GEORGETOWN UNIVERSITY LAW CENTER

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To the Permanent Editorial Board:

I am an Associate Professor of Law at Georgetown University Law Center, in Washington, D.C., where I teach courses in secured credit (UCC Article 9 and real property security), payment systems (including UCC Article 3), structured finance, consumer finance, and contracts. I have testified repeatedly before Congress regarding chain of title issues in mortgage foreclosures and closely follow the commercial law issues involved in mortgage foreclosures.

I am writing to express serious concerns about the draft Report on Ownership and Enforcement of Notes Secured by a Mortgage authored by Permanent Editorial Board (PEB) for the Uniform Commercial Code. It is my understanding that the PEB will seek public comment on the draft report in January 2011. I strongly urge the PEB not to issue the draft report for public comment because its premises are so flawed.

I am concerned by the draft report for four reasons, each of which is addressed below in more detail. First, the report addresses issues that go beyond the scope of the UCC. Second, it weighs in on controversial issues that are the focus on numerous on-going litigations, which is an inappropriate action for the PEB. Third, the report relies heavily on UCC section 9-203(g), a provision that has deep conceptual problems and is in conflict with non-UCC law. And fourth, as the controversies involving mortgage notes do not involve divergent interpretations of the UCC, but rather questions about the requirements of non-UCC law, there is no need for the PEB report to clarify the UCC. At best, the draft report addresses unnecessary issues and at worst, it could have the effect of interfering in on-going litigation, and create an impression of certainty of results that will in fact vary widely under state law.

1. The PEB Report Addresses Topics Beyond the Scope of the UCC

The proposed report goes far beyond UCC issues and thus beyond the proper authority of the PEB. Instead, the report describes, relies upon, and could affect issues of real property law such as statute of frauds requirements, mortgage priority, effect of recording (such as the permissibly of recording in the name of a nominee), and mortgage enforceability. In particular, there are arguably conflicts between the provisions of UCC Article 9 regarding the transfer of mortgages related to promissory notes and other non-uniform provisions of state law. The UCC purports to provide a method for transferring mortgages when promissory notes are transferred, but many states have specific provisions governing the transfer of mortgages, and there is no reason to believe that the

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UCC supersedes long-standing non-UCC real property law. In particular, in "title theory" states, a mortgage is considered the ownership of real property (cf. the technical sale and repurchase operation of a deed of trust), which means that the transfer of the mortgage must comply with the requirements for transferring realty. These provisions are sometimes more extensive than those contemplated by section 9-203(g). The reconciliation of these provisions is an issue best left for courts and state legislatures, not for the PEB.

The PEB report claims not to opine on non-UCC issues,[1] yet it repeatedly does so. For example, it states that "the transferee need not take possession of the note or file an assignment of the mortgage in the real property records in order for the transferee to have an interest in the note and mortgage enforceable as against the transferor." Such a sentence might be an accurate statement of the law *if the law governing real property transfers consisted only of the UCC*, but there is of course law beyond the UCC. The failure to account for the nonuniform interaction of the UCC with non-UCC law makes statements like this misleading as to the actual state of mortgage enforceability.

Indeed, this particular issue—about what is necessary to render a mortgage enforceable—is particularly problematic, because it directly conflicts with the Official Commentary to the UCC, which is clear that the UCC takes no position on whether a mortgage is enforceable.[2] UCC section 9-308 Official Comment 6 states that:

> Under this Article, attachment and perfection of a security interest in a secured right to payment do not themselves affect the obligation to pay. For example, if the obligation is evidenced by a negotiable note, then Article 3 dictates the person whom the maker must pay to discharge the note and any lien securing it….Similarly, this Article does not determine who has the power to release a mortgage of record. That issue is determined by real-property law.

As the Official Comment makes clear, Article 9 says nothing about enforceability of a note against the maker; that is left to Article 3. Article 9 is similarly silent on the question of mortgage enforceability. The Official Comment does not even refer to Article 3 because Article 3 does not address mortgage enforceability, only the enforceability of negotiable notes. One cannot conclude from silence that Article 9's provisions about the transfer of a mortgage also control the mortgage's enforceability. Moreover, the Official Comment's statement that Article 9 does not determine the power to release a mortgage is strong evidence that Article 9 does not govern mortgage enforceability because the two issues are inseparably connected. To read mortgage enforceability into the UCC as the PEB draft report does is to unleash the UCC from its textual moorings.

