

No Free Houses: Few Mortgages Have Fatal Flaws

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These are historic times. Among the many facets of the economic crisis facing America is the foreclosure crisis. While we may debate the various possible causes of the crisis, no one can doubt that the increasing number of foreclosures nationwide is perniciously persistent. Unfortunately for Idaho, its foreclosure rates are consistently among the highest in the country.¹

Idaho apparently has also been following a related trend of defaulting homeowners filing lawsuits against their mortgage lenders. In a few rare out-of-state cases, judges have found that sloppy mortgage loan practices have rendered the mortgages unenforceable, effectively awarding a free house to the borrowers. National media attention on issues like “robo-signing” coupled with a collective anger over economic hardship has no doubt fueled the rapidly rising number of lawsuits.² While many troubled homeowners are trying to keep their heads above the murky waters of foreclosure and modification procedures, others are clearly just trying to win the free house lottery.³

This article cannot possibly address the multitude of claims asserted by troubled homeowners. It is tempting to digress by addressing some of the more unusual theories, giving highest tribute to the creativity of the plaintiffs’ bar. Without intentionally indulging that temptation, however, this article will instead focus on one of the more common claims that homeowners raise: a claim of quiet title in an attempt to remove the mortgage⁴ lien from their residence.

Quiet title

In a quiet title action, the plaintiff is requesting the court to declare that he has good title to real property and to forever bar particular adverse claims.⁵ The primary purpose of many of these new cases is the elimination of the mortgage lien on the property. The plaintiff has the burden of proof to show that he owns the property free of the mortgage.⁶ There are several theories under which the plaintiff will at-

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tack the validity of the mortgage in a quiet title action. The plaintiff may argue that the mortgage should be eliminated where (1) the defendant cannot produce an original promissory note, (2) Mortgage Electronic Registration Systems, Inc. (MERS) is acting as a nominee for the beneficiary under a deed of trust, or (3) ownership of the note was transferred or securitized.

The tender rule

As a preliminary matter, before the plaintiff even gets to the merits of the quiet title claim, he must satisfy the tender rule. That is, a mortgagor cannot quiet title against a mortgagee without showing that he has paid or tendered payment of the debt.⁷ The tender rule is emerging as a threshold issue. A quiet title complaint intended to remove a mortgage will not survive a motion to dismiss without an allegation that the obligation securing the mortgage has been paid.⁸ This is true even if the mortgage is unenforceable under the statute of frauds.⁹

The bottom line is that “[w]ithout evidence or even an assertion that Plaintiffs can or are willing to tender payment on their loan, they cannot succeed on their quiet title action, as a matter of law.”¹⁰ Because most of these cases involve homeowners who are unable to make their payments, they will be unable to make it past the pleading stage.¹¹

Produce the note

Despite the passage of the industrial age into the internet age, many attorneys seem stuck on the idea that there is some overriding magical quality in the physical existence of paper. In a nutshell, the assertion is that an original “wet ink” promissory note is required for enforcement of the note and mortgage. Without any legal authority whatsoever, plaintiffs raise a claim that the mortgage lender cannot foreclose a defaulted mortgage without the original loan documents.

First, it is worth noting that these plaintiffs typically admit that they borrowed money, admit they signed a promissory note and admit the note is in payment default. Many plaintiffs will then tiptoe around not admitting that a particular copy of the note is accurate. A stray pencil squiggle on a copy becomes a windfall of an excuse for avoiding the admission of plaintiff’s signature. An endorsement on the back of a note seems to provide an even better excuse for avoiding the admission of plaintiff’s signature on the front of the note. The bottom line is that when a plaintiff admits borrowing money, admits signing the note, admits the default, and a copy of the note is available, the existence of the actual original piece of paper is not, and should not, be required to enforce the obligation.

Idaho Courts are in agreement.¹² An original wet ink note is not required to foreclose a deed of trust.¹³

Role of MERS

Mortgage Electronic Registration Systems, Inc., (MERS), is a private electronic database “that tracks the transfer of the ‘beneficial interest’ in home loans, as well as any changes in loan servicers.”¹⁴ Many home loan deeds of trust refer to MERS as the beneficiary and the nominee for the beneficiary. The owner or lender is the entity that is ultimately entitled to the beneficial interest, which is repayment of the loan.¹⁵ A loan servicer is the entity that “collects payments from the borrower, sends payments to the lender, and handles administrative aspects of the loan.”¹⁶

It has become common practice for lenders who originate a mortgage loan to subsequently resell the loan or even bundle the beneficial interest in individual loans and sell them to investors as part of mortgage backed securities. “MERS was designed to avoid the need to record multiple transfers of the deed by serving as the nominal record holder of the deed on behalf of the original lender and any



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subsequent lender.”¹⁷ Thus, even where the ownership of the mortgage loan paper changes, the role of MERS as a nominee for the beneficial interest remains unchanged.

