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Federal Court Rules Widely-Used Mortgage System Ineffective to Permit Foreclosures

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A bankruptcy court has issued an opinion that could have a wide-reaching impact on lenders in New York and, perhaps, throughout the nation. In its opinion, the court held that the system operated by Mortgage Electronic Registration Systems, Inc. ("MERS"), a private mortgage registration company involved with up to 50 percent of American home mortgages, cannot serve as an agent to assign mortgages. The court further found that the MERS system cannot provide standing for a mortgage owner that obtained its mortgage assignment through the MERS system.

On February 10, 2011, in *In re Agard*, No. 10-77338, 2011 BL 34342 (Bankr. E.D.N.Y. Feb. 10, 2011), the United States Bankruptcy Court for the Eastern District of New York granted a motion filed seeking relief from the automatic stay. The mortgage at issue in that case had been assigned through the MERS system. The court granted the mortgage servicer permission to foreclose, finding that because the servicer had already obtained a foreclosure judgment from the state court, the bankruptcy court could not undo that judgment under the *Rooker-Feldman* doctrine and the doctrine of *res judicata*. Nonetheless, the court decided that it was "appropriate to set forth its analysis" on the role of the MERS system "in the ownership and transfer of real property notes and mortgages," in light of the many cases in which the "validity of MERS assignments" is at issue.[1] In so doing, the court essentially rendered an advisory opinion that, if followed by other courts, could have a dramatic effect on the mortgage industry.

The MERS System

As indicated on its website, "MERS is an innovative process that simplifies the way mortgage ownership and servicing rights are originated, sold, and tracked. Created by the real estate finance industry "in the mid 1990's to simplify and enable the transfer of mortgage loans," MERS eliminates the need to prepare and record assignments when trading residential and commercial mortgage loans."[2] MERS' participants include such leading financial institutions as Bank of America, CitiMortgage, Fannie Mae, Freddie Mac, HSBC, and Wells Fargo.[3]

In a typical MERS mortgage transaction, MERS itself is named as the beneficiary of a mortgage or deed of trust as "nominee" for the lender. That way, a new paper assignment does not have to be recorded every time the ownership of the loan changes – the mortgage remains in the name of MERS, and MERS itself tracks the change of ownership among its members. MERS maintains a private database that tracks changes in ownership of the loan. That database is accessible only by MERS members. In the event of a borrower's default, MERS typically

assigns its interest in the mortgage to the lender that is the current holder of the loan and has the right to foreclose. That entity then initiates the foreclosure action against the borrower, usually after a written assignment of mortgage has been recorded in the land records.

In creating the MERS system, the financial industry sought to facilitate the transfer of mortgage loans from one owner to another and to enable lenders to avoid the cumbersome and expensive process of recording each individual transfer of a mortgage's ownership in the local land records.

The Court's Decision Regarding the MERS System

The mortgage lender in the *Agard* case had argued that "the provisions of the Mortgage grant to MERS the right to assign the Mortgage as 'nominee,' or agent, on behalf of the [original] lender," and that MERS therefore had the proper authority "to assign the Mortgage" to the lender.[4] However, the *Agard* court held that neither "the MERS rules of membership and terms and conditions, [nor] the Mortgage itself…expressly creates an agency relationship or even mentions the word 'agency.'" The court further found that "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.'"[5] As a result of its opinion, the court has called into question the efficacy of the MERS system and the ability of MERS to effectuate assignments.

Limitations of the Agard *Ruling*

Although potentially far-reaching, it is important to note that the ruling regarding the MERS system was merely dicta. The issue of the validity of the MERS system was not before the *Agard* court. Indeed, the only issue before the court was the right of the mortgagee to obtain relief from the automatic stay, which relief was granted. Moreover, the issue of agency was not raised by those parties who would have standing to do so—MERS and the mortgagee. Instead, the court decided to address a question that, arguably, was outside of the scope of the issues before it.

