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# Challenges to California Foreclosures Based on MERS Transfers

Roger Bernhardt and Alex Volkov

## Introduction

In February, the Fourth District court of appeal handed down its decision in *Gomes v Countrywide Home Loans, Inc.* (2011) 192 CA4th 1149, 121 CR3d 819 (reported at 34 CEB RPLR 66 (Mar. 2011)) mechanism of MERS (Mortgage Electronic Registration Systems, Inc.) transfers, thereby implicitly validating the secondary market process by which MERS operates in California and throughout the rest of the country. To spare readers from having to dredge up t

## Background: The MERS System

As readers know, a mortgage loan begins its existence with the borrower's execution of a note, promising to repay the loan, and (in California) a deed of trust, entitling the lender to foreclose and sell the borrower's real property if the loan is not paid. In a plain-vanilla situation, both instruments are made out to the lender—as payee of the note and as beneficiary of the deed of trust. The deed of trust, as a title document, is recorded; the note, not affecting title, is not. (Because of historical quirks, title to the property is technically held by a trustee, different from both payor/trustor and beneficiary.) Since the two documents represent a single loan obligation, they would sensibly be kept together.

However, when the lender desires to transfer the loan, complications arise. The note should be endorsed (or assigned) and physically transferred to each new holder, a transaction regulated by Article 3 of the Commercial Code, whether it is a mortgage note or an unsecured note. The deed of trust, on the other hand, should be assigned, and perhaps physically transferred, but it is not endorsed like a note is, and its assignment should be recorded, just as the original deed of trust was, and unlike anything done with the note.

The rise of the secondary market and its attendant multiple transfers and pooling of loan documents led to concern over the recordation requirement of assignments of deeds of trust and the recordation fees (and, in some states, imposition of transfer taxes). MERS, invented in 1993, offered a clever bypass: By putting the deed of trust in the name of MERS directly, as some sort of agent of the true lender, and keeping the document under the MERS name, mortgage transfers could merely be made inside MERS's electronic database and outside the public records until the end of the life of the loan (whether by a payoff or through a foreclosure), at which point MERS would execute and record a formal assignment to the last beneficiary.

The drafting mechanism chosen to accomplish this was the naming of MERS as “nominee” and “beneficiary of record” in the deed of trust, separate from the lender. (The document typically recites, “MERS is a separate corporation that is acting solely as a nominee for Lender and Lender’s successors and assigns. MERS is the beneficiary under this Security Instrument.” In other jurisdictions, MERS is named as “the mortgagee in a nominee capacity for [the lender] ... MERS is a company separate from your lender that operates an electronic tracking system for mortgage rights. MERS is not your lender; it is a company that provides an alternative means of registering the mortgage lien in the public records.... Naming MERS as the mortgagee and registering the mortgage on the MERS electronic tracking system does not affect your obligation to your lender, under the Promissory Note.”) Unsurprisingly, MERS is not named in the note—as lender, payee, or anything else.

Consistent with all of that, the loan documents in *Gomes* showed KB Home Mortgage Company (a retail outlet for Countrywide) as the original “lender,” First American Trustee Company as “Trustee” under the deed of trust, and MERS as “nominee” for beneficiary (in one place) and “beneficiary” (in another) in that document. The deed of trust was then apparently assigned to The Bank of New York Mellon FKA The Bank of New York as Trustee for a trust, with Countrywide Home Loans as servicer and ReconTrust (a division of Countrywide) being later substituted in (probably by MERS) as trustee for the trustee’s sale. (Countrywide has been taken over by Bank of America, but that “transfer” can be ignored for our purposes here.)

### **The Litigation Posture**

Gomes filed his lawsuit in May, before Countrywide seemed close to conducting a trustee sale of the property. (Because Countrywide sent its notice of default (NOD) in March, notice of sale could not have been given before June—at the earliest—making an actual sale unlikely to occur before July.) The suit was therefore not one to set aside any completed sale, nor (peculiarly) even to stay or enjoin any threatened pending sale, but rather solely for damages for “wrongful initiation of foreclosure,” *i.e.*, the sending of the NOD.

