

The End of Mortgage Securitization? Electronic Registration as a Threat to Bankruptcy Remoteness*

John Patrick Hunt[†], Richard Stanton[‡] and Nancy Wallace[§]

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Abstract

A central tenet of asset securitization in the United States—that assets are bankruptcy remote from their sponsors—may be threatened by innovations in the transfer of mortgage loans from the loan-origiators (sponsors) to the legal entities that own the mortgage pools (the Special Purpose Vehicles (SPVs)). The major legal argument advanced in the paper is that because the mortgage is an interest in *real property*, the bankruptcy-remoteness rules applicable to real property, including §544(a)(3) of the Bankruptcy Code, create a risk to the bankruptcy remoteness of mortgage transactions unless proper recording occurs. We review the traditional mortgage transfer process and discuss why the real-property characteristics of mortgages makes them special. We next discuss how the chain of title transfer using traditional recorded assignment at the local jurisdiction helps to assure that the promissory note and the mortgage that are transferred into the SPVs are, indeed, bankruptcy remote from the loan originators and sponsors. We then discuss why the more recently introduced Mortgage Electronic Registration System (MERS) method of transfer introduces significant vulnerability into the mortgage transfer process and leads to a significant risk that bankruptcy remoteness will fail. Our arguments address scholarly and case-law theories of the legal foundations of achieving bankruptcy remoteness for mortgage transfers, the eligibility requirements for “true-sale” accounting treatment of transferred mortgages under Financial Accounting Standards (FAS 140), and the finance literature that addresses the economics of securitization through bankruptcy remoteness. We conclude with a first step toward policy prescriptions concerning possible promissory note and mortgage transfer processes that could achieve bankruptcy remoteness and the associated economic efficiency objectives of mortgage securitization.

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[†]U.C. Davis School of Law, U.C. Davis, jphunt@ucdavis.edu.

[‡]Haas School of Business, U.C. Berkeley, stanton@haas.berkeley.edu.

[§]Haas School of Business, U.C. Berkeley, wallace@haas.berkeley.edu.

Contents

1	Introduction	2
2	The Importance of “Bankruptcy Remoteness”	3
2.1	Defining “Bankruptcy Remoteness”	3
2.2	Bankruptcy Remoteness is a Defining Premise of Securitization	6
3	MERS’ Role in Private-label Mortgage Securitization	11
3.1	The “Two-Step” Private-label Mortgage Securitization Process	11
3.2	MERS in the Private-Label Securitization Process	14
4	Mortgage Securitizations Probably Are Subject to State Recording Statutes, and MERS Registration Does Not Comply with These Statutes	17
4.1	The Role of Recording Systems in Tracking and Protecting Property Interests	17
4.2	Most States Require Owners to Record Mortgage Assignments to Protect Their Interests . .	19
4.3	MERS Does Not Record Mortgage Assignments	21
4.4	The Common-Law Principle That “The Mortgage Follows the Note” Does Not Supersede State Recording Statutes	22
4.5	Revised Article 9 of the U.C.C. Probably Does Not Supersede State Recording Statutes . . .	24
4.5.1	Revised Article 9 Apparently Conflicts with the Recording Statutes	24
4.5.2	Analysis of the Apparent Conflict Between Article 9 and State Recording Statutes . .	28
4.6	Publicly Filed Documents Suggest That Many Transactions Were Not Structured to Take Advantage of Revised Article 9	31
5	The Use of MERS Instead of Recorded Assignments Threatens Bankruptcy Remoteness	35
5.1	If MERS, Inc. Can Convey Mortgages Recorded in its Name to a Bona Fide Purchaser, Then Bankruptcy Remoteness Fails	35
5.1.1	Section 544(a)(3) and Mortgages	39
5.1.2	Section 541(d) and Section 544(a)(3)	40
5.2	There is a Significant Risk That MERS, Inc. can Convey the Mortgages Recorded in its Name to a Bona Fide Purchaser	40
5.2.1	MERS, Inc. Holds Legal Title, so the Default is That it Can Convey the Mortgages Recorded in its Name	40
5.2.2	MERS, Inc.’s Lack of Interest in the Note Does Not Eliminate the Risk to Bankruptcy Remoteness	41
5.2.3	MERS, Inc.’s Status as a ‘Nominee’ Does Not Eliminate the Risk to Bankruptcy Remoteness	46
5.2.4	There is a Substantial Risk That MERS, Inc. Would be Found Able to Convey Good Title to Mortgages	49
5.3	The Risk of MERS, Inc. Bankruptcy is Not “Remote”	54
6	Conclusions	56
A	State Recording Statutes	58
B	GSAMP 2006-HE3 and Article 9	70

1 Introduction

The asset-backed securities (ABS) market in the United States is enormous,¹ and its operational practices have been deeply implicated in the continuing financial crisis.² Residential mortgage-backed securities (RMBS) are by far the largest category of securitized assets.³

In an asset securitization, the assets are transferred to a so-called “Special Purpose Vehicle” (SPV), a separate organization, usually a trust, which in turn issues securities backed by the assets. A central tenet of asset securitization in the U.S. is the bankruptcy-remoteness of the SPV. Most of the existing literature treats all ABS as being the same, focusing primarily on non-mortgage assets. However, not only do RMBS represent the vast majority of all ABS, but in addition they differ significantly from other ABS because a mortgage is an interest in real property. In particular, the bankruptcy-remoteness rules applicable to real property, including Bankruptcy Code §544(a)(3), create a risk to the bankruptcy remoteness of mortgage transactions unless proper recording occurs.

This paper focuses on the law and economics of private-label residential-mortgage securitization,⁴ and shows that recent innovations in the securitization chain of legal title for the underlying promissory notes and mortgages pose a significant threat to bankruptcy remoteness. We first review the traditional mortgage transfer process and discuss why the real-property characteristics of mortgages make them special. We then discuss why the traditional chain of title transfer using recorded assignment at the local jurisdiction helps assure that the promissory note and the mortgage that are transferred into the SPVs are, indeed, bankruptcy remote from the loan originators/sponsors. We then discuss why the more recently introduced Mortgage Electronic Registration System (MERS) method of transfer (which is used for the vast majority of private-label MBS) introduces significant vulnerabil-

¹The outstanding stock of ABS was \$9.734 trillion at the end of the second quarter of 2011. See Securities Industry and Financial Markets Association (SIFMA), <http://www.sifma.org/research/statistics.aspx>.

²See, e.g., Viral Acharya and Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REVIEW 195 (2010), and Atif Mian and Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis*, 124 Q.J. ECON. 127 (2009).

³By the second quarter of 2011, RMBS made up more than 73% of the stock of U.S. asset-backed securities. *Id.* The SIFMA statistics for the second quarter of 2011 indicate that the major securitized non-mortgage assets were: car loans (1.18%), credit cards (2.18%), student loans (2.42%), other (8.21%), and equipment (.13%) See <http://www.sifma.org/research/statistics.aspx>.

⁴The private-label securitization channel includes single-family residential mortgage loans that do not meet the conventional conforming-loan limits, or credit quality requirements, of the former Government Sponsored Entities (GSEs), Freddie Mac and Fannie Mae. In general, these loans are jumbo loans originated in high-cost housing markets such as the coastal states of California, Texas, Florida, and New York, and “subprime” loans originated with alternative ARM contracting structures, lower FICO limits, and/or no documentation. The outstanding stock private-label RMBS was \$1.55 trillion at the end of the second quarter of 2011. See <http://www.sifma.org/research/statistics.aspx>.

ity into the mortgage transfer process and leads to likely failure of bankruptcy remoteness. Our arguments integrate scholarly and case law theories of the legal foundations of achieving bankruptcy remoteness for mortgage transfers, the eligibility requirements for “true-sale” accounting treatment of transferred mortgages under Financial Accounting Standards (FAS 140), and the small finance literature that addresses the economics of securitization through bankruptcy remoteness. We conclude with a first step toward policy prescriptions concerning possible promissory note and mortgage transfer processes that could achieve bankruptcy-remoteness and the associated economic efficiency objectives of mortgage securitization.

This paper makes two main contributions. First, it shows that the use of MERS poses a significant threat to the bankruptcy remoteness of residential mortgage securitizations. Ours is the only paper we are aware of that addresses the risks to bankruptcy remoteness created by MERS, and is one of only a very small number of papers to address how mortgages present different bankruptcy-remoteness issues from other financial assets. Second, our review of publicly filed documents from a sample of subprime-mortgage securitizations suggests that many note transfers in these transactions may not have been structured as sales of promissory notes under Article 9 of the Uniform Commercial Code. This is important because structuring a transfer as a note sale may be important in achieving bankruptcy remoteness.

The paper is organized as follows. Section 2 discusses the importance of bankruptcy remoteness in asset-backed securitization. Section 3 discusses the two-step private-label mortgage securitization supply chain and the use of Mortgage Electronic Registration System (MERS) for recording. Section 4 considers whether state recording statutes apply to securitized mortgages, and discusses why MERS registration does not comply with these statutes. Section 5 explains how the use of MERS instead of recorded assignments threatens bankruptcy remoteness. Section 6 proposes possible policy responses and concludes.

2 The Importance of “Bankruptcy Remoteness”

2.1 Defining “Bankruptcy Remoteness”

The term “bankruptcy remoteness” captures a central feature of securitization: the isolation of securitized assets from all other entities⁵ so that investors in the securitization look only to the securitized assets for returns. Using the term “bankruptcy remoteness” instead of simply “isolation” or “separation” of assets emphasizes the fact that problems with isolation

⁵ See JASON H.P. KRAVITT ET AL., SECURITIZATION OF FINANCIAL ASSETS §5.01 (2d ed. 2010) at 5-9 to 5-11 (describing bankruptcy concerns in securitization in terms of risk that creditors of the seller of securitized assets could reach the assets in the event of the seller’s bankruptcy).

and separation typically arise in the context of bankruptcy. “Bankruptcy remoteness” can fail in the absence of any bankruptcy. For example, if assets are never transferred in the first place, they are never isolated and bankruptcy remoteness has failed.

However, bankruptcy proceedings are an especially important threat to asset isolation because bankruptcy law gives bankruptcy trustees and courts special powers to take control of property that the debtor has transferred away and bring it back into the bankruptcy estate for distribution according to bankruptcy-law principles.

Legal analysis of “bankruptcy remoteness” thus typically focuses on whether three conditions are satisfied. Satisfaction of each condition closes off one pathway by which assets could be brought into the estate so that they are no longer isolated:

1. **The transaction is a “true sale” of assets.** A transaction is a “true sale” if all of the debtor’s property rights passed to the purchaser at the consummation of the sale, leaving nothing in the debtor that, should bankruptcy later occur, could be labeled as “property of the estate.”⁶

The bankruptcy trustee’s “strong-arm” powers may expand the bankruptcy estate beyond what one would think of as the debtor’s property under non-bankruptcy state law. This kind of strong-arm power can be thought of as defeating “true sale.” The use of MERS creates a risk that the strong-arm power could be used to reach securitized mortgages.

2. **The transaction is not a fraudulent conveyance.** Transfers of property away from an insolvent debtor are scrutinized. For example, a debtor that senses impending insolvency may transfer assets for inadequate consideration to friendly parties, harming creditors. The law of fraudulent conveyance addresses this issue by giving creditors, or the bankruptcy trustee as their representative, the power to “avoid” (reverse) transfers of property that either were done with actual intent to hinder or defraud creditors or closely resemble the sorts of transfers that would be done with intent to hinder or defraud creditors. If a securitization transaction is found to be a fraudulent conveyance, the assets will be brought back into the bankruptcy estate. Commentators seem to agree that there is little risk that most securitization transfers will be invalidated on fraudulent-conveyance grounds under the objective test, because most securitizations involve the exchange of reasonably equivalent values.⁷ As discussed below,⁸ this particular assumption may not hold for the sponsor-depositor transfer in many existing

⁶Schwarcz et al., *supra* note , at 70.

⁷Schwarcz, *supra* note , at 84; Kettering, *Securitization*, *supra* note , at 1588.

⁸See discussion *infra* Part .

securitization transactions because many transfers may have been for nominal consideration.

3. **The transaction vehicle will not be “substantively consolidated” with any other entity in bankruptcy.** Bankruptcy courts claim the authority to “look through” corporate separation and treat the securitization vehicle as part of the overall estate of the debtor. If this occurs, the court may treat the assets of the vehicle as assets of the debtor. The outer limits of the substantive consolidation doctrine are not clear, as the court’s power apparently rests on general equitable principles and not on a specific statutory grant of power.⁹ Substantive consolidation can be seen as a bankruptcy version of corporate veil-piercing. A major purpose of the corporate veil-piercing doctrine is to combat the use of corporate formalities to accomplish fraud, especially through the use of undercapitalized entities.

The accounting term for bankruptcy remoteness is “legal isolation,” and it captures a very similar concept to the legal definition of bankruptcy remoteness. Securitizations are structured to be accounted for as sales.¹⁰ The accounting authorities have required that the securitizing party “surrender control” over the assets in order for the transaction to qualify for sale accounting.¹¹ “Surrender of control” in turn has required “legal isolation” of the assets, and “legal isolation” has required that the assets be “put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy.”¹² The accounting authorities’ requirements of “surrender of control” and “legal isolation” thus reflect the interpretation and application of the legal concept of bankruptcy remoteness.¹³

⁹See Kettering, *supra* note , at 1625 (“The doctrine is in the nature of an equitable override of the ordinary axiom that each entity’s assets and liabilities stand on their own.”).

¹⁰One advantage of sale accounting is that it ensures that the securitized mortgages do not remain as assets on the balance sheet of the sponsor or depositor.

¹¹ See Financial Accounting Standards Board [hereinafter FASB], Statement of Financial Accounting Standards No. 140 [hereinafter FAS 140] §9 (2000). The Financial Accounting Standards Board has adopted a new codification of accounting standards (the “Accounting Standards Codification” or “A.S.C.”) that apparently became effective on September 15, 2009. See FASB, A.S.C. 105-10-05-1. A.S.C. 861-10-40 covers the concepts of legal isolation and bankruptcy remoteness in the context of securitization.

¹²See FAS 140, *supra* note 11, at §9; see also FASB, A.S.C. 860-10-40-5 (repeating that placement of assets “presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership” is a requirement for sale treatment).

¹³For institutions subject to FDIC receivership instead of bankruptcy, the accounting treatment of bankruptcy remoteness feeds back into the legal treatment. In 2000, the Federal Deposit Insurance Corporation (FDIC) adopted a rule, *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation*, 65 Fed. Reg. 49, 191 (Aug. 11, 2000), *codified at* 12 C.F.R. §360.6. The rule provided that the FDIC “shall not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. §1821(e), reclaim, recover, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution that meet all conditions for sale accounting treatment under generally accepted accounting principles, other than the ‘legal isolation’ condition. . .”

Financial economists incorporate an assumption of bankruptcy remoteness when they model securitized assets without considering the credit risk of other entities with a relation to the assets, such as the originator.

2.2 Bankruptcy Remoteness is a Defining Premise of Securitization

Despite its significance, the institutional details of mortgage securitization have received remarkably little theoretical attention from scholars in either the legal or financial literatures. Commentators who have tried to explain and evaluate securitization have treated bankruptcy remoteness as a central, defining feature of securitization. Many commentators argue that achieving bankruptcy remoteness is the primary motive for securitization. Others present different explanations for securitization, but those explanations depend on bankruptcy remoteness. Under all accounts, failure of bankruptcy remoteness undermines the purpose of securitization.

Although there is a large financial literature on debt contracting, starting with the costly state verification papers of Robert Townsend¹⁴ and Douglas Gale and Martin Hellwig,¹⁵ there is only a very limited literature focusing on the differences between various debt-like contracts, and in particular their different treatments during bankruptcy. For example, although Peter DeMarzo¹⁶ shows that value can be created by forming ABS-like structures, with the pooling and tranching of cash flows from an underlying set of assets, he does not explain why it is necessary to put these assets into a bankruptcy-remote SPV, rather than merely creating a set of secured loans.

Scholars who have tried to explain securitization often point to bankruptcy remoteness as the primary motive. Kenneth Ayotte and Stav Gaon¹⁷ focus explicitly on what makes securitization different from (and sometimes preferable to) secured lending. The key difference is that in a securitization, provided the assets have been transferred via a “true sale”

12 C.F.R. §360.6(b) (2000). Instead of the accounting authorities’ definition of ‘legal isolation,’ the FDIC required securitizations to meet its own ‘legal isolation’ requirement: the securitizing insured depository institution must “receive adequate consideration for the transfer” and the documentation effecting the transfer must “reflect[] the intent of the parties to treat the transaction as a sale, and not a secured borrowing, for accounting purposes.” *Id.* §360.6(c) (2000). Except for a 2009 provision protecting existing securitizations from changes in accounting rules that may have tightened the requirements for sale accounting, *see* 74 Fed. Reg. 59,068 (Nov. 17, 2009), the FDIC’s 2000 rule remains in effect. *See* 12 C.F.R §360.6 (2011).

¹⁴Robert M. Townsend, *Optimal Contracts and Competitive Markets with Costly State Verification*, 21 J. ECON. THEORY 265 (1979).

¹⁵Douglas Gale & Martin Hellwig, *Incentive-Compatible Debt Contracts: The One-Period Problem*, 52 REV. ECON. STUD. 647 (1985)

¹⁶Peter DeMarzo, *The Pooling and Tranching of Securities: A Model of Informed Intermediaries*, 18 REV. FIN. STUDS. 1 (2005).

¹⁷Kenneth Ayotte & Stav Gaon, *Asset-Backed Securities: Cost and Benefits of “Bankruptcy Remoteness,”* 24 REV. FIN. STUDS. 1299 (2011)

to the SPV, the assets cannot become part of the originating firm's estate in the event of a bankruptcy. Instead, even with the bankruptcy of the originating firm, the securitized assets of the SPV can continue to the benefit of the SPV investors. Ayotte and Gaon also give an account of how securitization can add value. In the event of bankruptcy, firms can raise additional Debtor-in-Possession (DIP) financing, which is senior to all junior creditors and partially senior to existing secured creditors. This can lead to over-investment and excess continuation. Ayotte and Gaon¹⁸ argue that securitizing reduces these inefficiencies because it makes raising additional Debtor-in-Possession (DIP) financing less attractive.

Gary Gorton and Nicholas Souleles¹⁹ also argue that SPVs exist in large part to reduce bankruptcy costs. In their modeling framework, originators provide "implicit support" for their SPVs and investors rely on these relational contracts even though the sponsors cannot legally be bound to this support and keep the tax shields associated with bankruptcy remoteness. They argue that asset securitization is an important risk reduction tool for originators, because SPVs have lower bankruptcy costs due to their relative transparency, the strict restrictions on asset substitutions between the equity and debt holders of SPVS, and the impossibility of bankruptcy if they are properly structured. As a result, assets that are held by SPVs are valued differently by investors (usually their valuations are higher).

Under both of these accounts, the disadvantages of bankruptcy for a secured lender explain why securitization happens, and avoiding direct costs of or inefficient outcomes in bankruptcy are the reasons that securitization is good. Much of the legal literature is quite similar. Bankruptcy remoteness has been called "the distinctive feature" of securitization,²⁰ and legal scholars have argued that "securitization has a lower cost precisely due to bankruptcy remoteness."²¹ It is said that securitization is useful because it allows the buyers of securitized assets to avoid the "bankruptcy tax" to which they would be subject if they had instead become secured lenders to the seller, lending cash and taking a security interest in the assets in return.²²

The term "bankruptcy tax" refers to the obstacles the Bankruptcy Code puts in the way

¹⁸See Ayotte & Gaon, *supra* note .

¹⁹Gary Gorton & Nicholas Souleles, *Special Purpose Vehicles and Securitization*, in THE RISKS OF FINANCIAL INSTITUTIONS 549 (M. Carey & R. M. Stulz eds. 2006). See also Gary B. Gorton and Andrew Metrick, *Securitization*, Working paper, Yale University (2011).

²⁰Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1556 (2008)

²¹Steven Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1573-74 (2004); Thomas E. Plank, *Sense & Sensibility in Securitization*, 30 CARDOZO L. REV. 617, 619 (2008) (securitization lowers financing costs "because it avoids the costs that the Bankruptcy Code imposes—unwisely, in my view—on secured creditors"); Kettering, *Securitization and Its Discontents*, *supra* note , at 1561 ("The prototypical securitization structure has no purpose, and no significant effect, other than to circumvent the . . . 'Bankruptcy Tax' that the Bankruptcy Code can be thought of as imposing on secured lenders. . .")

²²See, e.g., Plank, *Sense and Sensibility*, *supra* note , at 622.

of realizing the value of security in the event of bankruptcy, and includes the automatic stay,²³ which prevents secured lenders from seizing assets immediately and delays collection, the debtor’s right to use the cash collections on collateral as long as the court deems the secured lender “adequately protected,”²⁴ the possibility that the debtor can use the collateral to secure post-petition financing with priority over the pre-petition security interest as long as the secured lender’s interest is “adequately protected,”²⁵ the debtor’s right to possess the collateral during the proceeding,²⁶ and the possibility that the terms of the secured debt may be restructured over the secured creditor’s objection.²⁷ Thomas Plank identifies additional elements: (1) immediate acceleration of the secured debt, which becomes payable at par, regardless of market value;²⁸ and (2) non-accrual of interest for undersecured claims.²⁹

Plank, one of the few legal scholars to focus on mortgage securitization specifically, contends that the “bankruptcy tax” has especially obvious consequences in the long-term single family mortgage market, arguing that “entities eligible to be debtors under the Bankruptcy Code. . . cannot feasibly engage in the long-term financing of mortgage loans.”³⁰

Not all accounts of securitization focus on bankruptcy remoteness. Although bankruptcy remoteness is not the reason for securitization in these explanations, it is still a defining feature. The explanations these scholars proffer make sense only if assets are isolated.

Probably the most popular alternative explanation is the argument that securitization cures the “lemons problem” that arises when an informed party sells to an uninformed party.³¹ Edward L. Glaeser and Hedi H. Kallal explain the pooling of mortgages into mortgage-backed securities (MBS) in this way. Pooling increases the cost of becoming in-

²³11 U.S.C. §362(a). These elements of the “bankruptcy tax” are set out in Kettering, *supra* note , at 1566-68.

²⁴11 U.S.C. §§363(c)(2), 363(e).

²⁵11 U.S.C. §364(d).

²⁶11 U.S.C. §542.

²⁷11 U.S.C. §§1123(a), 1123(b), 1129(b)(2).

²⁸11 U.S.C. §502(b) (cited in Plank, *Sense & Sensibility*, *supra* note , at 622 n.21)

²⁹United Sav. Ass’n of Texas v. Timbers of Inwood Forest, 484 U.S. 365, 382 (1988)(cited in Plank, *Sense & Sensibility*, *supra* note , at 622 n.23).

³⁰Plank, *Sense & Sensibility*, *supra* note , at 619.

³¹The term “lemons problem” comes from the market for used cars discussed in George Akerlof’s seminal article on asymmetric information. See George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 89 QUARTERLY J. OF ECON. 488 (1970). Such a market might include cars of a range of quality from high to low (the latter being “lemons”). A buyer who is willing to pay a price corresponding to the average quality of used cars in the market will not induce the owner of a high-quality used car to sell as the price will not be high enough. The higher quality owners may withdraw their cars from the market, leaving only lower-quality cars. This reduces average quality and the price the buyer is willing to pay. The lower price drives still more sellers out of the market, further reducing price and leading to the market unwinding. If market participants anticipate this dynamic, the market may never get started. The term “lemons problem” can be used more generally to refer to any situation where one party to a transaction has more information than another and the other party knows this.

formed about the pool's aggregate payoffs, thereby inducing the intermediary to remain uninformed and avoiding a lemons problem when the intermediary tries to sell.³² In the legal literature, both Claire Hill,³³ and Edward Iacobucci and Ralph Winter,³⁴ argue that the primary purpose of securitization is to reduce the lemons cost of external finance by isolating claims on transparent assets where valuation is less subject to asymmetric information.

Although this explanation does not rely on bankruptcy costs as the reason for securitization, it does rely on separating specified assets into pools and analyzing the characteristics of those pools.

Other explanations for securitization include the signaling benefits of securitization³⁵ and incentives associated with regulatory-capital objectives.³⁶ Hayne Leland³⁷ argues that by separating (low-risk) assets from the (higher risk) other assets of the firm, and capitalizing the two separately, an SPV is able to lever up more than would be possible if the two assets were held by a single firm, realizing greater tax benefits. Peter Tufano's recent comment on the bankruptcy-based explanation offered by Gorton and Souleles draws on all of these themes.³⁸

Given the importance of bankruptcy remoteness to securitization, it is no surprise that normative arguments about securitization often revolve around attitudes toward avoiding the bankruptcy tax. For example, if securitization's only benefit is that it allows secured lenders to impose the "bankruptcy tax" on secured lending imposed by the Bankruptcy Code, it is no surprise that legal scholars have divided over its usefulness. Approving of securitization in this context seems to require the determination that (a) a "bankruptcy tax" on secured lending is undesirable, and (b) it is so undesirable that parties should be able to contract around bankruptcy.³⁹ But each proposition is the subject of an unresolved

³²Edward L. Glaeser & Hedi H. Kallal, *Thin Markets, Asymmetric Information, and Mortgage-Backed Securities*, 6 J. OF FIN. INTERMEDIATION 64 (1997) Similar arguments about the benefits of pooling in other contexts such as auctions of financial securities (See Ulf Axelson, *Pooling, Splitting, and Security Design in the Auctioning of Financial Assets*, Ph.D. Thesis, Carnegie Mellon University).

