UNIFORM HOME FORECLOSURE PROCEDURES ACT
A BRIEF HISTORY and ISSUES MEMORANDUM

2015 Annual Meeting, Williamsburg, Virginia

I. INTRODUCTION I would like to report to you that this Act has the strong support of both lenders and consumers. Unfortunately, that support has continued to elude the Drafting Committee, despite what I believe were repeated and vigorous efforts to secure it.

For the lending industry, the Act purportedly represents 'too much regulation' – despite the expressed interest from large lenders for a uniform set of rules. In a December, 2014 letter available on the Drafting Committee webpage, the American Bankers Association took particular exception to five provisions in the Act:

- The prohibition on borrower waivers (Section 108)
- The 'mediation-like procedure of Article 3 – known as Foreclosure Resolution in the Act – which the ABA describes as a 'material industry concern';
- The maintenance obligations imposed on creditors after a foreclosure process is commenced and the court determines that the home is Abandoned Property (Section 606)
- All the remedies against creditors provided in Section 701
- The amendments to the Holder In Due Course Doctrine (Section 705)

Despite very serious efforts to offer alternative language in all five instances, the American Bankers Association declined to reconsider their opposition. Perhaps we should not be surprised; as one spokesperson for a lending trade group told me: "our lawyers tell us they know the existing laws, so a new law that we may not understand is less desirable than a bad one that we do understand."

And there has been a unanimous silence from organized consumer groups regarding the Act, despite the fact that we have repeatedly urged the National Consumer Law Center and others to engage with us in the drafting process. The contrast with their behavior to prior mortgage law drafting efforts is striking: in 2002, the National Consumer Law Center and Consumers Union both urged the then ULC President to delay approval of the proposed Non-Judicial Foreclosure Act to enable both organizations to participate in the drafting process. Although many of the proposals in the Act are recommended by the National Consumer Law Center, we speculate that the opposition may flow from legal service and other foreclosure defense lawyers, who disfavor the Act's clarification of several issues that commonly form the basis for foreclosure appeals and procedural delay.

In any case, in connection with prior Readings of the Act, the Committee Chair prepared a memorandum entitled "Brief History and Policy Issues." For this Final Reading, I've summarized that history here for the benefit of new commissioners and others who may not have read it.

II. A BRIEF RESTATEMENT OF HISTORY

In July, 2011 the President of the Conference appointed an expedited study committee to examine whether the Uniform Law Commission (the 'ULC') should create a drafting committee on mortgage foreclosure practices and procedures – a subject he characterized as a 'very important and timely issue.'

After completing its work, the Study Committee recommended that drafting go forward, and stated:

> <u>the overall thrust of any act should incorporate meaningful and substantial provisions addressing the concerns of borrowers in the current housing market crisis, and that the act should not be limited to expediting the foreclosure process, however warranted that may be in those circumstances where there is no practical remedy for the borrower.</u>

Your Drafting Committee believes that over the past three years of meetings, it has accomplished the twin goals of

> **First,** incorporating meaningful and substantial provisions addressing the concerns of borrowers in the recent housing market crisis – provisions that, if enacted, would help alleviate many of those concerns in any future foreclosure crisis; and

> **Second,** resolving a number of legal uncertainties, and proposing new tools, that the Drafting Committee believes would materially assist in expediting foreclosures where there is no justification for delay.

III. POLICY ISSUES

A. Scope <u>Which properties and which foreclosure actions are covered?</u>

1. One to Four Unit Residential Properties Section 103 provides that the act "applies to foreclosure of mortgaged property in this state." "***Mortgaged Property***" is defined in Section 102 (14) as "real property improved with not more than four dwelling units" that is subject to a mortgage, without regard to owner-occupancy or the amount of the mortgage loan. The hoped for result will be that a servicer or attorney can readily determine the applicability of the uniform act based solely on the nature of the mortgaged property.

On the recommendation of observers, the definition includes this language:

> The term does not include real property that, when the mortgage being foreclosed was created, was used or intended to be used primarily for nonresidential purposes such as farming, commercial, or industrial use.

2. 'Owner-occupancy' Requirements The Drafting Committee considered whether the act as a whole should apply only to owner-occupied residential units (thereby excluding investor-owned units) or to larger or smaller properties. Ultimately, the Committee opted for a 'bright-line' applicability standard. However, the mandatory mediation-like provisions of Article 3 – a process known in the Act as 'foreclosure resolution' - only apply to owner-occupied one-to-four unit properties.

3. Applicability to all Mortgages but only to Post-Enactment Foreclosures. The Act's applicability is further clarified in Section 804:

> This [act] applies to foreclosure of a mortgage created before, on or after the effective date of this [act], unless the creditor has commenced a foreclosure before the effective date of this [act].

4. Applicability of Remedies against Holders In Due Course limited to Post-Enactment Mortgages Section 705 (e) of the Act provides that "this section applies to obligations incurred after [the effective date of this [act]." As a consequence, potential remedies available to borrowers whose debt is owed to a creditor entitled to 'Holder In Due Course' status under UCC Section 3-305 apply only to mortgages signed after the effective date of the act in the state where the mortgaged property is located.

5. The Act as an Overlay to Existing State Foreclosure Laws Finally, as to Scope, the Committee decided that, as a matter of policy, the Act would serve as an overlay to existing state foreclosure laws, and will not generally displace those existing laws. As a consequence, except as expressly repealed or changed by this Act, States may continue to foreclose using judicial foreclosure, non-judicial foreclosure, or a combination of both.

