

*Best Practices in Client Advocacy:
From Beginning to Bitter End*

Creditor Breakout

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Compliance with Rule 9037 and Beyond

The Practitioner's Duty to Monitor for Protected Personal Information

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Companies and individuals who seek the protection of the bankruptcy laws are required, throughout the duration of their bankruptcy case, to submit a rather large amount of information and data to the court—from the petition and its supporting documentation—to the various notice matrices, statements of assets and liabilities, schedules of financial affairs and monthly operating reports. Unless specific relief is sought from the bankruptcy court, all of this data is filed on the court docket and becomes a matter of public record.¹ This level of public disclosure is essential to the proper functioning of the bankruptcy process.



Jessica L. Wasserstrom

Only with transparency can the bankruptcy court, creditors, U.S. Trustee and other interested parties have access to the information they need in order to accurately assess the debtor's financial situation and ensure a distribution of available assets in accordance with the priorities set forth in the Bankruptcy Code. Furthermore, consistent with the fundamental tenets of bankruptcy law, public access to the details of the debtor's financial affairs and its liabilities aids the administration of bankruptcy cases, promotes the public trust in the system and encourages legal compliance.

In the current technological age, the ease with which publicly available information and data can be accessed, even when stored on "secure" servers, requires bankruptcy practitioners to consider and balance this desire for transparency with the ever-growing need to assess and protect private information. Rather than limiting the focus to simple compliance with the disclosures required by the Bankruptcy Code and Rules, the careful practitioner

¹ See 11 U.S.C. § 107(a).

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the initials of any minor; and (4) the last four digits of a financial-account number. Apart from the specific exemptions listed



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in Rule 9037(b),³ these restrictions apply to the filing of any document that may contain this information, including, but not limited to, proofs of claims, declarations, motions, orders, settlement agreements

or even the exhibits to any of the foregoing. When the restricted information is present, Rule 9037 basically gives practitioners two options: redact, or request court approval to file under seal.⁴

Practical Implications

Two areas particularly impacted by these privacy rules are proofs of claim and various creditor and notice matrices.

Building Blocks

damaging disclosure of personally identifiable information does not occur.

Protected Information

Various states have enacted their own privacy laws governing the protection of confidential information.² The bankruptcy system took its first steps toward implementing these types of protections in connection with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), adding Rule 9037 to the Federal Rules of Bankruptcy Procedure. Rule 9037, which took effect in 2007, prohibits certain personal information, such as an individual's Social Security number, birth date or financial account number, or the name of a person known to be a minor, from being disclosed in any document filed with the court. Specifically, Rule 9037(a) requires that this personal information be redacted so that it only provides the following information: (1) the last four digits of a Social Security or taxpayer identification number; (2) an individual's birth year; (3)

For practitioners representing or otherwise working with the debtor, the filing of the creditor matrix, in accordance with Rule 1007 of the Federal Rules of Bankruptcy Procedure, is the first and primary area of focus for these concerns. In most cases, the matrix is compiled using information obtained directly from the debtor's various accounts-payable systems. Because these internal accounts-payable systems regularly contain data subject to Rule 9037, such as account numbers, Social Security numbers and tax IDs, particularly for its employees, it is critical that the data be reviewed carefully for personal information subject to Rule 9037's restrictions. Moreover, unless a noticing agent is retained and appropriate relief is sought to maintain the matrix elsewhere, the matrix itself must be filed on the court docket and can

³ Rule 9037(b) provides that the redaction requirement does not apply to the following: (1) a financial account number that identifies the property allegedly subject to forfeiture in a forfeiture proceeding; (2) the record of an administrative or agency proceeding unless filed with a proof of claim; (3) the official record of a state court proceeding; (4) the record of a court or tribunal, if that record was not subject to the redaction requirement when originally filed; (5) a filing covered by subdivision (c) of this rule; and (6) a filing that is subject to § 110 of the Code.

⁴ Rule 9037(c) provides, in relevant part, that "[t]he court may order that a filing may be made under seal without redaction."

² See Massachusetts 201 CMR 17.00 and Nevada NRS 603A, as amended by SB 227. See also New York State General Business Law § 899-aa and 815 Illinois Compiled Statute § 530/1, et seq.

be accessed and used by creditors and other interested parties throughout the pendency of the case. Care must similarly be employed by the debtors and their professionals when preparing and filing their schedules of assets and liabilities and statements of financial affairs.

For practitioners representing creditors, these privacy concerns most often arise in connection with the filing of a proof of claim. In order to satisfy the requirements of Bankruptcy Rule 3001 and Official Form 10, claimants are required to submit with their proof-of-claim form sufficient supporting documentation to evidence the debt claimed therein, as well as any lien securing such debt. While every claim and its supporting documentation should be carefully reviewed prior to filing, the claims that most typically encounter these issues are those based on personal injury, wrongful death, lost wages or other similar basis, as they often attach documentation relating to the claimant's medical treatment or otherwise containing protected items of information.