Numerous challenges have been raised to the authority of MERS to act on behalf of the holder of the beneficial interest. A few out-of-state cases have held that MERS does not have the authority to transfer the promissory note.¹⁸ A few others have held that MERS does not have the authority to appoint a trustee under a deed of trust or conduct foreclosure proceedings.¹⁹ Idaho judges, however, have consistently upheld the authority of MERS to appoint a trustee in a deed of trust and conduct a foreclosure sale.²⁰ To my knowledge, not a single Idaho case has denied MERS authority as a matter of law.²¹ However, this issue is currently pending in front of the Idaho Supreme Court in *Trotter v. Bank of New York*, and we should soon learn whether the unanimity of the Idaho state courts is in accord with the ultimate authority on the issue.²²

If the Idaho Supreme Court holds that MERS cannot appoint a trustee and initiate a foreclosure, the bar could be gainfully employed for years with the messy aftermath from the thousands of Idaho foreclosure sales conducted in this manner. The ambiguities created by those wrongful foreclosures may wreck our already crippled real estate markets.²³ For the moment, we can only wait and see.

Note transfers

One primary theory used to attack the authority of MERS to act on behalf of the beneficial interest has come to be known as the “split the note” theory.²⁴ To understand the “split the note theory” it is helpful to start with the basic functioning of a real estate secured loan under Idaho law. In a typical Idaho real estate finance transaction, a deed of trust grants a security interest for the repayment of an obligation, usually a promissory note.²⁵ If there is a breach of the note, the deed of trust may be enforced by foreclosure.²⁶ Therefore, the deed of trust is enforced by its beneficiary who is also the holder of the note that was breached.

The “split the note theory” comes into play where the holder of the note is a different person than the beneficiary under the deed of trust. If the holder of the note no longer has an interest in the deed of trust, it cannot enforce the note by foreclosing the deed of trust.²⁷ In this case, the note is said to be “split” from the deed of trust, potentially making the deed of trust unenforceable.

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Like many states, Idaho law allows the assignment of loans.²⁸ When a note secured by a deed of trust is assigned, the deed of trust follows the note.²⁹ However, the mere fact that a transfer occurred does not sever the note from the deed of trust.³⁰ In order for a plaintiff to successfully invalidate the deed under this theory, they must show that the holder of the loan is a *different* entity than the beneficiary under the deed of trust. The deed would only become unenforceable where the note and deed were irreparably split when “MERS or the trustee, as nominal holders of the deeds, are *not* agents of the lenders.”³¹ Because MERS *is* acting in a representative capacity for the beneficiary, the involvement of MERS alone is insufficient to invalidate the deed.

Who owns the note?

Another popular theory with the goal of invalidating mortgage obligations is the “who owns the note” theory. A plaintiff raising this point simply states that the mortgage obligation should not be enforced because the plaintiff does not know who currently owns the paper behind that obligation.³² Of course, there is nearly always a servicer of the loan that is responsible for collecting payments and distributing to the person so entitled. The plaintiff asserts that he should not be required to make payments to the servicer without knowing the exact identity of the person entitled to the ultimate payment.

However, as long as the identity of the servicer is clear and the borrower knows where to send payments, disclosure of the ultimate person entitled to payment is not a defense to payment. The United States Bankruptcy Appellate Panel for the Ninth Circuit issued an opinion earlier this year with an extensive analysis of Article 3 of the Uniform Commercial Code on exactly this point.³³ The *Veal* court concluded that “[u]nder established rules, the maker [borrower] should be indifferent as to who owns or has an interest in the note so long as it does not affect the maker’s ability to make payments on the note.”³⁴ Further, “it is thus irrelevant whether the Note has been fractionalized or securitized—so

long as they do know who they should pay.”³⁵

Article 3 of the Uniform Commercial Code contains no provisions that entitle the maker of a promissory note to any information regarding the subsequent transfers or negotiation of that note.³⁶ The only information relevant to the borrower is where to send payment, which is typically to the servicer. As long as that information is clear, payment must be sent and there is no basis for quiet title against the deed of trust under the “who owns the note” theory.

Miscellaneous theories

Congress has enacted a wide array of conflicting, confusing and probably often worthless legislation in attempts to address the foreclosure crises. Plaintiffs have concocted a creative variety of claims under these statutes to challenge their mortgages in quiet title actions. However, “the mere existence of a federal statute does not create a private cause of action.”³⁷ Therefore, homeowners will not win the free house lottery because their lender or servicer (1) obtained TARP funds, (2) did not give them a loan modification, or (3) violated a federal policy to preserve home ownership.³⁸ A plaintiff inclined to bring a claim under any federal statute must be prepared to cite the Court to the specific provision that sets out a private right of action. A plaintiff that cannot find that specific authority should not bring the claim.

