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MERS: Creating Efficiencies or Clouding Titles? Examining Challenges to the Mortgage Electronic Registration System

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Examining Challenges to the Mortgage Electronic Registration System

**ABSTRACT.** The Mortgage Electronic Registration System has recently come under fire amidst the recent foreclosure crisis. Since MERS is mortgagee of record to more than 60 million mortgages in the United States, the question as to whether it has standing to foreclose on defaulted loans presents a hurdle to the speedy recovery of the housing market.

It is likely that the MERS framework is a sound one that complies with longstanding principles of property and agency law. Examination of the controlling Supreme Court case *Carpenter v. Longan* and Restatement commentary reveals that a separation of the mortgage and the note does not render the debt unsecured. Further, the holder in due course doctrine allows MERS and its affiliates to endorse a note in blank and deliver it to the party intending to bring a foreclosure action.

MERS is a sound system that reduces transaction costs involved in mortgage securitization, just as the stock transfer agent reduced costs involved in publicly traded stock transactions more than 40 years ago. Its existence reduces the cost of borrowing and its framework should be preserved.
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INTRODUCTION

The housing market has experienced far-reaching evolution and a subsequent reversal in the previous ten years. Innovations like mortgage securitization and customized subprime mortgage products led to what financial institutions and market critics to hail the coming of the “democratization of credit.”1 This development was meant to open the credit market to more consumers who previously could not obtain credit at any cost. The federal government2 and the Federal Reserve Bank3 pursued this goal through explicit policy. Such relatively recent advancements in financial markets have led to both positive and negative developments; most recently, however, the housing bubble and subsequent credit crisis can find many of their roots in recent financial innovations and their abuse.

One particular innovation of the financial services industry is the Mortgage Electronic Registration System, or “MERS.” MERS is mortgagee of record for over 60 million mortgages in the United States.4 The financial services industry developed MERS as a method for increasing liquidity in secondary mortgage markets by eliminating the need to record a new mortgage assignment in county land records

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2 “[E]ven though federal regulators had issued caution to banks holding subprime loans directly on their balance sheets, they generally supported the growth of the subprime mortgage market.” Daniel Immergluck, Private Risk, Public Risk: Public Policy, Market Development, and the Mortgage Crisis, 36 Fordham Urb. L.J. 447 (2007); see also Steven A. Holmes, Fannie Mae Eases Credit to Aid Mortgage Lending, N.Y. TIMES, Sept. 30, 1999, at C2.
3 See David Henderson et al., Symposium: Did Alan Greenspan’s Federal Reserve Cause the Housing Bubble? WALL ST. J., Mar. 27, 2009, at A13 (suggesting that the Fed’s “easy money” policy, perpetuated by a low federal funds rate, was a major culprit in providing the capital that fueled the credit crisis).
offices every time a mortgage changes hands. In the age of the mortgage-backed security, MERS has saved financial institutions thousands of hours of paperwork and millions of dollars in recording fees.\textsuperscript{5}

Recent media coverage of the “robo-signing” scandal,\textsuperscript{6} and waves of foreclosures being filed with incomplete or erroneous documentation\textsuperscript{7} has brought MERS into the public eye. Many critics have raised legal objections as to its contractual relationship with banks and whether it has standing to foreclose even though it holds no true beneficial ownership of the mortgage note.\textsuperscript{8}

This article will examine the various legal challenges levied against MERS and their veracity, enumerate the various benefits MERS provides the mortgage market, and make suggestions as to how its legal status may be strengthened and institutionalized into the ancient regime of U.S. property law. Section I discusses the historical evolution of mortgage securitization, the impact of U.S. monetary policy upon this framework, and possible causes of the foreclosure crisis. Section II discusses traditional criticisms of foreclosure jurisprudence and recent responses to the foreclosure crisis. Section III introduces the concept of the Mortgage Electronic Registration System, its function, and

\textsuperscript{5} Recording costs for mortgage assignments typically start at $15-30 for the first page and $2-3 for each additional page. Beau Phillips, MERS: Mortgage Electronic Registration System, 63 CONSUMER FIN. L.Q. REP. 262, 263 (2009).

\textsuperscript{6} See, e.g., Editorial, On the Foreclosure Front, N.Y. TIMES, Oct. 3, 2010, at WK7 (“the signers at Chase and GMAC processed 10,000 or more documents a month — “robo-signing” in industry parlance — without personal knowledge of the facts.”).


\textsuperscript{8} See, e.g., Peterson, supra n. 4; Dale A. Whitman, How Negotiability Has Fouled Up the Secondary Mortgage Market, and What to Do About It, 37 PEPP. L. REV. 737 (2010); Robert T. Myers, Foreclosing on the Subprime Loan Crisis: Why Current Regulations are Flawed and What is Needed to Stop Another Crisis from Occurring, 87 OR. L. REV. 311, 350 (2008); Christopher L. Peterson, Predatory Structured Finance, 28 Cardozo L. Rev. 2185 (2007).
Section III also overviews the process of creating a mortgage-backed security in order to aid the reader’s understanding of the role of MERS in mortgage securitization. Section IV outlines the various arguments lodged against MERS and addresses them in turn. Section V discusses the benefits that MERS confers upon the mortgage lending market. Section VI proposes solutions and compromises to satisfy valid concerns with the current framework. Section VII briefly concludes.

I. History of Mortgage Securitization

Traditionally, a bank that extends mortgage credit holds several mortgages for their full duration, called “portfolio lending.” The bank would originate the loan, fund it with its own capital, and service the loan. Because banks have limited capital to lend in such a long-term capacity, portfolio lending tends to localize the availability of credit: for example, if a region experienced a building boom with an attendant increase in creditworthy individuals seeking loans, banks in the area would quickly run out of free capital to lend.

Congress essentially created the secondary mortgage market in 1938 when it chartered the Federal National Mortgage Association, or Fannie Mae. The agency, along with others like the Federal Housing Authority and the Veteran’s Administration, promulgated guidelines for the types of mortgages it would purchase, thus establishing

9 See Phillips, supra n. 5.
the standard for the thirty-year fixed-rate mortgage.\textsuperscript{11} Fannie Mae would purchase both newly originated and already-executed or "seasoned loans," package them into portfolios of mortgages, and sell them to investors on the open market.\textsuperscript{12} Fannie Mae was thus the first issuer of mortgage-backed securities.\textsuperscript{13}

By buying and selling mortgages, Fannie Mae and other government agencies were able to reallocate capital from region to region by purchasing mortgages from fully-leveraged banks and selling them to banks that had excess capital on hand.\textsuperscript{14} The Federal Home Loan Mortgage Corporation ("Freddie Mac"), Fannie Mae’s twin agency, pioneered the collateralized mortgage obligation in 1983, where a pool of mortgages provides a payment stream allocated between different classes of securities.\textsuperscript{15} This development, the direct predecessor to the modern secondary mortgage market, was responsible for lowering the average cost of mortgage financing by one quarter of one percent between June and December 1983.\textsuperscript{16}

It was not long until private financial institutions began to emulate the instruments and devices pioneered by Fannie Mae and Freddie Mac.\textsuperscript{17} Because the two government corporations only deal in prime mortgages, private institutions decided to satisfy the

