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Commentary on Transfers of Mortgage Loans to RMBS Securitization Trusts

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There is a tremendous amount of public commentary these days about possible defects in foreclosure proceedings commenced by loan servicers. Much of this discussion concerns procedural matters, such as whether the appropriate steps are being taken to verify the accuracy of statements made in affidavits executed in connection with these proceedings. These issues are very fact specific and it may take some time to ascertain what effect, if any, they may have on any given loan.

Within this overall dialogue, however, more fundamental issues have been raised challenging both the validity of the procedures used to convey mortgage loans into securitization trusts and the qualification of the securitization trusts as a real estate mortgage investment conduit ("REMIC") at the time those trusts were formed. These statements are false and misguided.

The reasoning behind these statements appears to be as follows: (i) in order to satisfy procedural requirements in connection with foreclosure, certain steps may need to be taken in order to document the ownership of a mortgage loan by the securitization trust, and (ii) since not all of these steps were taken at the time of the securitization, the securitization trust must not own the mortgage loan. This reasoning is faulty, because some of the steps that may be required under applicable state law in order to bring a foreclosure action are not required to transfer ownership of the mortgage loan.

The purpose of this article is to refute these challenges to the efficacy of mortgage loan transfers to securitization trusts. Simply stated, the industry standard procedures used for decades in transferring mortgage loans to securitization vehicles comply with the well-settled principles of law governing the transfer of mortgage loans, and therefore are effective to transfer ownership of the mortgage loans.

Standard procedures for transferring a mortgage loan

A mortgage loan can be thought of as a bundle of rights, including (i) a borrower's obligation to repay debt, evidenced by a note, and (ii) a lien on real property collateral securing this obligation to repay the debt, which is created by a mortgage or a deed of trust. (As used in this article, "mortgage" includes a deed of trust.) Transfers of notes are governed by applicable state contract law including the Uniform Commercial Code (UCC). Transfers of a mortgage or deed of trust are generally governed by state real property law. While these laws do not conflict, they do have the result of transfers of mortgage loans being legally complex. There is no single legally prescribed format for transferring mortgage loans, such as the certificate of title rules for motor vehicles. In addition, ownership of a mortgage loan does not require the owner to have recorded an assignment of the mortgage in the real property records.

There are decades of custom and practice in the transfer of mortgage loans as between the originator and successive purchasers or into a securitization. The practices used in conveying mortgage loans to private label securitization trusts are consistent with the practices used in transferring mortgage loans to Fannie and Freddie. In addition, these practices are the same practices used in sales of mortgage loans ("whole loan sales") in transactions prior to or not involving a securitization, as between the originator and successive purchasers in these whole loan sales.

These standard transfer procedures are essentially designed to meet three objectives: 1) document the parties' intent to effect a sale of the mortgage loans and memorialize all terms and conditions of that sale, 2) evidence the transfer of ownership by delivering the physical notes with endorsements consistent with UCC provisions, which protects the purchaser from being subject to adverse third party claims in the mortgage loans, and 3) enable the purchaser to become the mortgagee of record as needed for foreclosure proceedings or other purposes.

General custom and practice in the sale of mortgage loans involves three key steps from a documentary perspective:

- Contract. In mortgage loan sale transactions, there is almost always a contractual agreement as between seller and purchaser which: clearly establishes the parties intent to sell the mortgage loans to the purchaser; identifies the specific mortgage loans being sold by use of a loan level schedule; contains granting language which states that it conveys ownership of the mortgage loans; identifies the time of sale; and specifies the governing law for the sale transaction (frequently, the laws of the State of New York are designated by the parties as the governing law). These contractual agreements typically also contain representations and warranties made by the seller. An agreement of this type is essential to establish the parties' intent to sell the loan, to actually convey the loan to the purchaser and to articulate the terms and conditions of the sale. (Delivery of the note and an assignment of mortgage, while important for the reasons discussed below, do not in and of themselves establish the parties intent and articulate the terms and conditions of the sale.)

In a private label RMBS transaction, the relevant contractual agreement is typically a pooling and servicing agreement, which conveys the mortgage loans from the depositor to the trustee on behalf of the securitization trust. Another relevant document could include a separate mortgage loan purchase agreement, under which the mortgage loans are sold by the sponsor to the depositor immediately prior to the sale from the depositor to the trust, with representations and warranties that are assigned to the trustee. These documents contain clear granting language that conveys ownership of all of the seller's "right, title and interest in and to" the mortgage loans to the trustee on behalf of the securitization trust. There is a schedule or exhibit to these documents that specificly identifies each loan sold under the agreement.

