Burning Down the House:

Mortgage Issues in Chapter 7 Cases

CONCURRENT SESSION

Jonathan T. Brand
Lakelaw; Chicago

Hon. Jacqueline P. Cox
U.S. Bankruptcy Court (N.D. Ill.); Chicago

David A. Lerner
Plunkett Cooney; Bloomfield Hills, Mich.

C. Daniel Motsinger
Krieg DeVault LLP; Indianapolis

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Panelists:
Hon. Jacqueline P. Cox
United States Bankruptcy Court for the Northern District of Illinois
Jonathan T. Brand
LakeLaw (Chicago, IL)
David A. Lerner
Plunkett Cooney (Bloomfield Hills, MI)
C. Daniel Motsinger
Krieg DeVault LLP (Indianapolis, IN)

Fred and Wilma own a house in Bedrock

Fred and Wilma Execute a Note and Mortgage to the 1st National Bank of Bedrock

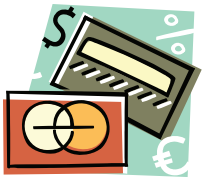
1st National Bank Assigns Note to Bedrock Trust

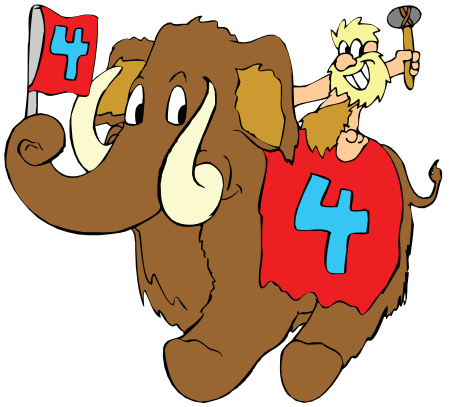
1st National Bank Assigns Mortgage to Mortgage Rock Registration System (MRRS)

Gravel Home Loan Services is Servicer of Note for Bedrock Trust

Fred and Wilma Grant Home Equity Loan (HELOC) to No Equity Mortgage Company

Fred overextends his credit cards and loses his money in one get-rich-quick-scheme after another





Fred and Wilma File a Joint Voluntary Chapter 7 Bankruptcy Petition

Trustee asserts that the mortgage may not be perfected correctly; files §544 adversary proceeding to avoid mortgage

Fred and Wilma file notice of intention to reaffirm mortgage, but then fail to make payments on mortgage

1st National Bank files Proof of Claim and files Motion for Relief from Stay

Fred and Wilma oppose the Relief Stay Motion and Object to Claim

Fred and Wilma fail to maintain insurance on the house

Issues

- Can the Trustee collect rent from Fred and Wilma?
- Does the Trustee need to insure the house?
  - If so, from what funds?
    - What if there is no money in the estate?

Issues, continued

- Does 1st National Bank have standing to file Relief Stay Motion and/or Proof of Claim?
  - Does Gravel Home Loan Services, as Servicer of Note for Bedrock Trust, have standing in this regard?
- If 1st National Bank's mortgage is valid, and 1st National gets relief from stay and forecloses, can the Trustee redeem?
- If the Trustee redeems from foreclosure sale, does Trustee need to pay second mortgage held by No Equity Mortgage Company?

Issues, continued

- When can the Trustee be compelled to abandon the house?
- What if only Fred filed for bankruptcy?
  - Is Wilma's interest in the house property of the estate?
  - Can the Trustee avoid the mortgage with respect to Wilma's interest in the house?

Issues, continued

- Assume house is titled in both Fred and Wilma's names, as husband and wife
  - If Fred elects the §522(d) federal exemptions, do the §522(b)(2) state exemptions (tenancy by the entireties) apply?
  - Can the Trustee avoid the mortgage if Fred and Wilma owe no other joint debt?

Issues, continued

- If the Trustee avoids the mortgage, do Fred and Wilma get their exemptions?
- If the Trustee avoids the mortgage, can the Trustee collect the Note payments?

Questions

STANDING ISSUES TO LIFT STAY

Fifty ways (or maybe not) to be a "holder" of a Note:

1) Physical possession of Note – MCLA 440.1201(20)

2) Note endorsed in blank – "bearer" paper – negotiated by transfer of possession – MCLA 440.3205(2)

3) Note may be enforced by a transferee – MCLA 440.3203(2)

Transfer of instrument when it is delivery by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument

MCLA 440.3203(1)

"Delivery" means voluntary transfer of the instrument – MCLA 440.1201(14)

4) Non-holder in possession of the Note who has the rights of a holder can occur if:

a) delivery of the Note constitutes a transfer – MCLA 440.3203
Transfer of a Note vests in the transferee any right of the transferor to enforce the instrument – MCLA 440.3203(2)

5) One may enforce Note, that does not require possession of the Note if "the person can not reasonably obtain the possession of the instrument because the instrument was destroyed, its whereabouts cannot be determined, or it is in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process". MCLA 440.3309(1)

DOCUMENTATION REQUIRED FOR MOTION TO LIFT STAY

LBR 4001-1(b): "Legible and complete copy of any relevant loan agreements, security agreements, documents establishing perfection and prior court orders."

Does this rule require then?

Note? Allonge to Note? Endorsements? Recorded Mortgage?

Assignment of Mortgage? Securitization agreement?

Trust agreement? Servicing agreement? Pooling agreement?

CASES

In re: Montag, 09-67842 (Bankr E.D. MI)

GMAC LLC moved to lift stay, mortgage and note with GMAC Corp. Note and mortgage apparently transferred to a Pooling and Servicing Agreement.

District Court reversed bankruptcy court finding that GMAC LLC had not shown that it, the LLC, had an interest in the Note and Mortgage

In re: Miller Case no. 11-12132 (10th Cir., 2012)

Tenth Circuit found that Deutsche Bank failed to show it had possession of the Note that was endorsed. Note was endorsed in blank as such was bearer paper. Deutsche Bank failed to show it was a transferee of the Note.

In re: Kemp, 440 BR 624 (Bankr. NJ 2010)

Lender's proof of claim disallowed given that the underlying Note executed by the debtor was not properly endorsed to the transferee and not placed in the transferee's possession. As result, the Note was not enforceable by Bank of New York that had filed the proof of claim.

The Note in question originally listed the lender as Countrywide Home Loans, Inc. No endorsement appeared on the Note. The Note was accompanied by an unsigned Allonge to Note in favor of America's Wholesale Lender. The Note and Mortgage apparently were pooled with other instruments and sold as a package to Bank of New York as trustee. The Note was never endorsed in blank or delivered to the Bank of New York.

The Court, relying upon the UCC found that a holder is defined as the person in possession if the instrument is payable to bearer or, in the case of an instrument payable to identified person, if the identified person is in possession. Mere ownership

or possession of a Note is insufficient to qualify as an individual as a holder. Where ownership of an instrument is transferred, the transferee 's attainment of the status of holder depends on the negotiation of the instrument to the transferee. The two elements required for a negotiation are the transfer of possession of the instrument to the transferee and its endorsement by the holder.

The court also examined the concept of a non-holder in possession. A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is wrongful possession of the instrument. A non-holder in possession of an instrument includes a person that acquired rights of a holder by subrogation or under §3-203(a)(MCLA 440-3203) The court finally determined that Bank of New York could not satisfy the third category of enforcing the note being a non-holder not in possession as result of a lost, destroyed or stolen instrument. MCLA 440-3309.

In re: Nosek, 609 F3d 6 (2010)
Prior history – 354 BR 331 (D. Mass, 2006), 363 BR 643 (Bankr. D. Mass, 2007) and 544 F3d 34 (1st Cir., 2008)

The bankruptcy court imposed sanctions upon Ameriquest, Norwest and Ameriquest counsel first in the amount of $750,000.00, later reduced to $650,000.00. Ameriquest had filed Proof of Claim in its own name and had moved to lift the automatic stay even though Ameriquest after making the loan to Ms. Nosek assigned the mortgage to a securitized trust for which Norwest Bank acted as trustee. Norwest had filed the Motion to Lift Stay asserting that it was the holder of the mortgage. However, Ameriquest did not hold the mortgage, but rather was only the servicer of the mortgage. Ameriquest counsel belatedly admitted that it was not the holder of the mortgage itself. The First Circuit ultimately upheld the sanctions but found that the sanctions amount were not reasonable and reduced the sanctions against Ameriquest to $5,000.

In re: Hunter, 2012 WL 525962 (Bankr. E.D. TN 2012)

The bankruptcy trustee challenged the standing of US Bank National Association as trustee to lift the automatic stay on the debtor's property. The debtor had originally executed a mortgage in favor of New Century Mortgage Corporation. Saxon Mortgage Services filed a proof of claim attaching copies of the Note between the debtor and New Century Mortgage. The Note contained a blank endorsement signed on behalf of New Century Mortgage Corporation. Later, US Bank National Association filed its Motion to Lift Stay. US Bank attached the Allonge to the Note containing an endorsement without recourse to US Bank National Association. The copy of the Note was different from the copy attached to the Proof of Claim filed by Saxon and did not reflect the endorsement from New Century Mortgage Corporation. US Bank National Association counsel produced the actual Note carrying the blank endorsement by New Century Mortgage and the Note was in the possession of US Bank's counsel.

The bankruptcy court found that US Bank was the proper party to enforce the Note. The bankruptcy court applying Article 3 of the UCC, Tennessee Code Annotated, defines a person entitled to enforce an instrument as (i) the holder of the instrument or (ii) a non-holder in possession of the instrument who has the rights of a holder. A holder is the person in possession of a negotiable instrument that is payable either to bearer or to an identified person that is the person in possession and the rights of a holder are conferred through negotiation. Negotiation means a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes its holder. If an instrument is payable to an identified person, negotiation requires transfer of possession of the instrument and its endorsement by the holder. If an instrument is payable to bearer, it may be negotiated by transfer of possession alone. If an endorsement is made by the holder of an instrument that is not a special endorsement payable to an identified person, it is a blank endorsement. When endorsed in blank, an instrument becomes payable to bearer and may be negotiated by transfer of possession alone unless specially endorsed. Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument.

US Bank, through its attorneys, was in possession of the Note, which contained a blank endorsement by New Century Mortgage that was supplemented by an Allonge to the Note with a specific endorsement from New Century to US Bank. On its face, US Bank National Association was the holder of the Note and either it or its designated agent, Saxon Mortgage, had the ability to enforce the Note.

Curiously, the record before the Court contained two copies of the same Note; one with a blank endorsement executed on behalf of New Century Mortgage Corporation and one without any endorsement. However, the Court found that given that US Bank National Association, through its counsel, had possession of the original Note which contained the signature of a representative of New Century Mortgage Corporation endorsing the Note in blank through the blank endorsement, the bearer, US Bank, became the holder and was entitled to enforce the Note. The record was clear that US Bank through its attorneys had possession of the original Note and therefore was the holder and owner by virtue of the blank endorsement from New Century as well as the Allonge to the Note with the specific endorsement from New Century to US Bank. As the owner and holder of the Note, US Bank had the unqualified right to enforce the document pursuant to Tennessee Code annotated. The parallel citation in Michigan would be MCLA 440.3301.

In re: Wilson, 442 BR 10 (D. Mass 2010)

The debtor challenged the standing of Deutsche Bank as not being the assignee of the mortgage nor the holder of the promissory note that the mortgage secured. The court found that Deutsche Bank was in fact the holder of the Note and owner of the mortgage. Deutsche Bank asserted that the Note in question was endorsed in blank by New Century, which made it into a bearer instrument, negotiable by transfer of possession alone and that possession of the Note was transferred by New Century to Deutsche Bank.

