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**Rebalancing Public and Private in the Law  
Of Mortgage Transfer**

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## REBALANCING PUBLIC AND PRIVATE IN THE LAW OF MORTGAGE TRANSFER

*John Patrick Hunt,<sup>\*</sup> Richard Stanton,<sup>†</sup> and Nancy Wallace<sup>‡</sup>*

### Abstract

*The law governing the United States' \$13 trillion mortgage market is broken. Courts and legislatures around the country continue to struggle with the fallout from the effort to build a 21st century global market in mortgages on a fragmented, arguably archaic legal foundation. These authorities' struggles stem in large part from the lack of clarity about the legal requirements for mortgage transfer, the key process for contemporary mortgage finance.*

*We demonstrate two respects in which American mortgage transfer law is unclear and offer suggestions for fixing it. Revisions to the Uniform Commercial Code adopted around the turn of the century may be interpreted as doing away with preexisting laws arguably requiring parties to record their ownership interests to protect them. But the interaction of these revisions and preexisting state recording laws is most unclear.*

*Moreover, it is not clear just what parties have to do to invoke the provisions in question: the rules require that the mortgages be transferred "in return for any consideration sufficient to support a simple contract," but that concept is notoriously malleable. In fact, our study indicates that in many transactions the requirement may not have been met because the parties used only nominal or other questionable consideration. At least in some states, the use of questionable consideration in existing transactions makes foreclosure more difficult and makes mortgage investments less secure. Consequently, the use of nominal consideration seems to strengthen mortgage investors' claims that transactions were not executed properly.*

*We suggest an approach to law reform that would provide needed clarity and bring about an appropriate balance between private and public. The Article 9 revisions reflect a*

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*preoccupation, prevalent in the 1990s, with reducing the cost of mortgage transfers to the transacting parties. Obviating public recording, as the Article 9 revisions purport to do, does reduce cost, but it also tends to eliminate public records of mortgage ownership. As we show, these public records have value not just for parties that may transact in mortgages, but for the public more generally. A more balanced approach would clearly require transacting parties to record their interests in order to protect them, but would adopt this change in tandem with an expansion of low-cost digital recording. This approach provides the public benefits of high-quality mortgage records while reducing the cost and inconvenience of recording to transacting parties.*

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## I. INTRODUCTION

Although the U.S. mortgage market is about 80% of the size of the U.S. stock market,<sup>1</sup> the mortgage market does not get anywhere near 80% of the stock market's attention from the legal academy. This would be understandable if mortgage law were clear and well-settled, and if the mortgage market functioned smoothly and well. But recent events have shown the opposite to be true. Failed mortgages lay at the heart of the financial crisis,<sup>2</sup> and the legal system spends an inordinate amount of time and energy piecing through the fallout.<sup>3</sup> Mortgage law is overdue for increased scrutiny, in line with its importance to the American economy and American lives. This Article seeks to contribute to a much-needed critical examination of mortgage law. It explains why a crucial piece of that law – the law of mortgage transfer – is currently broken, and offers suggestions for how to fix it.

Current law is intolerably vague and probably does not give enough weight to the value of public title records. Under current law, in most states it is not clear whether a mortgage buyer must record its interest to ensure that its ownership interest in the loan is protected from subsequent claimants. It is also unclear in many states whether the mortgage buyer must record its interest to ensure that it can foreclose on the mortgaged property in case of default. Our empirical study of subprime mortgage securitization highlights the need for reform, as it suggests

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<sup>1</sup> See S&P DOW JONES, *Dow Jones U.S. Total Stock Market Index Fact Sheet*, Jan. 31, 2013 at 1 (reporting float-adjusted market capitalization of U.S. stock market at \$16.5 trillion); Board of Governors of the Federal Reserve System, *Mortgage Debt Outstanding*, Dec. 2012 (reporting third-quarter 2012 mortgage debt outstanding of \$13.1 trillion).

<sup>2</sup> Such was the conclusion of both the majority and dissenting members of the Financial Crisis Inquiry Commission. See FINANCIAL CRISIS INQUIRY COMMISSION, *FINANCIAL CRISIS INQUIRY REPORT* xxiii (2011) (“We conclude collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis.”); *id.* at 417-18 (statement of dissenting commissioners) (“A credit bubble formed in the United States and Europe, the most notable manifestation of which was increased investment in high-risk mortgages.”).

<sup>3</sup> A search in Westlaw's ALLCASES on the term (mortgage “deed of trust”) /s foreclose! returns 5,111 results for 2012, as compared with 1,565 for 2006, the first year before the mortgage crisis.

that many already-executed transactions may be vulnerable under existing law. The law of mortgage transfer in the United States should be clarified and modernized to restore an appropriate balance between the values of public mortgage records on the one hand and convenience and economy on the other.

The uncertainty in the law exists even though certain provisions of Article 9 of the Uniform Commercial Code drafted in the 1990s and adopted in the fifty states in 1999-2001<sup>4</sup> apparently purport to speak directly to the problem of mortgage transfer and provide that buyers' interests are protected even if transfers are not recorded when the mortgage loan is sold.<sup>5</sup> The Permanent Editorial Board for the Uniform Commercial Code<sup>6</sup> recently affirmed the importance of these Article 9 rules, stating in a recent,<sup>7</sup> influential<sup>8</sup> report that they “determine matters that are important in the context of enforcement of mortgage notes and the mortgages that secure

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<sup>4</sup> We call these amendments the “1998 revisions” because they were approved by the memberships of the American Law Institute and the Uniform Law Commissioners in that year. They were adopted in all states by the end of 2001. JULIAN B. McDONNELL & JAMES CHARLES SMITH, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE §1A.01 (2012); David Frisch, *The Recent Amendments to UCC Article 9: Problems and Solutions*, 45 U. RICHMOND L. REV. 1009, 1009-10 n.3 (2011) (revised Article 9 went into effect in 45 states and the District of Columbia by July 1, 2001 and in all 50 states by January 1, 2002); Julian B. McDonnell, *Is Revised Article 9 a Little Greedy?*, 104 COM. L.J. 241 (1999) (at least six states had adopted amendments in 1999). Article 3 of the Uniform Commercial Code also contains provisions relevant to transfer of mortgage and note. See PERMANENT EDITORIAL BOARD, REPORT OF THE PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE: APPLICATION OF THE UNIFORM COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTGAGE NOTES, Nov. 14, 2011, at 4-7. Because the Article 3 rules do not address the issue of mortgage recording, we do not discuss them at length here, although compliance with Article 3 may be important in preserving the right to foreclose on transferred mortgages.

<sup>5</sup> See U.C.C. §§9-203(g), 9-308(e), 9-607(b).

<sup>6</sup> The Permanent Editorial Board for the Uniform Commercial Code was created pursuant to an agreement between the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1961. Promoting uniformity in the Code and discouraging nonuniform amendments are among its purposes. Charles W. Mooney, Jr., *Introduction to the Uniform Commercial Code Annual Survey: Some Observations on the Past, Present, and Future of the U.C.C.*, 41 BUS. LAW. 1343, 1346 & n.18 (1986).

<sup>7</sup> PERMANENT EDITORIAL BOARD, *supra* note 4.

<sup>8</sup> Many courts have cited the Report approvingly. See *Jones v. Wells Fargo Bank*, 666 F.3d 955, 960 n.4 (5th Cir. 2012); *Williams v. Wells Fargo Bank, N.A.*, 2012 WL 1204946, at \*2 n.2 (W.D. Wash. April 11, 2012); *In re Veal*, 450 B.R. 897, 908 n.12 (9th Cir. B.A.P. 2011); *In re Walker*, 466 B.R. 271, 279 n.13 (Bankr. E.D. Pa. 2012); *In re Jackson*, 451 B.R. 24, 29 (Bankr. E.D. Cal. 2011). In addition, the Oklahoma Supreme Court has cited the Report twelve times, always for the proposition that the owner of a note may not be entitled to enforce it (e.g., when the owner does not possess the note). See, e.g., *Wells Fargo Bank, N.A. v. Heath*, 280 P.3d 328, 333 n.7 (Okla. 2012).

them”<sup>9</sup> and “govern the transfer and enforcement of notes secured by a mortgage on real property.”<sup>10</sup>

We do not take issue with the Board’s parsing of the complex text of the Article 9 rules,<sup>11</sup> which we discuss in more detail below. Instead, we take up two issues the Board did not discuss: whether the rules apply to existing transactions and whether they prevail over potentially conflicting recording statutes if they do apply. In each case, we find statutory ambiguities that create doubts about existing transactions and illustrate the need for change.

The first source of uncertainty arises from the Code itself, and relates to whether many existing securitizations were in fact structured to take advantage of the Article 9 rules. The provisions the Board discussed apply only when a mortgage loan is acquired for “value,” defined as “in return for any consideration sufficient to support a simple contract.”<sup>12</sup> Because the common-law concept of consideration is amorphous, it is not clear when the Code’s provisions apply.<sup>13</sup>

Our empirical study of mortgage securitization documents suggests that this ambiguity is a real problem. We reviewed the publicly available documents from the deals that make up the most widely used index for subprime securitizations originated in 2005 through 2007<sup>14</sup> and found that in many cases only nominal consideration was given at one step of the transaction. Because it is not clear that exchanging a mortgage loan for nominal consideration transfers the

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<sup>9</sup> PERMANENT EDITORIAL BOARD, *supra* note 4, at 12

<sup>10</sup> PERMANENT EDITORIAL BOARD, *supra* note 4, at 1.

<sup>11</sup> Some law professors did criticize the Report for purporting to resolve major social and policy issues through a technical application of statutory text. *See* Robert M. Lawless, Adam J. Levitin, Christopher L. Peterson, Katherine Porter, Elizabeth Renuart, and Alan White, Letter to Permanent Editorial Board, May 27, 2011 (professors from University of Illinois, Georgetown, University of Utah, University of Iowa, Albany Law School, and Valparaiso University conclude, “A U.C.C. PEB report is simply an inappropriate forum for addressing major policy issues. Doing so under the guise of a technical report does serious harm to the credibility and reputation of the ALI and NCCUSL.”).

<sup>12</sup> U.C.C. § 1-204.

<sup>13</sup> *See* discussion *infra* Part IV.C.

<sup>14</sup> *See* discussion *infra* Part IV.B.

mortgage “in return for any consideration sufficient to support a simple contract” under the Code, our findings raise questions about whether the Article 9 provisions were activated in actual subprime securitizations.

The second source of uncertainty in the law is the Code’s interaction with other law – that governing recording.<sup>15</sup> This ambiguity arises because mortgage loans have two parts, each potentially governed by its own set of rules, and the rules may be in conflict.

Mortgage loans, as currently structured, typically consist of two instruments, a mortgage and a promissory note. Under the law of most states, the mortgage is a real property interest covered by the real property recording laws. Under these statutes, a buyer is at some risk if it does not record its interest in the mortgage in local records.<sup>16</sup> The promissory note, on the other hand, is governed by the Uniform Commercial Code. Since the early 2000s,<sup>17</sup> the Code apparently has purported to provide in all states that the buyer’s interest in the mortgage is protected even if the buyer does not record. The Code and real-property recording statutes thus may give different answers to the question whether the buyer’s ownership interest is secure.

The Code also may conflict with other law on the subject of foreclosure. State laws may require a recorded chain of assignments for nonjudicial foreclosure,<sup>18</sup> while the Code seems to establish a provision for nonjudicial foreclosure that does not require such a chain.

Our results have three implications: First, they affect the resolution of disputes over existing securitizations.<sup>19</sup> Second, they suggest that under current law transacting parties should

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<sup>15</sup> Other scholars have criticized the Report for ignoring bodies of law outside the Code that are relevant to the issues the Report addresses. Lawless et al., *supra* note 11, at 2.

<sup>16</sup> See discussion *infra* Part III.

<sup>17</sup> The Code revisions discussed in the Report and this paper were adopted in all states by January 1, 2002. See discussion *supra* note 4.

<sup>18</sup> See, e.g., *Niday v. GMAC Mortg., LLC*, 284 P.3d 1157, 1169 (Or. Ct. App. 2012) (“A beneficiary that uses MERS to avoid publicly recording assignments of a trust deed cannot avail itself of a nonjudicial foreclosure process that requires that very thing—publicly recorded assignments.”).

<sup>19</sup> See discussion *infra* Part V.



consider structuring transactions to make it clear that Article 9 applies.<sup>20</sup> Third, they highlight the need for law reform to clarify and enhance the role of mortgage recording.<sup>21</sup>

With respect to the first subject, dispute resolution, our results are relevant in at least three areas. First, at least in some states mortgage foreclosure seems to be more difficult than the Board's report might imply. The Article 9 provisions the Board discusses probably make foreclosure easier, but the Report does not address whether the provisions apply to existing transactions. Our findings suggest that they may not apply in many cases. Second, ownership of mortgages is less secure and more vulnerable to subsequent claimants than it otherwise would be. Although most disputes to date over securitized mortgages have focused on enforceability rather than ownership, there could be a very large ownership contest if the corporate entities that operate the Mortgage Electronic Registration System ("MERS") enter bankruptcy.<sup>22</sup> One of these entities owns legal title to perhaps 30 million<sup>23</sup> mortgages, and a bankruptcy trustee could seek to bring the mortgages into the bankruptcy estate for the benefit of the MERS entities' creditors. This possibility should concern mortgage investors who assume that securitization vehicles have secure title to securitized mortgages. Third, the insecurity strengthens investors' claims that parties arranging the securitization breached representations and warranties that the transactions were correctly executed.<sup>24</sup>

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<sup>20</sup> See discussion *infra* Part VI.

<sup>21</sup> See discussion *infra* Parts VII -VIII.

<sup>22</sup> We discuss issues related to bankruptcy of MERS, Inc. and subsequent contests over mortgage ownership in detail in John Patrick Hunt et al., *All in One Basket: The Bankruptcy Risk of a National Agent-Based Recording System*, forthcoming 46 U.C. DAVIS L. REV. 1 (2012).

<sup>23</sup> See TESTIMONY OF R.K. ARNOLD, PRESIDENT AND CEO OF MERSCORP, INC. BEFORE THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY, HOUSE FINANCIAL SERVICES COMM., at 11 (Nov. 18, 2010) [hereinafter ARNOLD TESTIMONY] ("Since [MERS's] establishment in 1997, about 66 million loans have been registered and tracked on the MERS® System. About half of those loans (about 31 million) are active mortgage loans.").

<sup>24</sup> Relatedly, if the Article 9 provisions do not apply, existing mortgage-backed securities, probably with face value running into the hundreds of billions of dollars, are worth less than they otherwise would be. See Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, 24 REV. FIN. STUDS. 1848, 1853-54 (2011) (reporting that FirstAmerican CoreLogic database contains approximately 85% of subprime loans and

With respect to the second subject, guidance to transacting parties under current law, our results suggest that parties to transactions should avoid the use of nominal consideration and make sure that transactions are properly documented to take advantage of Article 9's protections. Mortgage buyers who do not do so may find it more difficult to foreclose and may be vulnerable to competing claims of ownership.

The most important subject may be the third, law reform. Mortgage buyers need clearer guidance on what does and does not protect their ownership interest in mortgages and their right to foreclose on the mortgages. But transacting parties' interests are not the only ones to be considered. Potential buyers of real property, borrowers, and the public more generally all have legitimate interests in transparent, public title records, including mortgage records. Article 9 gives short shrift to the interest in high-quality public records, because it purportedly allows ownership interests to be transferred without any recording anywhere. Despite the questions we raise about whether these provisions apply to all existing transactions and prevail over other, potentially conflicting sources of law, the Code at least purports to create a purely private system of ownership authentication based on documents known only to transacting parties.

There is at least some doubt about whether lawmakers really thought about and understood what they were doing when they enacted the Code provisions we discuss. But even if they did, the world looks different now: the value of transparent, public mortgage records is clearer than it was before the foreclosure crisis. At the same time, technology promises to overcome the biggest objection to maintaining transparent public records, namely the cost and delay of the traditional recording system. It seems likely that digitization now makes it possible

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records \$1.614 trillion in subprime loans were originated from 2001 to 2007 and records securitization rates implying that \$1.113 trillion of those loans were securitized). Extrapolating from the FirstAmerican CoreLogic data to the whole market would suggest that \$1.3 trillion of subprime loans were securitized between 2001 and 2007. The balance outstanding is only a fraction of the amount issued due to refinancing and foreclosures, but seems likely to be large, but hundreds of billions are outstanding even if 85% of the balances have disappeared.

to give the financial services industry the speed and low cost per mortgage it demands, while also providing transparency for borrowers, potential purchasers, and other users of land records.

