

REPORT

TO: Payment Issues Study Committee; Permanent Editorial Board for the UCC

FROM: Fred Miller

DATE: March 14, 2011

This is a report on activity since the ULC Executive Committee approved the expanded charge for the committee in January.

Since one possible approach for drafting may involve parts of the Uniform Commercial Code (UCC), The Executive Committee action was referred to The American Law Institute (ALI), our partner in the UCC work. The Permanent Editorial Board (PEB) will hold a conference call on April 5th to recommend appropriate action going forward on this matter.

Meanwhile, as part of the overall effort, the PEB has continued work on a report that will detail, within the jurisdiction of the PEB, how the relevant UCC provisions apply to mortgage transfer and foreclosure issues. It is hoped this will result in guidance to courts and attorneys and alleviate some of the current confusion that from time to time surrounds various issues.

In the interim, the reporter, Linda Rusch, has worked on a preliminary list of possible issues to be addressed if a drafting committee is created to focus initially on improving the applicable law relevant to mortgage transfers and foreclosures. That document is attached. If a drafting committee is formed, a stakeholders' meeting is contemplated, probably in mid-May, to refine the list and move forward an agenda of issues for an initial drafting meeting possibly early in the fall. It is worth note that Linda also has engaged in extensive discussions at the Atlanta Federal Reserve Bank on payment issues and that agency has expressed strong support for ultimately dealing with such issues. However, given the current focus on mortgage issues, and the new Federal Reserve proposals to amend Regulation CC, that effort must wait. Nonetheless, the support of the Federal Reserve will help us when a drafting committee, if appointed, does turn to consideration of payment issues.

Also in the interim, Fred Miller and Connie Ring had a series of meetings in Washington, D.C. There were discussions with MERS, the general counsels of the Treasury and the central Federal Reserve, with the president and chief operating officers of the American Bankers Association, and with staff members from the staff of Senator Tim Johnson of South Dakota, the chair of the Senate Banking Committee. We were well received and the discussions all were favorable in reference to our possible mortgage project. Tom Baxter from the New York Federal Reserve Bank joined us in discussions

with Treasury and the central Fed, and the New York Federal Reserve Bank continues its strong support for both our mortgage and payments projects.

George Madison, general counsel for the Treasury Department, suggested that news articles about the mortgage issues and the project be created. Your chair has prepared such an article. If a drafting committee is formed, the article will be circulated in newspapers and in some legal publications that go to interested constituencies.

Senator Johnson's staff was particularly interested in our discussions with MERS, and expressed interest in not only following our efforts closely but in cooperating with us to the extent that a combination of state and federal law appears desirable, much like what was done in UCC Articles 4A and 8.

The central Fed was particularly interested in consumer aspects for the mortgage issues. Your chair has contacted Leonard Chanin, with whom he worked when Mr. Chanin was in the Division of Consumer and Community Affairs of the Central Fed, and will discuss the project with him so there can be coordination there. Also yet to be contacted are a number of other possibly interested constituencies, including ICBA, CSBS, the mortgage bankers, Attorney Generals, and servicing entities, to name important interests.

The discussion with MERS suggested that much confusion exists over the role of servicers and the separation of that function from that of the mortgage investors. In particular, the diverse laws involved in the "fractionalization" of interests has led to unfortunate results in the opinion of MERS. It was strongly suggested that amending those diverse laws, while it could update and clarify the law, would not make it more transparent as a whole. Further discussion suggested that dealing with mortgage transfers and foreclosures in a separate from the UCC and unified act might be a better option, even though such an effort would indirectly amend some of the UCC. This seems like an option that is definitely worth exploring substantively. It also would more clearly separate the payments issues from the mortgage issues, and thus would make it easier for interested parties to participate in the project of their interest. It also would work for the timing of projects.

Hopefully, a project will soon be underway. Our window of opportunity for the mortgage project is only open for so long. Our discussions at the Senate indicated Congress is discussing action. Federal agencies are doing so as well. Finally, state attorney generals and legislatures are considering settlements and further laws. To the extent these go into place, our task will only be more difficult.

