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RECONCILING THE LEGAL CONFLICT BETWEEN MORTGAGE LAW AND TECHNOLOGY IN THE TWENTY-FIRST CENTURY

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ABSTRACT

As technology continues to advance at a rapid pace, the law is often slow to adapt. A perfect example of the conflicts caused by this slow adaptation can be seen in the secondary mortgage market. In an effort to cut costs, investment banks have taken shortcuts in the paperwork required to assign a securitized mortgage from the mortgage originator to the trustee that pools mortgages into marketable securities. The result has been a rash of failed foreclosures because the banks cannot prove they own the promissory notes underlying the mortgages.

Complicating matters is an internet company that claims to be the mortgagee for sixty million home loans: the Mortgage Electronic Registration System (MERS). Designed to simplify the paperwork in the secondary mortgage market, MERS has taken the radical step of foreclosing on home loans. The problem is that MERS does not own legal title to the mortgages on which it is foreclosing.

From analyzing MERS and the investment banks, one can conclude that the mortgage industry demands reform. This paper recommends that legislators create a legal tool called a mass pooling agreement (MPA). The MPA will simplify and economize the securitization process by offering a legal avenue for the mass pooling of promissory notes during the creation of mortgage-backed securities.

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INTRODUCTION

"The institutions seem to adopt the attitude that, since they have been doing this for so long, unchallenged, this practice equates with legal compliance. Finally put to the test, their weak legal arguments compel the court to stop them at the gate." [1]

- Judge Christopher A. Boyko, Federal District Court, Cleveland, Ohio, Oct. 31, 2007

In the midst of the subprime mortgage crisis of 2007, lenders were presented with yet another obstacle. While attempting to foreclose on fourteen separate properties, Deutsche Bank National Trust Company learned the hard way that a common industry practice does not equal legal compliance. On October 31, 2007, Federal District Court Judge Christopher A. Boyko dismissed the fourteen cases after ruling that Deutsche Bank did not have standing to foreclose.[2] The problem for Deutsche Bank arose during the process of securitization. This is a process during which Wall Street bankers have often taken legal shortcuts. Despite longstanding practices, these shortcuts may now prevent them from foreclosing on residential mortgages in default.[3]

Rulings such as Judge Boyko's could have a profound impact on commercial banks, investment banks, and investors. "At a minimum this lapse could impose extra costs on the mortgage industry when it can ill afford it. At the maximum it could open mortgage investors to an obscure legal attack by homeowners that in some cases could block foreclosure."[4] If trustees are unable to foreclose, then mortgage-backed securities become worthless: homeowners could

[1] Alf Young, *Alf Young on Tuesday; Paulson rides to rescue of sub-prime have-nots*, THE HERALD (Glasgow), Dec. 4, 2007, at 27.
[2] Gretchen Morgenson, *Foreclosures Hit a Snag For Lenders*, N.Y. TIMES, Nov. 15, 2007, at C1.
[3] Michael Orey, *Foreclosures: Not So Fast; Court ruling may make it tougher for holders of mortgage-backed securities to take back the keys*, BUSINESS WEEK, Dec. 10, 2007, at 28.
[4] *Id.*

simply cease making their mortgage payments and the investors in secondary mortgage pools would have no legal recourse.

Of course, a party like Deutsche Bank should be able to re-file its foreclosure suits if it can produce evidence that it does own the promissory notes. But it is not clear that such evidence can be produced. During securitization, trustees are required to create individual assignments for each mortgage in a mortgage pool. Trustees have, however, adopted the practice of creating a document known as a pooling-and-servicing agreement (PSA), which economizes the securitization process by lumping all the mortgages together without creating individual assignments. Courts, however, have not recognized PSA's as legal substitutes for assignments.[5] Furthermore, PSA's "assign" the mortgages, but the promissory notes are left behind. This creates a serious problem because it is well established that mortgages are meaningless without an underlying promise to repay a debt. That promise takes the form of a promissory note.

Deutsche Bank is not the only institution that has encountered legal problems when foreclosing on securitized mortgages. Perhaps the most interesting company in the mortgage business today is the Mortgage Electronic Registration System (MERS). MERS is an internet-based mortgage registration service that has recently become involved in foreclosures. Like Deutsche Bank, MERS is having difficulty proving it has standing to foreclose, but for a more fundamental reason: whereas Deutsche Bank simply cannot prove it holds the legal title, MERS does not actually hold the legal title.

This paper will explore the legal obstacles to and consequences of foreclosing on securitized mortgages. Part I begins with a summary of the laws governing real estate, foreclosure, and the process of securitization. Part II describes the failed foreclosures of companies like Deutsche Bank. Part III discusses MERS and the role of technology in the

[5] *Id.*

mortgage industry. Part IV recommends reforms by policy-makers and private industry that are designed to economize the secondary mortgage market and reconcile the legal conflicts created by technologies such as the internet. The paper concludes that legislators should create a legal tool called a mass pooling agreement that will simplify and economize the securitization process by allowing for the mass pooling of promissory notes during the creation of mortgage-backed securities. This solution would accomplish the goals of increasing transparency in the secondary mortgage market, reducing transaction costs, and preserving real estate ownership records. Without such reform, the secondary mortgage market could suffer from a serious disruption.

I. RULES GOVERNING REAL ESTATE OWNERSHIP

This part will begin with a brief discussion of real estate terminology, recording requirements, and foreclosure. Building on this foundation, this paper will analyze the process of securitization and the role of subprime lending in the secondary mortgage market. This part will conclude with a summary of the legal requirements for foreclosing on a securitized mortgage in federal court.

A. The Note and Title in Mortgages

The lender in a mortgage relationship is called the mortgagee, and the borrower is the mortgagor. A mortgage relationship includes two components: the mortgage and the promissory note.[6] A mortgage is defined as "a pledge or security of a particular property for the payment of a debt or the performance of some other obligation, whatever form the transaction may take, but is not now regarded as a conveyance; a written instrument providing security for payment of a debt."[7] A promissory note is defined as "the personal promise of the debtor to repay the loan and is evidence of the debt."[8] The promissory note is the debt that the mortgage secures, and a mortgage cannot be enforced without a promissory note.[9]

In a mortgage relationship, one party "will hold title to the property and the other will have an interest in the property."[10] Which party retains the title to the land is determined by state law. In states subscribing to "title theory," the mortgagee retains the title to the property and has the right to possession and rent collection.[11] In states adhering to "lien theory," the mortgagor

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[6] MARIANNE M. JENNINGS, REAL ESTATE LAW 7E 374 (2005).
[7] *Id.* at 372.
[8] BARLOW BURKE, REAL ESTATE TRANSACTIONS 2E 225 (1999).
[9] JENNINGS, *supra* note 6, at 374.
[10] *Id.* at 372.
[11] *Id.*

retains the title to the property and the mortgagee has the right to possession and rent collection only in a foreclosure.[12]

One important clause included in a standard promissory note is the acceleration clause.[13] This allows the mortgagee to "declare the whole sum of accrued interest plus unpaid principal due and payable."[14] Without the acceleration clause, the mortgagee could only collect missed payments and would have to file a new lawsuit each time the mortgagor missed a payment.[15] The mortgagee may also increase the interest rate charged on an accelerated mortgage balance if an interest acceleration clause is included in the promissory note.[16] Acceleration, as well as foreclosure, typically do not occur until after the mortgagee has attempted to collect the late payments by writing letters, making telephone calls, or trying other collection procedures.[17]

B. Recording Requirements

Recording is the "process of placing a deed or other document on the public records to give notice of a transaction or interest in the land."[18] Recording statutes in America date as far back as the Massachusetts Bay Act of 1634, and all fifty states currently have some form of recording act.[19] The recording process may vary by county but is rather straightforward: "the mortgagee must generally deliver a copy of the document in question…to a county clerk that time stamps, indexes, and files the document."[20] The recording party receives a receipt, which,

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[12] *Id.*
[13] BURKE, *supra* note 8, at 299.
[14] *Id.*
[15] *Id.*
[16] JENNINGS, *supra* note 6, at 385.
[17] BURKE, *supra* note 8, at 300.
[18] JENNINGS, *supra* note 6, at 650.
[19] *Id.* at 316.
[20] Christopher L. Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System* 4-19, 7 (Univ. of Utah S.J. Quinney College of Law Working Paper Series, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1469749.

with the time stamp, is "often critical in establishing title and lien rights in the property."[21] The same process applies to assignments, and the copy of the mortgage or assignment that is delivered to the county clerk is usually notarized. Both the notary and the county recording office charge a fee, and the entire process typically costs between $25 and $50.[22] As will be discussed in subsequent sections, recording fees can mount for multiple mortgages, and are a sizable transaction cost for investment banks in the securitization business. As a result, the banks have developed ways to streamline the process.