Conclusion

The financial systems of this country are apparently ill equipped to handle the volume of foreclosures occurring now. Mistakes do happen, even in Idaho, and even among the better run institutions. Where there are legitimate mistakes, there may be grounds for challenging a foreclosure or defending repayment of a loan. Counsel to troubled homeowners will best serve their clients by carefully reviewing a foreclosure or a loan modification for material and actual mistakes. Remedies may be rightfully available.

People are not entitled to a free house, however, just because their deed of trust contains the word "MERS" or their promissory note was transferred, securitized or lost. The local legal authority on these points is becoming so voluminous that attorneys need to take a hard look at their Rule 11 obligations before asserting these types of claims. Blindly filing meritless complaints copied off the internet further adds litigation stress and expense to people who are already overburdened with stress and expense, and that goes for the homeowners, too.

About the Author

Kelly Greene McConnell is a partner at the law firm of Givens Pursley LLP, she has extensive experience in all facets of bankruptcy and reorganization issues, having worked on credit recovery, in agriculture, healthcare, real estate, and a variety of other industries. In addition, Ms. McConnell routinely handles complex financial transactions and state regulations of financial institutions. Committed to financial literacy, she works with the Board of Trustees for the Commercial and Bankruptcy Section of the Idaho Bar Association in promoting their financial education program. She received her B.S. in International Business Administration from California State University in 1986 and her J.D. from the University of the Pacific, McGeorge School of Law in 1989.

Endnotes

¹ *Idaho Remains Among Top 10 States in Foreclosure Rate*, IDAHO STATESMAN, August 11, 2011. Citing RealtyTrac, the Statesman reports that Idaho foreclosure rates have ranked among the top 10 states for 30 consecutive months, dating back to 2009.

² Givens Pursley is currently representing loan servicers in well over two dozen Idaho lawsuits. To my knowledge, other Idaho law firms have similar case loads. We have no statistics on the number of currently pending "free house" cases, but anecdotally at least the numbers are substantial.

³ For lack of a better description, my team has dubbed these lawsuits "free house cases." Derrick O'Neill deserves credit as the genesis of that reference from his public lament during last year's Bankruptcy Section annual meeting along the lines of – all of a sudden everyone thinks they should get a free house because the word MERS is in their deed of trust. Unfortunately, I don't remember the exact quote.

⁴ The instrument almost always at issue is, in fact, a deed of trust. However, where the legal analysis does not involve a point particular to the form of the instrument, this article may reference the instrument as a "mortgage."

⁵ 65 Am. Jur. 2d *Quieting Title* § 1, p. 6.

⁶ *Lossee v. Idaho Co.*, 148 Idaho 219, 222, 220 P.3d 575, 578 (2009).

⁷ *Trusty v. Ray*, 73 Idaho 232, 236, 249 P.2d 814, 817 (1952).

⁸ *Russell v. OneWest Bank FSB*, 2011 WL 5025236, *12 (D. Idaho, October 20, 2011) (dismissing a quiet title claim where the plaintiff did not allege that the mortgage obligation had been paid); *Gilbert v. Bank*

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— *In re Sheridan*

of America, 2011 WL 4345004, *2 (D. Idaho, September 15, 2011).

⁹ *Trusty*, 73 Idaho at 236, 249 P.2d at 817.

¹⁰ *Gilbert*, 2011 WL 4345004 at *12.

¹¹ In fact, our experience has been that nearly all or all of the free house cases fail at the pleading stage.

¹² *Doan v. Columbia Mortgage*, District Court for the Fifth Judicial District for the State of Idaho, Blaine County Case No. 11-0516, Memorandum Decision on Defendants' Motion to Dismiss (October 12, 2011); *Doan v. Sun Valley Brokers*, District Court for the Fifth Judicial District for the State of Idaho, Blaine County Case No. 11-0517; Memorandum Decision on Defendants' Motion to Dismiss (October 12, 2011); see also, *In re Veal*, 450 B.R. 897, 910 (9th Cir. 2011).

¹³ *Id.*; see also I.C. § 28-3-308 (negotiable instruments are still enforceable if the original was lost, destroyed or stolen).

¹⁴ *Cervantes v. Countrywide Home Loans*, 656 F.3d 1034, 1038 (9th Cir.2011).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ E.g., *Bellistri v. Ocwen Loan Servicing, LLC*, 284 S.W.3d 619 (Mo. 2009).

