Transfer of Mortgage Loans

Securitization of Mortgages

Mortgage Loan Assignments

• Primary asset transferred is mortgage note (which embodies borrower’s obligation to pay mortgage debt)
• If note is properly assigned, mortgage follows the note automatically — even if there’s no written “assignment” of the mortgage document! [Restatement §5.4(a)]
  • Rationale: a mortgage has no purpose or value, other than to secure the obligation to pay the debt
Transfer by the Mortgagee

- Transfer/assignment of a mortgage loan can occur in one of two ways:
  - 1) By outright sale of ownership (buyer of note takes all risks and benefits associated with collecting the note), or
  - 2) By “collateral” assignment or “assignment for security” purposes (lender receives a lien on the right to collect payments due on note, as security for another debt)

Securitization Process (Simple Model)

- Secondary Market Buyer
- Originator
- Borrower (x10,000+)
- Securitization Trust (SPV)
- Investors
- Trustee

Monthly P&I payments on Borrower’s mortgage (through Servicer)
Securitization Process (Simple Model)

- There are TWO key rights to keep in mind when a mortgage note is transferred, and it is important to distinguish them:
  - The first is **ownership** of the note (i.e., who owns the right to the money if the note is paid/colllected?)
  - The second is the **right to enforce** the note (i.e., who has the right to bring an action to collect the note and to foreclose if the note maker defaults?)

- These can (and often do) reside in same person, **but they do not have to**
Relevant Commercial Law

- UCC Article 3 governs right to enforce borrower’s obligation to pay a negotiable note
- Common law of contracts governs right to enforce borrower’s obligation to pay a non-negotiable note
- UCC Article 9 is relevant to the question of who owns a note (whether or not the note is negotiable), as Article 9 applies to “sales” of promissory notes [§ 9-109(a)(3)]

Problem 1

- June 1: Litton borrows $100K from Bowman, signing a note to repay on Dec. 1, with 5% interest
- Sept. 1: Bowman sells note to Uphoff for $90K cash
  - He gives Uphoff a photocopy of the note and signs a letter stating “I assign Uphoff all my rights” under the note
- Dec. 1: Uphoff presents the photocopy of the note to Litton and demands repayment. Can Uphoff legally do so?
Answer depends on whether the note is “negotiable”

A promissory note is “negotiable” [§ 3-104(a)] if:
- It is an unconditional promise or order to pay a fixed amount of money (principal), with or without interest
- It is payable “to bearer” or “to order” of specific person
- It is payable on demand or at a definite time, and
- It does not state any other undertaking to do any act in addition to the payment of money (other than an undertaking to provide or maintain collateral)

Most courts have concluded that the Fannie/Freddie Uniform Note is a “negotiable” instrument

Transfer of a Negotiable Note: Say Hello to PETE

If a note is negotiable, the right to enforce it can be transferred (whether by sale or by assignment for security purposes) ONLY as required by UCC Art. 3
- Usually occurs by “negotiation”: indorsement (i.e., payee signs back of note) and delivery of note to transferee
- Transferee thus becomes “holder” of note and the PETE (“Person Entitled to Enforce” the note) [UCC § 3-301]
• UCC Article 3 provides that the obligation of the maker of a note is owed to the Person Entitled to Enforce the note (or the PETE)

• UCC § 3-301 — the PETE is:
  • The holder (the original payee, or another person to whom the note was properly negotiated)
  • A nonholder in possession of the note with the rights of a holder (someone with possession of an unendorsed note)
  • In some cases, the owner of a “lost” note

• Problem 1: If the promissory note Litton signed was negotiable, Uphoff cannot enforce it
  • Uphoff is not the PETE (note was not endorsed to him, nor does he have physical possession of it)
  • If Bowman still has the original note, Bowman is the “holder” and thus the PETE — even though he has actually sold ownership of the note to Uphoff!
  • Having possession of a photocopy of the note ≠ possession of the note
Nonnegotiable Notes

• By contrast, if Litton’s note was NOT negotiable, transfer of the right to enforce it is governed by the common law of Contracts, not UCC Article 3
  • More flexible; transfer can occur by written agreement, w/out indorsement (such as by Bowman’s signed letter)
  • Thus, if note was nonnegotiable, Uphoff (as assignee) could enforce the note vs. Litton