Recording offers the general public and private industry many benefits. Recording creates an historical record of property ownership. Academic and social benefits include assisting professional historians in their research projects, or facilitating genealogical research by curious ancestors. In business and law, recording serves two primary purposes: establishing chain of title and determining priorities of interest.

By searching the property records, one can determine the chain of title—that is, "the history of how a piece of real estate has been transferred over the years between successive owners."[23] An unbroken chain of title helps protect the parties to a mortgage against claims from other parties. Additionally, the originator of the loan typically purchases title insurance to protect its investment in case a defect in the title arises after closing.[24]

Priority refers to the position of the mortgagee in relation to other creditors.[25] Although recording is not required for a mortgage to be valid, recording is required to give the mortgagee priority over other creditors.[26] In addition, if the mortgage is not recorded, then fraudulent

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[21] JENNINGS, *supra* note 6, at 317.
[22] Peterson, *supra* note 20, at 7.
[23] JENNINGS, *supra* note 6, at 317.
[24] *Id.* at 316-318.
[25] *Id.* at 384.
[26] *Id.*

conveyances may occur.[27] For example, one could sell the same property to different parties, and depending on the state's recording laws, the first party to properly record the mortgage could be entitled to the property regardless of whether he was the first party to be sold the property.[28] The same is generally true when a securitized loan is traded on the secondary mortgage market.[29]

C. The Foreclosure Process

If the mortgagor does not comply with the provisions of the mortgage and promissory note, he or she is said to be in default.[30] Default usually results in foreclosure when the mortgagor fails to make one or more timely payments.[31] Mortgagees will typically try to settle the dispute—for example, by restructuring the loan—because foreclosure can be lengthy and costly;[32] however, once these options have been exhausted, the mortgagee will pursue a foreclosure.[33]

There are two types of foreclosure: judicial foreclosure and power-of-sale, or non-judicial, foreclosure.[34] Judicial foreclosure requires court approval of the foreclosure sale; power-of-sale foreclosure does not.[35] The type of foreclosure and specific process vary by state but can be described in general terms.

In judicial foreclosure, the process begins with the mortgagee filing the petition in the proper court, which must include the basis for foreclosure and requested relief.[36] Next, the interested parties are served and public notice of the foreclosure action is filed.[37] Then a

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[27] *Id.* at 319.
[28] *Id.*
[29] Peterson, *supra* note 20, at 9.
[30] JENNINGS, *supra* note 6, at 395.
[31] WILLIAM B. BRUEGGEMAN AND JEFFREY D. FISHER, REAL ESTATE FINANCE AND INVESTMENTS 13E 24 (2008).
[32] *Id.* at 25.
[33] *Id.* at 29.
[34] JENNINGS, *supra* note 6, at 396-400.
[35] BURKE, *supra* note 8, at 219.
[36] JENNINGS, *supra* note 6, at 397.
[37] *Id.*

foreclosure trial is held.[38] Assuming the court finds for the mortgagee, the next step depends on state law. All states allow some form of redemption, which "is the process of canceling or annulling a title conveyed by a foreclosure sale by paying the debt or fulfilling the other conditions in the mortgage."[39] There are two types of redemption: equity and statutory.[40] All states allow a period of equity redemption, and about half provide for statutory redemption.[41] Equity redemption occurs in the time before the foreclosure sale;[42] statutory redemption, the length of which is fixed by state statute and is usually six to twelve months,[43] occurs after the foreclosure sale.[44] The final step in the judicial foreclosure process is the foreclosure sale.[45]

The power-of-sale foreclosure process is faster and less expensive.[46] The mortgagee is required to notify all interested parties, as well as the general public, of the foreclosure sale.[47] Once this is done, the sale can be held, and there is no period of statutory redemption.[48]

Another state-by-state variance is deficiency judgment.[49] The revenue provided by a foreclosure sale is usually less than the amount owed to the mortgagee.[50] Therefore, some states allow the mortgagee to collect the difference from the other personal assets of the mortgagor.[51] This is called deficiency judgment. Alternatively, the mortgagee may choose to sue on the note, not the mortgage, thereby going after the mortgagor's personal property from the beginning.[52] Most mortgagees, however, "will normally elect to sue on the note and foreclose on the

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[38] *Id.*
[39] BRUEGGEMAN, *supra* note 31, at 29.
[40] *Id.* at 29-30.
[41] *Id.* at 30.
[42] BURKE, *supra* note 8, at 219.
[43] JENNINGS, *supra* note 6, 397.
[44] BURKE, *supra* note 8, at 219.
[45] JENNINGS, *supra* note 6, at 398.
[46] BURKE, *supra* note 8, at 305.
[47] JENNINGS, *supra* note 6, at 400.
[48] *Id.*
[49] *Id.* at 404.
[50] BRUEGGEMAN, *supra* note 31, at 33.
[51] BURKE, *supra* note 8, at 227.
[52] BRUEGGEMAN, *supra* note 31, at 17.

mortgage simultaneously."[53] State-by-state differences in deficiency judgment and the foreclosure process help illustrate the decentralized nature real estate law, which can be problematic when financial institutions begin securitizing millions of mortgages at the macro level.

D. The Secondary Mortgage Market, Securitization, and Subprime Lending

Securitization is defined as "a financial operation [that] allows a financial institution to transform unmarketable financial assets, such as mortgage assets or lease contracts, into marketable securities" called mortgage-backed securities.[54] Mortgage-backed securities are traded on what is known as the secondary mortgage market.[55] The secondary mortgage market was created in the 1970s to offer investors a new product and lenders an opportunity to reduce risk.[56] Although commercial mortgages can be securitized, the largest market—and the focus of this paper—is the residential mortgage-backed securities market.[57] Traditionally, only prime residential mortgages were securitized.[58] Recent years, however, have seen an increase in the demand for subprime mortgage-backed securities.[59]

There are four broad categories of mortgages, as summarized in Table 1.[60]

[53] *Id.*
[54] R. Mansini & M.G. Speranza, *A Multidimensional Knapsack Model for Asset-Backed Securitization*, 53 J. OF THE OPERATIONAL RESEARCH SOC'Y 822, 822 (2002).
[55] Gerald Korngold, *Legal and Policy Choices in the Aftermath of the Subprime and Mortgage Financing Crisis*, 60 S.C. L. Rev. 727 (2009).
[56] BRUCE TUCKMAN, FIXED INCOME SECURITIES 2E 455 (2002).
[57] Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Provisions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1078 (2009).
[58] Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit*, FED. RESERVE BANK OF N.Y. STAFF REPORT NO. 318, 2 (2008).
[59] *Id.*
[60] *Id*.

Table 1: Categories of Mortgages	
Type of Mortgage	*Characteristics*
Prime (Conforming)	borrowers with good credit history
Jumbo	prime loans with initial balance over $417,000
Alt-A	borrowers with good credit, featuring more aggressive underwriting
Subprime	borrowers with poor credit history

In 2006, the total value of mortgages issued was $2.5 trillion, $1.9 trillion (76.9%) of which were securitized into mortgage-backed securities.[61] Also in 2006, 91% of Alt-A, 87% of conforming, 75% of subprime, and 46% of jumbo loans were securitized.[62] It can be seen that the majority of home loans were securitized in 2006. By the end of 2008, the value of outstanding residential mortgage-backed securities was nearly $6.8 trillion.[63] Mortgage-backed securities are issued by both government-sponsored entities and by private industry. Table 2 presents the percentage of each in 2008.[64]

Table 2: Residential Mortgage-Backed Securities by Issuer	
Issuer	*Percent of Secondary Market in 2008*
Fannie Mae or Freddie Mac (GSEs)	64%
Private Institutions	27%
Ginnie Mae	8%

The Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") are major players in the secondary mortgage market for conventional home loans.[65] These government-sponsored entities (GSEs) guarantee timely payment of the mortgages they securitize. Similarly, the mortgage-backed securities issued by the Government National Mortgage Association ("Ginnie Mae"), which underwrites mortgages

[61] *Id.*
[62] *Id.*
[63] Gelpern, *supra* note 57, at 1080.
[64] *Id.* at 1080-1081.
[65] BURKE, *supra* note 8, at 213.

associated with federal housing programs,[66] are backed by the full faith and credit of the United States government.[67] Although Fannie Mae, Freddie Mac, Ginnie Mae, and private institutions use the same process to securitize loans, the focus of this paper is private institutions, as federal entities are regulated differently[68] and are currently under federal conservatorship.[69]

Dozens of parties can be involved in securitization, but three are key to understanding the process: the originator, the special-purpose vehicle (SPV), and the trustee. Once securitized, the mortgage-backed securities are sold to investors, which are typically large financial institutions.

