Outside Counsel

Mortgage Securitization: What Is Its Impact on Lender's Ability to Foreclose?

By **Christopher A. Gorman**

In a recent oral argument in an appeal in a mortgage foreclosure action pending before the Appellate Division, the presiding justice asked the attorneys what may seem like a simple question—if the plaintiff-lender attached a copy of the original promissory note to the complaint, would it not be the case that the plaintiff had standing to foreclose? The answer, of course, would seem to be "yes," since the law is that the mortgage follows as an inseparable incident to the debt (i.e., the promissory note), so the party in possession of the promissory note at the commencement of the foreclosure action has standing to foreclose. See, e.g., *Bank of New York v. Silverberg*, 86 A.D.3d 274, 280 (2d Dept. 2011).

However, a simple "yes" answer to the question would ignore recent case law concerning whether a borrower in a foreclosure action can assert defenses founded upon alleged non-compliance with documents governing the securitization of the underlying loan—e.g., pooling and servicing agreements. To date, there is a developing body of conflicting law among courts interpreting New York law on the subject. This article seeks to show the distinctions in the two divergent bodies of law that are developing, and highlight the importance of having a New York state appellate court clarify New York law on this subject before even more divergent results are reached in mortgage foreclosure actions.

Securitization and Trusts

Securitization involves the process by which multiple loans are pooled into a trust and converted into mortgage-backed securities. Residential mortgage-backed securities (RMBS) trusts are generally formed pursuant to a pooling and servicing agreement (PSA), which is a contract that governs the trust. Generally, parties to a PSA include, among others, the "depositor," who conveys the loans to the trustee in return for certificates, and the trustee, who owns and holds mortgage loans in trust for investors who buy the certificates backed by the pooled mortgage loans. PSAs generally contain provisions requiring the delivery of trust assets—i.e., promissory notes and mortgages—to the trustee in a particular manner on or before a specified closing date. See generally *Anh Nguyet Tran v. Bank of New York*, 2014 WL 1225575 (SDNY March 24, 2014) (generally describing the securitization process), aff'd, 2015 WL 394338 (2d Cir. Jan. 30, 2015).

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Many RMBS trusts are formed as REMIC—"real estate mortgage investment conduit"—trusts under the Internal Revenue Code (IRC). Under the REMIC provisions of the IRC, the "closing date" of the trust is also the startup day for the trust, and the closing date/startup date is significant because all assets of the trust must be transferred to the trust on or before the closing date to ensure that the trust receives its REMIC status. See generally *In re Saldivar*, 2013 WL 2452699 (Bankr. S.D. Tex. June 5, 2013). The IRC limits REMIC treatment to entities that, "as of the close of the 3rd month beginning after the startup day" of the trust, have "qualified mortgages" as "substantially all of [the entity's] assets." 26 U.S.C. §860D(a)(4). Obligations secured by real property transferred to the REMIC trust either on the startup day or within the following three-month period are "qualified mortgages." 26 U.S.C. §860G(a)(3).

A claim which borrowers have raised in mortgage foreclosure actions and other litigation centers upon circumstances where the delivery of trust funds—i.e., the notes and mortgages that were pooled—were transferred in violation of the PSA because the delivery was not completed on or before the closing date for the trust. In other words, borrowers have claimed that post-closing date assignment of loans by predecessor lending institutions to the trustee seeking to foreclose are invalid and deprive the lender of standing.

The foundation for this argument is New York Estates Powers & Trusts Law (EPTL) §7-2.4. EPTL §7-2.4 states: "If the trust is expressed in the instrument creating the estate of the trustee, every sale, conveyance or other act of the trustee in contravention of the trust, except as authorized by this article and by any other provision of law, is void." A minority of courts have held that non-compliance with the terms of a PSA based upon a transfer of a loan after the closing date of the securitized trust renders an assignment void under EPTL §7-2.4.

The leading case holding as much is *Wells Fargo Bank v. Erobobo*, 2013 WL 1831799 (Sup. Ct. Kings Co. April 29, 2013). In *Erobobo*, the defendant-borrowers in a foreclosure action argued in opposition to the plaintiff-lender's motion for summary judgment that the lender, a REMIC trust, was not the owner of the note because the lender obtained the note and mortgage after the trust had closed in violation of the terms of the PSA. The Erobobo court, in denying the lender's motion for summary judgment, concluded that the lender failed to provide any "evidence that the trustee had authority to acquire the note and mortgage... after the trust had closed" and that, since "the trustee acquired the subject note and mortgage after the closing date,

» Page 7

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Outside Counsel / Corporate Update

Mortgage

« Continued from page 4

the trustee's acts in acquiring them exceeded its authority and violated the terms of the trust."

The court also concluded that acquiring the mortgage after the trust's closing date not only violated the trust's terms, but also "jeopardize[d] the trust's REMIC status." As such, the court, citing EPTL §7-2.4, concluded that the lender was not entitled to summary judgment because "[u]nder New York Trust Law, every sale, conveyance or other act of the trustee in contravention of the trust is void," and, therefore, "the acceptance of the note and mortgage by the trustee after the date the trust closed, would be void."

Similarly, in *Aurora Loan Services v. Scheller*, 43 Misc.3d 1226(A) (Sup. Ct. Suffolk Co. 2014), the court granted the borrowers' motion to amend the answer to assert defenses to a foreclosure action based upon the securitization of the loan. The court, accepting as true the borrowers' allegation that the acceptance of the note and mortgage by the trustee occurred "in a manner other than that either prescribed or permitted" by the governing PSA, found that "it inexorably follows that the acts taken by the trustee were clearly ultra vires and therefore would necessarily be void ab initio."