Problem 2

• Suppose the note also said: “This note is secured by a Deed of Trust, of even date, the terms of which are hereby incorporated by reference as if fully set forth herein”

• Could Uphoff enforce the note, or not?
  • Yes; incorporating the Deed of Trust into the note by reference defeats its negotiability (because the Deed of Trust incorporates additional “undertakings”)

Problem 3: Payment/Discharge

• Litton borrows $100K from Bowman and signs a negotiable note, secured by mortgage on his home
  • Bowman later properly “negotiates” the note to Uphoff, but does not tell Litton
  • Litton later tenders $100K prepayment to Bowman (who then disappears with the money)

• Can Uphoff now collect the note from Litton, or can Litton argue it has been paid/discharged?

• Problem: Litton did not pay the PETE (Uphoff, the note’s “holder”)
  • Thus, Litton’s obligation to pay the note was not discharged by his payment to Bowman [UCC § 3-602(a)]

• Uphoff can thus collect the note from Litton (and foreclose the mortgage if note is unpaid)!
  • Is this the appropriate result?
• Revised Art. 3 reversed the “payment rule” [p. 569]
  • Under Revised UCC § 3-602(b), Litton’s payment to Bowman discharged the note, b/c it occurred before Uphoff notified him of the transfer (consistent w/Article 9 rule for collection of accounts receivable)
• Only ≈ 25% of states have adopted Rev. Art. 3; MO still has old Art. 3 (payment to someone other than PETE does not discharge the obligation)
• What should Litton have done differently?

• In a state that follows the payment rule, before Litton makes payment, he must make sure that he is paying the PETE, i.e., he should ask Bowman
  • For proof that Bowman holds the note (and is thus the PETE), or
  • For proof that Bowman is the authorized agent of the PETE (i.e., authorized to collect the note on behalf of the PETE, such as a servicer)
• People don’t often ask for this proof, however
Payment Rule: Nonnegotiable Notes

• Also applied to nonnegotiable notes
• But, it is rejected by Restatement of Mortgages [§ 5.5, p. 570], which takes the same position as Rev. Article 3
  • Under that approach, if the note is nonnegotiable, Litton’s payment to Bowman before receiving notice of the transfer to Uphoff would discharge Litton’s debt

Problem 4: Defenses

• May 1: Litton borrows $150K from Bank and grants Bank a mortgage on his home
  • Bank sells note to Fannie Mae, but continues to “service” it pursuant to a servicing agreement with Fannie Mae
• When Litton receives his payment coupon book, the amount of payments is suspiciously high
Problem 4 (Continued)

• Litton looks at the loan documents he signed, and learns that the note he signed bears a 15% interest rate (for a $1,786 P&I payment)
  • But, Litton had a written commitment from Bank for a 5% interest rate (a $913 monthly payment)!
• Can Litton successfully assert this defense against Fannie Mae?

If Note Is Nonnegotiable ...

• If the note is non-negotiable, enforcement governed by the common law of contracts (not UCC Article 3)
  • Under contract law, assignee takes subject to all defenses of the counterparty to the contract (i.e., derivative rights)
  • Thus, Fannie Mae’s ability to collect the note from Litton would be subject to Litton’s valid defenses
If Note Is Negotiable ...

• If the note is “negotiable,” Article 3 applies, including its “holder in due course” (HIDC) rule

• HIDC takes note free of maker’s personal defenses (e.g., failure of consideration) [UCC § 3-305(b)]
  • Thus, if Fannie Mae is a HIDC, it can collect the note from Litton, even though Litton would have had a valid partial defense against Bank!