The debtor challenged the validity of the endorsement given that the signatures on the endorsement and on the Assignment of Mortgage purportedly from the same

person were very different. The bankruptcy court held, however, that in an action with respect to an instrument, the authenticity of a signature on the instrument is admitted unless specifically denied in the pleadings. Given that the debtor failed in her complaint to challenge the authenticity of the signature, the signature was deemed admitted as a matter of law. See MCLA 440.3308.

The debtor further challenged the timing of the signatures on the endorsements. The bankruptcy court found that regardless of when the Note was endorsed, it was uncontroverted that it was endorsed as of the time of the challenge to the standing of Deutsche Bank. When endorsed in blank, an instrument becomes payable to bearer and may be negotiated by transfer of possession alone until specially endorsed. See MCLA 440.3205. By virtue of its possession of the Note endorsed in blank, Deutsche Bank was the holder of the Note. See MCLA 440.3301. The court further overruled the debtor's objections to the assignment of the mortgage process and the designation of Deutsche Bank on the proof of claim.

In re: Walker, 2012 WL 443014 (Bankr. E.D. PA, 2012)

The debtor filed an objection to the proof of claim filed by the Bank of New York Mellon as Trustee of a trust. The debtor challenged the validity of the claim based upon the alleged defects in the process by which the underlying mortgage loan was securitized. The bankruptcy court overruled the debtor's objection finding that the underlying loan Note was a negotiable instrument and that Bank of New York Mellon had the right to enforce the Note under Article 3 of the UCC.

The Note in question was executed by the debtor to Allied Mortgage Group, Inc. The Note contained an undated endorsement signed by the President of Allied which stated "pay to the order of _____ without recourse". The original Note had been in the possession or control of Bank of New York Mellon since January, 2006. The mortgage had been assigned from MERS as nominee for Allied to Bank of New York Mellon as trustee of the trust. The assignment was recorded in the register of deeds office.

The bankruptcy court crystallized the three ways in which a person may qualify as a person to enforce the Note to whom the borrower owes the obligation to pay; namely, first, by being its holder (i.e. in possession of the Note when the Note is payable to the person or is payable to bearer); second, by being a non-holder in possession who has the rights of a holder, and third, if the Note has been destroyed or is lost or is in the lawful possession of an unknown person or a person that cannot be found, by establishing that the person was formally in possession of the Note with the right to enforce when the loss off possession occurred (and the loss was not a result of a transfer of lawful seizure).

The court found that the Bank of New York Mellon had possession of the Note that had been endorsed by Allied in blank without recourse. As the endorsement was neither payable to an identified person or to bearer, it was not a special endorsement. MCLA 440.3205. Rather, it was a blank endorsement and as such, the Note is payable to bearer and may be negotiated by transfer of possession alone until specially endorsed. MCLA 440.3205. As result of the negotiation in this fashion, and by virtue of its possession of the Note, Bank of New York was the holder of the Note. MCLA 440.3201. As the holder, Bank of New York was the person entitled to enforce the Note. MCLA 440.3301.

The debtor then asserted that the trust never owned the Note given that it violated its own pooling and service agreement that prevented the trust from ever having an enforceable right to the Note and mortgage. The bankruptcy court overruled the debtor's position by finding that the Note was in fact a negotiable instrument, that the pooling and service agreement did not supplant the UCC, under the UCC, the debtor's payment to Bank of New York Mellon as holder of the Note satisfied the debtor's obligation under the Note and therefore it was irrelevant whether the parties to the pooling and service agreement complied with the requirements in connection with the assignment of the Note to the trust. The court noted that in the past several years numerous courts have held that a borrower lacks standing to challenge a securitized trust authority to enforce a loan Note and mortgage based on a purported violations of the underlying pooling and service agreement. Such challenges have come in

bankruptcy proceedings in which debtors have objected to proofs of claim or challenged the mortgagee's right to seek relief from the automatic stay.

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REPORT OF THE PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE

APPLICATION OF THE UNIFORM COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTGAGE NOTES

NOVEMBER 14, 2011

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PREFACE

In 1961, the American Law Institute and the Uniform Law Commission, the organizations that jointly sponsor the Uniform Commercial Code, established the Permanent Editorial Board for the Uniform Commercial Code (PEB). One of the charges of the PEB is to issue commentaries "and other articulations as appropriate to reflect the correct interpretation of the [Uniform Commercial] Code and issuing the same in a manner and at times best calculated to advance the uniformity and orderly development of commercial law." Such commentaries and other articulations are issued directly by the PEB rather than by action of the American Law Institute and the Uniform Law Commission.

This Report of the Permanent Editorial Board is such an articulation, addressing the application of the Uniform Commercial Code to issues of legal, economic, and social importance arising from the issuance and transfer of mortgage notes. A draft of this Report was made available to the public for comment on March 29, 2011, and the comments that were received have been taken into account in preparing the final Report.

REPORT OF THE PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE

APPLICATION OF THE UNIFORM COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTGAGE NOTES

Introduction

Recent economic developments have brought to the forefront complex legal issues about the enforcement and collection of mortgage debt. Many of these issues are governed by local real property law and local rules of foreclosure procedure, but others are addressed in a uniform way throughout the United States by provisions of the Uniform Commercial Code (UCC).[1] Although the UCC provisions are settled law, it has become apparent that not all courts and attorneys are familiar with them. In addition, the complexity of some of the rules has proved daunting.

The Permanent Editorial Board for the Uniform Commercial Code[2] has prepared this Report in order to further the understanding of this statutory background by identifying and explaining several key rules in the UCC that govern the transfer and enforcement of notes secured by a mortgage[3] on real property. The UCC, of course, does not resolve all issues in this field. Most particularly, as to both substance and procedure, the enforcement of real estate mortgages by foreclosure is primarily the province of a state's real property law (although determinations made

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[1] The UCC is a uniform law sponsored by the American Law Institute and the Uniform Law Commission. It has been enacted in every state (as well as the District of Columbia, Puerto Rico, and the United States Virgin Islands) in whole or significant part. This Report is based on the current Official Text of the UCC. Some states have enacted some non-uniform provisions that are generally not relevant to the issues discussed in this Report. Of course, the enacted text of the UCC in the state whose law is applicable governs. See note 6, *infra*, regarding the various different versions of Article 3 of the UCC in effect in the states.

[2] In 1961, the American Law Institute and the Uniform Law Commission, the organizations that jointly sponsor the UCC, established the Permanent Editorial Board for the Uniform Commercial Code (PEB). One of the charges of the PEB is to issue commentaries "and other articulations as appropriate to reflect the correct interpretation of the [Uniform Commercial] Code and issuing the same in a manner and at times best calculated to advance the uniformity and orderly development of commercial law."

[3] This Report, like Article 9 of the UCC, uses the term "mortgage" to include a consensual interest in real property to secure an obligation whether created by mortgage, trust deed, or the like. See UCC § 9-102(a)(55) and Official Comment 17 thereto and former UCC § 9-105(1)(j). This Report uses the term "mortgage note" to refer to a note secured by a mortgage, whether or not the note is a negotiable instrument under UCC Article 3.

pursuant to the UCC are typically relevant under that law). Accordingly, this Report should be understood as providing guidance only as to the issues the Report addresses.[4]

Background

Issues relating to the transfer, ownership, and enforcement of mortgage notes are primarily governed by two Articles of the UCC:

- In cases in which the mortgage note is a negotiable instrument,[5] Article 3 of the UCC[6] provides rules governing the obligations of parties on the note[7] and the enforcement of those obligations.
- In cases involving either negotiable or non-negotiable notes, Article 9 of the UCC[8] contains important rules governing how ownership of those notes may be transferred, the effect of the transfer of ownership of the notes on the ownership of the mortgages securing those notes, and the right of the transferee, under certain circumstances, to record its interest in the mortgage in the applicable real estate recording office.

This Report explains the application of the rules in both of those UCC Articles to provide guidance in:

- Identifying the person who is entitled to enforce the payment obligation of the maker[9] of a mortgage note, and to whom the maker owes that obligation; and

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[4] Of course, the application of the UCC rules to particular factual circumstances depends on the nature of those circumstances. Facts raising legal issues other than those addressed in this Report can result in different rights and obligations than would be the case in the absence of those facts. Accordingly, this Report should not be read as a statement of the total legal implications of any factual scenario. Rather, the Report sets out the UCC rules that are common to the transactions discussed so as to provide a common basis for understanding the application of those rules. The impact of non-UCC law that applies to other aspects of such transactions is beyond the scope of this Report.

[5] The requirements that must be satisfied in order for a note to be a negotiable instrument are set out in UCC § 3-104.

[6] Except for New York, every state (as well as the District of Columbia, Puerto Rico, and the United States Virgin Islands) has enacted either the 1990 Official Text of Article 3 or the newer 2002 Official Text (the latter having been adopted in ten states as of the date of this Report). Unless indicated to the contrary all discussions of provisions in Article 3 apply equally to both versions. Much of the analysis of UCC Article 3 in this Report also applies under the older version of Article 3 in effect in New York, although many section numbers differ. The Report does not address those aspects of New York's Article 3 that are different from the 1990 or 2002 texts.

[7] In this Report, such notes are sometimes referred to as "negotiable notes."

[8] Unlike Article 3 (which has not been enacted in its modern form in New York), the current version of Article 9 has been enacted in all 50 states, the District of Columbia, and the United States Virgin Islands. Some states have enacted non-uniform provisions that are generally not relevant to the issues discussed in this Report (but see note 31 with respect to one relevant non-uniformity). A limited set of amendments to Article 9 was approved by the American Law Institute and the Uniform Law Commission in 2010. Except as noted in this Report, those amendments (which provide for a uniform effective date of July 1, 2013) are not germane to the matters addressed in this Report.

[9] A note can have more than one obligor. In some cases, this is because there is more than one maker (in which case they are jointly and severally liable; see UCC § 3-116(a)). In other cases, there may be an indorser. The obligation

- Determining who owns the rights represented by the note and mortgage.

Together, the provisions in Articles 3 and 9 of the UCC (along with general principles that appear in Article 1 and that apply to all transactions governed by the UCC) provide legal rules that apply to these questions.[10] Moreover, these rules displace any inconsistent common law rules that might have otherwise previously governed the same questions.[11]

This Report does not, however, address all of the rules in the UCC relating to enforcement, transfer, and ownership of mortgage notes. Rather, it reviews the rules relating to four specific questions:

- Who is the person entitled to enforce a mortgage note and, correspondingly, to whom is the obligation to pay the note owed?
- How can the owner of a mortgage note effectively transfer ownership of that note to another person or effectively use that note as collateral for an obligation?
- What is the effect of transfer of an interest in a mortgage note on the mortgage securing it?
- May a person to whom an interest in a mortgage note has been transferred, but who has not taken a recordable assignment of the mortgage, take steps to become the assignee of record in the real estate recording system of the mortgage securing the note?[12]

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of an indorser is different from that of a maker in that the indorser's obligation is triggered by dishonor of the note (see UCC § 3-415) and, unless waived, indorsers have additional procedural protections (such as notice of dishonor; see UCC § 3-503)). These differences do not affect the issues addressed in this Report. For simplicity, this Report uses the term "maker" to refer to both makers and indorsers.

[10] Subject to limitations on the ability to affect the rights of third parties, the effect of these provisions may be varied by agreement. UCC § 1-302. Variation by agreement is not permitted when the variation would disclaim obligations of good faith, diligence, reasonableness, or care prescribed by the UCC or when the UCC otherwise so indicates (see, *e.g.*, UCC § 9-602). But the meaning of the statute itself cannot be varied by agreement. Thus, for example, private parties cannot make a note negotiable unless it complies with UCC § 3-104. See Official Comment 1 to UCC § 1-302. Similarly, parties may not avoid the application of UCC Article 9 to a transaction that falls within its scope. See *id.* and Official Comment 2 to UCC § 9-109.

