HOME FORECLOSURE PROCEDURES ACT-
<u>BRIEF HISTORY & POLICY ISSUES</u>

"What we are faced with is an enormous opportunity disguised as an insoluble problem."
John Gardner

Contents:

I. INTRODUCTION Commissioner Carlyle C. Ring, Jr. recently described the tone of the Drafting Committee's efforts to date for the Virginia delegation. In part he wrote:

> Since June, 2012, the drafting committee has had four meetings with comprehensive participation by representatives of the stakeholders. The representatives have actively engaged in the discussions and have been very knowledgeable as well as holding positions of substantial responsibility in the stakeholder each represents.
>
> The openness of the discussion has increased with each session. There remains much skepticism as to whether an act can be crafted which could be enacted on a uniform basis. In the first session there was a great deal of defensiveness. As we proceeded session to session, there was more genuine debate on the merits, and growing consensus that the legal infrastructure is broken and needs to be fixed. However, there are still significant differences on what the fix should be.
>
> The collapse of the housing market had many causes – government policy, regulatory oversight, banking management, greed, out of date and inconsistent laws, changing technology and market as financing of credit shifted from local to national securitization. The drafting effort, however, is focused on only one aspect -- updating the legal infrastructure in harmony with the changing technology and marketing and the evolving federal and state regulatory oversight. …
> ****

At this point in our deliberations, almost every stakeholder at the table concedes that a uniform law to update to current technology and procedures would be most desirable. As I read it, however, the stakeholders are concerned about whether:

- the drafting committee will be able to strike a balance?
- the rules will be beneficial to their particular interest?
- ULC will be steadfast in insisting on enactment with uniformity?
- Federal laws and regulations will be in harmony?

The draft provides wraparound procedures but does not change existing law except as expressly repealed or changed. Thus, states may continue judicial foreclosure, non-judicial foreclosure, or a combination of both. The procedural changes are proposed as a package in a way that it may make it possible for divergent interests to accept on balance as being more good than bad.
****
The deliberations of the Committee to date have been genuine and meaningful, and there is reason to hope that a final product can be achieved that could be enacted on a uniform basis. There is much hard work ahead in order to realize that hope.

II. BACKGROUND 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.' In addition to detailing at least some of the topics that the Committee might consider, the President charged the Study Committee with preparing a report to the ULC Scope and Program Committee that "should also address the issues of availability of funding for a drafting committee and potential challenges to enactability."

A. *The Study Committee* The Study Committee, most ably assisted by the Chicago ULC staff and by Barry Nekritz, our American Bar Association advisor, met three times by conference call and then held a one day meeting with stakeholders on January 13, 2012 in Washington DC. 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>

The Study Committee made a number of additional specific recommendations regarding the scope of the proposed Act and the subjects that it might address:

Major Scope Issues

1. Should a potential act cover only residential mortgage foreclosure, or should it cover commercial situations?

2. Should a potential act be designed as a comprehensive replacement for existing provisions, or as an overlay to work with existing state laws?

Substantive Issues – Section III.B. of this memorandum lists the issues that the Study Committee recommended for consideration in the act that the Drafting Committee has chosen not to consider. All of the other issues that were recommended by the Study Committee are addressed in the current draft.

B. *Enactability* The issue of 'enactability' is posed by the following requirement, as stated in the ULC's "*2010 Statement of Policy Establishing Criteria and Procedures for Designation and Consideration of Acts*":

> (c) Every act drafted by the ULC must conform to the following requirements:
>
> ***
>
> (2) There must be a reasonable probability that an act, when approved, either will be accepted and enacted into law by a substantial number of states or, if not, will promote uniformity indirectly.

The issue of enactability continues to confront the Drafting Committee, as touched on in Commissioner Ring's remarks. This remains especially important, given (1) the states' collective unwillingness to date to enact any of ULC's previous acts in the foreclosure area; and (2) the broad array of legislation enacted in recent years in most states that supports debtor rather than lender interests.

Drafting Committee members and the ABA advisor have repeatedly met or tried to meet with a broad range of individuals and groups representing both lenders and borrowers; these efforts are consistent with the Commission's customary practice of engaging all stakeholders in its deliberations regarding a drafting topic.

To date, some individual lawyers representing debtors and some law professors have engaged in the drafting effort. However, most major organizations that purport to represent the debtor community, including the National Association of Attorneys General, the Center for Responsible Lending, the Consumer Financial Protection Bureau, and the National Consumer Law Center and most individual advocates have declined to participate in our efforts.

On the other hand, we have been well served indeed by those consumer advocates who do choose to engage with us, and by various representatives of the lending community and various related governmental and private sector stakeholders. Our most active lender stakeholders have been representatives of the Federal Housing Finance Agency ("FHFA") Fannie Mae and Freddie Mac (the two largest Government-Sponsored Enterprises or GSE's) and the American Bankers

Association. More recently, several representatives of the securitization industry – the secondary mortgage market – have become interested in our work. Conversely, the Mortgage Bankers Association, which initially supported our drafting efforts, has been absent from our meetings.

III. POLICY ISSUES

A. ***Scope*** As noted, above, the Study Committee posed two major scope issues:

1. Which properties and which foreclosure actions are covered?

a. One to Four Unit Residential Properties This draft, in Section 103, provides that the act "applies to the foreclosure of a mortgage only on residential property in this state." Residential property is defined in Section 102 (22) as "real property improved with not more than four dwelling units" without regard to owner-occupancy, amount of the mortgage loan, or other narrowing criteria. The 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.

The Drafting Committee also concluded that foreclosure of commercial mortgages did not appear to create a problem under current practice, and therefore the act would not apply to a foreclosure of commercial property

b. `No 'owner-occupancy' Requirements The Drafting Committee debated whether the act should apply only to owner-occupied units (as opposed to investor-owned units) or to larger –or smaller – properties but ultimately decided that a 'bright-line' applicability standard was the preferable outcome..

c. Applicability to all Mortgages but only to Post-Enactment Foreclosures A related 'scope' or applicability' issue is resolved by Section 701; it provides that the Act applies to foreclosure of any mortgage on residential property, regardless of whether that mortgage was created before or after the effective date of this Act, but it would not apply if the foreclosure action was commenced before the Act takes effect.

d. Applicability of Remedies to Post-Enactment Mortgages Finally, as discussed in more detail below, the Drafting Committee has discussed, but has not agreed on, whether certain potential remedies available to borrowers – including any potential amendments to the Holder In Due Course Doctrine - should apply in the defense of all mortgage foreclosures or only to foreclosure of mortgages signed after the effective date of the act in the state where the mortgaged property is located.

2. Should the Committee draft the act as a comprehensive replacement for existing provisions, or as an overlay to work with existing state laws?

As a matter of policy, the Committee draft does not replace all existing foreclosure procedures in the State; as Commissioner Ring noted:

The draft provides wraparound procedures but does not change existing law except as expressly repealed or changed. Thus, states may continue judicial foreclosure, non-judicial foreclosure, or a combination of both. The procedural changes are proposed as a package in a way that it may make it possible for divergent interests to accept on balance as being more good than bad.

