

## Leveraging UCC Art. 9 and 3, State Foreclosure Laws to Protect Enforceability of Mortgages and Promissory Notes

Overcoming Challenges of Securitization and MERS in Mortgage Foreclosure Proceedings

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THURSDAY, AUGUST 14, 2014

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Today's faculty features:

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O'MELVENY & MYERS LLP

***Leveraging Articles 3 and 9 of the Uniform Commercial Code  
To Protect Enforceability of Mortgages and Notes***

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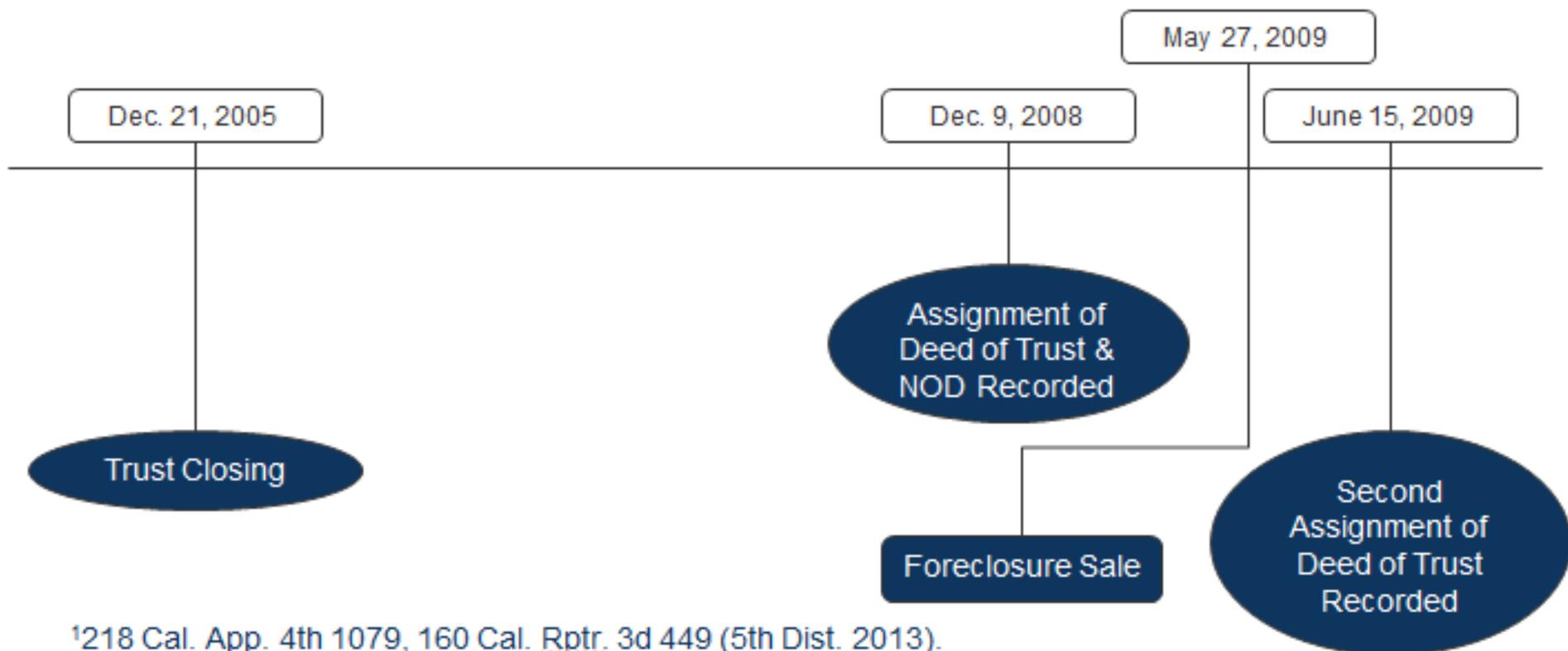
# Overview

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- I. Applicability Of U.C.C. Articles 3 And 9 To Mortgages And Promissory Notes
  
- II. U.C.C. Article 3 And Enforcement Of Promissory Notes
  
- III. Transfer Of Security Interests Under Article 9
  
- IV. Interplay Between U.C.C. Art. 3 & 9 and State Foreclosure Law

# Introduction: The Glaski Decision<sup>1</sup>

- Theory: foreclosing entity was not true owner of loan because recorded assignments postdated trust closing date:



<sup>1</sup>218 Cal. App. 4th 1079, 160 Cal. Rptr. 3d 449 (5th Dist. 2013).