B. Study Committee Issues <u>Not</u> Addressed The Drafting Committee determined not to address in this Act a number of issues posed by the 2011 Study Committee. These include:

> 1. **Post - Redemption rights** Law in the various States differs widely on whether the borrower should be entitled to a right of post-foreclosure redemption – that is, the right to regain title to property when title has already passed in foreclosure.
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> 2. **Deficiency judgments** A deficiency judgment is the recovery of a personal judgment against the borrower for a dollar sum equal to the difference between the total amount of the debt and the value of the borrower's home at foreclosure, either based on an auction sales price, a private sale or, far more commonly, the appraised value of the home as calculated by the lender's appraiser. This draft of the act bars recovery of deficiency judgments in the case of a negotiated transfer under Sections 501 through 504, but otherwise relies on existing state law regarding this subject.

3. **Use of private actors in foreclosure processes** The Drafting Committee chose not to risk engaging the lobbying interests of organized process servers and others –as opposed to local sheriffs and marshals - in ways that might adversely affect the enactability of this Act.

4. **Post-sale confirmation, presumption of sale validity**: State statutes vary regarding post-sale confirmation- that is, requiring a court to confirm the lawfulness of a foreclosure sale. Lenders and title insurers, however, did not perceive a need for such a process.

Nonetheless, after considerable debate, the Drafting Committee has included an optional section 407 addressing this topic.

5. **Mandating judicial supervision over foreclosures of all residential mortgages, and over the accounting of foreclosure sale proceeds and a prompt release of any surplus to the borrowers**. After the Drafting Committee determined to draft an 'overlay' act rather than a completely new procedure for every State, it became clear that requiring judicial foreclosure would be inconsistent with existing non-judicial procedures in the many States where that is the customary foreclosure procedure.

6. **Empower state foreclosure judges to temporarily restructure mortgage notes on principal residences**. Whatever the merits and practical utility of this concept might be, it became clear at the Committee's first meeting with stakeholders that creating a state procedure that parallels the debt restructuring authority of a federal bankruptcy judge would be vigorously opposed by the lending community and it was therefore abandoned.

7. Deletion of any reference to a federal or state electronic note and mortgage registry. In prior years, drafts of this Act had included reference to the possibility that if a note and mortgage were recorded in an electronic mortgage registry, the 'person entitled to foreclose a mortgage' under Section 104 would be the person so designated by the administrator of the mortgage registry. This concept had been originally proposed by the General Counsel of the New York Federal Reserve Bank, and its deletion was also done at his suggestion.

Subsequently, two members of the Drafting Committee and other members of the Uniform Law Conference proposed that the Act might include a new article which would have authorized creation of such note and mortgage registries at the state or regional level; after discussion, that idea was also pulled back by its original proponents.

C. POLICY ISSUES IN THE CURRENT DRAFT

ARTICLE 1: GENERAL PROVISIONS

Definitions (Section 102)

Most defined terms in the Act are used in ways familiar to lawyers and scholars working in the real estate field. Several definitions, however, deserve special note.

"Creditor" and "Servicer" The Drafting Committee discussed these two definitions at length.

"Creditor' is defined in Section 102 (3) as 'a person that is entitled to foreclose a mortgage under Section 104.'

A significant debate in the Drafting Committee centered on which party on the 'lender side' of a mortgage transaction has any duty to the borrower as well as having the power to foreclose the mortgage: that is, should the Act impose the primary bundle of rights and duties on either:

> (i) the individual or organization entitled to the economic benefit of the note or other obligation secured by the mortgage being foreclosed – that is, the 'owner' of the underlying debt, or a party holding a security interest in a negotiable note and who may therefore be entitled to foreclose as a result of UCC Article 9; or
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> (ii) solely on the 'person entitled to enforce' the debt – that is, the so-called 'PETE' under Section 3-301 of the Uniform Commercial Code. [1]

After considerable discussion and at the urging of the Permanent Editorial Board on the Uniform Commercial Code (the "PEB"), the Drafting Committee voted to follow the PEB's recommendation and impose the obligations and duties only on the persons entitled to enforce the note.

A clear benefit of this decision is that the analysis in the PEB's very important Report dated November 14, 2011 entitled '*Application of the Uniform Commercial Code*

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[1] UCC Section 3-301. (Person Entitled To Enforce Instrument) provides that:

> "Person entitled to enforce" an instrument means (i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 (lost notes) or 3-418(d) (payment or acceptance by mistake). A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument.

To Selected Issues Relating to Mortgage Notes'[2] – primarily discussing who can enforce a mortgage note - now applies with equal force to the determination of who can enforce a mortgage securing that note.

At the same time, several other consequences flow from that decision.

First, in the usual case, the definition of a 'creditor' under the Act will include not only the owner of the loan but also the 'servicer' of the loan. A servicer is defined in Sections 102 (22) and (23) as the person who receives scheduled payments from borrowers or who makes payments to the 'owner of an obligation' in those cases where the owner of the loan is not also servicing a loan that it owns.

In earlier times, the 'owner of an obligation' was commonly the lending institution that continued to hold and service loans that it originated. Much more commonly today, however, the originating lender will choose to sell that loan. In the case of a loan that has been sold and becomes part of a mortgage pool – the very common 'mortgage backed security' – the 'owner of the obligation' would be either the trustee of a pool of mortgages (the 'legal' owner) or perhaps the investors in that pool – the 'equitable' owners.

Thus, by definition, the duties imposed on a 'creditor' under this Act will not necessarily fall directly on the owner of the loan being foreclosed. Instead, the duties fall directly on whomever is entitled, either by law or by contract, to 'foreclose' the mortgage and therefore, as Section 104 provides, on the PETE – the person entitled to enforce the note. As note 15 to the PEB Report points out,

> [t]he concept of 'person entitled to enforce' a note is not synonymous with "owner" of the note. See Comment 1 to UCC Section3-203. A person need not be the owner of the note to be the person entitled to enforce it, <u>and not all owners will qualify as persons entitled to enforce.</u>

(Emphasis added.) In many but certainly not in all instances, both the owner of the loan as well as the 'servicer' - who is employed by the owner to collect money from the borrower, to work with the borrower if the borrower defaults on the loan and, ultimately to foreclose on the loan on behalf of the owner of that loan – will satisfy this requirement.