2. A PEB Report Is Not the Appropriate Vehicle for Addressing Controversial and Not-Yet-Settled Issues Such as Concerns About Mortgage Note Title Transfers

The PEB draft report attempts to resolve controversial policy issues that are best left to specific state or federal consultation with experts working on current mortgage issues, followed by a true state or federal drafting process, rather than to a report. The PEB's charter notes that "that Annotations or Comments which suggest a substantial departure from an accepted interpretation of the Code shall first also be approved by the Executive Committees of the Conference and the Institute and if those bodies direct shall be circulated for suggestions by interested groups prior to their becoming final." [3] This strongly suggests that the PEB is not to adopt controversial positions on its own.

The PEB draft report "suggest[s] a substantial departure for an accepted interpretation of the Code" both in terms of the interpretation of UCC section 9-203, discussed below under number 3. If

[1] *E.g.*, PEB at 2 ("This Report does not address issues that are the particular province of real property law.").

[2] UCC section 9-607(b) does not alter this conclusion. First, the provision only addresses nonjudicial enforcement of mortgages, making it facially inapplicable to judicial foreclosure proceedings. Second, it merely permits a filing in the furtherance of enforcement; it does not in and of itself create any rights to enforcement. *See* UCC § 9-607 Official Comment 8 (noting "Subsection (b) would not entitle the secured party to proceed with a foreclosure unless the mortgagor also were in default or the debtor (mortgagee) otherwise enjoyed the right to foreclose.").

[3] *See* PEB Charter *at* http://www.ali.org/doc/03-PEB%20for%20UCC%2003.pdf at B.5.b.

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the PEB's draft report were issued in final and followed by courts, it would effectively result in changes to the UCC and non-UCC law in terms of what is required in terms of mortgage enforceability.

Moreover, the PEB draft report goes to the heart of a hotly contested issues related to residential mortgage foreclosures, in particular the effect of a recording of a mortgage by the Mortgage Electronic Registration System (MERS) and chain of title and transfer problems in private-label residential mortgage securitizations. A PEB report is not an appropriate vehicle for resolving the serious legal issues posed by MERS or chain of title problems in private-label residential mortgage securitizations. Unfortunately, the PEB's draft report appears to be an attempt, if not to resolve these issues, than at least to put a finger on the scale in favor of large financial institutions and against financially-distressed homeowners, MBS investors, and insurers when these issues are decided in courts. Attempting a *sub rosa* resolution of such controversial issues of law through a PEB report would seriously undermine the perceived independence and credibility of the PEB and damage the reputation of the American Law Institute and the National Conference of Commissioners on Uniform State Law.

Accordingly, I would suggest that the PEB report is the wrong channel through which to advance these views. While I believe that these are issues are beyond the purview of the UCC, if the PEB believes that they should be addressed through the UCC, the PEB should put them forward as recommendations to the Executive Committees of the Conference.

3. The PEB Draft Report Is Based on a Reliance on Dubious Legal Principles

Much of the analysis in the PEB's draft report is based on the application of principles of agency law and real property law to the UCC. The PEB's draft report invokes these principles by reference to the Restatements of the Law on Agency and Property. The Restatements, however, are not law and are widely recognized as having strong normative components. Yet the PEB draft report reaches conclusions about the proper interpretation of the UCC based on agency and real property principles that are not actually the law in many states. If those states' actual law on agency or real property were to be applied, the interpretation of the UCC might well be different.

Nowhere is this clearer than in the PEB's draft report's insistence on repeating the mantra that "the mortgage follows the note." This principle underlies Parts 1 and 4 of the PEB draft report. While the "mortgage follows the note" principle is endorsed by the Restatement (Third) on Property and by UCC section 9-203 Official Comment 9,[4] it is highly problematic and evinces little consideration of the numerous situations in which a mortgage cannot (or should not) follow a note.

Section 9-203(g) codifies a legal position that is demonstrably at odds with other principles of law. It is also drafted in such a uniquely opaque and abstruse manner. In light of the conflicts section 9-203(g) raises with other long-standing provisions of state law, it is difficult to believe that state legislatures knowingly adopted the provision with the interpretation advanced by the PEB draft report.