The originator is the mortgagee, or original lender. The originator is responsible for the title search and generally takes out title insurance on the property.[70] In return for its services, the originator receives a commission. In order to reduce or eliminate the risks associated with interest rates and default, the originator sells the mortgages it initiates, typically to a subsidiary of an investment bank.[71]

"Ultimately, the promissory note and mortgage are then assigned, along with many other loans, to a special purpose vehicle that usually takes the form of a trust." The SPV is a financial intermediary that packages the loans into marketable securities.[72] Next, "a pooling and servicing agreement specifies a trustee to manage the loan assets and a servicer to collect monthly payments and interact with the homeowner."[73] The originator often becomes the servicer and is paid a fee for collecting payments.[74] When combined, the cash flows from thousands of loans can be sliced and diced into different packages with varying levels of risk and

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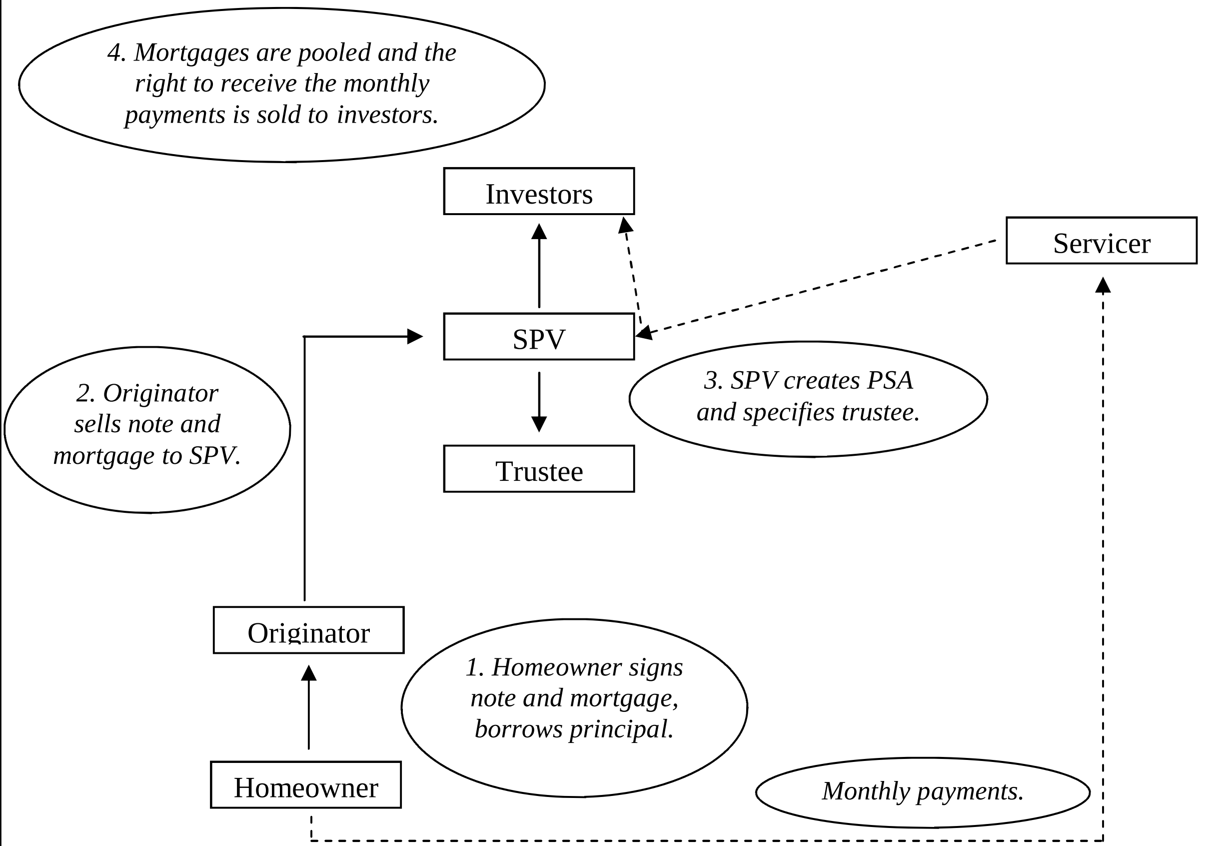
[66] *Id.*
[67] Gelpern, *supra* note 57, at 1081.
[68] *Id.* at n.21.
[69] *Id.* at n.16.
[70] Peterson, *supra* note 20, at 9.
[71] *Id.*
[72] Mansini, *supra* note 54, at 823.
[73] Peterson, *supra* note 20, at 9.
[74] BURKE, *supra* note 8, at 212.

expected return. The packages—mortgage-backed securities—are then sold to investors, who receive a portion of the mortgagors' monthly payments as compensation for assuming the risk of default.[75]

The process of securitization is presented visually in Figure 1.[76]

Figure 1: Securitization



A significant problem created by securitization is that loan originators have an incentive to make more subprime loans than they would if they had to assume the risk of default:

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[75] Korngold, *supra* note 55, at 729.
[76] Figure 1 is derived from Peterson, *supra* note 20, at 9.

> The volume of MBS originated and traded reached $3 trillion in 2005 in a U.S. housing mortgage industry of $10 trillion. Securitization enabled banks and mortgage companies, the originators of these loans, to take on more loans as they moved the securitized loans off their books….Many large housing developers aggressively pushed mortgages to borrowers in order to boost sales….The dissociation of ownership of assets from risks encouraged poor credit assessment and was fundamental in reducing the margin of safety and increasing the margin of risks.[77]

Prime borrowers rarely defaulted and their mortgages were bundled into reliable, low-risk securities.[78] With interest rates at 1.75% in 2001 and 1.00% in 2003, however, more people with poor credit could afford to make monthly payments on a house.[79] During the early part of the 2000s, housing prices increased and interest rates remained low.[80] Many of the subprime borrowers, however, had received adjustable-rate mortgages.[81] Eventually, the interest rates increased, the borrowers could not make their payments, and therefore began to default.[82] "These defaults caused an implosion of the mortgage backed securities…industry."[83] This implosion triggered the current financial crisis, and was very costly. The "IMF [International Monetary Fund] estimates subprime loses at nearly a trillion dollars; about $143 for every person on the planet."[84] With borrowers in default, the next step was for the owners of the promissory notes to foreclose in an effort to recover some of their investment.

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[77] Michael Mah-Hui Lim, *Old Wine in New Bottles: Subprime Mortgage Crisis—Causes and Consequences*, 3 J. OF APPLIED RES. IN ACCOUNTING AND FIN. 3, 4 (2008).
[78] Korngold, *supra* note 55, at 730.
[79] Lim, *supra* note 77, at 6.
[80] *Id.* at 4.
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] Peterson, *supra* note 20, at 3.

Once foreclosures began on a massive scale, it became obvious that one of the sticky points of the securitization process is the pooling and servicing agreement (PSA). The PSA is usually prepared in lieu of properly recording each assignment—and paying the recording fee.[85] Thus, it is unclear who actually owns the promissory note—i.e., the right to receive the mortgage payments—at the end of the transaction. In practicality, this is not a huge issue as long as the mortgagor continues to make his or her monthly mortgage payments; but if the mortgagor defaults, then it is uncertain who has the legal right to foreclose on the property.

E. Foreclosing on a Securitized Mortgage in Federal Court

The cases dealing with foreclosure on securitized mortgages that have gotten the most attention, including Judge Boyko's landmark ruling, were made by federal courts.[86] The reason for this is not clear, but it may be that federal courts are considered friendlier to corporations. Federal judges are appointed by the president and confirmed by the Senate,[87] and may be seen as more professional and less beholden to local political trends than judges who are elected on the state level. Banks began encountering failed foreclosures in Ohio, as will be discussed in Part II; the banks chose to sue in federal court, which may be explained by the fact that Ohio elects judges at the trial and appellate levels.[88] The banks would not want a judge whose neighbor is the defendant, and more significantly, an ardent campaign supporter.

Corporations and banks may *prefer* to sue in federal court, but to do so they must satisfy two legal requirements. First, the Constitution requires that it be a dispute between citizens of

[85] Orey, *supra* note 3.
[86] *See, e.g.*, *In re Foreclosure Cases*, 2007 WL 3232430, Oct. 31, 2007; *Whittiker et al., v. Deutsche Bank National Trust Company et al.*, 08CV300; and *Deutsche Bank National Trust Company v. Harper*, 07CV2563 (discussed in greater detail in Part II, these three cases all came before the U.S. District Court, Northern District of Ohio, Eastern Division).
[87] U.S. Courts, Federal Judges, http://www.uscourts.gov/faq.html (last visited Apr. 2, 2010).
[88] OHIO CONST. art. 4, § 6.

different states.[89] This is called diversity jurisdiction.[90] A corporation is considered a citizen of the state in which it is headquartered as well as its principle place of business.[91] For example, if a bank or mortgage company is a national company headquartered in California but doing business in Ohio, then a federal court in Ohio has diversity jurisdiction between the bank and citizens of Ohio.

