Mortgage	\$229,889	11.6%	8 ABN Amro Mortgage	\$205,953
9	Wachovia	\$175,244	10.8%	9 National City Mortgage	\$169,557
10	National City Mortgage	\$171,006	0.9%	10 Wachovia	\$158,110
11	PHH Mortgage	\$160,298	1.9%	11 PHH Mortgage	\$157,302
12	IndyMac Bancorp, Inc.	\$147,994	63.1%	12 SunTrust Mortgage, Inc.	\$105,561
13	SunTrust Mortgage, Inc.	\$129,974	23.1%	13 First Horizon Home Loans	\$95,284
14	First Horizon Home Loans	\$101,755	6.8%	14 IndyMac Bancorp, Inc.	\$90,721
15	U.S. Bank Home Mortgage	\$99,799	19.7%	15 U.S. Bank Home Mortgage	\$83,403
Total		\$6,638,233	15.7%	Total	\$5,738,111

Source: National Mortgage News

Figure A2 illustrates the main functions of mortgage servicers. For the most part, those functions can be broken down into those relating to periodically collecting and remitting mortgage principal and interest payments, as well as tax, insurance, and mortgage insurance premium escrow payments (the bottom row in Figure A2) and those relating to dealing with delinquencies and foreclosures.

FIGURE A2: TYPICAL LOAN SERVICING ACTIVITIES

Primary Servicing Checklist		
<p>Collection/Workout</p> <ul style="list-style-type: none"> Management and collector experience Level of borrower contact Formal collection strategy Familiarity with industry and conduit guidelines Tracking system 	<p>Foreclosure/Bankruptcy</p> <ul style="list-style-type: none"> Management and staff experience Committee foreclosure approval Familiarity with state requirements Attorney selection and monitoring Property inspections 	<p>REO Management</p> <ul style="list-style-type: none"> Marketing strategy Compliance with industry, state, and conduit guidelines Expense management Security, protection, and repair of properties
<p>Escrow Management</p> <ul style="list-style-type: none"> Management experience Escrow analysis method Timely tax and insurance disbursements Documented county guidelines Servicing system capabilities Disaster response plan 	<p>Investor Accounting/Reporting</p> <ul style="list-style-type: none"> Relationship to financial accounting Management involvement Documentation on industry and conduit guidelines Servicing system capabilities Timely reports and remittances 	<p>Custodial Account Management</p> <ul style="list-style-type: none"> Adherence to industry standards Formal reconciliation process Minimal acceptable ratings of institutions with principal and interest funds on deposit Specific titling of accounts Separation of principal and interest and taxes and insurance accounts

Source: Fitch Ratings, *Mortgage and Housing Products Origination and Servicing Guidelines*, Jun. 3, 1997

³⁹ Moody's Investors Service, *Deal Sponsor and Credit Risk of U.S. ABS and MBS Securities*, December 2006.

There are three classes of mortgage servicers: master servicers, primary servicers, and special servicers. Master servicers oversee all the servicing processes and work directly for the trust that manages the loans on behalf of investors. Primary servicers manage the routine tasks on the bottom row of Figure 3 and sometimes the tasks related to delinquency and foreclosure on the top row. Special servicers specialize in delinquency and foreclosure-related tasks. Many transactions have all three types of servicers present, while others may only have one or two.⁴⁰ According to Fitch Ratings' "Ratings Definitions," some of the reasons for the various structures are age of the transaction, complexity of the loans, strength of the primary servicer, current or anticipated delinquency, and need for advancing funds on behalf of borrowers.

The sections that follow illustrate that even though servicers do not bear direct credit risk from the loans they service, credit deterioration can impose high costs and cash flow difficulties on servicers.

A. Loan Servicers are Paid Fees to Perform Routine Tasks Related to Loan Administration and Act on Investors' Behalf

Mortgage loan servicers are typically remunerated on the basis of a servicing fee of between 12.5 and 50 basis points of the outstanding principal balance, down substantially from 25-100 basis points in 1999. Direct servicing fees, however, do not always adequately compensate the servicer for costly services that are sometimes necessitated by the types of borrowers involved.

Over the years, therefore, loan servicers have attempted to charge directly for higher-cost servicing activities. One way to do this is through ancillary fees charged directly to the borrower. Such fees typically included escrow account maintenance fees, loan history fees, phone payment fees, loan document service fees, payoff statement fees, demand letter fees, and forbearance agreement fees. In recent times, however, servicers have moved away from those ancillary fees "due to concerns that this practice has been abused and the relationship between servicers and borrowers has been unfairly leveraged."⁴¹

The industry has now largely replaced ancillary fees with various incentive arrangements for personnel. The typical incentive arrangements, however, have distinct shortcomings. For instance, incentives based on loss severity can be affected by changes in property values, skewed initial appraisals, the LTV distribution of the loans, and other factors. Incentives to pursue more difficult long cases of delinquency can help pay for the greater costs involved, but can also be an incentive to draw out difficulties to generate revenue. Incentives based on resolution type can encourage loan reinstatements and modifications, but can affect the property disposition (the choice of short sale, foreclosure, or other variant, in different ways depending upon other terms in the loan).

The generally accepted solution to the flaws of these various incentive arrangements (on the level of the servicing entity as a whole) has been equity incentives. Generally, equity incentives take the form of residual first-loss investment stakes that are worth more in the event of solid servicing. The

40. Fitch Ratings, *Residential Mortgage Services Ratings*, Feb. 21, 2003.

41. Moody's, *Trends in Residential Mortgage Servicing Practices*, Aug. 9, 2004.

problem is that the value of equity incentives is murky, as is the total value of the mortgage servicing enterprise.

The total value of a mortgage servicing enterprise is the sum of the value of its contracts. The values of those contracts, called mortgage servicing rights (MSRs) is the present value of the series of uncertain direct service fee payments. The reason the fees are uncertain is that they rely crucially on how many mortgages remain with the servicer after prepayments and defaults. Since prepayments and defaults are not well understood,⁴² MSRs are difficult to value with any degree of certainty and the valuations that result can be very volatile to actual conditions realized in the servicing pool. Residual first-loss investment stake valuations rely crucially upon the same conjectures about prepayment speeds and default rates, and are therefore similarly difficult to value.

It should not be surprising, therefore, that the vast majority of bank failures since 1992 have involved substantial issues of MSR and residual valuations. Nonetheless, many of the mortgage servicers listed in Figure A1 derive a great deal of their value from equity incentives and MSRs. WaMu's MSRs amount to 23 percent of their capital, IndyMac's amount to 90 percent of their capital, and Countrywide's amount to 115 percent of their capital. Clearly, having MSRs worth more than the value of capital creates a high risk that valuation difficulties can wipe out a firm's underlying capital with the stroke of a pen.

B. Loan Servicer's Costs Depend on how Much Work is Involved in Servicing

The two main types of operating costs associated with servicing mortgages are maintenance costs and mortgage default-related costs. Maintenance costs consist of basic elements of customer service (payment collection, mailings, systems, etc). These types of maintenance costs can be reduced on a per unit basis through scale economies and off-shoring. Mortgage-default related costs are all additional costs imposed on the servicer due to late payments and subsequent activities, including everything from additional calls and the human capital required to make those calls, to the legal and physical costs of foreclosure and sale.

Bank of America recently analyzed servicing costs per loan, starting with the Mortgage Bankers Association's (MBA) 2006 Servicing Operations Study and Forum and consulting with various servicing industry representatives. Because costs vary significantly by product with more complex and riskier products such as Option ARMs and subprime mortgages costing more to service, Bank of America used the MBA's "Mega" category, which essentially represents large, diversified mortgage servicers, as a rough guideline for mortgage servicing operating cost per loan estimates. The Bank of America study estimates that average annual operating costs per loan for performing loans range between \$49 and \$53 per loan. Average costs for loans in default and foreclosure may be reasonably expected to increase by over 700 percent.⁴³ Those costs can be

42. See Joseph Mason & Joshua Rosner, *How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions*, Hudson Institute Working Paper, Feb. 14, 2007.

43. Bank of America, *The Hidden Credit Costs of Mortgage Servicers*, SPECIALTY AND MORTGAGE FINANCE WEEKLY, Mar. 23, 2007.

expected to rise significantly in the current market environment with far greater defaults and rising home inventories making it difficult to sell foreclosed collateral.⁴⁴

Servicers are already beginning to restructure their operations to achieve cost savings wherever possible, including consolidating operations, rather than outsourcing. As the American Banker explains, "In an effort to cut the costs associated with foreclosure, Wells Fargo & Co., JPMorgan Chase & Co., and Bank of America Corp. have all in recent months brought in-house certain default management and loss-mitigation work.... The moves by three of the top 10 home lenders to what is called a "direct sourcing" model are a blow to the major title companies and others whose default-management outsourcing units had handled their work (and still do for many other lenders)."⁴⁵

The reason for such drastic measures is that default costs can also create substantial cash flow difficulties. Cash flow difficulties arise because the legal and other costs related to foreclosing upon and selling repossessed real estate, while ultimately reimbursable from the trust, are only reimbursed when the collateral is sold. "Advancing" funds in such circumstances can substantially disrupt the cash flows of the servicing entity. If the servicer does not have cash on hand to cover the cash flows those advances must be funded in the interim through borrowings, and while the direct costs of the disposition are reimbursed, the funding costs are not.