B. ***Study Committee Issues Not Addressed*** The Drafting Committee determined not to address on a systematic basis in this Act a number of issues posed by the Study Committee. These include:

1. **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. This is a complex and politically charged issue, especially in farm states where redemption may indeed provide a meaningful right to farmers whose crops may fail in one year, but a successful crop in the following year provides the means to repay or refinance the farm. The Committee concluded that achieving broad consensus would be very difficult. Instead, this draft of the act modifies redemption rights only in limited circumstances: for example, redemption rights are extinguished after an accelerated foreclosure of abandoned property (Section 506(d)).

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 (including interest and the costs and fees of foreclosure) 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. Some states currently prohibit foreclosing lenders from recovering such judgments in a non-judicial foreclosure proceeding; other states have no limitation on the recovery of such judgments. 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** In judicial foreclosure states, lenders may encounter substantial delays when sheriffs exercise control of the sale process and do not perform these duties expeditiously. These delays frequently involve substantial additional fees and costs. This can negatively affect the borrower's opportunity and ability to redeem, or increase the borrower's potential exposure for a deficiency judgment. The Study Committee asked whether a uniform law might consider whether private actors (e.g., auctioneers) might fulfill certain judicial foreclosure functions while still offering protections for the borrower. However, the Drafting Committee concluded that this subject might engage the lobbying interest of organized process servers and others 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. The need for post-sale confirmation (or the type of evidence

to be considered in post-sale confirmation) may legitimately vary, depending upon such factors as whether the lender is seeking a deficiency judgment or merely confirmation of its title, and whether the foreclosure process itself was judicially supervised or a non-judicial foreclosure. The Study Committee thought that a uniform law might provide better guidance on whether post-sale processes are warranted, in both judicial and non-judicial foreclosures. Concerns were also expressed as to the desirability of enacting a permissive procedure for securing judicial confirmation of the sale as a means of encouraging title insurance companies to address the validity of a sale to a third party when the record is silent on the question of whether the sales procedures taken conformed to statutory requirements.

The reporters in fact drafted a series of alternative provisions for judicial confirmation of judicial and non-judicial sales tied to a presumption of validity, and prepared extensive commentary regarding these subjects. However, after considerable debate, the Drafting Committee voted to delete all those provisions at our April 2013 meeting on the grounds that lenders and title insurers did not perceive a need for such a process.

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 this proposal would be inconsistent with non-judicial procedures in all states that have them.

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 our first meeting with stakeholders that such a concept would be vigorously opposed by the lending community and it was therefore abandoned.

C. ***Policy Issues in the Current Act's Draft***

Article 1: General Provisions

The significant issues addressed in Article 1 include the definitions in Section 102, the Scope of the Act [in Section 103 and discussed earlier], and two substantive provisions – one imposing the duty of Good Faith (Section 104) and one generally prohibiting creditors or servicers and their agents from engaging in acts that either discourage a reasonable borrower from participating in a loss mitigation process or misrepresent any aspect of the foreclosure process to the borrower (Section 105).

While the definitions were the subject of considerable discussion, most of the defined terms will be familiar to real estate practitioners. Care was taken to conform customary definitions to customary usage in our existing Uniform acts including the UCC, other statutes, and federal regulations.

Two definitions, however, will be unfamiliar. First is the term 'Facilitation' (Section 102(5) and the second is the term 'Mortgage Registry' (Section 102(14). 'Facilitation' is the term used to describe the mediation or negotiation process mandated by the Act in Article 3; "Mortgage Registry' refers to the possibility discussed in Article 4 that a number of Federal agencies including the Federal Reserve Banking system, FHFA, and the US Treasury may create a new federally mandated system for the electronic recording of promissory notes, mortgages, and other related mortgage documents. As a matter of policy, the Drafting Committee seeks to accommodate the possible creation of such a system.

The "Good Faith' provisions track generally the provisions of existing UCC requirements.

The activities proscribed in Section 105 are intended to reinforce the importance provided in this Act for the facilitation / mediation process, and to minimize the likelihood that creditors or servicers would in any way misrepresent the rights granted borrowers in this act.

Article 2: Notice, Right to Cure

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 is drawn from two sources: the existing widely used Fannie Mae/Freddie Mac uniform mortgage instrument, and the national mortgage settlement, which is an agreement between certain large mortgage servicers, federal agencies and the state attorneys general.

The aim of the drafters has been to provide clear guidance so that the mortgage servicing industry can move towards a simple, standardized pre-foreclosure notice. However, states may still require some separate notices for programs unique to them.

The Act also specifies how and when a homeowner may cure a default, i.e. undo the acceleration of the mortgage debt and resume normal payments. This topic is governed by statute in some states, and only by contract in others. Uniform rules should also be helpful to mortgage servicers and attorneys working across state lines.

Article 3: Facilitation

In the wake of the 2007 foreclosure crisis the states have passed dozens of new laws aimed at preventing unnecessary foreclosures. Seventeen states have adopted statewide mandatory mediation programs either by statute or court initiative. Other states, like California, have enacted laws requiring mortgage servicers to offer homeowners the chance to apply for all available foreclosure avoidance programs, such as loan modifications and short sales. These mediation programs have broad support and a record of success in preventing avoidable foreclosure sales.

At the federal level, the Consumer Financial Protection Bureau (CFPB) has adopted regulations that will take effect in January 2014 that will require mortgage servicers to notify homeowners of foreclosure alternatives prior to foreclosure sales.[1]

The current draft would establish a uniform basic structure for facilitation/mediation programs, leaving many details to a court or agency rulemaking process, and deferring to the CFPB rules as to servicer duties to notify homeowners about foreclosure alternatives and handle homeowner applications appropriately.

The draft Act would establish a facilitation process but leaves to the responsible state agency broad latitude in designing the program.

The term “facilitation” is used because the term “mediation” may unduly constrain the role of a third-party neutral.

The committee first considered a detailed set of mediation provisions modeled on a Washington State statute. After a robust discussion at the November 2012 meeting, the chair, reporters and ABA representative met with several observers and experts on state mediation programs in December of 2012 and formulated a set of best practices for foreclosure mediation programs.

At its February and April 2013 meetings the Drafting Committee approved the framework in the current draft, which establishes a basic facilitation program and requires notice to the homeowner and a temporary hold on foreclosure for homeowners who participate. The current draft omits detailed requirements that appear in many existing state laws, and instead authorizes the state court or agency responsible for supervising the program to issue rules governing the facilitation program.

However, the draft includes in the comments the complete set of best practices developed at the December meeting as guidelines for the court or agency rules.

Clearly, there are significant policy issues embedded in this process.

For example, in all our discussions, FHFA’s consistent focus has been on the extraordinary length of time is required to foreclose in some states, and the resulting cost that delay imposes on Fannie Mae, Freddie Mac and Federal Home Loan Banks and other lenders and on those who have purchased interests in Residential Mortgage Backed Securities or RMBSs - bonds secured by pools of residential mortgages. .