³³See Claire Hill, *Securitization: A Low Cost Sweetener for Lemons*, 74 WASH. U.L.Q. 1061 (1996).

³⁴See Edward Iacobucci & Ralph Winter, *Asset Securitization and Asymmetric Information*, 34 J. LEGAL STUDS. 161 (2005).

³⁵See Stuart Greenbaum & Anjan Thakor, *Bank Funding Modes: Securitization versus Deposits*, 11 J. BANKING & FIN. 379 (1987)

³⁶See George Pennacchi, *Loan Sales and the Cost of Bank Capital*, 43 J. OF FIN. 375 (1988)

³⁷Hayne Leland, *Financial Synergies and the Optimal Scope of the Firm: Implications for Mergers, Spinoffs, and Structured Finance*, 92 J. FIN. 765 (2007)

³⁸Peter Tufano, *Comment on "Special Purpose Vehicles and Securitization, by Gary B. Gorton & Nicholas S. Souleles*, in THE RISKS OF FINANCIAL INSTITUTIONS 597 (M. Carey & R. M. Stulz eds. 2006) Tufano suggests that bankruptcy costs may be secondary. Instead he focuses on several other advantages of SPVs, including "more attractive accounting treatment, to be more tax efficient, to avoid regulations (such as capital requirements), to tap new pools of capital through changing the risk characteristics of an asset, or to form more transparent funding vehicles and in turn reduce deadweight costs due to information asymmetries."

³⁹See Kettering, *supra* note , at 1717 ("Analysis of the efficiency of securitization. . . involves the same par-

debate: legal scholars are divided about both whether the “bankruptcy tax” should be higher⁴⁰ and whether parties ought to be able to contract around bankruptcy.⁴¹

Apart from competing explanations for securitization and debates over whether it is good or bad, there is also a robust debate in the legal literature over the likely effectiveness of securitization structures in achieving bankruptcy remoteness.⁴² The financial crisis has intensified the debate, with some commenters calling for bankruptcy courts to exercise their equitable powers to set aside securitization transactions for the benefit of creditors of bankrupt transferors of securitized assets, including home-mortgage borrowers.⁴³

A particularly interesting feature of this debate is that there has not yet been a clear distinction drawn between the requirements for achieving bankruptcy remoteness in securitizing assets such as credit cards or equipment securitization and the requirements for achieving bankruptcy remoteness for real-property assets such as mortgages. We show that mortgages are subject to special recording requirements and, as real property interests, are subject to special rules in bankruptcy. The combination of these characteristics makes public recording uniquely important for mortgage securitization.

ties and interests that are involved in analyzing the efficiency of secured credit, but with smaller stakes. . . .”)

⁴⁰See articles collected in Kettering, *supra* note , at 1717 nn. 541-42; see also Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 859 (1996) (arguing that “the efficiency case for full priority [for secured claims in bankruptcy] is at best problematic” because preferential treatment of secured creditors induces inefficient behavior by debtors and lenders and suggesting possible ways to reduce the preference afforded secured debt).

⁴¹See Kettering, *supra* note , at 1577 nn. 59-60.

⁴²Articles arguing that securitization structures were not likely to survive challenge in bankruptcy include David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055 (1998); Lois R. Lupica, *Asset Securitization: The Unsecured Creditor’s Perspective*, 76 TEX. L. REV. 595, 636-50 (1998); Kenneth N. Klee & Brent C. Butler, *Asset-Backed Securitization, Special Purpose Vehicles and Other Securitization Issues*, 35 U.C.C. L.J. 23 (2002); Kettering, *supra* note , at 1585 (“Fraudulent transfer law can be applied, consistent with established usages, to avoid the asset transfer from Originator to SPE that is the core of the prototypical securitization transaction, in order to vindicate the bankruptcy policy that the securitization structure is designed to circumvent.”). Kettering also argues that “a bankruptcy court so inclined could readily defeat the prototypical securitization structure by ordering the substantive consolidation of the Originator and the SPE.” *Id.* at 1562.

⁴³See Ryan E. Scharar, *The Limits of Securitization: Why Bankruptcy Courts Should Substantively Consolidate Predatory Sub-Prime Mortgage Originators and Their Special Purpose Entities* MICH. ST. UNIV. L. REV. 913, 937-38 (1998) (arguing that bankruptcy courts should substantively consolidate sub-prime lenders and affiliated SPEs where the entities share “enough of an ‘identity of interest,’ the lender “engage[s] in the origination of illegal predatory loans,” and “investors in the SPEs know or should have known that they were engaging in the origination and securitization of illegal loans”). See Kettering, *supra* note , at n.28 for criticisms in a similar vein.

3 MERS' Role in Private-label Mortgage Securitization

3.1 The “Two-Step” Private-label Mortgage Securitization Process

As shown in Figure 1, the private-label mortgage securitization supply chain begins with a borrower who takes out a mortgage loan on a residential property through a lender, or originator. The “mortgage” is actually two contracts. The first is the promissory note, which establishes the borrower’s legal obligation to repay the loan principal and interest, stipulates the periodic payment structure, defines the contractual rules for exercising the prepayment option, and identifies the conditions that would trigger default and foreclosure. States do not require that the promissory note be recorded for it to be enforceable.

The second contract, the mortgage, or deed of trust,⁴⁴ grants a lien or other security interest in the borrower’s real property to the lender (or the trustee, for the lender’s benefit) to secure the contractual obligations of the promissory note. State law governs the relationship between the mortgage and note. Our principal concerns are with how recording protects mortgage owners from subsequently arising claims of ownership, and with how failure to record exposes mortgage owners to such risks.

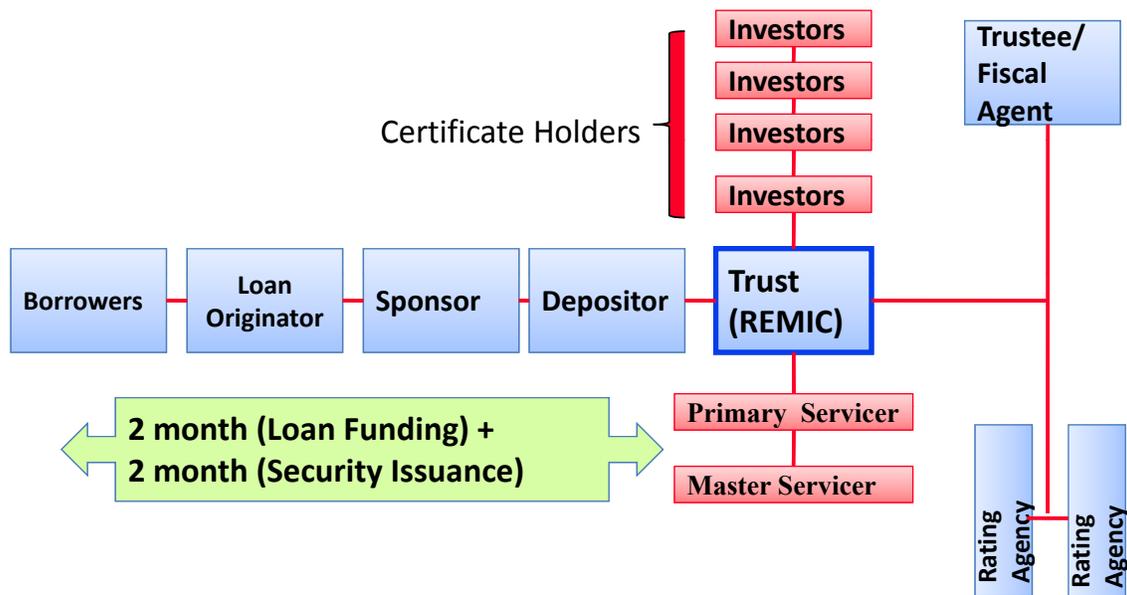
In the next stage in the securitization supply chain, the originators sell the contracts, the promissory note and the mortgage, to an aggregator, or sponsor, as shown in Figure 1.⁴⁵ The sponsor is a special purpose stand-alone entity that has no assets or liabilities of its own, but is often affiliated with a large financial institution or investment bank. The sponsor structures the securitization by devising the bond payout structure and the subordination of the bonds under the advice of two rating agencies and the underwriter who will sell the bonds.⁴⁶

⁴⁴Differences between mortgages and deeds of trust generally are said to be slight. *See, e.g.*, RESTATEMENT OF PROPERTY (THIRD): MORTGAGES, §1.1 cmt. (“The principles of this Restatement apply irrespective of the precise form of the mortgage. It may, for example, be styled a deed of trust or deed to secure debt.”). The preference for deeds of trust over mortgages in California, for instance, apparently comes from now-eroded advantages that deeds of trust once offered the lender. *See* 1 ROGER BERNHARDT, CALIFORNIA MORTGAGES, DEEDS OF TRUST, AND FORECLOSURE LITIGATION (2011) §1.35, at 30-31. Bernhardt explains that in California, deeds of trust were not until 1933 subject to the same debtor-protection rules as mortgages and became popular. Although the California Supreme Court’s decision in *Bank of Italy Nat’l Trust v. Bentley*, 20 P.2d 940 (1933), “deprived the deed of trust of almost all of its previous advantages over the mortgage,” deeds of trust remained more popular in California because “the many years of judicial analysis of the deed of trust as a security interest were invaluable to an industry interested in certainties.” We discuss any important differences in the context in which they arise and otherwise use the term “mortgage” to cover both types of security instrument.

⁴⁵The originator and the sponsor could also be the the same entity. In this case, the first transfer would be from sponsor to depositor.

⁴⁶In the typical private label structuring there would be eighteen to twenty bond classes rated from AAA to below investment grade. There would also be one or more residual classes that make up the equity position in the trust and bears all of the tax liability and it is held by the depositor.

Figure 1: Mortgage Supply Chain for the REMIC Special Purpose Vehicle (SPV)



In the third stage in the supply chain, the sponsor initiates the securitization by transferring the loans to a depositor along with warranties and representations concerning the quality of the loans. The depositor is an entity that is designed to be independent from the sponsor and to have no liabilities or risk of bankruptcy.⁴⁷

In the final stage of the chain, the depositor transfers the mortgages to a special purpose vehicle (“SPV”), typically a trust.⁴⁸ The depositor has ongoing responsibilities in conjunction with the trustee to appoint a successor servicer and/or to appoint a successor trustee.

As an example of the two-step process, we consider at various points in the paper a 2006 subprime mortgage transaction, the GSAMP 2006-HE3 transaction. This transaction involved several Goldman Sachs entities and several loan sellers. The sponsor for GSAMP 2006-HE3 was Goldman Sachs Mortgage Company (GSMC), a New York limited partnership in which the general partner is Goldman Sachs Real Estate Funding Corporation and the limited partner is the Goldman Sachs Group (NYSE: GS). As the sponsor, GSMC aggregated mortgages from six originators: Aames Capital Corporation, Fremont Investment & Loan, Impac Funding Corporation, and Meritage Mortgage Corporation, SouthStar Funding, LLC and MILA, Inc. a Delaware Corporation. The originators sold their loans to GSMC.⁴⁹ As

⁴⁷ERNST & YOUNG, FINANCIAL REPORTING DEVELOPMENTS: TRANSFERS AND SERVICING OF FINANCIAL ASSETS, ACCOUNTING STANDARDS CODIFICATION 860 70 (2010).

⁴⁸The SPV is usually organized as a Real Estate Mortgage Investment Conduit (REMIC) trust. The REMIC designation is defined in the Internal Revenue Code. *See* 26 U.S.C. §§860A–860G.

⁴⁹GSAMP 2006-HE3 filed purchase and sale documents relating to four originators. These agree-

sponsor, GSMC transferred the loans forward to the depositor Goldman Sachs Mortgage Securities Corp., which is a wholly owned subsidiary of GSMC that is incorporated in Delaware.

In the transactions we have reviewed, the depositor is invariably a corporate affiliate of the sponsor. Why do mortgage securitizations involve this apparently superfluous transfer between two members of the same corporate family? Put differently, why is the transfer from sponsor to SPV a two-step rather than a one-step process? The answer appears to lie in accounting rules dealing with bankruptcy remoteness.

As discussed, securitizations are structured to be accounted for as sales, and that in turn requires “legal isolation,” or bankruptcy remoteness, of the assets. Prior to January 1, 2002, the sponsor would have sold the loans directly into the SPV following a one-step procedure.⁵⁰ However, accounting firms reported that this process created doubts about “legal isolation” when the sponsor, in addition to receiving cash proceeds from selling the loans, also retained an interest in the “reserve fund” or credit enhancements of the SPV.⁵¹ Such retained interests create continued involvement between the sponsor and the SPV. And, as accounting firms reported, this involvement made it “difficult to obtain reasonable assurance that the transferred financial assets were legally isolated from the sponsor,”⁵² or the avoidance of a judgment that the transfer was “a secured borrowing.”⁵³

Starting January 1, 2002, the accounting authorities affirmed that using a two-step process, with an additional sale from sponsor to depositor, presumptively created “legal isolation.”⁵⁴ Even if the transfer from depositor to SPV did not create legal isolation because of the depositor’s retained interest, the sponsor had no continuing interest and the depositor

ments, and the abbreviation used for each in this paper, are: Aames Capital Corporation (“Aames”), Fremont Investment & Loan (“Fremont”), Impac Funding Corporation (“Impac”), and Meritage Mortgage Corporation (“Meritage”). Impac is a successor in interest to Novell Financial Services Corp., whose name appears on some Impac agreements. *See* GSAMP 2006-HE3 Pooling & Servicing Agreement §1.01, “Impac Assignment Agreement.” Interestingly, the prospectus refers to additional sellers that do not appear to be mentioned in the filed agreements: SouthStar Funding, LLC and MILA, Inc. GSAMP 2006-HE3, Prospectus Supplement dated Sept. 7, 2006, at S-7. According to the prospectus, these two sellers accounted for approximately 45% of the mortgages sold into the securitization. *Id.* at S-38. and LaSalle National Bank as securitization trustee.

⁵⁰If there was only one originator, it would likely have been the sponsor and would have sold the loans directly into the SPV.

⁵¹Deloitte & Touche, *Learning the Norwalk Two Step*, HEADS UP, April 25, 2001, at 4. Our survey of securitization agreements suggests that it is quite common for the sponsor to retain interests in the mortgages through its ownership of certain classes of certificates.

⁵²ERNST & YOUNG, *supra* note 47, at 68.

⁵³Deloitte & Touche, *supra* note 51, at 4; Marty Rosenblatt, Jim Johnson & Jim Mountain, *Securitization Accounting: The Ins and Outs (And Some Do’s and Don’ts) of FASB 140, FIN 46R, IAS 39 and More* (2005).

⁵⁴*See* FAS 140, *supra* note 11, and FASB, Technical Bulletin No. 01-1 (2008).

was structured to render bankruptcy extremely unlikely.⁵⁵ Current accounting rules reflect a judgment that the two-step transfer process generally achieves legal isolation of transferred promissory notes and the mortgages from the sponsor.⁵⁶

3.2 MERS in the Private-Label Securitization Process

As discussed, what in ordinary language is called a “mortgage” is actually two contracts: the promissory note and the mortgage. The mortgage is intended to enable the lender (“mortgagee”) to enforce the note by selling the mortgaged property, following applicable state law governing foreclosure. Although there is considerable variability in state real property law, all state statutes we have examined use recording rules to determine priority of the mortgage relative to other possible claims to the property.⁵⁷

As explained below, for any of the mortgage originator, the sponsor, the depositor, or the SPV trust to have clear first priority among competing claims to own the mortgage, it must have been the first to record the mortgage. Even if an unrecorded mortgage is enforceable against the borrower, it is exposed to the risk that it would lose priority to a junior lien that was created later but recorded promptly. And even if the mortgage itself is recorded, failure to record an assignment along the chain exposes the non-recording assignee to the risk of losing priority to a subsequent assignee who does record. For these reasons, the recipients of mortgage transfers anywhere in the mortgage transfer supply chain should have a strong incentive to record their mortgages as quickly as possible.

Generally speaking, mortgage recording is carried out at the county recorder’s office or equivalent⁵⁸ in the county where the collateral is located. The recorder’s offices maintain records on who owns each tax parcel in the county and records the existence of liens on these properties in the form of mortgages and trust deeds, among others. County recorders typically are elected officials and recorder’s offices usually charge a fee for each document that is recorded. For the two-step private-label mortgage securitization process, as discussed above, the mortgage and the promissory note must be sold at least twice to achieve legal isolation. Under the mortgage recording system, shown in Figure 2, each subsequent owner of the mortgage in the mortgage transfer supply chain would need to re-record its ownership of the mortgage at the appropriate recording office for the property. Since the two-step

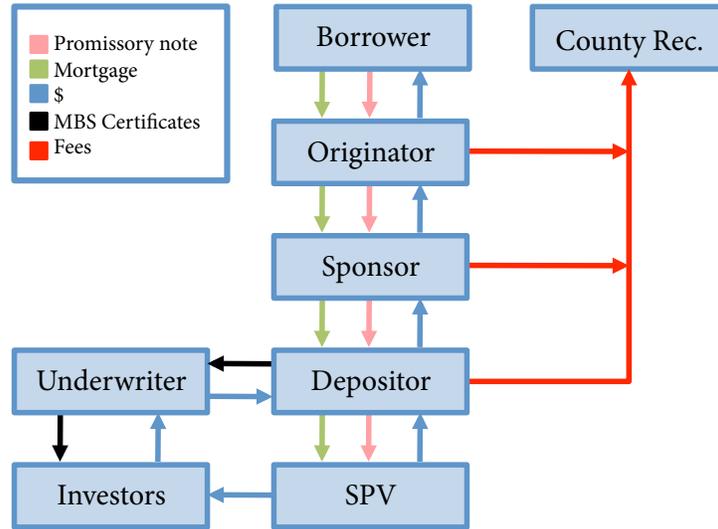
⁵⁵ See *id.*

⁵⁶ See FASB, A.S.C. 860-10-55-22 (“two-step securitizations, taken as a whole, generally would be judged under present US law as having isolated the financial assets beyond the reach of the transferor, its consolidated affiliates (that are not bankruptcy remote entities) included in the financial statements presents, and its creditors, even in bankruptcy or other receivership.”).

⁵⁷ See discussion in Appendix A.

⁵⁸ Local recording offices have various designations, such as “county clerk-recorder” (Alameda and Yolo Counties, California), “county recorder” (Dade County, Florida), or “city register” (New York County).

Figure 2: Mortgage and Promissory Note Transfer With Traditional Recording



process shown in Figure 1 usually was completed within four months after the loans were originated, the rapid growth of private-label securitization put significant pressure on the processing capacity of recorder’s offices.⁵⁹

In 1995, in what apparently was at least in part a response to the recording backlogs in recorder’s offices,⁶⁰ twenty-eight mortgage industry companies and organizations including: the Mortgage Bankers Association; Fannie Mae; Freddie Mac; First American Title Insurance Corporation, and large commercial lenders such as Wells Fargo Bank, Bank of America, Citimortgage, Chase, and Washington Mutual became shareholders of a closely held private corporation, called MERSCORP, Inc.⁶¹ In 1998, a subsidiary of MERSCORP, Inc., called Mortgage Electronic Registration Systems, Inc. (“MERS, Inc.”) was incorporated in Delaware.⁶²

⁵⁹See Christopher Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, U. CIN. L. REV. 78 (2010); Adam J. Levitin, *Written Testimony Before the House Financial Services Committee, Subcommittee on Housing and Community Opportunity*, (Nov. 18, 2010).

⁶⁰Phyllis K. Slessinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 IDAHO L. REV. 805, 808 (1995) (“The establishment of MERS will greatly simplify a terribly cumbersome, paper-intensive, error-prone, and therefore costly process for transferring and tracking mortgage rights.”). This law review article is important for understanding MERS’ genesis because the authors were the Senior Director, Secondary Market & Investor Relations, and the Director of Technology Initiatives at the Mortgage Banker’s Association of America while MERS was planned and they appear to have been involved in its creation. *Id.* at 805.

⁶¹<http://www.mersinc.org>

⁶²See Certificate of Incorporation of Mortgage Electronic Registration Systems, Inc. State of Delaware Secretary of State, Division of Corporations, Filed 03:01 pm 12/30/1998, 981509524-2990193. For brevity, we refer to this entity as “MERS, Inc.” throughout the paper.

assignment, but up until that time the mortgage remains recorded in the name of MERS, Inc. as nominee. The fact that intermediate assignments are not recorded is a key point: MERS apparently was intended as a substitute for such recording.⁶⁶

4 Mortgage Securitizations Probably Are Subject to State Recording Statutes, and MERS Registration Does Not Comply with These Statutes

4.1 The Role of Recording Systems in Tracking and Protecting Property Interests

Transfers of different types of property rights are subject to different formalities. For example, the transfer of possession of a dollar bill is sufficient to transfer the right to spend that particular dollar bill. The law of negotiable instruments—a category that includes the bank notes from which dollar bills are descended, personal checks, and probably most mortgage promissory notes—likewise permits the transfer of the right to enforce the instrument by transfer of possession. There are no official public records of dollar-bill or personal-check ownership.

Other property rights, including most property interests in real estate, as well as most security interests in personal property, are subject to recording rules. Failure to record one's ownership of such an interest can result in loss of the interest to another claimant.

A “security interest” can be understood as a right to sell property to satisfy a debt if the debtor defaults. One bankruptcy authority sums up the essence of security interests and the associated recording rules as follows:

[A] creditor seeks assurance that if the debtor cannot pay the loan back, the creditor can seize property of the debtor. The fundamental legal problems are priority and notice: When two creditors have security interests in the property, usually the creditor who filed notice first wins. The property to be secured could be realty or not. Realty interests are generally governed by state realty mortgage statutes. They set up a local realty filing system, with mortgage priority accorded the first filer in the realty records. Non-realty interests (in machinery, inventory, raw materials, patents, etc.) are governed by Article 9 of the Uniform Commercial Code.⁶⁷

⁶⁶See Slessinger & McLaughlin, *supra* note 60, at 812 (“Once MERS is established as the mortgagee of record, all subsequent transfers of ownership would be recorded electronically, eliminating the need to physically prepare, deliver, record, and track mortgage assignment documents.”).

⁶⁷MARK J. ROE, BANKRUPTCY AND CORPORATE REORGANIZATION: LEGAL AND FINANCIAL

The distinction between the interest of a lender with a security interest in property and that of a buyer of the property is not always clear, but the typical residential mortgage is typically understood as a security interest. Security interests in real property are denominated “mortgages”⁶⁸ (or “deeds of trust”). Security interests in personal property are simply called “security interests.”⁶⁹

The law of security interests in both real and personal property recognizes a distinction between the enforceability of the security interest against the borrower,⁷⁰ (the U.C.C. calls this “attachment”),⁷¹ and the protection of that security interest against competing claimants with interests in the property (the U.C.C. calls this “perfection”).⁷²

Recording generally is not required for attachment of a security interest⁷³ but perfection often requires some kind of public recording of the interest to give notice of its existence and ownership to the world.⁷⁴ Potential buyers of the property or lenders against the property can check the public record and rely on the results of their search. If the record discloses a prior interest, the potential buyer or lender can know that he or she will be junior to the existing interest. If the record does not disclose a prior interest, the buyer can proceed on the assumption that no such interest exists.

As an idealized example of a recording system, consider a situation where a homeowner borrows money from Bank A and signs a contract giving Bank A a mortgage on the home. Bank A fails to record the mortgage. Loosely, one might say that Bank A’s security interest has “attached” but is not “perfected.”⁷⁵ Later, the borrower seeks a mortgage from Bank

MATERIALS 199 (2d ed. 2007).

⁶⁸RESTATEMENT OF PROPERTY (THIRD): MORTGAGES §1.1 (1997) (“A mortgage is a conveyance or retention of an interest in real property as security for performance of an obligation.”).

⁶⁹U.C.C. §1-201(35) (“Security interest’ means an interest in personal property or fixtures which secures payment or performance of an obligation.”).

⁷⁰U.C.C. §9-109(a).

⁷¹U.C.C. §9-203(a).

⁷²A security interest in personal property is superior to some subsequent claims even if not perfected, but is superior to almost all subsequent claims, including the claims of a representative of creditors in insolvency, if it is perfected. *See* U.C.C. §9-308 cmt. 2; *see also* STEVE H. NICKLES & DAVID G. EPSTEIN, DEBTOR-CREDITOR: CREDITOR REMEDIES AND DEBTOR RIGHTS UNDER STATE AND NON-BANKRUPTCY FEDERAL LAW 1085 (2009).

⁷³Under U.C.C. Article 9, which governs the creation of security interests in personal property, U.C.C. §9-109(a), a security interest generally attaches when value has been given (that is, credit extended), *id.* §9-203(b)91), the debtor has rights in the collateral, *id.* §9-203(b)(1), a security agreement has been reached, *id.* §9-102(a)(73), and the security agreement is evidenced by possession or control of the collateral by the debtor or a signed writing that describes the collateral and contains language creating or providing for an interest in or claim to the property. *Id.* §9-203(b)(3)(A)

⁷⁴U.C.C. §§9-310(a), 9-502(a) (security interest typically perfected upon filing with state Secretary of State of a financing statement specifying names of debtor and creditor and the collateral covered by the statement. However, as explained below, *see* discussion *infra* Part 4.5.1, revisions to the U.C.C. that took effect in 2001 may create exceptions to the filing requirement that provide for perfection of certain security interests *without* any recording anywhere.).

⁷⁵The terminology of “attachment” and “perfection” comes from personal property, but the idea of record-

B, which does not know about the prior mortgage. Bank B checks the property records, sees no mortgage, and lends the money, takes a mortgage in return, and records the mortgage. The result could be that both Bank A and Bank B have the right to sell the house if the borrower defaults, but that Bank A's interest is junior to Bank B's (that is, Bank A gets only whatever is left over after Bank B is paid). In this example, Bank A lost priority by failing to record its interest.