Further, according to the complaint, Countrywide’s initiation of foreclosure was not allegedly wrongful for any particularized reason (such as that the loan was predatory or had been induced by fraud, or that Gomes was not in default, or that Countrywide had promised to forebear, or that some impropriety had occurred in the loan transfers). According to Gomes, foreclosure would be wrongful because the transfer process itself—even when in perfect conformity with MERS regulations—did not entitle the ultimate transferee of the original lender to conduct a trustee sale against a borrower, even when that borrower was admittedly in default.

While that contention might be viewed as a bit audacious, it also means that a court’s rejection of it is hardly devastating to the foreclosure defense bar. All of the “real” defenses that other borrowers have against foreclosure are left unimpaired by Gomes’s loss. Gomes’s defeat is somewhat like going back from strict to negligence liability:

Borrowers will have to show that their lenders actually did something wrong before those borrowers will be excused from having to pay their mortgage.

As another, but important, side effect, the demand on the judiciary to review the foreclosure process is significantly lightened by the court's rejection of Gomes's second cause of action—one for declaratory relief as to whether the foreclosure seller was “duly authorized to do so by the owner of a beneficial interest” in the loan. Success on that claim might have allowed borrowers to compel judicial review of the entire loan transfer process—and perhaps also, by extension, the default and foreclosure process—in every case, simply by asking for it. Upholding Gomes's cause of action for declaratory relief would have gone a long way toward appeasing critics of our nonjudicial foreclosure process, who complain of its total immunity from any review by any government official at any stage (although it might still have required the borrower to initiate some kind of action to bring an official into the picture, rather than requiring the lender to—as a matter of course—get its own stamp of approval from the official before selling).

Because the complaint was treated as a sort of facial attack on all MERS-related secondary market transfers, the opinion did not pay much attention to any particularized claims of defect or harm. The court said, in a footnote, that the complaint might be arguing that MERS lacked authorization from the current holder of the note to initiate foreclosure (the NOD was sent by ReconTrust, describing itself as MERS's agent), or that MERS might lack standing to do so, even if it was authorized. These contentions were rejected, but on grounds that were not made very clear.

### **The Merits**

Civil Code §2924a provides that “If, by the terms of any trust or deed of trust a power of sale is conferred upon the trustee, the attorney for the trustee, or any duly authorized agent, may conduct the sale and act in the sale as the auctioneer for the trustee.” Vexingly, §2924(a)(1)§2924c(e)§2924d§2924.7ns make some reference to an agent. The reference to agency in §2924(a)(1) allowed the court to say that the clause in the deed of trust whereby Gomes agreed that MERS could foreclose barred him from challenging its authority to do so, and apparently gave MERS such authority, at least as an agent of the beneficiary, whether or n

### **Outside the Trustee Sale Context**

The *Gomes* holding can be read in different ways. Broadly, it might mean that the entire MERS secondary market transfer process is valid (as long as each step is done properly). More narrowly, the findings of validity could be limited to the case of (1) a trustee sale (2) conducted directly by MERS, leaving open the issues of (3) judicial foreclosures and (4) foreclosure proceedings of any sort brought not by MERS itself, but by a successor lender who had taken an assignment from MERS.

The intellectual difficulty in being an assignee from MERS is that the assignment transfers only the deed of trust, not the note (which MERS never had). Civil Code §2936s

always held that the transferee of the note will prevail over the transferee of the mortgage, and is the only one entitled to foreclose (*Adler v Sargent* (1895) 109 C 42, 48), being assignee of the deed of trust from MERS does not seem to accomplish much when that assignee is not the holder of the financial interest in the note. *MERS v Saunders* (2010) 2 A3d 289.)

On the other hand, CCP §725a appears to go in the other direction, permitting the holder of the security to bring a foreclosure action, whether or not it also holds the note. The section states:

The beneficiary or trustee named in a deed of trust or mortgagee named in a mortgage with power of sale upon real property or any interest therein to secure a debt or other obligation, or if there be a successor or successors in interest of such beneficiary, trustee or mortgagee, then such successor or successors in interest, shall have the right to bring suit to foreclose the same in the manner and subject to the provisions, rights and remedies relating to the foreclosure of a mortgage upon such property.