In all instances, it is evident that bankruptcy professionals need to be keenly aware of the information that they submit when making any unsealed filing with the court. The committee notes to Rule 9037 specifically recommend that attorneys advise clients that any and all information contained in court filings (including exhibits) will be available over the Internet if not otherwise redacted.⁵ Failing to do so, or take the appropriate care in preventing the disclosure of information protected by Rule 9037, can result in a variety of consequences. While it remains to be seen if lawyers who include unredacted confidential information in documents filed with the court (electronically or otherwise) will be subject to malpractice claims, bankruptcy courts have thus far appeared unwilling to subject an attorney (or his or her law firm) to actual liability for failure to comply with the rule. Instead, they have found that Rule 9037 "does not...provide a private right of action...to...assess sanctions against the defendant for attaching documentation to the proof of claim containing [protected information]."⁶ Rather, the remedy for violations of Rule 9037, according to the decisions currently available, is "either redaction or for the court

to restrict access to un-redacted information."⁷ The only exception to this has been where the court has found an intentional violation (*i.e.*, the party at issue "flaunted the law with knowledge of its proscriptions, failed to take remedial action once violations were discovered, or acted deliberately as opposed to mistakenly or inadvertently").⁸

The problem with this approach is that it does not adequately account for the damage that may already have been done to the individual whose information has been disclosed. By the time that the court is alerted to the disclosure and can order that it be redacted or otherwise sealed from the public record. The proverbial egg may have already been scrambled. Absent a vehicle to redress the resultant injury, it is quite possible—if not likely—that the jurisprudence in this area will struggle going forward to find appropriate means to adequately compensate individuals that have been meaningfully harmed by the disclosure of their personal protected information, whether inadvertent or otherwise.

Parallel Concerns

Another area of potential concern for the practitioner is the potential disclosure of employee names and home addresses. While the privacy laws currently enacted, including Rule 9037, do not specifically protect or prohibit the disclosure of mere name and address information, their disclosure, most often in the debtor's schedules, can still be problematic or damaging to the company. For example, there can be provisions in certain of the debtor's employment agreements (particularly those with upper management) that prohibit the disclosure of such personal information, at least without the express consent of the individual. In the rush typically associated with a case filing and first few weeks of emergency hearings, such questions or concerns can often be lost in the push to ensure compliance with all of the required filings. Failing to identify and comply with any covenants or provisions restricting disclosure could expose the company to additional liability.

Even absent such covenants or agreements, the name and addresses for the debtor's employees may still be something that the company needs to protect from full disclosure, particularly where the debtor is anticipating a sale of all or substantially all of its assets in the course

of its bankruptcy proceeding. In certain industry segments, particularly those that are service-related, the employees themselves are valuable assets of the company. If their names and addresses are included in court-filed documents that are not redacted or otherwise sealed, competitors and others can easily access that information and attempt to poach the debtor's employees or otherwise interfere with their continued employment. Given that employees of a debtor in bankruptcy are often already entertaining concerns about the future of the company and their employment, they may be easily persuaded.

To anticipate and prevent these types of potential issues, debtor's counsel should proactively discuss with the company—prior to the case filing wherever possible—whether its employment or other agreements contain restrictions on the disclosure of information and whether it wishes to, or otherwise should, protect the names and/or home addresses of its employees from public disclosure. As most debtors and their professionals are unfamiliar with the inner-workings of the bankruptcy process, they are not in a position to anticipate the potential disclosure of information that may be required throughout the life of the case. In contrast, if the issues are fleshed out and identified from the outset, simple measures can be taken by debtor's counsel to protect the required or desired information and avoid the potential pitfalls and liabilities associated with even inadvertent disclosure. For example, court authority can be sought, and is typically granted, to use numerical references for employees in the schedules (or references limited to initials only), which are then maintained or tracked via a private database or spreadsheet (*e.g.*, "Employee No. 1" or "Employee-AB"). By employing such methods, the schedules can be filed in a way that both accurately discloses the liabilities on the company's books, thereby fulfilling the transparency goals underpinning their filing, while simultaneously protecting the name and address of the employees.

The concerns surrounding the potential disclosure of employee name and address information goes beyond the mere filing of the debtor's matrix and schedules and statements. Perhaps the most common area where these disclosures are often inadvertently made is the filing of certificates or affidavits of service. When completed in the traditional

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⁵ See Rule 9037 Advisory Committee Note—2007 amendment ("Counsel should therefore notify clients of this fact so that an informed decision may be made on what information is to be included in a document filed with the court.")

⁶ *French v. Am. Gen. Fin. Servs. (In re French)*, 401 B.R. 295, 307 (Bankr. E.D. Tenn., 2009). See also *In re Matthews*, Bankr. No. 09-16585-AJM-13, Adv. No. 09-50794, 2010 WL 2176086, at *5 (Bankr. S.D. Ind. May 26, 2010).

⁷ *Barnhart v. Union Bank Inc. (In re Barnhart)*, No. 09-ag-00109, 2010 Bankr. LEXIS 471, at *8-10 (Bankr. N.D. W.Va. Feb. 26, 2010).