Now consider a situation where Bank A did record its interest. Bank A purports to sell the mortgage to Bank B, which pays but does not record its interest, and later purports to sell the mortgage to Bank C, which does not know of the A-B transaction, and which also pays Bank A and does record its interest. It is possible that Bank C would own the mortgage and Bank B would have nothing but a claim against Bank A. The result depends on the state's recording statute and on the interaction of the statute with the Uniform Commercial Code, matters taken up later in this paper.

Recording systems thus are devices for giving notice to the world of particular property interests, including security interests. Properly functioning recording systems enable parties to enter into transactions with confidence, and also serve a public function by creating transparent records of property ownership. Owners have an incentive to create these public benefits because they must use the recording system to protect their property interests against competing claimants.⁷⁶

4.2 Most States Require Owners to Record Mortgage Assignments to Protect Their Interests

All fifty states have real property recording statutes.⁷⁷ Generally speaking, the effect of these statutes is that when Party A acquires an interest in real estate but does not record it, and Party B subsequently pays for an interest in the same real estate, Party B may prevail over Party A in some circumstances. In other words, recording matters for real estate.

The situations in which the second buyer prevails over the first depends on the state's recording statute. Recording statutes are conventionally divided into three categories: "pure race," "race-notice," and "pure notice."⁷⁸ In a "pure race" state, an unrecorded purchase

ing a property interest to protect it from competing claimants applies to both types of property.

⁷⁶See Peterson, *supra* note 59, at 1394.

⁷⁷See 14 RICHARD R. POWELL ET AL., POWELL ON REAL PROPERTY, §82.02[1][b] (2011), at 82-16 to 82-17 (providing citations).

⁷⁸14 POWELL ET AL., *supra* note 77, §82.02[1][b], at 82-15 (setting out the three categories and acknowledging that "[c]onfusion often arises when trying to categorize a particular piece of legislation as one of the three (or four) types of recording acts," largely because of "imprecise and inconsistent terminology used by many legislatures in their enactments").

is vulnerable to any subsequent purchase where the second purchaser records first—perhaps even if the second purchaser knows of the first purchaser’s interest.⁷⁹ In a “race-notice” state, an unrecorded purchase is vulnerable to a second purchaser where the second purchaser records first and lacks notice of the first purchase.⁸⁰ In a “pure notice” state, an unrecorded purchase is vulnerable to the second purchaser if the second purchaser has no notice of the first purchase, regardless of whether the second purchaser records.⁸¹

The real estate recording statutes generally cover not just transfers of possessory interests, but also the origination and assignment of mortgages. A mortgage is conventionally described as a conveyance of an interest in real estate,⁸² and most states,⁸³ including nine of the top ten⁸⁴ private-label mortgage securitization states,⁸⁵ treat mortgage assignments as conveyances of interests in real estate that are subject to the recording laws. So unrecorded mortgage assignments are potentially vulnerable to subsequent claims in certain situations.

In a typical MERS transaction, at least up until foreclosure the only public record of the mortgage states that MERS, Inc. is the legal owner of the mortgage on behalf of the originator and its successors up until foreclosure.⁸⁶ There is no explicit public record of the several subsequent mortgage assignments that take place in a securitization. For example, there is no record of any assignment to the securitization trustee, at least for mortgages that are not in foreclosure. Thus, it seems that the securitization trustee’s interest in the mortgage is potentially vulnerable to other entities that actually take subsequent assignments of the

⁷⁹14 POWELL ET AL., *supra* note 77, §82.02[1][b], at 82-15. Pure race statutes are rare, *id.* §82.02[1][c], at 82-19 n.7, although they do govern mortgage priority in some states, such as Arkansas, *see* ARK. STAT. ANN. §18-40-102.

⁸⁰14 POWELL ET AL. §82.02[1][b], at 82-15.

⁸¹14 POWELL ET AL. §82.02[1][b], at 82-15. Recording provides notice and thus protects prior claimants under such a statute. Some authorities recognize a fourth type of statute, the “period of grace” statute, under which the second purchaser will not prevail if the first purchaser records the interest within a specified grace period. *See id.* (noting that such statutes “are not very common today and are generally limited to mechanics’ lien statutes”).

⁸²*See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §1.1 (“A mortgage is a conveyance or retention of an interest in real property as security for performance of an obligation.”). The grant or transfer of a mortgage is a conveyance of an interest in real property regardless of whether the state adheres to the majority “lien theory” or the minority “title theory” of mortgages. *Id.* cmt. (“In many jurisdictions today it is customary to employ a form that gives the mortgagee a lien or security interest. This, too, is ‘an interest in real property’ as that phrase is used in this section.”).

⁸³*See* 4 POWELL ET AL., *supra* note 77, §37.27, at 37-177 to 37-178 (2010) (“Because mortgages involve an interest in land, the usual formalities for transferring property interests must be met. . . . As with other transactions involving real estate, it is always important to record the document creating the real estate interest—in this case, the assignment.”).

⁸⁴We define our “top ten” as the ten states with the largest number of mortgages securitized in private-label transactions.

⁸⁵*See* discussion *infra* Part 4.2.

⁸⁶*See* discussion *supra* Part 3.2.

mortgage from the originator or MERS, Inc.,⁸⁷ and is also potentially vulnerable to entities that might *constructively* take such assignments, such as the bankruptcy trustee for MERS, Inc.⁸⁸

The state recording statutes for each of the top ten private-label securitization states are discussed in detail in Appendix A. Our review suggests that the real property recording statute covers mortgage assignments in nine of the ten states (all but Georgia),⁸⁹ and that mortgages are considered real property interests in nine of the ten states (all but Florida).

4.3 MERS Does Not Record Mortgage Assignments

When mortgage assignments must be recorded in order to protect the assignee's interest, it might be argued that tracking the mortgage transfers within the MERS database satisfies this requirement. MERS standard form mortgage documents⁹⁰ provide that MERS, Inc. holds legal title to the rights granted in the mortgage as "nominee" for the originator.⁹¹ It could be argued on this basis that the internal recording of transfers within the MERS database "counts": The public records point the user to MERS, and the current owner can be determined by contacting MERS. Thus, it might be argued that MERS records mortgage assignments.

Such an argument is likely to fail. First, under the text of statutes that require recording it seems difficult to call an internal database entry a recorded assignment.⁹² Second, it is highly doubtful that MERS in fact has maintained or does maintain a comprehensive database of assignments.⁹³ Third, permitting private, internal assignments to satisfy the recording statutes would completely undermine the statutes.

Most importantly, MERS, Inc. itself asserts that its internal transfer records are not recorded assignments⁹⁴ and apparently has not argued in litigation that changing the MERS

⁸⁷ See discussion *infra* Part 5.2.

⁸⁸ See discussion *infra* Part 5.1.

⁸⁹ Although the recording provisions of Florida and Maryland appear to cover mortgage assignments in the first instance, other provisions of those states' laws that affirm the primacy of U.C.C. Article 9 may change this conclusion.

⁹⁰ Our review of the MERS case law suggests that there are small variations among MERS' form security instruments, such as references to MERS, Inc.'s authority to exercise any or all "rights" versus any or all "interests," and differences necessary to fit the form of a mortgage versus the form of a deed of trust. Our review has turned up no differences among MERS form documents relevant to any major issues we discuss. To the extent that small differences exist, they are addressed as they come up.

⁹¹ See discussion *supra* Part 3.2.

⁹² See recording statutes in Appendix A.

⁹³ See, e.g., Michael Powell & Gretchen Morgenson, *MERS? It May Have Swallowed Your Loan*, N.Y. TIMES, at BU1 (March 6, 2011) (reporting that Prof. Alan White attempted to match MERS records against those in the public domain and found that "fewer than 30 percent of the mortgages had an accurate record in MERS.")

⁹⁴ See MERSCORP, Inc. & MERS, Inc., Case Law Outline (March 2011), at 5 ("Recording versus

database effects a recorded assignment. Such an argument would be inconsistent with the company's current practice of requiring its members to take an assignment of mortgage from MERS, Inc. before foreclosing.⁹⁵ If MERS' internal transfer records constituted recorded assignments, there would be no reason for MERS to execute additional assignments before foreclosing.

4.4 The Common-Law Principle That “The Mortgage Follows the Note” Does Not Supersede State Recording Statutes

Where a state statute provides that a mortgage assignment must be recorded in order to preserve the assignee's priority against subsequent assignees, this requirement may be in conflict with the idea that “the mortgage follows the note.” If the assignee owns the note but has not recorded the mortgage, and “the mortgage follows the note,” then perhaps the assignee owns the mortgage too. In its original common-law form, “the mortgage follows the note” apparently spoke to the note holder or owner's ability to enforce the mortgage without a separate assignment of the note, not to competing claims to ownership of the mortgage. The 2000 revisions to Article 9 of the U.C.C. can be interpreted to have expanded the scope of the maxim “the mortgage follows the note” to cover competing ownership claims, but if Article 9 is interpreted this way, it is in conflict with state real property recording statutes.

“The mortgage follows the note” may be the most commonly repeated phrase in the MERS controversy. The idea is the cornerstone of the American Securitization Forum's White Paper on chain-of-title and MERS issues. It appears in common-law decisions,⁹⁶ is

Registration. The mortgage or deed of trust is RECORDED in the applicable county land records. The mortgage information is REGISTERED on the MERS(R) System. The mortgage, deed of trust or assignment to Mortgage Electronic Registration Systems, Inc. must be recorded in the land records in order to perfect the mortgage lien. Registering the mortgage loan information on the MERS(R) System is separate and apart from the function that the county recorders perform.”). No recording fee is paid and no change to public records is made when a mortgage transfer is recorded in MERS.

⁹⁵See MERSCORP, Inc. Rules of Membership, Rule 8, §1(a) (July 2011) (requiring note owner or note owner's servicer to cause MERS, Inc. to execute an assignment from MERS, Inc. to the owner or servicer before initiating foreclosure); *Id.* §1(d) (revoking member authority to foreclose in MERS' name). The requirement that the note owner take an assignment from MERS, Inc. rather than foreclosing in MERS, Inc.'s name is a change from practices in effect earlier this year. See MERS Announcement, Feb. 16, 2011 (“MERS is planning to shortly announce a proposed amendment to Membership Rule 8. The proposed amendment will require Members to not foreclose in MERS' name.”).

⁹⁶See AMERICAN SECURITIZATION FORUM, TRANSFER AND ASSIGNMENT OF RESIDENTIAL MORTGAGE LOANS IN THE SECONDARY MORTGAGE MARKET [hereinafter ASF WHITE PAPER] 16-21 (Nov. 16, 2010). See also 1 BERNHARDT, *supra* note , §1.25, at 23 (2011) (“If the creditor transfers the note but not the deed of trust, the transferee receives a secured note; the security follows the note, legally if not physically.”) (citing *Seidell v. Tuxedo Land Co.*, 216 Cal. 165 (1932); *Lewis v. Booth*, 3 Cal. 2d 345 (1935); *Kelley v. Upshaw*, 246 P.2d 23 (Cal. 1952); *Polhemus v. Trainer*, 30 Cal. 685 (1866)). Although the weight of authority appears to support the notion that the mortgage follows the note, not all courts agree. See, e.g., *U.S. Bank, N.A. v. Ibanez*, 941 N.E.2d 40, 53-54 (2011). *Ibanez* apparently holds that a party must show that it holds both the

recognized in the *Restatement (Third) of Property: Mortgages*,⁹⁷ and is said to have been codified in the 2000 amendments to Article 9 of the Uniform Commercial Code.⁹⁸

The phrase “the mortgage follows the note” is susceptible to many interpretations.⁹⁹ Its original meaning seems to have been that “the transferee of a note secured by a mortgage gains the right to *enforce the mortgage against the mortgagor*.” This, for example, is what the Supreme Court held in *Carpenter v. Longan*¹⁰⁰ which is often the earliest case cited as embracing the principle. This meaning of “the mortgage follows the note” is relevant to most recent litigation involving MERS, where a defaulting borrower/homeowner resists enforcement of the mortgage,¹⁰¹ and this meaning is what the American Securitization Forum¹⁰² and the U.C.C. Permanent Editorial Board seek to establish.¹⁰³

By contrast, “the mortgage follows the note” apparently did *not* mean that the note transferee acquired a property interest superior to *competing claims* of subsequent purchasers

mortgage and the note separately in order to foreclose. *Id.* at 55. The court did not consider—and, based on the bank’s briefs, the bank apparently did not raise—an argument that Article 9 codifies the “mortgage follows the note” rule. A recent survey of how courts have treated assignment issues in crisis-era mortgage litigation is *Victoria v. Corder, Homeowners and Bondholders as Unlikely Allies: Allocating the Costs of Securitization in Foreclosure*, 30 NO. 5 BANKING & FIN. SERVS. POL’Y REP. 19 (May 2011).

⁹⁷RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §5.4(a) (“A transfer of an obligation secured by a mortgage also transfers the mortgage unless the parties to the transfer agree otherwise.”)

⁹⁸PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, DRAFT REPORT: UCC RULES APPLICABLE TO THE ASSIGNMENT OF MORTGAGE NOTES AND TO THE OWNERSHIP AND ENFORCEMENT OF THOSE NOTES AND THE MORTGAGE SECURING THEM 8 (March 29, 2011) (“[W]hile this matter has engendered some confusion, the law is clear, and the sale of a mortgage note not accompanied by a separate conveyance of the mortgage securing the note does not result in a separation of the mortgage from the note.”).

⁹⁹For example, “the mortgage follows the note” could mean that when a transferee becomes a noteholder, the transferee is able to enforce the mortgage without a separate assignment. It could mean that when a transferee becomes the equitable owner of the note, it acquires an equitable right to direct the mortgagee to assign the mortgage. It could mean that when a transferee acquires ownership of a note, it acquires a superior claim to ownership of the mortgage to any subsequent transferee. It could mean that a purported transfer of the mortgage without the note leaves mortgage and note in the hands of the purported transferor, or that such a purported transfer leaves the transferor with an unsecured note and the transferee with an unenforceable mortgage.

¹⁰⁰83 U.S. 271 (1872).

¹⁰¹*See, e.g., In re Agard*, 444 B.R. 231 (Bankr. E.D.N.Y. 2011) (rejecting principle that “the mortgage follows the note” when MERS is used; the “very foundation of [MERS, Inc.’s] business model . . . requires that the Note and Mortgage travel on divergent paths”); *CitiMortgage, Inc. v. Bischoff*, No. 255-4-09, Rutland Super. Ct. Vt. Oct. 28, 2009, at 3 (where mortgage was originally recorded with MERS, noteholder could not enforce mortgage without evidence that MERS, Inc. had assigned the mortgage to noteholder to “reunite the obligation and mortgage deed that secures it”).

¹⁰²The ASF White Paper cites a number of cases that it describes as “affirm[ing] and appl[y]ing the ‘mortgage follows the note’ rule” where the mortgage assignment was not recorded. ASF WHITE PAPER, *supra* note 96, at 21-22. The White Paper does not assert that the cited cases involved competing claimants, as opposed to disputes between the mortgagor and the mortgagee’s assignees.

¹⁰³PERMANENT EDITORIAL BOARD, *supra* note 98, at 3 (listing questions addressed and omitting rights of competing claimants to mortgage); *id.* at 6-8 (discussing transfer of ownership rights in promissory notes and mortgages without discussing competing ownership claims or real property recording statutes).

for value regardless of recording statutes.¹⁰⁴ It appears that “the mortgage follows the note” historically did not speak to competing claims of ownership of the mortgage. Such competing claims are the subject of this paper. For example, what if the originator itself, through fraud or mistake, purports to transfer the mortgage (and note) again to New Buyer X after the securitization, and New Buyer X records the assignment? What if MERS, Inc. purports to transfer the mortgage in this way? What if the originator or MERS, Inc. goes bankrupt, investing the bankruptcy trustee with the rights of New Buyer X? Even if the securitization trustee prevails over the borrower because “the mortgage follows the note,” it does not follow that the securitization trustee necessarily prevails over a competing claimant that records its interest first—or over the bankruptcy trustee, who stands in the shoes of such a claimant.

4.5 Revised Article 9 of the U.C.C. Probably Does Not Supersede State Recording Statutes

Although the common-law principle that “the mortgage follows the note” discussed above apparently does not cover situations where there are competing claims to the mortgage and certainly would not trump the real property recording statutes, recent revisions of Article 9 of the U.C.C.¹⁰⁵ may purport to do both. Revised Article 9 of the U.C.C. may be read to provide that a mortgage note buyer who does not record an interest in the mortgage automatically has an interest superior to subsequent buyers who do record, no matter what real property recording statutes say. We call this interpretation the “Article 9 argument” and analyze it in this section.

4.5.1 Revised Article 9 Apparently Conflicts with the Recording Statutes

The Article 9 argument follows a rather convoluted path through the U.C.C.’s provisions,¹⁰⁶ as follows.

Since 2001, Article 9 has covered sales of promissory notes, accounts, and payment in-

¹⁰⁴In *Carpenter*, the United States Supreme Court held that a person who purchased the mortgage for value was entitled to enforce it against the borrower, despite the borrower’s tender of valuable goods to the assignor. No competing claims of ownership to the mortgage were presented. 83 U.S. at 274-75.

¹⁰⁵The Article 9 revisions in question are dated 2000 and went into effect in 2001.

¹⁰⁶When Article 9 was revised in the late 1990s, the drafters decided to use the term “security interest” to cover both security interests as classically understood and certain ownership interests, such as those in accounts and chattel paper. This change made the statute rather more difficult to follow, and also has been criticized on substantive grounds. See, e.g., Thomas E. Plank, *Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under the U.C.C. and the Effects of Violating a Fundamental Drafting Principle*, 26 CONN. L. REV. 397, 494 (1994) (“[B]ecause of the abnormal definitions, rules intended only for security transactions apply to the sales of accounts and chattel paper.”).

tangibles, not just classical security interests.¹⁰⁷ In other words, Article 9 covers most sales of rights to payment, at least according to some commenters.¹⁰⁸ When a promissory note is sold under Article 9, the buyer is the “secured party.”¹⁰⁹ Because of Article 9’s origins in secured transactions, the vocabulary for describing sales of rights to payment under Article 9 is a bit strange. the seller is the “debtor,”¹¹⁰ and the note is the “collateral.”¹¹¹ The buyer’s ownership interest in the promissory note is a “security interest.”¹¹²

Specifically, the Article 9 argument proceeds as follows:

1. A security interest is good against the parties to the transaction when it attaches, and good against the rest of the world when it is perfected.¹¹³
2. Selling a promissory note is granting a security interest in the promissory note.¹¹⁴
3. The buyer’s security interest in a purchased promissory note is perfected as soon as it attaches.¹¹⁵
4. In a sale of promissory notes, the buyer’s security interest in the notes attaches as soon as the buyer has given value and the notes are either specifically described in a signed security agreement or in the buyer’s possession.¹¹⁶
5. The buyer’s security interest in the *mortgage* attaches as soon as the interest in the *note* attaches¹¹⁷ and is perfected as soon as the interest in the promissory note is perfected.¹¹⁸
6. Although “the creation and transfer of an interest in or lien on real property” generally is excluded from Article 9, there is an express exception to this rule for the foregoing provisions.¹¹⁹

¹⁰⁷U.C.C. §9-109(a)(3).

¹⁰⁸See Steven L. Schwarcz, *The Impact on Securitization of Revised UCC Article 9*, 74 CHI.-KENT L. REV. 947, 949-50 (1999). The U.C.C. defines a “payment intangible” as “a general intangible under which the account debtor’s principal obligation is a monetary obligation.” U.C.C. §9-102(a)(61).

¹⁰⁹U.C.C. §9-102(72)(D).

¹¹⁰U.C.C. §9-102(28)(B).

¹¹¹U.C.C. §9-102(12)(B).

¹¹²U.C.C. §1-201(35).

¹¹³See U.C.C. §9-308 cmt. 2 (“This Article uses the term ‘attach’ to describe the point at which the property becomes subject to a security interest. . . . ‘Perfected’ means that the security interest has attached and the secured party has taken all the steps required by this Article. . . . [I]n general, after perfection the secured party is protected against creditors and transferees of the debtor and in particular, against any representative of creditors in insolvency proceedings instituted by or against the debtor.”).

¹¹⁴U.C.C. §9-109(a)(3) (Article 9 applies to sales of promissory notes); 9-102(a)(12)(B) (promissory notes that have been sold are “collateral”), (28)(B) (seller of promissory notes is a “debtor”), 72(D) (“person to whom promissory notes have been sold” is a “secured party”).

¹¹⁵U.C.C. §9-309(4).

¹¹⁶U.C.C. §9-203(a)-(c), discussed in greater depth *infra* Part

¹¹⁷U.C.C. §9-203(g).

¹¹⁸U.C.C. §9-308(e).

¹¹⁹U.C.C. §9-109(d) (“This article does not apply to . . . (11) the creation or transfer of an interest in or lien

The effect of these provisions taken together seems to be that the interest in the mortgage is *perfected* as soon as the interest in the note *attaches*, which happens once value is given and the note is physically transferred or described in a signed security agreement.

It is not crystal clear from the text of the Code that the note buyer's perfected security interest in the mortgage is an outright ownership interest. The code specifies that the ownership interest of the purchaser of a *note* is a type of security interest,¹²⁰ but has no analogous provision addressing the *mortgage*. But commentators have embraced the idea that the mortgage is transferred when the note is sold:

Article 9 makes it as plain as possible that the secured party need not record an assignment of mortgage, or anything else, in the real property records in order to perfect its rights to the mortgage.¹²¹

If the buyer's security interest in each of the note and the mortgage is perfected immediately upon attachment, without recording, then as far as the U.C.C. is concerned no recording anywhere is needed. Finally, notes can be sold in Article 9 transactions without being physically transferred. That means that notes and mortgages purchased outright could be bankruptly remote without any physical transfer or recording:

The end result is that a buyer of the promissory note may leave it in the possession of the seller and still have an interest immune from avoidance by the seller's trustee in bankruptcy under §544(a) of the Bankruptcy Code. The buyer's interest is secret. No notice of it is given by change of possession or by public filing of any kind. The buyer's priority is based solely on the privately authenticated record. So long as the sale to the buyer is evidenced by such a record, the buyer prevails over the trustee under Section 544(a). The result follows not only as to individual notes but also as to notes secured by real estate sold in bulk incident to securitization or secondary market transactions. The notes secured by mortgages may be left in the hands of the originating financial institutions as agents for collection and the outright purchaser will still have a valid interest in bankruptcy. The felt need to facilitate bulk sales of real estate notes overwhelms the historic fear of secret conveyances.¹²²

on real property...except to the extent that provision is made for: (A) liens on real property in Sections 9-203 and 9-308...").

¹²⁰U.C.C. §1-201(35)

¹²¹JULIAN B. McDONNELL & JAMES CHARLES SMITH, SECURED TRANSACTIONS UNDER THE U.C.C. §16.09 (2011), cited in ASF WHITE PAPER at 21.

¹²²McDONNELL & SMITH, *supra* note 121, §16.09.

Although the “Article 9 argument” is comforting to existing investors who may have purchased mortgages created using MERS, the argument goes a long way toward obviating MERS—or, indeed, any mortgage recording—in the future. MERS is a recording utility, so its usefulness seems limited if recording is not needed to protect the buyer’s interest.¹²³ Indeed, if using MERS separates mortgage and note, as some courts have held,¹²⁴ then doing so may be seen as opting out of the Article 9 mortgage-follows-the-note rule.¹²⁵ Using MERS may actually be less attractive than relying on Article 9.

Many commenters have remarked on Article 9’s relationship to mortgage transfers in the wake of the foreclosure crisis. Both defenders¹²⁶ and critics¹²⁷ of the securitization industry have agreed with the U.C.C. Permanent Editorial Board’s drafting team¹²⁸ that Article 9 codifies the principle that “the mortgage follows the note” for transactions that it covers. However, there appears to be a conflict between revised Article 9 and the real property recording statutes. In most states these statutes continue to provide that an unrecorded mortgage assignment is *void* against a subsequent bona fide purchaser of the land *or of an interest in the land, including a mortgage*, for value without notice of the prior claim to the mortgage. That seems to be in direct conflict with the Article 9 argument presented above.

Perhaps recognizing the conflict, practitioners seemed to have had doubts about whether Article 9 obviates statutory requirements to record mortgage assignments. Practitioner-written treatises counseled against relying exclusively on the Article 9 argument to obviate recording.¹²⁹

¹²³There are reasons to record other than priority. For example, some foreclosure procedures require a recorded chain of assignments, *see* MINN. STAT. §580.02(3) (foreclosure by advertisement in Minnesota requires complete chain of assignments); MICH. COMP. LAWS §600.3204(1)(d) (foreclosure by advertisement in Michigan requires complete chain of assignments), and legal notices may be sent to the owner of record. ASF WHITE PAPER, *supra* note 96, at 23-24.

¹²⁴*See* cases cited *supra* note 101.

¹²⁵Compare Levitin, *supra* note 59, at 23 (“The UCC is simply a set of default rules. Parties are free to contract around it, and need not do so explicitly.”)

¹²⁶*See* ASF WHITE PAPER 16-23.

¹²⁷*See* Adam J. Levitin, *Testimony Before the House Financial Services Committee* 22 (Nov. 18, 2010) (“the mortgage could ‘follow the note’ if it is an Article 9 transfer. There is consensus that this process would work if Article 9 governs the transfer of the note.”).