The law should respond to the changes being worked by digitization. Specifically, policymakers should consider requiring mortgage buyers to make public records of their interests in order to protect them, and should consider introducing this requirement in tandem with electronic recording. The most efficient way of accomplishing this may be through a national, authoritative lien registry, but that approach risks resistance from local authorities. Accordingly, policymakers should also consider the alternative approach of upgrading local recording capabilities and phasing in the recording requirement on a state-by-state basis as the upgrades are complete.

The Article proceeds as follows. Part II describes basic mechanics of mortgage securitization and transfer, focusing on the fact that mortgage assignments were not recorded in securitizations in the 2000s. Part III describes the unclear interaction between Article 9 rules applicable to unrecorded mortgage transfers and other state laws relating to recording. Part IV explains how the requirement of “value” under the Code is unclear and reports the results of our empirical study of whether transacting parties met this requirement. Part V evaluates how the Article 9 rules should (and likely would) be applied in disputes over existing transactions. Part VI argues that taking steps to make it clear that Article 9 applies to mortgage transfers offers a low-cost way to reduce transactions’ legal risk under current law. Part VII argues that policymakers should reconsider mortgage title rules, and do so giving serious consideration to the value of public mortgage title records. Part VIII argues that mortgage transfer law should be reformed in tandem with increased use of electronic recording and sketches alternative legal and institutional arrangements for accomplishing this reform. Part IX concludes.

## II. MORTGAGE SECURITIZATION AND MORTGAGE TRANSFER

Under current practice, a mortgage loan has two parts: a promissory note containing the borrower's promise to repay the loan with interest and a security instrument (called the "mortgage" or "deed of trust") granting a lender a security interest in the real property securing the debt.<sup>25</sup> We use "note" to refer to the promissory note and "mortgage" to refer to the associated mortgage or deed of trust. To refer to the two together, we use "mortgage loan." We use the term "mortgage securitization" rather than "mortgage loan securitization" because of its greater familiarity, but in doing so we refer to transactions that attempt to transfer ownership of mortgage and note together.

Mortgage securitizations in the 2000s typically involved several transfers of the promissory note and associated mortgage: from an "originator" to an investment bank subsidiary known as a "sponsor," from the sponsor to another subsidiary known as the "depositor," and finally from the depositor to the trustee of a trust charged with holding the mortgages on behalf of investors.<sup>26</sup> This structure apparently has its origin in requirements for bankruptcy remoteness.<sup>27</sup>

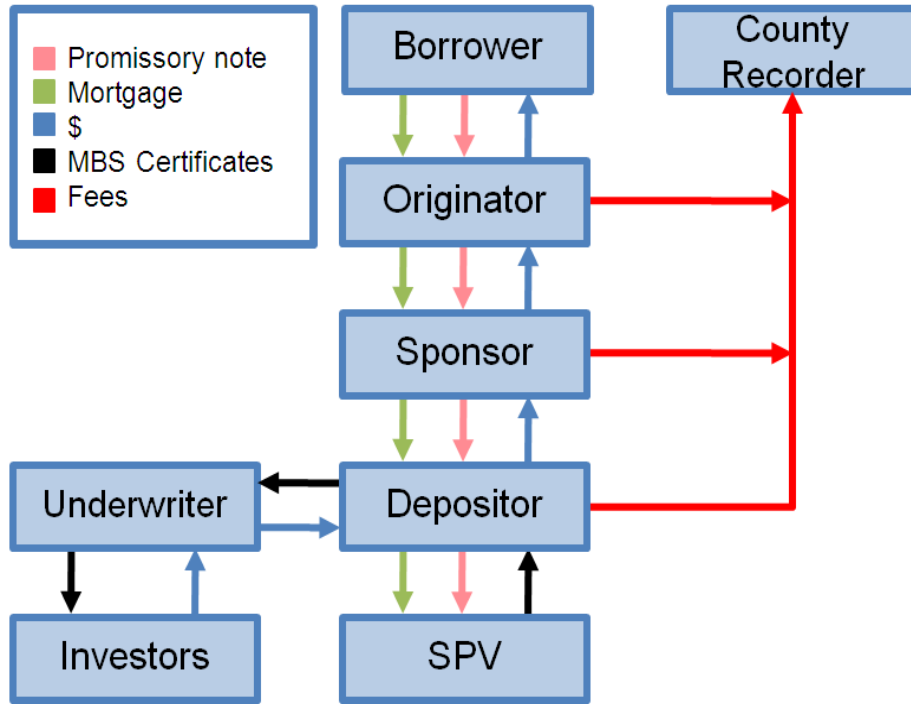
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<sup>25</sup> See GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 5.27, at 385 (2004) ("The mortgagee of real property has two things: the obligation owed by the mortgagor, and the interest in the realty securing the obligation."); 4 GEORGE E. OSBORNE, AMERICAN LAW OF PROPERTY §16.107, at 253 (1952) (same).

<sup>26</sup> For example, in one transaction the authors have reviewed in depth, the GSAMP 2006-HE3 transaction, the sponsor was Goldman Sachs Mortgage Co. and the depositor was GS Mortgage Securities Corp.

<sup>27</sup> See discussion Part IV. C below; FINANCIAL ACCOUNTING STANDARDS BOARD [hereinafter FASB], STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 140, § 9 (2000); FASB TECHNICAL BULLETIN NO. 01-1 (2008); Deloitte & Touche, *Learning the Norwalk Two Step*, HEADS UP, April 25, 2001, at 4; Marty Rosenblatt, Jim Johnson & Jim Mountain, *Securitization Accounting: The Ins and Outs (And Some Do's and Don'ts) of FASB 140, FIN 46R, IAS 39 and More* (2005).

Figure 1: Mortgage and Promissory Note Transfer with Traditional Recording



State laws usually provide that mortgage assignments can be recorded.<sup>28</sup> Some state statutes appear on their face to require recording.<sup>29</sup> Others make recorded assignments a prerequisite for at least some nonjudicial foreclosures.<sup>30</sup> Most state statutes, however, encourage recording rather than requiring it. They do so by protecting the assignee from subsequently arising claims to the mortgage loan,<sup>31</sup> by making a chain of recorded assignments a procedural

<sup>28</sup> See NELSON & WHITMAN, *supra* note 25, at 456 (there are “very few jurisdictions in which the recording acts do not apply to mortgage assignments”).

<sup>29</sup> See, e.g., TEXAS LOCAL GOV'T CODE § 192.007 (“To ... transfer ... an instrument that is filed, registered, or recorded in the office of the county clerk, a person must file, register, or record another instrument relating to the action in the same manner as the original instrument was required to be filed, registered, or recorded”); ILL. CODE CH. 765 § 5/28 (“Deeds, mortgages, powers of attorney, and other instruments relating to or affecting the title to real estate in this state, *shall* be recorded in the county in which such real estate is situated”) (emphasis added). *But see* Union County v. MERSCORP, Civ. No. 12-665-GPM (S.D. Ill. Jan. 30, 2013) (finding no mandatory duty to record under § 5/28).

<sup>30</sup> See discussion *infra* note 208 and accompanying text.

<sup>31</sup> See NELSON & WHITMAN, *supra* note 25, at 456-57 (recording “generally” protects first assignee of mortgage against subsequent assignees).

prerequisite to nonjudicial foreclosure, or both.<sup>32</sup> These recording rules do not cover promissory notes.<sup>33</sup>

Mortgage assignments were not recorded in mortgage securitizations, at least in the late 1990s and early 2000s.<sup>34</sup> Recording may simply have been impractical: Recording mortgage assignments is burdensome in mortgage securitizations because of the large volume of assignments and the relatively tight time frame for each transaction.<sup>35</sup> In a typical “private-label”<sup>36</sup> mortgage securitization from the 2000s, thousands of mortgage loans from different geographic regions<sup>37</sup> passed through at least two corporate entities on their way from the mortgage loan’s originator to their intended destination, a special purpose vehicle (“SPV”), generally a trust, that was to hold the mortgage loans in a pool on behalf of investors who bought certificates entitling them to cash flows from the pool. For a transaction involving 10,000 mortgage loans, each following the originator-sponsor-depositor-SPV path,<sup>38</sup> there would be

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<sup>32</sup> See, e.g., OR. REV. STAT. §86.735(1).

<sup>33</sup> But see *Niday v. GMAC Mortg., LLC*, 284 P.3d 1157, 1169 (Or. Ct. App. 2012) (“Nothing prevents parties from recording a copy of the indorsed note or a separate writing memorializing that transfer.”).

<sup>34</sup> See White, *supra* note 315, at 484-85.

<sup>35</sup> Tax rules effectively impose a three-month timeframe on mortgage securitizations by imposing a 100 percent tax on contributions to the securitization vehicle made more than three months after the vehicle’s startup date. See 26 U.S.C. § 860G(d). Although this rule covers only one particular type of securitization vehicle, the REMIC (“real estate mortgage investment conduit”), the large majority of residential mortgage securitizations reportedly employ this form. AEQUITAS COMPLIANCE SOLUTIONS, INC., FORECLOSURE IN CALIFORNIA: A CRISIS OF COMPLIANCE 17 (Feb. 2012). The pooling and servicing agreement that governs a given transactions likewise may impose a deadline by which mortgages must be conveyed to the trust.

<sup>36</sup> Our discussion focuses on “private-label” securitizations, that, securitizations other than those carried out by the government-sponsored housing enterprises, Fannie Mae and Freddie Mac.

<sup>37</sup> See Prospectus Supplement dated Sept. 7, 2006 for Mortgage Pass-Through Certificates issued by GSAMP Trust 2006-HE3, at S-40 (describing mortgage pool for one transaction as containing 10,736 mortgage loans with aggregate principal balance of \$1.6 billion, with no more than 0.23% of the loans secured by properties in any one area).

<sup>38</sup> It appears that in some cases the mortgage may not have followed the originator-sponsor-depositor chain at all. See *Bank of America, N.A. v. Bassman LBT*, 2012 Ill. App. LEXIS 487, at \*3-\*4 (construing record as showing that securitized mortgage was never conveyed to sponsor or depositor).

30,000 separate assignments of the mortgages. The problem may have been compounded by backlogs at local recording offices.<sup>39</sup>

At the same time that market participants were not recording assignments, the mortgage-recording rules discussed above remained on the books. Thus, failing to record mortgage assignments entailed some legal risks, even if they were thought to be small.<sup>40</sup> Two innovations of the mid-to-late 1990s apparently were intended to reduce those risks by obviating recording. The first was the Mortgage Electronic Registration System,<sup>41</sup> and the second was the revision of Article 9 of the Uniform Commercial Code to codify the proposition that “the mortgage follows the note.” We now turn to those revisions.

### III. U.C.C. ARTICLE 9 AND OTHER LAW

Article 9 of the Uniform Commercial Code contains two sets of rules that may reduce the risks that arise from not recording mortgage assignments. The first set of rules<sup>42</sup> addresses mortgage ownership, and the second set of rules<sup>43</sup> addresses procedural requirements for mortgage foreclosure. The Permanent Editorial Board’s report on mortgage transfer summarizes these rules,<sup>44</sup> and we discuss them here. For brevity we use “Article 9” to refer to the sets of rules discussed in the Report rather than the entire article, except where more specificity is needed. Both sets of rules may conflict with other state laws, and this potential conflict creates risk and uncertainty.

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<sup>39</sup> See ARNOLD TESTIMONY, *supra* note 23, at 18 (“[A]t certain time periods, the flow of assignments were [sic] overwhelming the county recorder system, resulting in long backlogs, and in some cases, taking the county recorded over a year to record an assignment.”).

<sup>40</sup> See, e.g., NELSON & WHITMAN, *supra* note 25, at 464 (“After reviewing all of the issues related to recording mortgage assignments . . . , one must conclude that for the most part, recording is not very important.”).

<sup>41</sup> See discussion *infra* Part V. D.

<sup>42</sup> See U.C.C. §§9-203(g), 9-308(e).

<sup>43</sup> See U.C.C. § 9-607(b).

<sup>44</sup> See PERMANENT EDITORIAL BOARD, *supra* note 4, at 9-14.

All the pertinent rules are triggered by parties' structuring a note transfer as an Article 9 sale. For convenience, we call this "complying with Article 9." We use this terminology even though Article 9 does not require "compliance," except by imposing conditions that must be met to invoke its protections.

As relevant to mortgage securitizations, the rules described below come into effect only if a transaction is a sale of notes under Article 9.<sup>45</sup> There are several prerequisites to treating a transaction as a sale of promissory notes. In brief, the seller must be able to sell the notes,<sup>46</sup> there must be an authenticated agreement that describes them,<sup>47</sup> and the buyer must give "value" for them.<sup>48</sup> As discussed below, our findings raise questions about whether "value" was given at each stage of the transaction.

#### *A. Article 9 Mortgage-Ownership Rules*

A basic feature of property recording systems is that recording protects an owner from subsequent claims of ownership to the property.<sup>49</sup> Parties to securitization transactions did not record mortgage assignments, so it is natural to ask how, and whether, buyers' ownership interests in the mortgages were protected. Article 9's rules address this issue. The 1998 revisions to Article 9 contain provisions that apparently provide that in certain circumstances ownership of a promissory note automatically confers ownership of the associated mortgage. In

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<sup>45</sup> In the language of Article 9, the rules we discuss are activated when a "security interest" is created. A "security interest" includes both the interest of a note purchaser and the interest of a secured lender who takes an interest in the notes as collateral for the loan.

<sup>46</sup> U.C.C. § 9-102(b)(2).

<sup>47</sup> U.C.C. § 9-203(b)(3)(A).

<sup>48</sup> U.C.C. § 9-203(b).

<sup>49</sup> 14 RICHARD R. POWELL & MICHAEL ALLAN WOLF, POWELL ON REAL PROPERTY § 82.02[1][b] at 82-15 (2000) (identifying three types of recording statute, under each of which recording protects ownership interest from subsequent purchasers).



other words, as the Permanent Editorial Board explains at some length,<sup>50</sup> the Code apparently purports to codify the proposition that “the mortgage follows the note.”

Understanding the Article 9 mortgage-follows-the-note rules is challenging because these previously obscure provisions use terms in ways that may be somewhat unfamiliar, using the vocabulary of secured transactions to describe sales of promissory notes.<sup>51</sup> Thus, the buyer of a promissory note is the same as someone who made a loan secured by the note: she is a “secured party,”<sup>52</sup> the note seller is the “debtor,”<sup>53</sup> and the note being sold is the “collateral.”<sup>54</sup> In the vocabulary of the U.C.C., the ownership interest (security interest) is good against the debtor (seller) when it “attaches.”<sup>55</sup> It is good against the rest of the world when it is “perfected.”<sup>56</sup> The latter is what is relevant here. Recording a real-property interest protects the recording party against subsequently arising claims, and that is what “perfection” under the U.C.C. does. In fact, many security interests under the U.C.C. are perfected by a filing procedure analogous to real-property recording.<sup>57</sup>

Since 1998, the official text of the U.C.C. has stated that in the sale of a promissory note secured by a mortgage, the security interest in the mortgage attaches when the security interest in the note attaches,<sup>58</sup> and that the security interest in the mortgage is perfected when the security

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<sup>50</sup> See PERMANENT EDITORIAL BOARD, *supra* note 4, at 8-12.

<sup>51</sup> In ordinary usage, we recognize a difference between selling something and putting it up as collateral for a loan. Creating a workable legal distinction between selling and secured lending against promissory notes has proved elusive, however, leading to the decision to merge the two concepts in the 1998 revisions. See PERMANENT EDITORIAL BOARD, *supra* note 4, at 8-9 (“Article 9 uses nomenclature conventions to apply one set of rules to both types of transactions” [transactions in which notes are sold and transactions in which they are collateral]. This decision has been criticized. See Thomas E. Plank, *Assignment of Receivables Under Article 9: Structural Incoherence and Wasteful Filing*, 68 OHIO ST. L.J. 231, 235-37 (2007).

<sup>52</sup> U.C.C. § 9-102(72)(D).

<sup>53</sup> U.C.C. § 9-102(28)(B).

<sup>54</sup> U.C.C. §9-102(12)(B).

<sup>55</sup> U.C.C. §9-203(a). The interest is also valid against parties with actual notice of it when it attaches. *Id.*

<sup>56</sup> U.C.C. §9-203(b)(1).

