REVENGE OF THE DEBTORS: WHO CAN LEGALLY ENFORCE A MORTGAGE AFTER A "LANDMARK" CASE?

By

Timothy F. Nixon

Godfrey & Kahn, S.C
333 Main St., Suite 600
Green Bay, WI 54301
Telephone: (920) 432-9300
E-mail: tnixon@gklaw.com

A recent Kansas Supreme Court decision, *Landmark Nat'l Bank v. Kesler,* 216 P.3d 158 (Kan. 2009), is the most recent decision casting doubt on the ability of non-lender parties to appear in foreclosure or bankruptcy proceedings as a proper party in interest. These cases encourage debtors and other parties to defensively use the mortgage securitization servicing system to prohibit servicers and other non-lending parties from enforcing rights under a mortgage. This trend, if it continues, may have significant impacts for consumer-debtor lawyers, as well as law firms that enforce mortgages and participated in mortgage loan securitization. *Landmark's* logic, carried further, could impact commercial mortgage enforcement as well.

To understand the issue, it is necessary to compare more recent practice with how things "used to be." Historically, when a debtor mortgaged property, it was mortgaged to the local bank. That bank held the mortgage and the mortgage note until satisfied. Gradually, with government programs and new Wall Street financing vehicles, mortgage origination itself became a business. Originating lenders sold loans, rather than holding a note and mortgage to maturity. The note and mortgage were pooled and sold again, ultimately as securitized loans to

institutional investors. A note and mortgage may go through multiple transfers. Documentation of these transfers is imperfect, and many assignments were not recorded at the local real estate filing offices.

Traditionally, the party prosecuting a mortgage foreclosure, or appearing in a bankruptcy proceeding to enforce its mortgage, was the party that held the mortgage and the mortgage note. In recent practice, by contrast, the party who originated the mortgage may merely remain as a mortgage servicer, or there may be an entirely difference party servicing the mortgage. However, it may not be clear who exactly currently holds the note and the mortgage.

The creation of Mortgage Electronic Registration Systems, Inc. ("MERS") further complicated matters. Accurately describing MERS is more difficult than it seems. MERS's website describes MERS as follows:

> MERS was created by the mortgage banking industry to streamline the mortgage process by using electronic commerce to eliminate paper. Our mission is to register every mortgage loan in the United States on the MERS® System.
>
> MERS acts as nominee in the county land records for the lender and servicer. Any loan registered on the MERS® System is inoculated against future assignments because MERS remains the nominal mortgagee no matter how many times servicing is traded.

In *Mortgage Electronic Registration System v. Nebraska Dept of Banking*, 704 N.W.2d 784, 787 (Neb. 2005), the Nebraska Supreme Court held that MERS was not a mortgage bank. It relied on MERS's representations that it does not make loans, hold escrows "or provide any loan servicing functions whatsoever. MERS merely tracks the ownership of the lien."

In mortgage foreclosure and/or subsequent bankruptcy, *a* party has to assert rights under the mortgage. The modern and largely electronic pooling and securitization process challenges traditional legal concepts of "standing" and "real party in interest" that previously were not obstacles for secured creditors. In federal practice, "[a]n action must be prosecuted in the name

of the real party in interest" as required by Federal Rule of Civil Procedure 17 incorporated into Federal Rule of Bankruptcy Procedure 7017. The party in interest rule is derived from the legal standing doctrine, required in bankruptcy to file a proof of claim or seek relief from the automatic stay.

The legal questions are many. Is the mortgage servicer a real party in interest? Is it an authorized agent? Do the rules prohibit a servicer or nominee from asserting the rights of the underlying note and mortgage holder? Is the current note holder a necessary party? What evidence is required to prove standing? MERS, which is not a mortgagee or servicer but "merely tracks ownership," raises these questions more directly. These issues have been considered by a growing number of courts. *Landmark* is one of the most recent and most notable.