- Delivery of Note. Physical delivery of the mortgage note to the purchaser or its agent, together with an endorsement of the note by the seller in blank, are also key components in the sale of mortgage loans for several reasons. First, because mortgage notes are generally “instruments” under the UCC, possession of the mortgage note by the purchaser in a valid sale is generally sufficient to establish that the purchaser's ownership rights are superior to the rights of any other person in the mortgage loan. Second, as an “instrument”, the note can be transferred and the purchaser will be recognized as the holder in accordance with applicable UCC provisions, upon physical delivery of the note to the purchaser with an endorsement (which may be in blank). (The question of whether a mortgage note is a negotiable instrument is fact specific, and the standard transfer procedures are designed to be effective irrespective of whether it is a negotiable instrument.) Third, since there is generally only one physical note per mortgage loan, delivery by the seller to the purchaser effectively prevents the seller from engaging in any mistaken, improper or fraudulent sale or pledge of the mortgage loans to multiple parties. Fourth, possession of the mortgage note may be needed for enforcement of the note in the event of default, including by foreclosure.

Notes may be delivered to the purchaser with an endorsement in blank. It is common for a mortgage note for a mortgage loan that has been sold to have stamped on it an endorsement to the effect of "Pay to the order of _____________, without recourse", signed by the originator or a subsequent purchaser. Such an endorsement has the effect that any subsequent transfer of the note presumptively only requires physical delivery (i.e., with no additional endorsement). Therefore, where there are successive purchasers to a note, the endorsement in blank by any prior holder is a sufficient endorsement for purposes of the most recent purchaser. For this reason, a mortgage note that has been transferred numerous times typically will only show one endorsement, which remains in blank. Importantly, for all purposes for which an endorsement of a mortgage note may be necessary or desirable in connection with a sale of the mortgage note, an endorsement in blank is sufficient and is equally effective as an endorsement where the name is filled in.

In private label RMBS transactions, the prevailing and nearly universally-followed practice has been for the endorsed notes to be physically delivered to the trustee, or to a custodian as the trustee's agent, at the closing of the securitization. Typical procedures include a requirement that the trustee or custodian provide an initial certification at closing and a final certification a specified number of days thereafter in order to confirm the delivery of each mortgage note. Any exceptions noted in these certifications result in a repurchase obligation of the seller within a specific period of time. Significantly, these procedures require a specific verification by the trustee or custodian that it has in fact received the physical notes for each loan listed on the mortgage loan schedule. These procedures make it highly unlikely that there has been any widespread failure to deliver the mortgage notes that simply went undetected.

- Assignment of Mortgage. The final key step in transferring ownership of a mortgage loan is to provide an assignment of mortgage in recordable form to the purchaser. Typically, the assignment is in blank so the name of the assignee can be filled in later prior to recordation. Because the mortgage “follows the note”, it secures the debt for the benefit of the noteholder, and as between seller and purchaser it is not necessary to record the assignment in the name of the purchaser in order to convey rights under the mortgage to the purchaser. However, in order to exercise its rights under the mortgage against the borrower following default, it may be necessary, under certain states’ law, that the purchaser become the mortgagee of record. Delivery of an assignment of mortgage in recordable form in blank is intended to enable the purchaser to become the mortgagee of record by completing the assignment in its name and submitting it for recording. Because every recording of an assignment of mortgage involves a filing fee and other expenses, it is not unusual for these assignments to remain unrecorded until such time as is needed in connection with a foreclosure of a specific defaulted loan.

In a private label RMBS transaction, the prevailing practice has been to deliver an original signed assignment of mortgage in recordable form in blank. In many cases, the securitization governing documents have not required that the assignments of mortgage be recorded in favor of the trust as a general matter. Certification of receipt by the trustee or custodian of the assignments of mortgage has been required under the same procedures as for the mortgage notes.

Variations from the above procedures

In our experience, we are not aware of material deviations from the general practice of delivering the physical mortgage notes to the trustee or its custodian. In some programs, delivery of the notes was permitted to occur within a specified period of time after issuance, but subject to the overall procedures for checking in the notes and providing a certification of receipt by the trustee or custodian with repurchase required for any delivery failures as described above.