\textsuperscript{11} Id. at 992.
\textsuperscript{12} Id. at 994.
\textsuperscript{13} Id. at 1001.
\textsuperscript{14} Id. at 994.
\textsuperscript{15} Id. at 1008-09. A collateralized mortgage obligation differs slightly from a collateralized debt obligation, which was developed by the private sector.
\textsuperscript{16} Id. at 1009.
\textsuperscript{17} Id. at 994-95.
need for subprime lending by applying the securitization process to the subprime mortgage market.18

In 2001, the Federal Reserve lowered the federal funds interest rate to 1%, the lowest in nearly 50 years, in order to stave off the effects of recession and jump-start the economy.19 Financial institutions were now replete with access to credit at low interest rates, excess cash from the Fed’s open market operations,20 and a way to originate, securitize and sell off loans immediately, pocketing a handsome commission.21 Such distortion of demand and monetary policy continue to create moral hazard through explicit government guarantees of new mortgages,22 the government-sponsored entities Fannie Mae and Freddie Mac,23 and legislation designed to encourage mortgage modifications.24

18 “Blemished credit, prior bankruptcies, higher debt burdens and irregular incomes all are factors that routinely result in the denial of credit to subprime applicants for home mortgage loans to be insured or guaranteed by FHA and VA or to be sold to Fannie Mae and Freddie Mac. The private subprime lending industry has sought to fill this void by meeting the legitimate needs of the underserved subprime credit markets....” George P. Miller, Regulatory Developments in Securitization, 843 PRAC. LAW INST. 733, 819-20 (2002).
21 See discussion infra part III.A.
22 See Nick Timiraos, FHA Loan Defaults Surpass 9%, WALL ST. J., Feb. 9, 2010 (discussing increasing default rates on loans guaranteed by the Federal Housing Authority).
When the housing bubble finally burst, many of the careless and often fraudulent activities perpetrated by the mortgage industry came to the attention of the public. This revelation of wrongdoing has led several banks to halt foreclosure proceedings,\textsuperscript{25} has alerted courts to the possibility that a foreclosure plaintiff has a defective claim, and has contributed to the near-overnight explosion of the foreclosure defense legal practice.\textsuperscript{26} Although foreclosure litigation has until now been a fairly straightforward, uneventful process, undoubtedly the increasing complexities of the modern secondary mortgage market will drive courts and scholars to find answers to the mounting legal questions raised by the process of securitization.

II. The Evolution of Foreclosure Law

Until recently, most scholarly discourse about how the law handles foreclosures focused on the fairly limited exercise of streamlining the process or protecting the debtor’s rights in the proceedings.\textsuperscript{27} Since the credit crisis began, the sheer volume of foreclosures, often alleged by the media to be fraudulent, has led scholars to discuss

\textsuperscript{26} See, e.g., Helen Gunnarsson, Foreclosure Defense a Practice Option Real Estate Lawyers, 97 ILL. B.J. 222 (2009).
\textsuperscript{27} See Melissa B. Jacoby, The Value(s) of Foreclosure Law Reform. 37 PEPP. L. REV. 511, 512 (2010).
more radical solutions, like loan modifications,28 the “right to rent,”29 or an all-out attack on the very structure of the mortgage lending industry.30

The rising incidence of foreclosure complaints has led courts to adopt a rubber-stamping procedure to clear their dockets. This trend has led to several highly publicized wrongful foreclosure cases where the plaintiff-mortgagee made a documentation error and foreclosed on the wrong property.31 Because of such media attention, courts are now scrutinizing foreclosure complaints much more closely in order to assure that the correct parties in interest are before the court. Courts have begun to dismiss foreclosure cases because of documentation and chain of title mistakes.32 Legal scholars and courts are now turning their attention to the questions raised by how banks structure mortgage loans, what procedures they use, and how they can be used to invalidate mortgage loans in favor of the borrower.

III. An Introduction to MERS

At the center of this controversy is Mortgage Electronic Registration Systems, Inc. This party is listed as “nominee” to over 60 million mortgages in the United States.33 Its

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30 See, e.g., Whitman, supra n. 8; Alex M. Johnson, Jr., Preventing a Return Engagement: Eliminating the Mortgage Purchasers' Status as a Holder-in-Due-Course: Properly Aligning Incentives Among the Parties, 37 PEPP. L. REV. 529 (2010).
31 See, e.g., Lauderdale man’s home sold out from under him in foreclosure mistake, SUN SENTINEL, Sept. 23, 2010.
32 See, e.g., Andrew J. Kazakes, Protecting Absent Stakeholders in Foreclosure Litigation: the Foreclosure Crisis, Mortgage Modification, and State Court Responses, 43 LOY. L. REV. 1383, 1418 (2010) (describing Judge Schack’s and other courts’ increased scrutiny in recent foreclosure cases).
33 See Peterson, supra n. 4, at 1379.
role is to provide financial institutions with a central database to track mortgages and their current owners without having to re-record the mortgage every time it is assigned or traded to another party.\textsuperscript{34}

Courts are split as to whether this party has standing to bring a foreclosure suit, whether the assignment to MERS destroys the chain of title because the note and the mortgage is separated, and whether any party may foreclose.\textsuperscript{35} Any court decision that prevents MERS or any servicer from foreclosing could potentially cause major banks to fail, render the value of investors’ holdings valueless, and cloud the titles of 60 million mortgages for years to come.

This article will assess the merits of a centralized records database for mortgages, and whether MERS or its assignee should be a proper mortgage holder able to assert a foreclosure claim. Although the system in its current form is flawed in many ways, this author contends that the theory behind a central mortgage records database is sound and desirable for society, as it improves the liquidity of the mortgage market, increases credit available to consumers, and hastens the speed at which banks process mortgage transactions.

\textsuperscript{34} See R.K. Arnold, \textit{Yes, There is Life on MERS}, 11-AUG PROB. & PROP. 32 (1997).

\textsuperscript{35} See discussion infra Section IV.
A. The Process of Mortgage Securitization

First, a mortgage broker or bank loan officer, working directly with a potential borrower, originates a loan with financing from mortgage lender. The mortgage lender and broker work together to assure that the borrower and the loan applied for complies with the underwriting standards of whatever bank or entity is ultimately going to fund the loan. When the bank purchases the loan, it immediately sells the loan, and several hundred or thousand other loans, to a single “special purpose vehicle,” usually a trust, in a single transaction in exchange for mortgage-backed securities. The bank then markets the mortgage-backed securities to investors, typically mutual funds, pension funds, or other large institutional investors looking for low-risk, long-term securities. The trust then becomes subject to a “Pooling and Service Agreement,” executed upon creation, that outlines how the mortgages will be serviced, who will service them, how the investors get paid, among other relevant

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36 The mortgage broker will gather basic information about the borrower’s assets, liability, income, credit score, and occupancy intent for the purpose of evaluating credit risk, then will compile the information into a file and send it to the mortgage lender for further analysis. Christina M. Schuck, A New Use for the Responsible Corporate Officer Doctrine: Prosecuting Industry Insiders for Mortgage Fraud, 14 LEWIS & CLARK L. REV. 371, 375 (2010).

37 Many underwriting departments use computerized underwriting systems to determine if the borrower is eligible for the loan. Id. at 376.

38 The special purpose vehicle is legally distinct from the lending institution. Kathleen C. Engel, Turning a Blind Eye: Wall Street Finance of Predatory Lending, 75 FORDHAM L. REV. 2039, 2045 (2007).