[11] UCC § 1-103(b). As noted in Official Comment 2 to UCC § 1-103:

> The Uniform Commercial Code was drafted against the backdrop of existing bodies of law, including the common law and equity, and relies on those bodies of law to supplement its provisions in many important ways. At the same time, the Uniform Commercial Code is the primary source of commercial law rules in areas that it governs, and its rules represent choices made by its drafters and the enacting legislatures about the appropriate policies to be furthered in the transactions it covers. Therefore, while principles of common law and equity may *supplement* provisions of the Uniform Commercial Code, they may not be used to *supplant* its provisions, or the purposes and policies those provisions reflect, unless a specific provision of the Uniform Commercial Code provides otherwise. In the absence of such a provision, the Uniform Commercial Code preempts principles of common law and equity that are inconsistent with either its provisions or its purposes and policies.

[12] The Report does not discuss the application of common law principles, such as the law of agency, that supplement the provisions of the UCC other than to note some situations in which the text or comments of the UCC identify such principles as being relevant. See UCC § 1-103(b).

Question One – To Whom is the Obligation to Pay a Mortgage Note Owed?

If the mortgage note is a negotiable instrument,[13] Article 3 of the UCC provides a largely complete set of rules governing the obligations of parties on the note, including how to determine who may enforce those obligations and, thus, to whom those obligations are owed. The following discussion analyzes the application of these rules to that determination in the context of mortgage notes that are negotiable instruments.[14]

In the context of mortgage notes that have been sold or used as collateral to secure an obligation, the central concept for making that determination is identification of the "person entitled to enforce" the note.[15] Several issues are resolved by that determination. Most particularly:

(i) the maker's obligation on the note is to pay the amount of the note to *the person entitled to enforce the note*,[16]

(ii) the maker's payment to *the person entitled to enforce the note* results in discharge of the maker's obligation,[17] and

(iii) the maker's failure to pay, when due, the amount of the note to *the person entitled to enforce the note* constitutes dishonor of the note.[18]

Thus, a person seeking to enforce rights based on the failure of the maker to pay a mortgage note must identify the person entitled to enforce the note and establish that that person has not been paid. This portion of this Report sets out the criteria for qualifying as a "person entitled to enforce" a mortgage note. The discussion of Question Two addresses how ownership of a mortgage note may be effectively transferred from an owner to another person.

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[13] See UCC § 3-104 for the requirements that must be fulfilled in order for a payment obligation to qualify as a negotiable instrument. It should not be assumed that all mortgage notes are negotiable instruments. The issue of the negotiability of a particular mortgage note, which requires application of the standards in UCC § 3-104 to the words of the particular note, is beyond the scope of this Report.

[14] Law other than Article 3, including contract law, governs this determination for non-negotiable mortgage notes. That law is beyond the scope of this Report.

[15] The concept of "person entitled to enforce" a note is not synonymous with "owner" of the note. See Official Comment 1 to UCC § 3-203. A person need not be the owner of a note to be the person entitled to enforce it, and not all owners will qualify as persons entitled to enforce. Rules that address transfer of ownership of a note are addressed in the discussion of Question 2 below.

[16] UCC § 3-412. (If the note has been dishonored, and an indorser has paid the note to the person entitled to enforce it, the maker's obligation runs to the indorser.)

[17] UCC § 3-602. The law of agency is applicable in determining whether a payment has been made to a person entitled to enforce. See *id.*, Official Comment 3. Note that, in states that have enacted the 2002 Official Text of UCC Article 3, UCC § 3-602(b) provides that a maker is also discharged by paying a person formerly entitled to enforce the note if the maker has not received adequate notification that the note has been transferred and that payment is to be made to the transferee. This amendment aligns the protection afforded to makers of notes that have been assigned with comparable protection afforded to obligors on other payment rights that have been assigned. See, *e.g.*, UCC § 9-406(a); Restatement (Second), Contracts § 338(1).

[18] See UCC § 3-502. See also UCC § 3-602.

UCC Section 3-301 provides only three ways in which a person may qualify as the person entitled to enforce a note, two of which require the person to be in possession of the note (which may include possession by a third party that possesses it for the person)[19]:

- The first way that a person may qualify as the person entitled to enforce a note is to be its "holder." This familiar concept, set out in detail in UCC Section 1-201(b)(21)(A), requires that the person be in possession of the note and either (i) the note is payable to that person or (ii) the note is payable to bearer. Determining to whom a note is payable requires examination not only of the face of the note but also of any indorsements. This is because the party to whom a note is payable may be changed by indorsement[20] so that, for example, a note payable to the order of a named payee that is indorsed in blank by that payee becomes payable to bearer.[21]
- The second way that a person may be the person entitled to enforce a note is to be a "nonholder in possession of the [note] who has the rights of a holder."
    - How can a person who is not the holder of a note have the rights of a holder? This can occur by operation of law outside the UCC, such as the law of subrogation or estate administration, by which one person is the successor to or acquires another person's rights.[22] It can also occur if the delivery of the note to that person constitutes a "transfer" (as that term is defined in UCC Section 3-203, see below) because transfer of a note "vests in the transferee any right of the transferor to enforce the instrument."[23] Thus, if a holder (who, as seen above, is a person entitled to enforce a note) transfers the note to another person, that other person (the transferee) obtains from the holder the right to enforce the note even if the transferee does not become the holder (as in the example below). Similarly, a

[19] See UCC § 1-103(b) (unless displaced by particular provisions of the UCC, the law of, *inter alia*, principal and agent supplements the provisions of the UCC). See also UCC § 3-420, Comment 1 ("Delivery to an agent [of a payee] is delivery to the payee."). Note that "delivery" of a negotiable instrument is defined in UCC § 1-201(b)(15) as voluntary transfer of possession. This Report does not address the determination of whether a particular person is an agent of another person under the law of agency and the agency law implications of such a determination.

[20] "Indorsement," as defined in UCC § 3-204(a), requires the signature of the indorser. The law of agency determines whether a signature made by a person purporting to act as a representative binds the represented person. UCC § 3-402(a); see note 12, supra. An indorsement may appear either on the instrument or on a separate piece of paper (usually referred to as an *allonge*) affixed to the instrument. See UCC § 3-204(a) and Comment 1, par. 4.

[21] UCC Section 3-205 contains the rules concerning the effect of various types of indorsement on the party to whom a note is payable. Either a "special indorsement" (see UCC § 3-205(a)) or a "blank indorsement" (see UCC § 3-205(b)) can change the identity of the person to whom the note is payable. A special indorsement is an indorsement that identifies the person to whom it makes the note payable, while a blank indorsement is an indorsement that does not identify such a person and results in the instrument becoming payable to bearer. When an instrument is indorsed in blank (and, thus, is payable to bearer), it may be negotiated by transfer of possession alone until specially indorsed. UCC § 3-205(b).

[22] See Official Comment to UCC § 3-301.

[23] UCC § 3-203(b).

subsequent transfer will result in the subsequent transferee being a person entitled to enforce the note.

- Under what circumstances does delivery of a note qualify as a transfer? As stated in UCC Section 3-203(a), a note is transferred "when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument." For example, assume that the payee of a note sells it to an assignee, intending to transfer all of the payee's rights to the note, but delivers the note to the assignee without indorsing it. The assignee will not qualify as a holder (because the note is still payable to the payee) but, because the transaction between the payee and the assignee qualifies as a transfer, the assignee now has all of the payee's rights to enforce the note and thereby qualifies as the person entitled to enforce it. Thus, the failure to obtain the indorsement of the payee does not prevent a person in possession of the note from being the person entitled to enforce it, but demonstrating that status is more difficult. This is because the person in possession of the note must also demonstrate the purpose of the delivery of the note to it in order to qualify as the person entitled to enforce.[24]

- There is a third method of qualifying as a person entitled to enforce a note that, unlike the previous two methods, does not require possession of the note. This method is quite limited – it applies only in cases in which "the person cannot reasonably obtain possession of the instrument because the instrument was destroyed, its whereabouts cannot be determined, or it is in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process."[25] In such a case, a person qualifies as a person entitled to enforce the note if the person demonstrates not only that one of those circumstances is present but also demonstrates that the person was formerly in possession of the note and entitled to enforce it when the loss of possession occurred and that the loss of possession was not as a result of transfer (as defined above) or lawful seizure. If the person proves those facts, as well as the terms of the note, the person is a person entitled to enforce the note and may seek to enforce it even though it is not in possession of the note,[26] but the court may not enter judgment in favor of the

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[24] If the note was transferred for value and the transferee does not qualify as a holder because of the lack of indorsement by the transferor, "the transferee has a specifically enforceable right to the unqualified indorsement of the transferor." See UCC § 3-203(c).

[25] UCC § 3-309(a)(iii) (1990 text), 3-309(a)(3) (2002 text). The 2002 text goes on to provide that a transferee from the person who lost possession of a note may also qualify as a person entitled to enforce it. See UCC § 3-309(a)(1)(B) (2002). This point was thought to be implicit in the 1990 text, but was rejected in some cases in which the issue was raised. The reasoning of those cases was rejected in Official Comment 5 to UCC § 9-109 and the point was made explicit in the 2002 text of Article 3.

[26] To prevail the person must establish not only that the person is a person entitled to enforce the note but also the other elements of the maker's obligation to pay such a person. See generally UCC §§ 3-309(b), 3-412. Moreover, as is the case with respect to the enforcement of all rights under the UCC, the person enforcing the note must act in good faith in enforcing the note. UCC § 1-304.

person unless the court finds that the maker is adequately protected against loss that might occur if the note subsequently reappears.[27]

Illustrations:

1. Maker issued a negotiable mortgage note payable to the order of Payee. Payee is in possession of the note, which has not been indorsed. Payee is the holder of the note and, therefore, is the person entitled to enforce it. UCC §§ 1-201(b)(21)(A), 3-301(i).
2. Maker issued a negotiable mortgage note payable to the order of Payee. Payee indorsed the note in blank and gave possession of it to Transferee. Transferee is the holder of the note and, therefore, is the person entitled to enforce it. UCC §§ 1-201(b)(21)(A), 3-301(i).
3. Maker issued a negotiable mortgage note payable to the order of Payee. Payee sold the note to Transferee and gave possession of it to Transferee for the purpose of giving Transferee the right to enforce the note. Payee did not, however, indorse the note. Transferee is not the holder of the note because, while Transferee is in possession of the note, it is payable neither to bearer nor to Transferee. UCC § 1-201(b)(21)(A). Nonetheless, Transferee is a person entitled to enforce the note. This is because the note was transferred to Transferee and the transfer vested in Transferee Payee's right to enforce the note. UCC § 3-203(a)-(b). As a result, Transferee is a nonholder in possession of the note with the rights of a holder and, accordingly, a person entitled to enforce the note. UCC § 3-301(ii).
4. Same facts as Illustrations 2 and 3, except that (i) under the law of agency, Agent is the agent of Transferee for purposes of possessing the note and (ii) it is Agent, rather than Transferee, to whom actual physical possession of the note is given by Payee. In the facts of Illustration 2, Transferee is a holder of the note and a person entitled to enforce it. In the context of Illustration 3, Transferee is a person entitled to enforce the note. Whether Agent may enforce the note or mortgage on behalf of Transferee depends in part on the law of agency and, in the case of the mortgage, real property law.
5. Same facts as Illustration 2, except that after obtaining possession of the note, Transferee lost the note and its whereabouts cannot be determined. Transferee is a person entitled to enforce the note even though Transferee does not have possession of it. UCC § 3-309(a). If Transferee brings an action on the note against Maker, Transferee must establish the terms of the note and the elements of Maker's obligation on it. The court may not enter judgment in favor of Transferee, however, unless the court finds that Maker is adequately protected against loss that might occur by reason of a claim of another person (such as the finder of the note) to enforce the note. UCC § 3-309(b).