Holder in Due Course [§ 3-302]

• To be HIDC of negotiable note, assignee must:
  • Be a “holder” (i.e., indorsement + delivery)
  • Pay value to acquire the note
  • Take the note in “good faith,” and
  • Take it “without notice” that it is/has been (a) overdue or dishonored, (b) forged or altered, (c) subject to claim of another party, or (d) subject to defenses
“Real” and “Personal” Defenses

• Real defenses (even HIDC takes subject to them)
  • Infancy/incapacity
  • Duress
  • Forgery
  • Fraud in the factum
  • Bankruptcy discharge

• Personal defenses (HIDC takes free of them)
  • Any general contract defense (breach of warranty, failure of consideration)
  • Fraud in the inducement

• Should the holder in due course (HIDC) rule apply in the modern mortgage market?
• Does applying the HIDC rule in this context create the appropriate incentives for those involved in the process of making and securitizing mortgage loans?
Rationale for Keeping HIDC Rule?

• Promotes commerce by facilitating the availability of business credit on more favorable terms

• Policy argument: “Investors would be less likely to buy notes (or lenders would be less likely to lend using notes as collateral) if the notes were subject to the maker’s defenses or third party claims. Investors or lenders would demand higher returns. Mortgage rates would go up.”

Critique of HIDC Rule

• Encourages bad underwriting practices

• A lender holding loans in its own portfolio has a strong incentive to maintain rigorous underwriting standards

• “Loan-to-sell” lenders may not be as scrupulous, because risk of loan default is being shifted to note buyers!

• HIDC rule diminishes incentive for note buyers to vet loan originators from whom they purchase mortgage loans
• Note: HIDC doctrine has been pretty much abolished in all other consumer credit contexts (through introductions of the Uniform Consumer Credit Code, the FTC rule, or state “lemon laws”)
  • This was based on substantial abuses/frauds in the making/transfer of consumer auto/appliance loans [pages 559-562]
• Home mortgages is only major form of consumer financing in which HIDC rule still survives

• UCCC § 3.404(1): “With respect to a consumer credit sale or consumer lease, an assignee … is subject to all claims and defenses of the consumer against the seller or lessor arising from the sale or lease of property or services, notwithstanding that the assignee is a holder in due course of a negotiable instrument ….”
  • E.g., assignee of retail installment sale contract for sale of a car would take subject to buyer’s warranty defenses
• FTC Rule requires that any consumer credit contract for $25,000 or less must say: “NOTICE. ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED WITH THE PROCEEDS HEREOF.”
  • Legend (if included in contract) prevents transferee from qualifying as HIDC
  • Not including the legend is an “unfair trade practice” (fines)

Mortgage Assignments

• When a mortgage loan is transferred, the mortgage “follows the note” automatically [note 1, p. 533]
• Thus, in Problem 4, if Bank properly transferred the note to Fannie Mae (and Fannie Mae became PETE), Fannie Mae can enforce the mortgage, even if Bank:
  • Doesn’t make a written assignment of the mortgage, or
  • Doesn’t record any written assignment of the mortgage
Still, Note Buyer Wants a Written Assignment of Mortgage Because ....

1. If foreclosure is required, note buyer will want to record evidence of mortgage assignment (to establish a proper “chain of title” to the land), and
2. Without recording an assignment of the mortgage, the note buyer becomes subject to the risk of wrongful or negligent release by record mortgagee.

Example: In Problem 4, Bank sells Litton’s loan to Investor (no assignment of mortgage is recorded).

Two months later, Bank mistakenly records a release of the mortgage after getting loan numbers mixed up.

Litton then sells the home to Bailey, who thinks (based on the Bank’s release) that Litton has clear title.

Bailey would take title to land free of the mortgage.

- As record mortgagee, Bank has apparent power (but not the legal right) to record a release; Bank’s release is **voidable, not void** [note 5, p. 574].
- Bailey, as BFP, would take the land free of the apparently released mortgage under the recording act.
• Given the risk, why wouldn’t a note buyer like Fannie Mae record an assignment of every mortgage?
  • Cost of recording a mortgage assignment ≈ $25-50
  • If Fannie Mae is pooling 20,000 mortgages into an RMBS pool, the cost of recording assignments for mortgages in that pool = $500K-$1MM per assignment!
  • Thus, note buyers like Fannie Mae often have the originating mortgagee execute a written assignment of the mortgage, but only record it if borrower later defaults and it becomes necessary to foreclose