Memorandum

TO: Permanent Editorial Board of the UCC

FROM: Fred H. Miller, Chair, Study Committee on Payment Issues
Linda J. Rusch, Reporter, Study Committee on Payment Issues

DATE:

RE: List of potential issues for purposes of the proposed Drafting Committee on Promissory Notes, Mortgages, and Related UCC Article 3 Issues

For purposes of providing a starting point of issues regarding promissory notes and mortgages,¹ this memorandum provides a list of issues that have arisen during the recent financial crisis, as posed in cases, news reports, or by comments received from others. This list should be considered to be a starting point and will need to be revised based upon input from various constituencies as developed through a stake holders meeting or other forums.²

1. Issues regarding Article 3

a. Negotiability and the rights of a holder in due course. The courts that have been addressing foreclosure issues have not engaged in any analysis of whether a note is negotiable or nonnegotiable. In some circumstances, the courts flatly state that the note is negotiable and in other circumstances, the court applies Article 3 provisions without any statement or analysis that the note is in fact negotiable. Some commentators have questioned whether the typical residential mortgage note is in fact negotiable, and others have stated that the notes are typically negotiable.³ One commentator has advocated that Article 3 be amended to make mortgage notes nonnegotiable.⁴ Another author has advocated that the holder in due course doctrine not apply to negotiable mortgage notes.⁵

- Should there be a simplification, modification, or clarification of the requirements for negotiability?
- Should negotiability for mortgage notes, or other types of notes, be eliminated?
- Should the holder in due course doctrine not apply to negotiable mortgage notes?

¹ The reference to mortgages should be read to include deeds of trust or other similar security devices granting an interest in real property to secure a debt.

² To the extent the Drafting Committee may eventually consider payments issues as related issues, the Study Committee's October 9, 2009 memorandum contains a detailed list of issues.

³ Compare Ronald J. Mann, Searching for Negotiability in Payment and Credit Systems, 44 UCLA L. Rev. 951 (1997) with Transfer and Assignment of Residential Mortgage Loans in the Secondary Mortgage Market at 9, ASF White Paper Series (Nov. 16, 2010).

⁴ Dale A. Whitman, How Negotiability Has Fouled Up the Secondary Mortgage Market, and What to Do About It, 37 Pepp. L. Rev. 737 (2010).

⁵ Alex M. Johnson, Jr., Preventing a Return Engagement: Eliminating the Mortgage Purchasers' Status as a Holder-in-Due Course: Properly Aligning Incentives Among the Parties, 37 Pepp. L. Rev. 529 (2010).

- What would be the practical consequences of modifying or eliminating negotiability or the holder in due course doctrine for mortgage notes (either residential or commercial or both), or for other notes? Are those consequences desirable? Does industry practice depend upon these concepts of negotiability and holder in due course for transfer and securitization of mortgage notes (i.e. to obtain freedom from claims and defenses, U.C.C. §§ 3-305, 3-306)?

b. Lost notes. In some of the cases, the entity seeking to foreclose is unable to produce the original note or a verified copy of the original note. UCC § 3-309 provides for enforcement of a note that cannot be produced because it has been lost or destroyed.⁶ That section was amended in 2002 to clarify and perhaps broaden its application.⁷ Only a few states have adopted the 2002 version.