[27] See *id.* UCC § 3-309(b) goes on to state that "Adequate protection may be provided by any reasonable means."

Question Two – What Steps Must be Taken for the Owner of a Mortgage Note to Transfer Ownership of the Note to Another Person or Use the Note as Collateral for an Obligation?

In the discussion of Question One, this Report addresses identification of the person who is entitled to enforce a note. That discussion does not address who "owns" the note. While, in many cases, the person entitled to enforce a note is also its owner, this need not be the case. The rules that determine whether a person is a person entitled to enforce a note do not require that person to be the owner of the note,[28] and a change in ownership of a note does not necessarily bring about a concomitant change in the identity of the person entitled to enforce the note. This is because the rules that determine who is entitled to enforce a note and the rules that determine whether the note, or an interest in it, have been effectively transferred serve different functions:

- The rules that determine who is entitled to enforce a note are concerned primarily with the maker of the note, providing the maker with a relatively simple way of determining to whom his or her obligation is owed and, thus, whom to pay in order to be discharged.
- The rules concerning transfer of ownership and other interests in a note, on the other hand, primarily relate to who, among competing claimants, is entitled to the economic value of the note.

In a typical transaction, when a note is issued to a payee, the note is initially owned by that payee. If that payee seeks either to use the note as collateral or sell the note outright, Article 9 of the UCC governs that transaction and determines whether the creditor or buyer has obtained a property right in the note. As is generally known, Article 9 governs transactions in which property is used as collateral for an obligation.[29] In addition, however, Article 9 governs the sale of most payment rights, including the sale of both negotiable and non-negotiable notes.[30] With very few exceptions, the same Article 9 rules that apply to transactions in which a payment right is collateral for an obligation also apply to transactions in which a payment right is sold. Rather than contain two parallel sets of rules – one for transactions in which payment rights are collateral and the other for sales of payment rights – Article 9 uses nomenclature conventions to apply one set of rules to both types of transactions. This is accomplished primarily by defining the term "security interest" to include not only an interest in property that secures an obligation

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[28] See UCC § 3-301, which provides, in relevant part, that "A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument . . . ."

[29] UCC § 9-109(a)(1).

[30] With certain limited exceptions not germane to this Report, Article 9 governs the sale of accounts, chattel paper, payment intangibles, and promissory notes. UCC § 9-109(a)(3). The term "promissory note" includes not only notes that fulfill the requirements of a negotiable instrument under UCC § 3-104 but also notes that do not fulfill those requirements but nonetheless are of a "type that in ordinary business is transferred by delivery with any necessary indorsement or assignment." See UCC §§ 9-102(a)(65) (definition of "promissory note") and 9-102(a)(47) (definition of "instrument" as the term is used in Article 9).

but also the right of a buyer of a payment right in a transaction governed by Article 9.[31] Similarly, definitional conventions denominate the seller of such a payment right as the "debtor," the buyer as the "secured party," and the sold payment right as the "collateral."[32] As a result, for purposes of Article 9, the buyer of a promissory note is a "secured party" that has acquired a "security interest" in the note from the "debtor," and the rules that apply to security interests that secure an obligation generally also apply to transactions in which a promissory note is sold.

Section 9-203(b) of the Uniform Commercial Code provides that three criteria must be fulfilled in order for the owner of a mortgage note effectively to create a "security interest" (either an interest in the note securing an obligation or the outright sale of the note to a buyer) in it.

- The first two criteria are straightforward – "value" must be given[33] and the debtor/seller must have rights in the note or the power to transfer rights in the note to a third party.[34]
- The third criterion may be fulfilled in either one of two ways. Either the debtor/seller must "authenticate"[35] a "security agreement"[36] that describes the note[37] or the secured party must take possession[38] of the note pursuant to the debtor's security agreement.[39]

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[31] See UCC § 1-201(b)(35) [UCC § 1-201(37) in states that have not yet enacted the 2001 revised text of UCC Article 1]. (For reasons that are not apparent, when South Carolina enacted the 1998 revised text of UCC Article 9, which included an amendment to UCC § 1-201 to expand the definition of "security interest" to include the right of a buyer of a promissory note, it did not enact the amendment to § 1-201. This Report does not address the effect of that omission.) The limitation to transactions governed by Article 9 refers to the exclusion, in cases not germane to this Report, of certain assignments of payment rights from the reach of Article 9.

[32] UCC §§ 9-102(a)(28)(B); 9-102(a)(72)(D); 9-102(a)(12)(B).

[33] UCC § 9-203(b)(1). UCC § 1-204 provides that giving "value" for rights includes not only acquiring them for consideration but also acquiring them in return for a binding commitment to extend credit, as security for or in complete or partial satisfaction of a preexisting claim, or by accepting delivery of them under a preexisting contract for their purchase.

[34] UCC § 9-203(b)(2). Limited rights that are short of full ownership are sufficient for this purpose. See Official Comment 6 to UCC § 9-203.

[35] This term is defined to include signing and its electronic equivalent. See UCC § 9-102(a)(7).

[36] A "security agreement" is an agreement that creates or provides for a security interest (including the rights of a buyer arising upon the outright sale of a payment right). See UCC § 9-102(a)(73).

[37] Article 9's criteria for descriptions of property in a security agreement are quite flexible. Generally speaking, any description suffices, whether or not specific, if it reasonably identifies the property. See UCC § 9-108(a)-(b). A "supergeneric" description consisting solely of words such as "all of the debtor's assets" or "all of the debtor's personal property" is not sufficient, however. UCC § 9-108(c). A narrower description, limiting the property to a particular category or type, such as "all notes," is sufficient. For example, a description that refers to "all of the debtor's notes" is sufficient.

[38] See UCC § 9-313. As noted in Official Comment 3 to UCC § 9-313, "in determining whether a particular person has possession, the principles of agency apply." In addition, UCC § 9-313 also contains two special rules under which possession by a non-agent may constitute possession by the secured party. First, if a person who is not an agent is in possession of the collateral and the person authenticates a record acknowledging that the person holds the collateral for the secured party's benefit, possession by that person constitutes possession by the secured party. UCC § 9-313(c). Second, a secured party that has possession of collateral does not relinquish possession by delivering the collateral to another person (other than the debtor or a lessee of the collateral from the debtor in the ordinary course of the debtor's business) if the delivery is accompanied by instructions to that person to hold possession of the collateral for the benefit of the secured party or redeliver it to the secured party. UCC § 9-313(h).

- Thus, if the secured party (including a buyer) takes possession of the mortgage note pursuant to the security agreement of the debtor (including a seller), this criterion is satisfied even if that agreement is oral or otherwise not evidenced by an authenticated record.
- Alternatively, if the debtor authenticates a security agreement describing the note, this criterion is satisfied even if the secured party does *not* take possession of the note. (Note that in this situation, in which the seller of a note may retain possession of it, the owner of a note may be a different person than the person entitled to enforce the note.)[40]

Satisfaction of these three criteria of Section 9-203(b) results in the secured party (including a buyer of the note) obtaining a property right (whether outright ownership or a security interest to secure an obligation) in the note from the debtor (including a seller of the note).[41]

Illustrations:

6. Maker issued a mortgage note payable to the order of Payee.[42] Payee borrowed money from Funder and, to secure Payee's repayment obligation, Payee and Funder agreed that Funder would have a security interest in the note. Simultaneously with the funding of the loan, Payee gave possession of the note to Funder. Funder has an attached and

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See also Official Comment 9 to UCC § 9-313 ("New subsections (h) and (i) address the practice of mortgage warehouse lenders.") Possession as contemplated by UCC § 9-313 is also possession for purposes of UCC § 9-203. See UCC § 9-203, Comment 4.

[39] UCC §§ 9-203(b)(3)(A)-(B).

[40] As noted in the discussion of Question One, payment by the maker of a negotiable note to the person entitled to enforce it discharges the maker's obligations on the note. UCC § 3-602. This is the case even if the person entitled to enforce the note is not its owner. As between the person entitled to enforce the note and the owner of the note, the right to the money paid by the maker is determined by the UCC and other applicable law, such as the law of contract and the law of restitution, as well as agency law. See, e.g., UCC §§ 3-306 and 9-315(a)(2). As noted in comment 3 to UCC § 3-602, "if the original payee of the note transfers ownership of the note to a third party but continues to service the obligation, the law of agency might treat payments made to the original payee as payments made to the third party."

[41] For cases in which another person claims an interest in the note (whether as a result of another voluntary transfer by the debtor or otherwise), reference to Article 9's rules governing perfection and priority of security interests may be required in order to rank order those claims (and, in some cases, determine whether a party has taken the note free of competing claims to the note). In the case of notes that are negotiable instruments, the Article 3 concept of "holder in due course" (see UCC § 3-302) should be considered as well, because a holder in due course takes its rights in an instrument free of competing property claims to it (as well as free of most defenses to obligations on it). See UCC §§ 3-305 and 3-306. With respect to determining whether the owner of a note has effectively transferred a property interest to a transferee, however, the perfection and priority rules are largely irrelevant. (The application of the perfection and priority rules can result in the rights of the transferee either being subordinate to the rights of a competing claimant or being extinguished by the rights of the competing claimant. See, *e.g.*, UCC §§ 9-317(b), 9-322(a), 9-330(d), and 9-331(a).)

[42] For this Illustration, as well as Illustrations 7-11, the analysis under UCC Article 9 is the same whether the mortgage note is negotiable or non-negotiable. This is because, in either case, the mortgage note will qualify as a "promissory note" and, therefore, an "instrument" under UCC Article 9. See UCC §§ 9-102(a)(47), (65).

enforceable security interest in the note. UCC § 9-203(b). This is the case even if Payee's agreement is oral or otherwise not evidenced by an authenticated record. Payee is no longer a person entitled to enforce the note (because Payee is no longer in possession of it and it has not been lost, stolen, or destroyed). UCC § 3-301. Funder is a person entitled to enforce the note if either (i) Payee indorsed the note by blank indorsement or by a special indorsement identifying Funder as the person to whom the indorsement makes the note payable (because, in such cases, Funder would be the holder of the note), or (ii) the delivery of the note from Payee to Funder constitutes a transfer of the note under UCC § 3-203 (because, in such case, Funder would be a nonholder in possession of the note with the rights of a holder). See also UCC §§ 1-201(b)(21)(A), 3-205(a)-(b), and 3-301(i)-(ii).

7. Maker issued a mortgage note payable to the order of Payee. Payee borrowed money from Funder and, in a signed writing that reasonably identified the note (whether specifically or as part of a category or a type of property defined in the UCC), granted Funder a security interest in the note to secure Payee's repayment obligation. Payee, however, retained possession of the note. Funder has an attached and enforceable security interest in the note. UCC § 9-203(b). If the note is negotiable, Payee remains the holder and the person entitled to enforce the note because Payee is in possession of it and it is payable to the order of Payee. UCC §§ 1-201(b)(21)(A), 3-301(i).
8. Maker issued a mortgage note payable to the order of Payee. Payee sold the note to Funder, giving possession of the note to Funder in exchange for the purchase price. The sale of the note is governed by Article 9 and the rights of Funder as buyer constitute a "security interest." UCC §§ 9-109(a)(3), 1-201(b)(35). The security interest is attached and is enforceable. UCC § 9-203(b). This is the case even if the sales agreement was oral or otherwise not evidenced by an authenticated record. If the note is negotiable, Funder is also a person entitled to enforce the note, whether or not Payee indorsed it, because either (i) Funder is a holder of the note (if Payee indorsed it by blank indorsement or by a special indorsement identifying Funder as the person to whom the indorsement makes the note payable) or (ii) Funder is a nonholder in possession of the note (if there is no such indorsement) who has obtained the rights of Payee by transfer of the note pursuant to UCC § 3-203. See also UCC §§ 1-201(b)(21)(A), 3-205(a)-(b), and 3-301(i)-(ii).
9. Maker issued a mortgage note payable to the order of Payee. Pursuant to a signed writing that reasonably identified the note (whether specifically or as part of a category or a type of property defined in the UCC), Payee sold the note to Funder. Payee, however, retained possession of the note. The sale of the note is governed by Article 9 and the rights of Funder as buyer constitute a "security interest." UCC § 1-201(b)(35). The security interest is attached and is enforceable. UCC § 9-203(b). If the note is negotiable, Payee remains the holder and the person entitled to enforce the note (even though, as between Payee and Funder, Funder owns the note) because Payee is in

possession of it and it is payable to the order of Payee. UCC §§ 1-201(b)(21)(A), 3-301(i).