While servicers generally believe that the current level of servicing fees in transactions, particularly subprime deals, is currently "adequate to cover the increasing cost to service subprime loans,... unanticipated costs that could come from mandatory actions or moratoriums on actions like foreclosure, which are being discussed by regulators or legislative factions... may cause extensions or delays in processes and make it very difficult for servicers to accurately project actual costs."⁴⁶ If servicers fail because servicing fees cannot cover costs, there may be no buyer for those servicing contracts in the event of servicer bankruptcy. Several such difficulties were experienced in the late 1990s, and led to protracted bankruptcies and high losses.

44. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

45. Kate Berry, *Default Servicing Comes Back In-House*, AMERICAN BANKER, Jun. 1, 2007.

46. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF NEW YORK

-----X
In re:

FERREL L. AGARD,

Debtor.
-----X

Case No. 810-77338-reg

Chapter 7

MEMORANDUM DECISION

Before the Court is a motion (the “Motion”) seeking relief from the automatic stay pursuant to 11 U.S.C. § 362(d)(1) and (2), to foreclose on a secured interest in the Debtor’s real property located in Westbury, New York (the “Property”). The movant is Select Portfolio Servicing, Inc. (“Select Portfolio” or “Movant”), as servicer for U.S. Bank National Association, as Trustee for First Franklin Mortgage Loan Trust 2006-FF12, Mortgage Pass-Through Certificates, Series 2006-FF12 (“U.S. Bank”). The Debtor filed limited opposition to the Motion contesting the Movant’s standing to seek relief from stay. The Debtor argues that the only interest U.S. Bank holds in the underlying mortgage was received by way of an assignment from the Mortgage Electronic Registration System a/k/a MERS, as a “nominee” for the original lender. The Debtor’s argument raises a fundamental question as to whether MERS had the legal authority to assign a valid and enforceable interest in the subject mortgage. Because U.S. Bank’s rights can be no greater than the rights as transferred by its assignor – MERS – the Debtor argues that the Movant, acting on behalf of U.S. Bank, has failed to establish that it holds an enforceable

right against the Property.¹ The Movant's initial response to the Debtor's opposition was that MERS's authority to assign the mortgage to U.S. Bank is derived from the mortgage itself which allegedly grants to MERS its status as both "nominee" of the mortgagee and "mortgagee of record." The Movant later supplemented its papers taking the position that U.S. Bank is a creditor with standing to seek relief from stay by virtue of a judgment of foreclosure and sale entered in its favor by the state court prior to the filing of the bankruptcy. The Movant argues that the judgment of foreclosure is a final adjudication as to U.S. Bank's status as a secured creditor and therefore the *Rooker-Feldman* doctrine prohibits this Court from looking behind the judgment and questioning whether U.S. Bank has proper standing before this Court by virtue of a valid assignment of the mortgage from MERS.

The Court received extensive briefing and oral argument from MERS, as an intervenor in these proceedings which go beyond the arguments presented by the Movant. In addition to the rights created by the mortgage documents themselves, MERS argues that the terms of its membership agreement with the original lender and its successors in interest, as well as New York state agency laws, give MERS the authority to assign the mortgage. MERS argues that it holds legal title to mortgages for its member/lenders as both "nominee" and "mortgagee of

¹ The Debtor also questions whether Select Portfolio has the authority and the standing to seek relief from the automatic stay. The Movant argues that Select Portfolio has standing to bring the Motion based upon its status as "servicer" of the Mortgage, and attaches an affidavit of a vice president of Select Portfolio attesting to that servicing relationship. Caselaw has established that a mortgage servicer has standing to seek relief from the automatic stay as a party in interest. *See, e.g., Greer v. O'Dell*, 305 F.3d 1297 (11th Cir. 2002); *In re Woodberry*, 383 B.R. 373 (Bankr. D.S.C. 2008). This presumes, however, that the lender for whom the servicer acts validly holds the subject note and mortgage. Thus, this Decision will focus on whether U.S. Bank validly holds the subject note and mortgage.

record.” As such, it argues that any member/lender which holds a note secured by real property, that assigns that note to another member by way of entry into the MERS database, need not also assign the mortgage because legal title to the mortgage remains in the name of MERS, as agent for any member/lender which holds the corresponding note. MERS’s position is that if a MERS member directs it to provide a written assignment of the mortgage, MERS has the legal authority, as an agent for each of its members, to assign mortgages to the member/lender currently holding the note as reflected in the MERS database.

For the reasons that follow, the Debtor’s objection to the Motion is overruled and the Motion is granted. The Debtor’s objection is overruled by application of either the *Rooker-Feldman* doctrine, or *res judicata*. Under those doctrines, this Court must accept the state court judgment of foreclosure as evidence of U.S. Bank’s status as a creditor secured by the Property. Such status is sufficient to establish the Movant’s standing to seek relief from the automatic stay. The Motion is granted on the merits because the Movant has shown, and the Debtor has not disputed, sufficient basis to lift the stay under Section 362(d).

Although the Court is constrained in this case to give full force and effect to the state court judgment of foreclosure, there are numerous other cases before this Court which present identical issues with respect to MERS and in which there have been no prior dispositive state court decisions. This Court has deferred rulings on dozens of other motions for relief from stay pending the resolution of the issue of whether an entity which acquires its interests in a mortgage by way of assignment from MERS, as nominee, is a valid secured creditor with standing to seek relief from the automatic stay. It is for this reason that the Court’s decision in this matter will address the issue of whether the Movant has established standing in this case notwithstanding the

existence of the foreclosure judgment. The Court believes this analysis is necessary for the precedential effect it will have on other cases pending before this Court.

The Court recognizes that an adverse ruling regarding MERS's authority to assign mortgages or act on behalf of its member/lenders could have a significant impact on MERS and upon the lenders which do business with MERS throughout the United States. However, the Court must resolve the instant matter by applying the laws as they exist today. It is up to the legislative branch, if it chooses, to amend the current statutes to confer upon MERS the requisite authority to assign mortgages under its current business practices. MERS and its partners made the decision to create and operate under a business model that was designed in large part to avoid the requirements of the traditional mortgage recording process. This Court does not accept the argument that because MERS may be involved with 50% of all residential mortgages in the country, that is reason enough for this Court to turn a blind eye to the fact that this process does not comply with the law.

Facts

Procedural Background

On September 20, 2010, the Debtor filed for relief under Chapter 7 of the Bankruptcy Code. In Schedule A to the petition, the Debtor lists a joint ownership interest in the Property described as follows:

A “[s]ingle family home owned with son, deed in son’s name since 2007; used as primary residence . . . Debtor was on original deed and is liable on the mortgage, therefore has equitable title. Debtor is in default of the mortgage with a principal balance of over \$450,000.00. The house is worth approximately \$350,000. A

foreclosure sale was scheduled 9/21/10.”

According to Schedule D, the Property is valued at \$350,000 and is encumbered by a mortgage in the amount of \$536,920.67 held by “SPS Select Portfolio Servicing.”

On October 14, 2010, the Movant filed the Motion seeking relief from the automatic stay pursuant to 11 U.S.C. §362(d) to foreclose on the Property. The Motion does not state that a foreclosure proceeding had been commenced or that a judgment of foreclosure was granted prior to the filing of the bankruptcy petition. Nor does it mention that the Debtor holds only equitable title and does not hold legal title to the Property. Instead, Movant alleges that U.S. Bank is the “holder” of the Mortgage; that the last mortgage payment it received from the Debtor was applied to the July, 2008 payment; and that the Debtor has failed to make any post-petition payments to the Movant. Movant also asserts that as of September 24, 2010, the total indebtedness on the Note and Mortgage was \$542,902.33 and the Debtor lists the value of the Property at \$350,000 in its schedules. On that basis, Movant seeks entry of an order vacating the stay pursuant to 11 U.S.C. § 362(d)(1) and (d)(2).

Annexed to the Motion are copies of the following documents:

- Adjustable Rate Note, dated June 9, 2006, executed by the Debtor as borrower and listing First Franklin a Division of Na. City Bank of In. (“First Franklin”) as the lender (“Note”);
- Balloon Note Addendum to the Note, dated June 9, 2006;
- Mortgage, dated June 9, 2006 executed by the Debtor and listing First Franklin as lender, and MERS as nominee for First Franklin and First Franklin’s successors and assigns (“Mortgage”);
- Adjustable Rate and Balloon Rider, dated June 9, 2006;
- Addendum to Promissory Note and Security Agreement executed by the Debtor; and

- Assignment of Mortgage, dated February 1, 2008, listing MERS as nominee for First Franklin as assignor, and the Movant, U.S. Bank National Association, as Trustee for First Franklin Mortgage Loan Trust 2006- FF12, Mortgage Pass-through Certificates, Series 2006-FF12, as assignee (“Assignment of Mortgage”).