<sup>57</sup> U.C.C. § 9-310(a), 9-502(a).

<sup>58</sup> U.C.C. § 9-203(g).

interest in the note is perfected.<sup>59</sup> The U.C.C. thus appears to provide that in this context the ownership interest in the mortgage is equal to the ownership interest in the note; the mortgage follows the note.<sup>60</sup>

The Code also provides that the security interest in the promissory note can attach and be perfected without any recording.<sup>61</sup> Combining this no-filing-for-notes provision with the mortgage-follows-the-note provision, it seems that the Code purports to provide that the buyer can get a perfected interest in a mortgage without any recording or filing anywhere.<sup>62</sup>

But apparently only a few states amended their recording laws to follow the new U.C.C. regime.<sup>63</sup> Thus, the Code's rule that mortgage ownership is perfected without recording seems to be in conflict<sup>64</sup> with real-property recording laws that continue to provide that unrecorded real property interests are vulnerable to subsequent claimants.<sup>65</sup> The Board's report does not address this potential conflict, as critics of the report have noted.<sup>66</sup>

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<sup>59</sup> U.C.C. §9-308(e).

<sup>60</sup> U.C.C. §§ 9-203 cmt. 9; 9-308 cmt. 6.

<sup>61</sup> See U.C.C. § 9-309(4) (security interest in note is perfected immediately upon attachment).

<sup>62</sup> See MCDONNELL & SMITH, *supra* note 4, § 16.09 (2011).

<sup>63</sup> Our research on the ten states with the largest numbers of mortgages securitized in private-label transactions indicates that at most two states, Florida and Maryland, amended their real-property statutes to recognize the primacy of the Code's priority rules as to mortgage assignments. See Hunt et al., *U.S. Residential Data Transfer: A System in Crisis*, in Margarita Brose et al., HANDBOOK OF FINANCIAL DATA AND RISK INFORMATION (2012).

<sup>64</sup> If the Code does not defer to real property statutes, courts might try to harmonize the statutes, for example by finding that "perfection" under the U.C.C. is limited by real property recording statute. In other words, they could find that U.C.C. "perfection" does not substitute for recording as against bona fide purchasers for value who take without notice and record first. Perfection under the U.C.C. could apply to other classes of competing claimants, such as judgment or statutory lienors.

<sup>65</sup> Our research on the ten states with the largest numbers of mortgages securitized in private-label transactions indicates that at most two states, Florida and Maryland, amended their real property statutes to recognize the primacy of the U.C.C.'s priority rules as to assignments of security interests in real property. The results of our survey of state mortgage law are on file with the authors. Both amendments used the phrase "security interest in a mortgage." A Westlaw search in the STAT-ALL database on this phrase on July 27, 2011 did not locate any additional states that had changed their recording statutes.

<sup>66</sup> See Lawless et al., *supra* note 11, at 6. Despite these criticisms, there seemed to be little disagreement over the Board's reading of the Code's text. See Kenneth Kettering, E-mail re Draft Report of the PEB, March 30, 2011 ("The Draft Report is a lucid description of the U.C.C. provisions that pertain to the matters covered by the report."). However, at least one academic did take issue with the Board's interpretation of the Code. See Bruce A. Campbell, Comments on U.C.C. PEB Report on U.C.C. Rules on Assignment of Mortgage Notes, at 1 (emeritus professor at University of Toledo concludes "The Draft Report is thus, overall, a substantial oversimplification, and

The 1998 amendments are the latest development in a longstanding debate about how the U.C.C.’s rules interact with state recording statutes. Before the 1998 amendments, the Code seemed to cede primacy to the recording statutes. Official Comments to the Code expressly deferred, first to “local real property law,”<sup>67</sup> later to “other law,”<sup>68</sup> on “the question of the effect on the rights under the mortgage of delivery or non-delivery of the mortgage or of recording or non-recording of an assignment of the mortgagee’s interest.”<sup>69</sup> Although the Code appeared to defer to real-property law, prominent commentators argued that mortgagor and mortgagee “live in different worlds,”<sup>70</sup> so that state recording laws were irrelevant to transfers of the mortgage. Some<sup>71</sup> but not all<sup>72</sup> courts followed this approach. The 1998 amendments eliminated the language deferring to local real-property law.

Although the 1998 revisions eliminated specific language in the Code’s Official Comments deferring to mortgage recording law, the revisions did not go as far as they could have: language asserting that the Code’s mortgage-follows-the-note rules prevailed “notwithstanding other law” was dropped in the Code drafting process.<sup>73</sup>

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an oversimplification which distorts analysis and reaches dubious conclusions, potentially misleading lawyers, diplomats, and courts”).

<sup>67</sup> U.C.C. § 9-102(3) Official Comment 4 (original).

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> The “different worlds” phrase apparently first appeared in Jan Z. Krasnowiecki, J. Gregg Miller & Lloyd R. Ziff, *The Kennedy Mortgage Co. Bankruptcy: New Light Shed on the Position of Mortgage Warehousing Banks*, 56 AM. BANKR. L.J. 325, 334 (1982).

<sup>71</sup> *In re SGE Funding Corp.*, 278 B.R. 653 (Bankr. M.D. Ga. 2001).

<sup>72</sup> See *In re Maryville Sav. & Loan Ass’n*, 743 F.2d 413, 416-17 (6th Cir. 1984), *clarified* 760 F.2d 119 (6th Cir. 1985) (“the U.C.C. does not supersede the law in this state with respect to liens upon real estate.”). The court in *Maryville* held that a party’s interest in deeds of trust was perfected even though its interest in the related notes was not perfected. *Id.*

<sup>73</sup> Drafts of the Article 9 revisions from October 1997 through the ALI Proposed Final Draft of April 15, 1998 read as follows: “Perfection of a security interest in a right to payment or performance also perfects a security interest in a lien on personal or real property securing that right, *notwithstanding other law to the contrary.*” The 1998 Annual Meeting Draft dropped the italicized language. It also changed the associated legislative note from “To avoid confusion, any statute conflicting with subsection (e) should be made expressly subject to that section,” to “Any statute conflicting with subsection (e) must be made expressly subject to that section.” As noted, it does not appear that most states changed their real-property recording laws in response to this.

More general provisions of the Code may still be understood as deferring to real-estate recording statutes. For example, the Code yields to other statutes where the other statute “was specifically intended to provide additional protection to a class of individuals engaging in transactions covered by the Uniform Commercial Code.”<sup>74</sup> If Article 9 applies to mortgage sales, then those transactions are covered by the Code, and the real-property recording statutes seem intended to provide additional protection to mortgage purchasers. Moreover, the Code is to be interpreted “to promote its underlying policies and purposes” which are to “simplify, clarify, and modernize the law” and “permit the continuing expansion of commercial practices through custom, usage, and agreement of the parties.”<sup>75</sup>

Both these Code provisions and general principles of statutory construction<sup>76</sup> suggest that a court should try to give effect to both statutes to the extent possible. One way of doing this would be to find that the term “perfected” under the U.C.C. is limited by state recording statutes—in other words, that the U.C.C. simply does not provide for perfection as against bona fide purchasers of real property for value who take without notice and record first. Perfection under the U.C.C. could apply to other classes of competing claimants, such as judgment lienors or statutory lienors. Although this gives some effect to the U.C.C.’s automatic perfection provisions without doing violence to the preexisting recording statutes, it does significantly undercut the U.C.C.’s provisions, because it effectively renders them inapplicable to real property in states with conflicting statutes.

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<sup>74</sup> U.C.C. § 1-103 cmt. 3.

<sup>75</sup> U.C.C. § 1-103(a)(2).

<sup>76</sup> 2B NORMAN SINGER & J.D. SHAMBLE SINGER, SUTHERLAND STATUTORY CONSTRUCTION §51:2 (7th ed. 2012) (“Courts try to construe apparently conflicting statutes on the same subject harmoniously, and, if possible, give effect to every provision in both.”).

If a conflict were found to exist, courts would turn to general principles of statutory construction.<sup>77</sup> One such principle is that the specific trumps the general:<sup>78</sup> Perhaps Article 9's mortgage-follows-the-note provisions should prevail because they are more specific than the recording statutes. The mortgage-follows-the-note provisions apply specifically to sales of mortgage promissory notes, while the recording statutes apply to transfers of real property interests generally. While this may be true in general, many states do have specific provisions specifically governing the recording of mortgages<sup>79</sup> or mortgage assignments<sup>80</sup> specifically, including statutes that specifically cover recording mortgage assignments in foreclosure.<sup>81</sup>

Another argument that Article 9's provisions should govern is that they were enacted after the recording statutes and therefore repealed inconsistent provisions by implication.<sup>82</sup> Most states' recording statutes do date from long before 2000-01<sup>83</sup> when state legislatures enacted the Article 9 revisions.<sup>84</sup> However, some states have passed legislation requiring mortgage assignments for foreclosure since 2001.<sup>85</sup> Moreover, the fact that a statute was enacted later does not mean that it automatically trumps the previous statute under the laws of all states,

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<sup>77</sup> See U.C.C. § 1-103 cmt. 3 (resolution of any conflict between U.C.C. and competing state statute depends on "principles of statutory interpretation that specifically address the interrelationship between statutes.").

<sup>78</sup> See 2B SINGER & SINGER, *supra* note 76, § 51:5 (7th ed. 2012) ("[I]f two statutes conflict, the general statute must yield to the specific statute involving the same subject.").

<sup>79</sup> See, e.g., ALASKA STAT. § 34.20.110; 765 ILL. COMP. STAT. 5/28.

<sup>80</sup> See, e.g., ARIZ. REV. STAT. ANN. § 33-706; GA. CODE ANN. § 44-14-35.

<sup>81</sup> See statutes cited *infra* note 208 (apparently requiring recorded mortgage assignments for nonjudicial foreclosure).

<sup>82</sup> See 1A SINGER & SINGER, *supra* note 76, § 23:9 ("A repeal may arise by necessary implication from the enactment of a subsequent act.").

<sup>83</sup> See 14 RICHARD R. POWELL & MICHAEL ALLAN WOLF, POWELL ON REAL PROPERTY § 82.01[1][b] (describing colonial adoption of recording laws and their extension to Northwest Territory in 1795).

<sup>84</sup> See discussion *supra* note 4 and accompanying text.

<sup>85</sup> See GA. CODE ANN. § 44-14-162 (requiring that foreclosing party file "security instrument or assignment thereof vesting the secured creditor with title to the security instrument" with county clerk before foreclosure sale). This 2008 law reportedly was intended to "help borrowers 'identify who has the right to foreclose before they actually do.'" Austin Hall, *Review of Selected 2008 Georgia Legislation*, 25 GA. ST. U. L. REV. 265, 270 (2008) (quoting Georgia legislator's statement in House proceedings).

especially where there is no evidence that state legislators intended to supersede the old statute<sup>86</sup> and where the later statute did not refer explicitly to the earlier one.<sup>87</sup>

Only a few cases<sup>88</sup> deal with the state-by-state issue of how Article 9 interacts with real-property recording laws, and in most states it remains uncertain just how this interaction works.<sup>89</sup> Although commentators have assumed that Article 9's rules would prevail,<sup>90</sup> one leading treatise does counsel against relying exclusively on the proposition that the mortgage follows the note, under Article 9 or otherwise, instead of recording mortgage assignments.<sup>91</sup> We discuss how Article 9 might interact with other statutes in specific contexts below,<sup>92</sup> but the crucial point is that under current law, this is a question of state law, to be determined under the statutory schemes of each state, in light of each state's policies and the legislative history of the relevant

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<sup>86</sup> See, e.g., 1A SINGER & SINGER, *supra* note 76, § 23:9 (“As legislative intent defines operation of a statute and divulges the purposes and limitations of the enactment, it may establish or deny a repeal by implication.”); Robert M. Lawless & Adam J. Levitin, Comments on Draft PEB Report, at 7 n.11 (May 27, 2011) (arguing that it is “implausible” that state legislators intended to upset long-standing state real property law in revising Article 9).

<sup>87</sup> See Committee on Legal Opinions of the American Bar Ass’n, Comments on Draft PEB Report, at 2 (May 31, 2011) (questioning whether Revised Article 9 “would be effective to change the requirements of real estate recording statutes without making express reference to such statutes” and asserting that “[u]nder many states’ statutory construction rules (e.g., Washington State), passage of a statute may not automatically have the effect of amending or reversing contrary statutory provisions without expressly referring to the supplemental or superseded statutes.”).

<sup>88</sup> See, e.g., *Provident Bank v. Community Home Mortg. Corp.*, 498 F. Supp. 2d 558, 566-71 (E.D.N.Y. 2007) (analyzing the conflict under New York law and resolving it in favor of the U.C.C.).

<sup>89</sup> See, e.g., Robert M. Lawless & Adam J. Levitin, *Comments on Draft PEB Report*, at 7 n.11 (May 27, 2011) (arguing that it is “implausible” that state legislators intended to upset long-standing state real property law in revising Article 9). In general, the Code acknowledges that resolution of any conflict depends on “principles of statutory interpretation that specifically address the interrelationship between statutes,” U.C.C. §1-103 cmt. 3, and defers to other statutes that are “specifically intended to provide additional protection to a class of individuals engaging in transactions covered by the Uniform Commercial Code,” U.C.C. § 1-103 cmt. 3.

<sup>90</sup> MCDONNELL & SMITH, *supra* note 4, at § 16.09 (“Article 9 makes it as plain as possible that the secured party need not record an assignment of mortgage, or anything else, in the real property records in order to perfect its rights to the mortgage ....”). This result would be consistent with the overall thrust of the Article 9 amendments, as identified by McDonnell in a different forum: “The U.C.C. specialists devoutly believe in secured credit. With appropriate fanfare, they have introduced changes designed to make it easier for financiers to create and perfect security interests in the many different contexts in which secured financing is used ... It is as though U.C.C. specialists identified with secured creditors as the Clients, the Good Guys ...”. See McDonnell, *supra* note 4, at 241-42.

<sup>91</sup> See 2 JASON H.P. KRAVITT ET AL., *SECURITIZATION OF FINANCIAL ASSETS*, § 16.04[A], at 16-157 (2d ed. & 2009 Supp.) (“[W]hether the transferee, as owner of the note acquires all rights of the mortgagee without having to record an assignment of the mortgage, is not entirely clear. In addition, there are reasons why recordation of the mortgage may be wise in order for the transferee to obtain the greatest possible rights in the mortgage and in the other ancillary loan documents ...”).

<sup>92</sup> See discussion *infra* Part V.

enactments. It does seem likely that structuring a transaction as a note sale under Article 9 strengthens the buyer's position in case of an ownership contest, but the potential conflict<sup>93</sup> creates unnecessary risk for everyone concerned.

### *B. Article 9 Foreclosure Procedures*

In addition to its provisions dealing with mortgage ownership, Article 9 also contains rules that may be relevant to foreclosure litigation. They provide that, “[i]f necessary to enable a [buyer] to enforce the mortgage nonjudicially,” a note buyer may record a copy of the sale agreement and an affidavit stating that a default has occurred and that the buyer is entitled to enforce the mortgage nonjudicially.<sup>94</sup> This provision apparently is intended to permit the buyer to become the “assignee of record” in states where only an assignee of record can use nonjudicial foreclosure.<sup>95</sup>

Although this procedure apparently never has been used in a case generating a reported opinion,<sup>96</sup> the Permanent Editorial Board does discuss it<sup>97</sup> and it may be relevant in some contexts. However, the Code's procedure may be in conflict with laws in some states that expressly require a recorded chain of assignments as a prerequisite to foreclosure.<sup>98</sup>

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<sup>93</sup> A recent student case comment argues that there is no conflict between Massachusetts real property recording statutes and the U.C.C. because the mortgage follows the note as a “security interest” but not as a “real property interest.” Case Comment, *Massachusetts Supreme Judicial Court Unanimously Voids Foreclosure Sales Because Securitization Trusts Could Not Demonstrate Clear Chains of Title to Mortgages*, 125 HARV. L. REV. 827, 832 (2012). The case comment's author does not further flesh out this intriguing suggestion.

<sup>94</sup> U.C.C. § 9-607(b).

<sup>95</sup> U.C.C. § 9-607, cmt. 8.

<sup>96</sup> A search in the Westlaw ALLCASES database on August 31, 2012 turned up no such cases.

<sup>97</sup> See PERMANENT EDITORIAL BOARD, *supra* note 4, at 13-14.