- Are these provisions adequate in light of the modern method of originating and transferring mortgage notes?

c. Electronic notes. Under current law, a negotiable note must be in writing. UCC §§ 3-104, 3-103. Under the Uniform Electronic Transactions Act § 16, an electronic note may be treated as a negotiable note if the parties have expressly agreed that it be treated as a transferable record under that section. As stated in comment 2 to UETA § 16, a paper note that is imaged would not qualify as a transferrable record under that provision. Under the Electronic Signatures in Global and National Commerce Act (Esign), 15 U.S.C. § 7021, a similar provision allows for electronic notes secured by real property to be created and be treated as a negotiable note. This

⁶ After the 1990 revision of UCC Article 3, UCC § 3-309 provided:

(a) A person not in possession of an instrument is entitled to enforce the instrument if (i) the person was in possession of the instrument and entitled to enforce it when loss of possession occurred, (ii) the loss of possession was not the result of a transfer by the person or a lawful seizure, and (iii) the person cannot reasonably obtain possession of the instrument because the instrument was destroyed, its whereabouts cannot be determined, or it is in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process.

(b) A person seeking enforcement of an instrument under subsection (a) must prove the terms of the instrument and the person's right to enforce the instrument. If that proof is made, Section 3-308 applies to the case as if the person seeking enforcement had produced the instrument. The court may not enter judgment in favor of the person seeking enforcement unless it finds that the person required to pay the instrument is adequately protected against loss that might occur by reason of a claim by another person to enforce the instrument. Adequate protection may be provided by any reasonable means.

⁷ In 2002, UCC § 3-309(a) was amended to provide:

(a) A person not in possession of an instrument is entitled to enforce the instrument if:

(1) the person seeking to enforce the instrument:

(A) was entitled to enforce the instrument when loss of possession occurred; or

(B) has directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred;

(2) the loss of possession was not the result of a transfer by the person or a lawful seizure;

and

(3) the person cannot reasonably obtain possession of the instrument because the instrument was destroyed, its whereabouts cannot be determined, or it is in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process.

Subsection (b) was not amended.

provision similarly only applies to electronic records that the issuer has agreed to treat as a transferrable record.

- Are these provisions adequate in light of the modern method of originating and storing negotiable notes?
- Is there a need to provide for paper negotiable notes to be converted to electronic records in order to facilitate efficient storage and retrieval of the notes?

2. Issues regarding Article 9: Assignment of a right to payment secured by a lien interest in property.

U.C.C. Article 9 applies to most consensual security interests in payment obligations in a borrowing transaction and to most sales of accounts, chattel paper, payment intangibles and promissory notes. UCC § 9-109(a), (d). When the transaction is a covered sale of a payment obligation, the buyer's interest is denominated a security interest even though it is in fact the owner of the payment obligation. UCC § 1-201(b)(35). The payment obligation may be secured by an interest in either personal or real property or both. Article 9 applies to the creation of a security interest in a secured obligation even if the secured obligation is not itself governed by Article 9. UCC § 9-109(b). Article 9 does not apply to the creation or transfer of an interest in or a lien on real property except as provided regarding liens in real property in UCC §§ 9-203, 9-308, fixtures in UCC § 9-314, fixture filings in UCC §§ 9-501, 9-502, 9-512, 9-516, 9-519, and security agreements that cover both real and personal property in UCC § 9-604. U.C.C. § 9-109(d)(11).

Attachment of a security interest to a right to payment that is secured by a lien, such as a security interest or mortgage, automatically attaches the security interest to the lien interest and perfection of a security interest in a secured right to payment automatically perfects a security interest in the lien interest that secures that right to payment. UCC §§ 9-203(g), 9-308(e).

When the secured obligation is secured by a lien interest in real property and that secured obligation is transferred in a transaction that falls within the scope of Article 9, should the text or comments⁸ of Article 9 clarify the effect of the following actions on the creation and perfection of the rights of an assignee of the payment obligation:

- execution of a mortgage/security agreement in favor of a person other than the payee or assignee of the payment obligation;
- execution of a mortgage/security agreement assignment to an assignee other than the payee or assignee of the payment obligation;
- failure to execute any assignment of the mortgage/security agreement even though there is an executed assignment of the payment obligation;
- failure to record in the applicable real estate records an assignment of the mortgage; and
- recording a mortgage or an assignment in the name of someone other than the payee or the assignee of the payment obligation.