Second, the mortgagee in a foreclosure action must have standing to sue—that is, "a party must have a legally-protected and tangible interest at stake."[92] Furthermore, the issue must be a justiciable controversy—that is, "a controversy that is real and substantial, as opposed to hypothetical or academic."[93] Specifically, "a plaintiff must adequately establish: (1) an injury in fact…(2) causation…and (3) redressability."[94] The injury is that the defendant is in default and the plaintiff is therefore entitled to recover damages according to the mortgage and promissory note.[95] Once diversity jurisdiction and standing have been satisfied, the bank can execute the foreclosure action.

The inability of financial institutions to prove standing has become more common since 2008. The result has been many failed foreclosures in recent years. To illustrate this point, Part II discusses several specific cases with similar circumstances.

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[89] U.S. CONST. art III, § 2.
[90] BLACK'S LAW DICTIONARY (8th ed. 2004).
[91] *Id.*
[92] KENNETH W. CLARKSON ET AL., WEST'S BUSINESS LAW 37 (9th ed., 2004).
[93] *Id.*
[94] *Sprint Communications Co., L.P. v. APCC Services, Inc.*, ___ U.S. ___, 128 S.Ct. 2531, 2534 (2008).
[95] JENNINGS, *supra* note 6, at 395-396.

II. FAILED FORECLOSURES & THE CURRENT CRISIS

The beginning of the twenty-first century saw an unsustainable increase in property values. Between 2000 and 2006, the median house price increased by 40%, then began to decline in 2006.[96] "In 2006, 1.2 million household loans were foreclosed, up 42% from the previous year."[97] Twenty-five percent of these were subprime loans, which "were fine as long as the housing market continued to boom and interest rates did not rise."[98] Unfortunately, these conditions did not last, and "the first to default were subprime borrowers."[99]

The failure of subprime borrowers to make their mortgage payments signaled the end of the credit boom in 2007.[100] The effects of the subprime mortgage meltdown will continue to be felt for years but have already been severe. Consequences include the government takeover of mortgage lenders Fannie Mae and Freddie Mac,[101] the government bailout of insurance company American International Group,[102] and the bankruptcy of investment bank Lehman Brothers.[103] Although other factors were involved, the credit crunch caused by the subprime mortgage bust resulted in an international financial crisis.[104]

With millions of subprime mortgagors in default, the investment banks and trustees that had securitized their mortgages began circling the wagons—that is, foreclosing. As early as late 2007, however, the banks received bad news: many of their foreclosures were failing, a problem that, if it occurred on a wide scale, could mean bankruptcy. This part explores the legal causes and effects of this rash of failed foreclosures.

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[96] Lim, *supra* note 77, at 4.
[97] *Id.*
[98] *Id.*
[99] *Id.*
[100] Ben S. Bernanke, Chairman, Fed. Reserve, Four Questions about the Financial Crisis (Apr. 14, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm.
[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] *Id.*

A. Opening the Floodgate: The First Failed Foreclosures

The state leading the rebellion against the improper foreclosure practices of large banks is Ohio.[105] The first wave of foreclosure dismissals came when federal judge Christopher Boyko "opened the flood gates" by dismissing fourteen foreclosure cases filed by Deutsche Bank National Trust Company in October 2007.[106] At least two other major cases have been filed in Ohio following Judge Boyko's ruling. The first is *Whittiker v. Deutsche Bank National Trust Co.*, a class action seeking damages for shady foreclosure practices.[107] The second is *Deutsche Bank National Trust Co. v. Harper*.[108]

On October 10, 2007, Judge Christopher A. Boyko of the U.S. District Court for the Northern District of Ohio "issued an Order requiring Plaintiff-Lenders [Deutsche Bank] in a number of pending foreclosure cases to file a copy of the executed Assignment demonstrating Plaintiff was the holder and owner of the Note and Mortgage as of the date the Complaint was filed."[109] Deutsche Bank had filed the foreclosure actions on behalf of investors in a securitized mortgage pool.[110] Instead of filing the assignment as requested by Judge Boyko, Deutsche Bank filed a note and mortgage with the original lending institution identified as the mortgagee. Citing Article III of the United States Constitution, Judge Boyko dismissed all fourteen cases because Deutsche Bank could not prove it had standing to foreclose.[111]

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[105] *In re* Foreclosure Cases, No. 1:07CV2282, 07CV2532, 07CV2560, 07CV2602, 07CV2631, 07CV2638, 07CV2681, 07CV2695, 07CV2920, 07CV2930, 07CV2949, 07CV2950, 07CV3000, 07CV2039, 2007 WL 3232430 (N.D. Ohio Oct. 31, 2007) (This was the first case in which foreclosure cases were dismissed due to the bank's failure to produce proof of owning the note, and in the aftermath, judges across the country have followed Judge Boyko's lead).

[106] Julie Kay, *Judges, Attorneys Work to Staunch Foreclosures*, July 14, 2008, http://www.naca.net.News-Events/News.aspx?item=54224.

[107] Complaint at 1-3, Wihttiker, et al., v. Deutsche Bank Nat'l Trust Co., et al., No. 08CV300 (N.D. Ohio 2008).

[108] Complaint at 1, Deutsche Bank Nat'l Trust Co. v. George Murray Harper, No. 07-05740 (N.D. Ohio 2007).

[109] *In re* Foreclosure Cases, 2007 WL 3232430, at *1.

[110] Morgenson, *supra* note 2.

[111] *In re* Foreclosure Cases, 2007 WL 3232430, at *2.

It is important to note that the above-mentioned lawsuits were dismissed because Deutsche Bank could not *prove* it owned the right to foreclose. The court did not rule that Deutsche Bank did not, in fact, have the right to foreclose, and Deutsche Bank is free re-file the cases if able to satisfy standing.

Judge Boyko's opinion is entertaining to read. It seems that the attitude and conduct of the plaintiff and its attorneys angered Judge Boyko. As his decision goes on, he becomes more enraged:

> Plaintiff's "Judge, you just don't understand how things work," argument reveals a condescending mindset and quasi-monopolistic system where financial institutions have traditionally controlled, and still control, the foreclosure process…unchallenged by underfinanced opponents, the institutions worry less about jurisdictional requirements and more about maximizing returns. Unlike the focus of financial institutions, the federal courts must act as gatekeepers, assuring that only those who meet diversity and standing requirements are allowed to pass through.…Finally put to the test, [Plaintiff's] weak legal arguments compel the Court to stop them at the gate.[112]

He finally ruled against the plaintiff, but not without mocking Deutsche Bank and the practices of its industry a bit more.

As entertaining as Judge Boyko's decision is to read, it is also well-rooted in the law. As explained in Part I, a plaintiff must prove standing in order to foreclose on a securitized mortgage. The plaintiff was required to submit an affidavit along with the complaint identifying

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[112] *Id.* at n.3.

plaintiff as the original mortgagee or assignee.[113] Since Deutsche Bank could not produce an assignment proving it had standing, the court dismissed the cases.

Ohio law requires that an assignment not only be prepared, but also properly recorded. So what exactly did Deutsche Bank fail to do? Ohio law states, in relevant part, that

> All deeds, land contracts…and instruments of writing properly executed for the conveyance…of lands…shall be recorded in the office of the county recorder of the county in which the premises are situated. Deeds of assignment for benefit of creditors must be left for record in each county where real estate of assignor is situate…An assignment of a mortgage falls within the category of an instrument in writing for the encumbrance of lands and is subject to the provisions of GC 8543 (RC 5301.25)… Deeds of assignment must be recorded in each county.[114]

For the assignment to be properly prepared, Ohio requires it to be in writing, notarized, and recorded with proper local authority in the "'record of deeds.'" [115]

As of December 27, 2008, Deutsche Bank had yet to respond to the dismissal. The cases had not been re-filed in federal court, suggesting that Deutsche Bank still cannot prove it owns the promissory note to the foreclosed properties.[116]

B. Deutsche Bank: The Big Fish in the Sea

In the wake of Judge Boyko's ruling, a class action was filed in Ohio in February 2008. A class action is a lawsuit in which a small group of people with similar legal and factual issues

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[113] *Id.* at *1.
[114] OHIO REVISED CODE § 5301.25.
[115] OHIO REVISED CODE § 5301.25.
[116] *See, e.g., In re* Foreclosure Cases, No. 1:07CV2532, 07CV2560, 07CV2602, 07CV2631, 07CV2638, 07CV2681, 2007 WL 3232430 (N.D. Ohio Oct. 31, 2007)

represent a larger group of people.[117] Class actions are practical when hundreds, or thousands, of plaintiffs have suffered similar injuries because the plaintiffs can file together, instead of clogging the courts with thousands of individual lawsuits.[118] Titled *Whittiker, et al. v. Deutsche Bank National Trust Company, et al.*, the action alleged that Deutsche Bank and several law firms that represented the company violated the Federal Fair Debt Collection Practices Act (FDCPA)[119] and Ohio's Pattern of Corrupt Activities (RICO) Act.[120] The plaintiffs were Ohio residents Jerry and Frances Whittiker, Valeria Kimball, and James Stepanek. The defendants included the Ohio-based law firms of Manley Deas Kochalski LLC, Reisenfeld & Associates, and Weltman Weinberg & Reis Co., LPA. Deutsche Bank is based in Santa Ana County, California.[121]

The lawsuit alleged that Deutsche Bank had filed foreclosure suits against the plaintiffs "without possessing legally enforceable, recorded assignments which demonstrate the chain of ownership an assignment of the mortgages from the actual mortgagees."[122] The plaintiffs further alleged that Deutsche Bank engaged in the business of a trust company, as defined by Ohio law, without actually meeting the legal requirements of a trust company. In all the cases in question, the original mortgage was sold into a mortgage pool, with Deutsche Bank acting as—or at least pretending to be—the trustee. Instead of preparing and recording an assignment as required by Ohio R.C. §5301.25, Deutsche Bank prepared pooling and servicing agreements, documents which, for now, have not survived judicial scrutiny.