Question Three – What is the Effect of Transfer of an Interest in a Mortgage Note on the Mortgage Securing It?

What if a note secured by a mortgage is sold (or the note is used as collateral to secure an obligation), but the parties do not take any additional actions to assign the mortgage that secures payment of the note, such as execution of a recordable assignment of the mortgage? UCC Section 9-203(g) explicitly provides that, in such cases, the assignment of the interest of the seller or other grantor of a security interest in the note automatically transfers a corresponding interest in the mortgage to the assignee: "The attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also attachment of a security interest in the security interest, mortgage, or other lien." (As noted previously, a "security interest" in a note includes the right of a buyer of the note.)

While this question has provoked some uncertainty and has given rise to some judicial analysis that disregards the impact of Article 9,[43] the UCC is unambiguous: the sale of a mortgage note (or other grant of a security interest in the note) not accompanied by a separate conveyance of the mortgage securing the note does not result in the mortgage being severed from the note.[44]

It is important to note in this regard, however, that UCC Section 9-203(g) addresses only whether, as between the seller of a mortgage note (or a debtor who uses it as collateral) and the buyer or other secured party, the interest of the seller (or debtor) in the mortgage has been correspondingly transferred to the secured party. UCC Section 9-308(e) goes on to state that, if the secured party's security interest in the note is perfected, the secured party's security interest

[43] *See, e.g.*, the discussion of this issue in *U.S. Bank v. Ibanez,* 458 Mass. 637 at 652-53, 941 N.E.2d 40 at 53-54 (2011). In that discussion, the court cited Massachusetts common law precedents pre-dating the enactment of the current text of Article 9 to the effect that a mortgage does not follow a note in the absence of a separate assignment of the mortgage, but did not address the effect of Massachusetts's subsequent enactment of UCC § 9-203(g) on those precedents. Under the rule in UCC § 9-203(g), if the holder of the note in question demonstrated that it had an attached security interest (including the interest of a buyer) in the note, the holder of the note in question would also have a security interest in the mortgage securing the note even in the absence of a separate assignment of the mortgage. (This Report does not address whether, under the facts of the *Ibanez* case, the holder of the note had an attached security interest in the note and, thus, qualified for the application of UCC § 9-203(g). Moreover, even if the holder had an attached security interest in the note and, thus, had a security interest in the mortgage, this would not, of itself, mean that the holder could enforce the mortgage without a recordable assignment of the mortgage to the holder. Whatever steps are required in order to enforce a mortgage in the absence of a recordable assignment are the province of real property law. The matter is addressed, in part, in the discussion of Question 4 below.)

[44] Official Comment 9 to UCC § 9-203 confirms this point: "Subsection (g) codifies the common-law rule that a transfer of an obligation secured by a security interest or other lien on personal or real property also transfers the security interest or lien." Pursuant to UCC § 1-302(a), the parties to the transaction may agree that an interest in the mortgage securing the note does not accompany the note, but such an agreement is unlikely. See, *e.g.*, Restatement (3d), Property (Mortgages) § 5.4, comment *a* ("It is conceivable that on rare occasions a mortgagee will wish to disassociate the obligation and the mortgage, but that result should follow only upon evidence that the parties to the transfer so agreed.").

in the mortgage securing the note is also perfected,[45] with result that the right of the secured party is senior to the rights of a person who then or later becomes a lien creditor of the seller of (or other grantor of a security interest in) the note. Neither of these rules, however, determines the ranking of rights in the underlying real property itself, or the effect of recordation or non-recordation in the real property recording system on enforcement of the mortgage.[46]

Illustration:

10. Same facts as Illustration 9. The signed writing was silent with respect to the mortgage securing the note and the parties made no other agreement with respect to the mortgage. The attachment of Funder's interest in the rights of Payee in the note also constitutes attachment of an interest in the rights of Payee in the mortgage. UCC § 9-203(g).

Question Four – What Actions May a Person to Whom an Interest in a Mortgage Note Has Been Transferred, but Who Has not Taken a Recordable Assignment of the Mortgage, Take in Order to Become the Assignee of Record of the Mortgage Securing the Note?

In some states, a party without a recorded interest in a mortgage may not enforce the mortgage non-judicially. In such states, even though the buyer of a mortgage note (or a creditor to whom a security interest in the note has been granted to secure an obligation) automatically obtains corresponding rights in the mortgage,[47] this may be insufficient as a matter of applicable real estate law to enable that buyer or secured creditor to enforce the mortgage upon default of the maker if the buyer or secured creditor does not have a recordable assignment. The buyer or other secured party may attempt to obtain such a recordable assignment from the seller or debtor at the time it seeks to enforce the mortgage, but such an attempt may be unsuccessful.[48]

Article 9 of the UCC provides such a buyer or secured creditor a mechanism by which it can record its interest in the realty records in order to conduct a non-judicial foreclosure. UCC Section 9-607(b) provides that "if necessary to enable a secured party [including the buyer of a mortgage note] to exercise ... the right of [its transferor]to enforce a mortgage nonjudicially," the secured party may record in the office in which the mortgage is recorded (i) a copy of the security agreement transferring an interest in the note to the secured party and (ii) the secured

[45] See Official Comment 6 to UCC § 9-308, which also observes that "this result helps prevent the separation of the mortgage (or other lien) from the note." Note also that, as explained in Official Comment 7 to UCC § 9-109, "It also follows from [UCC § 9-109(b)] that an attempt to obtain or perfect a security interest in a secured obligation by complying with non-Article 9 law, as by an assignment of record of a real-property mortgage, would be ineffective."

[46] Similarly, Official Comment 6 to UCC § 9-308 states that "this Article does not determine who has the power to release a mortgage of record. That issue is determined by real-property law."

[47] See discussion of Question Three, *supra*.

[48] In some cases, the seller or debtor may no longer be in business. In other cases, it may simply be unresponsive to requests for execution of documents with respect to a transaction in which it no longer has an economic interest. Moreover, in cases in which mortgage note was collateral for an obligation owed to the secured party, the defaulting debtor may simply be unwilling to assist its secured party. See Official Comment 8 to UCC § 9-607.

party's sworn affidavit in recordable form stating that default has occurred[49] and that the secured party is entitled to enforce the mortgage non-judicially.[50]

Illustration:

11. Same facts as Illustration 10. Maker has defaulted on the note and mortgage and Funder would like to enforce the mortgage non-judicially. In the relevant state, however, only a party with a recorded interest in a mortgage may enforce it non-judicially. Funder may record in the relevant mortgage recording office a copy of the signed writing pursuant to which the note was sold to Funder and a sworn affidavit stating that Maker has defaulted and that Funder is entitled to enforce the mortgage non-judicially. UCC § 9-607(b).

Summary

The Uniform Commercial Code provides four sets of rules that determine matters that are important in the context of enforcement of mortgage notes and the mortgages that secure them:

- First, in the case of a mortgage note that is a negotiable instrument, Article 3 of the UCC determines the identity of the person who is entitled to enforce the note and to whom the maker owes its payment obligation; payment to the person entitled to enforce the note discharges the maker's obligation, but failure to pay that party when the note is due constitutes dishonor.
- Second, for both negotiable and non-negotiable mortgage notes, Article 9 of the UCC determines whether a transferee of the note from its owner has obtained an attached property right in the note.
- Third, Article 9 of the UCC provides that a transferee of a mortgage note whose property right in the note has attached also automatically has an attached property right in the mortgage that secures the note.
- Finally, Article 9 of the UCC provides a mechanism by which the owner of a note and the mortgage securing it may, upon default of the maker of the note, record its interest in the mortgage in the realty records in order to conduct a non-judicial foreclosure.

As noted previously, these UCC rules do not resolve all issues in this field. The enforcement of real estate mortgages by foreclosure is primarily the province of a state's real property law, but legal determinations made pursuant to the four sets of UCC rules described in this Report will, in many cases, be central to administration of that law. In such cases, proper application of real property law requires proper application of the UCC rules discussed in this Report.

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[49] The 2010 amendments to Article 9 (see fn. 8, *supra*) add language to this provision to clarify that "default," in this context, means default with respect to the note or other obligation secured by the mortgage.

[50] UCC § 9-607(b) does not address other conditions that must be satisfied for judicial or non-judicial enforcement of a mortgage.

AMERICAN BANKRUPTCY INSTITUTE
CENTRAL STATES
TRAVERSE CITY, MICHIGAN
JUNE 6-10, 2012
BURNING DOWN THE HOUSE: MORTGAGE ISSUES IN CHAPTER 7 CASES

- ***Under what circumstances can a trustee be compelled to abandon real property?***
  - 11 U.S.C. §554.
  - Bankruptcy Rule 6007.
  - **Proper description of asset in schedules can lead to abandonment of assets.** Debtors that seek to have assets abandoned by the trustee at the time a case is closed should attempt to provide a general description of the asset in the schedules.
  - **Trustee holds real estate, not as the debtor held the real estate, but with the rights and powers of a bona fide purchase who purchased the real estate from the debtor.** Section 544(a)(3) grants strong-arm powers to trustees to avoid certain liens as hypothetical bona fide purchasers of real property as of the commencement of the bankruptcy case.
  - **Where the estate has no equity in an asset, so that unsecured creditors are unlikely to benefit from a sale of the property, it is generally recognized that abandonment is the appropriate method of dealing with the asset.** The Trustee only had an interest in property of the Debtor's estate where the asset can be liquidated and generate a distribution for the creditor body. This analysis requires the Trustee to take a Debtor's exemptions into consideration.
  - **Tenancy by the Entirety and Homestead Exemption may affect a Trustee's ability to sell property of the estate.** Depending on the state, tenancy by the entirety may extend to property other than the principal residence for the debtor(s). *See In re Giffune*, 343 B.R. 883, 891 (Bankr. N.D. Ill. 2006).
  - **Post-petition appreciation goes to trustee.** Trustee can claim non-exempt equity even after discharge, but before the case is closed.
  - **As long as a trustee has not affirmatively abandoned an interest in property of the estate, the asset is subject to the trustee's administration.** The petition date does not set the date of value for a chapter 7 trustee's administration of the asset. If the trustee believes the asset will appreciate in value and create equity, the trustee can keep an estate open to administer the asset.
  - **To be sufficient and effective, a notice of abandonment must be reasonably specific.** Trustee's notice of proposed abandonment of "non-exempt property" can be inadequate to effectuate abandonment of estate property.
  - **Simply filing a no-asset report does not mean a Trustee abandoned an asset of the estate.** If property of the estate does not have sufficient value for the trustee to administer, but is creating rental income during the course of the bankruptcy case.
  - **Revocation of no-asset report.** Revocation of abandonment is governed by Fed. R. Civ. Pro. 60(b) as made applicable to bankruptcy cases by Fed. R. Bankr. Pro. 9024. *LPP Mortgage, Ltd. v. Brinley* (*In re Brinley*), 547 F.3d 643 (6th Cir. 2008). Where the revocation is based upon a mistake of law, the case may be reopened and the no-asset report revoked. *Id*. However, where the trustee's revocation motion is based upon a mistake of fact, the court may consider not revoking the no asset report. *In re Reiman,* 431 B.R. 901 (Bankr. E.D. Mich. 2010).