<sup>98</sup> See, e.g., OR. REV. STATS. § 86.735(1); *Niday v. GMAC Mortg., LLC*, 284 P.3d 1157, 1159 (Or. Ct. App. 2012).

#### IV. THE UNCLEAR REQUIREMENT OF “VALUE”: DID SECURITIZATION PARTIES COMPLY WITH ARTICLE 9?

Our empirical study of transaction documents suggests that in many transactions the Article 9 rules discussed above may not apply. A party must give “value” to activate the rules. Parties to mortgage securitization transactions may have failed to provide “value” in intermediate stages of the transaction, because the depositor apparently provided only nominal or other questionable consideration to the sponsor. The uncertainty about whether the Article 9 rules apply to this sample of existing subprime securitizations highlights the need for greater clarity in the law.

##### A. *The Article 9 Requirement of “Value”*

Under Article 9, “value” must be given in order for the transaction to benefit from each of the Code provisions discussed above and in the Permanent Editorial Board’s report. Each of the provisions in question depends on the existence of a “security interest” under Article 9, and a security interest arises only if “value” is given: the Code provides that a security interest is “enforceable against the debtor and third parties with respect to the collateral *only if* value has been given.”<sup>99</sup>

The Code’s definition of “value” supplies several different ways of meeting the requirement,<sup>100</sup> but the part of the definition that appears relevant to mortgage securitization transactions is that value includes any consideration “sufficient to support a simple contract.”<sup>101</sup>

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<sup>99</sup> See 9-203(b). See also U.C.C. §9-203(a) (“A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral”); None of the other subsections of § 9-203 provides for enforceability without giving value. See also PERMANENT EDITORIAL BOARD, *supra* note 4, at 9 (“three criteria must be fulfilled in order for the owner of a mortgage note effectively to create a ‘security interest’ (either an interest in the note securing an obligation or the outright sale of the note to a buyer) in it. The first two criteria are straightforward – ‘value’ must be given ...”); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 1185 (6th ed. 2010) (“value must be given” to create an enforceable Article 9 security interest).

<sup>100</sup> U.C.C. §1-204 (providing that value is given when rights are acquired “in return for a binding commitment to extend credit or for the extension of immediately available credit;” “as security for ... a preexisting



“Value” is crucial for the rules we are discussing, even though the Code provides for ways of transferring notes without value.<sup>102</sup> No requirement to give value applies to such transfers, but the special U.C.C. provisions providing for immediate attachment and perfection of the security interest in the mortgage would not apply either.<sup>103</sup> In other words, the *U.C.C.* does not say that “the mortgage follows the note” in this type of transfer. Rather, transaction participants would be forced to rely on *non-U.C.C.* rules governing the relationship between note transfer and mortgage transfer. This is a matter of non-uniform state law, and some courts have rejected the proposition outright.<sup>104</sup> Moreover, unrecorded transfers may be vulnerable in some

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claim;” “by accepting delivery under a preexisting contract for purchase;” or “in return for any consideration sufficient to support a simple contract.”).

<sup>101</sup> See U.C.C. § 1-204(4). The U.C.C. also provides for three other ways of giving value – extending credit, settling a claim, or accepting as delivery under a *preexisting* contract for purchase – that do not seem relevant here. See U.C.C. § 1-204(1)-(3).

<sup>102</sup> For example, negotiable promissory notes may be transferred under Article 3 of the Code by endorsement and delivery. See PERMANENT EDITORIAL BOARD *supra* note 4, at 5. It appears that promissory notes were not endorsed in many securitization transactions. Endorsement issues are relevant to note transfer under Article 3, and a recent survey of the caselaw finds that courts typically have assumed that mortgage promissory notes are negotiable, see Dale A. Whitman, *How Negotiability Has Fouled up the Secondary Mortgage Market, and What to Do About It*, 37 PEPP. L. REV. 737, 755 (2010), although Ronald Mann has argued that most form mortgage promissory notes are not negotiable. See Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951 (1997). Where the promissory note is negotiable and is not properly endorsed to the party seeking to enforce it, the note may for practical purposes be enforceable only if it was “transferred,” as that term is used in Article 3. See U.C.C. § 3-301 (listing class of persons entitled to enforce negotiable instruments: holders, nonholders in possession, and persons not in possession entitled to enforce under §3-309). A person in possession of a note is a “holder” if the instrument is payable to “bearer” or to the possessor. U.C.C. §1-203(1)(b). If an instrument is not in the possession of the original payee and is not endorsed, it will not be payable to the possessor, so the possessor will not be a holder. A nonholder may be able to enforce an instrument if it is a transferee. U.C.C. § 3-203. In such a case, if the note is negotiable, it will be enforceable only if it was “transferred” as that term is used in Article 3, meaning that it was delivered by a party with the power to enforce the note with intent to give the recipient the right to enforce the note. U.C.C. §§3-203(a)-(b). If a transaction is structured as a sale of the promissory note, that is likely to help establish the intent element of transfer. Although structuring the transfer as an Article 9 sale probably is not necessary if intent to transfer can be established in some other way, the Permanent Editorial Board’s examples of transfer all involve sales of promissory notes. See PERMANENT EDITORIAL BOARD, *supra* note 4, at 6, 7.

<sup>103</sup> The same goes for U.C.C. § 9-310(c), another provision that appears to contemplate transfer without value being given, also does not apply to the issues we discuss. This section provides that “[i]f a secured party assigns a perfected security interest or agricultural lien, a filing under this article is not required to continue the perfected status of the security interest against creditors of and transferees from the original debtor.” U.C.C. §9-310(c). This provision addresses only filings “under this article,” that is, Article 9 of the U.C.C., not filings under the real property recording statutes.

<sup>104</sup> See, e.g., *In re Maryville Sav. & Loan*, 743 F.2d 413, 415-16 (6th Cir. 1984), *clarified* 760 F.2d 119; *In re Marron*, 455 B.R. 1, 6 (Bankr. D. Mass. 2011) (“Massachusetts, unlike many other states, does not subscribe to

circumstances even in states where non-U.C.C. law provides that the mortgage follows the note.<sup>105</sup>

### *B. Use of Nominal or Questionable Consideration in Existing Transactions*

As discussed, if a securitization transaction is structured to meet the requirements of Article 9,<sup>106</sup> that strengthens the position of the transacting parties by activating the Code's provision that the mortgage follows the note and by making the Code's foreclosure procedure available.

As we now explain, it is not clear that "value" was given at all stages of the transactions we reviewed. We have reviewed a sample of publicly filed documents from existing securitization transactions and found that in most cases the documents do not clearly disclose

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the theory that the mortgage 'follows the note'); *Ibanez v. U.S. Bank Nat'l Ass'n*, 941 N.E.2d 40, 53-54 (Mass. 2011) ("In Massachusetts ... the assignment of the note does not carry with it the assignment of the mortgage.").

<sup>105</sup> For example, California has both a non-U.C.C. statute providing that the mortgage follows the note and a statute providing that mortgage assignments may be recorded. *See* CAL. CIVIL CODE § 2936 ("The assignment of a debt secured by mortgage carries with it the security"); CAL. CIVIL CODE § 2934 ("Any assignment of a mortgage and any assignment of the beneficial interest under a deed of trust may be recorded, and from the time the same is filed for record operates as constructive notice of the contents thereof to all persons..."). Despite the mortgage-follows-the-note statute, mortgage assignees have lost out to subsequent claimants because they failed to record. *See In re Cedar Funding*, 2012 WL 1346265, at \*2 (Bankr. N.D. Cal. April 5, 2010) (mortgage assignees' interests vulnerable to bankruptcy trustee because unrecorded); *Security Mortg. v. Delfs*, 47 Cal. App. 599, 602-03 (Cal. Ct. App. 1920) (where assignor assigned same mortgage and note to two assignees, first assignee lost out to second; "if [the first assignee] had recorded its assignment ... its rights could have been protected.").

<sup>106</sup> Article 9's rules for sales of promissory notes are the ones that are relevant for this analysis. Article 9 does provide for immediate and automatic perfection of security interests in payment rights other than those embodied in promissory notes, such as payment intangibles and accounts. *See* U.C.C. § 9-309(2) (assigned accounts and payment intangibles); *id.* § 9-309(3) (sold payment intangibles). Indeed, mere assignment without consideration, rather than sale, of payment intangibles and accounts may be sufficient to create perfected security interests in them. Section 9-309(2) provides for perfection upon attachment of a security interest in "an assignment of accounts or payment intangibles," but Section 9-203 provides that a security interest attaches "to collateral" when "value has been given." U.C.C. § 9-203(a) & (b)(1). Moreover, Section 9-102(a)(12) defines "collateral" as, *inter alia*, "accounts, chattel paper, payment intangibles, and promissory notes that have been sold" (emphasis added). Exactly how Article 9 works when "accounts" and "payment intangibles" are assigned without being sold is unclear from this text. However, the obligation to pay in a typical mortgage transaction seems fairly clearly to fall outside the U.C.C.'s definition of a "payment intangible," *see* U.C.C. § 9-102(a)(61) ("payment intangible" is a subset of "general intangible"); *id.* § 9-102(a)(42) ("general intangible" excludes "instruments"); *id.* § 9-102(a)(47) ("instrument" includes "any writing that evidences the right to the payment of an obligation"). Because the lender's right to be paid in a residential mortgage transaction typically is evidenced by a note that evidences the right to payment, no "payment intangible" would or "account" would be involved. *See* U.C.C. § 9-109(a)(2) ("Account" excludes "rights to payment ... evidenced by an instrument."). Thus, the rules for promissory notes, rather than those for payment intangibles or accounts, are the ones that are relevant.

that consideration was given for the promissory notes in each stage of the transaction. Specifically, only nominal consideration may have been given at the sponsor-depositor stage of many transactions. Thus, it is not clear that the rules the Permanent Editorial Board discusses apply.

A word of caution about the results of our review is in order. It apparently was not the practice of SEC staff to require that documents establishing the existence of consideration for notes sales be filed with the Commission.<sup>107</sup> Thus, it is possible that such documents exist and are not in the public record. That said, SEC rules generally require that “material” contracts be filed,<sup>108</sup> so one might expect that documents establishing the terms of the sale of notes from sponsor to depositor would be filed if they exist, regardless of staff requirements. Perhaps more importantly, the documents we reviewed frequently purported to be mortgage sale agreements. Even if there is no requirement to file mortgage sale agreements, it seems strange to file a document that calls itself a mortgage sale agreement while holding back another document that sets forth the true terms of the sale. Thus, although the results of our review must be considered suggestive rather than conclusive at this stage, our review does suggest that the agreements on file may mean what they say and that only nominal or other questionable consideration changed hands at the sponsor-depositor stage in many cases. This is plausible because the sponsor and depositor typically were subsidiaries of the same institution.

Our study covered a sample of residential mortgage securitization transactions from 2005 to 2007. The pool from which the sample was drawn was all deals in the Markit ABX.HE 2006-1, 2006-2, 2007-1, and 2007-2 indices. The Markit ABX.HE index is a widely used credit default swap index for the subprime private-label securitization market. The indices track a

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<sup>107</sup> Interview with SEC Staff, Jan. 20, 2012 (interview notes on file with authors).

<sup>108</sup> 17 C.F.R. § 229.601 (requiring material contracts to be filed with securities prospectuses)

fixed set of deals that were selected as benchmarks for the overall performance of the private label mortgage-backed security market. Our pool contained 80 deals from 30 different shelves.<sup>109</sup> We reviewed at least one deal from each shelf for which deal documents were available on EDGAR, for a total of 27 deals from 22 of the 30 shelves. We coded the deal documents' description of the consideration for the sponsor-depositor mortgage transfer, as shown in Table 1.

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<sup>109</sup> A “shelf” is a group of deals covered by a single “shelf” registration statement. It is reasonable to think that deals from the same shelf are likely to be more similar to one another than deals from different shelves.

Table 1: Summary of deal documents' description of consideration for the sponsor-depositor mortgage transfer in 27 deals from 22 different shelves

| <b>Consideration</b>  | <b>“For Value”?</b> | <b>Shelf Count</b> | <b>Deal Count</b> |
|---|---------------------|--------------------|-------------------|
| Significant cash plus certificates                                  | Yes                 | 5                  | 5                 |
| Face value of mortgage loans, plus cash                             | Yes                 | 1                  | 1                 |
| Certificates plus blank cash  | Questionable        | 3                  | 3                 |
| Certificates only   | Questionable        | 5                  | 6                 |
| \$10 plus “good and valuable consideration”                         | Questionable        | 2                  | 3                 |
| Referenced in documents, but blank or contained in unfiled document | Questionable        | 3                  | 6                 |
| Not referenced  | Questionable        | 1                  | 3                 |
| Mixed (some deals in one category above and some in another)        | Questionable        | 2                  | NA                |
| Total   |                     | 22                 | 27                |
| Percent Questionable  |                     | 73%                | 78%               |

We describe certain types of recited consideration as “questionable” because exchanging the mortgages for certificates representing some subset of the future cash flows from the mortgages, or for plainly nominal consideration such as \$10, may not be exchanging them “for

value” as the term is used in connection with Article 9 sales of promissory notes.<sup>110</sup> We discuss this issue in greater detail below.

Based solely on our review of the publicly filed deal documents, it seems that whether the mortgages were exchanged for value at the sponsor-depositor step is questionable in 78% of deals and 73% of shelves in our sample. Although other unreferenced, unfiled documents may establish that the mortgages were transferred for value, we might have expected to see that the deal documents plainly established that the mortgages were exchanged for substantial cash, as secondary sources describing the mortgage market indicate.<sup>111</sup>

### C. Consideration “Sufficient to Support a Simple Contract”

Although “consideration sufficient to support a simple contract” functions in this context as a test for whether mortgage recording rules apply, the concept’s normal function is to determine whether courts will enforce promises. “Consideration” historically has functioned in common-law legal systems as one ground on which promises can be enforced.<sup>112</sup> It is often said that promises “supported by consideration” generally will be enforced, and that promises that are

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<sup>110</sup> The U.C.C. defines “value” for Article 9 as including “any consideration sufficient to support a simple contract.” U.C.C. § 1-204(4). The question whether recitation of nominal consideration, such as \$10 for mortgages worth hundreds of millions of dollars, supports a contract, has long bedeviled contract law. The *Restatement (Second) of Contracts* casts the issue in terms of sham consideration: The recitation of nominal consideration cannot transform a promise to make a gift into a contract. RESTATEMENT (SECOND) OF CONTRACTS § 71 (1981). The same principle would suggest that an assignment of mortgages cannot be transformed into a sale by reciting nominal consideration. Some authorities distinguish between “sham” and “nominal” consideration, finding that consideration is a sham only when it is clear that there was no genuine bargaining and the parties did not even go through the formality of delivering the \$10. The *Restatement (Second)* however, does not make this distinction.

<sup>111</sup> See, e.g., ERNST & YOUNG, FINANCIAL REPORTING DEVELOPMENTS: TRANSFERS AND SERVICING OF FINANCIAL ASSETS, ACCOUNTING STANDARDS CODIFICATION 860 68 (depicting “cash” flowing back through two-step securitization structure from depositor to sponsor).

<sup>112</sup> See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 17(1) (with exceptions, “the formation of a contract requires ... a consideration.”); 2 JOSEPH M. PERILLO & HELEN HADJIYANNAKIS BENDER, CORBIN ON CONTRACTS § 5.1 at 2-3 (rev. ed. 1995) (consideration has been used in a “broad sense” to cover all bases for enforceability and in a narrow sense to “denote one reason deemed sufficient for enforcement of promises: the bargained-for exchange.”); JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS §§ 53-54 at 220-22 (5th ed. 2011) (“Consideration is the best-known validation device,” where a validation device is “used to make promises enforceable.”); Val D. Ricks, *The Sophisticated Doctrine of Consideration*, 9 GEO. MASON L. REV. 99, 143 (2000) (consideration is “one sufficient, but not necessary, ground for an action on a promise. It is not the only ground, nor has it ever been.”).

not “supported by consideration” will not be enforced unless some other validation device is present.<sup>113</sup>

The “sufficiency” of consideration can be distinguished from its “adequacy.”<sup>114</sup> It is said that courts generally will not inquire into the “adequacy” of consideration, meaning that even small consideration *can* suffice to support an exchange of something of much greater value,<sup>115</sup> as long as it meets the other requirements of consideration.