The Arguments of the Parties

On October 27, 2010, the Debtor filed “limited opposition” to the Motion, alleging that the Movant lacks standing to seek the relief requested because MERS, the purported assignor to the Movant, did not have authority to assign the Mortgage and therefore the Movant cannot establish that it is a bona fide holder of a valid secured interest in the Property.

The Movant responded to the Debtor’s limited opposition regarding MERS’s authority to assign by referring to the provisions of the Mortgage which purport to create a “nominee” relationship between MERS and First Franklin. In conclusory fashion, the Movant states that it therefore follows that MERS’s standing to assign is based upon its nominee status.

On November 15, 2010, a hearing was held and the Court gave both the Debtor and Movant the opportunity to file supplemental briefs on the issues raised by the Debtor’s limited opposition.

On December 8, 2010, the Movant filed a memorandum of law in support of the Motion arguing that this Court lacks jurisdiction to adjudicate the issue of whether MERS had authority to assign the Mortgage, and even assuming the Court did have jurisdiction to decide this issue, under New York law the MERS assignment was valid. In support of its jurisdictional argument, the Movant advises the Court (for the first time) that a Judgment of Foreclosure and Sale (“Judgment of Foreclosure”) was entered by the state court in favor of the Movant on November 24, 2008, and any judicial review of the Judgment of Foreclosure is barred by the doctrines of

res judicata, *Rooker-Feldman*, and judicial estoppel.² The Movant argues that the Debtor had a full and fair opportunity to litigate these issues in state court, but chose to default, and cannot now challenge the state court's adjudication as to the Movant's status as a secured creditor or holder of the Note and Mortgage, or its standing to seek relief from the automatic stay in this Court. The Movant also notes that the Debtor admits in her petition and schedules that she is liable on the Mortgage, that it was in default and the subject of a foreclosure sale, and thus judicial estoppel bars her arguments to the contrary.

In addition to its preclusion arguments, on the underlying merits of its position the Movant cites to caselaw holding that MERS assignments similar to the assignment in this case, are valid and enforceable. *See U.S. Bank, N.A. v. Flynn*, 897 N.Y.S. 2d 855, 858 (N.Y. Sup. Ct. 2010); *Kiah v. Aurora Loan Services, LLC*, 2010 U.S. Dist. LEXIS 121252, at *1 (D. Mass. Nov. 16, 2010); *Perry v. Nat'l Default Servicing Corp.*, 2010 U.S. Dist. LEXIS 92907, at *1 (Dist. N.D. Cal. Aug. 20, 2010). It is the Movant's position that the provisions of the Mortgage grant to MERS the right to assign the Mortgage as "nominee," or agent, on behalf of the lender, First Franklin. Specifically, Movant relies on the recitations of the Mortgage pursuant to which the "Borrower" acknowledges that MERS holds bare legal title to the Mortgage, but has the right "(A) to exercise any or all those rights, including, but not limited to, the right to foreclose and

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The Judgment of Foreclosure names the Debtor and an individual, Shelly English, as defendants. Shelly English is the Debtor's daughter-in-law. At a hearing held on December 13, 2010, the Debtor's counsel stated that he "believed" the Debtor transferred title to the Property to her son, Leroy English, in 2007. This is consistent with information provided by the Debtor in her petition and schedules. Leroy English, however, was not named in the foreclosure action. No one in this case has addressed the issue of whether the proper parties were named in the foreclosure action. However, absent an argument to the contrary, this Court can only presume that the Judgment of Foreclosure is a binding final judgment by a court of competent jurisdiction.

sell the Property; and (B) to take any action required of Lender including, but not limited to, releasing and canceling [the Mortgage].” In addition, the Movant argues that MERS’s status as a “mortgagee” and thus its authority to assign the Mortgage is supported by the New York Real Property Actions and Proceedings Law (“RPAPL”) and New York Real Property Law (“RPL”). Movant cites to RPAPL § 1921-a which allows a “mortgagee” to execute and deliver partial releases of lien, and argues that MERS falls within the definition of “mortgagee” which includes the “current holder of the mortgage of record . . . or . . . their . . . agents, successors or assigns.” N.Y. Real Prop. Acts. Law § 1921(9)(a) (McKinney 2011). Although the definition of “mortgagee” cited to by the Movant only applies to RPAPL § 1921, Movant argues that it is a “mortgagee” vested with the authority to execute and deliver a loan payoff statement; execute and deliver a discharge of mortgage and assign a mortgage pursuant to RPL §§ 274 and 275.

In addition to its status as “mortgagee,” Movant also argues that the assignment is valid because MERS is an “agent” of each of its member banks under the general laws of agency in New York, *see* N.Y. Gen. Oblig. Law § 5-1501(1) (McKinney 2011),³ and public policy requires the liberal interpretation and judicial recognition of the principal-agent relationship. *See Arens v. Shainswitt*, 37 A.D.2d 274 (N.Y. App. Div. 1971), *aff’d* 29 N.Y.2d 663 (1971). In the instant case, Movant argues, the Mortgage appoints MERS as “nominee,” read “agent,” for the original

³ Movant cites to New York General Obligations Law for the proposition that “an agency agreement may take any form ‘desired by the parties concerned.’” The direct quote “desired by the parties concerned” seems to be attributed to the General Obligations Law citation, however, the Court could find no such language in the current version of § 5-1501(1). That provision, rather, defines an agent as “a person granted authority to act as attorney-in-fact for the principal *under a power of attorney*, and includes the original agent and any co-agent or successor agent. Unless the context indicates otherwise, an ‘agent’ designated in a power of attorney shall mean ‘attorney-in-fact’ for the purposes of this title. An agent acting under a power of attorney has a fiduciary relationship with the principal.” N.Y. Gen. Oblig. Law § 5-1501(1) (McKinney 2011) (emphasis added).

lender and the original lender's successors and assigns. As nominee/agent for the lender, *and* as mortgagee of record, Movant argues MERS had the authority to assign the Mortgage to the Movant, U.S. Bank, "in accordance with the principal's instruction to its nominee MERS, to assign the mortgage lien to U.S. Bank"

Finally, Movant argues that even absent a legally enforceable assignment of the Mortgage, it is entitled to enforce the lien because U.S. Bank holds the Note. The Movant argues that if it can establish that U.S. Bank is the legal holder the Note, the Mortgage by operation of law passes to the Movant because the Note and the Mortgage are deemed to be inseparable. *See In re Conde-Dedonato*, 391 B.R. 247 (Bankr. E.D.N.Y. 2008). The Movant represents, but has not proven, that U.S. Bank is the rightful holder of the Note, and further argues that the assignment of the Note has to this point not been contested in this proceeding.

MERS moved to intervene in this matter pursuant to Fed. R. Bankr. P. 7024 because:

12. The Court's determination of the MERS Issue directly affects the business model of MERS. Additionally, approximately 50% of all consumer mortgages in the United States are held in the name of MERS, as the mortgagee of record.

13. The Court's determination of the MERS Issue will have a significant impact on MERS as well as the mortgage industry in New York and the United States.

14. MERS has a direct financial stake in the outcome of this contested matter, and any determination of the MERS Issue has a direct impact on MERS.

(Motion to Intervene, ¶¶12-14).

Permission to intervene was granted at a hearing held on December 13, 2010.

In addition to adopting the arguments asserted by the Movant, MERS strenuously defends its authority to act as mortgagee pursuant to the procedures for processing this and other mortgages under the MERS "system." First, MERS points out that the Mortgage itself

designates MERS as the “nominee” for the original lender, First Franklin, and its successors and assigns. In addition, the lender designates, and the Debtor agrees to recognize, MERS “as the mortgagee of record and as nominee for ‘Lender and Lender’s successors and assigns’” and as such the Debtor “expressly agreed without qualification that MERS had the right to foreclose upon the premises as well as exercise any and all rights as nominee for the Lender.” (MERS Memorandum of Law at 7). These designations as “nominee,” and “mortgagee of record,” and the Debtor’s recognition thereof, it argues, leads to the conclusion that MERS was authorized as a matter of law to assign the Mortgage to U.S. Bank.

Although MERS believes that the mortgage documents alone provide it with authority to effectuate the assignment at issue, they also urge the Court to broaden its analysis and read the documents in the context of the overall “MERS System.” According to MERS, each participating bank/lender agrees to be bound by the terms of a membership agreement pursuant to which the member appoints MERS to act as its authorized agent with authority to, among other things, hold legal title to mortgages and as a result, MERS is empowered to execute assignments of mortgage on behalf of all its member banks. In this particular case, MERS maintains that as a member of MERS and pursuant to the MERS membership agreement, the loan originator in this case, First Franklin, appointed MERS “to act as its agent to hold the Mortgage as nominee on First Franklin’s behalf, and on behalf of First Franklin’s successors and assigns.” MERS explains that subsequent to the mortgage’s inception, First Franklin assigned the Note to Aurora Bank FSB f/k/a Lehman Brothers Bank (“Aurora”), another MERS member. According to MERS, note assignments among MERS members are tracked via self-effectuated and self-monitored computer entries into the MERS database. As a MERS member, by

operation of the MERS membership rules, Aurora is deemed to have appointed MERS to act as its agent to hold the Mortgage as nominee. Aurora subsequently assigned the Note to U.S. Bank, also a MERS member. By operation of the MERS membership agreement, U.S. Bank is deemed to have appointed MERS to act as its agent to hold the Mortgage as nominee. Then, according to MERS, “U.S. Bank, as the holder of the note, under the MERS Membership Rules, chose to instruct MERS to assign the Mortgage to U.S. Bank prior to commencing the foreclosure proceedings by U.S. Bank.” (Affirmation of William C. Hultman, ¶12).