The Drafting Committee has discussed this issue at length, but has not yet reached a consensus on how to integrate the time frame for facilitation with the existing practices of the lending community and with recently adopted regulations of the Consumer Financial Protection Bureau. The Drafting Committee recognizes that, in some considerable portion of all ‘facilitated’ foreclosures, the lender will still be required to proceed to foreclosure; in those instances, the

[1] 78 Fed. Reg. 10695 (Feb. 14, 2013).

lender may view the facilitation process as an additional expense with no offsetting value other than allowing the debtor an additional period of uncompensated residency.

At this time, it seems clear that a state statute that meaningfully reduces that aggregate time frame would necessarily be a part of any ULC drafting effort if ULC expects to secure FHFA/GSE support for such an effort. During the next year, it may be that other appropriate elements may be incorporated into the facilitation process to secure broader support from both the consumer and the lender stakeholders.

Other policy issues include the insistence of consumer representatives that any facilitation process much necessarily have recourse to judicial oversight to remedy what these advocates unanimously assert to be delaying or non-cooperative strategies employed by lenders and creditors.

Further, to the Drafting Committee's knowledge, there is no precedent in the Uniform Laws process for the suggestion of a set of 'best practices' without statutory mandate that they be used.

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

Reporters' memoranda on foreclosure mediation and the new federal mortgage servicing regulations are available on the committee's web site, which is http://www.uniformlaws.org/Committee.aspx?title=Home%20Foreclosure%20Procedures%20Act

Article 4: Right to Foreclose; Sales Procedures

Who has the right to foreclose? Section 401 addresses the foundational question of identifying the person who has the right to commence foreclosure. A basic problem is to determine the proper fit between foreclosure law and Article 3 of the UCC. Most residential mortgage loans are documented using promissory notes that are negotiable instruments governed by Article 3. For such loans, Section 401 authorizes foreclosure by the "person entitled to enforce" the instrument under Article 3. In most cases, the "person entitled to enforce" is a holder of the note, who has possession of the note with any necessary endorsements. Section 401 serves to unite the right to collect mortgage loan payments, which under existing law is specified by Article 3, with the right to foreclose on the collateral. Because the purpose of collateral is to ensure payment of the obligation, the two rights normally are bundled together. This idea is reflected by the legal maxim, "the mortgage follows the note." Separating those two rights, although conceptually possible, would create a number of problems that would be difficult to solve. By deferring to Article 3, Section 401 recognizes the traditional importance of a person qualifying as a holder of a negotiable instrument under Article 3, and seeks to protect borrowers by ensuring that proceeds of foreclosure sales will flow to the holder, thereby discharging the obligation.

However, the decision in Section 401 to defer to Article 3 when there is a negotiable note comes at a cost. Some residential mortgage loans are not documented using negotiable instruments. For example, the borrower may sign a promissory note, but that note may contain a provision that disqualifies the note from being classified as negotiable under Article 3; or the parties may use other documents, such as an installment land contract, which in some states is considered to be an equitable mortgage. In the absence of a negotiable instrument, Section 401 authorizes foreclosure by the owner of the mortgage obligation. In some cases – probably not a large number – it will not be easy to tell whether a particular promissory note is negotiable. If the holder of the note and the owner of the note are the same person, the uncertainty will not present a substantial problem under Section 401; the person can establish both bases. But if they are not the same person, there will be uncertainty as to who is the right person to foreclose, the resolution of which may require cooperation between the two persons or a judicial determination.

Evidentiary proof of the right to foreclose 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 that person must submit, and at what point in time. When there is a negotiable instrument, Section 401 requires the creditor to produce a copy of the instrument when commencing foreclosure. A few courts have required the physical presentation of the original promissory note to the court – the so-called "show me the note" rule. Section 401 does not require production of the original note as a general matter. Such a rule imposes substantial costs because original notes are often held by custodians and stored at locations distant from where the property is located, and in most cases produces no benefit. 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.

Section 403 provides guidance with respect to lost note affidavits, another frequently litigated topic, made notorious by the "robo-signing" practices of lenders and servicers. A lost note affidavit creates the risk for the borrower that a person other than the foreclosing creditor may present the promissory note and demand payment. Section 403 gives the borrower the right to adequate protection, a concept presently set forth in UCC Article 3, and extends that right by requiring an express indemnity from the creditor in all cases in which it uses a lost note affidavit.

Sometimes the promissory note is lost or destroyed by a predecessor of the creditor who is seeking to foreclose. It is not always easy or even possible for the foreclosing creditor to get the predecessor to execute an appropriate lost note affidavit. There is a split of authority as to whether the successor may execute a lost note affidavit when it never had possession of the note. Revised Article 3 expressly allows such a person to enforce a lost note, but 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. Section 403(a) presents two alternatives. Alternative A allows a lost note affidavit to be made by a successor to the person who lost the note, whereas Alternative B requires that the affiant had possession of the note at the time of its loss or destruction. The policy difference between the alternatives relates to the specific content of the affidavit and the degree to which the affiant should have personal knowledge of facts. For example, is a general statement that the note was "lost or destroyed" before a given date sufficient; or must the affidavit specify particulars as to when, where, and how the loss or destruction took place? If the latter specificity is required, Alternative B appears preferable because one should be skeptical as to whether the successor could truthfully attest to the details.

Assignments of mortgages Most residential mortgage loans are sold after origination, and therefore the foreclosing creditor is often a person other than the original mortgagee. In many states, assignments of mortgages are recorded in the county land records to reflect a transfer of the mortgage to the purchaser of the loan. State law presently conflicts as to whether a creditor must hold an express assignment of the mortgage in order to have the right to foreclose; and if so, whether that assignment must be recorded in the county land records prior to foreclosure.

Section 402 adopts the position that an express assignment of mortgage is unnecessary. Borrowers are sufficiently protected from risks associated with an improper person commencing foreclosure by requiring proof that the person is the holder of the negotiable instrument under Section 401 (or in the absence of a negotiable instrument, if the person owns the mortgage loan). Requiring that the foreclosing person also hold a recorded assignment adds costs, without an appreciable benefit for the borrower.

The interests of third parties are better handled by other mechanisms. For example, when a foreclosure ends in a foreclosure sale, instruments must be recorded to document title in the foreclosure purchaser, and those instruments must be satisfactory to title insurance companies. The nature and content of those instruments are left to local practice.

Notwithstanding the position taken by the Draft, it is likely that those states that presently require recorded assignments, and some consumer advocates, will object to this provision.

Public advertisement and notice of foreclosure sale 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, requiring a commercially reasonable advertisement of a foreclosure sale, which depends upon the particular facts. A local newspaper advertisement is no longer mandatory in all cases. 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 benefits both the creditor and the homeowner by saving the expense. In recognition of the growing importance of Internet advertising, Section 404 authorizes Internet advertising of foreclosure sales and creates a safe harbor, which deems an advertisement commercially reasonable when published in both an appropriate Internet website and a local newspaper.

Homeowners and obligors will not necessarily see the public advertisement indicating the scheduling of the foreclosure sale. For this reason, Sections 405 and 406 require that the creditor send a notice of foreclosure of sale to homeowners and obligors, as well as notices of cancellations and postponements of sales.

Article 5: Accelerated Dispositions; Association Liens in Common Interest Communities

Sections 501 through 504 address what this Act calls a 'negotiated transfer,' while Sections 504 through 507 deal with the foreclosure of abandoned property. Taken together, the Drafting Committee considers these two significant devices to enable lenders to secure title quickly when there are no homeowners who would be adversely affected by the sale.