## ***The Glaski Decision (Cont'd)***

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- “We conclude that Glaski’s factual allegations regarding postclosing date attempts to transfer his deed of trust into the WaMu Securitized Trust are sufficient to state a basis for concluding the attempted transfers were void. As a result, Glaski has [stated a] cognizable claim for wrongful foreclosure under the theory that the entity invoking the power of sale . . . was not the holder of the Glaski deed of trust.”  
218 Cal. App. 4th at 1097.
- What do Articles 3 and 9 of the U.C.C. have to say about this?

# Applicability of U.C.C. Art. 3 & 9 To Mortgages

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- Loan typically consists of promissory note and security instrument.
- If borrower breaches promise to pay, security instrument allows lender (or successors/assigns) to proceed against the real property.
- If mortgage note is a negotiable instrument, U.C.C. Art. 3 provides rules regarding enforcement.
- U.C.C. Art. 9 provides rules regarding effect of transfer of ownership of notes on ownership of mortgages securing those notes, including rights of transferees.

# U.C.C. Article 3 And Enforcement Of Notes

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- When is a party a “person entitled to enforce” the note?
- Special topics arising in connection with the enforcement provisions of Article 3, including:
  - Can a party still be “holder,” when the note is in the physical custody of a third party who is acting on behalf of the party seeking to enforce the note?
  - How can a nonholder in possession establish that a note was delivered to the party for the purpose of giving it the right to enforce the note?
  - What can be done to establish the right to enforce a lost note in jurisdictions that have not adopted the 2002 amendments to U.C.C. Section 3-309?

## Art. 3 And Enforcement Of Notes (Cont'd)

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- U.C.C. § 3-301. Person entitled to enforce instrument.

“Person entitled to enforce’ an instrument means (i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 or 3-418(d). 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.”

# Art. 3 And Enforcement Of Notes (Cont'd)

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- Holder:
  - 1) In possession of the note AND
  - 2) The note is payable to that person OR
  - 3) The note is payable to the bearer.

## Art. 3 And Enforcement Of Notes (Cont'd)

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- “Nonholder in possession of the [note] who has the rights of the holder.” *E.g.*:
  - One person is successor to or acquires another person’s rights.
  - Delivery of note to person in a manner that constitutes a “transfer” as defined under U.C.C. § 3-203 (*i.e.* when note is “delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument”).

## Art. 3 And Enforcement Of Notes (Cont'd)

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- Person not in possession of the note who is entitled to enforce the instrument pursuant to Section 3-309 or 3-418(d).
  - Only applies in cases where “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.” U.C.C. § 3-309(a)(3).
  - Person seeking to enforce the note must establish right to enforce the note and terms of the lost note → lost note affidavits.

## Art. 3 And Enforcement Of Notes (Cont'd)

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- Can a party still be a “holder,” or “nonholder in possession,” when the note is in the physical custody of a third party who is acting on behalf of the party seeking to enforce the note?
- **Yes:** “possession” may include possession by agent.
- Look to common law for guidance. *E.g.:*
  - “[C]onstructive possession exists when an authorized agent of the owner holds the note on behalf of the owner.” *MidFirst Bank v. C.W. Haynes & Co.*, 893 F. Supp. 1304, 1314 (D.S.C. 1994).
  - “[A] person is a holder of a negotiable instrument, and entitled to enforce the instrument, when the instrument is in the physical possession of his or her agent.” *U.S. Bank, N.A. v. Gray*, 2013-Ohio-3340, ¶ 25 (Ohio Ct. App. 2013).

## Art. 3 And Enforcement Of Notes (Cont'd)

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- How can a nonholder in possession establish that a note was delivered to the party for the purpose of giving it the right to enforce the note?
- Evidence to establish right to enforce note may include:
  - Asset purchase agreements or other deal documents with loan schedules.
  - Pooling and servicing agreements with loan schedules.

## Art. 3 And Enforcement Of Notes (Cont'd)

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- What can be done to establish the right to enforce a lost note in jurisdictions that have not adopted the 2002 amendments to U.C.C. Section 3-309?