Other consequences of this decision are addressed below in the discussion of Sections 104 and 108.

'Foreclosure Resolution' – This is another important but unfamiliar term in the Act; the term is defined in Section 102 (4) as

[2] The PEB Report can be found on the website of the Uniform Law Commission by clicking on 'Committees' and then, under the list of committees, clicking on the 'Permanent Editorial Board for the Uniform Commercial Code.' The PEB Report appears in the list of documents at the right side of the PEB web page.

a process in which a neutral individual assists the parties to exchange information, prepare for and attend an in-person meeting or other communication where a creditor, obligor, and neutral individual simultaneously can communicate with one another with the objective of reaching an agreement between the parties for an alternative to foreclosure.

The Floor might conceive of the process as akin to 'mediation'. While certainly different in important respects from the process of 'mediation' Article 3 of the Act describes the procedures of this process; the issues surrounding the process are described below in this memorandum.

'Homeowner' and 'Obligor' These two defined terms appear together throughout the Act, and it may be helpful to summarize why both terms so often appear.

A 'homeowner' is defined in Section102 (9) as a person who 'owns an interest in mortgaged property…'- that is, an owner of a mortgaged residential property containing no more than four dwelling units. The Act does not require that the homeowner occupy the property, although the benefits of Article 3 (Foreclosure Resolution) are not available to homeowners [or obligors] who are not owner-occupants.

In contrast, an 'obligor' is defined in Section102 (18) as a person who in any of the ways listed in the Act is financially responsible for the debt secured by the mortgage on the property. The common - though certainly not universal - paradigm is two married individuals who are both homeowner(s) and who are joint obligor(s) with respect to a single family home. However, there are many examples of homeowners who have no legal liability for the debt, and obligors – note guarantors, for example – who have no ownership interest in the property.

Besides the definitions and scope provisions of Article 1, the other significant issues in Article 1 include:

Person Entitled To Foreclose - (Section 104) As noted above, after the Drafting Committee debated whether to address this matter directly, rather than simply tracking the Uniform Commercial Code's standards of who can enforce a negotiable instrument – (the so-called "PETE"), the Committee chose to follow the recommendation of the PEB.

A second consequence is that the Act itself necessarily relies on the PEB's analysis to determine the rights of servicers, and the rights of persons who hold a security interest in the underlying note, to foreclose the mortgage.

A final consequence flows from the statement in Section 104 (3): if the note is neither a 'negotiable instrument' nor a 'transferrable record', the answer to the question of 'who can foreclose the mortgage?' is the same as 'who can enforce a non-negotiable instrument?' The answer under this Act is thus the same as under the UCC- that is, the answer is determined under other law, to the extent other law is at all clear.

Duty of Good Faith; Commercial Reasonableness (Section 105) Subsection (a) of the Act imposes on all parties subject to the Act the duty of 'good faith' established in UCC Section 1-304 while subsection (b) imposes on creditors an obligation to proceed in a 'commercially reasonable' manner in complying with all the obligations imposed on them by this act. The language in (b) is taken from UCC Section 9-607(c).

An issue debated at length in the Committee was whether to include language in the act that 'this section does not create an independent cause of action.' That language was deleted from the final act.

Prohibited Acts (Section 106) This section bars creditors from either *discouraging* a borrower from participating in a loss mitigation process **or** from *misrepresenting* any aspect of the foreclosure process. Remedies for violations are provided in Article 7. Especially since these prohibited acts are stated as subjective limitations on creditor behavior, these prohibitions did not attract creditor support.

Application of Local Regulations (Section 107) During the foreclosure crisis, many municipalities across the nation adopted local ordinances regulating various aspects of creditor behavior; lenders were especially troubled by local ordinances imposing fees and duties on creditors holding mortgages on vacant or abandoned properties in their communities – even before those creditors had elected to foreclose those mortgages. Lenders urge that such matters should be regulated exclusively at the State rather than local level, and the Act adopts that position. Consumer advocates opposed this limitation on local regulation.

Servicers (Section 108) As noted above in discussing the definitions of 'creditor' and 'servicer', the definition of 'creditor' in the usual case will mean the servicer of the loan, and may not mean either the legal or equitable owner of that loan. Because of that, the language of Section 108 requires some explanation.

Under subsection (a), a "creditor" (which, under its definition, includes a servicer) is authorized to delegate a duty that this Act imposes on that creditor to a "servicer". This raises two issues: first, would a servicer/creditor thus be authorized by this statute to engage a sub-servicer, and second, would this statutory authority override a contractual restriction imposed on a servicer by the 'owner' of the note that employed her.

In any event, under (b), a servicer to whom a creditor delegates a duty <u>or</u> a person authorized to foreclose under Section 104(c) or Section 402(b):

(1) has all the rights conferred on creditors by this [act] with respect to the authorized action, unless limited by contract; and

(2) is subject to the duties imposed by this [act] on the creditor.

Finally, under subsection (c), whether or not an ‘owner of the note’ would be liable as a principal for the acts of its agent – that is, the servicer – “is determined by law of this state other than this [act].”

This language was also debated at length. An earlier draft of this section provided that a person engaged by an owner of the note to foreclose on the mortgage securing the note was an agent of the owner. This result would be consistent with the PEB’s analysis of the relationship between the owner and servicer, which suggests that an agency relationship may exist between the owner and servicer.[3] However, representatives of both Fannie Mae and Freddie Mac claim that the servicers they employ are independent contractors and therefore that Fannie and Freddie are not liable under current law for the misdeeds of their servicers. Hence, this section represents a compromise position regarding the applicability of agency law to the relationship between the owners of the note and the servicers they employ.