That language does not seem to require a deed of trust beneficiary to also hold or have an interest in the note secured by that deed of trust.

However, concerns about MERS's right to foreclose are somewhat like maneuvering chairs around on the Titanic—given that MERS has announced that it intends to no longer do any foreclosing in its own name. On February 16, 2011, MERS proposed new rules that prohibit its members from initiating foreclosures in the name of MERS. (Freddie Mac has recently done the same, and Fannie Mae took the same position some time ago.) Thus, the *Gomes* decision upholds a procedure that soon will be obsolete.

### **MERS as Intermediate Transferor**

Withdrawal of MERS from direct foreclosure activity does not mean that trustee sales in California will stop. When defaults occur, MERS will instead assign the deeds of trust that it has held in its own name as nominee for the original lenders to the new, current holders of the promissory notes secured by those deeds of trust, so that they—now as both holder of the note and assignee of the deed of trust—can foreclose in their own name. From the point of view of compliance with *Gomes* standards, the process should be even easier to justify: The new lender need not prove that it is the authorized agent of the trustee or beneficiary since it is in fact, itself, the beneficiary.

But the foreclosure defense bar is not likely to roll over and die because of this new process. Battles will go on in different forums and over different issues. The federal courts have not been fully heard from (there appear to be far more federal decisions involving MERS than state court ones, but not yet from higher courts). The challenges will no longer be to MERS's power to foreclose but rather to its power to assign the mortgages and deeds of trust to the ultimate lenders, so that they can properly foreclose. On that question, the outcome so far is decidedly mixed.

## Bankruptcy Court Rulings on MERS

Some striking anti-MERS rulings have come from bankruptcy courts, inside and outside California. The challenge started in the Central District of California in 2008, when Bankruptcy Judge Bufford held that MERS lacked standing to lift a bankruptcy stay unless it could produce separate agency contracts from each of the various lenders who had held the promissory note during its various transfers. (“MERS is no longer an authorized agent of the holder unless it has a separate agency contract with the new undisclosed principal.”) *In re Vargas* (Bankr CD Cal 2008) 396 BR 511, 517, reported at 32 CEB RPLR 10 (Jan. 2009). The following year, an Idaho bankruptcy court denied MERS relief from stay because it was not a true beneficiary of the deed of trust receiving some actual economic benefit from it, nor a properly designated agent of the current holder of the note. *In re Sheridan* (Bankr D Idaho, Mar. 12, 2009, No. 08–20381-TLM) 2009 Bankr Lexis 552, \*4\it could transfer the mortgage, but that would not carry the loan along with it. *In re Box* (Bankr WD Mo, June 3, 2010, No. 10–20086) 2010 Bankr Lexis 1637.

More significantly, another bankruptcy court in the Eastern District of California concluded that since MERS had no interest in the underlying note, it could not transfer the beneficial interest in the companion deed of trust. *In re Walker* (Bankr ED Cal, May 20, 2010, No. 10–21656-E-11) 2010 Bankr Lexis 3781, \*6Any attempt to transfer the beneficial interest of a trust deed without ownership of the underlying note is void under Californiand others, holding that designation of MERS as nominee of deed of trust did not give it the authority to transfer the loan with *Vega v CTX Mortgage Co.* (D Nev, Jan. 19, 2011, No. 3:10-cv-00405-RCJ-VPC) 2011 US Dist Lexis 6170, \*3.