The ten dollars recited in some mortgage securitization agreements may not be sufficient to support a simple contract under Article 1 of the U.C.C., because the consideration may be merely nominal. Nominal consideration can be defined as a purported consideration that the promisor cannot reasonably be thought to have been seeking in exchange for the promise,<sup>116</sup> and typically refers to recitations that small sums are consideration for much more valuable promises.<sup>117</sup> The ten dollars recited in a mortgage securitization agreement is nominal consideration if it cannot reasonably be thought to have induced the sponsor’s transfer of the

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<sup>113</sup> Promises not supported by consideration may be enforced on other bases, such as the promisee’s reliance. RESTATEMENT (SECOND) OF CONTRACTS § 90. The extent to which this undermines the statement that consideration “generally” is required for enforcement is outside the scope of this project. The U.C.C. speaks in terms of “consideration,” not other bases for promise enforcement.

<sup>114</sup> *Id.* § 87 cmt. b. Compare JOSEPH M. PERILLO, CALAMARI & PERILLO ON CONTRACTS 154 (6th ed. 2009) (“As a general rule the courts do not review the adequacy of the consideration. The parties make their own bargains. Economic inadequacy of the detriment is, however, one of the factors to be considered in determining whether the promisor really exchanged the promise in return for a small detriment.”).

<sup>115</sup> See RESTATEMENT (SECOND) OF CONTRACTS §79 and cmt. c; RESTATEMENT (FIRST) OF CONTRACTS § 76 & cmt. a (“Legal sufficiency does not depend upon the comparative economic value of the consideration and what is promised in return.”); 1 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS (1950) § 127, at 540 (“Consideration in fact bargained for is not required to be adequate in the sense of equality of value.”).

<sup>116</sup> See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 71(1)-(2) (“To constitute consideration, a performance or a return promise must be bargained for. A performance or a return promise is bargained for if it is sought by the promisor in exchange for his promise and is given by the promisee in exchange for that promise.”); MURRAY, *supra* note 112, at 237 (“There is no doubt that all courts would consider the bargained-for exchange element essential.”); PERILLO & BENDER, *supra* note 112, § 5.1, at 6 (rev. ed. 1995) (“Current usage, no doubt influenced by both Restatements of Contracts, has restricted the term [consideration] to its narrow meaning of bargained-for exchange, . . .”). To be sure, not all authorities are convinced. See also PETER A. LINZER, A CONTRACTS ANTHOLOGY 271 (2d ed. 1995) (“Bargain held sway as the crux of contract formation during the “classical” period (roughly 1870 to World War II), and it still plays a basic role, particularly in carefully negotiated business dealings.”).

<sup>117</sup> See, e.g., *Capital Stack Fund v. Badio*, 2012 WL 3234283 (N.Y. Sup. Ct. July 15, 2012), at \*3 (“While there is scant case law on what constitutes ‘nominal consideration,’ the Court finds that, . . . ‘nominal consideration’ tends to refer to recitations like ‘ten dollars and other such good and valuable consideration.’”).

mortgages to the depositor.<sup>118</sup> It is not clear whether nominal consideration is “sufficient to support a simple contract” under Article 1 of the U.C.C.

In some cases, mortgage loan pools were exchanged for certificates entitling the owner to a subset of the pool’s cash flows. If a subset of the pool’s cash flows is mathematically worth less than all the cash flows, as seems likely, then this transaction is similar to the simultaneous exchange of two unequal sums of money. It is not clear that paying or promising to pay a smaller sum of money is “sufficient to support a simple contract” to pay a larger sum of money.

### 1. Nominal Consideration

One approach to deciding whether mortgages exchanged for nominal consideration are given “in return for consideration sufficient to support a simple contract” under the U.C.C. is to consider how the issue was understood when the Code was drafted and enacted<sup>119</sup> in the 1950s and 1960s.<sup>120</sup> The text of the Code provisions<sup>121</sup> defining “value” in terms of consideration for Article 9 have not changed in substance since the 1952 version of the Code, the first to be adopted by any state. The relevant official comment likewise has affirmed that the definition of

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<sup>118</sup> The documents we reviewed typically used language of present assignment and sale rather than promise. Although the word “consideration” is used to refer to what is given in exchange for an assignment rather than a promise, the U.C.C.’s definition of value in terms of a “simple contract” casts the issue in terms of promise.

<sup>119</sup> See SINGER & SINGER, *supra* note 76, § 50:1 (“Relevant antecedent common law comprises part of a statute’s legal history. And so the common law may be a relevant extrinsic aid to guide interpretation, along with all other components of the legal system at the time of enactment.”).

<sup>120</sup> A uniform commercial code was proposed at the 1940 conference of the National Conference of Commissioners on Uniform State Laws. The American Law Institute agreed to participate in 1942 and a revised sales act was approved in 1943-44. Drafting on a comprehensive code began in 1945 and an integrated draft was completed in 1949. Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798, 799-800 (1958). The Official Text with comments was first generally available in 1952. Mooney, *supra* note 6, at 1344. Pennsylvania enacted the 1952 Code in 1953. *Id.* at 1345. After revisions leading to 1957 and 1958 Official Texts, sixteen more states enacted the Code. See *id.* at 1345-46. The Official Text was amended again in 1962, and by 1967 all states but Louisiana had enacted a version of the Code. *Id.*

<sup>121</sup> Compare U.C.C. § 1-204(4) (2012) (outlining three ways of giving value (commitment to extend credit, acquisition is security for or in satisfaction of a preexisting claim, and accepting delivery under a preexisting contract for purchase) and concluding, “or (4) in return for any consideration sufficient to support a simple contract”) with U.C.C. 1952 OFFICIAL DRAFT, § 9-108(1), in 15 ELIZABETH SLUSSER KELLY, UNIFORM COMMERCIAL CODE DRAFTS 203 (1984) (value given if a person acquires rights “in consideration for any consideration sufficient to support a simple contract”).



value applicable to Article 9 “in substance continue[s] the definitions of value” in earlier uniform acts.<sup>122</sup>

The 1932 *Restatement (First) of Contracts*, which was current when the Code was drafted and enacted, expressly endorsed the use of nominal consideration. It provided that “[c]onsideration is not insufficient because of the fact ... that obtaining it was not the motive or a material cause inducing the promisor to make the promise,”<sup>123</sup> and gave an example in which a son’s promise his father to pay \$1 for land worth \$5000 was sufficient consideration.<sup>124</sup> It explained, “the intent of the parties as manifested to one another ... determines whether consideration is given for a promise, [so] the motive or cause is immaterial.”<sup>125</sup>

Even under the approach of the *Restatement (First)*, a false recital of consideration, “for \$1 in hand paid,” when the \$1 was not in fact paid or expected to be paid, was not sufficient.<sup>126</sup> The 1950 edition of *Corbin on Contracts* likewise provided, “A nominal consideration is not a sufficient one, if we mean by nominal that the stated consideration is a pretense and not a reality.”<sup>127</sup>

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<sup>122</sup> U.C.C. § 1-204 cmt. 1. Compare U.C.C. 1952 OFFICIAL DRAFT, § 9-108(1) cmt. 1, in 15 KELLY, *supra* note 121, at 203-06 (same). The comment to the 1952 Draft explained, “All the Uniform Acts in the commercial law field (except the Uniform Conditional Sales Act) have carried definitions of ‘value.’ All those definitions provided that value was any consideration sufficient to support a simple contract, including the taking of property in satisfaction of or as security for a pre-existing claim.” *Id.*

<sup>123</sup> RESTATEMENT (FIRST) OF CONTRACTS § 84. See also *Krell v. Codman*, 154 Mass. 454, 456 (1891) (Holmes, J.) (“Consideration is as much a matter of form as the seal.”); RESTATEMENT (FIRST) OF CONTRACTS § 84 illo. 1; Edwin W. Patterson, *An Apology for Consideration*, 58 COLUM. L. REV. 929, 949 (1958) (both “advisable to recognize” and “generally accepted in the United States” that “the requirement of consideration can be satisfied by a merely conventional exchange that actually occurs, the so-called ‘peppercorn’ consideration”) (citing RESTATEMENT (FIRST) OF CONTRACTS § 84(a)). See also Victor P. Goldberg, *Desperately Seeking Consideration: The Unfortunate Impact of U.C.C. Section 2-306 on Contract Interpretation*, 68 OHIO ST. L.J. 103, 108 (2007) (“traditional doctrine held that even a peppercorn would do”).

<sup>124</sup> RESTATEMENT (FIRST) OF CONTRACTS § 84 cmt. b Illo. 1.

<sup>125</sup> *Id.* cmt. b.

<sup>126</sup> *Id.* § 82 & Illo. 1; Patterson, *supra* note 123, at 949. See also JOSEPH M. PERILLO, CALAMARI & PERILLO ON CONTRACTS, § 4.6, at 158 (in nominal-consideration settings, “[t]he majority of courts have held that it may be shown that the consideration has not been paid and that no other consideration has been given.”).

<sup>127</sup> 1 CORBIN, *supra* note 115, § 130, at 557.

Some commentators have questioned whether the *Restatement (First)* accurately stated the law of nominal consideration when drafted,<sup>128</sup> and it is not clear that the leading commentators agreed with its analysis in the 1950s. The Third Edition of *Williston on Contracts*, published in 1957, provides that where “consideration of one dollar or other small sum is paid or alleged to have been paid in return for a promise to give or do something of considerable value ... an inquiry whether the dollar was really bargained for as the consideration will always be pertinent; for where a promise of value is stated to have been made for small money consideration, there is often reason to doubt whether a bargain to exchange the sum mentioned for the promise was really intended by the parties.”<sup>129</sup>

Moreover, the trend since the 1950s has been away from giving effect to nominal consideration. The *Restatement (Second) of Contracts*, from 1981, broke with the *Restatement (First)*. The *Restatement (Second)* declares that nominal consideration is ineffective, except in the special context of option and guaranty contracts. It provides that “to constitute consideration, a performance or a return promise must be bargained for,”<sup>130</sup> and further provides that “to be bargained for, a performance or a return promise is bargained for if it is ... sought by the promisor in exchange for his promise,”<sup>131</sup> that is if it “induces the making of the promise.”<sup>132</sup>

Thus, the *Restatement (Second)* tells us that if the purported consideration does not “induce” the making of the promise, it is not consideration at all, contradicting the *Restatement*

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<sup>128</sup> See Joseph Sipur, *The Peppercorn Reconsidered: Why a Contract to Sell Blackacre for Nominal Consideration Is Not Binding, But Should Be*, 97 NW. L. REV. 1809, 1821 (2003).

<sup>129</sup> 1 WALTER H.E. JAEGER, *WILLISTON ON CONTRACTS* §115, at 459-60 (3d ed. 1957).

<sup>130</sup> *RESTATEMENT (SECOND) OF CONTRACTS* §71(1).

<sup>131</sup> *Id.* §71(2).

<sup>132</sup> *Id.* §71 cmt. b. The *Restatement (Second)* does provide that “[t]he fact that what is bargained for does not of itself induce the making of a promise does not prevent it from being consideration for the promise.” *Id.* § 81(1). The apparent conflict with Section 71 and the more specific provisions on nominal consideration can be resolved by understanding the “of itself” in Section 81 as providing that the consideration need only be part of the inducement for the promise.

(*First*) view that “motive or cause is immaterial.”<sup>133</sup> The *Restatement (Second)* goes on to state explicitly that “where the purported consideration is merely nominal,” there is a “mere pretense of bargain” and no consideration.<sup>134</sup> It gives an example that expressly contradicts the *Restatement (First)*’s father-and-son illustration: “A desires to make a binding promise to give \$1000 to his son B. Being advised that a gratuitous promise is not binding, A offers to buy from B for \$1000 a book worth less than \$1. B accepts the offer knowing that the purchase of the book is a mere pretense. There is no consideration for A’s promise to pay \$1000.”<sup>135</sup> Applying the *Restatement*’s approach, if the receipt of \$10 did not “induce” the sponsor’s transfer of mortgages to the depositor, then it was not consideration for the transfer.

The development of the idea of consideration after adoption of the Uniform Commercial Code is relevant because consideration is a common-law concept, and common-law concepts evolve. Statutes that incorporate common-law concepts often are interpreted to authorize courts to apply the concepts as they change over time rather than to freeze their meaning at the time of enactment.<sup>136</sup> To be sure, eminent authorities have criticized the position of the *Restatement (Second)* on nominal consideration.<sup>137</sup> And the *Restatement (Second)* is not law and does not

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<sup>133</sup> RESTATEMENT (FIRST) OF CONTRACTS § 84 cmt. b.

<sup>134</sup> In such cases, the *Restatement* provides that the “promise may be enforced as a promise binding without consideration.” *Id.* §71 cmt. b.

<sup>135</sup> *Id.* § 71 Illo. 5; see also *id.* §79 Illo. 5 (“In consideration of one cent received, A promises to pay \$600 in three yearly installments of \$200 each. The one cent is merely nominal and is not consideration for A’s promise.”).

<sup>136</sup> See *Leegin Creative Leather Prods. v. PSKS, Inc.*, 551 U.S. 878, 888 (2007) (overruling precedent holding minimum resale price maintenance per se illegal as an unlawful “restraint of trade” under the Sherman Act: “The Sherman Act’s use of ‘restraint of trade’ ‘invokes the common law itself, not merely the static comment that the common law had assigned to the term in 1890.’” (citing *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 732 (1988)); *Li v. Yellow Cab, Inc.*, 532 P.2d 1226, 1233 (Cal. 1975) (interpreting statute thought to have codified contributory negligence standard to authorize application of comparative negligence: “It was not the intention of the Legislature in enacting [the relevant provision], as well as other sections of that code declarative of the common law, to insulate the matters therein from further judicial development; rather it was the intention of the Legislature to announce and formulate existing common law principles and definitions for purposes of orderly and concise presentation and with a distinct view toward continuing judicial evolution.”).

<sup>137</sup> See, e.g., PERILLO, *supra* note 126, at 158 (6th ed. 2009) (“minority and commercially sounder view” gives effect to recited consideration).

purport to summarize existing law in all respects.<sup>138</sup> But its provisions on the bargain theory of consideration are frequently cited,<sup>139</sup> and courts that cite the *Restatement (Second)* usually follow it, even when the *Restatement (Second)* departs from a traditional rule.<sup>140</sup>

It is unclear just how strong a foothold the approach set out in the *Restatement (Second)* has gained. Judicial authority on nominal consideration in contract law generally is scarce, but some courts have purported to apply the *Restatement's* rule, apply a mutual-inducement test, and decline to give effect to nominal consideration.<sup>141</sup> Contemporary contracts scholars make starkly different assumptions about whether courts generally give effect to nominal consideration.<sup>142</sup> One fairly recent survey of cases concludes that “the view that nominal consideration can be used to support a gratuitous promise ... simply cannot be maintained in light of the case law

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<sup>138</sup> *Id.* at 510-11 (quoting Herbert Wechsler’s description of Restatements as “normative” and Allan Farnsworth’s statement that “often a paucity of cases or a confusion in the courts’ analyses makes it impossible starkly to contrast innovation with tradition”).

<sup>139</sup> See e.g., *Lemmon v. Ayres*, 860 F.Supp.2d 489, 502 (S.D. Ohio 2012) (“the benefit or detriment need not be great, but it must be bargained for .... A detriment or benefit is bargained for if it is sought by the promisor in exchange for the promise and is given by the promisee in exchange for that promise.”); *Herman v. Bank of Nova Scotia*, 2012 4476656, at \*4 (D.V.I. 2012) (“Consideration requires a performance or a return promise that has been bargained for”) (citing *Restatement (Second)*); *Unified School Dist. No. 446 v. Sandoval*, 286 P.3d 542, 549-50 (Kan. 2012) (“formation of a contract requires a bargain in which there is a manifestation of mutual asset to an exchange and a consideration”) (citing *Restatement (Second)*). All these cases were decided in late August or September 2012.

<sup>140</sup> See Gregory E. Maggs, *Ipsa Dixit: The Restatement (Second) of Contracts and the Modern Development of Contract Law*, 66 GEO. WASH. L. REV. 508, 511-12, 542 (1998) (surveying judicial reception of six sections of *Restatement (Second) of Contracts* (§§ 15(1)(b), 86, 87(2), 89, 139, and 153) that “contradicted long-standing traditional rules – including black-letter rules that appeared in the original Restatement of Contracts” and finding that the provisions were “almost universally” accepted in the 241 cases that discussed them, with only eight decisions treating the new rules negatively).