39 Id. at 2065, n. 123. Investment-grade tranches sold to institutional investors who require such high-quality paper typically make up about 95% of a typical private-label RMBS. See Anna Gelpern, Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities, 82 S. Cal. L. Rev. 1075, 1085 (2009).
points.\textsuperscript{40} Often, the servicer named in the PSA will be the originating bank, although recently the loan servicing business has become more attractive to major banks. \textsuperscript{41}

Following is a graphical depiction of the basic process of originating, securitizing and placing a loan with an investor, illustrating the parties involved.

Mortgage-backed securities usually are classified by four or more “tranches,” reflecting the amount of risk an investor takes on. Typically each tranche is independently rated for risk by one of the three major credit rating firms.\textsuperscript{42} The arrangement of tranches determines how investors share losses in case of default. The

\textsuperscript{40} Such pooling and servicing agreements can be hundreds of pages long. Richard M. Hynes, \textit{Securitization, Agency Costs, and the Subprime Crisis}, 4 VA. L. & BUS. REV. 231, 239-240.
\textsuperscript{42} Id.
AAA tranche typically is the last to experience a default in the stream of payments; therefore, it receives the highest credit rating.\textsuperscript{43}

The trust holding the mortgages is bankruptcy remote; that is, the assets within the trust can never be reached by a bankruptcy trustee of any of the parties involved in the process.\textsuperscript{44} The pooling and service agreement provides for the settlement of defaulting mortgages and sets out the order in which the investor-creditors will be paid.\textsuperscript{45}

Example: An SPV has sold to its investors two tranches, A and B. Tranche A is senior to tranche B and tranche B takes all the risk of loss until the tranche produces no more cashflow. Both tranche A and B are entitled to $500 per month. One mortgage, yielding $500 per month, defaults. The trustee will “assign” this mortgage to the investors of tranche B, which will no longer receive their payments as long as this mortgage is in

\textsuperscript{43} See Gelpern, supra n. 39, at 1098.
\textsuperscript{44} Securitization is known in the industry as “structured finance,” which isolates the loan pool from the original lender(s), thus preventing lenders’ creditors from reaching the loans contained within the SPV trust. See Engel, supra n. 38, at 2045-46.
\textsuperscript{45} The method by which investors are paid off is known as a “waterfall,” where the senior tranche receives payments before any other, then the next tranche moves to the front of the line. Id. at 2047.
default. The investors of tranche B are entitled to the proceeds raised from foreclosure proceedings. Tranche A investors will continue to receive their $500 monthly payments until another mortgage defaults, in which case tranche A investors would now bear the risk of loss.

This system of SPVs and trustees was constructed to comply with IRS statutes giving tax-exempt status to entities called Real Estate Mortgage Investment Conduits, or REMICs. The IRS has very specific requirements as to what kind of mortgages may be contributed, when they may be contributed, and how they may be removed from the pool in order to maintain tax-exempt status. This introduces some rigidity into the system that often prevents loan servicers from modifying loans without actually purchasing them from the SPV.

Mortgage-backed securities allow investors to function like banks who do portfolio-lending, that is, a bank that holds many mortgages on its books, diversifying its holdings and reducing risk. The mortgage-backed security allows investors to use their money to engage in consumer lending directly, presumably without taking on extra risk by investing in an intermediary agent like a bank.

The development of a central clearinghouse like MERS was pivotal in the popularization of mortgage-backed securities due to the practical impossibility of recording several thousand owners of fractional interests in a given mortgage. In

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47 See Eggert, supra n. 41, at 1263-64.
addition, such mortgage-backed securities are often traded and repackaged into devices that further reduce risk known as collateralized debt obligations, further complicating the identities of the owners.\textsuperscript{48}

B. The Role of MERS

In order to overcome the obstacle to securitization posed by unwieldy paperwork, in 1994 various players in the mortgage lending industry\textsuperscript{49} formed the Mortgage Electronic Registration System, or MERS. The system was designed to function as a central clearinghouse for the recordation of the ownership of all mortgages originated by its member organizations. Members were subject to an agreement\textsuperscript{50} which set the guidelines as to how to collect payments, gives a procedure for foreclosure proceedings, and assesses fees for utilizing MERS services like its electronic mail room. A MERS member lender, upon originating the mortgage, records an assignment of mortgage to MERS as “nominee.” MERS is transferred a note, endorsed in blank, which it is to hold.\textsuperscript{51} It can then assert rights as a holder in due course, and also as mortgagee of record of the property. MERS does not own the mortgage note; it merely holds it in safekeeping for the mortgagee. Typically, however, because MERS has no active

\textsuperscript{48} \textit{Id.} at 1267.
\textsuperscript{49} “MERSCORP, Inc. is a privately held Delaware stock corporation currently owned by 28 companies, including Fannie Mae, Freddie Mac, the Mortgage Bankers Association of America, the American Land Title Association, First American Title, Stewart Title, MGIC, PMI, Merrill Lynch and various mortgage companies (large and small), including Countrywide, Wells Fargo, Household, Chase Manhattan and Washington Mutual.” \textit{MERS® Commercial: Legal Primer, 548 PRAC. LAW INST. 185, 187} (2008).
\textsuperscript{50} See Phillips, supra n.5, at 265-67.
\textsuperscript{51}See generally In re Samuels, Bkrtcy.D.Mass.2009, 415 B.R. 8 (trustee under pooling and servicing agreement that held promissory note endorsed in blank had standing to seek payment).
employees, MERS will assign the right to foreclose to an agent, or assign the mortgage and note together to the loan servicer.  

It should be noted that the practice of selling mortgage notes into the secondary market as bearer instruments predates the creation of MERS. Prior to MERS, a servicer of a securitized mortgage would hold the mortgage as agent for the investors and functioned in much the same way that MERS is intended to work. MERS streamlined the process further by eliminating the need for the servicer to assign the mortgage to another party if the investors opt to engage a different servicer.

This system allows investors in mortgage-backed securities the freedom to trade the security without having to execute a mortgage assignment every time an interest changes hands, and frees trusts from having to keep track of the true beneficial owners of every single entity that holds an interest in their mortgages. The system allows for free trading of mortgages on the open market unfettered by recording requirements.

MERS is structured in a way that promotes the ease of its usage by participating members – although it has no employees, MERS has several thousand mortgage servicers and lenders designated as “assistant secretary.” This arrangement affords

52 The MERS agreement strongly discourages bringing foreclosure proceedings in the name of MERS. See Phillips, supra n.5, at 266.
54 Servicers would have to list their address on the mortgage in order to receive legal process necessary for handling the loan. The MERS system eliminates the need for servicers to record assignments every time the servicing contract changed hands. See R.K. Arnold, Yes, There is Life on MERS, 11-AUG PROB. & PROP. 32, 35 (1997).
every member-servicer the right to assign mortgages or perform other tasks on behalf of MERS in order to facilitate the collection of payments or foreclosure proceedings.

The MERS system, where beneficial ownership is tracked by the owner of record, is not a new concept. As discussed in the next subsection, the MERS system is loosely modeled upon the structure of stock certificate recordation, where a common agent maintains a central database of the beneficial ownership of securities.