# Art. 3 And Enforcement Of Notes (Cont'd)

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- Former version of U.C.C. Section 3-309:
  - (a) A person not in possession of an instrument is entitled to enforce the instrument if
    - (i) the person was in rightful possession of the instrument and entitled to enforce it when loss of possession occurred.
- 2002 revised version of U.C.C. Section 3-309:
  - (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 it 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.**

## Art. 3 And Enforcement Of Notes (Cont'd)

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- Lost Note Affidavit Strategies In States With Former Section 3-309:
  - Obtain affidavit or declaration from party that was in possession when note was lost and use in combination with evidence regarding acquisition of interest in note.
  - Become assignee of record for mortgage or deed of trust.
  - Foreclose in the name of the owner where permitted by law.

# Transfer Of Security Interests Under Article 9

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- What if a mortgage note is sold, but the parties do not take further steps to separately assign the mortgage that secures the payment of the note?

# Mortgage Transfers Under Article 9 (Cont'd)

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- U.C.C. Section 9-203(g):

“The attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also attachment of a security interest in the security interest, mortgage, or other lien.”

- Official Comment 9:

“Subsection (g) codifies the common-law rule that a transfer of an obligation secured by a security interest or other lien on personal or real property also transfers the security interest or lien.”

# Mortgage Transfers Under Art. 9 (Cont'd)

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

- Report of the Permanent Editorial Board for the Uniform Commercial Code: Application of the Uniform Commercial Code to Selected Issues Relating to Mortgage Notes, at 12 (Nov. 14, 2011).

# Mortgage Transfers Under Art. 9 (Cont'd)

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- Important implication: Party entitled to enforce note is “mortgagee” of mortgage or “beneficiary” of deed of trust.

# Mortgage Transfers Under Art. 9 (Cont'd)

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- **Florida:** “[T]o have standing, an owner or holder of a note, indorsed in blank, need only show that he possessed the note at the institution of a foreclosure suit; the mortgage necessarily and equitably follows the note.” *U.S. Bank, N.A. v. Knight*, 90 So. 3d 824, 826 (Fla. Ct. App. 2012).
- **New York:** “Either a written assignment of the underlying note or the physical delivery of the note prior to the commencement of the foreclosure action is sufficient to transfer the obligation, and the mortgage passes with the debt as an inseparable incident.” *U.S. Bank, N.A. v. Collymore*, 68 A.D. 3d 752, 754 (N.Y. Sup. Ct. 2009).
- **Texas:** “The ability to foreclose on a deed of trust is transferred when the note is transferred, not when an assignment of deed of trust is either prepared or recorded.” *Bittinger v. Wells Fargo Bank N.A.*, 744 F. Supp. 2d 619, 625 (S.D. Tex. 2010).

# Interplay With State Foreclosure Law

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- Will discuss examples of circumstances where:
  - State law requires foreclosing party to be mortgagee or beneficiary by recorded assignment of mortgage or deed of trust.
  - State law expressly expands or narrows the definition of mortgagee or beneficiary for purposes of taking certain foreclosure-specific actions.
  - Courts have stated, inaccurately, that the U.C.C. “does not apply” to foreclosures.

# Interplay With State Foreclosure Law (Cont'd)

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- Recorded assignments required before commencement or completion of foreclosure. *E.g.*:
  - “The power of sale may be exercised by the assignee if the assignment is duly acknowledged and recorded.” Cal. Civ. Code § 2932.5.<sup>1</sup>
  - “The title to any promissory note, other instrument, or debt secured by a mortgage . . . conclusively is presumed to be vested in the person holding the record title to the mortgage.” Md. Real Prop. Code Ann. § 7-103(a).
  - “If the party foreclosing a mortgage by advertisement is not the original mortgagee, a record chain of title must exist before the date of sale . . .” Mich. Comp. Laws 600.3204(3).
- **Absent recorded assignments of the deed of trust, foreclosures can still proceed judicially.**

<sup>1</sup>*But see Herrera v. Federal Nat'l Mortg. Ass'n*, 205 Cal. App. 1495, 1509-11, 141 Cal. Rptr. 3d 326, 337-38 (4th Dist. 2012).

# Interplay With State Foreclosure Law (Cont'd)

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- States sometimes statutorily expand or narrow the scope of parties that can be considered mortgagees for purposes of taking certain foreclosure-specific actions, e.g. Illinois:

## LOSS MITIGATION AFFIDAVIT

I, \_\_\_\_\_ [name] \_\_\_\_\_, hereby state as follows:

(1) I am employed as \_\_\_\_\_ [job title] \_\_\_\_\_ of \_\_\_\_\_ [name] \_\_\_\_\_, the mortgagee as defined in section 15-1208 of the Illinois Mortgage Foreclosure Law for the residential mortgage loan that is the subject of the pending foreclosure case, and I am authorized to act on behalf of plaintiff.