¹²⁸PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, *supra* note 98, at 8 (“UCC Section 9-203(g) explicitly provides that the mortgage automatically follows the note.”)

¹²⁹*See* KRAVITT, *supra* note 5, §15.04[A], at 16-157 (“[W]hether the transferee, as owner of the note acquires all rights of the mortgagee without having to record an assignment of the mortgage, is not entirely clear. In addition, there are reasons why recordation of the mortgage may be wise in order for the transferee to obtain the greatest possible rights in the mortgage and in the other ancillary loan documents. . . .”)

4.5.2 Analysis of the Apparent Conflict Between Article 9 and State Recording Statutes

As explained above, Article 9 apparently provides that the purchaser of a promissory note secured by a mortgage automatically obtains a perfected ownership interest in the mortgage, which seems to be in conflict with the real-property law requirement mortgage assignments be recorded in order to be perfected.

Potential conflict between the UCC's recording and priority system for commercial paper and the real-property system existed even before the revisions to Article 9 became effective in 2001.¹³⁰ At least some courts resolved the issue by using the idea that mortgagor and mortgagee "live in different worlds."¹³¹

These courts bounded the domains of the competing recording systems by finding that the real estate recording statutes governed transactions in the "mortgagor's world," primarily the mortgagor's sale of the underlying property and the effect of a mortgage release, and the UCC recording system governed transactions in the "mortgagee's world," *i.e.*, a sale or pledge of the mortgage and note.¹³² For example, in *In re SGE Funding Corp.*,¹³³ the court concluded that a mortgage broker's unrecorded assignment of its interest in promissory notes and mortgages to its funders would be governed by the UCC's rules and not the recording statutes because it took place in "the mortgagee's world,"¹³⁴ while the "purpose and intent of the recording statutes are to protect those in the mortgagor's world,"¹³⁵

Other courts, however, did separately analyze perfection of the note and the mortgage. For example, in *In re Maryville Savings & Loan Association*,¹³⁶ the court found that "the U.C.C. does not supersede the law in this state *with respect to liens upon real estate*,"¹³⁷ so that a party's interest in deeds of trust was perfected even though its interest in the related notes was not.¹³⁸

¹³⁰ See, *e.g.*, Alvin C. Harrell, *Impact of Revised UCC Article 9 on Sales and Security Interests Involving Promissory Notes and Payment Intangibles*, 55 CONS. FIN. L.Q.R. 144, 148 (2001) ("There is . . . some inevitable interplay (and potential for conflict) between the claims of the holder of a negotiable instrument under UCC Articles 3 and 9, and potentially competing claims under a recorded assignment of the mortgage pursuant to real property law.").

¹³¹ The "different worlds" phrase apparently first appeared in Jan Z. Krasnowiecki, J. Gregg Miller & Lloyd R. Ziff, *The Kennedy Mortgage Co. Bankruptcy: New Light Shed on the Position of Mortgage Warehousing Banks*, 56 AM. BANKR. L.J. 325, 334 (1982).

¹³² Krasnowiecki et al., *supra* note 131, at 334.

¹³³ 278 B.R. 653 (Bankr. M.D. Ga. 2001).

¹³⁴ 278 B.R. at 662.

¹³⁵ 267 B.R. at 662. The court in *SGE* relied heavily on *In re Kennedy Mortgage Co.*, 17 B.R. 957 (Bankr. D.N.J. 1982), which was also the basis of Krasnowiecki's article.

¹³⁶ 743 F.2d 413 (6th Cir. 1984).

¹³⁷ 743 F.2d at 416 (emphasis in original).

¹³⁸ 743 F.2d at 416-17. See also *In re Bristol Assocs.*, 505 F.2d 1056 (3d Cir. 1974); *Rucker v. State Exch. Bank*, 355 So. 2d 171 (Fla. Dist. Ct. App. 1978).

Consistent with the overall thrust of the revisions to Article 9,¹³⁹ commentators have assumed that 2000 amendments clarified that “the mortgage follows the note.”¹⁴⁰ And the official commentary to the revised Code provides, “[t]his Article rejects cases such as *In re Maryville Savings & Loan Corp.*”¹⁴¹

The drafters of the UCC’s 2000 amendments may have intended to assert the primacy of the UCC recording system over state real property recording laws, but in fact the amendments seem to have created an express conflict. Before the 2000 amendments, the Official Comments to the UCC expressly deferred, first to “local real property law,”¹⁴² later to “other law,”¹⁴³ on “the question of the effect on the rights under the mortgage of delivery or non-delivery of the mortgage or of recording or non-recording of an assignment of the mortgagee’s interest.”¹⁴⁴ After the 2000 amendments, Article 9 of the UCC no longer expressly defers to state real property law, but instead apparently purports to resolve the issue itself. But it appears that state real estate recording laws were amended to accommodate the change in the UCC in at most two states.¹⁴⁵

The UCC’s drafters expressly recognized that when the UCC conflicts with another statute, the other statute may prevail, especially where the other statute “was specifically intended to provide additional protection to a class of individuals engaging in transactions covered by the Uniform Commercial Code.”¹⁴⁶ It would seem that land recording statutes are “specifically intended to provide additional protection” to purchasers of real property interests beyond what would be afforded if no recording statutes existed.

Moreover, the UCC is to be interpreted “to promote its underlying policies and purposes,” which are “to simplify, clarify, and modernize the law governing commercial transactions,”¹⁴⁷ and “to permit the continuing expansion of commercial practices through custom,

¹³⁹See Julian B. McDonnell, *Is Revised Article 9 a Little Greedy?*, 104 *COM. L.J.* 241, 241-42 (1999) (“The U.C.C. specialists devoutly believe in secured credit. With appropriate fanfare, they have introduced changes designed to make it easier for financiers to create and perfect security interests in the many different contexts in which secured financing is used . . . It is as though U.C.C. specialists identified with secured creditors as the Clients, the Good Guys . . .”).

¹⁴⁰*See, e.g.*, MCDONNELL & SMITH, *supra* note 121, §16.09.

¹⁴¹U.C.C. §9-109, Official Comment 7.

¹⁴²U.C.C. §9-102(3) Official Comment 4 (original).

¹⁴³U.C.C. §9-102(3) Official Comment 4 (1966).

¹⁴⁴U.C.C. §9-102(3) Official Comment 4 (1966).

¹⁴⁵Our research on the ten states with the largest numbers of mortgages securitized in private-label transactions indicates that at most two states, Florida and Maryland, amended their real property statutes to recognize the primacy of the UCC’s priority rules as to mortgage assignments. *See* discussion in Appendix A. Both amendments used the phrase “security interest in a mortgage.” A Westlaw search in the STAT-ALL database on this phrase on July 27, 2011 did not locate any additional states that had changed their recording statutes.

¹⁴⁶U.C.C. §1-103 cmt. 3.

¹⁴⁷U.C.C. §1-103(a)(1).

usage, and agreement of the parties.”¹⁴⁸ The “Article 9 argument” results in the creation of secret property interests in mortgages and seems to overturn settled commercial expectations and practices. As these results seem to be the opposite of “simplify[ing], clarify[ing], and moderniz[ing] the law” or respecting “custom [and] usage,” the UCC’s general interpretive principles disfavor an interpretation of the Code that would reach them. These considerations suggest that the “Article 9 argument” should fail.

But more importantly, the outcome of a case testing the Article 9 argument is uncertain.¹⁴⁹ The UCC drafters expected that resolution of any conflict would depend on “principles of statutory interpretation that specifically address the interrelationship between statutes.”¹⁵⁰ In a case where the securitization trustee relied on Article 9 of the UCC and a subsequent mortgage purchaser relied on the state’s land recording statute, those principles might lead a court to resolve the apparent conflict in many different ways. It could consider legislative history to see if revised Article 9 was intended to overrule state recording statutes. It could consider the overall purpose and likely intent of the Article 9 revision and recording statutes (separate from legislative history) to determine whether it makes sense for Article 9 to override recording. It could simply follow the last-enacted statute (likely to be revised Article 9).¹⁵¹

One way to resolve the apparent conflict is by finding that the term “perfected” under the UCC is limited by the express operation of the state recording statutes—in other words, that UCC simply does not provide for perfection as against bona fide purchasers for value who take without notice and record first. Perfection under the UCC could apply to other classes of competing claimants, such as judgment lienors or statutory lienors.

Predicting how a conflict between Article 9 and real property statutes would be resolved in each of the 50 states is beyond the scope of this Article. The point is that there is tremendous uncertainty on the subject.

¹⁴⁸U.C.C. §1-103(a)(2)

¹⁴⁹*See, e.g.*, Robert M. Lawless & Adam J. Levitin, Comments on Draft PEB Report, at 7 n.11 (May 27, 2011) (arguing that it is “implausible” that state legislators intended to upset long-standing state real property law in revising Article 9).

¹⁵⁰U.C.C. §1-103 cmt. 3.

¹⁵¹*But see* Committee on Legal Opinions of the American Bar Ass’n, Comments on Draft PEB Report, at 2 (May 31, 2011)(questioning whether Revised Article 9 “would be effective to change the requirements of real estate recording statutes without making express reference to such statutes” and asserting that “[u]nder many states’ statutory construction rules (e.g., Washington State), passage of a statute may not automatically have the effect of amending or reversing contrary statutory provisions without expressly referring to the supplemental or superseded statutes.”).

4.6 Publicly Filed Documents Suggest That Many Transactions Were Not Structured to Take Advantage of Revised Article 9

Even if U.C.C. Article 9 does provide that sale of the promissory note creates a perfected ownership interest in the mortgage without any need for recording and prevails over the recording statutes, that may not help many existing transactions.¹⁵² It is not clear that existing transactions were structured so that the transfers of promissory notes were in fact sales of the notes under Article 9. For example, that some intermediate transfers may have been “paper transfers” in which no real value was exchanged rather than sales of the notes.¹⁵³

Article 9’s rules for sales of promissory notes are the ones that are relevant for this analysis. Article 9 does provide for immediate and automatic perfection of security interests in payment rights other than those embodied in promissory notes, such as payment intangibles and accounts.¹⁵⁴ Indeed, mere assignment without consideration, rather than sale, of payment intangibles and accounts may be sufficient to create perfected security interests in them.¹⁵⁵ However, the obligation to pay in a typical mortgage transaction seems fairly clearly to fall outside the U.C.C.’s definition of a “payment intangible”¹⁵⁶ or an “account.”¹⁵⁷ Thus, the rules for promissory notes, rather than those for payment intangibles or accounts, are the ones that are relevant.

1. Elements of an Article 9 Sale

The question whether a promissory note has been sold is, in the nomenclature of post-2001 Article 9, the question whether a “security interest” has “attached” to

¹⁵²See discussion *supra* Part 4.5.1. The mortgage could follow the note automatically if the note is transferred by some means other than an Article 9 sale, such as a negotiation of the note under Article 3 of the UCC, but the argument that the mortgage follows the note is weaker in that case.

¹⁵³For example, negotiable promissory notes could be transferred under Article 3 by transfer of possession and endorsement. Non-negotiable notes could be transferred by documents of assignment. Neither approach is necessarily a “sale.” As explained below, a sale requires an exchange of the note for value, which may not have occurred in “paper transfers.”

¹⁵⁴See U.C.C. §9-309(2) (assigned accounts and payment intangibles); *id.* §9-309(3) (sold payment intangibles).

¹⁵⁵Section 9-309(2) provides for perfection upon attachment of a security interest in “an assignment of accounts or payment intangibles,” but Section 9-203 provides that a security interest attaches “to collateral” when “value has been given.” U.C.C. §9-203(a) & (b)(1). Moreover, Section 9-102(a)(12) defines “collateral” as, *inter alia*, “accounts, chattel paper, payment intangibles, and promissory notes that have been *sold*” (emphasis added). Exactly how Article 9 works when “accounts” and “payment intangibles” are assigned without being sold is unclear.

¹⁵⁶See U.C.C. §9-102(a)(61) (“payment intangible” is a subset of “general intangible”); *id.* §9-102(a)(42) (“general intangible” excludes “instruments”); *id.* §9-102(a)(47) (“instrument” includes “any writing that evidences the right to the payment of an obligation”). Because the lender’s right to be paid in a residential mortgage transaction typically is evidenced by a note that evidences the right to payment, no “payment intangible” would be involved.

¹⁵⁷See U.C.C. §9-109(a)(2) (“Account” excludes “rights to payment... evidenced by an instrument.”)

the promissory note as “collateral.”¹⁵⁸ This question is governed by Section 9-203, “Attachment and Enforceability of Security Interest,” which provides:

“Except as otherwise provided . . . a security interest is enforceable against the debtor and third parties with respect to the collateral only if:

- (a) value has been given;
- (b) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and
- (c) one of the following conditions is met:
 - the debtor has authenticated a security agreement that provides a description of the collateral;
 - the collateral is not a certificated security in registered form and is in the possession of the secured party under Section 9-313 pursuant to the debtor’s security agreement;
 - addresses certificated securities; presumably not relevant to the promissory notes themselves
 - the collateral is deposit accounts, electronic chattel paper, investment property or letter-of-credit rights, or electronic documents, and the secured party has control under Section 9-104, 9-105, 9-106, 9-107, or 7-106.”¹⁵⁹

Applying the above to the sale of promissory notes in a securitization transaction¹⁶⁰ in the common case where the notes are not electronic documents, the requirements are:

- (a) The buyer gives value in exchange for the notes, and
- (b) The seller has rights or the power to transfer rights in the notes, and
- (c) One of the following:
 - i. The seller “authenticates” (in other words, signs¹⁶¹) a security agreement that describes the notes, *or*
 - ii. The buyer possesses the notes under Section 9-313.

¹⁵⁸See discussion *supra* Part 4.5.1.

¹⁵⁹U.C.C. §9-203(b).

¹⁶⁰We are assuming that none of the notes have become “electronic documents” as the term used in the U.C.C. We have not observed any distinction drawn between electronic and non-electronic notes in MERS-related litigation.

¹⁶¹To “authenticate” means to sign or “to execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record.” U.C.C. §9-102(a)(7).

The description of the collateral must “reasonably identify”¹⁶² what is described, which can be done by “any method . . . if the identity of the collateral is objectively determinable.”¹⁶³

The buyer possesses the notes under section 9-313 if it takes possession itself,¹⁶⁴ or if “the person in possession authenticates a record acknowledging that it holds possession of the collateral for the [buyer’s] benefit; or the person takes possession of the collateral after having authenticated a record acknowledging that it will hold possession of collateral for the [buyer’s] benefit.”¹⁶⁵

We have examined the documents for each step of the GSAMP 2006-HE3 transaction to determine if each step was structured as an Article 9 sale of promissory notes. We present the results in Appendix B. In brief, the documents for this transaction suggest that each step *was* structured as an Article 9 note sale, although an examination of the publicly filed documents alone cannot establish with certainty whether value was actually transferred at each step or whether the notes being transferred were described with particularity. In fact, the documents raise doubts about whether value in fact was given in exchange for the notes in the sponsor-depositor transfer, as the agreement contains no description of the purchase price or how the price would be determined and lacks any provision describing when or how payment will be made.¹⁶⁶

2. Preliminary Results of Survey of Sponsor-Depositor Transactions

In addition to our comprehensive examination of the GSAMP 2006-HE3 deal documents, we examined a sample of residential mortgage securitization transactions from 2005 to 2007. This review, which covered a set of large deals executed by now-defunct entities, focused on one issue: whether the sponsor-depositor transaction was “for value” as required for a sale under Article 9. We focused our review on this element because sponsors and depositors are often affiliated, so the sponsor-depositor mortgage transfer seems least likely to be effected “for value” (as opposed to being effected by means of a simple gratuitous assignment). We reviewed 27 deals from 22 different shelves, and coded the deal documents’ description of the consideration for the sponsor-depositor mortgage transfer, as shown in Table 1.

The description of different types of consideration as “for value” is a judgment based on the idea that exchanging the mortgages for certificates representing some subset of the future

¹⁶²U.C.C. §9-108(a).

¹⁶³U.C.C. §9-108(b)(6).

¹⁶⁴U.C.C. §9-313(a).

¹⁶⁵U.C.C. §9-313(c).

¹⁶⁶*See* discussion *infra* Appendix B.

Consideration	“For Value”?	Shelf Count	Deal Count
Significant cash plus certificates	Yes	5	5
Face value of mortgage loans, in cash	Yes	1	1
Certificates plus blank cash	Questionable	3	3
Certificates only	Questionable	5	6
\$10 plus “good and valuable consideration”	Questionable	2	3
Referenced in documents, but blank or contained in unfiled document	Questionable	3	6
Not referenced	Questionable	1	3
Mixed (some deals in one category above and some in another)	Questionable	2	
Total		22	27
Percent Questionable		73%	78%

Table 1: Summary of deal documents’ description of the consideration for the sponsor-depositor mortgage transfer in 27 deals from 22 different shelves.

cash flows from the mortgages, or for plainly nominal consideration such as \$10, may not be “for value” as the term is used in connection with Article 9 sales of promissory notes.¹⁶⁷

Based solely on our preliminary review of the publicly filed deal documents, it seems that whether the mortgages were exchanged for value at the sponsor-depositor step is questionable in 78% of deals and 73% of shelves. It is possible that other unreferenced, unfiled documents establish that the mortgages were transferred for value. In any event, these results seem surprising. We might have expected to see that the deal documents plainly established that the mortgages were exchanged for substantial cash, as secondary sources describing the mortgage market often indicate.¹⁶⁸

¹⁶⁷The U.C.C. defines “value” for Article 9 as including “any consideration sufficient to support a simple contract.” U.C.C. §1-204(4). The question whether recitation of nominal consideration, such as \$10 for mortgages worth hundreds of millions of dollars, supports a contract has long bedeviled contract law. The *Restatement (Second) of Contracts* casts the issue in terms of sham consideration: The recitation of nominal consideration cannot transform a promise to make a gift into a contract. RESTATEMENT (SECOND) OF CONTRACTS §71. The same principle would suggest that an assignment of mortgages cannot be transformed into a sale by reciting nominal consideration.

¹⁶⁸*See, e.g.*, ERNST & YOUNG, *supra* note 47, at 68 (depicting “cash” flowing back through two-step securitization structure from depositor to sponsor).

5 The Use of MERS Instead of Recorded Assignments Threatens Bankruptcy Remoteness

If MERS, Inc. enters bankruptcy, it is possible that its bankruptcy trustee would be able to bring the mortgages recorded in MERS, Inc.'s name into the MERS, Inc. bankruptcy estate, threatening the bankruptcy remoteness of securitizations involving those mortgages. MERS is the legal title owner, has asserted broad powers over the mortgages, and frequently has prevailed when making these assertions. That gives rise to a significant risk that a bankruptcy court would find that MERS, Inc. could have passed good title to the mortgages outside bankruptcy, and therefore would conclude that MERS, Inc.'s bankruptcy trustee could bring the mortgages into the estate.

5.1 If MERS, Inc. Can Convey Mortgages Recorded in its Name to a Bona Fide Purchaser, Then Bankruptcy Remoteness Fails

As discussed above, if the securitized mortgages registered with MERS would become part of MERS, Inc.'s bankruptcy estate, then bankruptcy remoteness has failed as to the transactions involving those mortgages.

When an entity enters into bankruptcy, its property becomes part of the “bankruptcy estate.”¹⁶⁹ In the words of the Bankruptcy Code, the estate consists of “all legal and equitable interests of the debtor as of the commencement of the case.”¹⁷⁰

The Bankruptcy Code also provides that the bankruptcy trustee¹⁷¹ has several special powers to expand the bankruptcy estate beyond the legal and equitable interests of the debtor at the commencement of the case—in other words, to add certain types of property to the bankruptcy estate and bring them within the reach of creditors.¹⁷² These powers are set forth in section 544 of the bankruptcy code and are called the trustee’s “strong-arm powers.”¹⁷³

¹⁶⁹3 ALAN N. RESNICK ET AL., COLLIER BANKRUPTCY MANUAL §541.01, at 541-3 (3d ed. 2010).

¹⁷⁰11 U.S.C. §541(a)(1).

¹⁷¹The bankruptcy trustee represents the bankrupt debtor’s creditors as a group. JOHN D. AYER & BERNSTEIN, BANKRUPTCY IN PRACTICE (ed.). To say that the trustee has the power to bring property into the estate is to say that that the creditors as a group can reach the property, or in other words to say that the property is not bankruptcy remote.

¹⁷²*Belisle v. Plunkett*, 877 F.2d 512, 516 (7th Cir. 1989) (Easterbrook, J.) (“[W]e believe that allowing the estate to benefit from property the debtor did not own is exactly what the strong-arm powers are about . . . The estate gets what the debtor could convey under local law rather than only what the debtor owned under local law—a critical distinction . . .”) (emphasis in original).

¹⁷³*See* 11 U.S.C. §541; 3 RESNICK, *supra* note §544.02[1], at 544-3 (trustee’s powers under Section 544 are “strong-arm powers”).

Section 544(a)(3) of the Bankruptcy Code sets forth a strong-arm power of the trustee with respect to real property:

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

*... (3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of commencement of the case, whether or not such a purchaser exists.*¹⁷⁴

Although Section 544(a)(3) is not entirely clear, the text suggests that MERS, Inc.'s bankruptcy trustee would have the “rights and powers” of a “bona fide purchaser” of the mortgages recorded in MERS, Inc.'s name that had perfected the mortgage purchase at the time of MERS, Inc.'s bankruptcy. If a hypothetical bona fide purchaser had paid to buy the mortgage from MERS, Inc., had “perfected” the interest (via recording or otherwise) when MERS, Inc. entered bankruptcy, and if doing so would defeat the unrecorded claim of the securitization trustee then the mortgage could be brought into the bankruptcy estate.

The interpretation just presented is consistent with the majority view of Section 544(a)(3): The trustee takes whatever real property interests the debtor could convey, defeating unrecorded interests to the extent that a conveyance by the debtor would do so. Because the majority view of Section 544(a)(3) focuses on the debtor's power to convey, rather than its “true” ownership of property, it is sometimes said that Section 544(a)(3) can be used to expand legal title into equitable ownership.¹⁷⁵

The most frequently cited decision in this area is Judge Easterbrook's, in *Belisle v. Plunkett*.¹⁷⁶ Plunkett formed several partnerships to purchase a leasehold interest in real property and used his partners' money to purchase and record the interest in his own name.¹⁷⁷ Under local law, Plunkett's “bamboozled” partners had an equitable ownership interest in the property, and the law recognized this interest by impressing a constructive trust.¹⁷⁸ Nevertheless, despite the partners' superior claim of equitable ownership, the trustee was able to bring the property into the estate under Section 544(a)(3):

¹⁷⁴11 U.S.C. §544(a)(3).

¹⁷⁵KRAVITT ET AL., *supra* note 5, §5.02[G] at 5-42 n.162.

¹⁷⁶877 F.2d 512 (7th Cir. 1989).

¹⁷⁷877 F.2d at 513.

¹⁷⁸877 F.2d at 513.

If a hypothetical bona fide transferee from the debtor would come ahead of the ‘true’ owner’s rights, then the trustee takes ahead of the true owner.¹⁷⁹

Thus, the bankruptcy trustee and not the partners took the leasehold interest, because “[a] bona fide purchaser of the leasehold interest, without notice of the earlier claim, would take ahead of a person who has not recorded his entitlement.”¹⁸⁰

The approach Judge Easterbrook followed in *Belisle v. Plunkett*, that the rights of the trustee are measured by the rights of a bona fide purchaser, that this permits legal title to defeat unrecorded equitable ownership, and that this result is justified at least in part by the interest in encouraging recording, has been called the “majority”¹⁸¹ approach and has been followed repeatedly.¹⁸²

When a debtor’s bankruptcy estate is expanded under Section 544(a)(3) to property that the debtor does not own prior to bankruptcy, usually there is some other claimant to the property who is harmed by the expansion—perhaps one who is quite sympathetic. When the property enters the bankruptcy estate, that person may have to share the value of the property with other creditors, which may seem unfair. For example, in many of the cases that follow the majority approach, the competing claimant was, or was assumed to be, the victim of fraud by the debtor. When someone is defrauded out of the purchase price of real property, forcing that person to share the value of the property with other, non-defrauded creditors—such as those who simply took a calculated business risk in dealing with the debtor—may seem harsh.

Indeed, the majority approach to Section 544(a)(3) has been criticized on this ground. Some courts limit the effect of Section 544(a)(3) to the avoidance of an “actual transfer” by the debtor.¹⁸³

¹⁷⁹877 F.2d at 515.

¹⁸⁰877 F.2d at 514.

¹⁸¹See *In re Seaway Express Corp.*, 912 F.2d 1125 (9th Cir. 1990).

¹⁸²See *Seaway Express*, 912 F.2d at 1129 (trustee prevailed over bank claiming unrecorded equitable interest in real property exchange for account in which bank had security interest; state law “permits perfection of an interest such as [the bank’s] and “provides clear procedures for attaining that goal”); *In re Tleel*, 876 F.2d 769, 772 (9th Cir. 1989) (trustee prevailed over party assumed to be partner of debtor claiming interest in real property held in constructive trust, where partner “did not record his alleged interest”); *In re Roman Catholic Archbishop of Portland in Oregon*, 335 B.R. 868 (Bankr. D. Ore. 2005) (trustee prevailed where claimed, and assumed true for purpose of decision, that debtor held real property in express trust for benefit of others; what determines avoidability is whether “there was constructive [*i.e.*, record] notice of that interest at the time of bankruptcy”); *In re Great Plains W. Ranch Co.*, 35 B.R. 899, 905 (Bankr. C.D. Cal. 1984) (even assuming that general partner debtor who was record owner of real property had defrauded limited partners out of purchase price and therefore held property in constructive trust for limited partners, property nevertheless entered bankruptcy estate under §544(a)(3); “the law of real property is built around the recording acts.”); *Patel v. Rupp*, 195 B.R. 779 (D. Utah 1996); *In re Ebel*, 144 B.R. 510 (D. Colo. 1992); *In re Reasonover*, 235 B.R. 219, 227 (Bankr. E.D. Va. 1999) (“The majority view, which this court finds more persuasive, fully support[s] the position that §541(d) does not trump the trustee’s avoidance powers.”).