⁸ See *In re Gregg*, 2009 Bankr. LEXIS 1484 (Bankr. D. S.C. June 9, 2009).

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manner, the list of parties served with a particular paper or pleading is attached to the filing in order to demonstrate compliance with the Bankruptcy Rules or any applicable court ruling regarding service. In many cases, including service of the bar date notice, solicitation materials and various other notices relating to the disclosure statement and confirmation hearings, the parties served will likely include the debtor's employees, which are often served at their home addresses. Therefore, the mere filing of the certificate or affidavit of service can make this protected or otherwise valuable employee information available to the public, thereby violating any nondisclosure covenants or agreements. In the age of case-information websites easily searchable and viewable by the public at large at no cost, the concern can be even greater, as the data can then be retrieved using Internet search engines with no particular expertise needed.

As with the schedules, it is often a simple and straightforward matter to address and prevent these concerns from

the outset. Court relief can be sought to redact the employee name and/or address information in all certificates of service filed during the case—either as part of a first-day motion addressing noticing procedures generally, or at any point later in the case as the issue is confronted. The ability to adequately and appropriately address these disclosure concerns is not particularly challenging or difficult, but merely requires an awareness and discussion of the potential issues from the outset of the representation so that appropriate measures can be taken and protections obtained.

Conclusion

The need for transparency and thorough disclosure in the bankruptcy process is clear. It has been a cornerstone of U.S. bankruptcy jurisprudence and practice since before the current Bankruptcy Code was enacted, but what was likely never contemplated or anticipated by the original visionaries is the concept of court filings and documentation available and searchable electronically throughout the

world. As the electronic age has emerged, it has brought with it tremendous efficiencies and advantages, but not without also creating new issues and concerns. The careful practitioner who is knowledgeable and mindful of these issues from the outset of a representation can address and appropriately manage the potential pitfalls; knowledge and vigilance are key. However, courts and lawmakers will continue to face the challenge of how and to what extent to keep sensitive or otherwise valuable information secure, and whether to hold lawyers and their firms liable for failing to take adequate care to protect it. In the short time since the enactment of BAPCPA and Rule 9037, courts have been reluctant to do so, absent intentional indifference. As Rule 9037 and similar state court statutes become inculcated into our everyday practice, and as the harm perpetrated by identify theft and other information disclosure becomes more prolific, it seems inevitable that stricter penalties will need to be employed to ensure that such collateral damage does not ensue. ■

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Last in Line

BY ALEXANDER J. PLATTE

Beyond Rule 9011: Should You Really Sign That Proof of Claim?

Proofs of claim are commonplace to creditors and the attorneys who represent them. A lender with any significant volume of accounts is likely to have a system in place to handle customers' bankruptcy filings, including working with a bankruptcy attorney to file a proof of claim.

For many attorneys, a routine part of preparing a proof of claim is to sign the forms on behalf of their clients. Rule 3001 of the Federal Rules of Bankruptcy Procedure expressly authorizes a creditor's authorized agent to sign the claim,¹ and it might be more efficient for the attorney to sign than to coordinate the extra step of obtaining the client's signature. The client also might prefer to have his/her attorney sign the claim as a certification that the format of the claim is technically correct.

Attorneys who sign proofs of claim are likely aware of the Rule 9011 implications of their signatures; after all, the proof of claim form itself points the signer to Rule 9011 and emphasizes both the need for accuracy and the penalties for perjury.² A client's review and specific approval of the final proof of claim before filing might provide an attorney with some comfort that the Rule 9011 duty to verify the accuracy of information has been fulfilled.

However, to sign a proof of claim on a client's behalf is to do more than simply represent to the court that you have reasonably verified the information on the form. Signing a proof of claim makes the attorney a potential fact witness, unshielded by privileges and perhaps even vulnerable to disqualification in later litigation. Recent bankruptcy court decisions have shed light on these risks. While in most cases these risks might be unlikely to cause problems for a signing attorney, having the client sign the proof of claim is a simple step that avoids pitfalls and ensures that evidence is being presented to the court by a proper witness.

Rule 9011: Duty to Review

The Rule 9011 implications of signing a proof of claim might be obvious, but they should not

be overlooked. Bankruptcy Rule 9011, the counterpart to Rule 11 of the Federal Rules of Civil Procedure, requires that each paper that is submitted to the court must be signed by the attorney (if unrepresented) or party submitting it.³ By signing, the person signing the document is certifying that, to the best of his/her knowledge after a reasonable inquiry, that

- there is at least a nonfrivolous argument that the claims presented in the document are warranted by law; and
- the allegations and factual contentions in the document have evidentiary support, or are likely to after further investigation, among other things.⁴

The Rule 9011 implications flowing from an attorney's signature on a proof of claim were explored in *In re Obasi*, a 2011 decision from the U.S. Bankruptcy Court for the Southern District of New York.⁵ In *Obasi*, the proof of claim in question was for a mortgage, and it was signed electronically by the mortgagor's attorney.⁶ The debtor objected to the proof of claim, both because the mortgage's chain of title was incomplete and because of an alleged dispute regarding the claim's request for attorneys' fees.⁷

