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Mortgage Morass: New Rules, Continued Problems—Where Are We Now?

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INTRODUCTION

Webster's defines "morass" as "something that traps, confuses, or impedes." That's probably a good description of where we're at now. On the bankruptcy front, the new proof of claim rules look like a good, if modest, beginning. With respect to some of the more fundamental problems uncovered by the bursting of the housing bubble—traps, confusion and impediments remain.

MORTGAGE-BACKED SECURITIES

Real property law is old; securitization is relatively new. Some of the continuing difficulties result from pouring the new wine of mortgage-backed securities into the old skins of real estate recording and foreclosure rules. But other difficulties appear to result from failures in both the origination of loans and the creation and administration of trusts to securitize the loans. Among the administrative problems are the apparent failure to follow established procedures for transferring mortgage loan documentation, servicing, and foreclosing. And at least in some instances, it appears that these lapses triggered the fabrication of documents and "robo-signing." Consequences include not only harm to borrowers and the integrity of the foreclosure process, but also harm to investors and the integrity of the securities market.

Because of the association of these problems with the securitization of mortgage loans, it's helpful to review the participants in a mortgage-backed transaction.[1] See Figure 1 on the next page. In broad outline, mortgage loans are originated between lenders and borrowers. Rather than hold a loan to maturity, the lender typically will sell the loan on the secondary market and use the proceeds to make further loans.

The purchaser of the loans, who may or may not be affiliated with the lender, may assemble a pool of loans from multiple lenders for the purpose of securitizing the loans. Such a purchaser is the "sponsor" of the securitization. The sponsor typically transfers the loans to a "depositor," a special purpose affiliate created by the sponsor to provide additional insulation for the pool of loans from any legal risks associated with the sponsor, including bankruptcy.

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[1] For an excellent introduction to the changes in Texas real estate foreclosures associated with securitization, see G. Tommy Bastian, *How Securitization Changed Residential Foreclosures*, State Bar of Texas 32nd Annual Advanced Real Estate Law Course (San Antonio 2010).

For a critical and comprehensive look at the servicing issues in a mortgage-backed securities transaction, see Adam J. Levitin, Tara Twomey, *Mortgage Servicing*, 28 Yale Journal on Regulation 1 (forthcoming 2011), *available at* http://ssrn.com/abstract=1324023 (last visited Oct.17, 2011).

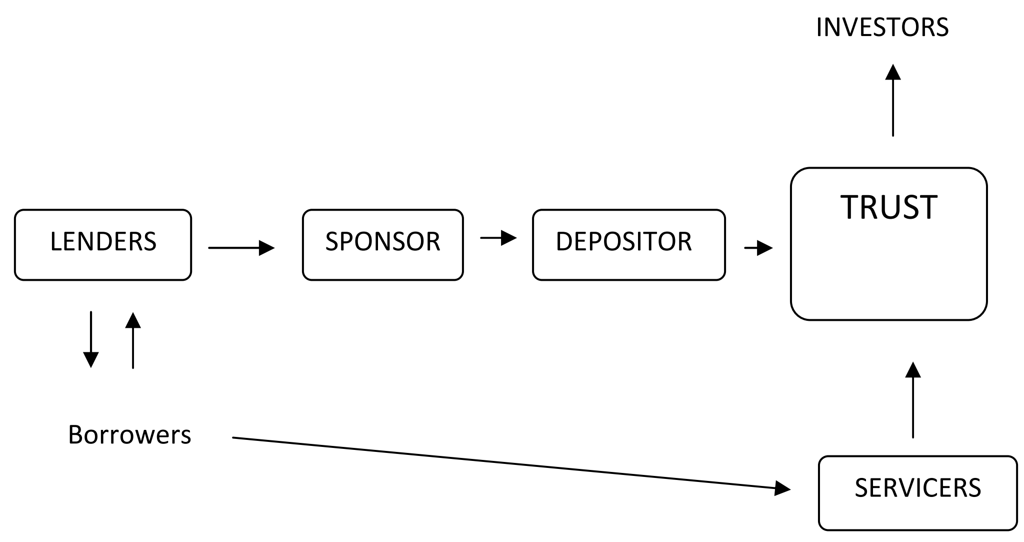
The National Consumer Law Center has created the Bankruptcy Mortgage Project, which collects local rules, forms, general orders, and court opinions addressing a variety of mortgage issues in consumer bankruptcy cases, *available at* http://www.bankruptcymortgageproject.org/ (last visited Oct. 17, 2011).

The depositor in turn transfers the pool of loans to another special purpose entity, typically a trust, which will hold the loans and issue securities to investors in the trust. The securities are collateralized by the pool of loans and the investors' return is dependent upon the cash flows generated by the pool. The proceeds from the sale of the securities issued by the trust will fund the purchase price of the pool of loans from the depositor.

The trustee for the trust holds legal title to the loans for the benefit of the trust pursuant to a pooling and servicing agreement ("PSA"). Pursuant to the PSA, the loans are serviced by a combination of master, primary and special servicers and custodians.

The forgoing is a simplified description of a "plain label" securitization sponsored by an investment or commercial bank, as opposed to mortgage-backed securities issued by a government sponsored entity, such as Federal National Mortgage Association or Federal Home Loan Mortgage Corporation.

Figure 1 Simplified Securitization



As is apparent from the above, the investors' rights are dependent on the cash flow from the pool of loans, so it is critical that the trust acting through the trustee and servicers be able to enforce the loans and foreclose on the property in the event of default. From the point of view of the borrower, it is important that the person seeking to enforce the loans has the right to do so in order to protect against duplicitous claims. Depending on the particular facts, the mortgage documents (the note and the mortgage or the deed of trust) may have been transferred multiple