¹⁸³See *In re Mill Concepts Corp.*, 123 B.R. 938, 940-44 (D. Mass. 1991) (purpose of §544(a)(3) to permit

But most courts have implicitly or explicitly rejected such contentions in favor of a broad interpretation of Section 544(a)(3). Courts and scholars have identified two related policies the broad interpretation helps to advance, and both policies disfavor the use of MERS.

The first is the policy of protecting those who act in reliance on “ostensible ownership.” A fundamental problem of property law is that when the apparent owner of property is not the ‘true’ owner, a buyer who deals with the apparent owner is likely to be prejudiced. One potential implication is that buyers who are aware of this danger will be reluctant to transact and/or will incur excessive costs trying to determine true ownership. The result could be to interfere with a dynamic commercial economy. Recording thus is to be encouraged, both to avoid prejudice to individual innocent buyers and to lubricate commerce.¹⁸⁴ Vindicating this policy through the Bankruptcy Code has been criticized on the ground that secret liens are a nonbankruptcy problem that ideally would be addressed by nonbankruptcy law,¹⁸⁵ but most commentators appear to agree that the objective purpose of section 544(a)(3) was to “address the evil of property interests with ostensible ownership problems that remained despite available curative measures under nonbankruptcy law.”¹⁸⁶

The second is the special interest in encouraging real property recording. Section 544(a)(3)’s strong-arm powers for real property are, under the majority view, more expansive than the trustee’s strong-arm powers over personal property. This difference has been explained by recognizing an especially strong interest in recording real property interests. As Judge Easterbrook put it, Section 544(a)(3) exists not just to deal with the problem of “ostensible ownership,” but also, independently, to affirm the policy in favor of recording interests in real property. The partners lost because “[a] bona fide purchaser from Plunkett would have taken ahead of the partners under local law. They neglected to record the partnerships’ interest, though recording is easy.”¹⁸⁷

As explained in greater detail below, MERS creates an ostensible ownership problem by claiming—often successfully—the incidents of true ownership of the mortgages recorded in its name. And because MERS creates unrecorded interests in real property, it undermines

trustee to prevail over the grantee of an unrecorded mortgage and effect is limited to that purpose).

¹⁸⁴See Doug Rendleman, *Liquidation in Bankruptcy Under the ’78 Code*, 21 WM. & MARY L. REV. 575, 611 (1980) (strong-arm power under §544(a)(3) “discourages secret liens, encourages creditors to record, and allows those who deal with the debtor to protect themselves by checking the record.”).

¹⁸⁵See Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 739 (1984) (“Ostensible ownership may—and often does—create problems, but it does not do so in any way that harms a collective proceeding relative to a system of individual remedies.”). Jackson does recognize that “[c]uring non-bankruptcy problems in bankruptcy may be preferable to not curing them at all.” *Id.* at 741-42.

¹⁸⁶See Jackson, *supra* note 185, at 737.

¹⁸⁷877 F.2d at 515. Easterbrook added: “The partners could, and in retrospect should, have refused to invest funds except through an escrow agent, who would have held the cash until good title had been recorded in the partnerships’ names.”

the special interest in real property recording. Although a literal application of a rule that the bankruptcy trustee gets whatever real property interests the debtor can record might undermine justified and well-settled expectations in some situations, for example where the trustee of an express trust becomes bankrupt,¹⁸⁸ the policies underlying the majority interpretation of Section 544(a)(3) do apply to MERS.

5.1.1 Section 544(a)(3) and Mortgages

It might be argued that someone who exchanges value for a mortgage is not a “purchaser of real property” under Section 544(a)(3) because the purchases of real property the section contemplates are transactions in the underlying land, not in mortgages on the land. But a mortgage is an interest in real property under most states’ laws,¹⁸⁹ and all purchases and sales of “real property” are purchases and sales of *interests* in real property. Certainly, Section 544(a)(3) is not limited to the purchase and sale of fee simple interests.¹⁹⁰

Probably because the widespread practice of separating mortgage and note is relatively new, little authority addresses whether Section 544(a)(3) applies to mortgages, as opposed to other types of interests in real property. In one case, a bankruptcy court, with little analysis, rejected the idea that 544(a)(3) covers mortgages. In *In re Ascot Mortgage, Inc.*,¹⁹¹ the court finds it “doubtful that Congress intended §544(a)(3) to come into play when the underlying real property is not in dispute.”¹⁹² The court in *Ascot Mortgage* had nothing more to say on the subject, and its doubts seem misplaced. As explained above, MERS implicates the

¹⁸⁸Although the inviolability of express trust property to trustee bankruptcy seems to be accepted as an article of faith by many scholars, authority directly supporting this proposition is surprisingly sparse. *See, e.g., In re Roman Catholic Archbishop of Portland, Oregon*, 335 B.R. 868, 878 (Bankr. D. Ore. 2005) (“Although constructive trusts are a different species of trust from trusts such as charitable or express trusts, that difference does not affect the trustee’s authority under 544(a)(3) to avoid unrecorded equitable interests”). In states that have adopted legislation stating that third parties purchase property from the trustee of an express trustee without inquiring into the trustee’s authority to transfer the property, *see, e.g., UNIFORM TRUST CODE* §1012(b), real property held in trust may in fact have some vulnerability. A court inclined toward a textual approach to Section 544(a)(3) might well find that both express trusts and MERS are vulnerable. A court inclined toward a more pragmatic approach might find grounds for distinction. The typical MERS securitization, unlike many express trusts, does not identify the beneficial property owner in the recorded instrument. The failure to identify the true beneficial owner of real property increases the vulnerability even of express trusts. Still more generally, express trusts have existed at least since Roman times, have proven their worth, and are governed by a well-developed body of law and reasonably settled expectations. By contrast, there is no consensus on how or whether MERS works, or on whether MERS’ purpose of avoiding recording of mortgage assignments is valuable or useful.

¹⁸⁹*See* Appendix A; RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §1.1.

¹⁹⁰*See Belisle, supra* note 172, at (applying Section 544(a)(3) to transfer of leasehold interest); *Missouri Breaks, LLC v. Burns*, 791 N.W.2d 33 (N.D. 2010) (applying §544(a)(3) to “working interest” in oil well, where “working interest” apparently is an interest in a leasehold interest).

¹⁹¹153 B.R. 1002 (N.D. Ga. 1993).

¹⁹²*In re Ascot Mortgage*, 153 B.R. at 1009.

policy concerns commonly thought to underlie Section 544(a)(3).¹⁹³

5.1.2 Section 541(d) and Section 544(a)(3)

Another argument that the bankruptcy trustee cannot reach mortgage interests in the hands of MERS, Inc. is that Section 541(d) of the Bankruptcy Code, written for the secondary mortgage market, is “in direct conflict”¹⁹⁴ with §544(a). Section 541(d) provides that if the debtor has a legal but not an equitable interest in property, such as a mortgage that has been sold but as to which the debtor retains legal title for servicing, the debtor’s interest becomes property of the estate “only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest that the debtor does not hold.”¹⁹⁵ The provision could be read to imply that the mortgages in MERS, Inc.’s hands do not become property of the bankruptcy estate because MERS, Inc. holds only legal title.

As explained above, the majority approach to this issue is that Section 544 empowers the trustee to *expand* the bankruptcy estate beyond what Section 541 provides, so that limits on the bankruptcy estate in Section 541 simply do not apply to the trustee’s powers under Section 544. Moreover, the Bankruptcy Code was amended in 1984, eliminating any textual conflict between the two provisions.¹⁹⁶

5.2 There is a Significant Risk That MERS, Inc. can Convey the Mortgages Recorded in its Name to a Bona Fide Purchaser

5.2.1 MERS, Inc. Holds Legal Title, so the Default is That it Can Convey the Mortgages Recorded in its Name

The very purpose of MERS, Inc. is to own legal title to mortgages recorded in its name, and its standard form mortgage clearly provides that MERS, Inc. is the legal title owner.¹⁹⁷

¹⁹³Given that Article 9, after the 2000 revisions, apparently countenances the creation of secret liens and dispenses with the filing system for commercial paper, see MCDONNELL, *supra* note , the real property recording system is the only system established to maintain records of mortgage ownership. Congress’ intent in Section 544(a)(3) to promote recording must be accomplished through the real property recording system if it is to be accomplished at all.

¹⁹⁴KRAVITT ET AL., *supra* note 5, §5.02[G], at 5-43 n.162.

¹⁹⁵11 U.S.C. §541(d).

¹⁹⁶Section 541(d) covers interests that “become[] property under the estate under subsection (a)(1) or (2)” of Section 541. Sections 541(a)(1) and (a)(2) do not reference Section 544. *See* 11 U.S.C. §541(a)(1)-(2). Section 541(d) thus does not appear to cover interests that become property of the estate under Section 544.

¹⁹⁷A Westlaw search in the ALLCASES database on June 7, 2011 on the phrase “MERS holds only legal title,” retrieved 89 results, and a quick review of a sample of these documents finds that they all quote MERS’ agreements with borrowers. The Declaration of William a. Hultman, Treasurer of MERS, Inc., dated Dec. 22, 2010, ¶6, states that “MERS is the mortgagee of record. It holds legal title to the mortgage and acts as the agent or nominee for the MERS Member lender, or owner of the mortgage loan.”; see also Jackson

There is no consensus on what follows from MERS, Inc.'s ownership of legal title to mortgages, nor does the term "legal title" have a precise, universal meaning. However, one of the core meanings of "legal title" is that third parties are able to deal with the legal titleholder. If A owns legal title to property and B has equitable title, then innocent third party C can deal with A without worrying about the relationship between A and B.

MERS, Inc.'s ownership of legal title to mortgages creates a presumption that a third party can take good title to the mortgages from MERS, Inc. Of course, that presumption might be defeated, for example by constructive or record notice that MERS, Inc. does not have authority to convey the mortgages. Those issues are discussed below, but the starting point for the discussion is that MERS, Inc. has legal title to the mortgage, that MERS, Inc. probably acquired legal title in a valid manner (it did not defraud the originator or record forged documents), and that that has consequences.

The archetypal case of division of legal title from equitable ownership is probably the trust, where a grantor confers legal title to property on a trustee, who is obligated to deal with the property on behalf of the beneficiaries, who have the equitable right to benefit from the property. Whether the grantor intends for the trustee to have the power to sell the property varies from trust to trust; the trust instrument may or may not contain a "power of sale." A perennial question in trust law is whether the trustee may pass good title to a good-faith purchaser if the trust instrument does not confer a power of sale.

The strong modern trend, enshrined in the Uniform Trust Code, is to protect the good-faith purchaser. A trustee has a power of sale unless a recorded document says otherwise,¹⁹⁸ and a party dealing with the trustee in good faith is not required to inquire into the extent of the trustee's powers or the propriety of their exercise."¹⁹⁹ In perhaps the most important context in which legal title and equitable ownership are divided, innocent third parties are protected in their dealings with the legal titleholder. They are not required to conduct extensive off-record investigations to determine the extent of the trustee's powers.

5.2.2 MERS, Inc.'s Lack of Interest in the Note Does Not Eliminate the Risk to Bankruptcy Remoteness

MERS, Inc. owns legal title to the mortgage. The recorded documents in a MERS mortgage do not state that MERS, Inc. has an interest in the note. It could be argued that MERS,

v. MERS, 770 N.W.2d 487, 493 (noting MERS mortgage deeds "included language that granted MERS legal title"); *id.* at 497 ("our decision turns, in part, on the difference between equitable and legal title to the security instrument in the property as applied to Minnesota's foreclosure by advertisement statutory scheme"; *id.* at 498-500 (rejecting argument that "MERS does not actually hold legal title").

¹⁹⁸See UNIFORM TRUST CODE §816(2) ("a trustee may... (2) acquire or sell property, for cash or on credit, at public or private sale").

¹⁹⁹UNIFORM TRUST CODE §1012(b).

Inc., having no interest in the note, cannot transfer the mortgage. This argument would fail either if mortgage and note can be transferred separately, or if MERS, Inc. could transfer both mortgage and note.

1. Sale of Mortgage Apart from Note

Although efforts to sell mortgages separately from notes are rare, even nonexistent, such a sale is not conceptually impossible. First, although much authority suggests that it is inherently impossible to separate note and mortgage, and that any attempt to do so is a “nullity,”²⁰⁰ the Restatement (Third) of Mortgages acknowledges that mortgage and note in fact *can* be separated.²⁰¹

Indeed, there is now ample authority, both pro-MERS and anti-MERS, holding that separation of mortgage and note is precisely what MERS recording effects.²⁰²

For example, Massachusetts recognizes that mortgage and note can be split. When this happens, including when MERS is used, the “mortgagee is deemed to hold the mortgage in trust for the owner of the note.”²⁰³ Moreover, MERS’ own behavior (purporting to “assign” mortgages recorded in its name) and its members’ acquiescence in that behavior suggest that MERS and its members affirm the view that mortgage and note can be separated. If mortgage and note inherently could not be separated, there would be no need for MERS to assign mortgages to noteholders and noteowners.

²⁰⁰ See, e.g., *Merritt v. Bartholick*, 36 N.Y. 44, 45 (1867) (“a transfer of the mortgage without the debt is a nullity, and no interest is acquired by it”); *Bank of New York v. Silverberg*, 2011 WL 2279723, at *4 (N.Y. App. Div. June 7, 2011) (collecting New York cases following *Merritt*); *HSBC Bank USA, N.A. v. Taher*, 2011 WL 2610525 (N.Y. Sup. July 1, 2011); *In re Veal*, 2011 WL 2652328; *In re Macklin*, 2011 WL 2015520 (Bankr. E.D. Cal. May 19, 2011); *In re Doble*, 2011 WL 1465559 (Bankr. S.D. Cal., April 14, 2011); *Elvin v. Wucetich*, 157 N.E. 243, 244-45 (Ill. 1927) (“It has often been decided that a mortgage cannot exist as an independent security in the hands of one person while the note it is given to secured belongs to another”); *In re Tucker*, 441 B.R. 638, 641 (Bankr. W.D. Mo. 2010) (“Effectively, the note and the deed of trust are inseparable.”).

²⁰¹ RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §5.4 cmt. b (“A transfer of the obligation with retention of the mortgage is possible”). The Restatement contemplates a situation where the assignor retains the mortgage as an agent of the new note owner in order to facilitate collections. *Id.*

²⁰² See, e.g., *Jackson v. MERS, Inc.*, 770 N.W.2d 487, 494 (Minn. 2009) (“MERS has essentially separated the promissory note and the security interest”); *Agard*, *supra* note ; *Bischoff*, *supra* note ; *MERS, Inc. v. Estrella*, 390 F.3d 522, 525 (7th Cir. 2004) (“MERS is a nominee only, holding title to the mortgage but not the note”); *Rinegard-Guirma v. Bank of America, N.A.*, 2010 WL 3945476, at *4 (D. Ore. Oct. 6, 2010) (noting authority suggesting that MERS splits mortgage and deciding that it was “at least initially persuaded” that plaintiff claiming improper foreclosure based on MERS deficiencies “has a likelihood of success on the merits”); *Residential Funding Co. v. Saurman* (no star pagination available) (MERS held interest “in the property as security for the note, not an interest in the note itself”).

²⁰³ *In re Marron*, 2011 WL 2600543, at *4 (Bankr. D. Mass. June 29, 2011) (citing *U.S. Bank v. Ibanez*, 941 N.E.2d 40, 54 (Mass. 2011); *Barnes v. Boardman*, 149 Mass. 106 (1889)). *In re Marron*, at *4 n.7 (“[T]he MERS phenomenon has created a national Massachusetts-like model where the legal and beneficial ownership of mortgages has been separated. Courts in states which do not permit the separation of ownership of notes and mortgages understandably find this a challenge which may account for some of the inconsistency in decisional authority. . .”).

Most importantly, there is no compelling reasoning underlying the flat statements that note and mortgage can never be separated. Such statements seem to rest on the following argument: (1) if mortgage and note were separated, the mortgage owner could never enforce the mortgage, because only the holder or owner of the note can do that; (2) the mortgage is therefore worthless without the note; (3) the attempt to assign a valueless mortgage is a nullity.

But (2) does not follow from (1). The right to enforce the note by selling the mortgaged property is valuable to both the borrower and the note's owner. The mortgage has value to the borrower because if the borrower owns the mortgage, the lender cannot foreclose on the property. The mortgage has value to the lender for the same reason. Why would the lender ever sell the mortgage separately from the note? To get money. Why would anyone buy the mortgage separately from the note? The borrower might buy it as a way of extinguishing the security interest, or an intermediary might buy it with the intention of selling it to the borrower, the lender, or a successor in interest to either of them.

Statements that “logic” dictates that an assignment of the mortgage without the note is a “nullity”²⁰⁴ and that the assigned mortgage therefore is a “worthless piece of paper”²⁰⁵ therefore appear to be erroneous.

A number of cases explicitly hold that MERS splits mortgage and note, and cases that uphold MERS' authority to assign the mortgage effectively do the same. Moreover, the statement that a mortgage “cannot” be separated from its note, though often repeated, does not really make any sense.

2. Sale of Mortgage, with Note Following

Even if mortgage and note cannot be separated, the note may follow the mortgage.²⁰⁶ As the *Restatement (Third) of Property: Mortgages* provides, the note follows

²⁰⁴Merritt v. Bartholick, 36 N.Y. 44, 45 (1867). Even some cases that state that the assignment of a mortgage apart from a note is a “nullity” appear to mean that such an assignment does effect a transfer of the mortgage, although the transferred mortgage is unenforceable until reunited with the note. *See, e.g., In re Veal*, 2011 WL 2652328, at *13 (quoting authority that assignment of the mortgage without the note is a “nullity” in support of the proposition that “the transfer of a mortgage without the obligation it secures renders the mortgage ineffective and unenforceable in the hands of the transferee.”).

²⁰⁵4 POWELL ET AL., *supra* note 77, §37.27[2], at 37-178 to 37-179 (quoting *Merritt*). *See also* McKenna v. Wells Fargo Bank, N.A., 2011 WL 1100160, at *2 n.26 (“without an ownership interest in [the] promissory [n]ote, the possession of the mortgage alone is possession of a worthless piece of paper”) (D. Mass. 2011); *In re Hawkins*, 2009 WL 901766, at *4 (Bankr. D. Nev. 2009) (assignee of mortgage without note “has a worthless piece of paper”); *Manufacturers & Traders v. Figueroa*, 2003 WL 21007266, at *2 n.6 (Conn. Super. Ct. April 22, 2003) (same).

²⁰⁶*See, e.g., In re Veal*, 2011 WL 2652328 (9th Cir. B.A.P. (Ariz.) June 10, 2011), at *3 (distinguishing between mortgage assignment that purported to assign note and mortgage assignment that did not purport to assign note).

the mortgage unless the parties to the transaction provide otherwise.²⁰⁷ This approach has been followed or recognized in a number of cases.²⁰⁸ MERS, Inc. and its users frequently make this very argument, arguing that MERS, Inc.’s assignment of a mortgage to a foreclosing party carries the note with it. This position prevails frequently,²⁰⁹ but not always.²¹⁰

²⁰⁷See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §5.4(b) (“Except as otherwise required by the Uniform Commercial Code, a transfer of a mortgage also transfer the obligation the mortgage secures unless the parties to the transfer agree otherwise.”). MERS, Inc. claims to be authorized to transfer both mortgage and note. The commentary explains that the phrase “except as otherwise required by the Uniform Commercial Code” refers to the fact that the right to enforce a negotiable instrument can be transferred only by delivery. *Id.* cmt. b. This does not appear to cover the transfer of beneficial ownership. Even a negotiable note could follow the mortgage in that the right to the money would be transferred, even if the right to enforce is not. See U.C.C. §3-203, cmt. 1. See also Phillip C. Ransdell, *Note, Mortgages-Effect of Assignment without Assigning the Debt—Formalities Necessary to Transfer the Mortgagee’s Title to the Mortgaged Property*, 36 N.C. L. REV. 225, 229 (1958).

²⁰⁸See *Villa v. Silver State Fin. Servs.*, 2011 WL 1979868, at *6 n.7 (D. Nev. May 20, 2011) (noting that Restatement proposes that note follows mortgage and that Nevada Supreme Court has followed Restatement in other contexts); *Smith v. Community Lending, Inc.*, 2011 WL 1127046, at *2 (“clear” that “interest in the note may follow the deed of trust as a matter of law”); *In re Martinez*, 2011 WL 996705, at *4 n.12 (Bankr. D. Wyo. March 16, 2011)(“when the ownership of a mortgage is assigned to another, the obligation secured by the mortgage is likewise transferred” unless parties agree otherwise); *Armacost v. HSBC Bank USA*, 2011 WL 825151 (D. Idaho Feb. 9, 2011) (report and recommendation of magistrate judge) (assignment of mortgage with intent to assign note may effect assignment of note); *U.S. Bank, N.A. v. Flynn*, 897 N.Y.S.2d 855, 859 & n.1 (N.Y. Sup. 2010) (finding that New York’s “long standing rule that a transfer of a mortgage without a concomitant transfer of the debt is void” is “at odds with the generally prevailing common law rule that a transfer of the mortgage also transfers the debt unless the parties otherwise agree or such transfer is precluded by an applicable provision of the Uniform Commercial Code”); *Crum v. LaSalle Bank, N.A.*, 55 So. 3d 266, 270 (Ala. Civ. App. 2009) see also DAVID A. SCHMUDDE, A PRACTICAL GUIDE TO MORTGAGES AND LIENS 189 (2004) (“If the parties agree, the note can be separated from the mortgage, but this requires affirmative express action”; describing such a situation as “rare”).

²⁰⁹*In re Veal*, 2011 WL 2652328, *supra* note 204; *Deutsche Bank Nat’l Trust Co. v. Greene*, 2011 WL 1590926 (Ohio Ct. App. April 22, 2011); *Deutsche Bank Nat’l Trust Co. v. Hansen*, 2011 WL 899625 (Ohio Ct. App. March 10, 2011); *Armacost v. HSBC Bank USA*, 2011 825151 (D. Idaho Feb. 9, 2011); *In re Corley*, 447 B.R. 375 (Bankr. S.D. Ga. 2011); *Vega v. CTX Mortg. Co.*, 761 F. Supp. 2d 1095 (D. Nev. 2011); *Deutsche Bank Nat’l Trust Co. v. Traxler*, 2919 WL 3294292 (Ohio App. Aug. 23, 2010); *Crum v. LaSalle Bank, N.A.*, 55 So. 3d 266 (Ala. Civ. App. Sept. 18, 2009); *Bank of New York v. Dobbs*, 2009 WL 2894601 (Ohio App. Sept. 8, 2009).

²¹⁰See *supra* note 101. When the assignee does not hold the note, there is ample authority that an assignment of the mortgage to the assignee by MERS does not effectively transfer the note, even if the mortgage assignment purports to transfer the note as well. In other words, the note does not follow the mortgage. See *Bellistri v. Ocwen Loan Servicing, Inc.*, 284 S.W.3d 619, 621 (Mo. Ct. App. 2009) (MERS’ attempt to transfer mortgage and “any and all notes secured by the mortgage” ineffective because MERS was not the noteholder and there was no evidence that the noteholder authorized MERS to transfer the note); *In re Weisband*, 427 B.R. 13, 19-20 (Bankr. D. Ariz. 2010) (MERS’ mortgage assignment did not give assignee standing to appear in borrower’s bankruptcy proceeding because note was not properly endorsed to assignee and MERS lacked an interest sufficient to confer standing); *Rinegard-Guirma v. Bank of America, N.A.*, 2010 WL 3945476 (D. Or. Oct. 6, 2010), at *4 (noting that “other courts have held that MERS does not have authority to transfer the note” and finding that homeowner was likely to succeed in challenge to securitization trustee’s authority to foreclose); *HSBC Bank v. Miller*, 889 N.Y.S.2d 430, 432 (MERS assignment of mortgage ineffective where purported assignee could not prove it held the note; “the assertion that the note follows the mortgage is unsupported by any law”); *In re Wilhelm*, Case No. 08-20577

As for the failure to produce the actual note and its relation to notice, it is true that at least one case has found that the seller's inability to produce the note put the purchaser on notice that the seller did not own the mortgage and thus defeated the purchaser's claim. In *re Ascot Mortgage* holds that when the seller/debtor does not have possession of the notes, "any purported purchaser of the debtor's interest in the [mortgages] . . . would have had constructive knowledge that the [d]ebtor could not produce and transfer the original notes. This would have put a purchaser on inquiry as to the state of the [d]ebtor's ownership of the [n]otes."²¹¹ There was no evidence in *Ascot Mortgage* that the debtor had authority from the lender to transfer mortgage or note.