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[117] BLACK'S LAW DICTIONARY, *supra* note 90.
[118] *Id.*
[119] Complaint at 1, Whittiker, et al. v. Deutsche Bank Nat'l Trust Co., et al., No. 08CV300 (N.D. Ohio 2008).
[120] *Id.*
[121] Complaint at 1, Deutsche Bank Nat'l Trust Co. v. George Murray Harper, No. 07-05740 (N.D. Ohio 2007).
[122] Complaint at 2, Whittiker, et al. v. Deutsche Bank Nat'l Trust Co., et al., No. 08CV300 (N.D. Ohio 2008).

The plaintiffs alleged that Deutsche Bank and its attorneys knew it was not legally able to conduct business as a trustee in Ohio, and further knew that its mortgage assignments were not properly prepared. Therefore, Deutsche Bank and the defendant law firms violated the Federal Fair Debt Collection Practice Act by knowingly filing illegal foreclosure suits, and in doing so repeatedly established a pattern of corrupt business in violation of Ohio's RICO statue.[123] Plaintiffs believed the potential size of the class to be in the thousands.

On March 17, 2009, Judge David Dowd, Jr., of the U.S. District Court for the Northern District of Ohio dismissed the case against all four defendants under the Federal Fair Debt Collection Practices Act.[124] Even considering all the plaintiffs' allegations in the "most favorable light," the complaint failed on two points: statute of limitations and failure to assert actionable claims. The FDCPA contains a statue of limitations of one year, and the Court ruled that the plaintiffs' action was "time-barred by the FDCPA statute of limitations."[125] Additionally, plaintiff Valeria Kimball did not include in the complaint that the property in question was "'primarily for personal, family, or household purposes'" as required by the FDCPA.[126] This alone is fatal, but Judge Dowd went on to rule that none of the plaintiffs' cases satisfied the requirement that Deutsche Bank's actions were "deceptive or misleading to the least sophisticated debtor."[127]

> A false statement that is not deceptive…is not a violation of the FDCPA….Further, simple inability to prove present debt ownership at the time a collection action is filed does not constitute a FDCPA violation. However, when

[123] Complaint, Whittiker, et al. v. Deutsche Bank Nat'l Trust Co., et al., No. 08CV300 (N.D. Ohio 2008).
[124] Memorandum Opinion at 28-29, Whittiker, et al. v. Deutsche Bank Nat'l Trust Co., et al., No. 08CV300 (N.D. Ohio 2009).
[125] *Id.* at 22.
[126] *Id.* at 18 (quoting 15 U.S.C. §1692a(5)(2006)).
[127] *Id.* at 26.

> a complaint for a FDCPA violation alleges that the plaintiff in the underlying collection action asserted it was the owner of the debt 'all the while knowing that they did not have means of proving the debt,' that FDCPA complaint will survive a motion to dismiss for failure to state a claim….In this case, plaintiffs do not claim that DBNTC filed the underlying foreclosure action all the while knowing that it did not have the means to prove ownership of the debts.[128]

Thus, Judge Dowd dismissed the complaint under the FDCPA. He did not, however, rule on the plaintiffs' RICO statute allegations, leaving them free to re-file in Ohio court. Even though this case was dismissed, the ruling suggests that this course of action may be viable in the future if the plaintiffs file in a timely manner and offer proof that the defendant knowingly filed illegal foreclosure actions. The fact that the *Whittiker* dismissal occurred more than a year after Judge Boyko ruled against Deutsche Bank for failing to demonstrate standing is evidence that Deutsche Bank knew of the legal questions surrounding its securitized mortgages.

C. Deutsche Bank's Arguments

Not all cases have ended in dismissals. In October 2007, another case came before the U.S. District Court in the Northern District of Ohio, this time before Judge Donald C. Nugent.[129] As part of the complaint, Deutsche Bank included an affidavit swearing, but not offering actual evidence, that it was the legal holder of the promissory notes for the cases involved. After Deutsche Bank filed the complaint for foreclosure, the court issued the following order:

> Since the Plaintiff bears the burden of establishing federal diversity jurisdiction as well as standing to bring an action, Plaintiff is Ordered, by October 19, 2007, to file a copy of the executed Assignment demonstrating Plaintiff was the holder and

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[128] *Id.* at 23.
[129] Plaintiff's Response to Court's Order of October 12, 2007 at 1, Deutsche Bank Nat'l Trust Co. v. Harper, 07CV2563 (N.D. Ohio 2007).

> owner of the Note and Mortgage as of the date the Complaint was filed, or the Court will Dismiss the Complaint.[130]

In their patronizing and somewhat insulting response, the attorneys for the plaintiff presented their legal arguments, which both the procedure and merits of their claims. They began by posing the following question: "When does an entity become the holder and owner of the Note and Mortgage?"[131] Deutsche Bank argued that

> while the execution of an Assignment of Mortgage, and its subsequent recording with the appropriate county authority, constitutes good and sufficient evidence necessary to prove ownership of the note and mortgage upon which to file a foreclosure action, said evidence is not the only means by which Plaintiff may obtain ownership of the note and mortgage.[132]

Deutsche Bank argued that "ownership of the securitized asset is often the necessary condition precedent" to the execution of an assignment.[133] Deutsche Bank went on to assert that it had standing to foreclose because it was the real party in interest.[134] In summary, Deutsche Bank submitted that "its standing to sue upon its asset is a matter of basic contract law. It has purchased an asset from another party for good consideration, and now seeks to enforce its rights on that asset."[135]

Regarding procedure, Deutsche Bank argued that failure to offer proof other than an affidavit that it owned the note and mortgage was not sufficient grounds to dismiss the foreclosure action; for the purpose of a motion to dismiss, the plaintiff's allegations must be

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[130] *Id.* at 1.
[131] *Id.*
[132] *Id.* at 4.
[133] *Id.* at 2.
[134] *Id.* at 5-7.
[135] *Id.* at 8.

presumed true.[136] Deutsche Bank also pointed out that an assignment does not have to be recorded to be valid,[137] which is generally true;[138] and used the impracticality of preparing individual assignments for every mortgage in a pool as a further excuse: "The sheer number of loans sold in a single sale transaction can easily be in the hundreds of thousands. The creation and recording of the assignments of these numbers of mortgages takes a considerable amount of time."[139] In other words, creating and recording this many assignments would considerably increase transaction costs.

The cases discussed in Part II are by no means an exhaustive list of foreclosure litigation within the past three years. They do, however, highlight the central legal question common to the disputes: When a mortgage is sold and securitized, who owns the promissory note and therefore has the right to foreclose, and how do they prove it? The mixed decisions from the courts indicate that there is no clear answer. The question becomes more complicated when the internet enters the fray. The paper now turns to the Mortgage Electronic Registration System, an entity that raises similar legal questions—more than it can answer.

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[136] *Id.* at 5 (quoting Washington Mutual Bank FA v. Green, 156 Ohio App. 3d 461, 464 (2004)).
[137] *Id.* at 6.
[138] JENNINGS, *supra* note 6, at 384.
[139] Plaintiff's Response to Court's Order of October 12, 2007 at 3, Deutsche Bank Nat'l Trust Co. v. Harper, 07CV2563 (N.D. Ohio 2007).

III. ELECTRONIC RECORDING AND ITS LEGAL IMPLICATIONS

As illustrated by the cases discussed in Part II, the legal requirement of preparing and recording assignments is creating friction in a financial services industry that has become accustomed to instantaneous transactions. These cases underscore the fact that the American system of recording real estate documents is extremely antiquated. "Indeed, Pennsylvania's first recording act, first adopted in 1717, remains in force to this day. Currently, all fifty states and the District of Columbia have recording statutes similar to their colonial predecessors."[140] The corner-cutting of investment banks can reasonably be interpreted as a demand for reform.