At a deposition for the debtor's objection, the signing attorney testified that he did not personally sign the proof of claim and had not even personally seen the claim before it was filed.⁸ Instead, he explained that his firm's procedure was to have staff prepare each proof of claim and have a junior attorney review the claim prior to filing.⁹ The signing attorney provided a checklist to use for claim review and preauthorized the use of his electronic signature for filing, but only the junior attorney actually reviewed each claim and directed it to be filed.¹⁰

This system of claim preparation and review was unacceptable to the court. The court emphasized that Rule 9011 imposes a *personal and non-delegable* responsibility to conduct a "reasonable investigation" of the proof of claim.¹¹ It was irrelevant how thorough the firm's review process might have been, since the attorney signing the proof of



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¹ See Fed. R. Bankr. P. 3001(b).

² The instructions for Box 8 of the proof of claim form provide, among other things, that "[i]f you sign this form, you declare under penalty of perjury that the information provided is true and correct to the best of your knowledge, information, and reasonable belief. Your signature is also a certification that the claim meets the requirements of FRBP 9011(b). Whether the claim is filed electronically or in person, if your name is on the signature line, you are responsible for the declaration.... Criminal penalties apply for making a false statement on a proof of claim." U.S. Courts, Official Bankruptcy Form B10, Proof of Claim, at 1 (April 2013), available at www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK_Forms_Current/B_010.pdf at 2.

³ Fed. R. Bankr. P. 9011(a); see also *In re Dansereau*, 274 B.R. 686, 688 (Bankr. W.D. Tex. 2002) ("Rule 9011 applies to proofs of claim filed in bankruptcy cases.");

⁴ Fed. R. Bankr. P. 9011(b).

⁵ 2011 Bankr. LEXIS 5011, 2011 WL 6336153 (Bankr. S.D.N.Y. Dec. 19, 2011).

⁶ *Id.* at *2.

⁷ *Id.* at *3.

⁸ *Id.* at *5.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* at *11-16.

claim had no intention of personally reviewing the document.¹² The court noted that even the fact that the information in a document might be accurate does not satisfy the Rule 9011 inquiry requirement.¹³

Rule 9011 dictates that an attorney signing a proof of claim *personally* make a reasonable inquiry as to its facts and a creditor's rights to make a claim. Though *Obasi* dealt with a case where the attorney whose name appeared on the form did not personally sign the claim, the court's reasoning suggests that the same result would be reached if an attorney does personally authorize his/her signature on a claim without having personally verified its contents.

As an aside, the requirements of Rule 9011 are not limited to attorneys; they apply to anyone who signs a submission to the court.¹⁴ Any representative of a creditor who signs a proof of claim on the creditor's behalf will be held to the same standard of inquiry as would a signing attorney.¹⁵

Becoming a Fact Witness

Another hazard of an attorney's signing a proof of claim is that it makes the attorney a potential fact witness in future litigation regarding the claim. This scenario was recently encountered by the U.S. Bankruptcy Court for the Southern District of Texas in *Schmidt v. Rodriguez (In re Rodriguez)*.¹⁶ *Rodriguez* involved the deposition of an attorney who signed his client's proofs of claim in the bankruptcy; the attorney objected to and refused to answer a total of 102 questions at the deposition on the grounds of privilege.¹⁷

In analyzing the potential application of privileges, the *Rodriguez* court first distinguished between an attorney's signature on a proof of claim and on a complaint.¹⁸ Importantly, unlike a complaint, "[a] properly filed proof of claim is *prima facie* evidence as to the claim's validity" and thus, as to the facts alleged in the claim.¹⁹ The court quoted from an analogous case, *Comp. Network Corp. v. Spohler*:

Here, [the attorney] was being a factual witness concerning fact issues [that] goes to the heart of this legal controversy. He cannot foreclose discovery of the factual basis for his factual representations in the affidavit anymore (sic) than he could take the witness stand and testify on direct examination to the factual matters set forth in his affidavit, and then preclude cross-examination by invoking the attorney/client privilege.²⁰

Presenting factual evidence to the court by signing and submitting proofs of claim waived the attorney/client privilege as to the facts of the claim.²¹ When questioned at the deposition about his activities prior to filing the proof of claim, such as the documents that he reviewed, the people with whom he spoke and his understanding of the law, the attorney in *Rodriguez* asserted the work-product privilege.²²

The court noted that the attorney's refusal to answer these questions on the grounds of the work-product privilege would usually be appropriate.²³ However, he had made himself a fact witness by signing the proofs of claim, and the court found that he could not "shield from discovery via the work-product privilege the basis for factual assertions [that were] made as a fact witness."²⁴

As demonstrated by *Rodriguez*, an attorney who signs a proof of claim on a client's behalf becomes a potential fact witness in future litigation. As a fact witness, the attorney could be exposed not only to questions regarding the facts of the claim, but also a broad range of topics relating to the attorney's practice and even legal knowledge.