- ***Sales During the Redemption Period.***[1]

  - ***Overview and Debtor's Perspective:***

    - **Debtors may not be able to obtain a loan modification and retain the property:** If a Trustee leaves a bankruptcy case open for any reason – including awaiting a possible underbid at foreclosure – then all the debtors' property, including the real property, remains property of the estate, unless it is abandoned, as discussed above. This may thwart Debtors' intent to modify mortgage loans.

    - **The Debtor cannot 'short sell' the property:** In addition, because the property has not been abandoned, it remains property of the estate. Thus, under Bankruptcy Code §363(B), only the Trustee has the right to sell the property.

    - **Right redeem real property arise under state law.** The right to redeem is a creature of state law and a homeowner's or chapter 7 trustee's rights to redeem are different in each state. Michigan redemption laws appear to be unique.

    - **Debtor cannot redeem the foreclosed mortgage.** Under 541(a)(6) proceeds, product, offspring, rents, or profits from property of the estate), the right to redeem a foreclosed mortgage is property of the estate. *Armstrong v. Harris (In re Harris),* 866 F.2d 1011, 1013 (8th Cir. 1989) (Redemption rights that attached post-petition are property of the bankruptcy estate because they are either proceeds, product, offspring, rents or profits of estate property). Thus, under §363(b), only trustee has the right to sell the house and redeem as part of the sale process.

    - **Issues with third parties and redemption rights:** Again, in an open bankruptcy case, because the right to redeem is property of the bankruptcy estate, only the Trustee has the right to redeem the property as part of any contemplated sale. In a closed case, however, the redemption right has been "technically" abandoned to the debtors, which means the right of redemption belongs to the debtors, unless the Trustee reopens the case and revokes the abandonment. In closed cases, third parties may approach debtors and offer to buy the redemption rights or make some other kind of deal. Debtors should call their attorney before selling their redemption rights to third parties or making any deals. Sometimes, the third party approaching the debtors is the party that bought the property at foreclosure and wants to prevent redemption. If a property has been underbid in a closed case, then debtors may be able to redeem the house or sell it themselves. Again, debtors are cautioned to call their attorneys when approached by third parties.

    - **Debtors must cooperate with a Trustee who wants to sell a house.** Under §521(a)(3), debtors are obligated to "cooperate with the Trustee as necessary to enable the Trustee to perform the Trustee's duties under this title" Because the Trustee has a duty to "collect and reduce to money property of the estate", §704(a)(1), debtors' refusal to cooperate is a basis for objecting to discharge generally under §727.

    - **Debtors may have to move out of a property before the redemption period expires.** Under §521(a)(4) debtors are obligated to "surrender to trustee all property of the estate." Duty to vacate property if trustee sells it.

[1] A significant portion of this section is a reproduction from the material prepared by Wendy Turner Lewis, Michelle Clark, Rodney Glusac and Jordan Sickman for their presentation *Real Property Issues: Judicial Foreclosure, Sales During the Redemption Period, MERS Issues* at the ABI Detroit Consumer Bankruptcy Conference 2011, pp. 613-14.

- **Debtors may not "strip" a property of all fixtures before moving out:** Fixtures – like interior doors, shower heads, toilets, light socket coverings, etc. – are property of the bankruptcy estate. Thus, debtors may not removed them if the Trustee sells the house. Indeed, removing fixtures jeopardizes a Trustee's ability o sell a house. And, by extension, the ability to pay exemptions.

- **Debtors may claim exemptions for the property, which ameliorates having to move out:** Trustees will have to negotiate with debtors regarding the amount of the exemptions if the claimed exemptions exceed the potential net sale proceeds.

- ***Trustee Perspective*:**

  - **Trustees, in some courts, are leaving cases open where redemption rights can be used to the advantage of creditors of the Debtor's estate:** Some judges in Michigan have said no to reopening cases to allow Trustees to sell underbid houses. *See e.g. In re Reiman*, 431 B.R 901 (Bankr. E.D. Mich. 2010); *In re Pioch*, Case NO. 08-61473, 2010 Bankr. LEXIS 2952 (Bankr. E.D. Mich. Sept. 1, 2010). As a result, Trustees are leaving cases open in to determine if houses are sold at foreclosure with an underbid in jurisdictions such as Michigan.

  - **Pre-Auction Sale Redemption Periods Prevent Trustee Sales:** In the majority of jurisdictions the redemption period takes place prior to an auction sale of the Debtor's real property. Therefore, the underbidding opportunities presented to Trustees in Michigan, do not regularly occur in other jurisdictions.

AMERICAN BANKRUPTCY INSTITUTE
CENTRAL STATES BANKRUPTCY WORKSHOP
TRAVERSE CITY, MICHIGAN
June 6-10, 2012

BURNING DOWN THE HOUSE: MORTGAGE ISSUES IN CHAPTER 7 CASES
DOES THE DEBTOR OWE THE TRUSTEE RENT AT FILING?

The property becomes property of the bankruptcy estate at filing. 11 U. S. C. § 541(a).

In re Szekely, 936 F.2d 897 (7th Cir. 1991). The Seventh Circuit ruled that Debtors do not owe rent to the Trustee upon filing and that the Trustee has to pay the Debtors their homestead exemption amount before requiring them to pay rent or to vacate the premises. Under Illinois law neither tenant in common can charge rent to the other.

Is a Chapter 7 Trustee entitled to charge a Debtor rent while the Trustee is trying to sell the home?

Successorship theory: the Trustee obtains a fee simple absolute interest in the property upon filing.

No right to rent because of the Debtor's homestead exemption; co-tenancy.

Does requiring the Debtor to pay rent counter bankruptcy's "fresh start"? No; the Debtor has to pay rent somewhere.

Does the Debtor have to continue to make mortgage payments between the filing date and the sale? Yes; however, the Chapter 7 discharge of the Debtor's in personam liability results in that amount becoming an *in rem* charge on the property.

Strong-arm theory: Trustee does not own the home in fee simple absolute. The Trustee holds a lien on the property; rent can not be sought until the home is sold and rent is then due to the purchaser.

11 U.S.C. § 544(a)(1) gives the Trustee rights of a hypothetical lien creditor. However, those rights have a limit: the liens do not disappear; they are avoided to a limited extent in that they can be satisfied after the Trustee's claims; they are subordinated. A creditor can receive only what he or she is owed, not fee simple title.

11 U.S.C. § 544(a)(3) gives the Trustee the power to avoid transfers of real property that would be avoidable under state law by a bona fide purchaser of real property. Secret liens and

unrecorded interests can be voided.

11 U. S.C. § 726(a)(6) provides that the Debtor is to receive proceeds from the sale of property if equity remains after certain creditors are satisfied. This reflects state law that a mortgagee may liquidate real property to satisfy its claim and then return any surplus to the Debtor.

11 U. S.C. § 554(c) provides that property scheduled and not administered at the time of the closing of a case is abandoned to the Debtor. This defeats the theory that a Trustee receives absolute title under Section 541(a)(1).

Because the Trustee is a creditor representative, the amount of claims should constitute a limit on the Trustee's right; this is inconsistent with the theory that a Trustee receives fee simple title absolute at filing.

Reference:

Vladimir Elgort, *Do Debtors Owe Rent to Their Bankruptcy Trustee for Remaining in the Home after Filing and Prior to Foreclosure, notwithstanding a Homestead Exemption?*, 23 Cardozo Law Review 2253 (2002).

Standing Issues in Bankruptcy (MERS and Special Servicers)

for

"Burning Down the House:" Mortgage Issues in Chapter 7 Cases
American Bankruptcy Institute Central States Bankruptcy Workshop
Traverse City, MI
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Submitted by
C. Daniel Motsinger, Krieg DeVault LLP, Indianapolis, IN

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I. Introduction[1]

The Great Recession and its accompanying massive economic displacement have generated a sharp increase in mortgage foreclosure lawsuits, which in turn have caused many borrowers to seek refuge in bankruptcy court. This national torrent of mortgage-related litigation has invited judicial scrutiny of the financial industry's practices in assigning the credit and collateral documents associated with mortgages (and other secured lending transactions) over the past several decades. Given the transactional, factual and legal complexity involved in unraveling many of these otherwise seemingly-straightforward transactions, the judicial response has been varied and is still evolving.

The following discussion provides a brief overview of the issues involved and some of the judicial response to date.

II. A Brief Background

Throughout American history it has been a common practice for lenders to sell promissory notes – and their related collateral documents (security agreements, mortgages, etc.) – to other lenders. As the Indiana Supreme Court's recent "Mortgage Foreclosure Best Practices" guidelines (the "Indiana Guidelines") suggest,[2] such promissory note assignments are governed by Article 3 of the Uniform Commercial Code ("UCC") ("[a]n instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument," UCC §3-203(a), and "[t]ransfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to

[1] This paper is adapted from a paper of a similar title delivered as part of the Indiana Continuing Legal Education Forum's December 2012 Annual Bankruptcy Institute, and is used with the permission of the Indiana Continuing Legal Education Forum.

[2] *In re Mortgage Foreclosure Best Practices*, Cause No. 94S00-1101-MS-3, "Order on Mortgage Foreclosure Best Practices," October 7, 2011, http://www.in.gov/judiciary/orders/other/2011/94s00-1101-ms-3a.pdf; the Indiana Guidelines themselves can be found at http://www.in.gov/judiciary/admin/mortgage/docs/mortgage-foreclosure-best-practices.pdf.

enforce the instrument, including any right as a holder in due course," UCC §3-203(b)).[3] Thus, as one commentator has noted, "at its core, between the parties to the assignment, assigning a mortgage is very much like selling a used lawnmower [; w]hat makes it more complex in practice is the potential for disputes and the precautions that must be taken to protect the parties."[4]

This "complexity in practice" has arisen chiefly from the fact that so many credit and collateral documents have been "securitized":

> Today, a mortgage originator might make hundreds of loans and assign them as collateral to borrow money from a bank in a "mortgage warehouse facility." The borrowed money is used to originate more mortgages. A mortgage warehouse is often only temporary, so the mortgages might be transferred from one facility to another. When the mortgage originator has a sufficiently large pool of mortgages, it may permanently "securitize" them by assigning them to a newly formed company that issues securities that are then sold to investors. In the end, the company owns the mortgages, and the investors receive payments on the securities which are based on the collections from the mortgage pool. In this manner, mortgages are effectively packaged as securities, which can more easily be traded than individual mortgages – hence the name "securitization."[5]

It is beyond the scope of this presentation to discuss all of the complexities of – or transactional documents involved in – a mortgage loan securitization. However, one of the salient documents involved is a Pooling and Servicing Agreement ("PSA"), which acts as the governing document when a large pool of loans is sold into the marketplace as securities. The PSA acts as a trust document, defining the rights of the investors (the "beneficiaries") and the duties of the trustee and servicer (or special servicer).[6]

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[3] *See also* American Law Institute, *Application of the Uniform Commercial Code to Selected Issues Related to Mortgage Notes*, Nov. 14, 2011, www.uniformlaws.org/shared/committees_materials/PEBUCC/PEB_Report_111411.pdf, at 5-7 (hereinafter "ALI Report").

[4] David E. Peterson, *Cracking the Mortgage Assignment Shell Game*, THE FLORIDA BAR JOURNAL, Nov. 2011, 11-12.

[5] *Id*. at 11.

[6] *See generally In re Hayes*, 393 B.R. 259, 267 (Bankr. D. Mass. 2008).