Landmark's facts are straight forward. The debtor granted Landmark National Bank a $50,000.00 first mortgage on real estate. Later, the debtor granted a second $93,000.00 mortgage on the same real estate to Millennia Mortgage Corporation. The Millennia mortgage was filed in the real estate recording office under MERS's name. Millennia, apparently, subsequently assigned the mortgage to Sovereign Bank, but no assignment was recorded. The debtor defaulted and Landmark foreclosed. Landmark gave notice of the foreclosure to Millennia at Millennia's address. It did not, however, give notice to MERS or to Sovereign. The property sold at auction for $87,000.00, resulting in a surplus above the first mortgage. On the day Landmark filed a motion for sale confirmation, MERS filed a motion to intervene claiming lack of notice and violation of due process. The district court denied the motion, and the intermediate court of appeals upheld the district court. Because the debtor had filed an intervening bankruptcy and received a discharge, the surplus reverted to the debtor.

The Kansas Supreme Court upheld the lower courts, holding that it was not an abuse of discretion for the district court to deny MERS, as the lender's "nominee," the right to intervene. The court observed that notice went to Millennia. MERS, pursuant to the mortgage documents, acted "solely as nominee" for the lender. The court observed that the word "nominee" can have more than one meaning. Whatever the meaning was, the court held that MERS was clearly not the lender. The court then held that a non-lender was not a necessary party to a foreclosure. It further went on to suggest that the mortgage may be unenforceable if the mortgage note holder was separate from the mortgage holder.

Historically, lenders' servicers or agents have been allowed by courts to assert the mortgagee's rights. *Landmark* and similar recent cases coming after the August 2008 financial collapse, at minimum, suggest courts are reconsidering that historic review. At worst, they may demonstrate a backlash against the lending industry. *Landmark* is not an isolated case. *In re Hayes*, 393 B.R. 259 (Bankr. D. Mass. 2008) and *In re Mitchell*, No. BK-S-07-16226-LBR (Bankr. D. Nev. Mar. 31, 2009) reached similar conclusions. The respected Southern District of New York Bankruptcy Judge Robert Drain *In the Matter of Parades*, Case No. 09-22261-RDD (Bankr. S.D. N.Y. Oct. 9, 2009), went so far as to expunge the mortgagee's claim because the servicer could not prove who owned the mortgage. While entertaining these challenges to a party's legal standing to assert the rights of a mortgagee may be a trend, it is not a unanimous tidal wave as evidenced by *Bucci v. Lehman Bros.,* No. PC-2009-3888 (R.I. Super. Ct., Aug. 25, 2009) holding that MERS has standing to foreclose a mortgage under Rhode Island law.

On a practical level, this may be much ado about nothing. For instance, if a debtor raises these or similar defenses, it may only be necessary for the servicers and the mortgagees to complete and file the proper assignment documents. The upside for the debtor is a delay in

enforcement. The downside is that most mortgages permit these costs to be added on to the amount due and owing. It may be a pyhrric victory for the debtor. Certainly, the process takes up significant judicial time. The debtor objects on *Landmark* grounds. Discovery goes back and forth. The judge prepares to make a decision. Can the mortgagee then produce all the paperwork and remedy any defects in party status identified in discovery?

It certainly seems prudent before filing a foreclosure to obtain authenticated copies of the note and mortgage and verify recording information. It may also be prudent to record any assignments and grant authority or agency rights to enforce the mortgage. Making the current holder or trustee a party of record also seems prudent when foreclosing or asserting a bankruptcy claim. Another approach may be to continue recent practices and deal with these issues as they occur on a case by case basis. While anathema to careful lawyers, cost benefit may make it a client's preferred solution.

It should be emphasized that *Landmark* is a case under the lenient "abuse of discretion standard." While disturbing to the financial industry, it is not a holding "as a matter of law" that MERS or others under similar circumstances can never be a party in interest. One remedy for MERS mortgages may be to ensure originating lenders forward notice. Any thought by the mortgage industry of a federal statutory fix, even if Congress were amenable, while it might affect future bankruptcy court decisions, may not be effective in foreclosure, which is a state law matter.

At minimum, these issues provide debtors, and perhaps not just residential debtors, with additional leverage and opportunity to slow down what is usually the foreclosure freight train. From a secured creditor enforcement standpoint, lawyers seeking to enforce mortgages in foreclosure or bankruptcy will need to do much more preparation in order to increase the chance

that they will successfully recover. Creditors argue debtors are evading obligations on technicalities. Debtors respond that the secured lenders have made billions of dollars in extra fees by enforcing technicalities and simply do not like their rules used against them. In either event, it is another side effect of the manner in which mortgages and the financial instruments trading them have evolved in recent years.