C. An Analogy: Stock Transfer Agents

The beneficial ownership of stock certificates in the past is a bulky process to track, requiring a corporation to update its books every time stock changed hands. This problem was alleviated in the 19th century, when courts began to adopt rules allowing stock transfers to be perfected solely by delivery of the certificate, in order to facilitate liquidity.\(^{56}\) The market responded by developing stock transfer agents and depositary nominees, which centralized the service of updating transfers and beneficial ownership of securities.\(^{57}\) The transfer agent remains the owner of record of the stock certificate according to the corporation’s and the stock exchange’s books.\(^{58}\) It keeps a central record of beneficial ownership, and facilitates proxy voting and dividend distribution as a service to the corporation.

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Although there exists no recording statute for stock certificates that parallels real property law (with the possible exception of SEC securities registration requirements), corporations had to keep such records in order to determine who had rightful title to duly issued securities, dividend payments and voting rights. Every time a security was bought or sold, corporations would destroy old stock certificates and issue new ones to new investors.\(^5^9\) Eventually, this paperwork burden became unmanageable as trading volume increased exponentially, leading the industry to develop a centralized book-entry database known as the transfer agent, reducing transaction costs by over 90 percent.\(^6^0\) Stock transfer agents such as the Depository Trust Corporation provide successful models for the structure of MERS.\(^6^1\)

The creators of MERS undoubtedly envisioned such a system, where a centralized service would replace public records in each of 50 state recorder’s offices, keeping up-to-date electronic records without having to make or pay for paper records inquiries. Given that recording statutes were drafted without anticipation of electronic databases, MERS introduces efficiencies into a system that badly needed modernizing. It enables liquid trading of mortgages in a secondary market, just as stock transfer agents had done for the trading of stock certificates. And because MERS continues to hold the

\(^{59}\) See Slesinger, supra n. 53, at 807.  
\(^{60}\) Id.  
\(^{61}\) Id. at 813.
recorded mortgage, the public county land record still serves its important role of providing notice of priority to other creditors without diminishing its effectiveness.⁶²

IV. Challenges to the MERS Framework

Courts seem to focus on three different logical frameworks when dismissing foreclosures involving MERS: first, that the very use of MERS is a violation of fundamental property law principles, second, that the documentation provided by the foreclosing party was somehow flawed or incomplete, and third, that the banks’ use of MERS is a violation of public policy.

A. MERS Improperly Separated the Mortgage and the Note

When a creditor executes a mortgage with a borrower, two documents are created: the promissory note, which embodies the actual contractual loan arrangement, including payment terms, principle and default terms; and the mortgage (or deed of trust)⁶³ which in most cases is merely a document filed in the local county recording office signifying that a lien has attached to the property. The promissory note contains the substance of the transaction, while the mortgage document merely serves to provide notice to other potential creditors that a lien may have attached to the property.

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⁶² Some scholars believe that because the true owner is not listed on the mortgage record, the record does not effectively give public notice of the lien. For further discussion, see infra part IV.E.
⁶³ Also known as a deed of trust in certain jurisdictions. With respect to rights to foreclose, mortgages and deeds of trust are functionally identical. Grant S. Nelson & Dale A. Whitman, Real Estate Finance Law § 8.3 (5th ed. 2007).
Most academic criticisms of MERS stem from the seminal case Carpenter v. Longan, where the U.S. Supreme Court examined the nuances of mortgage law.\footnote{Carpenter v. Longan, 83 U.S. 271 (1872) (quoting Jackson v. Blodget, 5 Cowan 205; Jackson v. Willard, 4 Johnson 43).} The court there stated that “[t]he note and mortgage are inseparable....”\footnote{Carpenter, 83 U.S. at 274.} Because MERS remains the mortgagee of record for the life of the loan, but the promissory note is endorsed in blank and transferred between several owners, opponents claim that MERS has impermissibly separated the note from the mortgage, therefore rendering the debt unsecured by any lien.\footnote{See Peterson, supra n. 4, at 1379.} But further reading of the dicta of this case tends to indicate that the court was merely observing that the mortgage instrument was incidental to the note. The complete quote stated: “The note and mortgage are inseparable; the former as essential, the latter as an incident. An assignment of the note carries the mortgage with it, while an assignment of the latter alone is a nullity.”\footnote{Carpenter, 83 U.S. at 274.} The court observes that a party may not need to attempt to assign the mortgage along with the note in order for the security interest to stand: “The transfer of the note carries with it the security, without any formal assignment or delivery, or even mention of the latter.”\footnote{Id. at 275.} The Restatement Third of Property provides further support for this position: "Except as otherwise required by the Uniform Commercial Code, a transfer of a mortgage also transfers the obligation the mortgage secures unless the parties to the transfer agree otherwise."\footnote{Restatement (Third) of Property: Mortgages § 5.4(b).}
Thus, *Carpenter* does not purport to prohibit the separation of the note from the mortgage, but instead observes that notwithstanding the actions of the parties, the mortgage transfers automatically when a note is assigned, allowing the assignee of a promissory note to foreclose on the lien created by the mortgage. *Carpenter* held only that the mortgage itself is incidental to the note and creates no right to foreclose standing alone.\(^70\) This interpretation allows us to arrive at a result that makes sense: the proper creditor holds the promissory note, which obligates the borrower to repay and creates the legal chose in action, and a mortgage is recorded in the public records, putting other potential creditors and good-faith purchasers on notice that a lien with higher priority is attached to the property. Thus, temporarily splitting the mortgage from the note is not fatal to the security interest.

Other courts provide strong support for this reasoning. *Diehl v. Mock*, applying Pennsylvania law, arrived at the conclusion that the security interest in the property was still valid even though the mortgage was never formally assigned to the noteholder; the noteholder nonetheless received an “equitable assignment of the mortgage.”\(^71\) *Ingomar Ltd. Partnership v. Packer* reached the same result applying Connecticut law—the foreclosing plaintiff had standing to bring a foreclosure action even though the mortgage was not formally assigned to the plaintiff by the time it

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\(^70\) Some academics criticize MERS for purporting to do this very thing—attempting to commence foreclosure proceedings as the mortgagee of record, but without possession of the note. Such an action would not pass muster under *Carpenter* if MERS were unable to produce a promissory note listing it or its principal as beneficiary. Any action commenced without the note is wrongful. See, e.g., Peterson, *supra* n.4.

commenced the action. Florida followed suit as well in \textit{Mortgage Elect. Registration Sys., Inc. v. Revoredo}, reasoning that the “mortgage security follows the note.”\textsuperscript{73} \textit{Richey v. Sinclair}, applying Illinois law, found that when a debtor specified the name of the creditor on the note but not the mortgage, the identity of the mortgagee was sufficiently clear that the security interest was enforceable.\textsuperscript{74} A Kentucky statute prescribes that a transfer of a promissory note effects an automatic transfer of the mortgage.\textsuperscript{75} Given the overwhelming authority holding that the mortgage is incidental to the note, one can conclude that separating the mortgage from the note is not fatal to the security interest.\textsuperscript{76}

The Restatement Third Property provides the most ammunition for opponents of MERS. “In the event that the note and the deed of trust are split, the note, as a practical matter becomes unsecured.”\textsuperscript{77} The assertion that MERS destroys the beneficial mortgagee’s right to foreclose requires an interpretation of this language out of context. The Restatement does not intend to create any rules different from those articulated in