MERS argues that the express terms of the mortgage coupled with the provisions of the MERS membership agreement, is “more than sufficient to create an agency relationship between MERS and lender and the lender’s successors in interest” under New York law and as a result establish MERS’s authority to assign the Mortgage. (MERS Memorandum of Law at 7).

On December 20, 2010, the Debtor filed supplemental opposition to the Motion. The Debtor argues that the *Rooker-Feldman* doctrine should not preclude judicial review in this case because the Debtor’s objection to the Motion raises issues that could not have been raised in the state court foreclosure action, namely the validity of the assignment and standing to lift the stay. The Debtor also argues that the *Rooker-Feldman* doctrine does not apply because the Judgment of Foreclosure was entered by default. Finally, she also argues that the bankruptcy court can review matters “which are void or fraudulent on its face.” *See In re Ward*, 423 B.R. 22 (Bankr. E.D.N.Y. 2010). The Debtor says that she is “alleging questionable, even possibly fraudulent conduct by MERS in regards to transferring notes and lifting the stay.” (Debtor’s Supplemental Opposition at 3).

The Movant filed supplemental papers on December 23, 2010 arguing that the Motion is

moot because the Property is no longer an asset of the estate as a result of the Chapter 7 Trustee's "report of no distribution," and as such, the Section 362(a) automatic stay was dissolved upon the entry of a discharge on December 14, 2010. *See Brooks v. Bank of New York Mellon*, No. DKC 09-1408, 2009 WL 3379928, at *2 (D. Md. Oct. 16, 2009); *Riggs Nat'l Bank of Washington, D.C. v. Perry*, 729 F.2d 982, 986 (4th Cir. 1984).

The Movant also maintains that *Rooker-Feldman* does apply to default judgments because that doctrine does not require that the prior judgment be a judgment "on the merits." *Charchenko v. City of Stillwater*, 47 F.3d 981, 983 n.1 (8th Cir. 1995); *see also Kafele v. Lerner, Sampson & Rothfuss, L.P.A.*, No. 04-3659, 2005 WL 3528921, at *2-3 (6th Cir. Dec. 22, 2005); *In re Dahlgren*, No. 09-18982, 2010 WL 5287400, at *1 (D.N.J. Dec. 17, 2010). The Movant points out that the Debtor seems to be confusing the *Rooker-Feldman* doctrine with issue and claim preclusion and that the Debtor has misapplied Chief Judge Craig's ruling in *In re Ward*.

Discussion

As a threshold matter, this Court will address the Movant's argument that this Motion has been mooted by the entry of the discharge order.

Effect of the Chapter 7 discharge on the automatic stay

Section 362(c) provides that:

Except as provided in subsections (d), (e), (f), and (h) of this section--

(1) the stay of an act *against property of the estate* under subsection (a) of this section continues until such property is no longer property of the estate;

(2) the stay of *any other act* under subsection (a) of this section continues until the earliest of--

(A) the time the case is closed;

(B) the time the case is dismissed; or

(C) if the case is a case under chapter 7 of this title concerning an individual or a case under chapter 9, 11, 12, or 13 of this title, *the time a discharge is granted or denied*;

11 U.S.C. § 362(c) (emphasis added).

Pursuant to Section 362(c)(1), the automatic stay which protects “property of the estate,” as opposed to property of the debtor, continues until the property is no longer property of the estate regardless of the entry of the discharge. The provision of the statute relied upon by the Movant for the proposition that the automatic stay terminates upon the entry of a discharge, relates only to the stay of “any other act under subsection(a),”, *i.e.*, an act against property that is *not* property of the estate, *i.e.*, is property “of the debtor.” The relationship between property of the estate and property of the debtor is succinctly stated as follows:

Property of the estate consists of all property of the debtor as of the date of the filing of the petition. 11 U.S.C. § 541. It remains property of the estate until it has been exempted by the debtor under § 522, abandoned by the trustee under § 554(a), or sold by the trustee under § 363. If property of the estate is not claimed exempt, sold, or abandoned by the trustee, it is abandoned to the debtor at the time the case is closed if the property was scheduled under § 521(1). If the property is not scheduled by the debtor and is not otherwise administered, it remains property of the estate even after the case has been closed.

If the property in question is property of the estate, it remains subject to the automatic stay until it becomes property of the debtor and until the earlier of the time the case was closed, the case is dismissed, or a discharge is granted or denied in a chapter 7 case.

In re Pullman, 319 B.R. 443, 445 (Bankr. E.D. Va. 2004).

Movant's position seems to be that the Chapter 7 Trustee's filing of a "report of no distribution," otherwise known as a "no asset report," effectuated an abandonment of the real property at issue in this case, and therefore the Property has reverted back to the Debtor. However, Movant fails to cite the relevant statute. Section 554(c) provides that "[u]nless the court orders otherwise, any property scheduled under section 521(1) of this title not otherwise administered *at the time of the closing* of a case is abandoned to the debtor and administered for purposes of section 350 of this title." 11 U.S.C. § 554(c) (emphasis added); Fed. R. Bankr. P. 6007. Cases interpreting Section 554(c) hold that the filing of a report of no distribution does not effectuate an abandonment of estate property. *See, e.g., In re Israel*, 112 B.R. 481, 482 n.3 (Bankr. D. Conn. 1990) ("The filing of a no-asset report does not close a case and therefore does not constitute an abandonment of property of the estate.") (citing *e.g., Zlogar v. Internal Revenue Serv. (In re Zlogar)*, 101 B.R. 1, 3 n.3 (Bankr. N.D. Ill. 1989); *Schwaber v. Reed (In re Reed)*, 89 B.R. 100, 104 (Bankr. C.D. Cal. 1988); 11 U.S.C. § 554(c)).

Because the real property at issue in this case has not been abandoned it remains property of the estate subject to Section 362(a) unless and until relief is granted under Section 362(d).

Rooker-Feldman and res judicata⁴

The Movant argues that U.S. Bank's status as a secured creditor, which is the basis for its standing in this case, already has been determined by the state court and that determination cannot be revisited here. The Movant relies on both the *Rooker-Feldman* doctrine and *res*

⁴ Because the Debtor's objection is overruled under *Rooker-Feldman* and *res judicata*, the Court will not address the merits of the Movant's judicial estoppel arguments.

judicata principles to support this position.

The *Rooker-Feldman* doctrine is derived from two Supreme Court cases, *Rooker v. Fidelity Trust Co.*, 263 U.S. 413 (1923), and *D.C. Court of Appeals v. Feldman*, 460 U.S. 462 (1983), which together stand for the proposition that lower federal courts lack subject matter jurisdiction to sit in direct appellate review of state court judgments. The *Rooker-Feldman* doctrine is a narrow jurisdictional doctrine which is distinct from federal preclusion doctrines. See *McKithen v. Brown*, 481 F.3d 89, 96-97 (2d Cir. 2007) (citing *Exxon Mobil Corp. v. Saudi Basic Indus. Corp.*, 544 U.S. 280, 284 (2005), and *Hoblock v. Albany County Board of Elections*, 422 F.3d 77, 85 (2d Cir. 2005)). In essence, the doctrine bars “cases brought by state-court losers complaining of injuries caused by state-court judgments rendered before the district court proceedings commenced and inviting district court review and rejection of those judgments. *Rooker-Feldman* does not otherwise override or supplant preclusion doctrine or augment the circumscribed doctrines that allow federal courts to stay or dismiss proceedings in deference to state-court actions.” *Exxon Mobil*, 544 U.S. at 283.

The Second Circuit has delineated four elements that must be satisfied in order for *Rooker-Feldman* to apply:

First, the federal-court plaintiff must have lost in state court. Second, the plaintiff must “complain [] of injuries caused by [a] state-court judgment[.]” Third, the plaintiff must “invit[e] district court review and rejection of [that] judgment [.]” Fourth, the state-court judgment must have been “rendered before the district court proceedings commenced”-i.e., *Rooker-Feldman* has no application to federal-court suits proceeding in parallel with ongoing state-court litigation. The first and fourth of these requirements may be loosely termed procedural; the second and third may be termed substantive.