The language of Section 108(c), when coupled with the definition of ‘creditor’, poses a closely related policy question: assume an owner of the note – who at one point in time plainly would be a ‘person entitled to enforce’ a note under UCC 3-301 and therefore a person entitled to foreclose the mortgage under Section 104 of this act – has assigned all its ‘duties’ under this act, and the right to foreclose the mortgage, to a servicer, In that case, the current language of the Act suggests that the owner of the note is not, by definition, a ‘creditor’ under this Act. However, notwithstanding the position of Fannie Mae and Freddie Mac, that owner may be liable as a ‘principal’ under the state law of agency; see Footnote 3.

No Waiver. (Section 109) This section prohibits an agreement between a borrower and any other party to waive rights conferred on borrowers by this Act, except as specifically provided in the Act. The only provision in this Act resulting in such an outcome is Section 504, where, in connection with a Negotiated Transfer, the borrower has surrendered title to her home.

The Committee debated whether, after a borrower’s default, the Act should permit that borrower to waive various rights conferred in the Act, in connection with an agreement reached between the parties or as part of a foreclosure resolution process under Article 3. The Committee voted not to incorporate such a provision in the Act.

ARTICLE 2: NOTICE, RIGHT TO CURE

This Article does not present significant policy issues, and the Comments to Section 201 articulate the policy choices made by the Drafting Committee.

The notice provisions establish a fairly detailed description of the pre-foreclosure notice for both judicial and non-judicial foreclosure processes. The content of the notice

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[3] Comment 40 to the PEB Report states in part: “As noted in Comment 3 to UCC § 3-602, ‘if the original payee of the notes 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 payment made to the third party.’ “

is drawn from two sources: the existing widely used Fannie Mae/Freddie Mac uniform mortgage instrument, and the national mortgage settlement reached in February, 2012, between the country's five largest mortgage servicers, 49 state attorneys general, the District of Columbia and the federal government.

As the comments make clear, an important policy matter addressed in Section 201 is that this Act is drafted in contemplation of the foreclosure procedures which are part of the regulations adopted on January 10, 2014 by the federal Consumer Financial Protection Bureau. The lending community had initially resisted much of this Article on the grounds that the Act was layering time delays on top of the delays already mandated by the contemplated CFPB regulations. Comment 3 addresses that concern:

> This Act refers in several sections to the 'foreclosure process'; see, for example, Sections 105(a) and this section 201. The notice of default under this Section is the beginning of the foreclosure process prescribed by this Act. However, the "first notice or filing" under federal regulations mandating a 120-day waiting period, 24 C.F.R. Section 1024.41(f)(1), is the [Complaint or other first court filing in judicial state][Notice of Sale in non-judicial state]. Therefore the notice of default may be sent during the 120-day waiting period under the federal rule.

ARTICLE 3: EARLY RESOLUTION

This entire Article is opposed by the lending industry, despite the fact that, as of July, 2015, some 26 states have various forms of a process, and despite independent studies confirming that this process does result in significantly more homeowners being able to retain ownership of their homes.

In addition to that overarching policy issue, several other significant matters are addressed in Article 3.

- The draft's approach represents a compromise between leaving all issues of foreclosure resolution/mediation to non-uniform state laws and rules, on the one hand, and adopting a detailed uniform model statute detailing the administrative process on the other hand.

- As a guide to states that may adopt this Article but have not drafted the contemplated administrative procedures, the Appendix to the Act which appears at the end of the Act contains 'Model Rules' and 'Best Practices' which the Drafting Committee developed in consultation with experts in the field.

Article 3 contains several provisions designed to minimize lender opposition to the process – an effort that proved unsuccessful. For example:

- Section 303 (c) provides in part that "a homeowner or obligor is eligible for foreclosure resolution only if the mortgaged property is occupied by the homeowner or obligor." This requirement thus makes abandoned property, or investor property, ineligible for the foreclosure resolution process.

- Section 305 of the Act permits the creditor to commence a foreclosure action at the time the creditor notifies the homeowner of the Article 3 foreclosure resolution process, or at any later time, thus again minimizing the time delay associated with foreclosure resolution. However, the creditor cannot seek judgment in the foreclosure action, or file any dispositive motion until the foreclosure resolution process has been completed- a period the Act defines as not later than 90 days. In contrast, earlier versions of the Act did not allow the creditor to begin foreclosure until after the foreclosure resolution process had been completed.

- Rules of the Federal Consumer Financial Protection Bureau ("CFPB") prevent a creditor from instituting foreclosure until 120 days after the borrower's default. This Act, as now drafted, anticipates that in the usual case, a diligent creditor could insure that foreclosure resolution could be instituted and completed before that 120 day period had run. As part of our unsuccessful effort to secure lender support, the Drafting Committee amended Section 303 to reduce from 60 days to 30 days the period of time within which a borrower or homeowner may request a meeting with a third party neutral. Further, as noted, Section 305(c) permits the creditor to finalize its foreclosure 90 days after notifying the borrower of its right to request the foreclosure resolution process.

  Note- Viewing this as an extremely creditor-friendly provision, at least one consumer advocate asserts that this is a statutory validation of the much criticized 'dual tracking' procedure, where lenders are simultaneously foreclosing on the borrower and engaged in a process designed to avoid foreclosure.

- Further, Section 304 (d) provides that

  > this [act] does not impose a duty on a creditor to provide any specific loss mitigation option. The foreclosure resolution agency rules may not impose a duty on a creditor to provide any specific loss-mitigation option.

- Finally, Sections 303(e) and 304(c) contemplate the possibility that the agency may develop a range of fee payment obligations, including fees to fund the agency's actions or mandatory payments of some reduced sum by the borrower to the lender as a condition of participation in the process. Consumer advocates generally oppose the imposition of fees on borrowers as a condition of participation in this process.

