A *MERS* PRIMER

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INTRODUCTION

Real estate mortgages have always been bought and sold among traditional primary market lenders in individual private transactions. For portfolio lenders, this could accomplish a wide variety of different institutional investment portfolio management objectives.[1] It was a one-off negotiated local market of intra-industry players who were already in the direct real estate finance business – insurance companies with other insurance companies, banks and thrifts with other banks and thrifts – but no pension or other funds or other investors participated in these private transactions. Except for the short lived "Guaranteed Mortgage Obligations" market in the 1920's, there was no national market for the purchase and sale of mortgage loans other than among traditional portfolio lenders in the primary market.[2]

SECONDARY MORTGAGE MARKET

The impetus for growth of a secondary market for residential mortgages, however, was the securitization of residential mortgages by the Government Sponsored Entities (GSEs) – Government National Mortgage Association, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation – in the 1970's. To issue their residential mortgage backed securities ("RMBS") for sale into the capital markets, the GSEs had to first acquire residential mortgages to aggregate and pool in their trust vehicle. The GSEs acquired these residential mortgages from traditional primary market lenders – initially in individual negotiated transactions and eventually on a flow basis pursuant to published individual GSE ("Agency") program criteria. By the early 1980's, "Private Label" (or non-Agency) RMBS were being issued by a broad spectrum of non GSEs. The development of this additional non-Agency market for residential mortgages was a tremendous boost to the continuing growth of a national secondary mortgage market.

TRANSFER BY ASSIGNMENT

In addition to the endorsement of the promissory note by the seller to the purchaser,[3] the acquisition of mortgages by a whole loan purchaser from a whole loan seller customarily involves a transfer of the whole loan by the delivery of an assignment of the mortgage and the recordation of the assignment in the local recording office.[4] As millions of mortgages began to be transferred by assignment to feed the explosive growth of RMBS conduits, traditional local

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[1] In this article, mortgages are meant to include deeds of trust, deeds to secure debt and other customary real estate security instruments.

[2] Louis Perlstein, "What the 1920's Tell Us About Mortgage Backed Securities Today", PROB & PROP Jan-Feb 1987, at 19. Excellent discussion of the failed Guaranteed Mortgage Obligations market created by title insurance and trust companies in the 1920's.

[3] Or by an endorsement "in blank" to facilitate further transfers of the note without the necessity of further endorsements especially in mortgage warehouse arrangements. *See* UCC §3-109.

[4] A whole loan sale is the purchase of the entire legal and beneficial interest in a loan as opposed to a fractional sale of a beneficial ownership interest in a mortgage such as participation.

recording offices were inundated with succeeding assignments for the same mortgage. Volume began to outpace capacity of the local governmental recorders and delays inevitably became commonplace especially in many urban areas. But the nature of the securitization process compounded the problem: Whole mortgage loans are transferred from originator to purchaser by assignment; the purchaser who accumulates and aggregates the mortgages for pooling usually finances its purchases with a traditional mortgage warehouse line or capital markets "repo" arrangement or even a collateralized debt obligation; then the purchaser has the loan released from the warehouse line, repo, etc., and transfers the loan to a single purpose entity depositor created solely to aggregate and transfer the mortgages into the RMBS pool by assignment to the trustee. This process can be accomplished in a few days, weeks or months, but each step requires an assignment which requires the recording information from the original mortgage and each preceding assignment in the chain of title.[5] Each recording delay therefore interferes with the ability to complete the next transfer and compounds the problem.

RECORDING DELAYS AND FAILURES

Hence, a mortgage recording delay could seriously hinder transfers even if they were being made in blank (as they usually are to warehouse lenders). An innovative Wall Street capital markets process was being seriously impeded by a traditional Main Street real estate market requirement. Innovation was being held captive by local government bureaucracies with inefficient and outmoded systems. It became more and more difficult to determine from the local records who actually currently held a mortgage when searching a title or, more importantly, when paying off a mortgage. In addition, in the traditional primary market, portfolio lenders serviced their own mortgage loans and had ongoing relationships with their borrowers. As RMBS developed (both Agency and Private Label), a new breed of third party loan servicers began to emerge in the real estate finance market – usually unrelated to the lender and unknown to the borrower. Thus, without knowing into which RMBS pool a mortgage loan had been deposited, it was frequently difficult, if not impossible, to determine who the servicer was for a mortgage loan. Thus, the impressive success of the MBS market had created an overwhelming and growing problem for its participants - who was the current holder of the mortgage and who was the servicer? [6] But the current paper-based recording system was clearly inadequate to accomplish its original primary purpose – to provide constructive notice to all who searched the record. The time lag was being attenuated and moreover, it did not disclose current servicers.[7] Yet the states and their local recording jurisdictions were clearly not in a financial position to completely overhaul and computerize their recording systems to meet the needs of this new era of real estate finance. And even if they were they were able to do so, the process the states adopted would be neither uniform nor consistent in their approaches to the detriment of the natural secondary mortgage market that was continuing to grow and develop.