McKithen, 481 F.3d at 97 (internal citation omitted and alteration in original) (quoting *Hoblock*,

422 F.3d at 85).

In a case with facts similar to the instant case, Chief Judge Craig applied the *Rooker-Feldman* doctrine to overrule a debtor's objection to a motion for relief from the automatic stay. See *In re Ward*, 423 B.R. 22 (Bankr. E.D.N.Y. 2010). In *In re Ward*, a foreclosure sale was conducted prior to the filing of the bankruptcy petition. When the successful purchaser sought relief from stay in the bankruptcy case to proceed to evict the debtor, the debtor opposed the motion. The debtor argued that the foreclosure judgment was flawed because "no original note was produced", "the mortgage was rescinded", "the plaintiff in the action doesn't exist" or "was not a proper party to the foreclosure action", and that "everything was done irregularly and underneath [the] table." *In re Ward*, 423 B.R. at 27. Chief Judge Craig overruled the debtor's opposition and found that each of the elements of the *Rooker-Feldman* doctrine were satisfied:

The *Rooker-Feldman* doctrine applies in this case because the Debtor lost in the state court foreclosure action, the Foreclosure Judgment was rendered before the Debtor commenced this case, and the Debtor seeks this Court's review of the Foreclosure Judgment in the context of her opposition to the Purchaser's motion for relief from the automatic stay. The injury complained of, *i.e.*, the foreclosure sale to the Purchaser, was "caused by" the Foreclosure Judgment because "the foreclosure [sale] would not have occurred but-for" the Foreclosure Judgment. Accordingly, the *Rooker-Feldman* doctrine does not permit this Court to disregard the Foreclosure Judgment.

In re Ward, 423 B.R. at 28 (citations omitted and alteration in original).

In the instant case, the Debtor argues that the *Rooker-Feldman* doctrine does not apply because the Judgment of Foreclosure was entered on default, not on the merits. She also argues that *Rooker-Feldman* should not apply because she is alleging that the Judgment of Foreclosure was procured by fraud in that the MERS system of mortgage assignments was fraudulent in nature or void. However, this Court is not aware of any exception to the *Rooker-Feldman*

doctrine for default judgments, or judgments procured by fraud and the Court will not read those exceptions into the rule. *See Salem v. Paroli*, 260 B.R. 246, 254 (S.D.N.Y. 2001) (applying *Rooker-Feldman* to preclude review of state court default judgment); *see also Lombard v. Lombard*, No. 00-CIV-6703 (SAS), 2001 WL 548725, at *3-4 (S.D.N.Y. May 23, 2001) (applying *Rooker-Feldman* to preclude review of stipulation of settlement executed in connection with state court proceeding even though applicant argued that the stipulation should be declared null and void because he was under duress at the time it was executed).

The Debtor also argues that *Rooker-Feldman* does not apply in this case because she is not asking this Court to set aside the Judgment of Foreclosure, but rather is asking this Court to make a determination as to the Movant's standing to seek relief from stay. The Debtor argues that notwithstanding the *Rooker-Feldman* doctrine, the bankruptcy court must have the ability to determine the standing of the parties before it.

Although the Debtor says she is not seeking affirmative relief from this Court, the net effect of upholding the Debtor's jurisdictional objection in this case would be to deny U.S. Bank rights that were lawfully granted to U.S. Bank by the state court. This would be tantamount to a reversal which is prohibited by *Rooker-Feldman*.

Even if *Rooker-Feldman* were found not to apply to this determination, the Court still would find that the Debtor is precluded from questioning U.S. Bank's standing as a secured creditor under the doctrine of *res judicata*. The state court already has determined that U.S. Bank is a secured creditor with standing to foreclose and this Court cannot alter that determination in order to deny U.S. Bank standing to seek relief from the automatic stay.

The doctrine of *res judicata* is grounded in the Full Faith and Credit Clause of the United

States Constitution. U.S. Const. art. IV, § 1. It prevents a party from re-litigating any issue *or defense* that was decided by a court of competent jurisdiction and which could have been raised or decided in the prior action. *See Burgos v. Hopkins*, 14 F.3d 787, 789 (2d Cir. 1994) (applying New York preclusion rules); *Swiatkowski v. Citibank*, No. 10-CV-114, 2010 WL 3951212, at *14 (E.D.N.Y. Oct. 7, 2010) (citing *Waldman v. Vill. of Kiryas Joel*, 39 F.Supp.2d 370, 377 (S.D.N.Y. 1999)). *Res judicata* applies to judgments that were obtained by default, *see Kellerman v. Andrijevic*, 825 F.2d 692, 694-95 (2d Cir. 1987), but it may not apply if the judgment was obtained by *extrinsic* fraud or collusion. “Extrinsic fraud involves the parties’ ‘opportunity to have a full and fair hearing,’ while intrinsic fraud, on the other hand, involves the ‘underlying issue in the original lawsuit.’” *In re Ward*, 423 B.R. at 29. The Debtor’s assertions that the MERS system of assignments may have been fraudulent is more appropriately deemed an *intrinsic* fraud argument. The Debtor has not alleged any *extrinsic* fraud in the procurement of the Judgment of Foreclosure which prevented a full and fair hearing before the state court.

As a result, the Court finds that the Judgment of Foreclosure alone is sufficient evidence of the Movant’s status as a secured creditor and therefore its standing to seek relief from the automatic stay. On that basis, and because the Movant has established grounds for relief from stay under Section 362(d), the Motion will be granted.

MERS

Because of the broad applicability of the issues raised in this case the Court believes that it is appropriate to set forth its analysis on the issue of whether the Movant, absent the Judgment of Foreclosure, would have standing to bring the instant motion. Specifically MERS’s role in

the ownership and transfer of real property notes and mortgages is at issue in dozens of cases before this Court. As a result, the Court has deferred ruling on motions for relief from stay where the movants' standing may be affected by MERS's participation in the transfer of the real property notes and mortgages. In the instant case, the issues were resolved under the *Rooker-Feldman* doctrine and the application of *res judicata*. Most, if not all, of the remainder of the "MERS cases" before the Court cannot be resolved on the same basis. For that reason, and because MERS has intervened in this proceeding arguing that the validity of MERS assignments directly affects its business model and will have a significant impact on the national mortgage industry, this Court will give a reasoned opinion as to the Movant's standing to seek relief from the stay and how that standing is affected by the fact that U.S. Bank acquired its rights in the Mortgage by way of assignment from MERS.

Standing to seek relief from the automatic stay

The Debtor has challenged the Movant's standing to seek relief from the automatic stay. Standing is a threshold issue for a court to resolve. Section 362(d) states that relief from stay may be granted "[o]n request of a party in interest and after notice and a hearing." 11 U.S.C. § 362(d). The term "party in interest" is not defined in the Bankruptcy Code, however the Court of Appeals for the Second Circuit has stated that "[g]enerally the 'real party in interest' is the one who, under the applicable substantive law, has the legal right which is sought to be enforced or is the party entitled to bring suit." See *Roslyn Savings Bank v. Comcoach (In re Comcoach)*, 698 F.2d 571, 573 (2d Cir. 1983). The legislative history of Section 362 "suggests that, notwithstanding the use of the term 'party in interest', it is only creditors who may obtain relief

from the automatic stay.” *Id.* at 573-74. (citing H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 175, reprinted in 1978 U.S.Code Cong. & Ad. News 5787, 6136); *see also Greg Restaurant Equip. And Supplies v. Toar Train P’ship (In re Toar Train P’ship)*, 15 B.R. 401, 402 (Bankr. D. Vt.1981) (finding that a judgment creditor of the debtor was not a “party in interest” because the judgment creditor was not itself a direct creditor of the bankrupt).

Using the standard established by the Second Circuit, this Court must determine whether the Movant is the “one who, under applicable substantive law, has the legal right” to enforce the subject Note and Mortgage, and is therefore a “creditor” of this Debtor. *See In re Toar*, 15 B.R. at 402; *see also In re Mims*, 438 B.R. 52, 55 (Bankr. S.D.N.Y. 2010). The Bankruptcy Code defines a “creditor” as an “entity that has a claim against the debtor that arose at the time of or before the order for relief” 11 U.S.C. § 101(10). “Claim” is defined as the “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured” 11 U.S.C. § 101(5)(A). In the context of a lift stay motion where the movant is seeking to commence or continue with an action to foreclose a mortgage against real property, the movant must show that it is a “party in interest” by showing that it is a creditor with a security interest in the subject real property. *See Mims*, 438 B.R. at 57 (finding that as movant “failed to prove it owns the Note, it has failed to establish that it has standing to pursue its state law remedies with regard to the Mortgage and Property”). *Cf. Brown Bark I L.P. v. Ebersole (In re Ebersole)*, 440 B.R. 690, 694 (Bankr. W.D. Va. 2010) (finding that movant seeking relief from stay must prove that it is the holder of the subject note in order to establish a ‘colorable claim’ which would establish standing to seek relief from stay).

Noteholder status

In the Motion, the Movant asserts U.S. Bank's status as the "holder" of the Mortgage. However, in order to have standing to seek relief from stay, Movant, which acts as the representative of U.S. Bank, must show that U.S. Bank holds both the Mortgage and the Note. *Mims*, 438 B.R. at 56. Although the Motion does not explicitly state that U.S. Bank is the holder of the Note, it is implicit in the Motion and the arguments presented by the Movant at the hearing. However, the record demonstrates that the Movant has produced no evidence, documentary or otherwise, that U.S. Bank is the rightful holder of the Note. Movant's reliance on the fact that U.S. Bank's noteholder status has not been challenged thus far does not alter or diminish the Movant's burden to show that it is the holder of the Note as well as the Mortgage.

