

MERS: Every Commercial Loan Needs a MOM

During its lifetime, the average mortgage loan will be sold and assigned a multitude of times, from initial lender to perhaps a wholesaler/trustee and then on to an agency such as Fannie Mae or Freddie Mac. Each time the loan is sold or assigned, it's possible the identity of the actual owner will be lost during the assignment process.

This problem exists because the actual assignments must be properly prepared and then recorded with the local filing office. Loan servicers will often rely on a title company or another outside service to ensure that these documents are properly recorded, only to find out later there are serious gaps in the recorded history of ownership for the loan.

The mortgage banking industry addressed this problem for residential loans by creating Mortgage Electronic Registration Systems Inc. (MERS), Vienna, Virginia. It is a system designed to streamline the mortgage loan process by having MERS act as a single mortgagee of record, thereby eliminating the need for assignments. MERS is also designed to pro-

The system that established an electronic registry for ownership of home mortgages and servicing rights seems perfect for the commercial mortgage-backed securities (CMBS) industry. Here's what MERS Commercial has to offer, and the obstacles that must be overcome to get there.

vide a system whereby members could electronically access key information about a loan that was originated through the MERS® System. MERS is now saving residential lenders and servicers millions of dollars annually.

Although MERS was initially developed and used for residential loans, the thinking was MERS would eventually be adapted for use with commercial mortgages. MERS is currently in the process of launching MERS® Commercial, which is based on the residential MERS System but modified to handle the specific requirements of the commercial mortgage-backed securities (CMBS) market.

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MERS Commercial is scheduled for release in the late summer of 2003. Because such a high proportion of commercial loans eventually end up in CMBS pools and due to the more complex servicing structures in CMBS transactions, MERS Commercial users are expected to realize even greater savings than their residential counterparts. MERS has said its long-term goal is to have every mortgage loan in the United States, whether residential or commercial, registered in the MERS system.

This article illustrates the potential benefits and impact MERS Commercial will have on the commercial mortgage industry. The article starts with a look at the impact MERS has had on the residential mortgage loan industry. Then we examine the limitations of the current system in the CMBS world, where assignments must be recorded each time a mortgage loan is sold and assigned. Then we discuss the basics of how MERS Commercial will work and the benefits it will provide to the commercial mortgage industry. We conclude by outlining some of the major issues and hurdles MERS Commercial must overcome in order to be successful.

Behind MERS

MERS was developed in 1996 as a result of a joint effort of members of the mortgage banking industry to combat the problem of missing assignments and defective loan files. Currently there are more than 700 companies registering residential loans through the MERS system. Loan registrations are averaging more than 25,000 per day and are expected to continue to increase as more companies use MERS.

In September 2002, MERS registered its 10 millionth loan. MERS executives and directors represent leaders in the fields of electronic commerce, mortgage banking and the title insurance industry. Companies in the mortgage banking industry also form the majority of the shareholders of MERS.

The problem with assignments

There are several major problems with the current process. Under that process, mortgage loans are assigned via paper assignments each time a mortgage loan is sold or transferred. The first and most obvious problem is the sheer hassle and cost of preparing an assignment each time a mortgage loan is sold or servicing is transferred, which can occur multiple times during the life of a loan.

Each time an assignment is prepared, the lender or servicer incurs costs. These expenses stem from the manpower required to prepare the assignment documentation, postage and other delivery costs; fees such as legal fees; and actual recording or filing fees and expenses. If the assignments are not prepared correctly the first time, more costs are incurred from having the assignment redone and resent for filing.

Not having a proper chain of assignments may cause disruptions in the servicing of a loan. To the extent previous

assignments have not been properly filed, the loan file must be corrected. This is done by locating prior lien-holders and then having assignments prepared and refiled. In addition, the identity of the lender must be correctly filed before any modification or release documents can be filed. This can result in delays in processing servicing requests, resulting in customer service-related issues (and possible liability)

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for lenders and their loan servicers.

The biggest problem with missing assignments, however, is they can have a serious financial impact on lenders. The majority of pooling and servicing agreements for securitized loans allow trustees to remove any loans from a securitization pool that do not meet the pooling and servicing agreement's document delivery requirements. The trustee or issuer may then force a repurchase of the defective loan. Missing assignments and a defective chain of title are among the items that can trigger a loan repurchase. This takes on added significance in the CMBS market. In the residential market the threat of a \$150,000 residential loan repurchase may not be that devastating, but the prospect of repurchasing a \$150 million commercial loan is quite another matter. Another drawback of improperly recorded assignments is gaps in the ownership records may adversely impact the rating and trading of the CMBS.