An important policy issue which the Drafting Committee did not address was a lending industry request that the Drafting Committee fashion some means of avoiding or severely limiting the process in 'hopeless cases' – that is, conceptually, cases where the borrower has no realistic prospect of retaining ownership of the home. Borrower advocates, including 'third party neutrals' who regularly conduct these proceedings, assert that no case is so hopeless that some form of relief – even if a 'graceful exist' – cannot be achieved in the process, and therefore, no such cases should be excluded.

Suggested Administrative "Best Practices' for Creating a State Level Foreclosure Resolution Procedure. Following the proposed statutory language of the Act, the Drafting Committee has prepared a set of recommended 'brest practices' rules of states considering adoption of the Act. These rules will not be read during the Floor presentation, but were prepared after considerable consultation with experts in the field.

ARTICLE 4: RIGHT TO FORECLOSE; SALES PROCEDURES

This article presents a number of issues.

The Act Does <u>Not</u> Address The Issue of Recording Mortgage Assignments. Last year I reported to the Floor that the Act "adopts the position that an express assignment of mortgage is unnecessary (in order for a creditor to foreclose). Requiring that the foreclosing person also hold a recorded assignment adds costs, without an appreciable benefit for the borrower."

Existing law varies greatly among the states: a minority of states require recorded mortgage assignments in favor of the creditor seeking to foreclose that mortgage, while the large majority of states do not require a recorded mortgage assignment. The majority position is consistent with the oft-cited doctrine that 'the mortgage follows the note' and the Restatement of Mortgages provides that a transfer of the note is also a transfer of the mortgage securing that note.

While most observers argue that the Restatement position is the only practical outcome under current securitization practice, it remains a volatile topic among some consumer groups and may well be a subject of controversy in the states at the time of enactment.

For that reason, the Drafting Committee voted to remain silent on this subject in this Act, and deleted the references to this subject which had been included in the 2014 draft. As a result, this issue will continue to be governed by other existing state law.

Production of Original Notes (Sections 401 and 402) Recent foreclosure litigation has often struggled not only with defining the person with the right to foreclose, but also with related issues detailing what evidentiary proof the foreclosing party must submit, and at what point in time. The final Act deals definitively with these issues.

Sections 401 and 402, deal respectively with judicial and non-judicial foreclosures. Section 401 (b) (2) (A) requires only that the creditor attach a copy of the note to the complaint when commencing foreclosure, rather than the original note, and state the name of the person in possession of the note. A few courts have required the physical presentation of the original promissory note to the court – the so-called "show me the note" rule,

Requiring production of the original note imposes substantial costs because original notes are often held by custodians and stored at locations distant from where the property is located; in most cases the cost of securing the original note – while traditional in pre-securitization practice - produces no benefit. However, if during the course of foreclosure an issue arises as to the authenticity of the copy or the whereabouts of the original instrument, then a court may choose to require production of the original.

In contrast, Section 402 does not require production of either the original note or a copy of the note in a non-judicial foreclosure; this is consistent with the Act's policy decision to leave undisturbed the states' choice of judicial versus non-judicial foreclosure; the practice in non-judicial foreclosure states commonly does not require delivery of the note at the time of foreclosure. However, Section 201 (b) grants to each borrower the right to ask for a copy of the note, whether or not the state is a judicial foreclosure state.

Not surprisingly, consumers advocated for a requirement that the original note be attached to the original complaint.

Lost Note Affidavits (**Section 403)** This section treats the frequently litigated topic of lost, stolen or destroyed notes, made notorious by the "robo-signing" practices of lenders and servicers. The subject is a controversial one.

Under the UCC, a lost note creates the risk for a borrower that a person other than the creditor who is lawfully entitled to enforce the note may present the promissory note and demand payment. Section 403 now extends that risk to the foreclosure process. Following UCC Section 3-309 (2002), Section 403 gives the borrower the right to adequate protection against a subsequent 'second' foreclosure, and extends that right by requiring an express indemnity from the creditor in all cases in which it uses a lost note affidavit.

The Drafters' Notes in the 2013 version of this section stated the policy issues clearly:

> The policy choice facing the Drafting Committee…is the extent to which this act should give license to foreclosing creditors who sign 'lost' or 'destroyed' note affidavits without ever having possessed either the original or certified copy of the note, and without any evidence of a written assignment of the underlying mortgage to that creditor….[I]f one is to speak of 'moral hazard', there is little doubt that a liberal 'lost note' affidavit policy offers a powerful incentive to the first note holder intentionally to discard the original note and thereby avoid the cost and uncertainty of maintaining original paper notes.

There is a split of authority as to whether a successor 'holder' may execute a lost note affidavit when it never had possession of the note. While revised Article 3-309 (2002) expressly allows such a person to enforce a lost note, only 10 states have adopted Revised Article 3. Under old Article 3, courts are split as to whether a note can be enforced by a successor to the person who lost the note.

The policy choices are stark: sometimes the promissory note has legitimately been lost or destroyed by a predecessor of the creditor who is seeking to foreclose and it is not always possible for the foreclosing creditor to get the predecessor to execute an appropriate lost note affidavit. An alternative – which appeared in earlier drafts of this Act – required more specific content in the affidavit concerning the degree to which the affiant had personal knowledge of facts, and the extent to which the affiant had made efforts to locate the note. Under the 2002 amendments to UCC 3-309 – which this Act now tracks in Section 403 - and in the model form of affidavit following Section 403, a general statement that the note was "lost or destroyed" before a given date is sufficient; the Section does not require that the affidavit specify particulars as to when, where, and how the loss or destruction took place.

Nevertheless, at the urging of the PEB/ UCC and in order that the UCC rules for enforcement of a note track the rules for foreclosure of a mortgage which secures that note, the Drafting Committee elected to track the 2002 amendments to UCC 3-309. The decision in this regard is likely to be at least as controversial in the States as the UCC revisions to the lost note affidavit have been.