Disqualification

Even worse, it is possible that since an attorney who signs a proof of claim becomes a potential fact witness, the attorney could be disqualified from representing the client in a future proceeding due to the dual "attorney" and "client" roles. Disqualification was at issue in *Duke Invs. Ltd. v. Amegy Bank NA (In re Duke Invs. Ltd.)*, wherein the court chose to publish its opinion "because it underscores the problems that can arise when an attorney signs a proof of claim on behalf of the client."²⁵

In *Duke*, an attorney prepared a proof of claim with the aid of significant consultation with his client.²⁶ After the client performed a final review, the attorney signed and filed the claim.²⁷ The debtor then filed an adversary proceeding to contest the claim, alleging that the creditor wrongfully charged the debtor fees, expenses and an exorbitant interest rate.²⁸ The debtor also filed a motion to disqualify both the attorney and his law firm from representing the creditor in the adversary proceeding, claiming that the attorney would "likely be a material fact witness."²⁹

The court based its decision on the disqualification standards in both the Texas Disciplinary Rules of Professional Conduct and the American Bar Association's Model Rules of Professional Conduct.³⁰ Under both sets of rules, a primary question is whether the lawyer will be a "necessary" witness in a proceeding.³¹ Key to the *Duke* court's reasoning was that although the attorney had prepared the proof of claim, he had done so in close consultation with the creditor, and there was at least one representative of the creditor who could testify to all the facts of the claim.³² The attorney's testimony was therefore merely cumulative, and the debtor failed to meet its burden to prove that he was a "necessary" witness.³³ Although the particular facts of *Duke* dictated that the attorney should not be disqualified, the court nonetheless took the opportunity to issue a warning to creditors' attorneys:

23 *Id.* at *19.
 24 *Id.* at *20.
 25 454 B.R. 414, 417 (Bankr. S.D. Tex. 2011).
 26 *Id.* at 417-18. As of the petition date, the attorneys' fees claimed by the attorney's law firm totaled nearly \$450,000. *Id.* at 419.
 27 *Id.* at 418-19.
 28 *Id.* at 419.
 29 *Id.* at 420.
 30 *Id.* at 422.
 31 *Id.* at 422-23; see also Model Rules of Prof'l Conduct R. 3.07(a); Tex. Disciplinary R. Prof. Conduct 3.08(a).
 32 *Id.* at 422-25.
 33 *Id.*

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12 *Id.* at *17-18.
 13 *Id.* at *19-20 (citing *In re Ulmer*, 363 B.R. 777, 782 (Bankr. D.S.C. 2007)).
 14 Fed. R. Bankr. P. 9011(a) ("By presenting to the court ... a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that...") (emphasis added).
 15 *Id.*
 16 2013 Bankr. LEXIS 5048, 2013 WL 2450925 (Bankr. S.D. Tex. June 5, 2013).
 17 *Id.* at *8.
 18 *Id.* at *11.
 19 *Id.* (emphasis added); Fed. R. Bankr. P. 3002(f) ("A proof of claim executed and filed in accordance with these rules shall constitute *prima facie* evidence of the validity and amount of the claim.")
 20 *Id.* at *12-13 (quoting *Comp. Network Corp. v. Spohler*, 95 F.R.D. 500, 502 (D.D.C. 1982)).
 21 *Id.* at *13.
 22 *Id.* at *18. The work-product privilege is defined by Fed. R. Civ. P. 26(b)(3). *Id.*

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Despite this holding, Stohner — and all other attorneys representing creditors in bankruptcy cases — ought to think twice before signing proofs of claim for their clients. There is no question that any attorney is allowed to do so, but the attorney puts himself at risk by becoming a fact witness. The Court would suggest that attorneys encourage clients to sign proofs of claim to avoid what has occurred in this suit. Here, the time-consuming and costly effects of the Motion are particularly instructive. Indeed, this whole ordeal could have been avoided if Stohner simply had a representative from [his client] knowledgeable about the loan ... sign the proof of claim.³⁴

Best Practices

These cases demonstrate that the choice of which person will sign a proof of claim can be very important. To sign a

³⁴ *Id.* at 426-27.

proof of claim is to certify that you have personally made a reasonable investigation of the facts, and that the claim is correct to the best of your knowledge. For an attorney, to sign the claim makes the client's facts your facts; the proof of claim is *prima facie* evidence, and your signature makes you a potential fact witness in a proceeding involving the claim. Signing the claim likely waives any privileges that might otherwise protect your testimony, and it could even result in your disqualification from representing your client. Even if no sanctions or disqualification result, you could be forced to spend time and money litigating any of these issues.

All of these pitfalls might be easily avoided by having your client sign each proof of claim. Although the representative who signs still bears the burden to personally verify all the facts under Rule 9011, it is the creditor who should be testifying to the contents of its own records. Getting your client's signature is a small step that can avoid a large hassle down the road. **abi**

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Does “the Mortgage Follow the Note”?