The birth of MERS Commercial

MERS Commercial was created in the latter half of 2002 as a way to tackle the issue of incomplete and/or defective loan files in the commercial mortgage industry. A MERS Commercial Business Requirements Development Meeting was held on Sept. 24-26, 2002, at the MERS offices in Vienna, Virginia. At that meeting, industry leaders met to discuss the needs of the commercial mortgage industry as well as the basic business requirements for MERS Commercial, such as Mortgage Identification Number (MIN) generation, document preparation, the registration process, maintenance and updating of records and other necessary features of MERS Commercial.

Major players in the mortgage banking industry such as Wells Fargo, Bear Stearns, Bank of America, GE Capital, GMAC Commercial Mortgage Corporation and John Hancock have provided initial funding to MERS Commercial, while the venture has been endorsed by the Commercial Mortgage Securities Association (CMSA) and the Mortgage Bankers Association of America's (MBA's) Commercial Real Estate/Multifamily Finance Board of Governors (COMBOG).

MERS also has been approved by Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Housing Administration (FHA), as well as all of the major Wall Street rating agencies. MERS Commercial will initially be targeted toward CMBS loans, with future plans to include agency multifamily loans.

How MERS Commercial works and the potential benefits

MERS Commercial will operate much like MERS functions for residential loans. MERS will act as the lender in the local recording office for the lender and servicer. Future assignments do not need to be prepared, because MERS remains the mortgagee no matter how many times a loan is sold or servicing is transferred.

Every time a commercial loan is sold, MERS will maintain an electronic record showing the loan's ownership history as well as pertinent information about the loan. MERS will remain the mortgagee of record until the mortgage lien is extinguished. All monthly mortgage payments, however, are made payable and sent directly to the loan servicer.

MERS Commercial will be Web-based and will provide the additional benefit of being a storehouse where information on MERS-originated loans will be collected in a centralized location. MERS will collect, maintain and display loan information such as the note amount and borrower; the properties, security instruments and Uniform Commercial Codes (UCCs) used as collateral for the loans; and the various parties to the loan transaction (note holders, servicers, custodians, etc.) and their relationship to each other. All of these components will be linked by an 18-digit MIN that will be the primary key to all of the records maintained within the MERS system.

When preparing loan documentation, lenders will designate MERS as the lender of record or, in MERS terminology, MERS as Original Mortgagee (MOM). Document preparers must include the loan's MIN on each document. They also will incorporate MOM language on all of the recordable documents and, at the option of the lender, the remaining loan documents. Immediately after the loan closing, the originating lender will enter the MIN, along with the required information to identify a loan and its collateral, into the MERS system.

Once a loan has been registered with MERS, authorized users will have the ability to access the MERS system and update a particular loan's records to track changes in the loan's ownership, servicing and collateral rights. All of the information mentioned earlier will be available online, but only to authorized users. Critical loan events will generate a loan history record known as a "milestone." This electronic registry has the added benefit of reducing the amount of time that lenders need to respond to servicing requests such as

loan assumption requests, since all the information for a particular loan will be readily available.

In the event of servicing issues, such as a required modification to a security instrument, MERS, as the mortgagee of record, normally would be required to sign any modification instruments. MERS has remedied this problem by providing each MERS member with a corporate resolution authorizing the servicer's officers to execute certain documents on behalf of MERS. This allows servicers to perform basic servicing functions without having to go to MERS each time, even though MERS remains the lender of record. In fact, the MERS system contemplates that all servicing obligations, responsibilities and liabilities will lie with the servicer or noteholder, as those parties allocate such responsibilities and liabilities in their pooling and servicing agreement.

The process for foreclosing loans entered into the MERS system will vary from state to state, because each state handles the foreclosure process differently. In most states, the trustee's/sheriff's deed can be issued directly to the servicer or investor, so that MERS does not end up with fee title at the conclusion of the foreclosure. Some states, however, require a strict foreclosure where MERS ends up with title to the foreclosed property. In these instances, MERS members will be required to issue a subsequent deed from MERS to themselves or the investors as soon as possible after the foreclosure.

To assist with troubleshooting and answering questions about MERS conveniently, MERS offers an online Forum. Anyone can access the Forum and ask questions and review answers related to MERS. These questions are posted online and answered by an in-

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house attorney at MERS. The MERS Forum also allows participants to learn about issues they may face in the future based on other users' experiences with MERS. MERS has also set up a help desk to answer questions.