\textsuperscript{73} Mortgage Elect. Registration Sys., Inc. v. Revoredo, 955 So.2d 33, 34 n.2 (Fla. App. 2007).
\textsuperscript{74} Richey v. Sinclair, 167 Ill. 184 (Ill. 1897).
\textsuperscript{75} Ky. Rev. Stat. Ann. §§ 355.3-101; see also Arnett v. Salyersville National Bank, 46 S.W.2d 124, 126 (Ky. 1931) (“the mortgage given to secure payment of the note followed the debt.”).
\textsuperscript{76} Some courts are notable exceptions, see, e.g., \textit{In re Foreclosure Cases}, 521 F. Supp.2d 650 (S.D. Ohio 2007); \textit{In re Foreclosure Cases}, No. 07-2282, 2007 WL 3232430 (N.D. Ohio Oct 31, 2007); LaSalle Bank Nat’l Assoc. v. Ahearn, 59 A.D.2d 911 (2009) (assignee of mortgage does not have standing to foreclose unless the assignment is complete at the time the action is commenced); 5-Star Management, Inc. v. Rogers, 940 F. Supp. 512, 521 n.5 (E.D.N.Y. 1996) (when mortgage is separated from note, note is unenforceable). However, it appears that the central issue in these cases was the failure of the plaintiff to plead that it was the holder of both the note and the mortgage, or the documentation was incomplete at the time of the commencement of the action. In addition, the Ohio federal courts seem to be at odds with the state courts as to whether MERS is a real party in interest, see, e.g., Chase Manhattan Mortgage Corp. v. Smith, No. C-061069, 2007 WL 3225534 (Ohio App. 2007).
\textsuperscript{77} Restatement (Third) Property: Mortgages § 5.4 cmt. (a).
Carpenter. The Restatement simply reaffirms Carpenter: “a transfer of a mortgage also transfers the obligation the mortgage secures unless the parties to the transfer agree otherwise.”78 The mortgage is incident to the note, and will follow the note, even if the transferee of the note is not aware that the note is secured by a mortgage.79 “This is so because separating the obligation from the mortgage results in a practical loss of efficacy of the mortgage….”80 Important here is the Restatement’s use of the word practical – separation of the note and the mortgage do not render the lien legally unenforceable; it only puts at risk the enforceability of the mortgage for other reasons. Recordation of the mortgage assignment is not necessary to effect a transfer of the security interest, although an assignee is “well advised to record.”81 If the transferor of the note remains the mortgagee of record, the transferee takes the risk that the transferor may make a side agreement with the mortgagor to discharge the mortgage, thus wrongfully clearing the record of the security interest. If the owner subsequently transfers the real estate to a good faith purchaser, the purchaser is entitled to rely upon the record and may then defeat the new noteholder’s security interest.82 This is why the Restatement declares that a separation of the note and mortgage renders the security interest unsecured: as a practical matter, the noteholder who does not insist upon assignment of the mortgage takes the risk that the mortgagee of record will destroy the security interest by side agreement with the mortgagor. Thus, the Comment serves as

78 Restatement (Third) Property: Mortgages § 5.4(b).
79 Id.
80 Id.
81 Restatement (Third) Property: Mortgages § 5.4(b).
82 Id.
more as a warning to the unwary transferee rather than a total prohibition of the practice.

The Restatement’s comment provides further evidence of this principle by suggesting that the parties may create an agency relationship by contract in order to prevent this kind of malfeasance from jeopardizing the security interest. The Restatement explicitly allows the parties to set up an agency relationship to defeat the loss of the security interest: “The practical effect of such a transaction is to make it impossible to foreclose the mortgage, unless the transferee is also made an agent or trustee of the transferor or otherwise has authority to foreclose in the transferor's behalf.”83 This is exactly what MERS does by virtue of its membership contract with participating lenders.84

Objections to MERS on the grounds that one cannot separate the note and mortgage evidence a misunderstanding of the long-settled precedent behind mortgage transfers. Transfer of a note without a transfer of the mortgage does not strip the noteholder of the ability to foreclose, as long as the mortgage lien is still on record. The two documents serve two different purposes: the note, to establish the obligation, and the mortgage, to create a security interest which will provide notice to future potential creditors or purchasers of its existence. The mortgage by itself does nothing to create rights or obligations, which is why Carpenter declares transfer of the mortgage alone a

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83 Restatement (Third) Property: Mortgages § 5.4 cmt. (b) (emphasis added).
practical nullity. Its only purpose is to provide notice, without which a lien cannot exist. The Restatement declares that a note separated from its mortgage is as a practical matter unsecured only because the noteholder runs the risk of losing the security interest by the malfeasance of the mortgagee of record. No precedent intended to create an arbitrary rule against separating the note and the mortgage. As long as notice of the lien is on the record, the security interest should stand regardless of who holds the note at the time of default.

B. MERS Is Not the Proper Party in Interest

MERS typically holds mortgages as “nominee” for the financial institution who securitized or originated the loan. Both academics and courts have expressed confusion regarding the definition and meaning of a “nominee.” The MERS contractual arrangement calls for MERS to list itself as a nominee, or a representative, of the investors. However, MERS often pleads in complaints that it is the owner of the note and mortgage, which is actually prohibited in the MERS membership agreement. It is this inconsistent position that often leads courts to the drastic conclusion that MERS is not the proper party with standing to foreclose, even though it is able to produce a note

85 Carpenter, 83 U.S. at 274.
87 “The Member shall not plead MERS as the note owner in any foreclosure document; including but not limited to, the foreclosure complaint.” The membership rules even provide for a monetary fine if a member pleads that MERS is the owner of the note. See MERSCORP, Inc. Rules of Membership, supra n. 84, at 26.
endorsed in blank and a mortgage executed in the name of MERS.\textsuperscript{88} One court even went so far as to liken MERS’ position to a blind man’s description of an elephant—“their description depended on which part they were touching at any given time.”\textsuperscript{89} Courts that have taken this position often conclude that MERS holds no property interest or rights with respect to the loan.\textsuperscript{90} Thus, in order to determine whether MERS is a proper party in interest with the standing to foreclose, one must determine MERS’ relationship with the beneficial owners of the note.

1. Is MERS a principal or agent?

Is MERS the owner of the note or the agent of the owner? In order to properly understand the question, one must examine MERS’ structure in depth. MERS is a company incorporated and owned by the banks, mortgage lenders, and government-sponsored enterprises that use the company’s services. These lenders use MERS as its agent to hold legal title to its mortgages on their behalf.\textsuperscript{91} Both the lenders and MERS are parties to the MERS membership contract, which sets up an agency relationship between MERS and its members.\textsuperscript{92} So at the time of the recordation of the mortgage, MERS holds the mortgage on behalf of the lender, who owns and holds the note. In essence, the lender is causing its subsidiary (since it owns a part of MERS) to hold the

\textsuperscript{88} A holder in due course is entitled to the same rights of enforcement as the original owner of the note. See U.C.C. § 3-104 (2002) (defining negotiable instruments); see also id. § 3-205 (allowing endorsements in blank); § 3-301 (possession entitles holder in due course to enforcement rights).


\textsuperscript{91} “MERS is a separate corporation that is acting solely as nominee for Lender and Lender’s successors and assigns.” Mortgage Elec. Registration Sys., Inc. v. Blumling, No. GD05-16795, slip op at 3 (Ct. Com. Pl. Allegheny Cty., Pa. May 31, 2006).