MERS

• Mortgage Electronic Registration System (MERS) was created by the mortgage industry to deal with “record” title to the mortgage
  • Buyers/sellers of mortgage loans on secondary market become members of MERS
  • Members register their loans with MERS, which keeps track of who owns the loan as the loan is transferred through the securitization process
• Problem 4: when Bank (a MERS member) makes a mortgage loan to Litton, the mortgage doesn’t name Bank as the mortgagee; instead, it names MERS as the mortgagee of record
  • But, MERS is just a “nominee” (agent) for note owner (Bank)
• When Bank sells the loan to Fannie Mae (also a MERS member), MERS tracks the transfer of the note, but no assignment of the mortgage is needed
  • MERS remains the mortgagee of record, but now as the nominee/agent for Fannie Mae, not Bank
Attacks on MERS [p. 528]

• There have been numerous judicial attacks on MERS
  • 1) Borrowers have argued: “Having MERS as mortgagee results in separation of note and mortgage, rendering the mortgage invalid”
  • 2) Recorders have argued: “MERS is an illegal scheme to avoid paying recording fees”
  • 3) Borrowers have argued: “MERS cannot legally foreclose the mortgage b/c it doesn’t own the note”

• As the text suggests (p. 529), nearly all of the litigation attacks on MERS have failed
  • Use of MERS does not “separate” the note and the mortgage
    • MERS member (e.g., Bank, Fannie) that holds the note has right to enforce note and mortgage; MERS functions as their agent for holding title to the mortgage
  • Use of MERS does not illegally avoid recording fees, b/c no one has any legal obligation to record a deed or mortgage
MERS and Foreclosures

- MERS itself has relatively few employees
  - To facilitate MERS’s operations, certain employees of MERS members (e.g., an originating lender) are also appointed as “officers” of MERS
  - Thus, if a member Bank needed to assign a mortgage following sale of a note, it’s a Bank employee that executes the assignment, but he/she does so as an officer of MERS

Foreclosures and MERS

- In early 2010s, many lenders exploited this structure to bring foreclosure proceedings in the name of MERS
  - E.g., Suppose Wells Fargo was the holder of the note
  - Rather than have MERS assign the mortgage back to Wells Fargo, and bring foreclosure action in its own name, Wells Fargo would use its authority as a MERS member to file the foreclosure action in MERS’s name
• This became highly controversial
  • MERS didn’t really hold the note, so why should it be allowed to foreclose the mortgage?
  • Even if it is technically defensible (if the note holder is a member of MERS) as an agency matter, it enabled note holders to conduct foreclosures without taking the PR hit (e.g., “MERS is taking my house” not “Wells Fargo is taking my house”)
  • When borrowers would contact MERS for information about the foreclosure or a loan modification, MERS would respond, “don’t ask us, ask your lender”

MERS and Foreclosures
• Because of criticisms and some successful judicial challenges in several judicial foreclosure states, MERS’s rules no longer allow MERS members to conduct foreclosures in the name of MERS
  • Now, when foreclosure is necessary, MERS will execute and record an assignment of the mortgage to the then-current holder of the note
  • That holder then must start a foreclosure in its own name
Foreclosure of Securitized Mortgages

• In a judicial foreclosure proceeding, foreclosing lender (or its servicing agent) must show that it had possession of the note, properly indorsed, at the time that it commenced the foreclosure action
  • This has been a big problem (belated indorsements and backdating, due to poor tracking of notes)
• If lender/servicer fails to make this showing, courts will dismiss the foreclosure action (without prejudice)

• In nonjudicial foreclosure states, foreclosure by a mortgagee of record, but who is not the PETE, may create a question about the validity of the sale
  • Courts in some states have held that a nonjudicial foreclosure sale by the record mortgagee is valid — even if the foreclosing party isn’t the PETE — b/c the foreclosure statute doesn’t require proof that foreclosing creditor is the PETE [note 9, p. 564]
  • That’s poor reasoning (as the mortgage follows the note)
  • Courts in other states have correctly set aside sales conducted by a creditor who was not the PETE [*Eaton v. Fannie Mae*, 969 N.E.2d 1118 (Mass. 2012)]