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[5] Joseph Philip Forte, "Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street", Real Property Probate and Trust Journal Fall 1996, at 489.

[6] Federal Regulations issued under the Real Estate Settlement Procedures Act specifically require the delivery of notices of transfer of servicing rights to residential borrowers from transferor and transferee and impose statutory damages and costs on servicers who fail to comply with its requests 24 CFR 3500.2 – Mortgage Servicing Transfers).

[7] Because of the growth of RMBS and its concomitant problems identifying servicers, several states have enacted legislation entitling borrowers to pay off and satisfy loans with attorney affidavits and payment escrows if the lender or servicer is unknown or unable to be determined by the insuring title company.

ELECTRONIC REGISTRATION

In the early 1990's, faced with these problems even before the development of the commercial mortgage backed securities ("CMBS") market, the Mortgage Bankers Association ("MBA") met with the GSEs to consider whether to establish a central repository for the purpose of registering the ownership of mortgage rights in a book entry form. They modeled their proposal on the existing example of the Depositary Trust Company ("DTC") in the securities market.[8] MBA issued a White Paper in 1993 and endorsed the creation of a real estate finance industry sponsored central repository to electronically register and track ownership of mortgages. MBA continued to advocate a DTC-like central repository until 1994 when MBA decided that the electronic registry should be funded and developed. Soon thereafter, MERS was founded and commenced operation in 1997. After some initial problems and a restructuring of its ownership, MERSCORP, INC. was in business.[9] The MERS® System is a "national electronic registry system that tracks the changes in servicing rights and beneficial ownership interest in mortgage loans that are registered on the Registry."[10] MERSCORP, which owns and operates the system, is also the corporate parent of Mortgage Electronic Registration Systems Inc., a bankruptcy remote single purpose corporation "whose sole purpose is to be the mortgagee of record and nominee for the beneficial ownership of the mortgage loan." When this two tier corporate structure modification that they had requested was completed, the three national credit rating agencies consented to MERS being mortgagee of record for a MBS securitization trustee without the necessity of a further assignment from MERS recorded into the MBS Trustee.

As originally conceived and set up, mortgage loans could only be registered by being assigned to MERS upon purchase of a mortgage by a MERS member with MERS as the named assignee in an assignment of the purchased mortgage. Only later was the program modified to allow MERS to be named at the closing of the loan origination as the Original Mortgagee of Record ("MOM") in the mortgage as nominee for the actual lender (who is the payee of the promissory note).

In any event, to participate in and benefit from use of the MERS System, a lender, investor, trustee or other party must become a member of the MERS System.[11]

NOT A SUBSTITUTE FOR RECORDING OR ASSIGNMENT

The MERS System is not designed to replace the local governmental recording system in each state nor does it facilitate the transfer of ownership rights in mortgages. A mortgage or an assignment into MERS must still be recorded in the local governmental recording office to perfect the lien or transfer the lien of record to/from MERS. The MERS System is simply a registry of the beneficial ownership of those mortgage rights for which MERS acts as nominee.

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[8] "DTC is [a] national depository for book-entry securities in the U.S. that records, maintains, and transfers securities for participants." Structured Finance: Glossary of Securitization. Standard and Poor (2003). DTC had been created by the securities industry to handle the avalanche of equities trading volume in the late 1960's.

[9] MERSCORP is now a privately held stock corporation owned by the GSEs, several industry trade associations, private mortgage insurers, commercial banks, investment banks and several mortgage companies.

[10] For information on MERS, I have relied extensively on "Understanding MERS", published by MERSCORP. INC., June 2007 and available on its website *www.mersinc.org.*

[11] The Membership application applicable contract documents are available on the MERS website.