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 505 provide a statutory framework that recognizes and 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, reflected by a charge given to the Drafting Committee, is whether to include a statutory "minimum sum" paid to the borrower in a negotiated transfer. After preliminary drafting and discussion, the decision was made 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. To date, the Committee's position is that a requirement that the agreement confirm to the substantive and procedural requirements of these sections will quickly become conventional practice in the states, without incurring the uncertainty as to which 'agreements' qualify for accelerated foreclosure, and which do not.

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. Sections 505 and 506 authorize 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, the homeowner is no longer using the property for shelter. A foreclosure sale will not result in a family being forced 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 507. This is a quid pro quo – the lender gets accelerated foreclosure, but has to take care of the property. The trigger for the duty to maintain is a judicial determination that the property is abandoned, which authorizes expedited foreclosure. In a judicial foreclosure, the court makes the determination as to whether a particular home is abandoned, guided by statutory criteria set forth in Section 505. In a nonjudicial foreclosure, the act enables a government official, such as a building code department, to make a determination that a home is abandoned. Also, in addition to a lender seeking a determination that the home is abandoned, the city or a homeowners' association will have the right to request the determination, thereby triggering a lender's duty to maintain the property.

Lien for sums due association; enforcement. Section 508 of the current draft addresses an issue of widespread concern to homeowner associations in condominiums, cooperatives and homes associations, the three forms of shared ownership known in this act and in the Uniform Common Interest Ownership Act ("UCIOA") as 'Common Interest Communities.' That issue is the relative lien priority which the law should grant to the association, compared to first and second mortgages on that unit, when a homeowner fails to pay her monthly common charge fee, and the association decides to foreclose that lien. The issue is both complex and controversial, with considerable lobbying in the states, and varying legislative results.

The current language of Section 508 incorporates all the relevant language of Section 3-116 of the existing UCIOA, with two exceptions:

First, subsection (c) of this draft limits the association's legal fees in an uncontested matter to a sum equal to 3 months of the association's common charges, while the only limit in UCIOA 3-116 is that the legal fees must be reasonable;

Second, subsection (d) provides that if a lender begins a foreclosure action and that foreclosure is not completed in 12 months, then, beginning in month 13, in addition to the existing 6 month priority granted to associations under existing UCIOA 3-116, the association's common charge lien would thereafter have an additional month's priority over the mortgage for every additional month that passes until the foreclosure is resolved.

The current language represents the Drafting Committee's effort to find some consensus with both lender and association advocates. Among a variety of issues, lenders claim that the association's legal fees are often excessive, while associations claim that, whatever validity the six month priority period may have had under the existing UCIOA, it is no longer adequate. They claim among other things, that foreclosure delays are often intentional by lenders because, unlike the result in single family homes where the lenders bear the cost of insurance and maintenance of their collateral during foreclosure, in a common interest community these costs are borne by the association.

Whatever validity such claims may have, the foreclosure crisis has materially harmed many associations in those instances where significant numbers of homeowners in their complexes fail to pay their common charges. The result has been the imposition of higher fees on those owners who do pay their common charges, reduced market values for units in complexes affected by high levels of default and, in some extreme instances, bankruptcy of the association. These outcomes, of course, have the unintended consequence of reducing the value of the lenders' collateral on those units and, should, therefore, present some opportunity for compromise.

Unfortunately, a compromise satisfactory to both lenders and associations has not materialized during the past year. In these circumstances, the policy issues confronting the Drafting Committee include, at a minimum, these questions:

- Does the proposed language in Section 508 strike the appropriate balance between lenders and associations? If not, is there a better compromise to be had?

- If consensus is not likely, is it prudent for the Drafting Committee to continue to include this section in the Act, or should the subject be dropped?

Article 6: Remedies

This article was discussed extensively at the April 2013 meeting; one particular section, dealing with a proposed abolition or modification of the Holder In Due Course Doctrine, resulted in creation of the sub-committee whose report appears below.

In preparing the other sections as they currently appear in the draft, the chair and reporters were in some respects guided by analogous provisions for foreclosure of personal property in Article 9 of the UCC. These provisions represent tentative decisions reached at that April meeting and are almost certain to be the object of continued discussion between lenders and borrowers.

The fact is that, in all these regards, industry and consumer positions are inherently difficult to reconcile.

Consumers naturally advocate full assignee liability, mandatory attorney's fees, liquidated damages, and similar remedies for all violations, as well as a full panoply of defenses and defensive remedies including dismissal with prejudice of a judicial foreclosure or injunction against a non-judicial foreclosure. At the same time, their advocates insist that these enhanced consumer remedies and restrictions on foreclosure practices should not result in higher creditworthiness standards, reduced availability of mortgage loans, or higher interest rates. Indeed, they threaten that if any such practices result in a 'disparate impact' on the poor and minority populations, those lenders who precipitate such impacts should be subject to liability for discrimination.

Lenders naturally oppose these remedies, and seek safe harbors, damage caps, no or limited assignee liability, and materiality and cure standards for violations. They also claim that these remedies are certain to result in higher costs for all borrowers and will preclude potential borrowers with marginal credit from buying homes.

Ultimately the Act will need to strike a balance in providing remedies adequate to insure compliance by lenders, as well as support from consumer advocates, but not creating excessive litigation exposurefor "gotcha" violations that would provoke vigorous mortgage industry opposition, and hopefully not adversely affecting the ability of the citizenry to purchase homes.

Holder in due course As noted above, the Drafting Committee did not adopt a position regarding the Holder in Due Course doctrine at its April, 2013 meeting. Rather, we determined to present a report on the subject to facilitate discussion on the floor at the annual meeting. The Report was principally prepared by a sub-committee of the Drafting Committee consisting of Commissioners Miller, Walters and Lisman.

REPORT OF POLICY CONSIDERATIONS CONCERNING THE HOLDER IN DUE COURSE DOCTRINE AS APPLIED TO RESIDENTIAL MORTGAGE LOANS

I. Introduction. The Drafting Committee for the Home Foreclosure Procedures Act (the 'Act') has discussed - but has not taken a position on - two significant issues with respect to residential real estate loans and the potential liability of assignees of mortgages and the notes they secure: first, the proper role, if any, of the Holder in Due Course rule, as articulated in Article 3 of the Uniform Commercial Code; and second, the extent to which an agreement by the borrower to waive defenses and claims against an assignee should be enforceable. In this Report, the HDC doctrine and the related waiver of defenses concept together are called the "Doctrine".

To refresh the recollection of Commissioners with respect to the Doctrine, a memorandum prepared by Professor James Charles Smith, one of the Drafting Committee's co-Reporters, summarizing several aspects of the Doctrine is attached as ***Exhibit A*** to this Report. In addition, those seeking additional information concerning this issue will find a range of thoughtful comments provided by various stakeholders – consumer representatives, regulators, academic writers and the securitization industry – on the ULC website for the Drafting Committee.