A host of other government services have gone digital in recent years. The Internal Revenue Service (IRS) offers several "electronic alternatives to filing paper returns."[141] Courts regularly accept, or require, electronic filing of documents; for example, the Supreme Court allows electronic submission of merits briefs.[142] And online banking and stock trading, which are regulated by the government, have blossomed in the last ten years.

In fact, during the last ten years county governments and private industry have begun working together to digitize land records. But some companies have taken it further than others, and have encountered legal obstacles in their paths. This part will explore the extent to which technology is currently used by county recording offices and the legal issues that have arisen as a result of technology in the secondary mortgage market.

A. The Electronic Recording Revolution

With the rise of the internet, it took less than a decade for the federal and state governments to begin legislating matters related to electronic commerce. In 1999, the National

[140] Peterson, *supra* note 20, at 6.
[141] Internal Revenue Service, Your Electronic Alternatives to Filing Paper Returns (Jan. 26, 2010), http://www.irs.gov/efile/index.html.
[142] U.S. Supreme Court, Electronic Submission of Briefs on the Merits (Aug. 15, 2008), http://www.supremecourtus.gov/casehand/casehand.html.

Conference of Commissioners on Uniform State Laws (NCCUSL) authored the Uniform Electronic Transactions Act (UETA), "the primary objective of [which] is to establish the legal equivalence of electronic records and signatures with paper writings and manually-signed signatures, removing barriers to electronic commerce."[143] UETA has since been adopted by forty-seven states, the District of Columbia, and the U.S. Virgin Islands.[144] In 2000, Congress enacted the Electronic Signatures in Global and National Commerce Act (ESIGN), which made "signatures on the Internet as enforceable by federal law as those signed on paper."[145] And in 2004, the NCCUSL drafted another model law called the Uniform Real Property Electronic Recording Act (URPERA).[146] URPERA, which as been adopted by twenty-two states, the District of Columbia, and the U.S. Virgin Islands, "authorizes, but does not mandate, local land records officials to begin accepting records in electronic form, store electronic records, convert existing records into electronic form, and set up systems for searching for and retrieving these land records."[147]

Despite legislators' attempt to keep pace with technology, many counties have been slow to react. For example, twenty-four counties in Pennsylvania currently use a program called LANDEX Remote, operated by Optical Storage Solutions, Inc.[148] Once filed on paper, mortgage documents are scanned into the LANDEX database, and subscribers pay per minute to search the land records on the internet using the same software that they would use to search at the county

[143] Nat'l Conference of Comm'rs on Uniform State Laws, Unif. Elec. Transactions Act, http://www.nccusl.org/update/uniformact_factsheets/uniformacts-fs-ueta.asp (last visited Apr. 2, 2010).
[144] *Id.* (Illinois, New York, and Washington have not adopted UETA.)
[145] Jennifer Rewick, *Digital Signatures Gain Legal Status As Act Takes Effect*, WALL ST. J., Oct. 2, 200, at B28.
[146] Nat'l Conference of Comm'rs on Uniform State Laws, Uniform Real Property Elec. Recording Act, http://www.electronicrecording.org/DesktopDefault.aspx (last visited Apr. 2, 2010).
[147] *Id.* (The following states have enacted URPERA as of January 2010: Alabama, Arizona, Arkansas, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Kansas, Minnesota, Nevada, New Mexico, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, US Virgin Islands, Virginia, Washington, and Wisconsin.)
[148] Optical Storage Solutions Inc., LANDEX Remote, http://www.landex.com/remote (last visited Apr. 2, 2010).

office.[149] LANDEX is, however, merely a search engine, and stops far short of electronic recording.

Other counties across the country have already begun electronic recording of real estate documents through private, third-party companies. One such company is Simplifile, which claims to "provide a streamlined, simple, yet scalable approach to electronic recording tailored to counties of all shapes and sizes."[150] Another company is U.S. Recordings, which claims to be a "one-stop-recording shop" for over 3,700 counties in 50 states.[151] Unlike Simplifile, U.S. Recordings advertises an electronic assignment service.[152] U.S. Recordings also deals with mortgages associated with MERS (discussed in depth in the next section).[153] According to its website, "U.S. Recordings simplifies [the assignment] process by registering loans directly into MERS on your behalf while assisting you in managing your MERS portfolio."[154]

It can be seen, then, that the mortgage industry has begun to move toward electronic recording of mortgages and assignments. Some states and counties, however, have been slow to respond, creating a fragmented national recording system with many legal uncertainties. One of these legal uncertainties is the Mortgage Electronic Registration System.

B. The Mortgage Electronic Registration System

In the early 1990s—before the height and crash of the internet bubble—a group of mortgage bankers formed a company that would change the face of the American mortgage industry. The bankers thought that they could lower transaction costs by creating an electronic system to record and track mortgages. A study by accounting firm Ernst & Young concluded

[149] *Id.*
[150] Simplifile, Overview, https://simplifile.com/eRecording/simplifile-overview.jsp (last visited Apr. 2, 2010).
[151] U.S. Recordings, About, http://www.usrecordings.com/about_us.aspx (last visited Mar. 28, 2010).
[152] U.S. Recordings, Assignments, http://www.usrecordings.com/services_assignments.aspx (last visited Mar. 28, 2010).
[153] U.S. Recordings, MERS, http://www.usrecordings.com/services_mers.aspx (last visited Mar. 28, 2010).
[154] *Id.*

that mortgage servicers and originators could save $77.9 million per year with such a system,[155] and in 1996 Mortgage Electronic Registration System, Inc., was founded.[156]

On the home page of its website, MERS describes itself as offering "an innovative process that simplifies the way mortgage ownership and servicing rights are originated, sold and tracked."[157] Under the traditional recording system discussed in Part I, an assignment would have to be prepared and recorded—thus incurring a recording fee—every time the mortgage changed hands in the secondary mortgage market. MERS reduces the securitization procedure to one assignment. After a mortgage is prepared with the originator as the mortgagee, the originator assigns the mortgage to MERS.[158] Both the mortgage and assignment are recorded with the proper county authorities, and "from that point on, no additional mortgage assignments will be recorded because MERS will remain the mortgagee of record throughout the life of the loan."[159]

The scope of MERS is massive. According to Peterson, approximately "60 million mortgage loans are registered on its system" and "MERS is legally involved in the origination of approximately 60% of all mortgage loans in the United States."[160] However, although securitized loans are often assigned to MERS, MERS does not receive any revenue directly from the loans.[161] Instead, MERS charges originators and servicers membership and transaction fees. MERS has different types of membership and charges fees based on the size of the company and

155 Phyllis K. Slesinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 IDAHO L. REV. 805, 811-12 (1995).
156 Peterson, *supra* note 20, at 10-11.
157 Mortgage Elec. Registration Sys., www.mersinc.org (last visited Dec. 2, 2009).
158 Peterson, *supra* note 20, at 11-13.
159 *Id.* at 12.
160 *Id.* at 4.
161 *Id.* at 12-13.

the annual volume of mortgage-based transactions. Annual fees range from $264 to $7,500; transaction fees range from $0.95 to $10 per mortgage.[162]

MERS registers both residential and commercial loans, and although it generates revenues from membership fees, it provides a free tool for searching its mortgage records. One can search by Mortgage Identification Number, which is a number assigned by MERS to all loans it registers; by the mortgagor's name and social security number; or by the property's physical address.[163] The search tool is used to find the name of the loan's servicer.[164]

Having mortgages assigned to it after origination is only part of MERS's business. MERS offers another service called "MERS as Original Mortgagee," or "MOM" for short. In a MOM loan, the originator is never listed as the mortgagee. Instead, MERS is listed as the mortgagee and the mortgage is recorded in the appropriate county's land records.[165] By eliminating the assignment, MERS estimates that it saves the originator an average of $30 per transaction.[166]

After entering the realm of MOM loans, MERS advanced one step further and became involved in foreclosures. In fact, MERS even lists "foreclos[ing] more quickly and efficiently" as a benefit of using MERS as the original mortgagee.[167] Since "MERS is listed in the county records as the owner of a mortgage, [the] courts have generally made the assumption that the

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[162] Mortgage Elec. Registration Sys., Pricing, http://www.mersinc.org/MersProducts/pricing.aspx?mpid=1 (last visited Dec. 2, 2009).
[163] Mortgage Elec. Registration Sys., Welcome to MERS for Homeowners, http://www.mersinc.org/homeowners/index.aspx (last visited Dec. 3, 2009).
[164] Mortgage Elec. Registration Sys., MERS Servicer Identification Sys., https://www.mers-servicerid.org/sis/ (last visited Apr. 17, 2010).
[165] Peterson, *supra* note 20, at 13-14.
[166] Mortgage Elec. Registration Sys., MOM Loans, http://www.mersinc.org/why_mers/mom.aspx (last visited Dec. 3, 2009).
[167] Mortgage Elec. Registration Sys., MERS Commercial Loan Brochure, http://www.mersinc.org/newsroom/brochures.aspx (last visited Dec. 3, 2009).

appropriate plaintiff to bringing a foreclosure action is MERS."[168] As with the cases in Ohio discussed in Part II, the practice of MERS foreclosing on properties has gone largely unchallenged by the parties on the other end of the foreclosure proceedings.