As a result of this language, a person who possesses only a faxed copy of a note endorsed in blank- that is, a person who possesses neither an original note, a copy of a note endorsed to that person, nor any written assignment of the mortgage- recorded or otherwise - may lawfully foreclose on a borrower's home solely on the basis of an affidavit from that same person making the simple conclusory statements that she (or her appointed agent) is the person entitled to enforce a note (and therefore foreclose the mortgage pursuant to Section 104) and that she cannot locate the original note. As the model form of affidavit appearing in the Act after Section 403 makes clear, the affiant's obligation of due diligence in determining that the note is lost is limited to a search of the lender's own records; a statement that "I looked and the note could not be found' would suffice.

Finally, in states that allow non-judicial foreclosure, that creditor - who possesses no documentation of its right to foreclose - may nevertheless proceed to foreclose without oversight by any judge, unless the borrower institutes a separate lawsuit to prevent the foreclosure. Experience suggests that this is rarely done.

The effect of Sections 402 and 403 of this Act, coupled with existing provisions of UCC Articles 3 and 9, is likely to be a focus of consumer opposition to this Act.

Public advertisement and notice of foreclosure sale (Section 404) Existing law generally requires the advertisement of foreclosure sales in local print newspapers, with no alternatives and no additional requirements except, in some states, posting of a sign at the location of the property being foreclosed.

Section 404 replaces this rule with a more flexible standard. First, this Section permits either a local newspaper advertisement that meets the standards of this section. Those standards are objective, and the final draft does not include the 'commercially reasonable' standard of earlier drafts.

In many communities, newspaper advertisements are no longer an effective means of informing the public about upcoming foreclosure sales. Under these circumstances, a creditor's decision not to publish in a newspaper may benefit both the creditor and the homeowner by saving the expense.

In recognition of the growing importance of Internet advertising, Section 404 (a)(2) authorizes Internet advertising of foreclosure sales, in lieu of newspaper publication, and establishes reasonably clear standards for when such internet advertising would be acceptable: to wit, the

> Internet website … is reasonably expected to be viewed by persons having an interest in purchasing the mortgaged property and the Internet publication remains regularly available between the time of posting and the time of sale.

Subsection (b) details the required content of either form of advertisement. Without a doubt, this policy change will be welcomed by the lending industry and vilified by the newspaper publishing industry.

The other significant changes in Section 404 are:

- Subsection (c), which states that the advertisement need not include either a legal description of the property, or any recording information regarding the deed; and

- Subsection (d), which provides that the creditor need not post an advertisement of the sale on the property.

In the Chair's view, the remaining three sections of Article 4 do not pose substantial policy issues. Section 407 is now an optional section which a State may choose to adopt in those instances where, most likely for title purposes, the affected parties would seek judicial confirmation of a foreclosure sale.

ARTICLE 5: NEGOTIATED TRANSFERS

Sections 501 through 504 address what this Act calls a 'negotiated transfer.' The Drafting Committee considers this a significant device to enable lenders to secure title quickly without the need for a formal foreclosure procedure when there are no homeowners who would be adversely affected by the transfer.

Background: a Negotiated transfer in satisfaction of debt Existing law in most states recognizes a "deed in lieu of foreclosure" transaction, in which the parties agree to a conveyance of the property to the lender as an alternative to a standard foreclosure. In recent years, such negotiated transfers have been called "cash-for-keys" agreements, reflecting the practice of lenders offering cash payments to homeowners in exchange for their relinquishing possession and agreeing not to contest the foreclosure. Under existing law, the presence of junior liens or other junior interests often prevents a deed in lieu of foreclosure, because the lender as grantee under the deed in lieu of foreclosure takes subject to the junior interests. The only way to terminate the junior interests is by formal foreclosure.

Sections 501 to 504 provide a statutory framework that enhances existing workout arrangements, including "deed in lieu" transactions. If a homeowner faced with foreclosure cannot afford to retain the home after exploring all possible options to keep possession of the property, then it is often in the best interests of all concerned if the parties can negotiate a transfer to the lender as an alternative to the completion of a foreclosure sale.

One policy consideration is whether to include a statutory "minimum sum" that must be paid to the borrower in a negotiated transfer. The Drafting Committee decided not to specify a minimum consideration based upon a concern that a substantial minimum consideration would chill use of the procedure, and that given the wide variety of mortgage loans and individual circumstances, it is very hard to say what minimum should be required in all cases. The main borrower protection set forth in the negotiated transfer provisions, other than requiring proper documentation and notices, is that the negotiated transfer results in full satisfaction of the mortgage debt. In other words, a deficiency judgment is barred.

Another policy issue that some have discussed is the negative reaction that junior creditors may have to being forced to abandon their position quickly in those states where their rights under a judicial foreclosure procedure may offer them greater leverage in dealing with a senior creditor.

A final issue that has been discussed is whether to make the benefits of this statutory procedure available in all 'deed in lieu' situations, whether or not the signed agreement provides that the agreement is made pursuant to this Act. The Committee believes that requiring the agreement to comply with the substantive and procedural requirements of Article 5 will quickly become conventional practice in the states, without incurring the uncertainty as to which 'agreements' qualify for accelerated foreclosure, and which do not.

In the Drafting Committee, we came to call this a 'Deed in Lieu on Steroids." The device will only be useful if there are multiple creditors claiming interests in the property; otherwise, a simple deed from the borrower to the sole creditor will suffice to transfer a fee simple interest to the creditor, without the need for a subsequent foreclosure action.

The device is entirely permissive, and Section 504 (f) makes clear that a creditor and borrower are free to enter any other form of agreement that they may negotiate; however, any form of agreement that does not provide it is made pursuant to Section 501 does not carry any of the consequences provided in this Article.