An even greater threat to the MERS process came from the February 10, 2011, decision of a bankruptcy court for the Eastern District of New York in *In re Agard* (Bankr ED NY 2011) 444 BR 231, in which the court ruled against the effectiveness of these transfers on almost every conceivable ground. New York uses mortgages and generally forecloses them judicially; in that context, Judge Grossman ruled that a foreclosing lender (1) would need to hold both the mortgage and the note in order to foreclose; (2) with regard to the note, would need to show a written assignment or physical possession plus proper endorsement; and (3) with regard to the mortgage, would need to show proper possession of that instrument as well, notwithstanding its valid possession of the note. Furthermore, (4) MERS would have to show authority to assign the mortgage, a conclusion it could not establish by virtue of merely having been named nominee; nor by (5) the MERS membership rules, which do not sufficiently demonstrate agency; nor by (6) state agency law, which in New York includes an equal dignid authority to foreclose in its own right simply because it had been named mortgagee of record; (8) an assignment by MERS would have to show MERS as nominee of the *current* lender, not the original lender; and finally (9) MERS would also need written authority from the current lender to assign the mo

What does that say for California? Some of these rulings are not serious obstacles. Point 7 above, regarding MERS foreclosing in its own name, can be disregarded since MERS

no longer does that. Point 1, as to the requirements of foreclosure, should also be inapplicable to a California trustee sale, which is a nonjudicial proceeding and subject to its own special statute. With regard to points 2 and 3, *Gomes* appears to hold that the foreclosing party in a California trustee's sale need not possess either the note or the deed of trust, such as *Agard* demanded in New York.

Many of *Agard*'s other challenges to MERS assignments seem largely correctable, both for past transactions and future ones. The *Agard* holdings that MERS needs written authority to assign (applicable in California as well) (point 6) and that it needs such written authority from the current note holder (point 9) should be curable by execution of new forms of documentation, properly granting, affirming, and ratifying all of MERS's past and future acts. Such authorization would eliminate the need to argue about the effect of MERS membership rules (point 5) and perhaps also about the effect of its dubious use of the term "nominee" (point 4) to describe its status—after all, if MERS is a properly authorized agent, it may not matter whether it also calls itself a nominee.

Several other bankruptcy courts elsewhere in the country have rejected most of *Agard*'s contentions. Nominee status has been held to confer proper authority to transfer in *In re Corley* (Bankr SD Ga, Feb. 7, 2011, No. 10–4033) 2011 Bankr Lexis 807 and *In re Lopez* (Bankr D Mass, Feb. 9, 2011, No. 09–10346) 2011 Bankr Lexis 476. MERS has been held to have generally sufficient authority to assign its security instruments. *Lane v Vitek Real Estate Indus. Group* (ED Cal 2010) 713 F Supp 2d 1092; *In re Tucker* (Bankr WD Mo 2010) 441 BR 638; *In re Martinez* (Bankr D Kan 2011) 444 BR 192.

*Gomes* itself said very little about assignments by MERS, other than to brush aside some claims of suspected, backdated transfers. (Improperly handled assignments generate a separate, independent set of issues—see, e.g., *United States Bank N.A. v Ibanez* (Mass 2011) 941 NE2d 40) *Gomes* appears to be generally favorable to the idea of MERS validly transferring deeds of trust to foreclosing lenders.

But, almost as proof of how uncertain the terrain is, another bankruptcy court in California subsequently rejected *Gomes* entirely, holding that MERS transfers just do not work. *In re Salazar* (Bankr SD Cal, Apr. 12, 2011, No. 10–17456-MM13) 2011 Bankr Lexis 1187. (This decision appeared as we were finalizing this article, making it impossible for us to perfectly integrate all of its holdings and compelling this rather separate, serial treatment of it.)

### *In re Salazar*

In *In re Salazar*, the bankruptcy court for the Southern District of California dealt with a situation in which US Bank had conducted a nonjudicial trustee sale and then filed an unlawful detainer, and was now attempting to lift the automatic stay triggered by the trustor's Chapter 13 filing on the eve of trial of that unlawful detainer action.

The particular challenge raised in *Salazar* was based on the fact that US Bank had not recorded the assignment to it of the deed of trust from MERS before conducting its

trustee sale, contrary to CC §2932.5h (The statute is not mentioned at all in *Gomes*.) This defect, almost visible on its face, would have been sufficient to keep the stay in place and might have rendered the cou

It was perfectly easy for the court to determine, as an initial matter, that CC §2932.5 applied to deeds of trust, even though it refers only to mortgages and even though various California federal district courts hlosure defense attorneys often complain of the difficulty of locating the proper person to deal with because of the opaqueness of the loan transfer process; the *Salazar* court has manifested its sympathy with that position. Whether recordation by the assignee will truly alleviate this difficulty as fatal as backdating or robosigning.