\textsuperscript{92} See MERSCORP, Inc. Rules of Membership, supra n. 84.
mortgage. If the lender assigns the note to another member of MERS, MERS continues as the mortgagee of record, but this time for a new principal, the assignee lender, with whom MERS is also contractually bound to act as agent.

The situation becomes more complicated when the lender moves to foreclose. In order to assure that the proceeds from a foreclosure sale reach the proper party, courts demand that the plaintiff produce the note proving that the plaintiff is the proper party in interest, entitled to the foreclosure proceeds. The MERS Membership Agreement provides for two procedures. The member lender (the true beneficial owner of the note) may foreclose in its own name, provided that it causes MERS to assign the mortgage to the lender.93 The lender may also opt to bring the foreclosure action in the name of MERS, provided that the lender endorses the note in blank and delivers it to MERS.94 Because MERS becomes the holder in due course when it comes into possession of the note, it steps into the shoes of the lender and gains the authority to foreclose.95 At this point, the role of MERS changes from agent to principal, since as holder in due course MERS may enforce the instrument.96 Critical here is the endorsement in blank and the delivery of the note to MERS.

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93 Usually, member lenders are vested with power to act as an officer of MERS in order to facilitate these transfers. See Peterson, supra n.4, at 1390-91.
94 This need not be a physical delivery, as the agent bringing the action is likely the lender acting in the capacity of an officer of MERS. Typically a lender or servicer is commissioned as an officer of MERS. Id.
95 See U.C.C. §§ 3-301—3-306 (2002) (allowing a holder of a bearer instrument to enforce it); see also id. § 3-203 (“An instrument is transferred for the purpose of giving to the person receiving delivery the right to enforce the instrument.”); U.C.C. § 9-607; see also Alvin C. Harrell, Impact of Revised UCC Article 9 on Sales and Security Interests Involving Promissory Notes and Payment Intangibles, 55 CONSUMER FIN L.Q. REP. 144 (2001)
96 See U.C.C. § 3-301 (entitling holder in due course to same enforcement rights of enforcement).
Several cases have raised the issue that MERS was acting in the capacity of a principal when it originally acquired the security interest solely in the capacity of a nominee.  It is axiomatic the same party cannot simultaneously be both an agent and a principal with respect to a property right. But Carpenter v. Longan and other similar cases have made it clear that the mortgage by itself does not embody a property right, as it is merely an *accessory* to the promissory note.  If a holder of a mortgage cannot foreclose without the note, it necessarily follows that the mortgage held by MERS does not embody any property rights; only the note gives the right to foreclose. The act of delivering the note endorsed in blank to MERS thus fundamentally changes the relationship between MERS and the member, just as if an agent of a corporation were to have bought a majority stake in the corporation. Even if the recording statute of that state demanded that every assignment of the mortgage be recorded before foreclosing, a simple assignment of the mortgage from MERS as nominee to MERS as beneficiary would serve to alleviate any challenges, and the chain of title would be preserved because, prior to the assignment, MERS held the mortgage on behalf of any and all assignees prior to delivery of the note endorsed in blank.

As the Nevada Supreme Court opined in Chartz v. Cardelli: “Mortgages are but contracts.” Thus, a court should always look to the note first in order to understand the contractual arrangement to which the borrower agreed, and should acknowledge

97 See, e.g., Peterson, *supra* n.4, at 1375.
98 See Restatement (Third) of Agency Law § 1.01; Peterson, *supra* n.4, at 1375 n.83.
99 Carpenter v. Longan, 83 U.S. at 275.
100 Chartz v. Cardelli, 279 P. 761, 763 (Nev. 1929).
that the mortgage or deed of trust is merely incident to this substantive arrangement, and should not be used to defeat a claim to a security interest.

2. Legality of the “nominee” designation

Some courts have exhibited unfamiliarity with the term “nominee” and how to treat it.\(^{101}\) The practice of a third party holding a mortgage as nominee or agent predates the creation of MERS.\(^{102}\) A mortgage servicer would often list itself as mortgagee on behalf of investors in order to facilitate collecting payments and foreclosure proceedings. This practice is fundamental to the secondary mortgage market. Holding a mortgage as an investor would become unwieldy if the investor, as mortgagee of record, were required to bring foreclosure proceedings.

The Restatement Third of Property gives the best support to MERS’ designation as “nominee”: the practical effect of splitting the deed of trust (or mortgage) from the promissory note is to make it impossible for the holder of the note to foreclose, unless the holder of the deed of trust is the agent of the holder of the note.\(^{103}\) The agency relationship enables the person holding the note to foreclose; the person holding the deed of trust will never experience default because only the holder of the note is entitled to payment.\(^{104}\)

\(^{102}\) See Slesinger, supra n. 53, at 808.
\(^{103}\) Restatement (Third) of Property: Mortgages § 5.4 cmt.
\(^{104}\) Id.
Minnesota recently took legislative action to end confusion by defining what “nominee” means in terms of mortgages and foreclosure proceedings. The statute expressly permits nominees to record “[a]n assignment, satisfaction, release, or power of attorney to foreclose.” Commonly known as the “MERS statute,” this amendment to Minnesota’s recording law disposes of any questions a court raises as to the legal soundness of MERS recording a mortgage as “nominee” and allows MERS to foreclose as the nominee of the true beneficial owner of the note.

The contractual agency arrangement established between MERS and its members seems to be dispositive for some courts determining the legality of MERS’ arrangement as nominee for the lender. For example, a Florida district court in *MERS, as Nominee for Countrywide Home Loans, Inc. v. Foster* held that MERS had standing to foreclose because a contractual relationship established that the owner of the note elected MERS as its nominee to carry out the foreclosure.

A Florida district court in *MERS v. Revoredo* took a practical tack when examining MERS’ interest in the proceeding: “there is no reason why mere form should overcome the salutary substance of permitting the use of this commercially effective means of business.” The court acknowledged that MERS was not the owner of the note, but merely the collection and litigation agent; MERS was only the holder of the note by delivery. Although MERS was the “mortgagee of record,” but not the owner of the note,

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105 Minn. Stat. § 507.413 (2008)
106 Id.
108 Revoredo, 955 So.2d at 34.
the court plainly dismissed this organizational thicket as irrelevant: “We simply don’t think this makes any difference.”

C. Insufficient Documentation

Most cases seem to focus on a breakdown in the securitization process, most often a failure of the lender to deliver the note to the securitization trust or MERS. This issue emerges in litigation as a failure of the foreclosing party to produce the original note, a problem which is becoming more and more frequent. When a loan servicer institutes a foreclosure proceeding, it either cannot produce a note altogether or produces an incomplete note. Some banks shred the original note after committing it to an electronic record, then during foreclosure, file a “Lost Note Affidavit” with the court as a matter of course. Some courts, especially Judge Schack of the Brooklyn, New York Supreme Court, view this as an abuse of judicial leave, as the note was not “lost” but was in fact deliberately destroyed. Fremont Inv. & Loan v Rose is one of the most outspoken opinions regarding missing documents and erroneous assignments, sua sponte demanding information such as the reasoning behind the contractual arrangement. Judge Schack has a track record of taking license to find reasons to deny foreclosure

109 Id. at n. 2 (citing Fla. R. Civ. P. 1.210(a) (action may be prosecuted in name of authorized person without joining party for whose benefit action is brought)).