¹⁹ See *MERS v. Graham*, 44 Kan. App. 2d 547, 2010 WL 1873567 (Kan. App. 2010) (citing to the well known decision on these issues of *Landmark National Bank v. Kesler* 289 Kan. 528, 216 P.3d 158 (Kan 2009)).

²⁰ *Washburn v. Bank of America*, United States District Court for the District of Idaho, Case No. 11-0193-EJL-CWD, Report and Recommendation on Motion to Dismiss, docket # 28 (October 21, 2011); *Doan v. Columbia Mortgage*, District Court for the Fifth Judicial District for the State of Idaho, Blaine County Case No. 11-0516, Memorandum Decision on Defendants' Motion to Dismiss (October 12, 2011); *Doan v. Bank of America*, District Court for the Fifth Judicial District for the State of Idaho, Blaine County Case No. 11-517, Memorandum Decision on Defendants' Motion to Dismiss (October 12, 2011); *Edwards v. MERS*, District Court for the First Judicial District of the State of Idaho, Kootenai County Case No. 10-2745, Memorandum Decision and Order Re: Defendants' Motion for Summary Judgment (November 16, 2010); *Trotter v. Bank of New York, et al.*, District Court of the First Judicial District of the State of Idaho, Kootenai County Case No. 10-95, Memorandum Decision and Order Re: Defendants' Motion to Dismiss (July 2, 2010).

²¹ MERS must have its documentation in order, like any other foreclosing party. This statement only applies to the authority of MERS as a legal principle and not upon any particular factual situation where the underlying foreclosure documentation may or may not have been handled properly. See *In re Sheridan*, 2009 WL 631355 (Bkrcty.D.Idaho) (holding even if MERS' authority in a representative capacity is valid, it must be prepared to make a showing on

proper documents of the real party in interest with standing to bring a motion for stay relief); See also, *Gomes v. Countrywide*, 192 Cal.App.4th 1149 (Cal. Ct. App. 2011) (holding that the grantor agreed to MERS' authority to foreclose per the express language in the deed of trust).

²² *Russell v. OneWest Bank FSB*, 2011 WL 5025236 (D. Idaho, October 20, 2011) (withholding a decision on the issue of whether MERS has the authority to initiate foreclosure proceedings pending the Idaho Supreme Court decision in *Trotter v. Bank of New York*).

²³ I.C. § 45-108 prevents a challenge to a foreclosure sale if it was conducted correctly. It would remain to be seen whether this statute as analyzed in *Russell v. OneWest Bank FSB* would prevent a post-foreclosure challenge to a foreclosure sale initiated by MERS if the Idaho Supreme Court overturns *Trotter*.

²⁴ See *In re MERS*, 2011 WL 251453 (D. Ariz., January 25, 2011) (identifying the "split the note theory" and rejecting it as a basis for quiet title, slander of title and unjust enrichment).

²⁵ See I. C. §§ 45-1502(3) and 45-1503(1).

²⁶ See I.C. § 45-1503(1).

²⁷ *Cervantes v. Countrywide Home Loans, Inc.*, 656 F.3d 1034, 1039 (9th Cir. 2011) ("The deed and note must be held together because the holder of the note is only entitled to repayment, and does not have the right under the deed to use the property as a means of satisfying repayment. Conversely, the holder of the deed alone does not have a right to repayment and, thus, does not have an interest in foreclosing on the property to satisfy repayment.")

²⁸ See I.C. § 28-3-201.

²⁹ RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4(a) (1997) ("A transfer of an obligation secured by a mortgage also transfers the mortgage unless the parties to the transfer agree otherwise.")

³⁰ *In re Tucker*, 441 B.R. 638, (Bkrcty. W.D. Mo. 2010) at *6 (holding severance does not occur if the note holder and deed of trust beneficiary are the same, even for subsequent parties to whom the note has been properly assigned).

³¹ *Cervantes*, 656 F.3d at 1044 (emphasis added).

³² A plaintiff taking up the sword to invalidate an obligation presents a different situation than a creditor taking up the sword to seek stay relief. See *In re Sheridan*, 2009 WL 631355 (Bkrcty.D.Idaho). A defendant does not need to prove his "standing" to be in the action.

³³ *In re Veal*, 450 B.R. 897 (9th Cir. 2011).

³⁴ *Id.* at 912.

³⁵ *Id.*

³⁶ *Edwards v. MERS*, District Court for the First Judicial District for the State of Idaho, Kootenai County Case No. 10-2745 ("...this Court concludes that the Note and Deed of Trust may be sold one or more times without prior notice to the Borrower.")

³⁷ *Id.*

³⁸ *Russell v. OneWest Bank FSB*, 2011 WL 5025236 (D. Idaho, October 20, 2011).