Lessons Learned, Best Practices for Assignment of a Note and Mortgage

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Ask any first-year law student who has completed a property course and he or she will tell you that good title to real property requires a recording of the deed in the local county records. Have a lien on real property? Record it with the local county. An easement? Record. In law school, if it is not recorded, it might as well not exist. Ask any law student who has taken secured transactions or a commercial paper course, and he or she will also tell you that in order to enforce and collect a note, one must be holder. The requirements seem so simple, so black and white. So then why are courts rejecting foreclosure actions for chain-of-title issues and improper note transfers, and what can lenders or servicers do to avoid these issues?



Deborah L. Thorne

With the increase in foreclosures and single-asset real estate cases, courts have increased scrutiny of note transfers, mortgage assignments and the transfer of collateral documents.

Further complicating this problem are the varying standards and practices for assignment of interests from lender to lender and the customs and practices of securitization. Unfortunately, the customs and practices for the assignment or transfer of a note and the accompanying collateral documents may not hold up in an enforcement action before a court. The recent criticism of the Mortgage Electronic Registration Systems (MERS) and securitization practices highlight the problem.

**Back to the Basics:
UCC Article 3 Primer**

Forgetting for the moment the realities or practicalities of note assignments,

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what would constitute the proper method for the assignment of a mortgage note? First, mortgage notes are negotiable instruments pursuant to § 3-104(a) of the Uniform Commercial Code (UCC). Also, under § 3-301 of the UCC, the right to enforcement of a note lies with the holder of a note and nonholders in possession of a note. “Nonholders in possession” must demonstrate possession of the note and that the transferor was the holder at the time of the transfer to the transferee in order to enforce the note.¹

Lien on Me

Transfer of the note by a holder is usually accomplished by negotiation, which requires the transfer of possession and endorsement of the note.² Endorsement may be made to a specific person to whom the instrument is made payable or “in blank,” in which case the endorsement does not identify the person to whom the note is payable.³ In the case of blank endorsements, the note may be negotiated by possession alone.⁴ In either case, possession of the note entitles the holder to collect and enforce the note.

Section 3-301 also permits a party to enforce a mortgage note if the note has been lost, stolen or destroyed. However, in these instances, the party that seeks to enforce the note must prove that it has the right to enforce the note, commonly established by a lost document affidavit.

“Mortgage Follows the Note”

The common-law rule is that the transfer of the note carries with it the

security.⁵ Section 9-203(g) of the UCC provides 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.” In some states, absent an express transfer of the mortgage or security interest, the noteholder is vested with only an equitable interest in the mortgage, while legal title to the mortgage remains with the mortgage-holder that holds the mortgage in constructive trust for the noteholder.⁶ Even so, as a matter of state-specific real estate law, without a recorded mortgage assignment, a party may not be able to enforce the mort-

gage. Section 9-607(b) of the UCC provides that a secured party may record a copy of the security agreement transferring an interest in the note to the secured party and the secured party’s sworn affidavit in recordable form stating that the default has occurred in the office in which the mortgage is recorded, in order for the secured party to exercise the right to enforce the mortgage non-judicially. Further, because the assignment of a note is not made publicly and a borrower may not have any notice of the assignment, for practical purposes, even if the note was transferred, an unrecorded assignment of the mortgage may weigh heavily in a court’s determination of the proper party and standing to foreclosure the mortgage. Finally, as

¹ U.C.C. §§ 3-301 and 3-203 (2002), cmt. 2.

² U.C.C. § 3-203 (2002).

³ U.C.C. § 3-205 (2002).

⁴ U.C.C. § 3-201(b) (2002) (“[N]egotiation requires transfer of possession of the instrument and its [e]ndorsement by the holder. If an instrument is payable to bearer, it may be negotiated by transfer of possession alone.”).

⁵ See Draft Report of the Permanent Editorial Board on the UCC Rules Applicable to the Assignment of Mortgages Notes and to the Ownership and Enforcement of Those Notes and the Mortgages Securing Them, Permanent Editorial Board for the Uniform Commercial Code, http://extranet.aali.org/directory/files/PEB_Report_on_Mortgage_Notes-Circulation_Draft.pdf; *Carpenter v. Langan*, 83 U.S. 271, 274 (1872) (“The note and mortgage are inseparable...the assignment of the note carries the mortgage with it, while an assignment of the latter alone is a nullity.”). In a few states, such as Massachusetts, state courts have held that legal title to the mortgage is held by another party in trust for the noteholder, and the mortgage-holder must be named in any foreclosure proceeding. See *First Nat'l Bank of Cape Cod v. North Adams Hoosac Savs. Bank*, 7 Mass. App. Ct. 790, 796 (1979).

the following cases demonstrate, reliance on the common law principles of note assignment alone may lead to unpredictable results.