⁸ The comments to UCC Article 9 provide some insight to these issues but may not provide sufficient clarity. See comments 7 and 10 to UCC § 9-109, comment 9 to UCC § 9-203, comment 6 to UCC § 9-308.

3. Issues regarding intersection of Articles 3 and 9 and other law.

a. Enforcement of lien interest in property that secures the payment obligation by assignee of the payment obligation.

If a payment obligation is secured by a lien in real estate, that payment obligation has been assigned in a transaction governed by Article 9, and there is a default in the payment obligation, issues have arisen regarding the right of the assignee of the payment obligation to enforce the lien interest in the real property through foreclosure.

UCC § 9-607(a)(3) provides that the secured party may enforce the rights of the debtor as against the person obligated on the payment obligation and with respect to the property that secures the obligation. UCC § 9-607(b) allows the secured party to record a document in the real property records if necessary to allow the secured party to pursue a nonjudicial foreclosure. UCC § 9-607(e) provides that these provisions do not determine whether the person obligated on collateral owes a duty to the secured party. If both real and personal property secure the obligation, UCC § 9-604 provides that the secured party may enforce the lien either against personal property without prejudice to the secured party's rights to pursue the lien against real property or as to both the real and personal property using the real property enforcement process.

A payment obligation may be represented by a negotiable promissory note. When a security interest is created in that negotiable note (either in a secured borrowing or a sale transaction), the assignee need not take possession of the note in order to have an attached security interest. UCC § 9-203. Generally, in order to be a person entitled to enforce a negotiable promissory note, the person has to be in possession of the note. UCC § 3-301.

An assignee of a promissory note who does not have possession of the note may not have priority in the note if the person in possession qualifies for priority under UCC § 9-330 or § 9-331. A holder in due course of a negotiable note takes the note free of claims to the note. UCC § 3-306.

At least the following issues arise from these provisions and the provisions in UCC § 9-203(g) and § 9-308(e):⁹

- If the secured obligation is represented by a negotiable promissory note, and the person entitled to enforce that promissory note (as determined under Article 3) is not the same person who is the assignee of the payment obligation (as determined by Article 9), should Article 3 and 9 be clarified to determine the rights of the assignee of the payment obligation to enforce the lien interest in the property that secures the obligation?
- If the secured obligation is assigned in a transaction covered by UCC Article 9, and the assignee is not the same person as the named person in a mortgage or security agreement that creates the lien that secures the obligation (or a subsequent assignment of those lien rights), should the rights of the assignee of the payment obligation to enforce the lien interest be clarified?¹⁰

⁹ These issues are broader than just enforcement of a mortgage against real property. This issue affects the rights of an assignee of chattel paper (which can consist of a negotiable note and a security agreement) or an assignee of a negotiable promissory note which is secured by an interest in personal property (which does not meet the definition of chattel paper).

¹⁰ This issue is implicit in the analysis in *In re Commercial Money Center, Inc.*, 350 B.R. 465 (B.A.P. 9th Cir. 2006).

- What is the effect of the Article 9 priority rules regarding the secured obligation on the right to enforce the lien interest that secures the note? For example, assume the assignee of the secured obligation does not have possession of the negotiable promissory note, and the person entitled to enforce the negotiable promissory note does not have priority in the note as determined under the Article 9 scheme (i.e., does not qualify for priority under either UCC § 9-330 or § 9-331). Should that priority result affect who has the right to enforce the lien interest securing the assigned obligation?
- If the obligation is secured by a mortgage and that obligation is assigned in a transaction covered by UCC Article 9, should Article 9 clarify the assignee's ability to enforce the mortgage under real property law through judicial or nonjudicial foreclosure? Is UCC § 9-607(b) sufficient for this purpose?

b. Relationship between agency law and UCC Articles 3 and 9.

Under UCC § 1-103, common law principles such as agency law, supplement the provisions of the UCC to the extent not displaced by the provisions of the UCC. UCC Article 3 incorporates agency principles explicitly concerning liability on an instrument through signing the instrument. UCC § 3-402. UCC Article 9 incorporates agency principles through comments regarding sufficient possession of collateral. Comment 3 to UCC § 9-313.