<sup>141</sup> But see *Weed v. Weed*, 185 Vt. 83 (2008) (recited sum of ten dollars in deed did not satisfy mutual-inducement test); *Sfreddo v. Sfreddo*, 720 S.E.2d 145, 154-56 (Va. App. 2012) (despite Virginia’s embrace of “peppercorn” theory of consideration, sale for nominal consideration may lack a bargain and represent a gift); *Ganser v. Schwartz*, 576 N.W.2d 89 (Wis. App. 1998) (tbl. disp.) (\$10 recited consideration, even where paid, not legal consideration where promisor did not expect it to be paid).

<sup>142</sup> Compare W. Bradley Wendel, *Explanation in Legal Scholarship: The Inferential Structure of Doctrinal Legal Analysis*, 96 CORNELL L. REV. 1035, 1071 (2011) (“It is certainly a puzzle why contract law treats a peppercorn as adequate consideration while using a seal is treated as a ‘mere formality,’ not satisfying the consideration requirement.”) with Gregory Klass, *Three Pictures of Contract*, 83 N.Y.U. L. REV. 1726, 1757 (2008) (“Where a purported consideration is ‘a mere formality or pretense,’ the law treats it as nominal and insufficient to satisfy the consideration requirement. The peppercorn rule denies enforcement precisely when the parties most clearly wanted it.”). Neither of these authors gives a detailed analysis of the caselaw on nominal consideration.

bearing on the subject,”<sup>143</sup> but the author’s finding is that few cases affirmatively find nominal consideration effective, not that many cases find nominal consideration ineffective.

A court that follows the more recent treatment of nominal consideration probably would find that nominal consideration alone<sup>144</sup> is “not sufficient to support a simple contract” as the term is used in the Uniform Commercial Code. It might be argued that the difference between the *Restatement (First)* and the *Restatement (Second)* relates to the fact of bargain (consideration) and not to the separate question of its sufficiency. Thus, because the \$10 could support *some* simple contract (for example, a contract to buy a book), it is “sufficient” in general.<sup>145</sup> But “sufficiency” has been understood as an attribute of a specific bargain, not as a freestanding, independent concept.<sup>146</sup> Put differently, if something is not consideration in the first place, it cannot be sufficient consideration.<sup>147</sup> If we no longer recognize nominal consideration as bargained for, we cannot recognize it as sufficient.

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<sup>143</sup> See Siprut, *supra* note 128, 1821 (2003). The author concludes that nominal consideration is effective only for option and guaranty contracts, and then only when the nominal consideration is in fact delivered.

<sup>144</sup> To be sure, a court might determine that the consideration given in the mortgage securitization transactions we reviewed was not the recited consideration of \$10 or a subset of the mortgage cash flows, but instead was supplied by the surrounding business context of the transaction: The sponsor wanted to accomplish the transaction, and the depositor’s assistance in doing so supplied the consideration. Compare Andrew Kull, *Reconsidering Gratuitous Promises*, 21 J. LEGAL STUD. 39, 39 (1992) (asserting that practical importance of consideration has decreased because of “a more realistic readiness to find consideration in the business motives behind business transactions”). Such a broad focus is inconsistent with the formalistic nature of mortgage securitization transactions more generally; for example, bankruptcy remoteness opinions apparently rely on the *separateness* of the sponsor-depositor and depositor-trust transfers.

<sup>145</sup> In comments, the *Restatement (First) of Contracts* expressly “distinguish[es] the two questions, whether there is consideration and whether that consideration is sufficient.” RESTATEMENT (FIRST) OF CONTRACTS §75 cmt. b. However, that the two inquiries can be distinguished does not mean they are independent.

<sup>146</sup> RESTATEMENT (FIRST) OF CONTRACTS § 75 cmt. c (“[A]lthough a price has been agreed upon and paid for a promise, the promise is not binding unless the law deems *the price* sufficient.”) (emphasis added). The existence vel non of a bargain goes to whether consideration exists, and there is a separate, further question, addressed in separate sections of the Restatement, about whether the consideration is “sufficient.” *Id.* § 76 (sufficiency of performance or forbearance); §§ 77-80 (sufficiency of promises). See also 1 JAEGER, *supra* note 129, § 100, at 371 (“Though a peppercorn *may* be sufficient consideration for a promise, whether or not it depends on whether it was in fact the exchange or at least a requested detriment induced by the promise”).

<sup>147</sup> See JAEGER, *supra* note 129, §101, at 373-74 (“If it is said that a promise is not supported by sufficient or valid consideration, the meaning is that, though the promisor may have asked and received a return for his promise, the return is not what the law deems ‘consideration’ to make the promise enforceable.”). Somewhat confusingly, Jaeger goes on to state that “a mere incidental or friendly detriment not intended as an ingredient for a

It is often argued that nominal consideration should be given effect because it compensates for the decline of the seal. The seal functioned as a purely formal validation device,<sup>148</sup> and since its decline<sup>149</sup> parties have had no reliable purely formal way of invoking enforcement of promises. Nominal consideration arguably fills this gap.<sup>150</sup> This argument actually implies nominal consideration is not consideration “sufficient to support a *simple* contract.” Simple contracts are enforceable because of consideration; formal contracts, by contrast,<sup>151</sup> are enforceable through purely formal validation.<sup>152</sup> A contract that is enforceable because of purely formal validation is a “formal contract,” and a contract that is enforceable because of consideration is a “simple contract.”<sup>153</sup> The Third Edition of *Williston on Contracts* introduces its discussion of formal contracts as follows: “The contracts dependent on form are those under seal; their use was common long before simple contracts were recognized.”<sup>154</sup> If nominal consideration makes a promise enforceable as a purely formal validation device, it does so because the promise is part of a formal contract, rather than a simple contract.

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bargain not intended as an ingredient for a bargain [is] therefore not a bargained-for consideration.” *Id.* (citing Restatement (First) of Contracts, §§75-76).

<sup>148</sup> In jurisdictions that recognize sealed promises, “[n]either consideration ... nor subsequent action in detrimental reliance is necessary to make the sealed promise enforceable.” ERIC MILLS HOLMES, 3 CORBIN ON CONTRACTS §10.14, at 399 (1996).

<sup>149</sup> The seal is no longer operative in most states. *Id.* §10.18, at 418. For views that nominal consideration compensates for the decline of the seal, see PERILLO, *supra* note 126, at 159; Siprut, *supra* note 128, at 1847-51.

<sup>150</sup> Compare Celia Taylor, *My Modest Proposal*, 18 ST. THOMAS L. REV. 117, 120 (2005) (nominal consideration does not serve the “cautionary” and “channeling” functions of consideration as well as the seal).

<sup>151</sup> See 3 HOLMES, CORBIN ON CONTRACTS, *supra* note 148, §10.18, at 423; RESTATEMENT (SECOND) OF CONTRACTS § 6 cmt. a (distinguishing between “formal” and “informal” or “simple” contracts); MURRAY, *supra* note 112, §17, at 35 (“The antithesis of the formal contract is the informal contract, which is sometimes also called a simple contract or bargain.”).

<sup>152</sup> See, e.g., *Columbia Ass’n v. Poteet*, 23 A.3d 308, 314-15 (Md. App. 2011) (three-year statute of limitations applicable to a simple contract; twelve-year limitation to “specialty,” or contract under seal); see also 1A CORBIN, *supra* note 115, § 252, at 435 n.98 (“Specialties -- those formal common-law contracts under seal -- were enforced in the absence of an allegation of consideration ... because consideration was not an essential element to such contracts.”).

<sup>153</sup> The *Restatement* explains its treatment of nominal consideration for option and guaranty contracts along these lines: the recital of nominal consideration is not itself “consideration” sufficient to support a simple contract, but rather something different: a purely formal validation device. See RESTATEMENT (SECOND) OF CONTRACTS § 87 cmt. c; MURRAY, *supra* note 112, § 62[B][4], at 268-69; *accord* 1464-Eight, Ltd. v. Joppich, 154 S.W.3d 101, 105-06 (Tex. 2004) (approvingly citing *Restatement* and Murray in course of deciding that option contract was enforceable despite nonpayment of recited nominal consideration).

<sup>154</sup> 1 JAEGER, *supra* note 129, at 765.

Courts that have applied the U.C.C.’s definition of “value” in recent cases have followed the *Restatement (Second)* and insisted on bargained-for exchange without parsing the issue as finely as we have here.<sup>155</sup> At least one court has suggested that the words “consideration sufficient to support a simple contract” in the Bankruptcy Code requires something beyond nominal consideration.<sup>156</sup> Although we have found no cases in which a court applied the U.C.C. definition of value in a case of nominal consideration, the trend in the U.C.C. caselaw about “value” seems to be toward insistence on actual mutual inducement, just as it is in the caselaw of consideration more generally.

## 2. Certificates for Pools

Under the *Restatement (First) of Contracts*, the transfer of \$5 at a given time and place is not sufficient consideration for a promise to transfer \$10 at the same time and place.<sup>157</sup> Nor is a promise to transfer \$5 sufficient to support a promise to transfer \$10.<sup>158</sup> Corbin explained that a smaller sum is not consideration for a promise to pay a larger sum because of a “mathematically certain relationship” of inequality of value.<sup>159</sup> Williston likewise explained: “The exception to

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<sup>155</sup> See *Chase Inv. Servs. v. Law Offices of Jon Divens*, 748 F. Supp. 2d 1145, 1169 (C.D. Cal. 2010) (“To constitute consideration sufficient to support a contract, it is not sufficient that a party simply confer a benefit or provide a service to the other party; rather, the performance of that service must be *bargained for*.”) (emphasis in original) (interpreting U.C.C. §1-204 and citing *Restatement (Second) of Contracts*); *Adelvision L.P. v. Groff*, 859 F. Supp. 797, 804 (E.D. Pa. 1994) (“valid consideration must be ... bargained for and given in exchange for the promise”) (interpreting former U.C.C. §1-201; *In re Blatstein*, 226 B.R. 140, 152 (E.D. Pa. 1998) (same), rev’d in part on other grounds, 192 F.3d 88 (3d Cir. 1999)).

<sup>156</sup> See *In re Judd*, 471 B.R. 830, 847 (D.S.C. 2010) (“consideration sufficient to support a simple contract” “need not be reasonably equivalent value” but is “analogous to the ‘value’ required under state law to achieve the status of a bona fide purchaser for value”) (interpreting 11 U.S.C. §550(b)).

<sup>157</sup> RESTATEMENT (FIRST) OF CONTRACTS § 76(c) (“transfer of money or fungible goods” not sufficient consideration for “a promise to transfer at the same time and place a larger amount of money or goods of the same kind and quality.”).

<sup>158</sup> RESTATEMENT (FIRST) OF CONTRACTS § 78 (“A promise is insufficient consideration if the promisor knows or has reason to know ... that it can be performed by some act or forbearance which would be insufficient consideration for a unilateral contract.”).

<sup>159</sup> See CORBIN, *supra* note 115, § 129, at 556 (“mathematically certain relationship” in which the smaller sum is less valuable renders the smaller sum not good consideration for the larger sum). See also WALTER H.E. JAEGER, 1 WILLISTON ON CONTRACTS § 115 at 460-61 (3d ed. 1957) (“The exception to the legal sufficiency of inadequate consideration is where the consideration is of the same nature as the thing promised and is equal or

the legal sufficiency of inadequate consideration is where the consideration is of the same nature as the thing promised and is equal or smaller in amount. The reason for this exception is that in such a case, it is clear that the law cannot indulge in the presumption of equivalence between the consideration and the promise.”<sup>160</sup> The *Restatement (Second) of Contracts* does not address the simultaneous exchange of unequal amounts of money, but states that courts “ordinarily” do not inquire into the adequacy of consideration, “particularly” “when one or both the values exchanged are uncertain or difficult to measure,”<sup>161</sup> and notes that “[d]isparity in value, with or without other circumstances, sometimes indicates that the purported consideration was not in fact bargained for but was a mere formality or pretense.”<sup>162</sup>

The same principle may apply to the exchange of a pool of mortgages for certificates representing a right to a fraction of the cash those mortgages will generate.<sup>163</sup> Although the value of the mortgage pool and the value of the certificates both are uncertain, the relationship of the values seems much closer to certain. We found that this kind of recital was fairly common, appearing in five of our 22 shelves.<sup>164</sup>

Although a federal trial court in Virginia stated that giving certificates representing claims to the entire flow of cash from a pool of mortgages constituted “value” under another version of the Code,<sup>165</sup> it did not analyze the question of value, instead simply stating that value was given because the certificates were given. Moreover, the statement is dicta. The court was analyzing whether the holder in due course doctrine protected the trustee’s right to enforce the

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smaller in amount. The reason for this exception is that in such a case, the law cannot indulge in the presumption of equivalence between the consideration and the promise.”)

<sup>160</sup> 1 JAEGER, *supra* note 129, §116, at 460.

<sup>161</sup> RESTATEMENT (SECOND) OF CONTRACTS § 79 cmt. c.

<sup>162</sup> RESTATEMENT (SECOND) OF CONTRACTS § 79 cmt. d.

<sup>163</sup> See 2 JASON H.P. KRAVITT ET AL., *supra* note 91, § 16.02[B], at 16-15 (MBS certificates are designed so that “required amortization from the mortgage pool will equal or exceed the scheduled payments of interest, at the related coupon rate, and principal on the pay-through mortgage-backed securities”) (2010).

<sup>164</sup> See *supra* Tbl. 1.

<sup>165</sup> Bankers Trust (Delaware) v. 236 Beltway Investment, 865 F. Supp. 1186, 1195 (E.D. Va. 1994).



notes in question, and it found that the doctrine did not apply because the notes were nonnegotiable even though value was present.<sup>166</sup> The court's determination about value has not been followed in any reported case.

### 3. Collapsing the Steps

If one collapses all the intermediate steps of a securitization transaction and views the transaction as a whole, it appears obvious that consideration was given. Investors parted with large amounts of money in exchange for claims on the cash flows of mortgages. Based on this, one might argue that focusing on the intermediate stages of the transaction is mere pettifoggery: consideration for the transaction taken as a whole implies consideration at each step. Relatedly, one might point to rules that a single consideration can support multiple promises<sup>167</sup> and that consideration need not move from promisee to promisor<sup>168</sup> to argue that the investors' payment was the consideration needed to create in turn first the sponsor's, then the depositor's, and finally the SPV's security interest. Either approach treats the entire transaction as one big exchange rather than a sequence of separate exchanges.

However, it appears the transacting parties relied on the separateness of the intermediate sponsor-depositor exchange to achieve at least two different but related goals of the securitization transaction. First, securitization transactions are designed so that the securitized assets will not be considered assets of the transferor and subjected to the jurisdiction of the bankruptcy court if the transferor enters bankruptcy.<sup>169</sup> This feature of securitization, called "true sale," allows the investors to worry only about the quality of the assets, not the credit

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<sup>166</sup> *Id.* at 1197-98.

<sup>167</sup> RESTATEMENT (SECOND) OF CONTRACTS § 80(1); RESTATEMENT (FIRST) OF CONTRACTS § 83.

<sup>168</sup> RESTATEMENT (SECOND) OF CONTRACTS § 71(4); RESTATEMENT (FIRST) OF CONTRACTS § 75(2).

<sup>169</sup> KRAVITT, *supra* note 91, § 5.01.

quality of the transferor.<sup>170</sup> Credit ratings for securitized assets also depend on true sale,<sup>171</sup> and the associated protection from bankruptcy been described as a central motivation for securitization.<sup>172</sup> Second, the transferor generally seeks to move the securitized assets off its balance sheet for accounting purposes.<sup>173</sup> This can be accomplished under accounting rules only if the assets are “legally isolated” from the transferor.<sup>174</sup> Legal isolation in turn relies on “true sale.”<sup>175</sup>

A simple sale from the sponsor to the securitization vehicle might accomplish true sale and legal isolation, but in many cases the simple approach is not satisfactory for transacting parties. In many securitizations, the parties wanted an entity affiliated with the sponsor to provide the investors with some kind of protection against credit or interest rate risk.<sup>176</sup> If the sponsor were to provide this protection directly, the assets would not be separate enough to qualify the transaction as a true sale.<sup>177</sup> For that reason, a special entity, the depositor, is created to provide the protection, and the assets are transferred in two steps: first from sponsor to depositor, and then from depositor to securitization vehicle.<sup>178</sup> Although the transfer from the depositor to the vehicle is not a true sale, the depositor is designed to have such a small chance of entering bankruptcy that this doesn’t matter: The assets are bankruptcy remote and legally

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<sup>170</sup> KRAVITT, *supra* note 91, § 5.03[A].