In some cases, at the time of the securitization it is known that the seller will be unable to produce the physical note because it had been previously lost or destroyed. In that case, a lost note affidavit executed by the seller would be delivered to the trustee which affidavit would confirm that the seller (i) had owned the loan, (ii) had possession of the original note, and (iii) had attached a true and complete copy of the original note to the affidavit, and also that the original note had been lost or destroyed. The securitization governing documents by their terms would still nevertheless convey ownership of those mortgage loans to the trustee, although the lack of the original note might in some states give rise to additional requirements that the lender must comply with in connection with a foreclosure (e.g., posting a bond).

With respect to mortgage loans where, as of the time of the securitization, the mortgage was held through the MERS system, instead of delivering an assignment of mortgage, the seller would transfer its beneficial interest in the mortgage to the trustee through MERS. In jurisdictions where the noteholder must be named as the mortgagee of record in order to complete a foreclosure, relatively simple steps can be taken to accomplish this, thereby permitting foreclosure if necessary (although delays may occur).

Validity of original transfer procedures

For the reasons described above, these standard procedures are sufficient to validly transfer ownership of the mortgage loans to the securitization trusts, consistent with the clear and unambiguous intent of all parties to the transactions (including the investors) at the time. Specifically, use of an endorsement in blank on the mortgage note is fully consistent with a sale. Recordation of an assignment of mortgage to the securitization trust is not necessary to evidence ownership of the mortgage loan by the trust, and the delivery of an assignment of mortgage in blank in recordable form is sufficient to enable the trust to become the mortgagee of record if needed for foreclosure.

There may be additional steps required at the time of foreclosure in order to comply with procedural or documentary requirements. For example, an assignment of the mortgage may need to be recorded to the securitization trust. Any such additional steps would not convey any new or additional ownership rights to the securitization trust and would not negate the sufficiency of the transfer procedures described above to convey ownership of the mortgage loans to the securitization trust at the time of issuance.

It should not be surprising that additional steps may be needed at the time of foreclosure. The standard transfer procedures described above are used in the context of transactions between sophisticated financial institutions and institutional investors, who clearly mutually intend for the transactions to be sales. As commercial transactions, the steps taken are certainly sufficient to legally convey ownership and protect the rights of the purchaser, but do not include additional steps not required to convey ownership that would involve additional time or expense. In contrast, the foreclosure process is adversarial and in that context it is understandable that extra requirements could be imposed over and above those necessary to convey ownership of the loan itself.

Is there a REMIC qualification issue?

A few commentators have added to the parade of horribles a concern that the REMIC would lose its qualification because it did not own the mortgage loans. The underlying premise to this argument is that the actions taken to convey ownership of the loans at issuance were ineffective and that any subsequent step taken to supposedly "cure" such deficiency (such as recordation of an assignment of mortgage) would have the effect of transferring the mortgage loan to the REMIC after the 90 day period following the issuance date during which transfers to the REMIC are permitted, causing a prohibited transaction tax. The simple response to this argument is that the mortgage loans have been legally conveyed to the securitization trust at the time of issuance, which satisfies the requirements of the Internal Revenue Code and the related Treasury Regulations governing REMIC qualification. Under basic principles of tax law in which substance is controlling over form, there is no question that the REMIC at the time of issuance was the owner of the mortgage loans for tax purposes.

Conclusion

We believe that the recent allegations of possible wholesale failures to convey ownership of mortgage loans to private label RMBS trusts are baseless and unfounded. All parties to these transactions, including issuers, underwriters, trustees and investors, clearly intended that the transactions convey ownership of the loans to the trusts, and appropriate steps were taken to effect such conveyance in accordance with well-settled legal principles governing transfers of mortgage loans. Any attempts to assert otherwise today are inaccurate and uninformed, and, if left to stand unchallenged, could cause substantial and unwarranted harm to the economy.

If you have any questions or would like further information concerning the subject matter of this Client

Alert, please contact Stephen Kudenholdt, Co-Chair of our Capital Markets Practice Group (+1 212 768 6847 or steve.kudenholdt@snrdenton.com), or Stephen F.J. Ornstein (+1 202 408 9122 or stephen.ornstein@snrdenton.com).

The following SNR Denton partners also contributed to this article: within our Capital Markets group, Andrea N. Mandell, Michael C. McGrath, Robert B. Olin, and Richard D. Simonds; and within our Real Estate group, Peter J. Mignone and Mitchell G. Williams.