The *Agard* ruling is also at odds with decisions rendered by other courts throughout the nation, including federal bankruptcy courts in Massachusetts[6] and Kansas,[7] which have found that a MERS assignment suffices to provide a mortgage lender with standing to pursue a foreclosure. In those cases, the bankruptcy courts found that a MERS assignment to the foreclosing entity was sufficient to grant that entity the power to foreclose, and that MERS had sufficient agency power to assign the subject mortgage. Furthermore, a New York appellate court[8] has held that the same mortgage language was "further support for MERS' standing . . . Coakley [the borrower] expressly agreed without qualification that MERS had the right to foreclose in the event of default," directly contravening the *Agard* court's dicta addressing MERS' authority.[9]

Effect of the Agard *Decision*

Importantly, the *Agard* decision failed to acknowledge that mortgages in the MERS system, like all mortgages, are in fact supported by consideration. In other words, the lenders provided the borrowers with the funds used to either purchase or refinance their properties. Those loans were secured by the mortgages. The borrowers received the benefit of the loans. If the *Agard* decision is followed, the borrowers would be unjustly enriched. Under the theory of an equitable assignment, the equities would compel enforcement of the mortgages. If a court is concerned about future claims of enforceability by other entities that may believe that they had an interest in the loan, it has the authority to provide such relief as it deems appropriate. For instance, the court may require lenders seeking foreclosure on a MERS generated assignment to indemnify the borrower against claims by other entities.

Although the *Agard* ruling does not invalidate or prevent any foreclosure, its dicta may be followed

in jurisdictions where a state court has not directly ruled on the validity of the MERS assignment system. In a jurisdiction where the *Agard* ruling is or may be followed, lenders may find themselves unable to foreclose on delinquent loans, causing the lenders and their investors to incur severe losses and resulting in windfalls for delinquent borrowers. Even worse, the decision may encourage borrowers with MERS loans to cease paying their mortgages, secure in the knowledge that the lender may not have the power to foreclose.

One would expect MERS and any lenders affected by the *Agard* decision to seek such relief as is needed to have the *Agard* decision given as limited effect as possible in order to protect the MERS system. The ultimate issue of the validity of MERS assignments will likely be decided in the appellate courts, and especially the state supreme courts in which questions of state law are typically decided. In the alternative, and as suggested by the *Agard* court, Congress or the state legislatures could explicitly validate MERS assignments by law. An act of Congress, however, could pose questions of federal power in regulating mortgage assignments, which have traditionally been the subject of state authority.

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[1] *In re Agard*, No. 10-77338, 2011 BL 34342, at *18-19 (Bankr. E.D.N.Y. Feb. 10, 2011).

[2] www.mersinc.org.

[3] www.mersinc.org/about/shareholders.

[4] *See Agard*, No. 10-77338, 2011 BL 34342, at *7.

[5] *Id.* at *34.

[6] *In re Lopez,* No. 09-10346-WCH, 2011 BL 32862, at *3, 9 (Bankr. D. Mass Feb. 9, 2011) (where the "Mortgage specifically identified MERS as the mortgagee under the instrument and granted it and its 'successors and assigns' a power of sale," the court found that the current mortgage holder had established proper standing, and that "even though MERS never had possession of the Note, it was legally holding the Mortgage in trust for the Note holder.").

[7] *Martinez v. Mortg. Elec. Registration Sys., Inc.*, No. 09-40886, 2011 BL 35727, at *20 (Bankr. D. Kan. Feb. 11, 2011) (holding that the loan owner's "interest is secured and it has the right to enforce the Note and Mortgage through its agent, MERS, or on its own (by directing its agent to assign the mortgage to it.")).

[8] *Mortg. Elec. Registration Sys., Inc. v. Coakley*, 838 N.Y.S. 2d 622, 623 (N.Y. App. Div. 2d Dep't 2007) (noting that "further support for MERS' standing…may be found on the face of the mortgage instrument itself" in that the borrower "expressly agreed without qualification that MERS had the right to foreclose…in the event of a default.").

[9] *Id.* at 623.