The device basically requires that any creditor – regardless of the creditor's priority - may enter into an Article 5 Negotiated Transfer so long as all the homeowners agree and their agreement expressly provides that it is made pursuant to Section 501.

Thereafter, the creditor is required to send notice to all other creditors with recorded interests in the property. If no objection to the transfer is made within 20 days, the Negotiated Transfer becomes final, and all interests in the mortgaged property that are subordinate to the interest of the creditor who seeks the negotiated transfer become void. Interests that are senior, however, are unaffected.

The final Act includes extended provisions in Section 503 to address the issues that arise when other creditors raise objections to the negotiated transfer. Under Section 503(a), if there is an objecting creditor, within a short time frame set by a court, the objecting creditor is entitled to tender the amount of the debt due the creditor seeking the negotiated transfer, and then step into the shoes of that creditor.

The remaining subsections of Section 503 provide a process to addresses those situations that may arise when there are either: (i) multiple objections to a negotiated transfer by junior lien holders; or (ii) non-objecting lien holders whose interests are subordinate to the creditor who proposed the negotiated transfer, but senior to the interests of an objecting lien holder; those procedures are generally based on the strict foreclosure procedures commonly used in Connecticut foreclosure practice.

Finally, Section 504 lists the consequences of a final negotiated transfer. They are:

- First, the transfer discharges the obligation in full, and any continuing financial obligation of the borrower is prohibited; this includes attorney's fees, costs, and other expenses against the homeowner and any other person liable for the obligation secured by the property.

- Second, the transfer gives to the creditor all of the homeowner's rights in the property, except for any right of the homeowner to continue to occupy the property pursuant to their agreement.

- Third, the transfer discharges the mortgage held by the creditor and any mortgage or other lien subordinate to the mortgage held by the creditor.

- Fourth, the transfer terminates any other subordinate interest in the property – such as a lease - except an interest protected from termination by law other than this act.

- Fifth, any redemption rights of the borrower under other law of the state are terminated.

- Importantly, under subsection 504(b), a subordinate interest is terminated even if the creditor fails to comply with the procedures of Article 5. However, a creditor that fails to comply with the requirements of Article 5 is liable for damages in the amount of any loss – such as a terminated junior mortgage - caused by that failure.

ARTICLE 6: ABANDONED PROPERTY

The Drafting Committee believes this accelerated procedure in Article 6 to foreclose abandoned homes – or what have come to be called 'Zombie Properties' - will enhance the interests of both lenders and borrowers, while improving property values and the well-being of residents in the neighborhoods where abandoned property is concentrated. The procedures in Article 6 are broadly based on existing statutes in several states which are viewed as successful.

The primary issues which have drawn opposition from the lending industry are, first, the obligations imposed on lenders to maintain properties that are determined to be abandoned until the lender either conveys the property to another person, or releases its mortgage, and second, the right which Sections 601 and 606 confer on local governments and common interest community associations (that is, condominiums, cooperatives and homes associations) to enforce the maintenance obligations.

Background: Accelerated foreclosure of abandoned property Foreclosures of abandoned or vacant homes raise special issues. Those properties often become derelict and remain empty for long time periods, creating substantial problems for the surrounding neighborhood. Article 6, consisting of Sections 601 through 606 - authorizes an expedited foreclosure procedure for abandoned properties for both judicial foreclosure and for nonjudicial foreclosures. Practically, this is of greater importance in judicial foreclosure states, as timelines for foreclosure in most nonjudicial foreclosure states are already relatively rapid.

An accelerated timeline is appropriate for two reasons. First, since the homeowner is no longer using the property for shelter, a foreclosure sale will not force a family to relocate to other housing. Second, vacant properties that are in foreclosure have significant negative impacts on neighborhoods and the surrounding communities. Vacancies reduce the market values of neighboring properties. Neighborhood crime increases. The vacant properties tend to suffer from lack of repair and maintenance, creating public health risks. There are fiscal impacts on local governments, who find property taxes on vacant properties often become delinquent; yet the governments are faced with added expenses to provide essential services to blighted neighborhoods, such as police and fire protection. The objective of the Act's expedited procedure is to return abandoned properties to the housing stock, occupied by families, as soon as reasonably possible.

A second main feature of the abandoned property provisions is to require maintenance of abandoned properties by lenders pursuant to the standards set forth in Section 606. The trigger for the duty to maintain is either:

in a judicial foreclosure under Section 601, a judicial determination that the property is abandoned, or

in a nonjudicial foreclosure under Section 602, a determination of abandonment by the local building code board that the property is abandoned.

In either case, the determination as to whether a particular home is abandoned, is guided by statutory criteria set forth in Section 601 and 602.

In an unsuccessful effort to secure lenders' support for the maintenance obligations of Section 606 and possible overlapping obligations under other law, the Act, primarily in Section 606 (i), provides that

- First, the creditor has no obligation under this Act to maintain any property until the creditor chooses to begin a foreclosure process and also chooses to invoke the accelerated foreclosure procedures of this Act. Thus, the imposition of maintenance obligations is only triggered by the creditor's decision to expedite the foreclosure process.

- Second, the creditor's maintenance obligations are limited to the obligations created by Section 606 (a) – thereby eliminating the possibility of overlapping obligations under different laws.

- Third, if the creditor becomes the owner of the property at any time after the determination that the property is abandoned, the creditor's obligations with respect to the property are determined by law of this state other than this act – that is, by the existing laws of the enacting state.

- Fourth, under subsection (e), the obligation to maintain abandoned property under either this statute or other law continues only until the property is conveyed to a purchaser or until the creditor records a release of its mortgage.