Potential obstacles facing MERS Commercial

Although the success of MERS residential has largely paved the way for the success of MERS Commercial, there are several issues with MERS that must be resolved, as well as unique problems that MERS Commercial will face in the CMBS market.

One of the greatest difficulties facing the MERS system is general unfamiliarity with its system. There have been instances where local recording offices and title insurance offices did not understand the MERS system, resulting in confusion, rejected recordings and other delays in the loan process. In some instances, documents naming MERS as mortgagee have initially been rejected where the beneficial ownership of a loan has changed, but the local recording offices will note the absence of any assignments, thus raising a red flag when documents need to be recorded.

For example, MERS documents were rejected by several recorders' offices in the state of New York based on an opinion from the attorney general of New York. The opinion stated in substance that documents will only be recorded under the name of the actual parties in interest. The attorney general's opinion was based on the incorrect assumption that MERS in fact had no legal interest in the documents, even though MERS is named as mortgagee (this fact was unknown to the attorney general at the time the opinion was issued). Thus, several jurisdictions in New York interpreted the attorney general's opinion to mean that all MERS documents should be rejected for recording.

MERS was forced to litigate this issue, and in June 2002 obtained a temporary order requiring that MERS documents be recorded. MERS is confident that the current state of the law is in its favor and that it will prevail in the litigation. This problem, although atypical, may yet appear in other jurisdictions that are unfamiliar with MERS.

Borrowers may also be unfamiliar with MERS. This may cause confusion when, for example, MERS appears as the plaintiff rather than the actual noteholder or servicer in a foreclosure action or condemnation proceeding. Borrowers then may become confused as to where to send payments or correspondence. These problems may persist until such time as there is a greater recognition of MERS and how the MERS system operates.

There is also the question of how MERS will function with complex commercial loan transactions—for example, where the loan security is cross-collateralized or where there are multiple notes per property. None of these issues appears in the residential loan context. MERS is currently developing methods whereby the MERS system will be able to accommodate complex or irregular transactions—such as Maryland's indemnity deed of trust structure, where the identity of the borrower and owner of the collateral are different—which may provide users with incomplete or confusing information about that particular loan.

Another area of concern relates to third parties that are involved in the loan process, such as borrower's counsel and title insurance companies. For example, in commercial loans, as opposed to residential loans, opinions of counsel are usually required whereby the borrower's attorney must opine that the loan documentation is enforceable against the borrower subject to certain customary qualifications. Attorneys may be hesitant to give such opinions where

MERS, as opposed to the original lender, is the mortgage holder of record. Although the answer to this question largely depends on state law, it would seem that the identity of the mortgage holder of record is largely irrelevant for a basic enforceability opinion. The fact that MERS is named as mortgagee in a document would generally not affect the underlying terms and enforceability of the docu-

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ments. Nevertheless, it should be expected that a fair number of the borrower's counsel may be unfamiliar with MERS and may raise MOM as an issue when delivering their opinions.

Similarly, title insurance companies may show resistance in providing lenders with a mortgagee's title insurance policy where the mortgage securing the original lender's loan shows MERS as the mortgagee. Title companies in the residential market have dealt with the problem by naming the "insured" in one of four ways: (1) the lender, its successors and assigns appearing of record as Mortgage Electronic Registration Systems Inc.; (2) the lender, its successors and assigns; (3) Mortgage Electronic Registration Systems Inc. as the beneficiary and the lender as the beneficial lender; and (4) the lender and/or Mortgage Electronic Registration Systems Inc. solely as nominee for the lender, its successors and assigns, as their interests may appear. Presumably, these approaches will be available and acceptable in the commercial market. Note that, here again, local title insurance law may alter this analysis.

The majority of these issues center on the novelty of MERS and will be remedied over time. Yet until MERS Commercial becomes a household name in the mortgage industry, these issues will need attention to bring about the smooth operation and success of MERS.

Considering the success MERS has enjoyed in the residential loan context, it seems likely it will experience the same success in the CMBS world. Much like in the residential context, the biggest hurdle facing MERS is a lack of understanding and unfamiliarity with the MERS system. Yet at the same time, MERS Commercial will undoubtedly face issues unique to the CMBS market.

Nevertheless, we believe the time will come when MERS Commercial will be a backbone of the CMBS world, and everyone will understand that every commercial loan needs a MOM. **MB**

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