II Background. Section 607 of the April 5, 2013 draft, in general, set out three basic positions on what the Drafting Committee might do with the Doctrine in the Act; that is:

- abolish the Doctrine as it applies to residential loans;
- keep the Doctrine unchanged; or
- take some middle position

There was vigorous debate on this subject at the April meeting of the Drafting Committee by both members of the Committee and various observers. At the conclusion of debate, the Drafting Committee decided that it was premature to take a position on these alternatives.

In order to further the discussion, the Chair of the Drafting Committee then appointed a subcommittee composed of Commissioners Walters, Miller and Lisman; their charge was to study the matter further and present a report for the entire Conference to consider at the annual meeting. This is that Report.

The draft of the Act presented for first reading at the 2013 annual meeting recognizes in §602, but does not specifically list, a considerable number of common law and statutory defenses, including violations of the Act itself, that might be raised in defense to foreclosure.

The recent financial collapse was due in part to a system that allowed lenders and investors to profit by simply making *more* loans rather than *quality* loans. One proposed solution to this problem would be to simply eliminate the Holder in Due Course Doctrine's protection of persons who purchase these loans from those who originated them. This approach would remove the protection now given to purchasers from originators and other participants who generate loans and who transfer them in securitization from most defenses and claims. This already exists at the federal level:

- The Dodd-Frank Wall Street and Consumer Protection Act did this through a mandated risk retention requirement. *See* 7 U.S.C. §941 (securitizer must retain an economic interest in a material portion of the credit risk for any asset that it transfers, sells, or conveys to a third party – "skin in the game" proposed at 5 percent).

- For some time the Federal Trade Commission Regulation on Holder in Due Course, 16 CFR Part 433, has allowed defenses and claims to be asserted against the holder of a consumer credit contract, which includes a purchase money loan (but limited to goods and services). Nonetheless the experience here is often cited for the proposition that the holder in due course doctrine is out dated and unnecessary.

- The Home Owners Equity Protection Act (HOEPA), which, in 15 U.S.C. §1640(d)(1), essentially does for "high cost" mortgages what the FTC rule does for services and personal property credit transactions but without the purchase money loan limitation.

All this has led to renewed cries to abolish the Doctrine – which as noted is a policy that frees an assignee from most defenses to payment and claims adverse to the holder of a right to payment.

After all, critics of the Doctrine assert, the experience with the FTC rule indicates that exposure to claims and defenses has had no appreciable impact on the market, either in refusals of credit or in increased cost of credit. Moreover they claim as a general theory that, as between the homeowner and market participants, there is no doubt who can best supervise to possibly preclude bad loans or, failing that, who can best spread the loss.

Among the forceful advocates of this position have been Mark Greenlee, counsel to the Federal Reserve Bank of Cleveland and Thomas Fitzpatrick IV, an economist with that bank. Greenlee and Fitzpatrick wrote a letter to the Chair of the Drafting Committee dated March 28, 2013; in that letter, they wrote the following at the conclusion of a detailed explanation of their views:

> In conclusion, we ask the Committee to draft the Act prospectively, eliminating holder in due course protections in the realm of residential mortgage foreclosure proceedings. We think that an Act with these features will re-align incentives and improve the functioning and efficiency of the residential mortgage market for all participants. We are confident in the resilience of the market and the resourcefulness of its participants to adapt to this change and re-price credit accordingly. We expect that a clearly delineated expansion in the liability of the purchasers of residential mortgage loans limited to the amount borrowed will propel innovation and reduce originator misconduct. If this change slightly increases the cost of credit and/or slightly decreases the availability of credit, we believe changes to the cost and availability of credit will be small, once the market reaches steady state, having no significant impact on the homeownership rate.

Whether experience with the FTC rule is applicable to the secondary mortgage market, and whether the arguments of those seeking abolition or modification of the Doctrine are accurate, is vigorously contested; supporters of the current rule assert instead that as a matter of principle and long established custom, participants in that market should not be expected to shoulder risk that is hard or impossible to detect. Some also assert it will either price most borrowers out of the market, or perhaps kill it altogether, or will lead to government subsidy at moral hazard to taxpayers. For example, the American Securitization Forum's Executive Director recently wrote a letter to the Chair of the Drafting Committee; in pertinent part he wrote:

> We, of course, cannot predict with any certainty the frequency and costs of claims that may be asserted by borrowers to challenge the lawfulness of the loans that they willingly undertook. One fact we have learned from the foreclosure crisis, however, is that borrowers routinely will use all lawful means at their disposal to delay or stop a foreclosure, even if the action merely delays the inevitable. We must assume that wrongful lending claims will proliferate regardless of the merits of the underlying facts simply because a tool to do so is made available. We believe any final language in this draft law should preserve borrowers' rights to make legitimate claims, but will not empower them to make frivolous ones.

> Otherwise, the resulting significant risk and costs of potential litigation will constrain investors from purchasing loans in the secondary market and investing in residential mortgage-backed securities ("RMBS") or a substantial risk premium will be necessary to offset the risk.
>
> ****
>
> Secondary market participants are not currently in a position to take on risks that sharply increased assignee liability would entail. In order to ensure the continuing recovery and increase affordable and accessible mortgage credit for borrowers, liquidity and efficiency in the secondary market should not be unnecessarily curtailed by undermining accepted holder in due course provisions.

The sub-committee feels there is no need to draft a provision stating that no change in the Doctrine is made. Complete abrogation is, to many, a radical position, but equally easy to draft. Note that abrogation of the Doctrine must go to both the obligation and the mortgage. To preserve the Doctrine as to liability on the obligation but allow claims and defenses as to the mortgage would, given a good defense, turn the obligation (to what extent depends on the defense) into an unsecured obligation that could allow judgment on the obligation as no defense is good, other than a "real defense" (the existence of which in most cases is unlikely), and allow the former mortgagee to execute on the real estate to satisfy that judgment (subject to any homestead or similar law). In that scenario, a homeowner might justly ask: "You mean I have a good defense to foreclosure, but I may lose my home anyway?"

III One Example of a Middle Ground. That leaves the possibility of a middle position. Since this issue is perhaps a "deal breaker" for consumers as well as the securitization industry, the sub-committee believes a careful, balanced resolution of the issues may be critical to securing enactments of any version of this Act.

One approach may be a short statute of repose or a statute of limitations; another might be a cap on liability. There are other possibilities to be explored.

The suggested approach of Mark Greenlee of the Federal Reserve Bank of Cleveland and his colleague Thomas Fitzpatrick, quoted above, follows the approach of the FTC Holder in Due Course rule and is one example of a middle position. As noted, Greenlee and Fitzpatrick would abrogate the Doctrine for both negotiable and non-negotiable notes; in the balance of their proposal, they would use a one-year statute of limitations approach for both, and would cap liability at original principal. They would also make clear that any change in the law would only apply prospectively, that is, to notes signed in the enacting state after the effective date of the act in that state.

Whatever approach is taken, it will be necessary to take into account existing federal law, including the qualified mortgage provisions of 15 U.S.C. §1639c. While that statute does not directly bear on the issue of holder in due course and assignee liability, it does so indirectly because it creates a mortgage loan that is less likely to go into default and thus foreclosure.