Other significant provisions in Article 6 are:

- Section 601 (b) creates a procedure for filing of affidavits supporting the proposed determination of abandonment, in anticipation of a summary proceeding in those instances where the homeowner or obligor fails to appear at the hearing. Section 601 (f) builds on that affidavit by providing that, in a judicial proceeding, the court must enter a determination of abandonment if the creditor filed the affidavit required by (b) and the homeowner fails to appear at the first hearing.

- The act does not require posting of any notice on the abandoned property.

- Section 605 creates two alternative means of passing title to abandoned property: in the first, the court may order a sale within 30 but not more than 45 days. In the second, akin to strict foreclosure, if the court on the foreclosing creditor's motion, determines that there is no equity in the property in excess of the foreclosing creditor's lien, the court may order transfer of title directly to the creditor and extinguishment of junior liens.

- Section 605(e) also extinguishes any rights of redemption of the borrower, and holds the foreclosing creditor or purchaser at the sale immune from any borrower claims for abandoned property.

ARTICLE 7: REMEDIES

Effect of Violation (Section 701) This section addresses the consequences of a material violation of the Act on a pending foreclosure matter. Under (a), in a judicial foreclosure, if there has been a material violation. the court may stay the action, dismiss the action, or impose a sanction. Any dismissal of a foreclosure action must be without prejudice 'unless the court determines that a new foreclosure action should be barred because of substantial misconduct by the creditor or servicer or other good cause.'

Subsection (b) contemplates an injunction action by a borrower to prevent a nonjudicial foreclosure, and the court's determination in such a proceeding would be governed by the same standards as those described in (a),

Subsection (c) limits the creditor from imposing legal fees when the borrower has proven a material violation of the Act.

Subsection (d) authorizes the borrower to bring an affirmative action for actual damages caused by a creditor's violation of the Act. An earlier provision allowing a bracketed amount for each violation of the Act, regardless of any actual damage, was deleted.

Subsections 701(e), (f) and (g) allow the award of statutory damages in those circumstances where the lender is guilty of what the statute describes as a 'pattern or practice' of non-compliance with the Act. However, (f) details defenses that the creditor may offer in mitigation of those damages, and (g) imposes a one year statute of limitations for 'pattern and practice' claims.

Lenders strongly objected to this section.

Defense or Remedy of Homeowner or Obligor under Other Law. (Section 702) This section makes clear that the Act does not change any remedies available to borrowers under other law of the enacting state.

Attorney's Fees and Costs. (**Section 703)** This section allows the award of costs and attorney's fees to a prevailing party in an action under this Act.

Enforcement By [Attorney General] (**Section 704)** This section authorizes the State Attorney General to **"**bring an action to enjoin a pattern or practice of violating this [act]." The Attorney General of Illinois, whose office participated in many of our meetings, strongly supported this section, while lenders were opposed.

Effect of the Holder in Due Course Rule. (Section 705) This section remains the single most controversial section from the perspective of the lending industry, and all efforts to identify a compromise solution have failed. With the exceptions noted below, the final draft of this section is not significantly different from the provision presented at the annual meeting last year in Seattle. .

Commissioners seeking more background on the topic may wish to review the Sub-Committee Report on that topic by Commissioners Lisman, Miller and Walters, which can be found beginning at page 15 of the 2013 Issues Memorandum, on the Drafting Committee's website. You may also wish to review the several letters, comments and other communications on this subject appearing on the same website, bearing dates from July 2013 through November 2013.

A note on the structure of the Section as it appears in the Act may be helpful.

Subsection (a) states the fundamental rule that a holder in due course is subject to the defenses identified in the subsection, despite UCC 3-305 (which otherwise insulates the holder in due course from such claims) and despite any waiver of such claims that the borrower may have signed.

The Subsection then allows a claim or defense against a holder in due course based on any one of three bases:

(i) fraud in connection with the original loan transaction;
(ii) material misrepresentation in connection with the original loan transaction; or
(iii) a breach of promise in connection with the original loan transaction that 'substantially deprives the obligor of the benefit of the expected bargain.'

Under subsection (b), the borrower may, in addition to asserting these defenses in a foreclosure action, bring a declaratory action "to establish any claim against the holder in due course described in subsection (a)."

Subsection (c) establishes a six year statute of limitations within which either a defense under (a) or an action under (b) may be asserted.

Subsection (d) limits any award against the holder in due course, "relief is limited to modification of the remaining obligation and recoupment." Further, "recoupment must be in the amount of the economic loss caused by the fraud, misrepresentation, or material breach of promise and may not exceed the amount owed on the obligation at the time of judgment." Thus, the holder in due course is not exposed to unlimited damages which might, in the absence of this language, exceed the amount due the creditor from that borrower.

Finally, under (e), "this section applies to obligations incurred after [the effective date of this [act]]."

As the Comments following this section make clear, "this section represents a middle-ground position between preservation of the status quo and complete abrogation of the HDC doctrine."

From an economic perspective in the 21st century, there is little reason to impose on borrowers – for no economic benefit - the risk that their claims against the original creditor would be barred against subsequent holders of the same note. Standard economic models suggest several devices by which the secondary market could – and likely would – protect itself from the possibility of such claims. In the auto loan field, the principal model would be to 'overfund' the trust that holds auto loans sold by dealers, with any balance remaining in the trust after the loans have matured (and claims having been adjudicated) being returned to the dealer/sellers.

Since this overfunding device tends to reduce profits, a less expensive model – and the one which triggered the downfall of AIG during the recent melt down – would be the purchase of 'credit default swaps' – a form of insurance against the possibility of Section 705 claims being successful. While the initial pricing of such swaps could be speculative in the first years, the Chair is informed that over time, the market would find the appropriate return necessary to compensate the counterparties to such 'swaps' for the risk they are incurring.

Notwithstanding the availability of such more or less traditional devices to shift risk to the appropriate parties, it is clear that the secondary market strongly opposes any proposal limiting the Holder in Due Course doctrine.