111 It is estimated that 99% of foreclosure proceedings brought in the last year are filed with “Lost Note Affidavits.” Garrett W. Wotkyns, A New Front in the Foreclosure Epidemic: Consumers Fight Back, 1789 PRAC. LAW INST. 477 (2010).

112 Id.


114 See, e.g., id. at *3 (“The Court needs to know why FREMONT gave the instant scratch and dent loan to ROSE and whether GRP knew it was purchasing a non-performing mortgage loan from FREMONT.”)
Insufficient documentation proving the plaintiff’s standing is quite possibly the single most common reason why courts deny MERS the right to foreclose. While it is more than likely true that a large percentage of foreclosure proceedings are commenced with insufficient documentation, such sloppy legal work does not and should not affect the legal soundness of the MERS theoretical framework.

D. MERS as a “Fraudulent Entity”

Some defendants in foreclosure actions have accused MERS of being a “fraudulent entity” or a “sham beneficiary” who should be barred from foreclosing on the defaulting borrower. The federal court for the District of Arizona in Cervantes v. Countrywide Home Loans, Inc. very directly addresses the allegations that MERS is a “sham” without ability to foreclose.116 “The fact that MERS does not obtain [full] rights as to collect mortgage payments or obtain legal title to the property in the event of non-payment does not transform MERS’ status into a “sham.”117 Just because MERS does not hold every benefit conveyed by the borrower in the note does not mean that MERS lacks the right to foreclose.

In a mortgage note destined to be handled by the MERS framework, borrowers almost always agree that MERS has an express right to foreclose in the event of a default.118 Thus, any borrower who signed such a note cannot in good faith advance the

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115 See Wotkyns, supra n. 111.
argument that MERS or the lender has committed fraud or has executed a “sham.” A New York court in *Mortgage Elec. Registration Sys, Inc. v. Coakley* made this clear:

“[F]urther support for MERS’ standing to commence the action may be found on the face of the mortgage instrument itself. Pursuant to the clear and unequivocal terms of the mortgage instrument, Coakley expressly agreed without qualification that MERS had the right to foreclose upon the premise in the event of a default. [citations omitted.]”

In many opinions, most notably in Judge Schack’s, courts call into question the legitimacy of the documentation the plaintiff presents because they often do not appear to be executed at arm’s length. Assignment documents will often list both assignor and assignee as the same party in different capacities. Such documents on their face could easily raise a red flag and mislead a court into thinking that some kind of subterfuge is occurring behind the scenes. This is no more a fraudulent practice than a single-member LLC assigning a contract to a wholly-owned subsidiary—such a transaction is not arm’s length, nor does it need to be. Because MERS allows its members to obtain commissions as officers of MERS in order to authorize such assignments, these transactions often occur within the MERS framework. This is common and desirable, as MERS is essentially a partially owned subsidiary of the member lender to or from whom the assignment is being made.

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119 Id. at 675.
120 See Wotkyns, supra n. 111.
E. MERS as a Violation of Public Policy

Some legal writers and prominent foreclosure attorneys call for the MERS framework to be thrown out altogether, alleging that MERS is itself a fraudulent sidestep of longstanding recording statutes and the attendant recording fees owed to the state.\textsuperscript{122} This argument seems to hold little water, however, because the state is not a party in interest during a foreclosure proceeding and a borrower will likely find it very difficult to use this objection to escape foreclosure as a result of default. This kind of objection is a matter of public policy, properly taken up in the state legislature, not a foreclosure courtroom.

The general purpose of recording statutes is to put potential creditors and purchasers on notice that a given parcel of real property has a prior lien that may take priority over a later-executed lien.\textsuperscript{123} The information provided by the lienholders in the mortgage or deed of trust is intended to aid the potential creditor or purchaser in his search for other outstanding security interests in order that he may verify whether the lien has been satisfied. Many objections to MERS attack the private nature of its database which tends to conceal the true beneficial owner of the lien, making it harder for potential creditors to find out the true status of the lien.

Various state entities have advanced this argument on behalf of borrowers in the courtroom, the most prominent of which was the New York Attorney General in a 2001

\textsuperscript{122} See, eg., Peterson, supra n.4.
opinion detailing that MERS violated public policy.\textsuperscript{124} According to the opinion, MERS runs contrary to the intent of New York recording statutes to identify information about beneficial interests in real property. Further, if MERS went out of business, it would be almost impossible to identify the true owners of the note or the mortgagees.\textsuperscript{125} These criticisms seem misplaced, as the lender is free to arrange its affairs as it sees fit, and any negative consequences arising from failure to identify the correct borrower will entirely be borne by the lender, resulting in a windfall to the borrower. Any failure of MERS to provide the correct information will not make it any more difficult for a borrower to defend a foreclosure action, and may in fact make a borrower’s defense stronger if the documentation is not in order or the correct parties cannot be reached.

As a practical matter, MERS does raise concerns about hiding the true beneficial mortgagee from the record. A second potential creditor may not be able to perform its due diligence because it is unable to contact the noteholder in order to determine if the mortgage lien still stands, as MERS may not be forthcoming on forwarding information about the status of the note or the true beneficial owners. However, this concern arises whenever a creditor refuses to respond to information requests by third parties. Recording statutes do not require mortgagees of record to disclose specific information about the creditor-borrower relationship, and the failure of a creditor to do so should not be fatal to the security interest.

\textsuperscript{125} Id.; see also Phillips, supra n. 5, at 264.
The inability of a potential creditor or borrower to ascertain the true beneficial owner of the note does create information problems, especially when one of these parties desire to negotiate a workout or refinance. However, MERS gives rise to no novel issues with respect to the efficacy of recording statutes— if a mortgagee of record refuses to cooperate in negotiation or refuses to respond to information requests, it is the mortgagee’s prerogative, and recording statutes do not require mortgagees to disclose anything. The purpose of the recording statute is not to facilitate such negotiation, but only to provide notice to potential creditors or good-faith purchasers that the real estate may be subject to a security interest.

V. The Benefits of MERS

There is little doubt that MERS accrues benefits to the secondary mortgage market. Any development that increases the efficiency of the extension of credit and lowers transaction costs directly benefits the consumer. Just as the introduction of the collateralized mortgage obligation instantly lowered prime mortgage rates in 1983, MERS effectively lowers the interest rates by reducing the capital outlays for constantly executing and recording new assignments even though most of the beneficial parties had not changed. Those savings accrue directly to servicers and originators.

MERS’ database also provides a much faster process for the release of liens, allowing a borrower to quickly discharge a mortgage. Such a process might take up to a

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126 See Malloy, supra n. 10, at 1009.
127 When MERS was introduced, it was estimated that it would save over $51.7 million accruing to servicers and $14.1 million to originators. See Slesinger, supra n. 53, at 812.
year under traditional lending models, but MERS through email and reference to its database can send out the proper documentation to all the proper parties in far less time.\textsuperscript{128}

When a loan is originated, MERS assigns it a unique serial number from its database that the loan will carry for its entire duration, called a mortgage identification number ("MIN"). This MIN can be used to reference that loan’s entry into the database and may be used to cross-reference a particular parcel of real estate.\textsuperscript{129} Before MERS, the practice of requesting that two lenders fund the same loan was a widespread fraudulent practice committed by corrupt mortgage brokers. Because loans are now assigned unique identification numbers and are entered into a database which lists the servicer, originator and funding entity, the occurrence of such double-funding fraud has been reduced.\textsuperscript{130}

Even though MERS may introduce some roadblocks if a borrower wishes to find out the true beneficial owners of their mortgage, more likely than not, a borrower given a choice between paying more to always know the identity of the noteholder, or paying less, would likely choose the latter. In the vast majority of situations, a borrower need not know the identity of however many thousands of beneficial owners to whom the payments are routed. In situations where the need arises, a court could compel MERS or

\textsuperscript{128} Id. at 817.
\textsuperscript{129} See R.K. Arnold, Yes, There is Life on MERS, 11-AUG PROB. & PROP. 32, 34-35 (1997).
\textsuperscript{130} See Phillips, supra n. 5, at 264.
the servicing lender to reveal that information based on authority derived from statute, or rules of procedure regarding necessary parties.