It was equally easy to rule that this recording requirement was not satisfied by the fact that MERS was itself of record. MERS was not the beneficiary at the time of foreclosure. That MERS was not conducting the foreclosure should have been enough to both settle the technical recording issue and completely distinguish away *Gomes*, where MERS itself was the foreclosing party. But the *Salazar* court could not resist the opportunity to declare its disagreement with the reasoning in *Gomes*. “Even if US Bank had not replaced MERS as the foreclosing beneficiary by the time of foreclosure here, MERS still had no authority to nonjudicially foreclose under Salazar’s deed of trust under its express terms.” (A footnote adds that MERS would also not qualify as one entitled to payment under §2923.5, since it did not hold the note.) *Gomes* was not good state law, worth being followed by a federal court. The provisions of CC §2924(a)(1), allowing agents to foreclose, do not trump the requirement of CC §2923.5, that assignments must be recorded before foreclosures start.

The *Salazar* court’s rejection of the *Gomes* rationale went further. The standard provisions in a MERS deed of trust on which *Gomes* had relied, especially those giving MERS the right to foreclose, applied only when “necessary to comply with law or custom,” a phrase the court found to be meaningless and amounting to an invalid waiver of lenders’ duties to comply with California’s foreclosure statutes. Those provisions certainly do not validate unrecorded assignments of the deed of trust. “As a matter of law, Salazar’s acknowledgment cannot be read as a waiver of his right to be informed of a change in beneficiary status.”

Finally, the MERS process itself received some gratuitous insults. The beginning of the *Salazar* opinion states that “MERS’ original involvement in this loan does not provide talismanic protection against US Bank’s foreclosure deficiencies” and its ending adds that “the Court also rejects US Bank’s invitation to overlook the statutory foreclosure mandates of California law, and rely on MERS as an extra-judicial commercial alternative.... This Court instead joins the courts in other states that have *rejected* MERS’ offer of an alternative to the public recording system.” (Emphasis in original; citing, inter alia, *In re Agard*.)

### **The Shaky Effect of Giving MERS Only the Deed of Trust**



An unavoidable observation from all of these fights is that the doctrine that the mortgage automatically follows the note runs into trouble when MERS enters the picture and takes only the mortgage, leaving the note somewhere else. See, *e.g.*, *Davidson v Countrywide Home Loans* (SD Cal, July 23, 2010, No. 09-CV-2694-IEG (JMA)) 2010 US Dist Lexis 74406. Whether a court holds that the transaction is thereby invalid, or valid notwithstanding the separation, the situation is no longer easy to resolve. A mortgage or deed of trust disconnected from its supporting promissory note is an odd creature. The design

The system itself is much to blame for all this uncertainty. The world deals one way with regard to the transfer of commercial paper and another way with regard to the transfer of real estate instruments. Commercial paper comes under Article 3 of the Uniform Commercial Code, wherein notes are negotiable or nonnegotiable, are not recorded, and are generally transferred by endorsement, and where possession of them is very important. Real estate instruments, in contrast, are generally (although not entirely) governed by local law where physical possession is not very important. The real estate rules of bona fide purchaser are not the same as the commercial rules—intellectually challenging.

When the secondary market arose in the 1980s, incompatibilities between the two systems generated enough inconvenience to prompt the creation of MERS as an attempt to avoid the delays, inconveniences, and costs of the recording system so that mortgages could be bundled and transferred as commercial paper. But those who midwived MERS's birth may have paid insufficient attention to old real estate doctrines, especially the principle of "numerus clausus" ("closed number")—which prohibits the creation of new forms of ownership without the approval of the appropriate authorities. See Merrill & Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 Yale LJ 1 (2000) to accept.