Recent case law has raised the following issues regarding the operation of agency law when a note is secured by a mortgage or deed of trust:

- If a named mortgagee is designated as a nominee in the mortgage on behalf of the owner of the promissory note that is secured by the mortgage, is that nominee an agent of the promissory note owner?
- If an assignee of a promissory note secured by a mortgage has allowed another entity be named in the mortgage as a nominee of the note assignee for purposes of recording the mortgage, does that serve to separate the obligation under the promissory note from the obligation under the mortgage so as to nullify the mortgage or deed of trust?
- May a nominee that is named as the mortgagee on a mortgage enforce the mortgage even if the nominee has mere legal title but not beneficial title under the mortgage and the assignee of the promissory note has beneficial title under the mortgage?
- What is the role of agency law under UCC Article 3 and UCC Article 9 when an agent is seeking to enforce a negotiable note on behalf of a person entitled to enforce the note (as determined under UCC Article 3) or on behalf of the note owner (as determined under UCC Article 9)?

c. Enforcement of lien interests in real property.

Neither UCC Article 9 nor UCC Article 3 address enforcement of lien interests in real property and the manner of that enforcement varies significantly from state to state. Some states allow only judicial foreclosure and some states allow power of sale foreclosure without judicial involvement. Uniform laws promulgated in this area have not met with success in the state enactment process.¹¹

¹¹ See Grant S. Nelson, *Confronting the Mortgage Meltdown: A Brief for the Federalization of State Mortgage Foreclosure Law*, 37 Pepp. L. Rev. 583 (2010); Uniform Nonjudicial Foreclosure Act (2002);

There appears to be a inconsistency from state to state and even within states as to what evidence must be presented in a judicial foreclosure to demonstrate entitlement to enforce a mortgage, and what documents must be filed or otherwise provided to commence a power of sale foreclosure.

- Should either UCC Article 3 or 9 or both be amended to specify what must be presented to enforce a mortgage when a negotiable note or the transaction is within the scope of Article 9?

4. Applicability of indirect holding system rules in UCC Article 8, Part 5.

The Mortgage Electronic Registration System (MERS) provides a system whereby it is designated as the mortgagee of record in the recorded mortgage and tracks the beneficial ownership of the note and mortgage as it is assigned from the originating lender to subsequent lenders. This system has come under attack in the courts in a large number of cases focusing on the following issues:

- Is MERS entitled to foreclose in its own name on behalf of the beneficial owner of the note and mortgage?
- Is the paperwork sufficient to demonstrate the assignments from MERS as the named mortgagee in the recorded mortgage to the foreclosing lender?
- What is the extent of MERS agency authority to assign the mortgage and note to the foreclosing lender?

These issues raise the question as to whether there needs to be an indirect holding system structure for notes and mortgages in order to facilitate the modern commercial practice of note and mortgage assignment.¹²

UCC Article 8, Part 5 is arguably readily available for this purpose, but seems to not have been used in the structure of MERS.¹³ The following issues should be explored:

- Is development of an indirect holding system for notes and mortgages desirable?¹⁴
- Is UCC Article 8, Part 5 a viable structure for an indirect holding system for notes and mortgages and if not, are there amendments that are desirable to make it viable?

¹² This issue is also not limited to merely the real estate mortgage context but is broadly applicable to all markets in which there is a practice of serial assignments of payment obligations.

¹³ This could be a function of the timing of the founding of MERS and the widespread enactment of revised UCC Article 8.

¹⁴ The Canadian system has the Depository Bills and Notes Act for commercial debt obligations which apply to negotiable notes deposited with a central repository in order to track assignments of beneficial interests in those debt obligations. See Bradley Crawford, The Depository Bills and Notes Act: Negotiable Instruments for the Electronic Age, 14 Banking and Finance Law Review 205 (1998-99).