VI. Proposed Solutions for Current Problems with MERS

Already, MERS has taken initiative to preempt legal challenges to its framework as the system is reviewed by courts. For example, the MERS rules now prohibit members from claiming that MERS owns the note or bringing a foreclosure action in the name of MERS in the state of Florida. MERS is now developing comprehensive foreclosure procedures for several jurisdictions which take into account the most recent legal challenges. However, since courts harshly criticize MERS for avoiding recording statutes, legislative efforts can alleviate these concerns without destroying this otherwise useful system.

A. Confirm Authority as Nominee

In order to resolve the question of whether a nominee or agent can hold a mortgage on behalf of investors, states should pass a statute that grants MERS standing to foreclose on any property to which it is mortgagee of record, similar to the one already enacted in Minnesota. Since the law has not previously defined “nominee” in many states, this could be a useful approach, but it again usurps the government’s interest in encouraging recordation of assignments to actual owners. However, in a new era like

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131 See MERSCORP, Inc. Rules of Membership, supra n. 84, at 26.
132 Challenges to MERS’ legal standing in Florida to foreclose as nominee have succeeded, prompting MERS to create special rules for litigating foreclosures in Florida. Id. at 25.
133 See Minn. Stat. § 507.413 (“Authority of Mortgagee Designated as Nominee or Agent.”)
this one when several owners own a fractional interest of a mortgage, the information as to who owns it at any given time is probably no longer necessary for the purpose of investigating liens on properties, especially considering that such a large percentage of lenders actively participate in the MERS system.

B. Make Lender Identity Publicly Available

States place high importance on a borrower’s knowledge of the true beneficial owner of a mortgage. MERS already has an electronic and telephone system for the purpose of looking into the ownership of a note, although this information is not always complete. States can enact statutes compelling the disclosure of such information to borrowers on demand, either through a borrower’s rights statute or as an amendment to a truth-in-lending statute. Some states have already enacted statutes requiring a foreclosing plaintiff to disclose the identity of the beneficial owner to the defendant.134 Such information would facilitate open and candid communication between borrower and lender, and possibly would increase the possibility that loan workouts will be reached, although it is very important to acknowledge that the owner of the note has exclusive authority to decline mortgage modification or loan workouts.

C. Prevent Fraud Between Originator and Investor by Contract

Investors in mortgage-backed securities usually execute pooling and service agreements with the securitization party, protecting them from the kind of fraud

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134 See Jacoby, supra n. 27, at n.158.
attendant to forged or missing documents. They should be able to pursue the depositor, or the investment bank that formed the security. From there, the blame rolls down the chain until it reaches the financial institution that underwrote the loan and bought it from the mortgage lender. While these institutions were probably not directly at fault for the missing or fraudulent documents, they made certain guarantees to their investors that these loans would be sound. Banks should absolutely assume the entire liability for faulty underwriting policies, and indeed they may be required to under pooling and servicing agreements. The bank may seek redress from the mortgage broker or lender, but more likely than not, these entities are out of business and are judgment-proof. The bank, typically the only solvent institution still in business, must indemnify the investors from loss by repurchasing the mortgages out of the pool.

If the note is destroyed and plaintiff cannot prove that it is the holder of the mortgage, the plaintiff should not be allowed to foreclose — to do otherwise would be to introduce major moral hazard into the system and possibly allow for wrongful foreclosures to take place. In these cases, the lender should be compelled to negotiate with the borrower to settle in exchange for discharge of the mortgage lien from the property, which should still encumber the property regardless of whether the mortgagee can produce a note. The depositor bank must assume total liability for the documentation errors and pay the investors accordingly.

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135 Pooling and servicing agreements often require the securitizing party to repurchase loans out of the pool if certain representations prove to be untrue. See Hynes, supra n. 40, at 243.
Most pooling and service agreements entitle investors to pursue the repurchase of loans by depositors whenever an error in documentation is made or the note was never delivered. The investors should pursue this option to the fullest extent of the law, and the depositing banks should be compelled to seek redress from the originator mortgage lenders if they still exist, who would in turn hold the brokers liable for any negligence or fraudulent activity.

VII. Conclusion

Although much of MERS’ framework is a relatively novel development in the field, leaving some issues untested, its contribution to the economy is undoubtedly a net positive. MERS lowers transaction costs, interest rates and allows borrowers easier access to credit. The benefits far outweigh the detriments, especially since the most pressing concerns raised by critics may be easily solved by simple legislation.

Property recording statutes, in place since the founding of this country, were simply not designed to handle the complex process of the modern secondary mortgage market, and did not anticipate the development of easy-to-access national electronic databases. MERS does not circumvent the primary purpose of recording a lien: to put potential creditors or bona fide purchasers on notice that a parcel of real estate is encumbered by a lien. Further, separating the note and the mortgage is not fatal to the security interest;
this rule was meant to protect a noteholder from losing the security interest due to wrongful acts of the mortgagee of record, not to establish a prohibition of the practice.

Courts should remain vigilant for plaintiffs with insufficient documentation, as mistakes are common; however, the mere fact that MERS has separated the note and mortgage should not bar the note-holding plaintiff from foreclosing. A judicially or legislatively imposed moratorium on foreclosures only serves to prolong the pain and cause vacant homes to fall into further decay. The fact that unsold home inventory is near an all-time high at 6.3 million units\textsuperscript{137} is an indicator that the housing market has not yet reached its equilibrium price and something is preventing prices from falling to meet this goal. Foreclosure is a natural market process designed to wrest assets from the nonpaying or unproductive owner and put it into the hands of an owner who will put the property to better use. Without it, the market cannot function.

Using MERS as a proxy mortgagee does not change the facts of the typical foreclosure case: the borrower applies for a loan, the lender extends credit to the borrower, the borrower defaults, and the lender forecloses. Provided there was no fraud in obtaining the credit, the substance of the transaction is sound and legal, whether MERS is involved or not.

MERS represents a significant advancement in lien recording technology, just as stock transfer agents pioneered electronic central databases more than thirty years

\textsuperscript{137} See Corelogic, Inc., \textit{Shadow Inventory Jumps More than 10 Percent in One Year, Pushing Total Unsold Inventory to 6.3 Million Units}, http://www.corelogic.com/uploadedFiles/Pages/About_Us/News/CoreLogic%20Shadow%20Inventory%20%20FINAL.pdf (retrieved Dec. 15, 2010).
earlier. Decreased transaction costs facilitate increased liquidity and benefits that pass on to the consumer. As the cabinets at the recording office gather dust, we must now acknowledge that the future of lien recording and tracking lies with electronic registration systems like MERS.