Relying upon EPTL §7-2.4, the court in *Scheller* concluded that, where the trustee's acts "are ultra vires, all successors and subsequent assignees are charged with constructive knowledge of the express terms of the trust and hence cannot claim to be bona fide purchasers thereafter inasmuch as they would either know or would have reason to know that any interest transferred would be subject to the operative terms of the trust."

Rejecting Borrowers' Defense

While some courts have been persuaded by the reasoning of *Erobobo*, the weight of the case law holds that borrowers cannot found a claim upon a post-closing date transfer to a trust. Indeed, the majority of courts have rejected the argument made by borrowers that they are entitled to relief based upon a post-closing date transfer of the loan documents. Courts have generally done so by proceeding upon two theories.

First, a number of courts have rejected this defense by holding that, because the borrower is not a party to the PSA, and was not a third-party beneficiary of the PSA, the borrower lacks standing to bring claims based upon alleged breaches of the PSA. See *In re Lake Charles Retail Development*, 2014 WL 4948234, at *9 (Bankr. EDNY Sept. 30, 2014) ("The debtor is not a proper party to challenge the validity of the transfer of the loan package into the trust, because debtor is not a third-party beneficiary to the PSA. Accordingly, because the debtor predicates its claims for relief on an alleged failure to comply with the PSA, the complaint is dismissed"); see also *Bank of New York Mellon v. Gales*, 116 A.D.3d 723, 982 N.Y.S.2d 911 (2d Dept. 2014) (stating without any analysis or any reference to EPTL §7-2.4 that the borrowers "did not have standing to assert noncompliance with the subject lender's pooling service agreement").

This, of course, is in direct contrast to courts in the minority position, which, in reliance upon EPTL §7-2.4, have held that, while a "third party generally lacks standing to challenge the validity of an assignment," a "borrower may...raise a defense to an assignment, if that defense renders the assignment void" from its inception. See, e.g., *Saldivar*, 2013 WL 2452699 (applying New York law).

The second basis for rejecting this defense is found in the decision of the U.S. Court of Appeals for the Second Circuit in *Rajamin v. Deutsche Bank National Trust*, 757 F.3d 79, 89 (2d Cir. 2014). In *Rajamin*, the borrowers sought a judgment declaring that the certain trusts did not own the borrowers' loans and mortgages because the parties to the trusts breached the terms of the securitization agreements. Finding that the borrowers lacked standing under the trusts, the district court dismissed the complaint for failure to state a claim.

The Second Circuit affirmed, concluding that, despite the express language of EPTL §7-2.4, "the weight of New York authority is contrary to [the borrowers'] contention that any failure to comply with the terms of the PSAs rendered [the] acquisition of [the borrowers'] loans and mortgages void as a matter of trust law." Instead, the Rajamin court held that "unauthorized actions by trustees are generally subject to ratification by the trust beneficiaries," and, thus, any unauthorized act by the trustee "is not void but merely voidable...at the instance of a trust beneficiary or a person acting in its behalf." Because the borrowers in *Rajamin* were "not beneficiaries of the securitization trusts," but rather, the "beneficiaries are the certificateholders," the court found that the "law of trusts provides no basis" for the borrowers' claims.

The court in *Rajamin* found *Erobobo* and *Scheller*, among other decisions taking the minority position, "unpersuasive," since the court was "not aware of any New York appellate decision that has endorsed th[e] interpretation of §7-2.4" advanced by those courts, and because those courts did not address whether the trust beneficiaries "may ratify otherwise unauthorized acts of the trustee."

Rajamin has been followed by a number of courts—including Supreme Court, Kings County—thereby creating an express conflict with *Erobobo* in the law of that court. See *U.S. Bank National Association v. Duthie*, 45 Misc.3d 1218(A) (Sup. Ct. Kings Co. 2014) (following *Rajamin* and declining to follow *Scheller*, "like the United States Court of Appeals, Second Circuit, this court declines to follow the holding in [*Scheller*] as acts may be ratified by the trust's beneficiaries and 'are voidable only at the instance of a trust beneficiary or a person acting in his behalf'").

> The issue is of nationwide importance. Indeed, many securitization trusts are formed under New York law and courts in other jurisdictions look to New York law when assessing the merit of defenses founded upon the securitization of the underlying loan.

Wide Impact

In sum, the law concerning whether a borrower can state a claim or defense founded upon a post-closing date assignment of loan documents is far from settled under New York law. Indeed, the law is rife with conflict, with federal courts located within the Second Circuit being bound by *Rajamin* and state courts being left to determine whether *Erobobo* and *Scheller* set forth a valid interpretation of EPTL §7-2.4.

This issue, however, impacts not only the thousands of foreclosure cases pending in New York State, but also is an issue of nationwide importance. Indeed, many securitization trusts are formed under New York law and courts in other jurisdictions look to New York law when assessing the merit of defenses founded upon the securitization of the underlying loan. Until the New York state appellate courts definitively weigh in on and interpret EPTL §7-2.4 in this context, practitioners can only expect more divergent results in foreclosure actions in which the borrower raises defenses founded upon alleged breaches of the documents governing the terms of the underlying securitization transaction.