“Mortgagee’ means (i) the holder of an indebtedness or obligee of a non-monetary obligation secured by a mortgage or any person designated or authorized to act on behalf of such holder and (ii) any person claiming through a mortgagee as successor.”  
735 ILCS 5/15-1208.

➔ Servicer can execute and submit affidavit even if not the holder.

# Interplay With State Foreclosure Law (Cont'd)

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- *Ibanez*<sup>1</sup> and *Eaton*<sup>2</sup>
- Mass. Gen. Laws Ch. 244, § 35C(b) states that:

“A creditor shall not cause publication of notice of foreclosure, as required under section 14, when the creditor knows or should know that the mortgagee is neither the holder of the mortgage note nor the authorized agent of the note holder.”
- If the mortgagee is neither the holder of the note or an authorized agent, may have to consider judicial foreclosure.

<sup>1</sup>458 Mass. 637, 941 N.E. 2d 40 (2011)

<sup>2</sup>462 Mass. 569, 969 N.E. 2d 1118 (2012)

# Interplay With State Foreclosure Law (Cont'd)

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- Courts sometimes make inaccurate statements about the applicability of the U.C.C. to various standing-related challenges:

“Although Article 3 of the UCC governs negotiable instruments, it does not apply to nonjudicial foreclosure under deeds of trust.” *Debrunner v. Deutsche Bank Nat’l Trust Co.*, 204 Cal. App. 4th 433, 441, 138 Cal. Rptr. 830, 836 (6th Dist. 2012) (quoting *Padayachi v. IndyMac Bank*, 2010 WL 4367221, \*3 (N.D. Cal. Oct. 28, 2010)).

- Cases are helpful in rejecting “show me the note” theory but language creates confusion about whether foreclosing entity can rely on U.C.C. noteholder status to confer standing to foreclose non-judicially.

# *The Glaski Decision Revisited*

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- Assumed plaintiff's note and deed of trust were transferred to the Trust after closing date based only on the date assignments of the deed of trust were recorded.
  - The transfer of the note, however, effected a transfer of the deed of trust, and a recorded assignment was unnecessary. See Cal. Com. Code § 9203(g); NY U.C.C. § 9-203(g); Del. Code Ann. tit. 6, § 9-203(g).
- As a matter of law, defendants were not required to provide evidence of note transfer—it was plaintiff's burden to plead that no such transfer had occurred.

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# **Consumer Arguments Made in Foreclosure Litigation Regarding Chain of Note and Mortgage Ownership**

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August 14, 2014

# The Borrower Argument

- Many borrowers have alleged that the separation of the note from the security instrument (i.e., the mortgage) renders the mortgage unenforceable, and any foreclosure invalid.
- This argument has been described as the “cow’s tail” argument:
  - › “The note is the cow and the mortgage the tail. The cow can survive without a tail, but the tail cannot survive without the cow.” See *Hines v. Wells Fargo Bank, N.A.*, 2013 WL 5786473 (S.D. Tex. Oct. 28, 2013).
  - › See also Restatement (3d) Property § 5.4 (“A transfer of an obligation secured by a mortgage also transfers the mortgage unless the parties to the transfer agree otherwise.”).



# What is a Mortgage?

- A mortgage is a security instrument between the borrower and the lender.
- The mortgage grants the lender a security interest in your property that the lender has the right to sell if the borrower does not pay the debt.
- The mortgage is also a contract that defines the rights and obligations of the borrower and lender.
- The mortgage does not create the debt and does not constitute the promise to repay it.

# What is a Promissory Note?

- A promissory note, or note, is a negotiable instrument.
- The note constitutes the promise to repay the debt.
- Standing alone, the note does not itself secure the property.
- Only with the addition of the mortgage does the note constitute secured debt.

# Why Are Notes and Mortgages “Split”?

- Generally, mortgages and assignments of mortgages are recorded in the land records where the property is located. Notes, on the other hand, are subject to the Uniform Commercial code and are more freely transferable.
- Traditionally, notes and mortgages were held by the same entity. Transferring a note from one entity to another usually accompanied a corresponding assignment of mortgage, which took time and cost money to prepare.