Under New York law, Movant can prove that U.S. Bank is the holder of the Note by providing the Court with proof of a written assignment of the Note, or by demonstrating that U.S. Bank has physical possession of the Note endorsed over to it. *See, eg., LaSalle Bank N.A. v. Lamy*, 824 N.Y.S.2d 769, 2006 WL 2251721, at *1 (N.Y. Sup. Ct. Aug. 7, 2006). The only written assignment presented to the Court is not an assignment of the Note but rather an "Assignment of Mortgage" which contains a vague reference to the Note. Tagged to the end of the provisions which purport to assign the Mortgage, there is language in the Assignment stating "To Have and to Hold the said Mortgage *and Note*, and also the said property until the said Assignee forever, subject to the terms contained in said Mortgage *and Note*." (Assignment of Mortgage (emphasis added)). Not only is the language vague and insufficient to prove an intent to assign the Note, but MERS is not a party to the Note and the record is barren of any representation that MERS, the purported assignee, had any authority to take any action with

respect to the Note. Therefore, the Court finds that the Assignment of Mortgage is not sufficient to establish an effective assignment of the Note.

By MERS's own account, it took no part in the assignment of the Note in this case, but merely provided a database which allowed its members to electronically self-report transfers of the Note. MERS does not confirm that the Note was properly transferred or in fact whether anyone including agents of MERS had or have physical possession of the Note. What remains undisputed is that MERS did not have any rights with respect to the Note and other than as described above, MERS played no role in the transfer of the Note.

Absent a showing of a valid assignment of the Note, Movant can demonstrate that U.S. Bank is the holder of the Note if it can show that U.S. Bank has physical possession of the Note endorsed to its name. *See In re Mims*, 423 B.R. at 56-57. According to the evidence presented in this matter the manner in which the MERS system is structured provides that, "[w]hen the beneficial interest in a loan is sold, the promissory note is [] transferred by an endorsement and delivery from the buyer to the seller [sic], but MERS Members are obligated to update the MERS® System to reflect the change in ownership of the promissory note. . . ." (MERS Supplemental Memorandum of Law at 6). However, there is nothing in the record to prove that the Note in this case was transferred according to the processes described above other than MERS's representation that its computer database reflects that the Note was transferred to U.S. Bank. The Court has no evidentiary basis to find that the Note was endorsed to U.S. Bank or that U.S. Bank has physical possession of the Note. Therefore, the Court finds that Movant has not satisfied its burden of showing that U.S. Bank, the party on whose behalf Movant seeks relief from stay, is the holder of the Note.

Mortgagee status

The Movant's failure to show that U.S. Bank holds the Note should be fatal to the Movant's standing. However, even if the Movant could show that U.S. Bank is the holder of the Note, it still would have to establish that it holds the Mortgage in order to prove that it is a secured creditor with standing to bring this Motion before this Court. The Movant urges the Court to adhere to the adage that a mortgage necessarily follows the same path as the note for which it stands as collateral. *See Wells Fargo Bank, N.A. v. Perry*, 875 N.Y.S.2d 853, 856 (N.Y. Sup. Ct. 2009). In simple terms the Movant relies on the argument that a note and mortgage are inseparable. *See Carpenter v. Longan*, 83 U.S. 271, 274 (1872). While it is generally true that a mortgage travels a parallel path with its corresponding debt obligation, the parties in this case have adopted a process which by its very terms alters this practice where mortgages are held by MERS as "mortgagee of record." By MERS's own account, the Note in this case was transferred among its members, while the Mortgage remained in MERS's name. MERS admits that the very foundation of its business model as described herein requires that the Note and Mortgage travel on divergent paths. Because the Note and Mortgage did not travel together, Movant must prove not only that it is acting on behalf of a valid assignee of the Note, but also that it is acting on behalf of the valid assignee of the Mortgage.⁵

⁵ MERS argues that notes and mortgages processed through the MERS System are never "separated" because beneficial ownership of the notes and mortgages are always held by the same entity. The Court will not address that issue in this Decision, but leaves open the issue as to whether mortgages processed through the MERS system are properly perfected and valid liens. *See Carpenter v. Longan*, 83 U.S. at 274 (finding that an assignment of the mortgage without the note is a nullity); *Landmark Nat'l Bank v. Kesler*, 216 P.3d 158, 166-67 (Kan. 2009) ("[I]n the event that a mortgage loan somehow separates interests of the note and the deed of trust, with the deed of trust lying with some independent entity, the mortgage may become unenforceable").

MERS asserts that its right to assign the Mortgage to U.S. Bank in this case, and in what it estimates to be literally millions of other cases, stems from three sources: the Mortgage documents; the MERS membership agreement; and state law. In order to provide some context to this discussion, the Court will begin its analysis with an overview of mortgage and loan processing within the MERS network of lenders as set forth in the record of this case.

In the most common residential lending scenario, there are two parties to a real property mortgage – a mortgagee, *i.e.*, a lender, and a mortgagor, *i.e.*, a borrower. With some nuances and allowances for the needs of modern finance this model has been followed for hundreds of years. The MERS business plan, as envisioned and implemented by lenders and others involved in what has become known as the mortgage finance industry, is based in large part on amending this traditional model and introducing a third party into the equation. MERS is, in fact, neither a borrower nor a lender, but rather purports to be both “mortgagee of record” and a “nominee” for the mortgagee. MERS was created to alleviate problems created by, what was determined by the financial community to be, slow and burdensome recording processes adopted by virtually every state and locality. In effect the MERS system was designed to circumvent these procedures. MERS, as envisioned by its originators, operates as a replacement for our traditional system of public recordation of mortgages.

Caselaw and commentary addressing MERS’s role in the mortgage recording and foreclosure process abound. *See* Christopher L. Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, 78 U. Cin. L. Rev. 1359 (2010). In a 2006 published opinion, the New York Court of Appeals described MERS system as follows:

In 1993, the MERS system was created by several large participants in the real estate mortgage industry to track ownership interests in residential mortgages.

Mortgage lenders and other entities, known as MERS members, subscribe to the MERS system and pay annual fees for the electronic processing and tracking of ownership and transfers of mortgages. Members contractually agree to appoint MERS to act as their common agent on all mortgages they register in the MERS system.

The initial MERS mortgage is recorded in the County Clerk's office with 'Mortgage Electronic Registration Systems, Inc.' named as the lender's nominee or mortgagee of record on the instrument. During the lifetime of the mortgage, the beneficial ownership interest or servicing rights may be transferred among MERS members (MERS assignments), but these assignments are not publicly recorded; instead they are tracked electronically in MERS's private system. In the MERS system, the mortgagor is notified of transfers of servicing rights pursuant to the Truth in Lending Act, but not necessarily of assignments of the beneficial interest in the mortgage.

Merscorp, Inc., v. Romaine, 8 N.Y.3d 90 (N.Y. 2006) (footnotes omitted).

In the words of MERS's legal counsel, "[t]he essence of MERS' business is to hold legal title to beneficial interests under mortgages and deeds of trust in the land records. The MERS® System is designed to allow its members, which include originators, lenders, servicers, and investors, to accurately and efficiently track transfers of servicing rights and beneficial ownership." (MERS Memorandum of Law at 5). The MERS® System ". . . eliminate[s] the need for frequent, recorded assignments of subsequent transfers." (MERS Supplemental Memorandum of Law at 4). "Prior to MERS, every time a loan secured by a mortgage was sold, the assignee would need to record the assignment to protect the security interest. If a servicing company serviced the loan and the servicing rights were sold, – an event that could occur multiple times during the life of a single mortgage loan – multiple assignments were recorded to ensure that the proper servicer appeared in the land records in the County Clerk's office." (MERS Supplemental Memorandum of Law at 4-5).

"When the beneficial interest in a loan is sold, the promissory note is still transferred by

an endorsement and delivery from the buyer to the seller, but MERS Members are obligated to update the MERS® System to reflect the change in ownership of the promissory note. . . . So long as the sale of the note involves a MERS Member, MERS remains the named mortgagee of record, and continues to act as the mortgagee, as the nominee for the new beneficial owner of the note (and MERS' Member). The seller of the note does not and need not assign the mortgage because under the terms of that security instrument, MERS remains the holder of title to the mortgage, that is, the mortgagee, as the nominee for the purchaser of the note, who is then the lender's successor and/or assign." (MERS Supplemental Memorandum of Law at 6). "At all times during this process, the original mortgage or an assignment of the mortgage to MERS remains of record in the public land records where the security real estate is located, providing notice of MERS's disclosed role as the agent for the MERS Member lender and the lender's successors and assigns." (Declaration of William C. Hultman, ¶9).