The sub-committee believes that it would be most useful to have more information as to the economics behind the federal rules, like "skin in the game" and HOEPA assignee liability before any decision is made. Further, we think that before any policy choice is reached, more consideration of various types of credit enhancements to cushion any possible effect of abolition, such as indemnity agreements and better due diligence options, should be considered.

However, regardless of what additional due diligence is undertaken, if the Drafting Committee were to take a 'middle ground' approach, a possible indication of what such a statute might provide is the following; the six year period comes from UCC § 3-118's statute of limitations.

The sub-committee also presumes that if the Drafting Committee were to choose such an approach, a parallel provision would insulate borrowers from being required to sign, as a condition of the loan, a 'boilerplate' instrument in which the borrower waived whatever rights would have been otherwise conferred by the statutory amendment.

We emphasize, however, that neither the drafting committee nor this sub-committee has decided on such an approach. Further, the Drafting Committee as a whole has not had the opportunity to consider this language nor to discuss in any detail the very tentative text contained in the April draft of the Act.

> [NEW] §606. <u>Any residential mortgage obligation incurred by a homeowner or obligor after the [act] becomes effective [in this state] shall contain, or be read as if it contains, the following provision in at least ten point, bold face, type</u>:
>
> <u>NOTICE</u>
>
> <u>FOR SIX YEARS AFTER THE DATE STATED IN THIS OBLIGATION, OR IF THE DUE DATE IS ACCELERATED, WITHIN 6 YEARS AFTER THE ACCELERATED DUE DATE, ANY PERSON ENTITLED TO ENFORCE THIS OBLIGATION AND THE MORTGAGE THAT SECURES IT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE HOMEOWNER OR OBLIGOR COULD ASSERT AGAINST THE INITIAL PERSON ENTITLED TO ENFORCE THIS OBLIGATION, UNLESS THE CLAIM OR DEFENSE IS SOONER BARRED BY A STATUTE OF LIMITATIONS OR REPOSE OR OTHER VALID DEFENSE.</u>
>
> <u>RECOVERY HEREUNDER BY THE HOMEOWNER OR OBLIGOR SHALL NOT EXCEED ['X' PERCENT OF] THE [ORIGINAL PRINCIPAL AMOUNT] [OUTSTANDING PRINCIPAL BALANCE], EXCLUDING ACCRUED INTEREST, OF THE OBLIGATION OF THE HOMEOWNER OR OBLIGOR HEREUNDER.</u>

In addition, UCC § 3-305 might be amended by adding language as follows:

> (e) In a consumer transaction <u>or residential mortgage transaction</u>, if law other than this article requires that an instrument include a statement to the effect that the rights of a holder or transferee are subject to a claim or defense that the issuer

could assert against the original payee, and the instrument does not include such a statement; (1) the instrument has the same effect as if the instrument included such a statement; (2) the issuer may assert against the holder or transferee all claims and defenses that would have been available if the instrument included such a statement; and (3) the extent to which claims may be asserted against the holder or transferee is determined as if the instrument included such a statement.

(f) This section is subject to law other than this article that establishes a different rule for consumer transaction or residential mortgage transactions.

Were the Conference to adopt this policy, the sub-committee believes that these two definitions also should be added to UCC § 3-103:

"Residential mortgage transaction" means a transaction in which an individual incurs an obligation primarily secured by real property improved with one-to-four family dwelling units, including ancillary structures to such dwelling units, attached single-family dwelling units and single-family manufactured housing units placed upon permanent foundations, and single-family common interest community.

"Common interest community" means real property with respect to which a person, by virtue of ownership of a unit, is obligated to pay for real property taxes, insurance premiums, maintenance, or improvement or other real property or services described in a declaration or other governing documents, however denominated. A common interest community includes properties held by a cooperative housing corporation. In this paragraph, "ownership" includes a leasehold interest if the period of the lease is at least [20] years, including renewal options.

June 14, 2013

EXHIBIT A

MEMORANDUM

UCC Article 3 and The Holder in Due Course Doctrine

James Charles I. INTRODUCTION Commissioner Carlyle C. Ring, Jr. recently described the tone of our Drafting Committee's efforts to date for the Virginia delegation. In part he wrote:

Smith, Reporter

February 11 and April 3, 2013

1. Introduction

The core idea of negotiability is that certain purchasers of monetary obligations take free of defenses to payments that the obligor (maker) might raise against the original payee. This is known as the holder in due course doctrine. It is an exception to a basic tenet of property law, reflected by the Latin phrase, ***Nemo dat quod non habet*** ("no one gives what he does not have"). Negotiability is a type of bona fide purchaser doctrine. It grants a power to the original payee of a negotiable instrument to sell rights he did not have to a buyer, who qualifies as a holder in due course. The purpose and effect is to take property away from the obligor (maker) and allocate it to the holder/purchaser.

Our law of negotiable instruments dates back to 18th century English legal innovations. England's law first recognized bills of exchange, and quickly thereafter promissory notes, as negotiable. The original function was to allow the development of money substitutes. Bills of exchange were issued by merchants, and notes by banks and other financial institutions, and those obligations were transformed into liquid assets (i.e., easily saleable to purchasers who did not have to inquire into the particular circumstances of their creation to determine whether the maker might assert a plausible defense to payment).

Early U.S. law followed the English pattern. Bank notes were the most important form of U.S. negotiable instruments prior to the federal government's decision to begin issuing paper currency in 1862. In modern practice, a large percentage of promissory notes are issued by individuals and small businesses, and they do not function in the economy as money substitutes. Today banks and other financial institutions are the primary holders, rather than the primary issuers, of negotiable promissory notes.

The modern justification for treating privately-issued promissory notes as negotiable is not providing for a money substitute, but enhancing the credit markets. Purchasers of negotiable instruments are relieved from the transaction costs of having to investigate the particulars of loans documented by negotiable notes, and therefore in theory, are willing to pay more for those notes. Under a "trickle down" theory, arguably borrowers also realize some of the benefit of this credit enhancement by paying a lower interest rate, or lower fees.

The negotiable note, therefore, is more liquid and more valuable in the hands of the originating lender and the other parties to the transaction, including the maker and the subsequent holder. It is worth noting, however, that the secondary mortgage market is but one type of "receivables" financing; many other robust markets for receivables financing – for example, automobile financing, accounts financings, credit-card receivables, and health-care insurance receivables – do not presently rely on negotiable paper to any appreciable extent.

2. Are Promissory Notes Secured by Mortgages Negotiable?

Article 3 of the Uniform Commercial Code applies only to negotiable instruments. Many promissory notes are negotiable instruments, but many are not, and non-negotiable promissory notes are completely outside the scope of UCC Article 3. They are generally governed by state common law, although some statutes are relevant, including UCC Article 9, which provides rules governing the sale of all forms of promissory notes and the creation of security interests in non-negotiable, as well as negotiable, promissory notes.

It is often hard to determine whether a particular note qualifies as a "negotiable instrument" under the Article 3 rules. Under Article 3, a promissory note is negotiable if it:

(1) contains an "unconditional promise … to pay a fixed amount of money, with or without interest or other charges described in the promise";

(2) "is payable to bearer or to order";

(3) "is payable on demand or at a definite time";

(4) "does not state any other undertaking or instruction by the person promising … payment to do any act in addition to the payment of money, but the promise … may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor"; and

(5) does not contain "a conspicuous statement, however expressed, to the effect that the promise … is not negotiable or is not an instrument governed by [Article 3].