U.S. Bank v. Ibanez

The recent Massachusetts Supreme Court decision in *U.S. Bank National Association v. Ibanez*⁷ highlights the issues raised by inaccurate recording of mortgage assignments. U.S. Bank National Association and Wells Fargo Bank NA each filed separate actions in the Massachusetts Land Court for a declaration of clear title after each foreclosed on residential mortgages and purchased the property at the foreclosure sale. In both instances, the trial court ruled that the foreclosure sales were invalid because the foreclosure sales named U.S. Bank and Wells Fargo as the mortgage-holders, but neither had yet been assigned the mortgages at the time of the respective foreclosure sales, therefore, at the time of the publication of notice and foreclosure sale, neither had an interest in the mortgages. Both moved to vacate the judgment on the grounds that they could demonstrate that they were the holders of the note and mortgage at foreclosure. Because the two actions addressed the same issues, the cases were heard together on appeal.

In 2005, Antonio Ibanez took out a loan for \$103,500, which was secured by a mortgage to the original lender, Rose Mortgage Inc. The original mortgage was properly recorded, and several days later, Rose Mortgage executed an assignment of the Ibanez mortgage in blank. The assignment was eventually stamped with the name of Option One Mortgage Corp. as assignee, which was recorded on June 7, 2006. Prior to the recording of the Option One mortgage assignment, Option One executed a subsequent assignment in blank. U.S. Bank asserted that Option One assigned the Ibanez mortgage to Lehman Brothers Bank FSB, which was assigned to Lehman Brothers Holdings Inc., which then assigned it to the Structured Asset Securities Corp., as part of a securitization, and then assigned it to U.S. Bank, as trustee, for the Structured Asset Securities Corp. Mortgage Pass-Through Certificates, Series 2006-Z.

On July 5, 2007, U.S. Bank, as trustee, purchased the Ibanez property at the nonjudicial foreclosure sale. The foreclosure deed and the statutory foreclosure affidavit from U.S. Bank,

as trustee, were recorded on May 23, 2008. On Sept. 2, 2008, American Home Mortgage Servicing Inc., “as successor-in-interest” to Option One, executed an assignment of mortgage to U.S. Bank, which was recorded nine days later. It is unclear from the facts described in the case whether this was a new assignment or if the prior blank assignment by Option One was stamped with U.S. Bank as assignee.

Similarly, in *Wells Fargo v. LaRace*, Mark and Tammy LaRace gave a mortgage to Option One as security for a \$103,200 loan, and the mortgage was recorded on the same day, on May 19, 2005. On May 26, 2005, Option One executed an assignment in blank. Well Fargo asserted that Option One assigned the mortgage to Bank of America on a July 28, 2005, and pursuant to a sale and serving agreement, Bank of America assigned the mortgage to Asset Backed Funding Corporation (ABFC) in an Oct. 1, 2005, mortgage loan-purchase agreement. ABFC then assigned the LaRace mortgage to Wells Fargo, as trustee for a pool of securitized mortgages. However, Option One remained the record-holder of the mortgage. The foreclosure sale occurred on July 5, 2007, and the statutory foreclosure affidavit and foreclosure deed were executed on May 7, 2008, by Wells Fargo.

In both *Ibanez* and *LaRace*, the alleged assignments to both mortgages were not recorded at the time of the foreclosure sale, and neither U.S. Bank nor Wells Fargo produced executed documentation of the alleged assignments. Because Massachusetts permits nonjudicial foreclosure, strict compliance with the statutory requirements is imposed on mortgage-holders. One of these requirements is that the power of sale can only be exercised by the mortgagee. The Massachusetts Supreme Court held that U.S. Bank and Wells Fargo lacked the authority to exercise the power of sale because they were not the assignees of the mortgages at the time of the notice of sale and subsequent foreclosure sale.

Bayview v. Nelson

In *Bayview Loan Servicing LLC v. Nelson*,⁸ the Illinois appellate court held that a loan-servicing company was not the proper party to bring a foreclosure action because the assignment of the note and the mortgage were made to a separate partnership and the loan-servicing company did not obtain any legal interest

in the subject mortgage other than merely servicing the mortgage payments. In *Bayview*, the assignment of the mortgage was dated June 22, 2004, and assigned the interest of Old National Bank’s (the original lender) interest in the mortgage to Bayview Financial Trading Group LP (the “partnership”). However, the partnership’s servicer, Bayview Loan Servicing LLC, brought the foreclosure action and asserted that it was the owner of the mortgage and note at issue, and therefore was entitled to foreclose.

At a hearing on Bayview’s motion for summary judgment, Bayview’s counsel acknowledged that Bayview was a legal entity separate and distinct from the partnership, that the partnership is the correct legal entity to which Old National Bank assigned the mortgage and note, and that Bayview is not the correct plaintiff.⁹ Based on this acknowledgment and coupled with the fact that no evidence was presented that Bayview obtained legal interest in the subject property, the court concluded that “there was no basis for entry of a summary judgment in favor of Bayview, a stranger to the mortgage.”¹⁰

Bank of America v. Alvarado

In *Bank of America NA v. Alvarado*,¹¹ the defendant did not dispute that she executed a note and mortgage to Washington Mutual Bank and that she was in default of the loan; instead, she contested the chain of ownership of the note. The defendant further contended that because the plaintiff was not in possession of the note, it could not enforce the note. The plaintiff, Bank of America, conceded that it was not in possession of the note because the note was lost by Washington Mutual before the loan was securitized and transferred.¹² Bank of America presented an affidavit of lost note as evidence that the original note was certified as lost by Washington Mutual, as original lender, and that the obligation represented in the affidavit was intended to be included in the pooled loans that were transferred.