Because these securitized transactions often involve the assignment of thousands of mortgages, "there is a temptation to skip the step of recording an assignment in the public records, particularly when the assignment is only a temporary collateral assignment."[7] This is because:

> Transactions sometimes take the form of nothing more than an unrecorded pledge of the mortgages in bulk to the bank, together with the delivery of the original notes to the bank for perfection. In many instances, even the task of holding possession of the notes is outsourced to a bailee who holds the notes for the bank's benefit. The mortgages might be transferred many times by unrecorded assignments in bulk without physically moving the notes, but with the bailee simply signing a receipt changing the name of the lender for whom it holds the notes.[8]

To accommodate the needs of this marketplace for an entity which could serve as such a bailee, the Mortgage Electronic Registration Systems (collectively with MERSCORP, Inc., "MERS") was founded in 1995[9] "by the mortgage banking industry to streamline the mortgage process by using electronic commerce to eliminate paper."[10] Creditors and loan servicers contract with MERS to become "MERS members."[11] MERS claims that it "is approved by Fannie Mae, Freddie Mac, Ginnie Mae, FHA and VA, California and Utah Housing Finance Agencies, as well as all of the major Wall Street rating agencies."[12]

According to MERS, MERS "acts as nominee in the county land records for the lender and servicer [; a]ny loan registered on the MERS® System is inoculated against future

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[7] *Peterson*, *supra*, at 11.
[8] *Id*.
[9] "MERSCORP, Inc. tracks the beneficial ownership interests in, and servicing rights to, mortgage loans as they change hands from and to its members through the life of the loan (as long as the holder and its assignees are members of MERS). Mortgage Electronic Systems, Inc. ("MERS"), a wholly owned subsidiary of MERSCORP, Inc., acts as the mortgagee or beneficiary (as "nominee" for the creditor and its successors and assigns)." Patricia Antonelli, *et al*., *Sand in the Gears: Wrong or No Paperwork, Flawed Assignments, Robo Signatures, Class Actions and Defenses*," AMERICAN BANKRUPTCY INSTITUTE 2011 EDUCATIONAL MATERIALS, Boston 3rd Annual Northeast Consumer Winter Forum, http://www.abiworld.org/committees/newsletters/consumer/vol9num1/sand.pdf, at 129.
[10] MERS, *About MERS*, http://www.mersinc.org/about/index.aspx.
[11] Antonelli, *supra* note 9.
[12] MERS, *supra* note 10.

assignments because MERS remains the mortgagee no matter how many times servicing is traded."[13] A MERS member agrees to appoint MERS as a nominee and to name MERS as a lienholder of record for all security instruments recorded in the MERS system.[14] When loans are conveyed between MERS members, the conveyances are tracked on the MERS system.[15] Through this arrangement, MERS claims that it can remain the nominee/beneficiary so long as the owners of the notes trade them within the MERS system.[16]

MERS in operation has been described as follows:

> A typical MERS scenario involves the creditor in a mortgage transaction nominating MERS as the nominee of the originating creditor and its assignees. The naming of MERS as nominee for the creditor can also occur after the loan is originated as a result of the recording of an assignment of a mortgage to MERS. Thus, a review of the land evidence records will show the MERS is the record title holder of the mortgage, although MERS' name will not appear on the note, and the beneficial interest in the mortgage remains with the original creditor or its assignee. The naming of MERS as the nominal mortgagee allows the MERS registry to track all future mortgage loan and mortgage loan servicing transfers or other assignments of the mortgage loan unless and until ownership is transferred to an entity that is not a MERS member. MERS serves as a central source of information and tracking system allowing creditors, investors, loan servicers, foreclosure attorneys and consumers to obtain information about the servicer and the beneficial holder of mortgage loans.[17]

As will be discussed briefly later, "[t]he use of MERS as the nominee for the benefit of the creditor and its assignees has become the subject of numerous challenges and litigation," with "[m]any of the challenges center[ing] around MERS' standing to initiate foreclosures."[18]

This background briefing began, and will end, with a discussion of the importance of being entitled to enforce the note that is being enforced. Under the UCC, "[i]f a note secured by a

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[13] *Id*.
[14] Ford Elsaesser and Suzanne Fegelein, P*aperless Pipedream? Rule 9011 and Standing Issues in the E-Bankruptcy World*, AMERICAN BANKRUPTCY INSTITUTE 2010 EDUCATIONAL MATERIALS, ABI 18th Annual Southwest Bankruptcy Conference, http://www.abiworld.org/committees/newsletters/consumer/vol8num8/pipedream.pdf, at 25-26 (citing *In re Mitchell*, 2009 WL 1044368 at **1-2 (Bankr. D. Nev. 2009).
[15] *Id*.
[16] *Id*.
[17] Antonelli, *supra* note 9.
[18] *Id*.

mortgage is sold . . . but the parties do not take any additional actions to assign the mortgage that secures payment of the note, such as execution of a recordable assignment of the mortgage . . . . UCC Section 9-203(g) explicitly provides that, in such cases, assignment of the seller . . . in the note automatically transfers a corresponding interest in the mortgage to the assignee."[19] Specifically, UCC §9-203(g) states that "[t]he attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also attachment of a security interest in the security interest, mortgage or other lien;" note that under the UCC, "a 'security interest' in a note includes the right of the buyer of the note."[20]

For this reason, many courts uniformly appear to have held that an assignment of a mortgage is effective when the promissory note secured by the mortgage is assigned, whether or not the mortgage also is assigned. By way of illustration (reviewing the decisions of the courts of Indiana), in *Connecticut Mut. Life Ins. Co. v. Talbot*, 14 N.E. 586 (Ind. 1887), the Indiana Supreme Court held:

> That the indorsee of a promissory note secured by mortgage succeeds to the benefits of the mortgage security, *even though the latter be not formally assigned*, is a familiar proposition. The written indorsement of the payee on the note *carries the legal title therein to the indorsee*; and the mortgage, *being a mere incident to, and security for*, the debt, the assignee of the note *becomes equitably entitled to participate in the security to the extent of his interest or ownership in the debt*.

Talbot, 14 N.E. at 587 [emphasis added]. In other words, the assignment of a note secured by a mortgage carries with it the mortgage, and "[t]he right of such an assignee to participate in the mortgage is wholly equitable, and grows out of the fact that *equity regards the mortgage as being merely accessory to the debt*." *Id*. at 587-88. (emphasis added).

As a result, once a note secured by a mortgage is assigned, the assignment is fully effective, and complete, as between the mortgagee/assignor and the assignee:

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[19] ALI Report, *supra* note 3, at 12.
[20] *Id*.

> It is, of course, certain that, *as between the mortgagee and his assignee and all others having notice of their respective rights*, the former can do nothing to prejudice the rights of the latter, after the debt has been assigned.

Id. at 588. (emphasis added).

What role does recordation play in all of this? As noted by the ALI Report, "[i]n some states, a party without a recorded interest in a mortgage may not enforce the mortgage non-judicially."[21] In such states, even though assignment of the note gives the buyer of the mortgage note rights in the mortgage, the failure to record the assignment may, as a matter of local real estate law, not entitle the buyer to enforce the mortgage upon the default of the maker.[22] In such states, however, UCC §9-607(b) can "save the day" by giving such a buyer a mechanism by which to record its interest in the realty records in order to conduct a non-judicial foreclosure, because UCC §9-607(b) provides that "if necessary to enable a secured party [including the buyer of a mortgage note] to exercise . . . the right of [its transferor] to enforce a mortgage nonjudicially," the secured party may record in the office in which the mortgage is recorded (i) a copy of the security agreement transferring an interest in the note to the secured party, and (ii) the secured party's sworn affidavit in recordable form stating that default has occurred and that the secured party is entitled to enforce the mortgage non-judicially.[23]

Other states (especially those which do not permit nonjudicial foreclosure) reach the same result through case law. As an example, in *Talbot*, the Indiana Supreme Court considered the applicability of Ind. Code §32-8-11-7, enacted in 1877, with respect to assignments which were made prior to the effective date of that statute but which remained unrecorded following that effective date.

Ind. Code §32-8- 11-7(a) provides:

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[21] ALI Report, *supra* note 3, at 13.
[22] *Id*.
[23] *Id*. at 13-14.

> Any mortgage of record or any part of the mortgage may be assigned by the mortgagee or any assignee of the mortgage, either by an assignment entered on the margin of the record, signed by the person making the assignment and attested by the recorder, or by a separate instrument executed and acknowledged before any person authorized to take acknowledgments, and recorded on the margin, or in the mortgage records of the county, in which case the assignment shall be noted in the margin by the recorder by reference to the book and page or to the instrument number where the assignment is recorded.

In *Talbot*, a mortgage held by one party was assigned to another party, Ind. Code §32-8-11-7 then was enacted, but the assignment never was recorded thereafter. After holding, as noted above, that assignments of mortgages are effective between the original parties upon execution, the Indiana Supreme Court held:

> The effect of the act of 1877 [Ind. Code §32-8-11-7] . . . was to postpone or render assignments of mortgages void, *as against any subsequent purchaser or mortgagee in good faith for a valuable consideration*, unless such assignments were recorded as therein provided.
>
> * * *
>
> The act of 1877, as applied to [the mortgage under review], and all others similarly held, impaired *no existing right of any assignee*. It simply enlarged the opportunities of assignees for giving notice of and protecting existing rights, and it left to each the option to procure and record an assignment of his mortgage in the manner provided or to take the chance that his assignor, *who held the legal title to his security in trust for him*, would act in good faith and not release the mortgage to his detriment.

Talbot at 588-589 [emphasis added]. Accordingly, the Court ruled that a subsequent assignee for value of a mortgage would prevail over a previous assignee, where the previous assignee had not recorded its mortgage. The Indiana Supreme Court reaffirmed *Talbot* in *Citizens' State Bank v. Julian et al.*, 55 N.E. 1007 (Ind. 1899), and the Indiana Court of Appeals followed it again in *Rowe v. Small Bus. Admin.*, 446 N.E.2d 991 (Ind. Ct. App. 1983).

In *Rowe*, defendants J.C. Rowe and Janice J. Rowe (the "Rowes"), as mortgagors, contended that the Small Business Administration ("SBA") could not foreclose on the Rowes'

mortgage, which was assigned to the SBA, where the SBA did not comply with the recording provisions of Ind. Code §32-8-11-7. Essentially, the Rowes argued that the SBA's mortgage was unenforceable because the assignment of it had not been recorded. In rejecting the Rowes' argument, the Court of Appeals, citing *Talbot*, held that "...the recording provisions of I.C. 32-8-11-7 *were enacted to protect subsequent purchasers and mortgagees*." *Rowe* at 993 (emphasis added). Therefore, the Rowes could not rely on the provisions of Ind. Code §32-8-11-7 to defeat that assignment because they, as mortgagors, were not the parties whose interests the statute was intended to protect, i.e., they were the principal obligors/mortgagors, not subsequent purchasers or mortgagees. *Id*. ("the Rowes have failed to fall within the provisions of I.C. 32-8-11-7"). In so ruling, the *Rowe* court noted, but did not address, the SBA's contention that the assignment was governed by the provisions of Ind. Code §32-8-12-1, which provides:

> It shall be the duty of each and every firm, person, limited liability company, or corporation who transfers or assigns any mortgage upon real estate within the state of Indiana securing the payment of any sum or sums of money, to sell, transfer or assign the same in writing, either upon the margin of the record where such mortgage is recorded or by written instrument, and cause the same to be duly acknowledged before some officer authorized to take acknowledgments of the execution of such mortgages.

The SBA had contended that Ind. Code §32-8-12-1 clearly establishes that "due execution" is all that is required for the effectiveness of an assignment in Indiana; however, in light of *Talbot*'s ruling to the same effect as a matter of Indiana common law, the *Rowe* court apparently did not see the need to address Ind. Code §32-8-12-1 further.