# Why Are Notes and Mortgages “Split”? (cont’d)

- As a way to streamline the process, the Mortgage Electronic Registration Systems, Inc. (“MERS”) was created. MERS acts as the mortgagee of record, as “nominee” for the noteholder. Using MERS allows lenders to record the mortgage once in MERS’s name (at origination), enabling lenders (and their assignees) to transfer the note freely to other parties while MERS remains mortgagee of record.
- If a borrower became delinquent, MERS would then assign the mortgage once, to the noteholder or noteholder’s agent (such as a loan servicer) seeking to foreclose. It is this process that borrowers refer to as “splitting” the note from the mortgage, and is the foundation of many claims attacking the mortgage’s validity and the mortgagee’s standing to foreclose.

# View #1: Agency Theory

- ▶ **One common view is that the mortgage and note can be split, as long as the foreclosing entity is acting on the noteholder's behalf.**
- Massachusetts: *Culhane v. Aurora Loan Services of Nebraska*, 708 F.3d 282, 292 (1<sup>st</sup> Cir. 2013) (“[T]he note and the mortgage need not be held by the same entity. The two instruments exist on separate planes, and the transfer of the note does not automatically transfer the mortgage.”)
- Arizona: *Cervantes v. Countrywide Home Loans, Inc.*, 656 F.3d 1034, 1044 (9<sup>th</sup> Cir. 2011) (“[T]he notes and deeds are not irreparably split: the split only renders the mortgage unenforceable if MERS or the trustee, as nominal holders of the deeds, are not agents of the lenders.”).

# View #1: Agency Theory (cont'd)

- Texas: *Martins v. BAC Home Loans Servicing, LP*, 722 F.3d 249 (5<sup>th</sup> Cir. 2013) (“[W]here the foreclosing party is a mortgage servicer and the mortgage has been properly assigned . . . [t]he party to foreclose need not possess the note itself.”).
- Rhode Island: *Bucci v. Lehman Brothers Bank, FSB*, 68 A.3d 1069 (R.I. 2013) (“[N]o reason why MERS, as an agent of the owner of the note, cannot foreclose on behalf of that entity.”).
- Restatement: The commentary makes clear that if the note and mortgage are split but the mortgage holder has an agency relationship with the noteholder, the mortgage remains enforceable. Restatement (3d) Property § 5.4.

## View #2: “Curable” Split

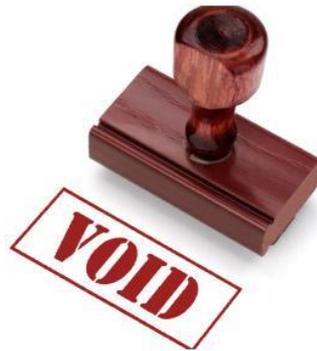
► A second view is that the foreclosing entity must hold both the note and mortgage, and that if the note and mortgage are split, they can be “reunited” to permit foreclosure:

- Nevada: *Edelstein v. Bank of New York Mellon*, 286 P.3d 249 (Nev. 2012) (Split “prevents enforcement of the deed of trust through foreclosure unless the two documents are ultimately held by the same party,” but MERS may assign its interest in deed of trust to noteholder).

# Nobody's View: Split Renders Mortgage Void

► Although a minority courts have required unity in order to foreclose, no borrowers have gained traction with argument that split renders mortgage void or unenforceable:

“No Court has held that ‘splitting’ a note from a deed destroys a debtor's underlying obligation to pay his mortgage.” *Cornelius v. Bank of America, N.A.*, 2012 WL 4468746 (N.D. Ga. Sept. 27, 2012).



# A Practical Perspective

- Despite the litigation and hand-wringing over “splitting” the note and mortgage, it is sometimes difficult to determine the harm to the consumer:
  - › No systemic problem of foreclosure on borrowers not in default.
  - › No evidence of strangers to the mortgage debt foreclosing.
  - › No evidence of borrowers being asked to pay twice or competing claims to the debt.

# Bottom Line: Know Your State's Foreclosure Law

- A split of the note and mortgage does not render the mortgage void or unenforceable.
- In many jurisdictions, the foreclosing entity need only hold the mortgage in order to foreclose.
- Where unity is required, most courts permit notes and mortgages that are split to be reunited prior to or contemporaneous with foreclosure.

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