The Superior Court of New Jersey Chancery relied on equity and unjust enrichment to conclude that to preclude Bank of America’s right to enforce the note would unjustly enrich the defendant. The court held that New Jersey recog-

⁹ *Id.* at 943.

¹⁰ *Id.* at 944.

¹¹ Superior Court of New Jersey, Chancery, Bergen County, Docket No. BER-F-47941-08 (Jan. 7, 2011).

¹² *Bank of America NA v. Alvarado*, Case No. BER-F-47941-08, (N.J. Super. Ct. Ch. Div. Jan. 7, 2011).

⁷ 941 N.E.2d 40 (Mass. 2011).

⁸ 890 N.E.2d 940, 944 (Ill. App. Ct. 2008).

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nizes “an equitable assignment when the equities of a circumstance so compel.”¹³

Interestingly, the court also addressed the possibility that another person may seek to enforce the note in the future. Accordingly, the court also ordered that Bank of America be required to intervene and participate in the defendant’s defense in the event another party sought to enforce the note against the defendant such that the defendant would not be liable twice on the same note.

Lessons Learned, Best Practices to Ensure Proper Chain of Title

These cases highlight the scrutiny courts give to the chain of title and loan documentation in support of foreclosure actions nationwide. Each case underscores the importance of ensuring proper documentation prior to initiating any foreclosure action.

First, in addition to proper negotiation of the note, there is no substitute for a formal assignment of the mortgage. All assignments should be dated, identify the assignor and assignee, and be recorded. Blank assignments may not be sufficient and may be void.¹⁴ Even a statement of a future intent to sell or transfer a note or mortgage may not be sufficient evidence of an actual assignment. Documents (e.g., purchase agreements, pooling and servicing agreements, etc.) evidencing an intent to assign the mortgage are not sufficient proof of actual assignment.¹⁵

Second, the chain of title should correspond and make chronological sense. Altering the “effective date” to a date prior to the foreclosure sale if the execution of the assignment is after the sale is

not sufficient to establish the mortgageholder’s right to foreclose at the time of the foreclosure sale.¹⁶

Lastly, in many states, the traditional rule is that an assignment of the mortgage without the corresponding note is ineffective (i.e., the note does not follow the mortgage).¹⁷ Prior to initiating any foreclosure proceeding, lenders and their counsel should, at minimum, ensure the following:

Being mindful of the basic principles of property law, secured transactions and commercial paper will prevent the inconsistencies experienced by many plaintiff lenders and servicers who were not.

1. *Any purchase agreement for the note and mortgage at issue should include a specific intent to sell and granting language for the mortgage loan with a specific identification of the loan at issue.* This should include language that establishes an intent to sell the mortgage loan(s) to the purchaser, including a specific listing of each mortgage loan being sold, granting language specifically conveying the mortgage loans and language identifying the effective date of the sale transaction.

2. *Confirm proper transfer and endorsement of the note.* The endorsement should be made on the instrument itself or on separate paper firmly affixed

to the instrument.¹⁸ While the practice of blank endorsements has been widely used in securitization, the practice has recently been called into question by state attorneys general and the Senate Banking Committee, so the better practice is to use a specific endorsement.

3. *Confirm possession of the note.* If the note has been lost, an affidavit of lost note by the assignor of the note may suffice.

4. *Confirm that all required assignments of the mortgage, and assignment of rents and leases, if applicable, have been properly recorded in the local land records.* There should be a corresponding assignment of the mortgage with each transfer. The date of execution for each assignment should ideally correspond to the date of the transfer. If the assignment is executed after the foreclosure proceeding is commenced but the effective date relates back to a date prior to the commencement of foreclosure proceedings, this may still create potential chain-of-title issue.

Conclusion

Being mindful of the basic principles of property law, secured transactions and commercial paper will prevent the inconsistencies experienced by many plaintiff lenders and servicers who were not. Although ensuring the proper transfer documents and recording the documents may create a delay in initiating a foreclosure proceeding, resolving any issues prior to litigation will almost certainly alleviate lenders and their counsel of the headaches of heightened scrutiny and additional costs in foreclosure actions by courts. ■

¹³ *Id.*

¹⁴ See *U.S. Bank Nat’l Ass’n v. Ibanez*, 941 N.E.2d 40 (Mass. 2011).

¹⁵ *Id.*

¹⁶ *Id.* See also *Davenport v. HSBC Bank USA*, 739 N.W. 2d 383 (Mich. Ct. App. 2007) (interest in mortgage and note must be acquired prior to first notice of publication for foreclosure).

¹⁷ *Vega v. CTX Mortg. Co. LLC*, ---F.Supp.2d---, 2011 WL 192514 (D. Nev. 2011).

¹⁸ U.C.C. § 3-204(a) (2002).

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