<sup>171</sup> KRAVITT, *supra* note 91, § 5.03[A]. (rating agencies rely on true sale to issue ratings based on assets rather than transferor).

<sup>172</sup> See Hunt et al., *All in One Basket*, *supra* note 22, at \_\_ (nn. 43-48).

<sup>173</sup> ERNST & YOUNG, *supra* note 111, at 67; KRAVITT, *supra* note 91, § 3.02[A] (“From the inception of modern securitization, analysts have recognized the importance to originators of removing financial assets and associated financing from the originator’s balance sheet.”).

<sup>174</sup> ERNST & YOUNG, *supra* note 111, at 67.

<sup>175</sup> ERNST & YOUNG, *supra* note 111, at 69.

<sup>176</sup> ERNST & YOUNG, *supra* note 111, at 69.

<sup>177</sup> ERNST & YOUNG, *supra* note 111, at 69.

<sup>178</sup> ERNST & YOUNG, *supra* note 111, at 70.

isolated from the sponsor.<sup>179</sup> If the assets were transferred directly from the sponsor to the trust, the assets would not be bankruptcy remote or legally isolated from the sponsor.

Thus, it appears that the separate sponsor-depositor transfer is a crucial feature of securitizations. The essence of the device is that there is a true sale from the sponsor, even if not from the depositor. Collapsing the transaction into one big exchange seems inconsistent with the idea that there are two separate transfers, one of which can be a true sale even if the other is not. Thus, collapsing the transaction would seem to undermine the protection from bankruptcy and the off-balance-sheet treatment the transaction structure is designed to achieve. While it is conceivable that the sponsor-depositor step could be disregarded for analysis of consideration and mortgage recording and respected for other purposes, such an analytical inconsistency would permit transacting parties to first select a structure and then pick and choose how that structure would be treated based on their own convenience. A court might be reluctant to sanction such obvious cherry-picking.

## V. ARTICLE 9 AND DISPUTES OVER EXISTING TRANSACTIONS

Courts faced with the question whether nominal consideration should be given effect in the context of mortgage securitization would evaluate “consideration sufficient to support a simple contract” with a high degree of freedom. Case precedent is sparse, particularly in the U.C.C. context, and academic commentary is inapposite. In this Part, we identify some policy concerns that could guide courts in applying the requirement of consideration “sufficient to support a simple contract” in disputes over existing mortgage securitizations and weigh these concerns in three contexts where Article 9 could become an issue.

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<sup>179</sup> ERNST & YOUNG, *supra* note 111, at 70.

### A. *Overarching Concerns About Article 9*

Two overarching policy concerns will lurk in the background in all the cases we discuss: First is the interest in security of transactions and stability of the financial system.<sup>180</sup> This concern will disfavor disturbing existing transactions, especially if many of them are disturbed at one time.

Second is the interest in maintaining public records of mortgage ownership. Because the Article 9 provisions permit the transacting parties to get many of the benefits of recording mortgage assignments without incurring the trouble and expense of recording, they encourage parties not to use the public recording system. Even though the risk to the recording system comes from Article 9 itself and not from the use of nominal consideration, courts that are concerned about the recording system might refuse to give effect to nominal consideration.

### B. *Overarching Concerns About Nominal Consideration*

It is not clear that the policies supposedly underlying consideration as a contract doctrine are served by refusing to give effect to nominal consideration in any of the cases we address. In general, those concerns relate to consideration's role in making promises enforceable as between promisor and promisee, not to what rights should exist against third parties.<sup>181</sup> However, the use of nominal consideration is important for at least three reasons.

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<sup>180</sup> See, e.g., White, *supra* note 315, at 499 (“Courts have been shocked at bank practices, but are probably unwilling to issue decisions that will void titles on a vast scale.”). Compare Elizabeth Renuart, *Property Title Trouble in Non-Judicial Foreclosure States: The Ibanez Time Bomb?*, 4 WM. & MARY BUS. L. REV. \_\_\_ (forthcoming 2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1968504](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1968504), at 79. (“[P]roperty title trouble is likely in Georgia and Nevada, and to a lesser extent California.”).

<sup>181</sup> See Nicholas C. Dranias, *Consideration as Contract: A Secular Natural Law of Contracts*, 12 TEX. REV. L. & POL. 267, 326-27 (2008) (proposing to protect autonomy by “returning consideration to its central role in rendering promises morally enforceable”); David Gamage & Allon Kedem, *Commodification and Contract Formation: Placing the Consideration Doctrine on Sounder Foundations*, 73 U. CHI. L. REV. 1299, 1367 (2006) (proposing reformulation of consideration doctrine to provide “a superior method for determining which promises parties actually desire to have enforced”); Daniel Markovits, *Contract and Collaboration*, 113 YALE L.J. 1417, 1482-83 (2004) (justifying the institution of contract in general, and the doctrine of consideration, in terms of collaboration between contract parties, and observing, “Bargains are in their nature wanted by, and invoke the

First, the Article 9 revisions can be understood as implementing a compromise between the values of recording<sup>182</sup> and those of convenience and economy. Insofar as they are understood as a compromise, there is value in strictly enforcing their scope. It is clear that the Article 9 revisions were intended to cover sales of promissory notes and lending against promissory notes, but interpreting the “value” requirement to cover transfers that do not resemble sales or secured lending because only nominal consideration is given would upset a balance. Even arrangements that appear arbitrary should be respected if they are the product of negotiation.

Second, even if a court is not convinced that an expansive reading of “value” would violate a carefully negotiated boundary between the domain where recording is not required (sales and pledges) and the domain where it is (gratuitous transfers), a pro-recording court could easily use consideration doctrine to reach its preferred result. A court determined to vindicate the importance of recording could determine what result it wanted to reach and rule on the

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intentions of, all participants”). Celia Taylor has proposed the return of the seal, in all its formality, to its former status. *See* Celia Taylor, *My Modest Proposal*, 18 ST. THOMAS L. REV. 117, 117 (2003) (“unfortunate fate of donative promises”); Melvin Aron Eisenberg, *The World of Contract and the World of Gift*, 85 CAL. L. REV. 821 (1997) (arguing that many “gratuitous” promises, such as promises to make one-sided contract modifications or hold offers open, should be enforced, but that simple promises to make gifts motivated by affection should not be enforced); Mark B. Wessman, *Retraining the Gatekeeper: Further Reflections on the Doctrine of Consideration*, 29 LOY. L.A. L. REV. 713, 845 (1995) (evaluating consideration doctrine in terms of the desirability of enforcing gratuitous promises and concluding that consideration should not be a necessary condition for presumptive enforceability); Kull, *supra* note 144. *See* Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261 (1980). Peter Benson, who understands the exchange of promises that satisfy mutual consideration as the transfer of property rights in the promised performances, concludes that “[b]ecause the entitlement is framed as an aspect of the transfer, it can only be between the parties and not as against third parties.” Peter Benson, *The Idea of Consideration*, 61 U. TORONTO L.J. 241 (2011).

<sup>182</sup> Scholars disagree over how useful public records have been in giving notice of mortgage ownership. Compare Christopher L. Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, 78 U. CIN. L. REV. 1359, 1400-04 (2010) (arguing that MERS threatens to render a useful public mortgage recording system useless) with Dale A. Whitman, e-mail to “propertyprof” listserv, March 15, 2012 (“For at least 25 years, and probably much longer, no one could reliably determine who held a mortgage loan by making a title search.”). *See also* MERSCORP, Inc. v. Romaine, 861 N.E.2d 81, 88 (N.Y. 2007) (Kaye, J., dissenting in part) (“[T]he MERS system will render the public record useless”). It does seem that mortgage assignments were commonly recorded as late as the late 1990s. Dale A. Whitman, *Digital Recording of Real Estate Conveyances*, 32 J. MARSHALL L. REV. 227, 241 (1999) (mortgage assignments are among the “twenty or thirty form documents that account for the vast bulk of real estate recordings”).

effectiveness of nominal consideration accordingly. Or a court could find its application of the doctrine colored by its preferred outcome. Consideration doctrine often has been used this way.<sup>183</sup>

Third, a formalistically inclined court might simply apply the commonly stated “rule” that nominal consideration is ineffective. This risk exists whether or not one believes that nominal consideration should be effective, and suggests that it is more prudent not to use nominal consideration in mortgage securitization transactions.<sup>184</sup>

### *C. In Foreclosure Litigation: Disputes Between Borrowers and Foreclosing Parties*

The interaction of Article 9 with state foreclosure law must be evaluated separately under the statutory scheme of each state.<sup>185</sup> As we discuss below, courts generally should respect Article 9 provisions in cases where there is no statutory requirement to record assignments and the borrower merely challenges the standing of a noteholder to foreclose or argues that a mortgage assignment is needed to satisfy the Statute of Frauds. On the other hand, where a statute that protects borrowers specifically requires recording as a prerequisite to foreclosure, Article 9 should not trump this requirement. Although the issue of failure to record mortgage assignments comes up in a variety of contexts under the heterogeneous foreclosure laws of the states, we divide these challenges into two categories.

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<sup>183</sup> See, e.g., Mark B. Wessman, *Should We Fire the Gatekeeper? An Examination of the Doctrine of Consideration*, 48 U. MIAMI L. REV. 45, 69-97 (1993) (cataloguing courts’ uses of consideration doctrine to police contracts against bargaining misconduct and for fairness, and to effect disguised policy judgments).

<sup>184</sup> See discussion *infra* Part VI.

<sup>185</sup> State law is heterogeneous. For example, just over half of states allow nonjudicial foreclosure, while the others require judicial involvement. See, e.g., *Niday v. GMAC Mortg., LLC*, 284 P.3d 1157, 1158 n.1 (Or. Ct. App. 2012) (listing 28 states that have enacted statutes permitting nonjudicial foreclosure).

## 1. Borrower Challenges Based on Standing and the Statute of Frauds

Borrowers frequently argue that the foreclosing party has not shown that it “has standing” or is a “real party in interest.”<sup>186</sup> This argument is common when the borrower is in bankruptcy, where the foreclosing party must affirmatively seek to lift the automatic stay to proceed with foreclosure.<sup>187</sup> Such arguments usually fail when the foreclosing party can show that it has the right to enforce the note. Courts often invoke a rule that “the mortgage follows the note” and decide that a party that can enforce the note need not do anything more to show that it can enforce the mortgage. Courts often find a basis for the rule in common law or a non-U.C.C. statute.<sup>188</sup>

Article 9 can be relevant in such foreclosure disputes because it apparently provides that note-transfer formalities to some extent trump mortgage-transfer formalities.<sup>189</sup> Courts have on occasion relied on Article 9 in holding that “the mortgage follows the note” in foreclosure-related litigation.<sup>190</sup> The Permanent Editorial Board states that “determinations made pursuant to the ... UCC rules described in this Report will, in many cases, be central” to decisions under

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<sup>186</sup> For a discussion of the current state of the law in the key nonjudicial foreclosure states of Arizona, California, Georgia, and Nevada, *see* Renuart, *supra* note 180.

<sup>187</sup> *See, e.g., In re Mann*, 907 F.2d 923-926-27 (9th Cir. 1990); *In re Alcide*, 450 B.R. 526, 536-37 (Bankr. E.D. Pa. 2011) (analyzing issue in terms of mortgage “holder” but treating holder status as equivalent to ownership).

<sup>188</sup> *See, e.g., BAC Home Loan Servicing, LP v. Canches*, 2012 WL 5278588 (non-U.C.C. statute “codifies the common law principle that ‘the mortgage follows the note’” in Connecticut); *MetLife Home Loans v. Hansen*, 2012 WL 4466143, at \*7 (Kan. App. Sept. 28, 2012) (“common-law concept of the mortgage following the note remains good law”).

<sup>189</sup> Courts in California have held that the state’s nonjudicial foreclosure statute is “exhaustive,” so that other portions of the Uniform Commercial Code are irrelevant to nonjudicial foreclosure. *See, e.g., Debrunner v. Deutsche Bank Nat’l Trust Co.*, 204 Cal. App. 4th 433, 440-41 (2012) (borrower’s reliance on U.C.C. Article 3 note transfer provisions “misplaced” in nonjudicial foreclosure proceeding).

<sup>190</sup> *See Anderson v. Burson*, 35 A.3d 452, 460 (Md. 2011) (citing §9-203(g) in support of proposition that dispute over transfer of mortgage loan governed by note-transfer rules; no dispute over transfer of mortgage as opposed to transfer of note presented in case); *In re Veal*, 450 B.R. 897, 910 n. 19, 919-20 (9th Cir. B .A.P. 2011) (citing § 9-203(g) for general proposition that mortgage follows note and holding in context of proof to claim to note (not attempt to lift stay to foreclose that assignment of mortgage that did not purport to assign note did not transfer right to enforce note); *Campbell v. IndyMac Mortgage Servs.*, 2011 WL 3897826, at \*2 (W.D. Wash. Sept. 6, 2011) (citing 9-203(g) for proposition status as holder of note entitled party to enforce deed of trust); *Deutsche Bank Nat’l Trust Co. v. Pietranico*, 928 N.Y.S.2d 818, 832 n. 12 (N.Y. Sup. July 27, 2011) (mentioning §§9-203(g) and 9-308(e) in passing in course of holding that MERS has authority to assign mortgages).

state foreclosure law,<sup>191</sup> and the Report itself seems likely to have been written in response to the foreclosure case of *Ibanez v. U.S Bank, N.A.*<sup>192</sup>

*Ibanez* is a very high-profile exception to the generalization that most states follow the rule that the mortgage follows the note. In *Ibanez*, the court held that a nonjudicial foreclosure conducted by a securitization trustee was invalid, even though the trustee held the note, because the trustee had not shown that it had an interest in the mortgage.<sup>193</sup> The court expressly rejected the “mortgage follows the note” rule<sup>194</sup> and required the foreclosing party to show separately that it had an interest in the mortgage.<sup>195</sup>

It seems likely that this decision prompted the Permanent Editorial Board’s report. Work on the report apparently began shortly after the opinion was issued, and the Board criticized *Ibanez* – the only case mentioned in the Report -- for “disregard[ing] the impact of Article 9.”<sup>196</sup> The report suggests that *Ibanez* could have come out differently if the court had considered Article 9, because if the securitization trustee had proven it had a security interest (such as a buyer’s interest) in the note, then it would have proven automatically that it had a security interest in the mortgage.<sup>197</sup> If the trustee automatically had a buyer’s interest in the mortgage, it

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<sup>191</sup> PERMANENT EDITORIAL BOARD, *supra* note 4, at 14. The only specific case the Board mentions is the Massachusetts Supreme Judicial Court’s decision in *U.S. Bank, N.A. v. Ibanez*, a decision that declined to follow “the mortgage follows the note” in a foreclosure context. *Id.* at 12 & n.43.

<sup>192</sup> *Ibanez v. U.S. Bank Nat’l Ass’n*, 941 N.E.2d 40.

<sup>193</sup> Technically, the court’s holding was that the trustee did not qualify to proceed under the Massachusetts nonjudicial foreclosure statute because it had not shown it was a “mortgagee” or one an “assign.” *Id.* at 50. This was solely based on the fact that the trustee did not have an assignment of the mortgage, however.

<sup>194</sup> *Id.* at 53-54 (“In Massachusetts, where a note has been assigned but there is no written assignment of the mortgage underlying the note, the assignment of the note does not carry with it the assignment of the mortgage.”). In *Ibanez*, the securitization trustee had itself purchased the mortgaged property at the foreclosure sale and sought to quiet title. *Id.* at 44. Thus, the foreclosing party was the plaintiff even though it used nonjudicial foreclosure. *Id.*

<sup>195</sup> *Id.* at 50 (Mass. 2011) (“[O]nly a present holder of the mortgage is authorized to foreclose on the mortgaged property, . . .”); *see also* *Eaton v. Federal Nat’l Mortg. Ass’n*, 969 N.E.2d 1118 (Mass. 2012) ((in post-sale challenge to nonjudicial foreclosure in Massachusetts, holding that party must hold security instrument and hold mortgage note or act on behalf of note holder in order to be a “mortgagee” authorized to carry out nonjudicial foreclosure under a power of sale).

<sup>196</sup> *See* PERMANENT EDITORIAL BOARD, *supra* note 4, at 12 & n.43.