MERS asserts that it has authority to act as agent for each and every MERS member which claims ownership of a note and mortgage registered in its system. This authority is based not in the statutes or caselaw, but rather derives from the terms and conditions of a MERS membership agreement. Those terms and conditions provide that "MERS shall serve as mortgagee of record with respect to all such mortgage loans solely as a nominee, in an administrative capacity, for the beneficial owner or owners thereof from time to time."

(Declaration of William C. Hultman, ¶5). MERS "holds the legal title to the mortgage and acts as the agent or nominee for the MERS Member lender, or owner of the mortgage loan."

(Declaration of William C. Hultman, ¶6). According to MERS, it is the "intent of the parties . . . for MERS to serve as the *common nominee or agent* for MERS Member lenders and their

successors and assigns.” (MERS Supplemental Memorandum of Law at 19) (emphasis added by the Court). “Because MERS holds the mortgage lien for the lender who may freely transfer its interest in the note, without the need for a recorded assignment document in the land records, MERS holds the mortgage lien for *any intended transferee of the note.*” (MERS Supplemental Memorandum of Law at 15) (emphasis added by the Court). If a MERS member subsequently assigns the note to a non-MERS member, or if the MERS member which holds the note decides to foreclose, only then is an assignment of the mortgage from MERS to the noteholder documented and recorded in the public land records where the property is located. (Declaration of William C. Hultman, ¶12).

Before commenting on the legal effect of the MERS membership rules or the alleged “common agency” agreement created among MERS members, the Court will review the relevant portions of the documents presented in this case to evaluate whether the documentation, on its face, is sufficient to prove a valid assignment of the Mortgage to U.S. Bank.

The Mortgage

First Franklin is the “Lender” named in the Mortgage. With reference to MERS’s role in the transaction, the Mortgage states:

MERS is a separate corporation that is *acting solely as a nominee for Lender and Lender’s successors and assigns.* MERS is organized and existing under the laws of Delaware, and has an address and telephone number of P.O. Box 2026, Flint, MI 48501-2026, tel. (888) 679 MERS. **FOR PURPOSES OF RECORDING THIS MORTGAGE, MERS IS THE *MORTGAGEE OF RECORD.***

(Mortgage at 1 (emphasis added by the Court)).

The Mortgage also purports to contain a transfer to MERS of the Borrower’s (*i.e.*, the

Debtor's) rights in the subject Property as follows:

BORROWER'S TRANSFER TO LENDER OF RIGHTS IN THE PROPERTY

[The Borrower] mortgage[s], grant[s] and convey[s] the Property to MERS (solely as nominee for Lender and Lender's successors in interest) and its successors in interest subject to the terms of this Security Instrument. This means that, by signing this Security Instrument, [the Borrower is] giving Lender those rights that are stated in this Security Instrument and also those rights that Applicable Law gives to lenders who hold mortgage on real property. [The Borrower is] giving Lender these rights to protect Lender from possible losses that might result if [the Borrower] fail[s] to [comply with certain obligations under the Security Instrument and accompanying Note.]

[The Borrower] understand[s] and agree[s] that MERS holds only legal title to the rights granted by [the Borrower] in this Security Instrument, but, if necessary to comply with law or custom, *MERS (as nominee for Lender and Lenders's successors and assigns) has the right: (A) to exercise any or all those rights, including, but not limited to, the right to foreclose and sell the Property; and (B) to take any action required of Lender including, but not limited to, releasing and canceling this Security Instrument.*

[The Borrower gives] MERS (solely as nominee for Lender and Lender's successors in interest), rights in the Property . . .

(Mortgage at 3) (emphasis added).

The Assignment of Mortgage references the Mortgage and defines the "Assignor" as "Mers' Mortgage Electronic Registration Systems, Inc., 2150 North First Street, San Jose, California 95131, *as nominee for First Franklin*, a division of National City Bank of IN, 2150 North First Street San Jose, California 95153." (Emphasis added by the Court). The "Assignee" is U.S. Bank.

Premised on the foregoing documentation, MERS argues that it had full authority to validly execute the Assignment of Mortgage to U.S. Bank on February 1, 2008, and that as of the date the foreclosure proceeding was commenced U.S. Bank held both the Note and the Mortgage. However, without more, this Court finds that MERS's "nominee" status and the

rights bestowed upon MERS within the Mortgage itself, are insufficient to empower MERS to effectuate a valid assignment of mortgage.

There are several published New York state trial level decisions holding that the status of “nominee” or “mortgagee of record” bestowed upon MERS in the mortgage documents, by itself, does not empower MERS to effectuate an assignment of the mortgage. These cases hold that MERS may not validly assign a mortgage based on its nominee status, absent some evidence of specific authority to assign the mortgage. *See Bank of New York v. Mulligan*, No. 29399/07, 2010 WL 3339452, at *7 (N.Y. Sup. Ct. Aug. 25, 2010); *One West Bank, F.S.B. v. Drayton*, 910 N.Y.S.2d 857, 871 (N.Y. Sup. Ct. 2010); *Bank of New York v. Alderazi*, 900 N.Y.S.2d 821, 824 (N.Y. Sup. Ct. 2010) (the “party who claims to be the agent of another bears the burden of proving the agency relationship by a preponderance of the evidence”); *HSBC Bank USA v. Yeasmin*, No. 34142/07, 2010 WL 2089273, at *3 (N.Y. Sup. Ct. May 24, 2010); *HSBC Bank USA v. Vasquez*, No. 37410/07, 2009 WL 2581672, at *3 (N.Y. Sup. Ct. Aug. 21, 2010); *LaSalle Bank N.A. v. Lamy*, 824 N.Y.S.2d 769, 2006 WL 2251721, at *2 (N.Y. Sup. Ct. Aug. 7, 2006) (“A nominee of the owner of a note and mortgage may not effectively assign the note and mortgage to another for want of an ownership interest in said note and mortgage by the nominee.”). *See also MERS v. Saunders*, 2 A.3d 289, 295 (Me. 2010) (“MERS’s only right is to record the mortgage. Its designation as the ‘mortgagee of record’ in the document does not change or expand that right...”). *But see US Bank, N.A. v. Flynn*, 897 N.Y.S.2d 855 (N.Y. Sup. Ct. 2010) (finding that MERS’s “nominee” status and the mortgage documents give MERS authority to assign); *Crum v. LaSalle Bank, N.A.*, No. 2080110, 2009 WL 2986655, at *3 (Ala. Civ. App., Sept. 18, 2009) (finding MERS validly assigned its and the lender’s rights to

assignee); *Blau v. America's Servicing Company, et al.*, No. CV-08-773-PHX-MHM, 2009 WL 3174823, at *8 (D. Ariz. Sept. 29, 2009) (finding that assignee of MERS had standing to foreclose).

In *LaSalle Bank, N.A. v. Bouloute*, No. 41583/07, 2010 WL 3359552, at *2 (N.Y. Sup. Aug. 26, 2010), the court analyzed the relationship between MERS and the original lender and concluded that a nominee possesses few or no legally enforceable rights beyond those of a principal whom the nominee serves. The court stated:

MERS . . . recorded the subject mortgage as “nominee” for FFFC. The word “nominee” is defined as “[a] person designated to act in place of another, usu. in a very limited way” or “[a] party who holds bare legal title for the benefit of others.” (Black's Law Dictionary 1076 [8th ed 2004]). “This definition suggests that a nominee possesses few or no legally enforceable rights beyond those of a principal whom the nominee serves.” (*Landmark National Bank v. Kesler*, 289 Kan 528, 538 [2009]). The Supreme Court of Kansas, in *Landmark National Bank*, 289 Kan at 539, observed that:

The legal status of a nominee, then, depends on the context of the relationship of the nominee to its principal. Various courts have interpreted the relationship of MERS and the lender as an agency relationship. See *In re Sheridan*, 2009 WL631355, at *4 (Bankr. D. Idaho, March 12, 2009) (MERS “acts not on its own account. Its capacity is representative.”); *Mortgage Elec. Registrations Systems, Inc. v. Southwest*, 2009 Ark. 152 ----, 301 SW3d 1, 2009 WL 723182 (March 19, 2009) (“MERS, by the terms of the deed of trust, and its own stated purposes, was the lender's agent”); *La Salle Nat. Bank v. Lamy*, 12 Misc.3d 1191[A], at *2 [Sup Ct, Suffolk County 2006]) ... (“A nominee of the owner of a note and mortgage may not effectively assign the note and mortgage to another for want of an ownership interest in said note and mortgage by the nominee.”).

LaSalle Bank, N.A. v. Bouloute, No. 41583/07, 2010 WL 3359552, at *2; see also *Bank of New York v. Alderazi*, 900 N.Y.S.2d 821, 823 (N.Y. Sup. Ct. 2010) (nominee is “[a] person designated to act in place of another, usually in a very limited way.”) (quoting Black’s Law

Dictionary)).