UCC § 3-104(a), (d) (2002). Prior to the 1990 revision to Article 3, there was a split of opinion as to whether adjustable rate notes qualified as negotiable. The 1990 revision resolved the issue, added a section making variable-interest-rate notes negotiable; *see* UCC § 3-112(b). Today qualification of a secured note as a negotiable instrument usually turns on only one issue: whether the note says too much about the maker's obligations with respect to the mortgaged property, so that it exceeds the bounds of the 4th element described above. Although one might conceivably interpret Section 3-104 to allow a note directly to incorporate a full range of standard mortgage covenants into the note, without destroying negotiability, conventional wisdom is that the drafter must avoid doing too much.

There is a growing body of cases indicating that the Fannie Mae/Freddie/Mac uniform promissory note – the overwhelmingly dominant form used in home mortgage financing – is a negotiable instrument. Most cases, however, reach that conclusion without providing any analysis. They do not bother to even mention the Article 3 requirements for a negotiable instrument. *See* Dale A. Whitman, *How Negotiability Has Fouled up the Secondary Mortgage Market, and What to Do About It*, 37 Pepp. L.Rev. 737, 754-56 (2010) (making the same observation for 42 cases he studied, which were decided between 1989 and 2009). A few courts have provided analysis. An example is HSBC Bank USA v. Gouda, 2010 WL 5128666 (N.J. Super. Ct. App. Div. 2010). The *Gouda* court examined the uniform note's prepayment clause, which provides:

4. BORROWER'S RIGHT TO PREPAY. I have the right to make payments of Principal at any time before they are due. A payment of Principal only is known as a "Prepayment." When I make a Prepayment, I will tell the Note Holder in writing that I am doing so. I may not designate a payment as a Prepayment if I have not made all the monthly payments due under the Note.

The *Gouda* court held that the prepayment clause was not a proscribed "other undertaking or instruction," even though the clause obligated the maker to "tell the Note Holder in writing" that his payment was to be a prepayment. The court observed:

The right of defendants, under the note, to prepay part of the principal does not constitute an 'additional undertaking or instruction' that adversely affects the negotiability of the note. Quite the opposite, the right of prepayment is a voluntary option that defendants may elect to exercise solely at their discretion. . . . The fact that defendants must notify the lender in the event they opt for prepayment imposes no additional liability on them and is not a condition placed on defendants' promise to pay. Rather, notification is simply a requirement of the exercise of the right of prepayment which, as noted, defendants are free to reject. This requirement does not render the note in issue non-negotiable.

Id. at *3. At least three other courts have also rejected the argument that the prepayment clause makes the note non-negotiable. *See, e.g.*, In re Walker, 466 B.R. 271, 2012 WL 443014 (Bankr. E.D. Pa. 2012) (relying on *Gouda* to hold note is negotiable); In re Edwards, 76 UCC Rep. Serv. 2d 220, 2011 WL 6754073 (Bankr. E.D. Wis. 2011) (note is negotiable: "providing information regarding a prepayment to the lender is not an express condition to payment or subject to 'another writing' within the meaning of the statute"); Picatinny Federal Credit Union v. Federal Nat. Mortgage Ass'n, 2011 WL 1337507 (D.N.J. 2011) (relying on *Gouda*).

More recently, a bankruptcy court rejected a set of arguments that the Fannie Mae/Freddie Mac uniform note is non-negotiable, including the prepayment clause and the note's explicit quotation of the due-on-sale clause set forth in the uniform mortgage (uniform security instrument). Mesina v. Citibank, NA, 77 UCC Rep. Serv. 2d 987, 2012 WL 2501123 (Bankr. D.N.J. 2012).

3. If the Note is Negotiable, How Does Article 3 Affect Identifying the Person Who Has the Right to Foreclose?

A key concept in Article 3 is a character known as a "***person entitled to enforce an instrument,***" defined in UCC § 3-301 (2002). The term replaced a simpler term, "***holder of an instrument***." The "person entitled to enforce" includes not only holders, but also a person enforcing a lost note and a person who possesses a note but fails to qualify as a "holder" as defined in UCC Article 1. "Entitlement to enforce" means that the person has the right to demand payment from the maker, in accordance with the terms of the note, and to sue on the note if payment is not made.

Article 3 does not attempt to deal with ***ownership of the obligation*** embodied in a negotiable instrument (i.e., ownership of the promissory note). Often but not always the "person entitled to enforce" will also own the note. When "entitlement to enforce" and ownership are separated, by definition the "person entitled to enforce" will have an obligation to remit the proceeds it collects to the owner. That obligation may stem from an express agency relationship, another type of contract, or have another source, such as the law of restitution. Again, Article 3 does not attempt to define ownership of negotiable instruments, or to regulate the relationship between "persons entitled to enforce" and owners.

Article 3 does not address the rights of a "person entitled to enforce" to foreclose on collateral, in the event the negotiable note is secured by collateral. It provides no guidance as to whether the proper person to foreclose should be the "enforcer" or another person.

Under the existing law of some states, the person who is entitled to foreclose is the "person entitled to enforce" the note under Article 3 (assuming that the note meets the Article 3 rules for negotiability). This approach was taken by our Nov. 2012 draft, and it is the first of the two alternatives set forth in Section 401 ("Right to Foreclose") of our Feb. 2013 draft. Ohio is one of several states adopting this approach. In *BAC Home Loans Servicing, LP v. Kolenich*, 2012 WL 5306059 (Ohio Ct. App. 2012), the court held that the plaintiff had the right to foreclose, as holder of the note, even though it had sold ownership of the debt through securitization to Fannie Mae. The court observed:

It is well-settled that the real party in interest in a foreclosure action is the current holder of the note and mortgage. *See, e.g., Everhome Mtge. Co. v. Rowland, 10th Dist. No. 07AP-615,* 2008-Ohio-1282, ¶ 12. The current holder of the note and mortgage is entitled to bring a foreclosure action against a defaulting mortgagor even if the current holder is not the owner of the note and mortgage. *See* R.C. 1303.31(A) (a "'[p]erson entitled to enforce' [a negotiable] instrument" includes "the holder of the instrument[,]") and R.C. 1303.31(B) ("[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").

Designating the "person with the right to enforce" as the proper person to foreclose has the beneficial effect of ensuring that the mortgage debt is discharged to the extent of the foreclosure proceeds (assuming that the foreclosing party in fact is the "person entitled to enforce"). On the assumption that the mortgage debt is evidenced by a promissory note that meets the standards for negotiability set forth in UCC Article 3, the law of negotiable instruments may specify who is entitled to foreclose the mortgage.