Section 9-203(g) provides that 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."[5] When read with the definitions of "security interest," "secured party" and "debtor,"[6] it becomes clear that the attachment of a security interest is meant to include the sale of a promissory note. Thus, the sale of a promissory note (a right to payment) secured by a security interest in real property (a mortgage) is also the sale of the mortgage.[7]

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[4] UCC § 9-203, Official Comment 9 (stating that UCC § 9-203(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.").

[5] UCC § 9-203(g).

[6] U.C.C. § 1-201(b)(35) (defintiion of "security interest); UCC § 9-102(a)(28)(B) (definition of "debtor"); § 9-102(a)(72)(D) (definition of "secured party").

[7] The drafting of the provision leaves something to be desired, as "attachment" is defined as enforceability, not sale. For the security interest itself—that is the interest of the buyer in the promissory note—attachment is sufficient to effectuate a sale, but it is not

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Conceptually, there are several significant problems with this provision. First, it is questionable whether section 9-203(g) has any effect if the security instrument is a deed of trust. The technical operation of a deed of trust is not a security interest, but a transfer of the deed to the property in trust for the benefit of the obligee on the associated note. The deed of trust operates as a sale and repurchase, rather than a lien. Interpreted strictly, then, a deed of trust should not qualify as a "security interest or other lien on personal or real property," so it would not fall within the ambit of section 9-203(g). Accordingly, reading section 9-203(g) to mean that a mortgage always follows a note would result in non-uniform state law because of the prevalence or even exclusive use of deeds of trust in some states.

Even if section 9-203(g) does apply to deeds of trusts, it would mean that the mortgage follows the note principle is not absolute. If the trust deed is seen as a security interest, not a sale and repurchase, then the trust deed is necessarily separated from the note. The deed of trust trustee holds the security interest and the obligee has the note. The question of who may claim the status of trust beneficiary is determined by reference to trust and real property law, not to the Uniform Commercial Code, and under such law it might be possible for the beneficial interest in the trust deed to be sold without the note being sold, for example.

Moreover, in title theory states, a mortgage or deed of trust is considered the actual ownership of real property (cf. the sale/repurchase interpretation of a deed of trust). These states have specific requirements for the transfer of real property interests, which would presumably apply to mortgages. By claiming that the transfer of a note effectuates the transfer of a mortgage in a title theory state, the UCC reaches beyond its proper ambit of commercial law and attempts to supersede state real property law.

There are further problems with the mortgage follows the note principal and section 9-203(g). While a thief of a bearer note is a person entitled to enforce the note by virtue of being a holder, UCC section 3-301, it surely cannot follow that the thief of a note (but not of the mortgage) also becomes the mortgagee under the "mortgage follows the note" principle, much less is able to enforce the mortgage given that mortgage foreclosure is an equitable action and a thief lacks clean hands. Likewise, a mortgage can be given to a guarantor of a note, rather than to the obligee. In such a situation, the obligee could sell the note, but that should not deprive the guarantor of the mortgage.

Finally, the case law pedigree of the "mortgage follows the note" principle is less than spotless. Often the phrase is used in a cavalier fashion in dicta and is not the real issue in the case, and indeed, there are cases that provide for the opposite principle: "the note follows the mortgage."[8] In addition, general principles of free alienability of property suggest that a note and a mortgage may in fact be decoupled. Given the absence of a compelling policy reason why a mortgage should necessarily follow a note and the transactional ease by which parties can ensure this result if they so desire, there is no reason for the PEB to so strongly indorse a "mortgage follows the note" principle that extends the UCC beyond its proper scope in governing the transfer of personalty interest into the realm of realty.

The conceptual problems with section 9-203(g) are particularly concerning given the uniquely opaque (and arguably disingenuous) drafting of section 9-203. It is the most strangely drafted provision I have encountered in the UCC or in any legal code; it is so counterintuitive that it takes me a full half hour to teach the basic workings of the provision in my structured finance and inevitably leads to repeated questions from 2Ls, 3Ls, and LLMs of "why on earth would anyone ever draft a provision this way?" The only answer I can provide is that the drafting might be intentionally obscure. I am concerned that state legislatures simply did not understand what it was they were adopting when they enacted section 9-203(g).

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clear what attachment would mean about a lien on personal or real property, as the definition of such a lien does not include the interest of a buyer of the lien.