But the standard of good faith and notice in the mortgage industry apparently does not support a finding that the seller's failure to produce the note is fatal to a buyer's claim that it took in good faith.²¹² It reportedly has been a widespread practice in the industry to consummate securitization transactions without transferring physical possession of the notes.²¹³ As a result, foreclosures based on "lost note" affidavits reportedly are quite common²¹⁴ and at least some courts have endorsed this practice.²¹⁵

(Bankr. D. Idaho July 7, 2009), slip op. at 23-24 (purported assignments by MERS ineffective where deeds did not authorize MERS to transfer promissory notes); *Saxon Mortg. Servs. v. Hillery*, 2010 WL 5170180, at *5 (N.D. Cal. Dec. 9, 2008) (purported assignment by MERS invalid; although court assumed MERS has authority to transfer security instrument, no evidence that MERS held or had authority to assign note) . See also *In re Veal*, 2011 WL 2652438, *supra* note , at *12-*13 (finding in non-MERS case that general common-law rule is that "the transfer of a mortgage without the transfer of the obligations it secures renders the mortgage ineffective and unenforceable in the hands of the transferee," although "some states may have altered this rule by statute").

²¹¹*In re Ascot Mortgage*, 153 B.R. at 1009.

²¹²See, e.g., U.C.C. §1-201(20) ("'Good faith,' except as otherwise provided in Article 5, means honesty in fact and the observance of reasonable commercial standards of fair dealing.")

²¹³See Dale a. Whitman, *How Negotiability Has Fouled up the Secondary Mortgage Market, and What to Do About It*, 37 PEPP. L. REV. 737, 758 (2010) ("While delivery of the note might seem to be a simple matter of compliance, experience during the past several years has shown that, probably in countless thousands of cases, promissory notes were never delivered to market investors or securitizers, and, in many cases, cannot presently be located at all.")

²¹⁴See Garrett Wotkins, *A New Front in the Foreclosure Epidemic: Consumers Fight Back*, 1789 PLI/CORP. 477, 479 (2010) (asserting (without attribution) that "[s]ome estimate" that over 99 percent of residential foreclosure actions are filed with lost note affidavits); Bob Ivry, *Banks Lose to Deadbeat Homeowners as Loans Sold in Bonds Vanish*, BLOOMBERG.COM (Feb. 22, 2008) (quoting Florida legal aid attorney as saying that 80 percent of 300 cases she had handled in past year involved lost-note affidavits).

²¹⁵See *Gibson v. Wells Fargo Bank*, 2011 WL 221188, at *3 (E.D. Va. Jan. 19, 2011); *U.S. Bank, N.A. v. Fraum*, 2008 WL 4033640 (Aug. 6, 2008), at *1.

5.2.3 MERS, Inc.’s Status as a ‘Nominee’ Does Not Eliminate the Risk to Bankruptcy Remoteness

MERS, Inc. holds title as a “nominee” for the mortgage lender and its successors and assigns. It could be argued that no one could reasonably think that such a “nominee,” one intended to act merely as a registration system, could sell the mortgages recorded in its name. But MERS, Inc. is presented to the world as much more than a registration system. MERS, Inc. and its members claim—often successfully—that the company can exercise all rights of the true owner of the mortgage, that MERS can convey ownership of mortgages, and that MERS owns constitutionally protected interests in mortgages and would be injured if its rights in the mortgages are impaired. As a result, a large body of precedent suggests that MERS, Inc. possesses broad authority over the mortgages as agent and/or owner. Even if it is possible to design an ideal nominee registration system that creates virtually no risk to bankruptcy remoteness, MERS as it exists is not that system.

MERS, Inc. explains its legal situation as follows: MERS, Inc. claims that it is the mortgagee of record, holding legal title as the “nominee,” or agent, of the true owner of the mortgage.²¹⁶ When a mortgage is transferred from one MERS member to another, the members are obligated under the membership agreement and rules to record the assignments on MERS,²¹⁷ so that the system itself has a complete and up-to-date record of the chain of mortgage assignments.²¹⁸ Although the true owner changes from time to time, MERS, Inc.—under its membership agreement and rules—is always an agent of the true owner.

MERS’ status as a nominee could defeat the claim of a bona fide purchaser, and therefore the bankruptcy trustee, under two theories that involve essentially the same inquiry: First, MERS, Inc. might lack both actual and apparent authority to convey the mortgages. Second, the prospective buyer might be found to have been on constructive and/or inquiry notice of MERS, Inc.’s status as an agent without authority to convey the mortgages.

²¹⁶*E.g.*, MERS Memorandum of Law in Support of Motion to Partially Set Aside and Reconsider Order, Case No. 810-77338 (Bankr. E.D.N.Y. Feb. 25, 2011), at 10 (“The Mortgage clearly demonstrates First Franklin’s delegation of authority to MERS, and the borrower’s acknowledgment and acceptance of MERS as the disclosed agent of the lender, and its successors and assigns. The Mortgage plainly states that MERS holds legal title in its capacity ‘as nominee for the Lender and the Lender’s successors and assigns.’”).

²¹⁷See MERS Corp., Inc. Rules of Membership, Rule 2, §3 (June 2009) (“Each Member shall promptly ... register on the MERS System ... any and all of the following transactions to which such Member is a party which involve a mortgage loan registered on the MERS System ... (c) the transfer of beneficial ownership of a mortgage loan by a Member to a Member; (d) the transfer of beneficial ownership of a mortgage loan by a non-Member to a Member; (e) the transfer of beneficial ownership of a mortgage loan by a Member to a non-Member ...”).

²¹⁸Notably, MERS does not appear to take the position that such a complete and up-to-date record actually exists in its database, only that its members are obligated to take steps that would result in the existence of such a record.

1. The Actual/Apparent Authority Issue

In the language of agency, MERS, Inc. has the authority to bind its principal to acts within the scope of MERS, Inc.'s actual or apparent authority. If a reasonable buyer would think that MERS, Inc. has the power to sell mortgages, or if its principals in fact granted MERS, Inc. the power to sell mortgages, then the buyer can take good title to the mortgages from MERS, Inc.

2. The Constructive and/or Inquiry Notice Issue

Given that the question of MERS' apparent authority would arise in the context of applying §544(a)(3), it could be phrased in the language of constructive and inquiry notice. Under §544(a)(3), the trustee is treated as a bona fide purchaser. Courts generally have found that although the trustee's actual knowledge of competing interests is irrelevant,²¹⁹ the trustee's powers as a hypothetical bona fide purchaser are limited by constructive (record) and inquiry notice.²²⁰

In general terms, these doctrines imply that if a reasonable investigation based on the public record would disclose that the record owner cannot convey good title, then the buyer will not be protected by recording statutes.²²¹ As applied to MERS, Inc., that would suggest that if a reasonable investigation based on the public record would turn up *both* that MERS, Inc. is in fact not the beneficial owner of the mortgages registered in its name *and* that MERS, Inc. has no authority to sell the mortgages on behalf of the beneficial owner, then the bankruptcy trustee would not be able to bring the mortgages into the estate.

An important consideration that goes into this inquiry, one that is recognized in the notice doctrines, is the importance of maintaining public land records that do not require extensive investigation. The extent of the off-record investigation a buyer must conduct to be protected from unrecorded interests is a long-standing question in real property law²²² that has never been presented in the context of a nationwide private

²¹⁹11 U.S.C. §544(a); *Tleel*, 876 F.2d at 772.

²²⁰See *Seaway Express*, 912 F.2d at 1129.

²²¹The terminology here is not uniform. One leading author defines "constructive notice" as "notice arising solely from the record," 14 POWELL ON REAL PROPERTY §82.02[1][d][ii], at 82-33, and "inquiry notice" as notice resulting from a reasonable investigation conducted on the basis of an "apparently extraneous" fact. *Id.* §82.02[1][d][iii], at 82-39. Where the record itself discloses the possibility of a competing interest that requires further investigation to verify, the line between the two concepts is blurred. The effect of notice also is expressed in differing terms. Sometimes it is said that a purchaser who has notice of a prior interest cannot be a bona fide purchaser, *id.* §82.02[1][d], at 82-38 to 82-39, sometimes it is said that such a purchaser is a "bona fide purchaser with notice." Whatever the terminology, the effect would be the same: a buyer with notice would not prevail over a competing claimant.

²²²See, e.g., Francis S. Philbrick, *Limits of Record Search and Therefore of Inquiry Notice*, 93 U. PA. L. REV. 125 (1944), 93 U. PA. L. REV. 259 (1944); 93 U. PA. L. REV. 391 (1945). Philbrick's seminal three-part article argues that "record notice should be limited by the search that can reasonably be required

effort to bypass the recording system in the presence of a Bankruptcy Code provision apparently intended to promote use of the public recording system, so a court's reaction is completely unpredictable.²²³

Would a reasonable inquiry based on the record disclose both that the 'true' owner of the mortgage has a valid interest and that MERS, Inc., the legal title holder, is not authorized to transfer that interest on behalf of the 'true' owner?²²⁴

On the first point, existence of a valid interest, it is most unclear that MERS does or can provide a prospective buyer with any information about the true owner of the mortgage. The available information suggests the possibility that MERS is not an up-to-date database, but rather is more or less static, updated only when an employee of a MERS member generates a mortgage assignment for foreclosure.²²⁵ The real property records state that MERS is the legal owner of the mortgage on behalf of the original lender, but the original lender is not the equitable owner of the mortgage. The equitable owner presumably is now the note owner, but the prospective purchaser has no way of determining who the note owner is, and therefore has no way of assessing the validity of the note owner's interest. Under these circumstances, as one authority states, "the inference of constructive notice is rebutted."²²⁶

On the second point, MERS' lack of authority to sell the mortgage, MERS' governing documents actually do not seem to make it clear upon a reasonable inspection that MERS lacks authority to sell the mortgage.²²⁷ Even if MERS' documents did make

of a purchaser; and that no inquiry notice should be attributed to any document unlawfully recorded." *Id.* at 132.

²²³ See, e.g., *Roman Catholic Archbishop*, 335 B.R. at 879-81 (considering and rejecting argument that Oregon recording statute abrogated purchaser's duty to investigate upon receipt of inquiry notice).

²²⁴ See 14 POWELL ON REAL PROPERTY, *supra* note 77, §82.02[1][d][C], at 82-46 to 82-47 ("According to generally accepted conveyancing principles, a purchaser is on inquiry notice of the existence of the trust, and its limitations, merely by the recording of a document naming the person 'as trustee.' The purchaser is obligated to make a reasonable inquiry to determine if the proposed conveyance is within the powers of the trustee under the trust.").

²²⁵ See discussion of typical MERS transaction, *supra* Part 4.2.

²²⁶ See 14 POWELL ON REAL PROPERTY §82.02[1][d], at 82-36 (citing *Leffler v. Smith*, 388 So. 2d 261 (Fla. Dist. Ct. App. 1980)); see also *id.* at 82-37 to 82-38 (indefinite reference, as to "prior unrecorded deed" or "all easements and covenants of record" may be insufficient to provide notice).

²²⁷ See MERS Terms and Conditions, *supra* note. The Terms and Conditions do not expressly forbid MERS from selling mortgages. They provide that "the MERS System is not a vehicle for creating or transferring beneficial interests in mortgages," *id.* ¶6, but this refers to the MERS *System*, that is, the database, not the corporate entity MERS, Inc. Moreover, this assertion is inconsistent with positions MERS, Inc. has taken in litigation. See discussion *infra* Part . The Terms and Conditions state that MERS serves "solely as a nominee, in an administrative capacity, for the beneficial owners from time to time," *id.* ¶2. Although "nominee" and "administrative capacity" suggest a limited scope of agency, the terms have no fixed meaning and in any event MERS, Inc. has argued that it possesses quite a broad scope of authority. See discussion *infra* Part 5.2.3. See also MERSCORP, Inc. Rules of Membership, *supra* note 217. The Rules likewise contain no express ban on mortgage sale. Indeed, the Rules expressly give MERS open-ended permission to

such an assertion, it would have to be weighed against MERS' constant assignments of mortgages and the broad assertions in litigation of MERS, Inc.'s authority to dispose of the mortgages registered in its name.²²⁸

Despite the different doctrinal contexts, both apparent authority and constructive/inquiry notice are trying to get at the same thing: Is it reasonable, in light of all relevant considerations, for a buyer to think that MERS, Inc. can convey good title to the mortgages?²²⁹

5.2.4 There is a Substantial Risk That MERS, Inc. Would be Found Able to Convey Good Title to Mortgages

The risk that MERS, Inc. would be found to be able to convey good title to the mortgages registered in its name, and therefore that the transactions involving those mortgages are not bankruptcy remote, comes largely from MERS, Inc. and the members of MERS. These parties have claimed—often successfully—that MERS, Inc. can exercise “any or all” rights of the mortgage lender, that MERS, Inc. possesses a beneficial (ownership) interest in the mortgage and has the power to convey this interest via assignment, and that MERS, Inc. has various types of legally protected interests in the mortgage, such as constitutionally protected property rights.

A hypothetical purchaser seeking to show that she or he acted in good faith in purchasing a mortgage from MERS, Inc. would point to each of these claims and to the cases in which they have succeeded to show that MERS, Inc. could convey the mortgages, either because of its apparent or actual authority as an agent, or because of its actual ownership of the

rely on instructions from the beneficial owner or servicer “with respect to transfers of beneficial ownership.” *Id.* Rule 2, §6. If anything, MERS' governing documents suggest that MERS could indeed sell mortgages as an agent for the beneficial owner.

²²⁸See discussion of MERS, Inc.'s litigating position, *infra* Part 5.2.3.

²²⁹This can be understood as the inquiry in other contexts where a party possesses some but not all of the attributes of ownership. Generally, when a party (the bailor) places personal property in the custody of another (the bailee), the bailee's ability to pass good title to a bona fide purchaser may depend on whether the bailee has clothed itself in the incidents of ownership. Under the traditional common law of bailments, a bailee could acquire power to pass good title through the owner's decision to clothe the bailee with “indicia of ownership.” When one party (the consignor) places personal property in the care of another party (the consignee) to sell, the consignee can pass good title to the property, even if it sells the property in violation of the consignment agreement. *See* U.C.C. §2-403(2) (“Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business.”); Padgett, *Uniform Commercial Code Section 2-403(2): The Authority of a Bailee to Convey Title*, 21 U. FLA. L. REV. 24 (1968). The details of the consignor-consignee relationship are not the buyer's problem, and the consignor is able to pass more extensive rights than it possesses. *See, e.g.*, Little, Brown & Co. v. American Paper Recycling Co., 824 F. Supp. 11, 16 (D. Mass. 1993). (while consignee “may have been able to transfer [consignor's] title to [goods] to [a purchaser], section 2-403 plainly would not vest title or ownership rights” in consignee.).

mortgage. And MERS, Inc.’s bankruptcy trustee, standing in the shoes of such a purchaser, would do the same thing.

1. MERS, Inc. as Plenary Agent: The Power to Exercise “Any or All” Rights of the Lender, Including the Right to Sell the Mortgage

A prospective buyer of mortgages from MERS, Inc. would encounter the following language in MERS, Inc.’s form mortgage:

I [the borrower] understand and agree that MERS holds only legal title to the rights granted by me in this Security Instrument, but, if necessary to comply with law or custom, MERS (as nominee for Lender and Lender’s successors and assigns) has the right: (A) *to exercise any or all of those rights* including, but not limited to, the right to sell the Property; and (B) to take any action required of Lender including, but not limited to, releasing and canceling this Security Instrument.²³⁰

MERS, Inc.’s right “to exercise any or all” of the rights granted the lender in the mortgage certainly seems to encompass a right to sell the mortgage on behalf of the lender. MERS members have relied on this language in claiming that MERS has a broad scope of agency authority to assign mortgages and foreclose on behalf of the principal.

In *Crum v. LaSalle Bank, N.A.*, the Alabama Court of Civil Appeals expressly held that the “any or all rights” language means that “MERS was authorized to perform any act on the lender’s behalf as to the property, *including selling the note and the mortgage to a third party*”²³¹ because the recorded instrument confers on MERS, Inc. “any or all of the lender’s interests in the mortgaged property.”²³²

²³⁰Mortgage, Ex. A to Affirmation of William C. Hultman, Dec. 10, 2010, filed in *In re Agard*, Case No. 10-77338-REG (Bankr. E.D.N.Y.)(emphasis added). Other form documents refer to “any or all interests” granted the lender, rather than “any or all rights”—a difference of no apparent relevance.

²³¹55 So. 3d 266, 269 (Ala. Ct. Civ. App. 2009).

²³²*Id.* *Crum* rejected a homeowner/borrower’s argument that the recipient of an assignment from MERS “had not acquired the power to undertake foreclosure proceedings.” *Id.* at 268.

Courts in Arizona,²³³ Arkansas,²³⁴ California,²³⁵ Georgia,²³⁶ Illinois,²³⁷ Massachusetts,²³⁸ Minnesota,²³⁹ Missouri,²⁴⁰ Nevada,²⁴¹ New York,²⁴² Ohio,²⁴³ Oregon,²⁴⁴ Texas,²⁴⁵ Utah,²⁴⁶ Virginia,²⁴⁷ Washington,²⁴⁸ and Wyoming²⁴⁹ have expressly relied on the “any or all” language in rejecting homeowner/borrowers’ contentions that MERS, Inc., as a mere nominee, did not have the right to assign or foreclose on mortgages.

It might be argued that the “necessary to comply with law or custom” language limits MERS, Inc.’s authority to sell mortgages, but courts citing the “any or all” language have not construed this “necessary to comply” clause as limiting MERS, Inc.’s authority. Instead, they have interpreted the form instrument as a plenary grant of authority to MERS to act as the lender’s agent.

2. MERS, Inc. as Assignor: The Power to Convey Ownership of the Mortgage

MERS, Inc. constantly purports to assign mortgages. An assignment generally is understood as a “transfer of rights or property,”²⁵⁰ so when MERS, Inc. purports to assign the mortgage, it is claiming the capability, either as principal or as agent, to transfer a right or property interest in the mortgage it is assigning. Likewise, when courts affirm the validity of MERS, Inc.’s assignments of mortgages, they are affirming MERS, Inc.’s capability to transfer such interests. Although MERS assignments typically do not involve sales, they do involve transfers of property interests. A third party dealing with MERS, Inc. could reasonably believe that MERS, Inc. has the authority

²³³ See *Silving v. Wells Fargo Bank, N.A.*, 2011 WL 2669246, at *9 (D. Ariz. July 7, 2011).

²³⁴ *Coley v. Accredited Home Lenders, Inc.*, 2011 WL 1193072, at *3 (E.D. Ark. March 29, 2011).

²³⁵ *Perry*, *supra* note, at *4. The text of *Perry* encloses the word “Borrower” instead of “Lender” inside square brackets, but the context makes it absolutely clear that this is a ministerial error and that the court was discussing the lender’s rights, not the borrower’s. Immediately before the quoted material, the court quotes MERS form deed of trust, which addresses MERS’ rights respecting the *lender’s* interests, not the borrower’s.

²³⁶ See *In re Bryant*, 2011 WL 2883196, at *4 (Bankr. S.D. Ga. July 11, 2011).

²³⁷ See *MERS, Inc. v. Barnes*, 940 N.E.2d 118, 124 (App. Ct. Ill. 2010) (quoting “any or all interests” language in support of holding that MERS could foreclose in its own name).

²³⁸ See *In re Marron*, 2011 WL 2600543 (Bankr. D. Mass. June 29, 2011).

²³⁹ See *Kebasso v. BAC Home Loans Servicing, LP*, 2011 WL 2960219, at *4 (D. Minn. July 20, 2011).

²⁴⁰ *Kulovic v. BAC Home Loans Servicing, Inc.*, 2011 WL 1483374, at *6 (E.D. Mo. April 19, 2011).

²⁴¹ See *Chandler v. MERS, Inc.*, 2011 WL 3419819, at *1 (D. Nev. Aug. 2, 2011).

²⁴² See *Deutsche Bank Nat’l Trust Co. v. Pietranico*, 2011 WL 3198834, at *12 (N.Y. Sup. Ct. July 27, 2011).

²⁴³ See *Deutsche Bank Nat’l Trust Co. v. Greene*, 2011 WL 1590296, at *2 (Ohio Ct. App. April 22, 2011).

²⁴⁴ See *Beyer v. Bank of America*, 2011 WL 33559938, at *4 (Aug. 2, 2011).

²⁴⁵ See *Santarose v. Aurora Bank FSB*, 2010 WL 2232819, at *5 (S.D. Tex. June 2, 2010).

²⁴⁶ See *Commonwealth Property Advocates v. MERS, Inc.*, 2011 WL 2714429, at *3 (Ct. App. Utah July 14, 2011).

²⁴⁷ See *In re Burnett*, 2011 WL 2214667, at *2 (Bankr. W.D. Va. April 28, 2011).

²⁴⁸ See *Rhodes v. HSBC Bank USA N.A.*, 2011 WL 3159100, at *3 (W.D. Wash. July 26, 2011).

²⁴⁹ See *In re Martinez*, 2011 WL 996705, at *5 (Bankr. D. Wyo. March 16, 2011).

²⁵⁰ BRYAN A. GARNER ET AL., *BLACK’S LAW DICTIONARY* 115 (7th ed. 1999).

to pass good title to mortgages.

It might be argued that no one could think that MERS, Inc. has more than legal title to the mortgage, so it is clear that an assignment of the mortgage is an assignment only of the legal title. However, this is wrong. Some jurisdictions do recognize that it is possible to separate legal and beneficial interests in the mortgage,²⁵¹ but MERS, Inc. in fact claims a beneficial and not just a legal interest in the mortgages recorded in its name. MERS, Inc.’s form mortgage assignment purports to transfer “*the Assignor’s [i.e., MERS, Inc.’s] beneficial interest*” in the mortgage.²⁵² MERS, Inc.’s own documents make clear that it purports to transfer beneficial ownership, not just legal title.

Courts have affirmed time and again MERS, Inc.’s authority to assign the mortgages recorded in its name,²⁵³ including specifically the right to assign “its” (i.e., MERS, Inc.’s) beneficial interest.²⁵⁴ Although there is significant disagreement on the issue,²⁵⁵ the majority of courts appear to agree that MERS possesses actual authority to assign the mortgages, and a substantial number of courts find that MERS also possesses actual authority to assign the notes.²⁵⁶

MERS, Inc. and the members of MERS create the impression that MERS, Inc. is

²⁵¹ See *Jackson v. MERS, Inc.*, 770 N.W.2d 487, 499 (Minn. 2009) (“[I]t is possible for a party to hold legal title in the security instrument—title that evidences apparent ownership but not necessarily signify a beneficial interest—without holding an interest in the promissory note”).

²⁵² See, e.g., *Assignment of Mortgage, Ex. F to Affirmation of William C. Hultman*, Dec. 10, 2010, filed in *In re Agard*, Case No. 10-77338-REG (Bankr. E.D.N.Y.) (emphasis added). This particular assignment recites that MERS, Inc. is a nominee for First Franklin, the original lender on the mortgage. See *In re Agard*, 444 B.R., at 237. Our review of the cases retrieved by a search on “mers /s beneficial” on Aug. 6, 2011 in the ALLCASES database retrieved 136 instances in which MERS, Inc. purported to transfer a beneficial interest in a mortgage or deed of trust and no instances in which MERS, Inc. claimed that its assignment did not transfer a beneficial interest.

²⁵³ See *Bertrand v. SunTrust Mortgage, Inc.*, 2011 WL 1113421, at *4 (D. Ore. March 23, 2011) (MERS form mortgage “grants MERS the power to initiate foreclosure and to assign its beneficial interest under the deed of trust”); *Ferguson v. Avelo Mortg., LLC*, 2011 WL 2139143, at *5 (Cal. Ct. App. June 20, 2011) (MERS had authority to enforce mortgage, and accordingly so did a party to which it assigned the mortgage); *In re Marron*, at *5 (under Massachusetts law, MERS is deemed to hold mortgage in trust for note owner and has power to assign it); *In re Tucker*, 441 B.R. at 645-46.

²⁵⁴ See *Perry v. National Default Servicing Corp.*, 2010 WL 3325623, at *4 (N.D. Cal. Aug. 20, 2010); *Baisa v. Indymac Federal Bank*, 2009 WL 3756682, at *4 (E.D. Cal. Nov. 6, 2009). Although *Perry* and *Baisa* involved deeds of trust, they have been cited in cases involving “true” mortgages without any distinction being made, see *In re Marron*, 2011 WL 2600543, at *3; and MERS, Inc.’s form assignment does not appear to be different in states where “true” mortgages predominate.

²⁵⁵ See, e.g., *In re Martinez*, 444 B.R. 192, 206 (Bankr. D. Kan. 2011) (MERS was an agent of the lender and noteholder, so the lender “had the right to enforce the Note and Mortgage through its agent, MERS, or on its own (by directing its agent to assign the mortgage to it)”; *In re Agard*, 444 B.R. 231 (Bankr. E.D.N.Y. 2011) (questioning MERS, Inc.’s authorization as agent to assign mortgages).

²⁵⁶ See, e.g., *Deutsche Bank v. Greene*, 2011 WL 1590296, at *3 (Ohio Ct. App. April 22, 2011); *Taylor v. Deutsche Bank*, 44 So. 3d 618, 622-23 (Fla. Dist. Ct. App. 2010) (finding that MERS’ assignment of mortgage assigned note with it).

capable of transferring ownership interests in mortgages, and MERS, Inc. engages in such transfers every day.

3. MERS, Inc. as Owner: Claims of Outright Ownership and Other Property Interests in Mortgages

In addition to the claim in MERS, Inc.’s standard form mortgage assignment that MERS, Inc. has a “beneficial interest” in the mortgage that it can assign, MERS, Inc. has taken other positions that explicitly or implicitly claim an ownership interest in mortgages.

For example, MERS apparently has on occasion claimed outright ownership of the mortgages recorded in its name²⁵⁷ and of the associated notes.²⁵⁸ And MERS, Inc. apparently has described itself as a “creditor” in communications with borrowers.²⁵⁹

MERS has frequently prevailed on claims that it owns a constitutionally protected property interest in the mortgage and/or note.²⁶⁰ All these claims suggest that MERS, Inc. is not a mere nominee, and not even a mere agent, but instead the true owner of the mortgages.