Instead of this approach, a number of states have foreclosure laws that specify a person other than the "person entitled to enforce" as the person who has the right to foreclose. For example, in *Trotter v. Bank of New York Mellon*, 275 P.3d 857 (Idaho 2012), the court held that a trustee has the right to foreclose under the Idaho Deed of Trust Act by complying with the act's express requirements, which include recordation of the trust deed, recordation of any assignments of the trust deed, and recordation of a notice that the borrower has defaulted. In *Trotter*, after receiving the trustee's notice of the proposed foreclosure sale, the borrower brought an action to enjoin the sale, alleging that the trustee and other defendants, including MERS, lacking standing to foreclose. The court rejected the borrower's argument that the trustee must prove "it is the current owner of the note" or that it had "authorization from the beneficiary" to foreclose. *Id.* at 861. The court emphasized that standing rules did not apply because "the foreclosure process in the Act is not a judicial proceeding." *Id. Accord, Jackson v. Mortgage Electronic Registration Systems, Inc.*, 770 N.W.2d 487 (Minn. 2009) (under Minnesota "foreclosure by advertisement" statute, legal holder of mortgage is entitled to foreclosure without proof as to identity of holder or owner of promissory note).

Allowing foreclosure by a person other than the note holder (or its proven agent) raises particular difficulty if the promissory note is negotiable. In some cases, if the "person entitled to enforce" under Article 3 has not received the foreclosure proceeds from the person who forecloses, the "person entitled to enforce" may assert a plausible claim that there has been no discharge. In some cases, the maker may successfully defend that claim with proof of express agency, implied agency, estoppel, or similar theories, but all of that could easily get messy. In essence, the situation is analogous to the risk imposed upon the maker of any negotiable instrument of making a payment to the wrong person. A maker who mistakenly pays someone other than the holder (or "person entitled to enforce") does not get a discharge, and undertakes the risk of having to pay twice. The difference is that normally the maker's risk is associated with the maker's voluntary payment. Here, the problem arises due to an "involuntary payment" made on behalf of the maker due to the foreclosure.

If the uniform statute confers standing to foreclose on a person other than the "person entitled to enforce" when the note is negotiable, it seems advisable to draft provisions that protect borrowers from the risk that the foreclosure proceeds will not be applied to discharge their debt.

4. <u>If the Note is Negotiable, May the Maker Still Assert Defenses in Foreclosure?</u>

If the mortgage note is negotiable, transfer to a holder in due course allows the holder to bring an action to collect the note, free of any "personal defenses" that the maker might have against the original lender. Article 3 governs, and the statutory language directly calls for this result. UCC § 3-305.

However, Article 3 does not state rules with respect to a holder's rights to foreclose on collateral. Thus, other law (usually state common law) determines whether the maker may assert personal defenses in mortgage foreclosure. The issue is usually framed in terms of whether the mortgage (or deed of trust) is negotiable. Does the fact that the note is negotiable make the mortgage negotiable? Shortly after U.S. states began holding that mortgage notes could qualify as negotiable instruments (late 19th- early 20th century), a few courts held the mortgage was not negotiable; in other words, the character of the note was not imputed to the mortgage.

The majority rule, however, extended the holder's protection from defenses to its foreclosure on the collateral. Presently, the rule making the mortgage negotiable when the underlying note is negotiable, if not universally accepted, is close to universally accepted. E.g., *Colburn v. Mid-State Homes, Inc.,* 266 So. 2d 865 (Ala. 1972); *Wilson v. Steele*, 259 Cal. Rptr. 851 (Ct. App. 1989); *Carnegie Bank v. Shalleck,* 606 A.2d 389 (N.J. Super. Ct. 1992); 127 A.L.R. 190. No modern cases hold a maker may assert personal defenses against the holder in due course of a promissory note in the context of mortgage foreclosure.

Thus, a uniform statute that allows mortgagors to assert "personal defenses" such as fraud and misrepresentation in foreclosure proceedings, would not conflict with Article 3 law. It would, however, overturn other well-accepted state law.

It is also worth noting that the Article 3 section that cuts off defenses in favor of a holder in due course states an exception for "law other than this Article" that protects obligors in a "consumer transaction," defined as a "transaction in which an individual incurs an obligation primarily for personal, family, or household purposes." UCC §§ 3-305(e), (f); 3-103(a)(3) (2002). Therefore, a statute overriding the holder in due course doctrine as a general matter for homeowners would not conflict with Article 3.

5. <u>Assuming the Holder of a Note is a 'Holder in Due Course', what differences exist between 'Personal' and 'Real' Defenses?</u>

The holder in due course doctrine cuts off some, but not all, defenses that a borrower might assert against the original payee of the instrument. As noted above, a holder in due course is said to take free of ***personal defenses*** but is subject to ***real defenses.***

UCC Article 3 codifies the real defenses, listing them as (1) infancy, (2) duress, (3) legal incapacity, (4) illegality of the transaction, (5) fraud that induced the obligor to sign the instrument without knowledge of its character or essential terms (often called "fraud in the factum"), and (6) discharge in insolvency proceedings.[2] Purchasers of residential mortgage loans in the secondary mortgage market have always taken subject to these real defenses.

Article 3 specifies that a holder in due course takes free of other defenses[3] (the so-called personal defenses). The UCC does not provide a list of personal defenses. The ones frequently identified by courts and commentators are:

- Fraud that did not prevent the obligor from obtaining knowledge of the character of essential terms of the instrument (often called "fraud in the inducement").
- Misrepresentation. Probably this is the most common claim cut off by the holder in due course doctrine in the context of residential mortgage loan origination. Typical claims are that a lender's representative or mortgage broker falsely described the characteristics of the loan, such as interest rate, other costs and fees, balloon payments, or prepayment terms; or made collateral promises, such as a promise to refinance at a better rate at a particular time in the future, which were not honored. Such alleged misrepresentations would often be characterized as fraudulent misrepresentation.
- Failure or lack of consideration. The starkest example is the borrower's failure to receive the loan proceeds.
- Unconscionability.
- Undue influence.
- Breach of warranty.
- Discharge by payment to someone other than the holder of the instrument.[4]

---

[2] Revised UCC § 3-305(a):

> [T]he obligation of a party to pay an instrument is subject to the following:
> (1) A defense of the obligor based on (i) infancy of the obligor to the extent it is a defense to a simple contract, (ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor, (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms, or (iv) discharge of the obligor in insolvency proceedings . . . .

The list of real defenses in pre-revision Article 3 is substantially the same. UCC § 3-305(2).

[3] Revised UCC § 3-305(b).

[4] Although payment to the wrong person is a personal defense, residential borrowers appear to be largely protected from this risk by federal law that requires the sending of a notice to the borrower when there is a new loan servicer to whom payments are to be made. 12 U.S.C. § 2605, *Servicing of mortgage loans and administration of escrow accounts*, provides:

> (b) *Notice by transferor of loan servicing at time of transfer*

- Statutory violations (to the extent that the statute does not expressly make transferees liable for violations by the originating lender).

---

(1) *Notice requirement*
Each servicer of any federally related mortgage loan shall notify the borrower in writing of any assignment, sale, or transfer of the servicing of the loan to any other person. . . .
(3) *Contents of notice*
The notice required under paragraph (1) shall include the following information: . . .
(E) The date on which the transferor servicer who is servicing the mortgage loan before the assignment, sale, or transfer will cease to accept payments relating to the loan and the date on which the transferee servicer will begin to accept such payments. . . .

This provision, enacted in 1990, is part of the Real Estate Settlement Procedures Act (RESPA).