[8] *See, e.g.*, Dickey v. Pocomoke City Nat. Bank, 89 Md. 280 (1899) ("That statute made a complete change of the law on the subject in this state. Prior to its passage, the mortgage followed the debt secured by it, and became the property of the owner of the latter; but since then the debt, after maturity, follows the mortgage, and is conclusively presumed to belong to the person holding the record title to the mortgage.").

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To recognize that section 9-203(g) provides that the sale of a note effectuates the sale of an associated mortgage, one must first understand that a "secured party" means a buyer of a promissory note, and that a "debtor" means the seller of a promissory note.[9] All of these are completely non-intuitive definitions, but at least they are contained in UCC Article 9. To understand that section 9-203(g) effectuates the *sale* of a mortgage, not merely a security interest in a mortgage, one must also recognize that the UCC Article 1 definition of "security interest" includes a the interest of a buyer of a promissory note.[10] This is an even less intuitive definition, as a sale is often inherently different from a lien.

Even if one understands all of these unusual definitions, the language of section 9-203 still does little to make clear that it effectuates a sale, rather than a security interest. Instead, it refers to the "attachment," meaning the enforceability of a "security interest" between a "debtor" and a "secured party." To this drafting, one must then add subsection (g), which provides that a security interest in a promissory note (meaning a sale of promissory note) includes a security interest (again meaning the sale) of an affiliated security interest. Subsection (g) never uses the term "mortgage." Section 9-203(g) is just about the least straightforward way the law could state that the sale of a promissory note is effectuates a sale of an associated security interest.[11]

Section 9-203(g) is so opaquely drafted that it is not even cited by litigants when it would support their position; the drafting is so obscure that litigants are simply not aware of its existence. A search through state codes for provisions on mortgage transfers or sales would not yield any reference to section 9-203. I am not aware of *any* occasion in which a lender's attorney has cited section 9-203(g) in a foreclosure case, even when it would be extremely helpful to the lender's position. Indeed, even in the most high-profile foreclosure litigation yet, *U.S. Bank National Association, as Trustee for the Structured Asset Securities Corporation Mortgage Pass Through Certificates Series 2006-Z v. Ibanez*, No. 10694 (Mass. 2010) which was argued before the Supreme Judicial Court in Massachusetts this fall, first-rate financial services attorneys from K&L Gates LLP failed to cite to section 9-203(g), which would have significantly strengthened their case.

If highly motivated litigants are not aware of the effect of section 9-203(g), it is hard to believe that state legislatures possibly understood the provision when they adopted Article 9 of the UCC. While states have adopted section 9-203(g), I would urge the PEB not to base its report on an expansive reading of this deeply problematic provision.

4. A PEB Report Is Not Necessary as the Controversies Involving Mortgage Notes Are Not UCC Issues

Finally, it is not apparent to me why a PEB report is even necessary. The chain of title concerns involving mortgage securitization do not revolve around conflicting interpretations of either Article 3 or Article 9 the UCC. Issues involving MERS relate to the interaction between the UCC and non-UCC law. Arguments about the problems caused by MERS transfers are not arguments about how to interpret the UCC. Instead, they are arguments about whether there are additional legal requirements beyond the UCC's for the transfer of mortgages. Likewise, arguments about securitization chain of title are not about the interpretation of the UCC. Instead, they turn on whether the UCC even applies to transfers in mortgage securitizations or whether securitization trust documents represent variations by agreement from the UCC.[12] Neither of these issues is properly within the bailiwick of the PEB. At most, there might be confusion over the interpretation of UCC section 3-309 regarding lost notes, but the real issue there is that many states have chosen (with good reason) not to adopt the 2001 revision of that provision, not problems in how to interpreted revised section 3-309.

[9] UCC § 9-102(a)(28)(B) (definition of "debtor"); § 9-102(a)(72)(D) (definition of "secured party").

[10] U.C.C. § 1-201(b)(35).

[11] I am aware that § 9-203 was designed so that the very same transaction could qualify as the granting of security interest if circumstances indicated that the transaction were not a true sale, and that this was done to facilitate asset securitization.

[12] *See* UCC § 1-302(a) (permitting variation by agreement); § 1-201(b)(3) (defining agreement); § 1-103 (noting that the principles of law and equity supplement the UCC).

For these reasons, I strongly urge the PEB not to issue its draft report. I am happy to discuss these concerns with the PEB at its convenience.

Yours,

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