The upshot of *Talbot*, *Rowe* and Ind. Code §32-8-12-1 is that in Indiana recordation is irrelevant to the effectiveness of an assignment of a mortgage. Put another way, once a note is assigned by a lender (among the other credit and collateral documents), the assignee owns the loan to which the note pertains, regardless of whether the related mortgage is assigned of

record.[24] It undoubtedly is for this reason that the Indiana Guidelines emphasize the importance, in a mortgage foreclosure context, for the plaintiff to allege how and why the plaintiff is entitled to enforce the note (which the mortgage secures) pursuant to Ind. Code §26-1-3.1-301.[25]

III. The Battle over Standing

The foregoing background (and complexity) most often spills over into bankruptcy court in the form of battles over whether the party seeking to enforce a note and/or mortgage via a motion for relief from stay or a proof of claim has standing to do so.[26] As one commentator has noted bluntly, "[i]f a lender cannot prove standing, the [bankruptcy] court has no authority to hear its motion for relief from stay and it must dismiss the motion."[27] This is because "the core requirement of standing is an essential and unchanging part of the case-or-controversy requirement of Article III," *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992), and as such is a threshold issue that must be addressed before a court may entertain a suit. *Warth v. Seldin*, 422 U.S. 490, 498 (1975). Moreover, federal prudential requirements also require that a party seeking to enforce a note and/or mortgage be the real party in interest.[28]

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[24] That said, it certainly is a "best practice" to assign a mortgage simultaneous with the assignment of the note. *See* Deborah L. Thorne and Ethel Hong Badawi, *Does "the Mortgage Follow the Note"? Lessons Learned, Best Practices for Assignment of a Note and Mortgage,* AMERICAN BANKRUPTCY INST. J., May 2011, at 54.

[25] *See* Indiana Guidelines, *supra* note 1.

[26] Note also that certain alleged mortgage servicing, foreclosure and bankruptcy abuses resulted in a February 9, 2012 settlement between the United States, 49 state attorneys general and five of the nation's largest mortgage services, wherein, inter alia, the servicers will pay $25 billion in cash and financial relief to homeowners, adhere to a uniform and comprehensive set of mortgage-servicing standards, including provisions specific to bankruptcy, and subject themselves to three and a half years of compliance review by an independent monitor. See Clifford J. White III and Ramona D. Elliott, $25 Billion Mortgage Servicer Settlement: Implications for USTP and Bankruptcy System, AMERICAN BANKRUPTCY INST. J., March 2012, at 18.

[27] Ford Elsaesser and Rudy J. Cerone, *Resolved: Servicers Lack Standing to Prosecute Motions for Relief from Stay on Behalf of Unnamed Beneficiaries*, AMERICAN BANKRUPTCY INSTITUTE 2010 EDUCATIONAL MATERIALS, ABI 18th Annual Southwest Bankruptcy Conference, http://www.abiworld.org/committees/newsletters/consumer/vol8num8/cases.pdf, at 9.

[28] *Id. See also In re Hwang*, 438 B.R. 661, 665 (C.D. Calif. 2010), and *In re Village of Rathskeller*, 147 B.R. 665, 668 (Bankr. S.D.N.Y. 1992).

Not surprisingly against the above-discussed backdrop of mortgage securitizations and MERS-recorded mortgages, the inquiry into whether a particular creditor has standing in bankruptcy to enforce a note and/or mortgage against the debtor hinges on what state law provides, for it is established that state law definitions of property interests are controlling in bankruptcy. In *Butner v. U.S.*, 440 U.S. 48, 55 (1979), the Supreme Court of the United States held :

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy." *Lewis v. Manufacturers National Bank*, 364 U.S. 603, 609, 81 S.Ct. 347, 350, 5 L.Ed.2d 323. The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property.

Butner, 440 U.S. at 55; *In re Wright*, 492 F.3d 829, 832 (7th Cir. 2007) (citing *Butner*).[29]

While not a bankruptcy case, a recent Indiana decision "require[d the Court of Appeals] to look at the relationship between MERS and [a lender], which is a matter of first impression in Indiana." *Citimortgage, Inc. v. Barabas*, 950 N.E.2d 12, 16, *modified following reh'g*, 955 N.E.2d 260 (Ind. Ct. App. 2011). In *Barabas*, the borrower (Barabas) had granted a mortgage to MERS "solely as nominee for Lender, as hereinafter defined, and Lender's successors and assigns." 950 N.E.2d at 13. The granting clause, after listing MERS' mailing address, then simply stated "Irwin Mortgage Corporation" in bold letters, later listing a Fishers, Indiana address for Irwin. *Id.* Barabas then granted a second mortgage on the property to ReCasa

[29] Thus, for example, federal courts have applied an Indiana statute that upholds the validity of Indiana mortgages which, though not satisfying all of the technical recording requirements of Indiana law, nonetheless were accepted for recording. *In re Hershman*, 417 B.R. 97, 100 (N.D. Ind. 2009). *See also Miller v. LaSalle Bank N.A.*, 595 F.3d 782 (7th Cir. 2010); *In re Kraft, LLC*, 429 B.R. 637 (Bankr. N.D. Ind. 2010); *Boston v. The Huntington Nat'l Bank*, 2009 WL 2563473 (S.D. Ind. Aug. 17, 2009).

Financial Group, Inc. LLC ("ReCasa"), and then defaulted on the ReCasa mortgage. ReCasa brought a mortgage foreclosure, naming Irwin Mortgage Corporation ("Irwin") as a defendant to answer as to its interest, but Irwin filed a disclaimer of interest, following which ReCasa obtained a foreclosure judgment by default. At the sheriff's sale ReCasa credit-bid its judgment, was the successful purchaser, and sold the property to a buyer, Sanders. A month after the sale to Sanders, MERS assigned the Irwin mortgage to Citimortgage, Inc. ("Citi"), which then sought leave to set aside the underlying default judgment of foreclosure. The trial court ultimately denied Citi's request, and Citi appealed, claiming that because MERS – the lienholder of record – had not received notice of the entry of the default judgment, that judgment was defective.

In upholding the trial court's ruling, a divided Indiana Court of Appeals, following a Kansas Supreme Court decision, *Landmark Nat'l Bank v. Kesler*, 289 Kan. 528, 216 P.3d 158, 161 (2009), held that MERS was a "mere nominee and holder of nothing more than bare legal title to the mortgage, [and] did not have an enforceable right under the mortgage separate from the interest held by Irwin." 950 N.E.2d at 17-18. Accordingly, the majority held that the trial court did not abuse its discretion in refusing to set aside ReCasa's default judgment. 950 N.E.2d at 18.

Disagreeing with the majority, the *Barabas* dissent noted that the mortgage at issue identified the mortgage holder as MERS – not Irwin – so that MERS "had a real interest in the Property," and as such, was entitled to notice of the foreclosure action because MERS "had an enforceable right under the mortgage." *Id.*[30] On rehearing on October 20, 2011, the Court of

[30] Albeit in a different context (Article 9 security interests), two Indiana bankruptcy courts recently have recognized that if an otherwise-valid security agreement is perfected by the filing of a financing statement in the name of the original secured party, and then subsequently is assigned to another secured party (but the assignment is not made of record), the assignee may assert the secured position of the assignor in bankruptcy pursuant to the Uniform Commercial Code, specifically Ind. Code §26-1-9.1-308(d) (a filing is not required to continue the perfected status of the security interest against creditors of and transferees from the original debtor). *See McGee v. Banc of America Practice Sol'ns, Inc. (In re McGee)*, Adv. Pro. No. 10-1001, Case No. 10-01001-reg (Bankr. N.D. Ind. Sept. 9,

Appeals modified a part of its holding unrelated to the MERS issue but otherwise reaffirmed its holding, and the dissent likewise reaffirmed its dissent. 955 N.E.2d 260, 261.[31]

The Indiana Court of Appeals also recently brushed with the issue of standing in the mortgage securitization context in *Wells Fargo Bank, N.A. v. Tippecanoe Associates, LLC*, 923 N.E.2d 423 (Ind. Ct. App. 2010). The caption of the decision notes that the holder of the mortgage interest at issue in the case was "Wells Fargo Bank, N.A., as Trustee for the Registered Holders of Commercial Mortgage Acceptance Corp., Commercial Pass Through Certificates, Series 1998-C-2, acting by and through its Special Servicer, Midland Loan Services, Inc., and Midland Loan Services, Inc." Although not discussed at length in the opinion, it appears from this caption that Wells Fargo Bank was the trustee under a PSA of the mortgage at issue, and that Midland Loan Services was "acting as Wells Fargo's loan servicer and agent . . . . [a]s put by [the borrower], Midland was Wells Fargo's 'mouthpiece' during the relevant period of time." *Tippecanoe*, 923 N.E.2d at 428. In the case, the borrower initiated a declaratory judgment action against both Wells Fargo and Midland seeking a declaration regarding the effect of certain of the credit and collateral documents governing its mortgage relationship.

Among the many issues addressed on appeal, Wells Fargo challenged the borrower's inclusion of Midland as a party to the litigation, and the Court of Appeals agreed that Midland was not a proper party and should be dismissed:

> Acting as an agent or a "mouthpiece," however, does not necessarily mean that the trial court's order herein – whichever way it may have turned out – would have affected a legal right, legal status, or legal relationship of Midland. On the contrary, Midland was merely acting at the behest of its principal, Wells Fargo, and presumably following Wells Fargo's instructions. Midland is not a party to the contracts being construed – it does not have a proverbial dog in this fight.

2010)(Grant, CJ), and *Boston v. Chrysler Fin. Services Americas LLC (In re Scott)*, 2010 WL 933896 (Bankr. S.D. Ind. March 11, 2010)(Coachys, J.).

[31] The Indiana Supreme Court granted Citi's Petition to Transfer on April 10, 2012, and has set oral argument for June 1, 2012, in Appellate Case No. 48-S-04-1204-CC-00213.

> Therefore, we can only conclude that Midland is not a proper party to this declaratory action and reverse the trial court's order denying [Wells Fargo's and Midland's] motion for judgment on the pleadings in that respect only.

Id. Although *Tippecanoe* was not a case where the foreclosure was brought in the name of the special servicer, it nonetheless provides a useful hint as to how an Indiana court might now view the role, rights and powers of special servicers in the mortgage foreclosure context.

As the foregoing discussion suggests, how courts – bankruptcy courts and state courts – have addressed these issues in the context of standing depends both upon the dictates of state law and the unique facts of each case.[32]

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[32] *See* Antonelli, *supra* note 9, at 130-134 for a summary of decisions (including bankruptcy court decisions) finding that the assignment and transfer of a mortgage to MERS as nominee for the benefit of the lender, the trustee and other transferees/assignees in the mortgage loan process does not adversely affect the right to foreclose on a mortgage, and at 134-136 for a summary of decisions taking issue with MERS (including the *Kesler* decision upon which the *Barabas* majority relied). *See also* Elsaesser and Cerone, *supra* note 27, for a further discussion of cases which have taken issue with MERS in the context of whether to allow standing in bankruptcy. Finally, for one of the most recent statements in this regard, *see Residential Funding Co., L.L.C. f/k/a Residential Funding Corp. v. Saurman,* and *Bank of New York Trust Co. v. Corey Messner*, SC: 143178 and SC: 143179 (Michigan Supreme Court November 16, 2011), where in two cases that were consolidated for purposes of appeal, the Michigan Supreme Court reversed the Michigan Court of Appeals and held that under Michigan law, MERS qualified as an owner of an interest in the indebtedness secured by the mortgage, and as such MERS owned a security lien on the properties at issue, which interest authorized MERS under Michigan law to pursue nonjudicial foreclosure against the properties. The Michigan Supreme Court clarified, however, that this holding did not mean that MERS held an ownership interest in the underlying notes (to which the mortgage indebtedness related).