Likewise, cases involving bankrupt homeowner/borrowers that find that the automatic stay causes an “injury in fact” to MERS, Inc. because MERS, Inc.’s “right to foreclose” is “impaired”²⁶¹ suggest that MERS, Inc. claims to own the right to foreclose, that is, to own the mortgage.

MERS has often claimed to be a “real party in interest” in foreclosure proceed-

²⁵⁷ See *MERS v. Young*, 2009 WL 1564994 (Tex. Ct. App. Ft. Worth June 4, 2009) (declining to accept MERS’ claim of ownership given state of record).

²⁵⁸ See *Chase Manhattan Mtge. Corp. v. Smith*, 2007 WL 3225534, at *3 (Ct. App. Ohio Nov. 2, 2007) (“MERS was the mortgage holder. . . MERS also owned the note on the loan.”).

²⁵⁹ See *Trent v. MERS, Inc.*, 288 Fed. Appx. 571, 572 (11th Cir. 2008) (dismissing unfair business practice claim against MERS, Inc. based on its self-description as creditor on ground that MERS, Inc. “has the legal right to foreclose”).

²⁶⁰ *Renkemeyer v. MERS, Inc.*, 2010 WL 3878572, at *1, *2 (D. Kan. 2010) (in case where MERS, Inc. argued that its interest as holder of legal title “arises to the level of a protected property interest and that its absence would therefore violate due process” and homeowners argued that “MERS has no real interest in the mortgage as a mere nominee of the lender or the holder of the note,” finding for MERS, Inc. on ground that it “claims an interest as nominee under the mortgage that is protected by the due process clause”). *Renkemeyer* states that the “argument that MERS has no independent interest as a mere nominee of the lender would seem to contradict [the] theory that the mortgage is unenforceable because the interests of the mortgage and the note have been separated.” *Id.* at n.2. Rephrasing this statement in formal logical terms, the court seems to be saying that “no MERS interest” implies “no separation” (because it would be “contradictory” if “no MERS interest” and “separation” were both true). As any assertion of this form is identical with its contrapositive, the court seems to be saying that “separation” implies “independent MERS interest.” The court’s logic implies that the cases finding the MERS does separate mortgage and note imply that MERS does have an independent interest in the mortgage once split. See also *MERS, Inc. v. Bellistri*, 2010 WL 2720802, at *14 (E.D. Mo. 2010) (“MERS had a legal right to file suit to foreclose the mortgage under [state statute]. The right to file a lawsuit is a constitutionally recognized property interest.”).

²⁶¹ See *In re Freeman*, 446 B.R. 625, 629 (Bankr. S.D. Ga. 2010).

ings, a status that in many states requires—as the name suggests—a true interest in the proceedings. MERS repeatedly has claimed to have standing in such cases and sometimes has prevailed.²⁶²

Mere registration systems do not own beneficial interests in mortgages, do not have constitutionally protected property interests in mortgages, do not suffer “injury in fact” when foreclosures are delayed, and are not “real parties in interest” in foreclosure proceedings.

It is hard to avoid the conclusion, reached by others,²⁶³ that MERS is fundamentally self-contradictory. Sometimes it is a passive nominee, sometimes a robust agent, sometimes a true owner. The problem for MERS, Inc. is that more aggressive versions of its powers undermine its reason for existing, because they create unacceptable risk to the bankruptcy remoteness of the transactions MERS was created to facilitate.

To some extent, MERS, Inc.’s predicament is a symptom of a recording entity that just got too greedy. MERS, Inc. does not inherently need to claim the power to foreclose on mortgages in its own name or various other rights and powers as principal and agent that it or its members have from time to time found it convenient to assert. A modest agent-based recording utility that sticks to recording could avoid much of the risk to bankruptcy remoteness.

But an agent-based national recording utility must at least claim the authority to assign (convey) legal title to mortgages, because foreclosure statutes in many states require a chain of assignments. There is no avoiding the risk that a court might find that this power to convey could reasonably be interpreted by a third party acting in good faith as the power to sell. Even if the probability of such a finding is low, recording a very large number of mortgages with the same utility—so that a single court’s finding could affect, say, 60 million mortgages—seems to introduce tremendous risk into the system. This appears to be a fundamental design flaw of the single-agent-based national recording model.

5.3 The Risk of MERS, Inc. Bankruptcy is Not “Remote”

MERS, Inc. apparently is a shell company without substantial assets. The assumption behind structuring MERS, Inc. in this way—that an entity can be empowered to legally own, assign, and foreclose on scores of millions of mortgages without incurring substantial

²⁶² See *MERS, Inc. v. Harris-Gordon*, 2011 WL 1590082, at *1-*2 (Ct. App. Ohio April 22, 2011) (rejecting homeowner/borrower’s claim that MERS was not “real party in interest”)

²⁶³ See Peterson, *supra* note 59; David P. Weber, *The Magic of the Mortgage Electronic Registration System: It Is and It Isn’t*, available on SSRN.

litigation risk—is questionable on its face, and the litigation risk to MERS, Inc. has now materialized.

At this writing, MERS, Inc. is a defendant in multidistrict litigation pled by 86 individual plaintiffs²⁶⁴ as a class action on behalf of all residents of Arizona, California, Nevada, and South Carolina²⁶⁵ damaged by certain conduct of MERS, Inc, and other major mortgage industry participants. The gravamen of the lawsuit is that recording in the name of MERS, Inc. as nominee splits mortgage and note, causing the note to become unsecured,²⁶⁶ so that efforts to foreclose on MERS mortgages are wrongful.

The MDL class action against MERS, Inc. has not yet been tested by a motion to dismiss and no class has been certified. Nevertheless, the scope of the action illustrates the potential magnitude of MERS, Inc.’s exposure.

MERS, Inc. is also exposed to potential claims from government officials. Local recorders in Massachusetts²⁶⁷ and North Carolina²⁶⁸ have suggested that MERS, Inc. owes large sums in evaded filing fees. State attorneys general, are currently investigating the company²⁶⁹ and could commence formal action against it. Massachusetts’ Attorney General recently declared that her state “will not sign on” to any settlement that includes a comprehensive liability release for “securitization and MERS conduct” and that “responsible parties must be held accountable in order to fully protect homeowners and return to a healthy economy.”²⁷⁰

Certainly, MERS, Inc. may escape unscathed from the lawsuits and investigations in which it is currently entangled.²⁷¹ But the likelihood of a scenario in which MERS, Inc.’s

²⁶⁴See United States Judicial Panel on Multidistrict Litigation, “Pending MDLs,” http://www.jpml.uscourts.gov/Pending_MDLS/pending_mdls.html, accessed Aug. 9, 2011.

²⁶⁵See Plaintiffs’ Consolidated Amended Master Complaint Regarding Claims Related to the Formation and Operation of the MERS System, June 4, 2011, Case No. 02:09-md-02119-JAT (D. Ariz.) (MDL-2119) [hereinafter MDL Complaint], at ¶¶226-27.

²⁶⁶MDL Complaint, ¶¶7, 10.

²⁶⁷See Press Release, Commonwealth of Massachusetts Southern Essex District Registry of Deeds, Feb. 22, 2011 (“Essex South Register of Deeds John O’Brien announced today that he will be seeking over 22 million dollars from the Mortgage Electronic Registration System.”).

²⁶⁸See Press Release, Guilford County, North Carolina Register of Deeds, March 2, 2011 (“Guilford County Register of Deeds Jeff Thigpen announced today that he will be conferring with [law enforcement officials] as to whether the Mortgage Electronic Registration Service (MERS) owes Guilford County fees estimated at \$1.3 million in lost revenue from mortgage assignments.”).

²⁶⁹Letter from Martha Coakley, Attorney General, Commonwealth of Massachusetts to William P. O’Donnell, Register of Deeds, Norfolk Registry District of the Land Court, July 25, 2011 (“[W]e are currently investigating creditor misconduct in connection with unlawful foreclosures. . . We have focused particularly on creditors’ reliance on MERS and whether MERS conforms to the requirements of Massachusetts law, in the context of foreclosures and otherwise. In the next week, we plan to send civil investigative demands to Registers in order to gather critical information to our investigation, and appreciate your continuing cooperation in this process.”).

²⁷⁰*Id.*

²⁷¹The basic point of the private lawsuit is that MERS, Inc. lacked authority to assign and foreclose mortgages. That may appear to be in tension with the argument presented here, that MERS, Inc. appears

adversaries prevail, become large creditors, force MERS, Inc. into bankruptcy, and attempt to bring securitized mortgages into the MERS, Inc. bankruptcy estate can hardly be described as “remote.”

6 Conclusions

Using MERS rather than traditional recording for mortgage assignments increases the risk that mortgage securitizations are not bankruptcy remote, seemingly to an unacceptable level.

Although MERS apparently seemed like a promising way for the securitization industry to deal with the problem of dealing with thousands of county recorders to perform each of the several assignments of each mortgage in each transaction, the system is failing to work reliably and that MERS, Inc. as constituted poses serious risks to securitization. In this context, it is natural to look for alternatives to MERS, and several have been proposed.

One suggestion is simply to open up MERS to public scrutiny so that members of the public could determine who owns mortgages recorded on MERS.²⁷² Although this would deal with the single most telling substantive objection to MERS—that it shrouds mortgage ownership in secrecy—simply making MERS more transparent would not cause it to come into compliance with state recording statutes. State laws contemplate and often require that mortgage assignments be recorded with public officers, not on a private database. Accordingly, this approach would not solve the outstanding legal problems with MERS, although it might motivate courts to look more favorably upon the system.

Another idea is to establish a federal title recording system that would accept electronic filings.²⁷³ To make this work, Congress would have to preempt state law in the area or states would have to amend their recording statutes to give effect to records in the new federal system. Congressional preemption seems unworkable given states’ historic control over land title law. Perhaps state recording statutes could be amended through the uniform-law process to accept recording of assignments on a transparent (and possibly regulated) version of MERS or on a new federal title system.

to have authority to sell mortgages. Thus, this lawsuit does not threaten existing securitizations because if MERS, Inc. loses the private lawsuit, that means it lacks authority to assign and foreclose mortgages, which means it lacks authority to sell mortgages. However, MERS, Inc. could settle the private lawsuits for a large sum without admitting the underlying facts, courts could find that MERS, Inc. lacked authority to convey mortgages but created the impression that it did, or MERS, Inc.’s bankruptcy court could simply decide the issues differently, as it probably would not be bound by any collateral estoppel effect of rulings in the main lawsuit.

²⁷²See Robert E. Dordan, *Mortgage Electronic Registration Systems (MERS), Its Recent Legal Battles, and the Chance for a Peaceful Existence*, 12 LOY. J. PUB. INT. L. 177, 207 (2010).

²⁷³See Tanya Marsh, *Foreclosures and the Failure of the American Land Title Recording System*, 111 COLUM. L. REV. SIDEBAR 19, 24-26 (2011).

The simplest alternative to MERS—and the only alternative that seems feasible in the short term—is simply to record mortgage assignments as provided by existing state recording statutes. Cumbersome and expensive though this may be, it increasingly seems like a superior alternative to MERS. The present lull in securitization activity may be a good time to redesign securitization processes to accommodate traditional recording in an age of electronic transfers and rapid deal flow. In the medium term, working with state and local officials to upgrade land title systems to accommodate electronic recording is a strategy that seems to avoid much of the potential conflict associated with either preemption or the uniform-act approach.

A State Recording Statutes

The Appendix reviews the state recording statutes for each of the ten states with the largest numbers of mortgages securitized in private-label transactions.

A.1 California

The California Civil Code provides:

Every conveyance of real property or an estate for years therein, other than a lease for a term not exceeding one year, is void as against any subsequent purchaser or mortgagee of the same property, or any part thereof, in good faith and for a valuable consideration, whose conveyance is first recorded, and as against any judgment affecting the title, unless the conveyance shall have been duly recorded prior to the record of notice of action.²⁷⁴

This is a “race-notice” statute, which means that a later-created lien can take precedence over an earlier-created one when:

- The earlier lien was not recorded;
- The later lienholder was without notice of the earlier lien;
- The later lienholder gave value for the lien; and
- The later lien was recorded first.²⁷⁵

The statute covers “every conveyance of real property or an estate for years therein”²⁷⁶ It is not crystal clear from the Code that the grant or transfer of a mortgage—as opposed to, say, a fee simple interest in the land itself—is a “conveyance of real property.”²⁷⁷ But the

²⁷⁴CAL. CIVIL CODE §1214; see also CAL. CIVIL CODE §1107 (grant of an estate in real property is conclusive against the grantor and against those claiming under grantor, “except a purchaser or incumbrancer who in good faith and for a valuable consideration acquires a title or lien by an instrument that is first duly recorded”).

²⁷⁵2 ROGER BERNHARDT, CALIFORNIA MORTGAGES, DEEDS OF TRUST, AND FORECLOSURE LITIGATION §9.44, at 755.

²⁷⁶CAL. CIVIL CODE §1214; see also *id.* §1107 (grant of an estate in real property is conclusive against the grantor and against those claiming under grantor, “except a purchaser or incumbrancer who in good faith and for a valuable consideration acquires a title or lien by an instrument that is first duly recorded”).

²⁷⁷See CAL. CIVIL CODE §658 (“Real or immovable property consists of: (1) Land; (2) That which is affixed to land; (3) That which is incidental or appurtenant to land; (4) That which is immovable by law.”). It is not clear that a mortgage falls into any of these categories, although it might be “incidental to” land. *But see* CAL. CIVIL CODE §1215 (“The term ‘conveyance,’ as used in Sections 1213 and 1214, embraces every instrument in writing by which any estate or interest in real property is created, aliened, mortgaged, or incumbered, or by which the title to any real property may be affected, except wills.”). Assuming that a mortgage is an “interest” in real property, this language seems to sweep in the creation and transfer (alienation) of a mortgage. Even if a mortgage is not an “interest” in real property, it seems likely that a mortgage can “affect” the title to real property.

courts that have addressed the issue have found that the statute covers both the grant²⁷⁸ and the sale²⁷⁹ of a mortgage or deed of trust.

Thus, California’s recording statute seems to cover mortgage assignments, and California’s courts have found—at least implicitly—that mortgages and deeds of trust are real property interests.

A.2 Florida

Florida’s general recording statute, a “notice” statute,²⁸⁰ covers any “conveyance, transfer, or mortgage of real property”:

No conveyance, transfer, or mortgage of real property, or of any interest therein, nor any lease for a term of 1 year or longer, shall be good and effectual in law or equity against creditors or subsequent purchasers for a valuable consideration and without notice, unless the same be recorded according to law; nor shall any such instrument made or executed by virtue of any power of attorney be good or effectual in law or in equity against creditors or subsequent purchasers for a valuable consideration and without notice unless the power of attorney be recorded before the accruing of the right of such creditor or subsequent purchaser.²⁸¹

Florida also has a special statute applicable specifically to mortgage assignments:

(1) An assignment of a mortgage upon real property or of any interest therein, is not good or effectual in law or equity, against creditors or subsequent purchasers, for a valuable consideration, and without notice, unless the assignment

²⁷⁸See *In re Cortez*, 191 B.R. 174 (B.A.P. 9th Cir. 1995) (“In California, the deed of trust is an instrument providing security or collateral which must be perfected by recordation to bind subsequent purchasers. The deed of trust is not perfected until it is recorded in the office of the County Recorder.”); *In re Planned Protective Servs., Inc.*, 130 B.R. 914 (Bankr. C.D. Cal. 1991) (stating, with reference to a deed of trust, “[p]rior to recordation, an interest in real property is not effective against intervening creditors”); *Frey v. Clifford*, 44 Cal. 335, 342 (1872) (“[A] mortgagee, in a mortgage given for the security of a preexisting debt, is to be regarded in this state as a purchaser for valuable consideration” under the recording statute).

²⁷⁹See *Taylor v. Weston*, 77 Cal. 534, 537-38 (1888) (“Under [the recording laws] operation the purchase of an apparent legal title may in some cases be protected by the rule as to bona fide purchasers . . . and the purchaser of a mortgage . . . is within its operation”); *Schelling v. Thomas*, 274 P. 755, 757 (Cal. Ct. App. 1929) (“conveyance” in Civil Code §1214 includes mortgages; where assignor mortgagee had priority over prior mortgagee because assignor was first to record, assignee who purchased mortgage from assignor also had priority over prior mortgagee).

²⁸⁰See *Argent Mortg. Co. v. Wachovia Bank, N.A.*, 52 So.3d 796, 798-99 (Fla. Dist. Ct. App. 2010) (“[c]ommentators appear uniformly to categorize section 691.01 as a ‘notice’ type of recording statute.”) (citing 2 RALPH E. BOYER, FLORIDA REAL ESTATE TRANSACTIONS §26.02 (2010) and Florida caselaw).

²⁸¹FLA. STAT. ANN. §695.01.

is contained in a document that, in its title, indicates an assignment of mortgage and is recorded according to law.

(2) This section also applies to assignments of mortgages resulting from transfers of all or any part or parts of the debt, note or notes secured by mortgage, and none of same is effectual in law or in equity against creditors or subsequent purchasers for a valuable consideration without notice, unless a duly executed assignment be recorded according to law.

(3) Any assignment of a mortgage, duly executed and recorded according to law, purporting to assign the principal of the mortgage debt or the unpaid balance of such principal, shall, as against subsequent purchasers and creditors for value and without notice, be held and deemed to assign any and all accrued and unpaid interest secured by such mortgage, unless such interest is specifically and affirmatively reserved in such an assignment by the assignor, and a reservation of such interest or any part thereof may not be implied.

(4) Notwithstanding subsections (1), (2), and (3) governing the assignment of mortgages, chapters 670-680 of the Uniform Commercial Code of this state govern the attachment and perfection of a security interest in a mortgage upon real property and in a promissory note or other right to payment or performance secured by that mortgage. The assignment of such a mortgage need not be recorded under this section for purposes of attachment or perfection of a security interest in the mortgage under the Uniform Commercial Code.

(5) Notwithstanding subsection (4), a creditor or subsequent purchaser of real property or any interest therein, for valuable consideration and without notice, is entitled to rely on a full or partial release, discharge, consent, joinder, subordination, satisfaction, or assignment of a mortgage upon such property made by the mortgagee of record, without regard to the filing of any Uniform Commercial Code financing statement that purports to perfect a security interest in the mortgage or in a promissory note or other right to payment or performance secured by the mortgage, and the filing of any such financing statement does not constitute notice for the purposes of this section. For the purposes of this subsection, the term mortgagee of record means the person named as the mortgagee in the recorded mortgage or, if an assignment of the mortgage has been recorded in accordance with this section, the term mortgagee of record means the assignee named in the recorded assignment.²⁸²

²⁸²FLA. STAT. ANN. §701.02.

The basic provision, in subsection (1), is a “notice” statute for mortgage assignments. But paragraphs (4) and (5) alter this notice rule in important ways. Paragraph (4) expressly defers to the U.C.C.’s rules on attachment and perfection of security interests in mortgages, and does so “[n]otwithstanding” subsection (1).²⁸³ This may mean that mortgage recording is not required to protect priority when the note is transferred according to the U.C.C. Florida’s recording statute appears to be rare in having a provision that expressly defers to the U.C.C.’s rules.²⁸⁴

Paragraph (5) authorizes any purchaser of any interest in real property to rely on an assignment of mortgage by the mortgagee of record. MERS, Inc. is the mortgagee of record in MERS transactions. Thus, if Florida followed the general rule that a mortgage is an interest in real property, then a purported purchaser of the mortgage from MERS, Inc. would be entitled to rely on the assignment from MERS, Inc. Thus, this provision could actually increase the risk to bankruptcy remoteness arising from the use of MERS.

However, at least some Florida caselaw indicates that Florida departs from the general rule and does not treat a mortgage as an interest in real property.²⁸⁵ Paragraph (5) thus may not be relevant to conflicts over mortgage ownership.

In sum, Florida’s basic recording provision covering mortgage assignments may be superseded by the 2000 amendments to the U.C.C., and Florida may not treat mortgages as real property interests.

A.3 Texas

Texas has a “notice” recording statute that applies by to any “conveyance of real property or an interest in real property or a mortgage or deed of trust”:

- A conveyance of real property or an interest in real property or a mortgage or deed of trust is void as to a creditor or to a subsequent purchaser for a valuable consideration without notice unless the instrument has been acknowledged, sworn to, or proved and filed for record as required by law.
- The unrecorded instrument is binding on a party to the instrument, on the party’s heirs, and on a subsequent purchaser who does not pay a valuable consideration or who has notice of the instrument.

²⁸³ See discussion *supra* Part 4.5.1.

²⁸⁴ A Westlaw search on July 27, 2011 in the ST-ANN-ALL database on the phrase “security interest in a mortgage” revealed that only Florida and Maryland use the term in their real property statutes.

²⁸⁵ *Barclay v. Robert C. Malt & Co.*, 985 So. 2d 53, 55 (Fla. Dist. Ct. App. 2008) (citing *Martyn v. First Fed. Sav. & Loan Ass’n of W. Palm Beach*, 257 So. 2d 576, 477-78 (Fla. Dist. Ct. App. 1971)).

- This section does not apply to a financing statement, a security agreement filed as a financing statement, or a continuation statement filed for record under the Business & Commerce Code.²⁸⁶

The text seems to distinguish between a mortgage and an “interest in real property,” suggesting that a mortgage may not be a real property interest. Nevertheless, Texas courts have recognized that “lienholders have an equitable interest in the secured property.”²⁸⁷

The Texas recording statute appears to apply to mortgage assignments, and Texas recognizes that a mortgage is a real property interest.

A.4 Illinois

Illinois has a “notice” recording statute that by its terms applies to “mortgages”:

All deeds, mortgages and other instruments of writing which are authorized to be recorded, shall take effect and be in force from and after the time of filing the same for record, and not before, as to all creditors and subsequent purchasers, without notice; and all such deeds and title papers shall be adjudged void as to all such creditors and subsequent purchasers, without notice, until the same shall be filed for record.²⁸⁸

Illinois also goes farther than some other states in that it apparently *requires* that mortgages be recorded, rather than simply making unrecorded mortgages potentially vulnerable:

Deeds, mortgages, powers of attorney, and other instruments relating to or affecting the title to real estate in this state, shall be recorded in the county in which such real estate is situated; but if such county is not organized, then in the county to which such unorganized county is attached for judicial purposes. No deed, mortgage, assignment of mortgage, or other instrument relating to or affecting the title to real estate in this State may include a provision prohibiting the recording of that instrument, and any such provision in an instrument signed after the effective date of this amendatory Act shall be void and of no force and effect. ²⁸⁹

²⁸⁶TEX PROP. CODE §13.001.

²⁸⁷Matagorda Cty. v. Russell Law, 19 F.3d 215, 221 (5th Cir. 1994) (citing Flag-Redfern Oil. Co. v. Humble Exploration Co., 744 S.W.2d 6, 8 (Tex. 1988)).

²⁸⁸ILL. CODE Ch. 765 §30.

²⁸⁹See ILL. CODE Ch. 765 §5/28.

Illinois courts have described a mortgage as a “real property interest.”²⁹⁰

The Illinois recording statute appears to apply to mortgage assignments, and a mortgage is a real property interest under Illinois law.

A.5 New York

New York has a “race-notice” statute that covers any “conveyance of real property.”

A conveyance of real property, within the state, on being duly acknowledged by the person executing the same, or proved as required by this chapter, and such acknowledgment or proof duly certified when required by this chapter, may be recorded in the office of the clerk of the county where such real property is situated, and such county clerk shall, upon the request of any party, on tender of the lawful fees therefor, record the same in his said office. Every such conveyance not so recorded is void as against any person who subsequently purchases or acquires by exchange or contracts to purchase or acquire by exchange, the same real property or any portion thereof, or acquires by assignment the rent to accrue therefrom as provided in section two hundred ninety-four-a of the real property law, in good faith and for a valuable consideration, from the same vendor or assignor, his distributees or devisees, and whose conveyance, contract or assignment is first duly recorded, and is void as against the lien upon the same real property or any portion thereof arising from payments made upon the execution of or pursuant to the terms of a contract with the same vendor, his distributees or devisees, if such contract is made in good faith and is first duly recorded. Notwithstanding the foregoing, any increase in the principal balance of a mortgage lien by virtue of the addition thereto of unpaid interest in accordance with the terms of the mortgage shall retain the priority of the original mortgage lien as so increased provided that any such mortgage instrument sets forth its terms of repayment.²⁹¹

Although New York’s statute does not mention mortgages expressly, New York’s courts have held that both the grant and the assignment of a mortgage falls within the statute’s scope.²⁹² New York case law treats mortgages as real property interests.²⁹³ As one recent

²⁹⁰Fuller Family Holdings, Inc. v. Northern Trust Co., 863 N.E.2d 743, 751 (Ill. App. 2007) (describing mortgagee’s security interest as “real property interest”).

²⁹¹N.Y. REAL PROP. LAW §291.

²⁹²Fox v. Sizeland, 9 N.Y.S.2d 350 (N.Y. Sup. 1938).

²⁹³See, e.g., Halstead v. Dolphy, 892 N.Y.S.2d 897, 897 (N.Y. App. Div. 2010) (treating mortgage as interest in real property); Gerow v. Sinay, 905 N.Y.S.2d 827, 831 (N.Y. Sup. 2010) (treating mortgagee as party that had “acquire[d] an interest” in real property);

opinion explained: “Distilled to its essence, a mortgage is a conveyance of an estate in land that is expressly intended to constitute security for some obligation., most commonly an indebtedness. It follows logically then that in order for a mortgage to be valid and subsisting, there must be an underlying obligation that is to be secured by an interest in real property,”²⁹⁴

New York’s recording statute covers mortgage assignments, and a mortgage is a real property interest under New York law.