Many experts are not convinced that MERS's claims hold any legal water. University of Utah law professor Christopher L. Peterson lists three reasons why MERS cannot be the mortgagee in a MOM loan: "MERS does not fund any loans….no homeowners promise to pay MERS any money….[and] MERS is never entitled to receive the proceeds of a foreclosure sale."[169] The same concept applies to mortgages that MERS claims to own by assignment: "Unlike the investment trust that actually owns the mortgage in a typical subprime securitization structure, MERS does not pay the loan originator value in exchange for the mortgage. On the contrary, the originator or servicer *pays MERS* to take the 'assignment.'"[170]

Peterson also argues that MERS does not have standing to foreclose on properties. As mentioned in Part I, the three requirements for foreclosing on a mortgage in federal court are an injury in fact, causation, and redressability.[171] Peterson asserts that there is no economic injury to MERS when a borrower defaults on a securitized loan:

> When a debtor cannot repay a mortgage loan this causes a clear injury in fact to the investors that have purchased securities that draw on revenue from that loan's monthly payments. What is less clear is how a debtor's failure to pay causes an injury in fact to MERS, a company that has no factual expectation of receiving loan payments or the proceeds of a foreclosure sale. MERS makes the same

[168] Peterson, *supra* note 20, at 14.
[169] *Id.* at 19.
[170] *Id.*
[171] *See supra* Part I.E (discussing *Sprint Communications Co., L.P. v. APCC Services, Inc.*, ___ U.S. ___, 128 S.Ct. 2531, 2534 (2008))..

> amount of money with respect to the original mortgage agreement whether the borrower repays or not.[172]

Compounding MERS's standing problem is the fact that there is another party that owns legal title to the debt: the trustee.[173] There has never "been a case that holds that there are *two* separate legal titles to the same property," which would be exactly the situation if MERS had standing to foreclose.[174] Thus, with neither an injury in fact nor the legal title to the note, it seems clear that MERS, despite its claims, does not have legal standing to foreclose on a securitized mortgage.

While the failed foreclosures discussed in Part II underscore the problems created by innovation in the financial services market, MERS highlights how that innovation, when combined with a powerful technology like the internet, can create profound legal problems. It is clear that homeowners involved in a foreclosure should be more aware of these standing issues. But events in recent years raise the question of what, if anything, the government should do. The paper now turns its attention to a discussion of policy solutions designed to reduce friction in the market while maintaining free enterprise.

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[172] Peterson, *supra* note 20, at 23.
[173] *Id.* at 25.
[174] *Id.* at 26.

IV. RECONCILING THE CONFLICT BETWEEN MORTGAGE LAWS AND TECHNOLOGY

The current system of securitization and foreclosure on mortgage-backed securities is not working. Securitization has caused an abundance of subprime lending, which has led to an increase in foreclosures. Many foreclosures, however, have been unsuccessful due to the sloppy paperwork habits of investment banks and the questionable legal foundations of MERS. The situation begs the question of what we as a society should do. Although it is important to understand the causes and effects of the current crisis in the mortgage industry, fixing the problem is more important than assigning blame. Thus, this paper will now turn its attention to how policymakers and the public should respond.

A. Overreactions and Inadequate Solutions

The consequences of an economic crisis often include increased federal government regulation. For example, in the midst of the financial turmoil of 2007-2008, "many press accounts blamed short-selling for declines in stock prices and even for the collapse of some firms."[175] The government's response was that "the SEC temporarily prohibited short-selling for nearly 1000 stocks whose business related in some way to the financial sector."[176] Given the economic damage done by the collapse of the secondary mortgage market, inaction is neither practical nor realistic.

The federal government has the authority to enact moderate reform of the secondary mortgage market. Mortgages from different states can be traded freely on the secondary market, just as the stocks of companies from different states—and countries—can be traded freely on the New York Stock Exchange. Thus, it seems clear that the authority to regulate the secondary

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[175] Ronel Elul, *Regulating Short Sales*, FED. RESERVE BANK OF PHILA. BUS. REV. 11, 11 (Q4 2009).
[176] *Id.* at 14.

mortgage market falls within the delegated power of Congress to regulate interstate and international trade.[177]

Many reforms of the secondary mortgage market have been suggested, however, that would not provide a solution to the problems described in this paper. Some potential reforms would represent gross overreactions to the turmoil in the secondary mortgage market, and other potential reforms would simply be inadequate to fix the problems. This section discusses several alternatives and argues against them.

With any crisis, one major concern is that the government will overreact. In the words of White House Chief of Staff Rahm Emanuel, "'Never allow a crisis to go to waste.'"[178] One expert to voice this concern is Edward L. Yingling, president and CEO of the American Bankers Association. As he noted in 2008, "the regulatory pendulum can quickly swing, making economic conditions worse rather than better."[179] Prohibiting securitization, subprime lending, or MERS—or all three—would be such an overreaction. In a free market society, the government should not prohibit something just because it creates some unfortunate consequences. Nevertheless, such a prohibition is always a concern, especially when high-ranking decision-makers see crises as opportunities for political gain.

Another overreaction—the opposite of abolishing the secondary mortgage market—would be nationalizing it. The term "nationalize" is used in this context to mean a whole or partial takeover of a business or industry by the government—that is, the government does more than regulate: it operates or exerts control. One problem with nationalization is that the government does not have the necessary specialized knowledge to manage corporations. A recent example of nationalization is General Motors (GM). In 2008, when auto sales tanked, so

[177] U.S. CONST. art. I, § 8.
[178] Jeff Zeleny, *Obama Weighs Quick Undoing of Bush Policy*, N.Y. TIMES, Nov. 10, 2008, at A19.
[179] Edward L. Yingling, *Action and Overreaction*, KY. BANKER MAGAZINE, Sept. 2008, at 24.

did GM's stock; and the company asked the federal government for a financial bailout.[180] In exchange, President Obama fired—or forced to resign—GM's Chief Executive Officer, Richard Wagoner, which was "an extraordinary intervention of the federal government into the management of a private company."[181]

Although prohibiting and nationalizing businesses may sound extreme, it has become more common since 2007 to propose them as solutions to friction in the market. The government should, however, try all alternative avenues of action before prohibiting or nationalizing anything. Society should therefore reject efforts to prohibit or nationalize the secondary mortgage market, and should instead seek more moderate, market-oriented solutions.

One reform being put into action in Florida—the state with the highest foreclosure rate in the nation[182]—is foreclosure mediation.[183] With judicial economy as the goal, homeowners in default would first meet with a foreclosure counselor, and would then participate in mediation with a third-party non-profit organization at the expense of the mortgagee.[184] Significantly, the Florida Supreme Court order establishing the mediation program specifies that lenders must be able to prove they own the promissory note before participating in mediation.[185] If enforced, this requirement could effectively halt foreclosures in which MERS is the plaintiff, since it cannot produce proof that it owns the promissory note. Investment banks acting as trustees, however, may not be able to participate in mediation because, although they own the promissory notes, their corner-cutting may have resulted in an inability to prove it. Although it may be very successful for non-securitized loans, mediation does not address the broader problem for

[180] Peter Whoriskey, *GM Chief to Resign at White House's Bequest*, WASH. POST, Mar. 30, 2009, at A1.
[181] *Id.*
[182] Duane Marsteller, *State's top court orders foreclosure mediation program*, MCCLATCHY -TRIBUNE BUSINESS NEWS, Dec. 29, 2009.
[183] *Id.*
[184] *Id.*
[185] *Id.*

securitized loans: the lack of a mechanism to economically assign promissory notes during the process of securitization.

B. Legal Solutions to Make Securitization More Economical

In discussing reforms to the secondary mortgage market, it is important to identify the interests and goals of the parties involved. Judicial decisions and public policy are often balancing acts among different interests, and reforming the secondary mortgage market is no different. Homeowners have an interest in knowing who owns their promise to pay their mortgage, and homeowners should have the peace of mind that the courts will not allow banks to take their homes without due process of law. Mortgage lenders and investment banks have an interest in knowing how the law expects them to conduct business, and they also have an economic interest in earning a profit. The government has an interest in preventing fraud and supervising the interstate marketplace; and the government, along with the citizens, has an interest in preserving public records. The underlying policy question, therefore, is: How should the government balance these diverse, and sometimes competing, interests?