In *LaSalle Bank, N.A. v. Bouloute* the court concluded that MERS must have some evidence of authority to assign the mortgage in order for an assignment of a mortgage by MERS to be effective. Evidence of MERS's authority to assign could be by way of a power of attorney or some other document executed by the original lender. See *Bouloute*, 2010 WL 3359552, at *1; *Alderazi*, 900 N.Y.S.2d at 823 (“To have a proper assignment of a mortgage by an authorized agent, a power of attorney is necessary to demonstrate how the agent is vested with the authority to assign the mortgage.”) (quoting *HSBC Bank USA, NA v. Yeasmin*, 866 N.Y.S.2d 92 (N.Y. Sup. Ct. 2008)).

Other than naming MERS as “nominee”, the Mortgage also provides that the Borrower transfers legal title to the subject property to MERS, as the Lender's nominee, and acknowledges MERS's rights to exercise certain of the Lender's rights under state law. This too, is insufficient to bestow any authority upon MERS to assign the mortgage. In *Bank of New York v. Alderazi*, the court found “[t]he fact that the borrower acknowledged and consented to MERS acting as nominee of the lender has no bearing on what specific powers and authority the lender granted MERS.” *Alderazi*, 900 N.Y.S.2d at 824. Even if it did bestow some authority upon MERS, the court in *Alderazi* found that the mortgage did not convey the specific right to assign the mortgage.

The Court agrees with the reasoning and the analysis in *Bouloute* and *Alderazi*, and the other cases cited herein and finds that the Mortgage, by naming MERS a “nominee,” and/or “mortgagee of record” did not bestow authority upon MERS to assign the Mortgage.

The MERS membership rules

According to MERS, in addition to the alleged authority granted to it in the Mortgage itself, the documentation of the Assignment of Mortgage comports with all the legal requirements of agency when read in conjunction with the overall MERS System. MERS's argument requires that this Court disregard the specific words of the Assignment of Mortgage or, at the very least, interpret the Assignment in light of the overall MERS System of tracking the beneficial interests in mortgage securities. MERS urges the Court to look beyond the four corners of the Mortgage and take into consideration the agency relationship created by the agreements entered into by the lenders participating in the MERS System, including their agreement to be bound by the terms and conditions of membership.

MERS has asserted that each of its member/lenders agrees to appoint MERS to act as its agent. In this particular case, the Treasurer of MERS, William C. Hultman, declared under penalty of perjury that "pursuant to the MERS's Rules of Membership, Rule 2, Section 5. . . First Franklin appointed MERS to act as its agent to hold the Mortgage as nominee on First Franklin's behalf, and on behalf of First Franklin's successors and assigns." (Affirmation of William C. Hultman, ¶7). However, Section 5 of Rule 2, which was attached to the Hultman Affirmation as an exhibit, contains no explicit reference to the creation of an agency or nominee relationship. Consistent with this failure to explicitly refer to the creation of an agency agreement, the rules of membership do not grant any clear authority to MERS to take any action with respect to the mortgages held by MERS members, including but not limited to executing assignments. The rules of membership do require that MERS members name MERS as "mortgagee of record" and that MERS appears in the public land records as such. Section 6 of Rule 2 states that "MERS

shall at all times comply with the instructions of the holder of mortgage loan promissory notes,” but this does not confer any specific power or authority to MERS.

State law

Under New York agency laws, an agency relationship can be created by a “manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and the consent by the other to act.” *Meisel v. Grunberg*, 651 F.Supp.2d 98, 110 (S.D.N.Y. 2009) (citing *N.Y. Marine & Gen. Ins. Co. v. Tradeline, L.L.C.*, 266 F.3d 112, 122 (2d Cir.2001)).

‘Such authority to act for a principal may be actual or apparent.’ . . . Actual authority arises from a direct manifestation of consent from the principal to the agent. . . . The existence of actual authority ‘depends upon the actual interaction between the putative principal and agent, not on any perception a third party may have of the relationship.’

Meisel v. Grunberg, 651 F.Supp.2d at 110 (citations omitted).

Because MERS’s members, the beneficial noteholders, purported to bestow upon MERS interests in real property sufficient to authorize the assignments of mortgage, the alleged agency relationship must be committed to writing by application of the statute of frauds. Section 5-703(2) of the New York General Obligations Law states that:

An estate or interest in real property, other than a lease for a term not exceeding one year, or any trust or power, over or concerning real property, or in any manner relating thereto, cannot be created, granted, assigned, surrendered or declared, unless by act or operation of law, or by a deed or conveyance in writing, subscribed by the person creating, granting, assigning, surrendering or declaring the same, *or by his lawful agent, thereunto authorized by writing.*

See N.Y. Gen. Oblig. Law § 5-703(1) (McKinney 2011); *Republic of Benin v. Mezei*, No. 06 Civ. 870 (JGK), 2010 WL 3564270, at *3 (S.D.N.Y. Sept. 9, 2010); *Urgo v. Patel*, 746 N.Y.S.2d 733

(N.Y. App. Div. 2002) (finding that unwritten apparent authority is insufficient to satisfy the statute of frauds) (citing *Diocese of Buffalo v. McCarthy*, 91 A.D.2d 1210 (4th Dept. 1983)); *see also* N.Y. Gen. Oblig. Law § 5-1501 (McKinney 2011) (“‘agent’ means a person granted authority to act as attorney-in-fact for the principal under a power of attorney. . .”). MERS asks this Court to liberally interpret the laws of agency and find that an agency agreement may take any form “desired by the parties concerned.” However, this does not free MERS from the constraints of applicable agency laws.

The Court finds that the record of this case is insufficient to prove that an agency relationship exists under the laws of the state of New York between MERS and its members. According to MERS, the principal/agent relationship among itself and its members is created by the MERS rules of membership and terms and conditions, as well as the Mortgage itself. However, none of the documents expressly creates an agency relationship or even mentions the word “agency.” MERS would have this Court cobble together the documents and draw inferences from the words contained in those documents. For example, MERS argues that its agent status can be found in the Mortgage which states that MERS is a “nominee” and a “mortgagee of record.” However, the fact that MERS is named “nominee” in the Mortgage is not dispositive of the existence of an agency relationship and does not, in and of itself, give MERS any “authority to act.” *See Steinbeck v. Steinbeck Heritage Foundation*, No. 09-18360cv, 2010 WL 3995982, at *2 (2d Cir. Oct. 13, 2010) (finding that use of the words “attorney in fact” in documents can constitute evidence of agency but finding that such labels are not dispositive); *MERS v. Saunders*, 2 A.3d 289, 295 (Me. 2010) (designation as the ‘mortgagee of record’ does not qualify MERS as a “mortgagee”). 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 take affirmative actions with respect to mortgages registered on its system.

In addition to casting itself as nominee/agent, MERS seems to argue that its role as "mortgagee of record" gives it the rights of a mortgagee in its own right. MERS relies on the definition of "mortgagee" in the New York Real Property Actions and Proceedings Law Section 1921 which states that a "mortgagee" *when used in the context of Section 1921*, means the "current holder of the mortgage of record . . . or their agents, successors or assigns." N.Y. Real Prop. Acts. L. § 1921 (McKinney 2011). The provisions of Section 1921 relate solely to the discharge of mortgages and the Court will not apply that definition beyond the provisions of that section in order to find that MERS is a "mortgagee" with full authority to perform the duties of mortgagee in its own right. 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.

Adding to this absurdity, it is notable in this case that the Assignment of Mortgage was by MERS, *as nominee for First Franklin*, the original lender. By the Movant's and MERS's own admission, at the time the assignment was effectuated, First Franklin no longer held any interest in the Note. Both the Movant and MERS have represented to the Court that subsequent to the origination of the loan, the Note was assigned, through the MERS tracking system, from First Franklin to Aurora, and then from Aurora to U.S. Bank. Accordingly, at the time that MERS, *as nominee of First Franklin*, assigned the interest in the Mortgage to U.S. Bank, U.S.

Bank allegedly already held the Note and it was at U.S. Bank's direction, not First Franklin's, that the Mortgage was assigned to U.S. Bank. Said another way, when MERS assigned the Mortgage to U.S. Bank on First Franklin's behalf, it took its direction from U.S. Bank, not First Franklin, to provide documentation of an assignment from an entity that no longer had any rights to the Note or the Mortgage. The documentation provided to the Court in this case (and the Court has no reason to believe that any further documentation exists), is stunningly *inconsistent* with what the parties define as the facts of this case.

However, even if MERS had assigned the Mortgage acting on behalf of the entity which held the Note at the time of the assignment, 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.

This Court finds that MERS's theory that it can act as a "common agent" for undisclosed principals is not support by the law. The relationship between MERS and its lenders and its distortion of its alleged "nominee" status was appropriately described by the Supreme Court of Kansas as follows: "The parties appear to have defined the word [nominee] in much the same way that the blind men of Indian legend described an elephant – their description depended on which part they were touching at any given time." *Landmark Nat'l Bank v. Kesler*, 216 P.3d 158, 166-67 (Kan. 2010).

Conclusion

For all of the foregoing reasons, the Court finds that the Motion in this case should be granted. However, in all future cases which involve MERS, the moving party must show that it

validly holds both the mortgage and the underlying note in order to prove standing before this Court.

Dated: Central Islip, New York
February 10, 2011

/s/ Robert E. Grossman
Hon. Robert E. Grossman
United States Bankruptcy Judge