A.6 Arizona

Arizona has a notice statute covering “instrument[s] affecting real property”:

- A No instrument affecting real property gives notice of its contents to subsequent purchasers or encumbrance holders for valuable consideration without notice, unless recorded as provided by law in the office of the county recorder of the county in which the property is located.
- B An instrument shall not be deemed lawfully recorded unless it has been previously acknowledged in the manner prescribed in this chapter except in the case of master mortgages as provided in §33-415.
- C For purposes of this section, an instrument affecting real property containing any defect, omission or informality in the certificate of acknowledgment and which has been recorded for longer than one year in the office of the county recorder of the county in which the property is located shall be deemed to have been lawfully recorded on and after the date of its recording.
- D An instrument affecting real property in this state executed, acknowledged and certified in any other state in accordance with the laws of that state, shall be valid and entitled to record as if executed in accordance with the laws of this state.
- E Letters patent from the United States or any grant from the government, executed and authenticated pursuant to law, may be recorded without further acknowledgment.²⁹⁵

Another provision expressly requires recording of “[a]ny document evidencing. . . transfer of real estate or any legal or equitable interest therein, excluding leases”:

²⁹⁴Beneficial Homeowner Serv. Corp. v. Steele, 2011 WL 6172, at *2 (N.Y. Sup. Ct. Jan. 7, 2011).

²⁹⁵ARIZ. REV. STAT. ANN. §33-411.

Any document evidencing the sale, or other transfer of real estate or any legal or equitable interest therein, excluding leases, shall be recorded by the transferor in the county in which the property is located and within sixty days of the transfer. In lieu thereof, the transferor shall indemnify the transferee in any action in which the transferee's interest in such property is at issue, including costs, attorney's fees and punitive damages.²⁹⁶

The grant of a mortgage is the sale of an interest in real property under Arizona law.²⁹⁷ Arizona's recording statute appears to cover mortgage assignments and to affirmatively require recording, and a mortgage is a real property interest under Arizona law.

A.7 Georgia

Georgia has a race-notice statute that covers “[e]very deed conveying lands.”²⁹⁸

Every deed conveying lands shall be recorded in the office of the clerk of the superior court of the county where the land is located. A deed may be recorded at any time; but a prior unrecorded deed loses its priority over a subsequent recorded deed from the same vendor when the purchaser takes such deed without notice of the existence of the prior deed.²⁹⁹

There is some doubt about whether the statute covers mortgage assignments.³⁰⁰ It appears that a mortgage is considered a real property interest under Georgia law.³⁰¹

Georgia's recording statute, which affirmatively requires recording, may not cover mortgage assignment. A mortgage appears to be a real property interest under Georgia law.

A.8 Virginia

Virginia has a “notice” statute that covers any “deed of gift, or deed of trust, or mortgage conveying real estate”:

²⁹⁶ARIZ. REV. STAT. ANN. §33-411.01

²⁹⁷*Owens v. M.E. Schepp Ltd. Partnership*, 165 P.3d 674, 681 (Ariz. App. Div. 2007) (citing *Fremming Constr. Co. v. Sec. Sav. & Loan Ass'n*, 566 P.2d 315, 317 (Ariz. App. 1977), *vacated on other grounds* 182 P.3d 775 (Ariz. 2008)).

²⁹⁸GA. CODE. ANN. §44-2-1.

²⁹⁹GA. CODE ANN. §44-2-1.

³⁰⁰*See Thomas v. Hudson*, 192 Ga. 622, 627 (Ga. 1940).

³⁰¹*See In re Jackson*, 446 B.R. 608, 609 n.1 (“Under Georgia law, a creditor may acquire an interest in real estate to secure a debt either through a mortgage, which creates only a lien on the real property, or a deed to secure debt . . . which transfers legal title”). *See also Equity Inv. Partners, L.P. v. Lenz*, 594 F.2d 1338, 1340 (11th Cir. 2010); *Tompkins v. United States*, 946 F.3d 817, 819 n.2 (11th Cir. 1991).

A. 1. Every (i) such contract in writing, (ii) deed conveying any such estate or term, (iii) deed of gift, or deed of trust, or mortgage conveying real estate or goods and chattels and (iv) such bill of sale, or contract for the sale of goods and chattels, when the possession is allowed to remain with the grantor, shall be void as to all purchasers for valuable consideration without notice not parties thereto and lien creditors, until and except from the time it is duly admitted to record in the county or city wherein the property embraced in such contract, deed or bill of sale may be. The fact that any such instrument is in the form of or contains the terms of a quit-claim or release shall not prevent the grantee therein from being a purchaser for valuable consideration without notice, nor be of itself notice to such grantee of any unrecorded conveyance of or encumbrance upon such real estate goods and chattels. The mere possession of real estate shall not, of itself, be notice to purchasers thereof for value of any interest or estate therein of the person in possession. As to goods whose possession is retained by a merchant-seller the provisions of subsection (2) of §8.2-402 of the Uniform Commercial Code shall be controlling. This section shall not apply to any security interest in goods under the Uniform Commercial

Code except as provided in subsection (5) of §8.9-302. [FN1] Any bill of sale or contract for the sale of goods or chattels when possession is allowed to remain with the grantor shall be deemed to be duly recorded when it is filed in the same manner as Uniform Commercial Code financing statements are filed under the criteria and in the places established by §8.9A-501 as if the grantor were a debtor and the grantee a secured party. A recordation under the provisions of this section shall, when any real estate subject to the lien of any such contract has been annexed to or merged with an adjoining city subsequent to such docketing, be deemed to have been recorded in the proper clerk's office of such city.

2. The clerk of each court in which any such instrument is by law required to be recorded shall keep a daily index of all such instruments admitted to record in his office, and, immediately upon admission of any such instrument to record, the clerk shall index the same either in the daily index or the appropriate general index of his office. All instruments indexed in the daily index shall be indexed by the clerk in the appropriate general index within 90 days after admission to record. During the period permitted for transfer from the daily index to the general index, indexing in the daily index shall be a sufficient compliance with the requirements of this section as to indexing.

3. a. In any circuit court in which any such instrument required to be

recorded is not recorded on the same day as delivered, the clerk shall install a time stamp machine. The time stamp machine shall affix the current date and time of each delivery of any instrument delivered to the clerk for recording that is not immediately recorded and entered into the general or daily index.

b. In the event there is no time stamp machine, or it is not functioning, the clerk shall designate an employee to affix the current date and time of each delivery of any instrument delivered to the clerk for recording.

c. In any circuit court in which instruments required to be recorded are not recorded on the same day as delivered, for purposes of subdivision 1 of this subsection, the term “from the time it is duly admitted to record” shall be presumed to be the date and time affixed upon the instrument by the time stamp machine or affixed by the clerk in accordance with subdivision 3 b of this subsection unless the clerk determines that the applicable requirements for recordation of the instrument have not been satisfied.

d. The provisions of subdivision 3 shall not apply to certificates of satisfaction or partial satisfaction or assignments of deeds of trust delivered to the clerk’s office other than by hand.

B. A credit line deed of trust, recorded pursuant to §55-58.2, shall have validity and priority over any (i) contract in writing, deed, conveyance or other instrument conveying any such estate or term subsequently recorded or (ii) judgment subsequently docketed as to all advances made under such credit line deed of trust from the date of recordation of such credit line deed of trust, regardless of whether or not the particular advance or extension of credit has been made or unconditionally committed at the time of delivery or recordation of such contract in writing, deed or other instrument or the docketing of such judgment. Any judgment creditor shall have the right to give the notice contemplated by §55-58.2 and from the day following receipt of such notice, the judgment as docketed shall have priority over all subsequent advances made pursuant to the credit line deed of trust except those which have been unconditionally and irrevocably committed prior to such date. Mechanics’ liens created under Title 43 shall continue to enjoy the same priority as created by that title. Purchase money security interests in goods and fixtures shall have the same priority as provided in §8.9A-317 et seq.³⁰²

The statute appears to cover assignments of mortgages, and the text suggests that a mortgage is a real estate interest under Virginia law.

³⁰²VA. CODE ANN. §55-96.

A.9 Michigan

Michigan has a race-notice statute that covers any “conveyance of real estate”:

Every conveyance of real estate within the state hereafter made, which shall not be recorded as provided in this chapter, shall be void as against any subsequent purchaser in good faith and for a valuable consideration, of the same real estate or any portion thereof, whose conveyance shall be first duly recorded. The fact that such first recorded conveyance is in the form or contains the terms of a deed of quit-claim and release shall not affect the question of good faith of such subsequent purchaser, or be of itself notice to him of any unrecorded conveyance of the same real estate or any part thereof.³⁰³

Under Michigan law, “a mortgage represents an interest in real property contingent on the failure of the borrower to repay the lender.”³⁰⁴ The grant of a mortgage is a “conveyance” covered by the recording laws³⁰⁵ as is a mortgage assignment.³⁰⁶

Thus, Michigan’s recording statute covers mortgage assignments, and a mortgage is a real property interest under Michigan law.

A.10 Maryland

Maryland has a “race-notice” statute that covers “[e]very recorded deed or other instrument.”:

Every recorded deed or other instrument takes effect from its effective date as against the grantee of any deed executed and delivered subsequent to the effective date, unless the grantee of the subsequent deed has:

- (1) Accepted delivery of the deed or other instrument:
 - (i) In good faith;
 - (ii) Without constructive notice under §3-202; and
 - (iii) For a good and valuable consideration; and
- (2) Recorded the deed first.³⁰⁷

Some judicial authority indicates that the recording statute covers mortgages.³⁰⁸

³⁰³MICH. COMP. LAWS §565.29.

³⁰⁴Residential Funding Co. v. Saurman, 2011 WL 1516819 (Mich. Ct. App. April 21, 2011) (unnumbered page); *see also id.* (“The indebtedness, i.e., the note, and the mortgage are two different things.”).

³⁰⁵Stover v. Bryant & Detwiler Imp. Corp., 45 N.W.2d 364, 365 (Mich. 1951); *see also* MICH. COMP. LAWS §565.35.

³⁰⁶Qual-Prop LLC v. Chase Manhattan Mortgage Corp., 2005 WL 3501586, at *1-*2 (Mich. Ct. App. Dec. 22, 2005).

³⁰⁷MD. REAL PROP. CODE §3-203.

³⁰⁸See Bourke v. Crick, 304 F.2d 501, 503, 505 n.12 (4th Cir. 1962).

Maryland has a statutory provision that may affirm the primacy of Article 9, but this is unclear:

(a) Every deed which by any other writing appears to have been intended only as security for payment of an indebtedness or performance of an obligation, though expressed as an absolute grant is considered a mortgage. The person for whose benefit the deed is made may not have any benefit or advantage from the recording of the deed, unless every other writing operating as a defeasance of it, or explanatory of its being intended to have the effect only of a mortgage, also is recorded in the same records at the same time.

(b) Subsection (a) of this section is not applicable to the grant of a security interest in a mortgage by a mortgagee, or one of several mortgagees, or any assignee of his interest in a mortgage as security for payment of an indebtedness or performance of an obligation. Such a transaction is governed by Title 9 of the Maryland Uniform Commercial Code.³⁰⁹

Section 7-101(b) apparently covers only “the grant of a security interest in a mortgage... as security for payment of an indebtedness of performance of an obligation.” On its face, this seems to refer only to grants of true security interests in mortgages, not to sales.³¹⁰

It appears that Maryland’s recording statute probably covers mortgage assignments, and that a mortgage is a real property interest under Maryland law.³¹¹

³⁰⁹MD. REAL PROP. CODE §7-101.

³¹⁰Certainly, the distinction between the grant of a security interest and a sale has been challenged by commentators, and current Article 9 treats the sale of a promissory note as a type of grant of a security interest. Nevertheless, the “as security for payment” language suggests that a distinction is intended here.

³¹¹General Ins. Co. v. United States Ins. Co., 10 Md. 517 (1857).

B GSAMP 2006-HE3 and Article 9

We examined the path of the loans sold into the GSAMP 2006 HE-3 transaction by one of the originators, Aames Capital Corporation, to determine whether each step of the transaction was structured as an Article 9 sale of the notes. It appears that the transaction documents are structured as Article 9 sales at each stage, although simply reviewing the documents cannot resolve the issue whether value was actually given for the notes at each stage of the transaction.

1. Transfer from originators to Sponsor (Goldman Sachs Mortgage Co.)

For each originator, this transfer is governed by the Flow Mortgage Loan Purchase and Warranties Agreement between Goldman Sachs Mortgage Company and the originator.³¹² Each of these agreements appears to be structured to follow the requirements for an Article 9 sale. Applying the checklist above:

- *Buyer gives value:* The agreements appear consistent with the buyer’s giving value.

The agreements use clear language of purchase and sale. Section 2 of each agreement, “Agreement to Purchase,” provides “The Seller . . . agrees to sell, and the Purchaser agrees to purchase, Mortgage Loans having an aggregate principal balance on the related Cut-Off Date in an amount as set forth in the related Purchase Price and Terms Agreement”³¹³

The agreements seem to be serious about value being given, as one would expect from originators that are not affiliated with Goldman. Section 4 of the agreements, “Purchase Price,” specifies the price as a percentage of par “as stated in the related Purchase Price and Terms Agreement.”³¹⁴ Although we have not been able to locate the Purchase Price and Terms Agreements, it appears—to the extent we can tell from the face of the documents—that the buyer intended to give value for the loans.

- *Seller has right to transfer:* Although the agreements cannot themselves establish the seller’s right to transfer, the seller does warrant in each case that it has the

³¹²See Aames Purchase Agreement, dated April 1, 2006, Ex. Y to the Pooling and Servicing Agreement [“PSA”]; Fremont Purchase Agreement, dated Jan. 1, 2006, Ex. Z to PSA; Impac Purchase Agreement, dated Dec. 1, 2005, Ex. AA to PSA; Meritage Purchase Agreement, dated Nov. 1, 2005, Ex. BB to PSA. We refer to each such agreement by its originator’s name and “Purchase Agreement.”

³¹³Aames Purchase Agreement, §2; Fremont Purchase Agreement, §2; Impac Purchase Agreement, §2; Meritage Purchase Agreement, §2.

³¹⁴Aames Purchase Agreement, §4; Fremont Purchase Agreement, §4; Impac Purchase Agreement, §4; Meritage Purchase Agreement, §4.

right to transfer the loans.³¹⁵

- *Authenticated Agreement Describing Notes*: Assuming the Mortgage Loan Schedule described in the agreements exists, it seems that this element is satisfied.

The agreements provide for delivery before closing³¹⁶ of a Mortgage Loan Schedule describing the mortgages covered by the agreement, with numerous pieces of information about each loan and further information about the loans in aggregate.³¹⁷ Thus, the agreements seem to contemplate a description of the notes. The agreements have spaces for the parties to sign (“authenticate”).

- *Conclusion*: The agreement documents suggest that these transactions were structured as Article 9 note sales. We cannot be sure that value was given for the notes just by reading the agreements, however.

2. Transfer from Sponsor (Goldman Sachs Mortgage Co.) to Depositor (GS Mortgage Securities Corp.)

As to loans from each originator, this transfer apparently is governed by the Assignment, Assumption, and Recognition Agreement between Goldman Sachs Mortgage Co., GS Mortgage Securities Corp., and the originator.³¹⁸

In these agreements, Goldman Sachs Mortgage Co. (the sponsor) is the “Assignor” and GS Mortgage Securities Corp. (the depositor) is the “Assignee.” The originator is

³¹⁵Aames Purchase Agreement, §9.01(a) (“[T]he Seller has the full power, authority and legal right to hold, transfer and convey the Mortgage Loans”); Aames Purchase Agreement §9.02(m) (“[T]he Seller has . . . full right to transfer and sell the Mortgage Loan to Purchaser free and clear . . .”); Fremont Purchase Agreement, §9.01(a) (identical to Aames except “full corporate power”); Fremont Purchase Agreement, §9.02(m) (identical to Aames agreement); Impac Purchase Agreement, §9.01(a) (same as Aames agreement); Impac Purchase Agreement, §9.02(m) (same as Aames agreement); Meritage Purchase Agreement, §9.01(a) (identical to Aames agreement except “full corporate power and authority”); Meritage Purchase Agreement, §9.02(n) (“Seller . . . has full right and authority subject to no interest or participation of, or agreement with, any other party, to sell and assign each Mortgage Loan pursuant to this Agreement and following the sale of each Mortgage Loan, the Purchaser will own such Mortgage Loan free and clear . . .”).

³¹⁶Aames Purchase Agreement, §3; Fremont Purchase Agreement, §3; Impac Purchase Agreement, §3; Meritage Purchase Agreement, §3.

³¹⁷The mortgage loan schedules are defined slightly differently in each document. See Aames Purchase Agreement, §1, “Mortgage Loan Schedule.” (43 pieces of information about each loan and additional information about the loans in aggregate); Fremont Purchase Agreement, §1, “Mortgage Loan Schedule” (referencing schedule setting out 46 pieces of information about each loan plus information about loans in aggregate); Impac Purchase Agreement, §1, “Mortgage Loan Schedule” (45 items about each loan plus information about loans in aggregate); Meritage Purchase Agreement, §1, “Mortgage Loan Schedule” (45 items about each loan plus additional information about loans in aggregate).

³¹⁸See Aames Assignment Agreement, dated May 26, 2006, unidentified exhibit after Ex. J to Ex. Y to the PSA; Fremont Assignment Agreement, dated May 26, 2006, Ex. Z to the PSA; Impac Assignment Agreement, dated May 26, 2006, Ex. AA to the PSA; Meritage Assignment Agreement, dated May 26, 2006, Ex. BB to the PSA. We refer to each such agreement by its originator’s name and “Assignment Agreement.” The assignment agreement and the purchase agreement for each seller are combined into the same exhibit. For Aames, the assignment agreement is after the purchase agreement; for the other originators, the assignment agreement is before the purchase agreement.

the “Company.” We translate into the sponsor/depositor/originator terminology.

- Buyer gives value. The agreement provides, “The [sponsor] hereby sells, grants, transfers and assigns to the [depositor] all of the right, title, and interest (other than those rights specifically retained by the [sponsor] pursuant to this Agreement) of the [sponsor], as purchaser, in, to, and under (a) those certain mortgage loans listed on the schedule . . . attached hereto as Exhibit A.”³¹⁹

Despite the reference to “sell[ing]” the right, title, and interest in the loans (along with granting, transferring, and assigning them) it is unclear whether the depositor/“buyer” actually gave value. There is no purchase price listed in the agreement, nor is there any discussion of how payment would take place.

There is a reference in both the Representations and Warranties Agreement between depositor and sponsor³²⁰ and the underwriting agreement³²¹ to a bill of sale dated May 26, 2006 between sponsor and depositor. We have not been able to locate this bill of sale in the public filing records.

- Seller has right to transfer. The sponsor does warrant that it has the right to “transfer and sell the mortgage loan” to the depositor.³²²
- Authenticated Agreement Describing Notes. There is a written agreement that describes the notes (assuming the referenced schedule actually exists), so assuming that the depositor has the appropriate rights to the notes, it seems that the agreement otherwise meets the formal requirements for an Article 9 sale.
- Conclusion: The contracts make it seem doubtful that the buyer gave value under the agreement, as there is no discussion of the price paid for the notes and mortgages. However, the documents do refer to a “bill of sale,” which would be evidence that the loans were sold if it in fact exists and memorializes an actual transfer of value in exchange for the mortgages.

3. Transfer from Depositor (Goldman Sachs Mortgage Securities Corp.) to Trustee (LaSalle Bank, N.A.)

³¹⁹Aames Assignment Agreement §1; Fremont Assignment Agreement §1; Impac Assignment Agreement §1; Meritage Assignment Agreement §1.

³²⁰Representations and Warranties Agreement between Goldman Sachs Mortgage Company and GS Mortgage Securities Corp. dated May 26, 2006, Ex. S to Pooling and Servicing Agreement, third “Whereas” clause.

³²¹Underwriting Agreement between GS Mortgage Securities Corp., GSAMP Trust 2006-HE3, and Goldman Sachs & Co., dated May 23, 2006, Ex. 1 to GSAMP Trust 2006-HE3 8-K filed Sept. 19, 2006. [Underwriting Agreement].

³²²Aames Assignment Agreement §9(a); Fremont Assignment Agreement §1; Impac Assignment Agreement §1; Meritage Assignment Agreement §1.

This transfer apparently is governed by the Pooling and Servicing Agreement among multiple parties dated May 1, 2006.³²³

- *Buyer gives value.* It appears that the Depositor receives value—either the certificates issued by the trust or the proceeds from the sale of the certificates to the underwriter—in exchange for the transfer of the mortgages to the trustee for the benefit of the certificateholders.

The agreement provides, “The Depositor, concurrently with the execution and delivery hereof, hereby sells, transfers, assigns, sets over and otherwise conveys to the Trustee for the benefit of the Certificateholders . . . all the right, title and interest of the Depositor in the Trust Fund.”³²⁴ As explained below, the Trust Fund means the mortgages transferred in the securitization.

The agreement also provides, “It is the express intent of the parties hereto that the conveyance (i) of the Mortgage Loans by the Depositor and (ii) of the Trust Fund by the Depositor to the Trustee each be, and be construed as, an absolute sale thereof.”³²⁵

In exchange for the mortgages, the depositor apparently receives the certificates: “[C]oncurrently with such transfer and assignment [i.e., the transfer and assignment of the mortgages], the Securities Administrator has executed and delivered to or upon the order of Depositor, the Certificates in authorized Denominations evidencing directly or indirectly the entire ownership of the Trust Fund.”³²⁶

A separate Underwriting Agreement between the depositor and the underwriter, Goldman Sachs & Co. provides for the depositor to (i) “cause GSAMP Trust 2006-HE3 to issue” the certificates and (ii) to sell the certificates to the underwriter for a purchase price of 99.835% of the aggregate class principal balance of the certificates.³²⁷ It is unclear whether the certificates are issued by the trust to the depositor and then sold to the underwriter (two-step) or whether the certificates are issued directly to the underwriter at the same time the underwriter

³²³The parties to the PSA are GS Mortgage Securities Corp. (Depositor), Litton Loan Servicing LP (Servicer), Select Portfolio Servicing, Inc. (Servicer), Avelo Mortgage L.L.C. (Servicer), J.P. Morgan Trust Co., N.A. (Custodian), U.S. Bank, N.A. (Custodian), Deutsche Bank National Trust Co. (Custodian), LaSalle Bank, N.A. (Trustee) and Wells Fargo Bank, N.A. (Master Servicer and Securities Administrator).

³²⁴GSAMP 2006-HE3 PSA, §2.01.

³²⁵GSAMP 2006-HE3 PSA, §12.04. The agreement also provides that in the event the transaction is found to be a secured loan rather than a sale, it is the parties’ intent that the agreement be a security agreement and that the conveyances in the agreement create a security interest in all of the assets transferred. Id. Notably, the Agreement

³²⁶GSAMP 2006-HE3 PSA, §2.04.

³²⁷Underwriting Agreement, *supra* note 321, first unnumbered paragraph and Schedule II.

pays the depositor (one-step). Under either approach, it seems that the depositor receives value in exchange for transferring the notes and mortgages to the trust; the value is the certificates in the two-step case or the cash in the one-step case.

- *Seller has right to transfer.* As with the other agreements, the agreement cannot itself establish the seller's right to transfer, but the seller does warrant that it has the right to transfer the loans.

The Depositor warrants that “immediately prior to the transfer and assignment by the Depositor to the Trustee on the Closing Date, the Depositor had good title to, and was the sole owner of each Mortgage Loan . . . and the Depositor has transferred all right, title, and interest in each Mortgage Loan to the Trustee. The transfer of each Mortgage Note as and in the manner contemplated by this Agreement is sufficient either (i) fully to transfer to the Trustee, for the benefit of the Certificateholders, all right, title, and interest of the Depositor thereto as note holder and mortgagee or (ii) to grant to the Trustee, for the benefit of the Certificateholders, the security interest referred to in Section 12.04.”³²⁸

- *Authenticated Agreement Describing Notes.* Assuming the Mortgage Loan Schedule described in the agreement actually exists, it seems that this element is satisfied.

The Trust Fund in turn is defined to include as “the Mortgage Loans.”³²⁹ A “Mortgage Loan” in turn is defined as “an individual Mortgage Loan which is the subject of this Agreement, each Mortgage Loan originally sold and subject to this Agreement being identified on the Mortgage Loan Schedule, . . .”³³⁰ The Mortgage Loan Schedule is “a schedule of Mortgage Loans delivered to the Securities Administrator on the Closing Date and referred to on Schedule I, such schedule setting forth the following information with respect to each Mortgage Loan as of the Cut-off Date.”³³¹ The definition of the Schedule goes on to specify 53 items of information for each loan and four items of information for the loans as a group.

- *Conclusion.* It appears that the documents here are set up to provide for an Article 9 transfer. Examining the documents, however, does not tell us whether value was actually given in exchange for the notes at each stage of the transfer.

³²⁸GSAMP 2006-HE3 PSA, §2.06(h). The “security interest referred to in Section 12.04” means the security interest that the agreement is intended to create in the event that the transactions it provides for are deemed to be secured loans rather than absolute sales. *Id.* §12.04.

³²⁹GSAMP 2006-HE3 PSA, §1.01, “Trust Fund.”

³³⁰GSAMP 2006-HE3 PSA, §1.01, “Mortgage Loan.”

³³¹GSAMP 2006-HE3 PSA, §1.01, “Mortgage Loan Schedule.”