Some may wonder, however, why the secondary mortgage market should continue to operate. After all, the attention paid to the market since 2007 has been almost entirely negative. Despite the negative attention, the secondary mortgage market offers many benefits to society. The secondary market helps make capital available to a wider array of first-time homebuyers.[186] The secondary market also globalizes the real estate industry, which offers investors around the world more choices and broadens the pool of capital available to would-be homebuyers with poor or no credit.[187] Furthermore, the secondary market benefits institutional investors, such as pension funds, by offering them a variety of investment products with varying rates of risk and

[186] Korngold, *supra* note 55, at 732.
[187] *Id.*

return, and helps spread the risk of default among different parties.[188] The secondary market in turn benefits mutual fund investors and people expecting pensions at retirement, and the market provides profit opportunities at several points in the securitization process. And all parties benefit from lower transaction costs.[189]

The next step is to establish the goals that reforming the secondary mortgage market are intended to accomplish. These goals may be inferred from the diversity of interests listed above. First, to ensure and facilitate transparency in lending associated with securitization and in securitization itself. Second, to decrease transaction costs for all parties involved. Third, to preserve public and historical records. Accomplishing these three goals will ensure and facilitate smoother operation of the secondary mortgage market.

One obstacle to accomplishing these goals is that the system of recording mortgages and promissory notes in America is extremely antiquated. This reality results in increased transaction costs and creates an economic incentive for businesses such as Deutsche Bank and MERS to probe the legal gray area surrounding current mortgage law. Since technology will only continue to advance, legislators must work to keep pace by adjusting the laws accordingly.

Since they have encountered slightly different legal problems, investment banks acting as trustees and MERS require slightly different solutions. This paper discusses the trustees first. The Supreme Court, over a century ago, declared that "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."[190] Thus, it is almost bizarre that

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[188] Chris Markus, Ron Taylor, and Blake Vogt, *From Main Street to Wall Street: Mortgage Loan Securitization and New Challenges Facing Foreclosure Plaintiffs in Kentucky*, 36 N. KY. L. REV. 395 (2009) (quoting Ben Bernanke, Chairman of the Federal Reserve, on the benefits of spreading risk in capital markets).
[189] *Id.*
[190] *Carpenter v. Longan*, 83 U.S. 271, 274 (1872).

investment banks have focused on assigning mortgages and have lost track of the promissory notes. If they want to be able to foreclose, trustees should ensure the notes are in order.

Congress and the state legislatures can help by making the assignment of the notes more economical. The massive scale of securitization has made preparing and recording individual assignments impractical—not to mention extremely expensive.[191] Legislators have two options for making assignments more economical: recognize pooling-and-servicing agreements, or create a similar legal tool to economize assignments on a massive scale. Part I discussed how trustees often create pooling-and-servicing agreements (PSA's) in lieu of preparing individual assignments for every mortgage in the pool.[192] Recognizing PSA's as legally-sufficient substitutes for assignments would help keep transaction costs at a minimum and slow or stop failed foreclosures.

Legislators may be resistant, however, to simply approving of the PSA because it can be seen as essentially rewarding corporations for operating outside the law. Furthermore, rubber-stamping the PSA does not solve the problem of locating the promissory notes in legal outer space. The alternative is to simplify the securitization process by creating a similar legal tool, called a "mass pooling agreement," or MPA for short. The MPA would allow for the mass pooling of promissory notes into investment pools and would be designed, with input from those in the industry, to adapt to changing technology and market demands. Following the Supreme Court's principle that the mortgage follows the note,[193] the trustee would not need to prepare an assignment or pooling agreement for the mortgages, but should be required to keep them on file in the interest of preserving land ownership records. Assignments and failed foreclosures are major expenses in the securitization process, and since the costs of doing business are inevitably

[191] Markus, *supra* note 188, at 399.
[192] *See supra* Part I.D.
[193] *Carpenter v. Longan*, 83 U.S. 271, 274 (1872)..

passed on the consumer, the MPA would benefit investors in addition to the investment banks and trustees.

The MPA would also be designed to reduce the contractual rigidity associated with the PSA and, in turn, reduce the rate of foreclosures. PSA's often prohibit the servicer of the loan from renegotiating or restructuring a loan in default.[194] Such prohibitions are often included in PSA's because, in theory, a borrower is more likely to make payments consistently on a loan that cannot be modified.[195] On the other hand, modification may yield a greater real cash flow over time than the proceeds from a foreclosure. Thus, the MPA should include a provision that would allow for modification of the loan in cases in which modification is likely to yield a greater cash flow than a foreclosure sale.

As for MERS, it should never be allowed to foreclose by the courts. As long as the trustee holds the legal title to the mortgage and the investor has the beneficial interest, MERS can never have standing to foreclose. When it comes time to foreclose, the trustee must be involved. As with the trustees, MERS should begin having the notes and mortgages assigned to it, not just the mortgages. MERS should be required, however, to maintain a record of what entity holds the legal title to the mortgages and notes it records (probably a trustee), and should be required to disclose the name of the title-holding entity and the servicer (the party to whom monthly payments are to be made) to the mortgagor.

These reforms are a solid first step. Since they rely on reform by private companies and the government, however, the possibility always exists that trustees and MERS will be unwilling to reform their business practices. The next step would be for Congress to grant the Securities

[194] Gelpern, *supra* note 57, at 1089.
[195] *Id.* at 1087.

and Exchange Commission (SEC) the authority to oversee and regulate the secondary mortgage market. Alternatively, the courts could continue stopping them at the gate.

Securitization as currently practiced may be fundamentally flawed, but the secondary mortgage market can function without friction. The recommended reforms on the part of the companies involved and the government would increase transparency in the market, reduce transaction costs, and help preserve real estate ownership records. Accomplishing these goals would serve the diverse interests of business and society.

CONCLUSION

As is the case with so many financial innovations, the secondary mortgage market has created serious problems that the courts, and society, must address. Securitization led to a proliferation of subprime lending, which resulted in millions of foreclosures after the housing bubble burst. Many financial institutions, however, were foreclosing without being able to prove they held the legal title to the mortgage, which was the result of sloppy paperwork. Going one step further, MERS began foreclosing on properties despite having no legal claim to the title.

These are serious problems that the courts have been addressing over the last three years. At some point, however, policymakers will need to intervene. Our antiquated mortgage laws were designed before the secondary mortgage market was created, and giving them a proper legal framework under which to operate requires more reform than the courts can offer. By reforming our antiquated mortgage laws, Congress and the states can adapt to the demands of free enterprise. Failure to act, however, could result in the dissolution of the secondary mortgage market and the collapse of even more financial institutions in the future. It is therefore in the best interests of industry and society reconstruct the operation of the secondary mortgage market in a way that benefits all parties involved.

Legislators have two feasible options when dealing with trustees. First, they can approve the pooling-and-servicing agreement as a legally-sufficient substitute for preparing individual assignments. Second, they can create a new legal tool specifically for the purpose of assigning promissory notes in securitized mortgages. Called a mass pooling agreement, this tool would focus on assigning the notes, not the mortgages, and would be an economical legal equivalent to individual assignments. MERS, however, should never be allowed by the courts to foreclose on homes unless it begins to act as a trustee and becomes the sole party holding the legal title to both the promissory notes and the mortgages to the homes on which it is foreclosing. Instead, the trustee should initiate the foreclosure action, and should adhere to the suggested reforms for trustees.

The recommended reforms are designed to increase transparency in the secondary mortgage market, reduce transaction costs, and help preserve real estate ownership records. Moderate, measured, and sensible, these reforms are neither an overreaction nor an inadequate solution to the subprime mortgage meltdown. Failure to act is not an option, as it would likely result in an increase in failed foreclosures. After Judge Boyko stopped the foreclosure-happy investment banks at the gate, the time has come to reopen the gate and allow the secondary mortgage market to operate in a legal environment that meets the demands of industry in the twenty-first century.

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Education

Pennsylvania State University – top 2% with honors (May 2010)
- Bachelor of Science in Finance
- Bachelor of Arts in History
- Bachelor of Arts in Political Science
- Minor in Chinese Language

Chinese University of Hong Kong – Study Abroad (summer 2008)
- Coursework: International Finance; History of China and the West
- Travel: Macau; Guangzhou, China

Research

Presidential Fellowship, the Center for the Study of the Presidency and Congress (2010)
- Thesis title: "Citizens United, Campaign Finance, and the Constitution: How the President and Congress should Regulate Foreign Expenditures on Domestic Elections"

Honors Thesis in Business Law
- Thesis title: "Reconciling the Conflict between Mortgage Law and Technology in the Twenty-first Century"

Activities

Penn State Mock Trial Association (2006-2010)
- Team Captain
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- Mock Trial Academy Coordinator

State College Youth Ice Hockey Association – Assistant Coach (2007-2009)
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West Halls Resident Association – Treasurer (2006-2007)

Experience

The Hershey Company – Category Development Intern (May - Dec. 2009)
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Awards

Thomas R. and Joan G. Dye Scholarship for Excellence in Political Science (2010)
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