<sup>197</sup> *See* PERMANENT EDITORIAL BOARD, *supra* note 4, at 12 n.43.



seems more difficult to conclude, as the court did, that the trustee was not an assignee of the mortgage.<sup>198</sup>

It is not clear how widely *Ibanez*, with its rejection of the common-law mortgage-follows-the-note rule, will be followed outside Massachusetts.<sup>199</sup> It appears that most states follow the common-law rule, although Georgia apparently may be an exception.<sup>200</sup>

Cases such as *Leyva v. National Default Servicing Corp.*<sup>201</sup> where the Nevada Supreme Court held that a separate assignment of the mortgage is needed to satisfy the state's statute of frauds<sup>202</sup> are similar: compliance with Article 9 seems to satisfy the purpose of the statute. Article 9's mortgage-follows-the-note rules are activated only if there is an authenticated security agreement,<sup>203</sup> or a security agreement coupled with possession of the note.<sup>204</sup> These requirements are themselves "in the nature of a Statute of Frauds."<sup>205</sup> In a Nevada case similar to *Leyva*, where the foreclosing party can prove that it owns the note<sup>206</sup> but has no separate assignment of the mortgage, it seems likely to be sensible to hold that meeting the Article 9

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<sup>198</sup> The report stops short of saying that Code would resolve the issue, noting that even if the foreclosing party proved it had a security interest in the mortgage," this would not, of itself, mean that the holder could enforce the mortgage in the absence of a recordable assignment of the mortgage to the holder," but points to the steps a note owner can take to become the record holder of a mortgage. *Id.* Nevertheless, the clear implication is that a separate mortgage assignment should not be required. *See id.* at 1-2 ("determinations made pursuant to the UCC are typically relevant" under state foreclosure law).

<sup>199</sup> *See Renuart, supra* note 180, at 79 ("*Ibanez* will have little effect in Arizona but should be influential in [California, Nevada, and Georgia] to varying degrees.>").

<sup>200</sup> *See Renuart, supra* note 180, at 59 ("It appears that Georgia courts have not expressly adopted the rule that the security instrument inevitably follows the note").

<sup>201</sup> 255 P.3d 1275 (Nev. 2011).

<sup>202</sup> *Id.* at 1279 ("Absent a proper assignment of a deed of trust, a party "lacks standing to pursue foreclosure proceedings.>").

<sup>203</sup> U.C.C. § 9-203(3)(A).

<sup>204</sup> U.C.C. § 9-203(3)(B).

<sup>205</sup> U.C.C. § 9-203 cmt. 3.

<sup>206</sup> In *Leyva*, the foreclosing party possessed the note, but the note was not endorsed and the foreclosing party could not prove how it came into possession. The court held that the foreclosing party had not proven its right to enforce the note. *Id.* at 1280-81. The foreclosing party apparently did not try to prove that it had an Article 9 security interest in the note.

requirements satisfies the real-property Statute of Frauds. The issue is simply proving that a particular transfer took place.<sup>207</sup>

In these cases, where the issue is in the nature of proving that a party entitled to enforce the note should be able to enforce the mortgage as well, Article 9 seems to serve the relevant policies. If the foreclosing party can show the relevant security agreements under Article 9, that would seem to prove the foreclosing party's standing to foreclose on the mortgage and satisfy the Statute of Frauds.

The use of nominal consideration probably should not change this result. The usual arguments in favor of giving effect to nominal consideration apply because there is a commercial context and the recitation of consideration satisfies evidentiary, cautionary, and channeling requirements. If the only issue is proving that the transfer took place, then there is no clear borrower interest at stake. Nevertheless, the fact that only nominal consideration was given creates a risk that a formalistically inclined court would find that Article 9's requirements were not met and that the foreclosing party could not prevail without showing an assignment of the note.

## 2. Borrower Challenges to Foreclosing Party Compliance with Statutes Protecting Borrower

The foreclosing party's case for applying Article 9 is weaker where it seeks to use Article 9's provisions to circumvent statutes that specifically require recording and that protect the borrower. Statutes requiring a recorded chain of assignments for nonjudicial foreclosure may fit this description.

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<sup>207</sup> The Nevada Supreme Court recently affirmed, without discussing Article 9, that mortgage and note must be analyzed separately. *See* *Edelstein v. Bank of New York Mellon*, 2012 WL 4461716, at \*8-\*9 (Nev. Sept. 27, 2012).

A number of state statutes appear to require recorded assignments for nonjudicial foreclosure.<sup>208</sup> In the context of securitization, such statutes arguably provide quite meaningful protections to borrowers: the requirement of a recorded chain of assignments permits the borrower to know and test the foreclosing party's claim that it can enforce the mortgage. Although this function would be served to some extent just by requiring the foreclosing party to provide the borrower with evidence of the chain of assignments without recording, the requirement that mortgages be recorded probably helps combat fraud against the borrower because recording false documents generally carries penalties<sup>209</sup> and because creating a public record makes the chain of title available for public scrutiny.

Courts have divided over whether laws requiring or encouraging public records of mortgage ownership protect the borrower<sup>210</sup> or just potential purchasers,<sup>211</sup> and some courts

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<sup>208</sup> IDAHO CODE § 45-1505(1); MINN. STAT. §580.02(3); MONTANA CODE § 71-1-313(1); S.D. CODIFIED LAWS §21-48-2; OR REV. STAT. § 86.735 (1); MICH. COMP. LAWS § 600.3204(3). At least one other statute requires that at least a single "assignment" be recorded. GA. CODE ANN. § 44-14-162(b) ("The security instrument or assignment thereof vesting the secured creditor with title to the security instrument shall be filed prior to the time of sale in the office of the clerk of the superior court of the county in which the real property is located."). California is an unusual case. See CALIF. CIVIL CODE § 2932.5 ("The power of sale may be exercised by [an] assignee if the assignment is duly acknowledged and recorded."). California's state courts have interpreted the statute to cover only deeds of trust and not mortgages. See *Herrera v. Federal Nat'l Mortg. Corp.*, 205 Cal. App. 4th 1495, 1509-10 (2012); *Haynes v. EMC Mortg. Corp.*, 205 Cal. App. 4th 329 (2012), *review denied* Aug. 8, 2012; *Calvo v. HSBC Bank USA, Inc.*, 199 Cal. App. 4th 118 (2011), *review denied* Jan. 4, 2012. See also *Stockwell v. Barnum*, 7 Cal. App. 413 (1908). As deeds of trust are far more common than true mortgages in the state, *In re Cruz*, 457 B.R. 806, 818 (Bankr. S.D. Cal. 2011), this interpretation effectively guts the rule. Until *Calvo*, it was widely believed that the distinction between mortgages and deeds of trust embraced in *Stockwell* had been eliminated in *Bank of Italy Nat. Trust & Sav. Ass'n v. Bentley*, 217 Cal. 644, 656 (1933). Some bankruptcy courts in California continue to read the statute to cover deeds of trust, *id.* at 818, although district courts generally have reversed such rulings. See, e.g., *In re Salazar*, 444 B.R. 814, 820-24 (Bankr. S.D. Cal. 2011), *rev'd*, 2012 WL 896214 (S.D. Cal. March 15, 2012). Compare *Barrionuevo v. Chase Bank*, 2012 WL 3235953, at \*6 (N.D. Cal. Aug. 6, 2012), (denying motion to dismiss wrongful foreclosure claim based in part on Section 2932.5 but expressly declining to address the provision).

<sup>209</sup> See OHIO REV. CODE ANN. § 2921.13(13); ARIZ. REV. STAT. § 33-420.

<sup>210</sup> See, e.g., *Bain v. Metropolitan Mortg. Co.*, 2012 WL 3517326 (Wash. Aug. 16, 2012), at \*17-\*18 (borrower may be injured by concealment of complete chain of title if she needs to "deal with the holder of the note to resolve disputes or to take advantage of legal protections," or if "there have been misrepresentations, fraud, or irregularities in the proceedings, and ... the ... borrower cannot locate the party accountable and with authority to correct the irregularity."); *Stubbs v. Bank of America*, 844 F. Supp. 2d 1267, 1270 (N.D. Ga. 2012) (purpose of Georgia statute requiring recording as a prerequisite to nonjudicial foreclosure is to give the borrower notice of "the entity to whom the debt is owed.").

<sup>211</sup> See, e.g., *Haynes v. EMC Mortg. Corp.*, 205 Cal. App. 4th 329 (2012), *review denied* Aug. 8, 2012.

interpreting their states' chain-of-assignment rules have declined to address the issue of borrower protection at all.<sup>212</sup> It appears that most states that require recorded assignments for nonjudicial foreclosure have not interpreted their provisions doing so.

In Oregon, the judiciary seems to take the recording requirement seriously. Following court followed several decisions of federal courts in Oregon,<sup>213</sup> the Court of Appeals of Oregon recently affirmed: "A beneficiary that uses MERS to avoid publicly recording assignments of a trust deed cannot avail itself of a nonjudicial foreclosure process that requires that very thing – publicly recorded assignments."<sup>214</sup> The court rejected the argument that the statute covers only formal, written assignments of the mortgage, as distinct from informal assignments that arise when the note is transferred.<sup>215</sup>

Another chain-of-assignments provision appears in a bill clearly intended to protect borrowers: the California Homeowners' Bill of Rights.<sup>216</sup> This legislation provides that a notice of default may not be recorded until the foreclosing party provides a statement to the borrower disclosing, among other things, the borrower's right to request "a copy of any assignment, if applicable, of the borrower's mortgage or deed of trust required to demonstrate the right of the

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<sup>212</sup> Jackson v. MERS, Inc., 770 N.W.2d 487, 502 (Minn. 2009) (stating that it would be "beyond our authority" to consider policy arguments and holding that use of MERS satisfies state requirement that "all assignments" of a mortgage be recorded in order to foreclose because the recording requirement covers only legal and not equitable assignments); Residential Funding Co. v. Saurman, 805 N.W.2d 183, 184 (Mich. 2011) (declining to consider possibility that requirement of recorded chain of assignments protects borrower in holding that MERS assignments satisfied statute).

<sup>213</sup> See Hooker v. Northwest Trustee Servs., Inc., Civ. No. 10-3111-PA, 2011 WL 2119103, at \*3-\*4 (D. Or. May 25, 2011) (tracking on MERS is not a substitute for recording assignments as required by Oregon law); Burgett v. Mortgage Elec. Reg. Sys., Inc., No. 09-6244-HO, 2010 WL 4282105 (D. Or. Oct. 20, 2010), at \*3 (assignments must be recorded as a condition for nonjudicial foreclosure; rejecting use of MERS); Richard v. Deutsche Bank Nat'l Trust Co., CIV. 09-123-AC, 2011 WL 2669084 (D. Or. May 12, 2011) (nonjudicial foreclosure improper where MERS was used instead of recorded assignments: "[W]here all assignments have not been recorded, nonjudicial foreclosure is not permitted"). The District Court reached the same conclusion as this magistrate's report and recommendation, but expressly declined to decide whether the magistrate's findings about recording were correct.

<sup>214</sup> Niday v. GMAC Mortg., LLC, 284 P.3d 1157, 1168-69 (Or. Ct. App. 2012).

<sup>215</sup> *Id.* at \*11-\*12. Interestingly, the *Niday* court relied on a textual and structural analysis of the statute and did not consider the purpose of the chain-of-assignments requirement.

<sup>216</sup> Calif. AB 278, § 6 (filed with Secretary of State July 11, 2012).

mortgage servicer to foreclose.”<sup>217</sup> To the extent that failure to comply with this provision, or failure to provide the assignment, is a defense to foreclosure, complying with Article 9 should not excuse that failure.<sup>218</sup>

Article 9 is relevant to express chain-of-assignment provisions in foreclosure statutes not because of its mortgage-follows-the-note rule, but because it contains its own set of procedural rules providing that a note owner<sup>219</sup> that does not have a recorded assignment of the mortgage can proceed with nonjudicial foreclosure. Specifically, the note owner can record a copy of the sale agreement and record its own affidavit stating that a default has occurred and that it is entitled to enforce the mortgage nonjudicially.<sup>220</sup>

The case for allowing the Article 9 procedure to substitute for a recorded chain of assignments seems relatively weak here, at least if these statutes function to provide meaningful borrower protection. Recording a single agreement does not provide the complete chain of title that some states’ statutes call for and exposes the borrower to the possibility of fraudulent claims.

As with borrower challenges to standing, the use of nominal consideration may be important because it gives the court a convenient way of indulging a preference for recording and may tempt the court to make a formalistic decision.

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<sup>217</sup> Cal. Civil Code § 2923.5(b)(1)(B)(iii) (effective Jan. 1, 2013).

<sup>218</sup> California’s courts have held that some provisions of Article 3 of the U.C.C. are irrelevant to foreclosure, *see* *Debrunner v. Deutsche Bank Nat’l Trust Co.*, 204 Cal. App. 4th 433 (2012), but have not yet opined on Article 9 specifically.

<sup>219</sup> The Code provision uses the terms “secured party” and a “security agreement” instead of “note owner” and “sale agreement,” reflecting the merger of sales and secured lending in the current version of Article 9. *See* U.C.C. § 9-607(b).

<sup>220</sup> U.C.C. §9-607(b).

*D. In MERS Bankruptcy: Disputes Between Mortgage Investors and MERS, Inc. Creditors*

Article 9 could become relevant if Mortgage Electronic Registration Systems, Inc. (“MERS, Inc.”), the nominal owner of 30 million mortgages,<sup>221</sup> enters bankruptcy. This could trigger a contest over ownership of the mortgages recorded on the system. Failure to record, and Article 9’s purported obviation of recording are more obviously relevant to contests over mortgage ownership<sup>222</sup> than to disputes over foreclosure.

Understanding this issue requires a brief introduction to the Mortgage Electronic Registration System (“MERS”). MERS was conceived as a substitute for recording mortgage assignments and has been described as a national electronic database that tracks ownership of mortgage loans.<sup>223</sup> The system’s members, who are participants in the mortgage industry, can cause a mortgage to be “registered” on MERS and publicly recorded in the name of “MERS, Inc.”<sup>224</sup> MERS is designed so that MERS, Inc. acts as a common agent for all MERS’ members, so that recording in the name of MERS, Inc. and tracking ownership transfers on MERS makes it unnecessary to record assignments of mortgages. In theory, the public record discloses the existence of the mortgage and the fact that MERS, Inc. holds legal title on behalf of one of MERS’ members. Private records maintained on MERS track, in theory, which one of MERS’ members is the current “true” (“beneficial” or “equitable”) owner. Under MERS’ current rules, in the event of foreclosure MERS, Inc. assigns the mortgage to the foreclosing party so that that

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<sup>221</sup> ARNOLD TESTIMONY, *supra* note 23, at 1; NELSON & WHITMAN, *supra* note 25, at 466 (MERS “has already proven to be a remarkable success”).

<sup>222</sup> Ownership also may be challenged in the event that the mortgage originator or MERS, Inc. wrongfully or by mistake assigns the mortgage to someone other than the trust after the securitization is completed. The subsequent-assignment problem comes up in academic discussions of mortgage recording and property recording generally. *See, e.g.*, NELSON & WHITMAN, *supra* note 26, at 456-60. Moreover, it seems plausible that subsequent mistaken or wrongful assignments occurred on the MERS system: MERS, Inc. has not supervised its 20,000 certifying officers, each capable of assigning a mortgage on MERS, Inc.’s behalf. Nevertheless, we are unaware of actual cases of duplicate mortgage assignment and do not discuss this issue further.

<sup>223</sup> *See* ARNOLD TESTIMONY, *supra* note 23, at 16-20 (describing MERS as a mortgage assignment tracking system).

<sup>224</sup> MERSCORP, Inc. Rules of Membership, Rule 2 (July 2011).

party has legal title at the time of foreclosure.<sup>225</sup> Figure 2 illustrates how a mortgage securitization using MERS would work.

The legal theory underlying MERS is as follows: In all 50 states, (1) it is permissible for a nominee to hold legal title to a mortgage; (2) the nominee can act as a common agent for multiple members who may transfer beneficial ownership of the mortgage from one to another; and (3) having the nominee hold legal title as a common agent for its members is a complete substitute for recording mortgage assignments. This theory did not receive much judicial scrutiny in MERS' early years, but it has come under increasing attack in the mortgage crisis. Although many courts have endorsed MERS,<sup>226</sup> others have questioned or rejected its claimed legal underpinnings.<sup>227</sup> The system's efficacy is in doubt, as is the continued solvency of the corporate entities that operate it.<sup>228</sup>

Figure 2: Mortgage and Promissory Note Transfer with MERS Recording

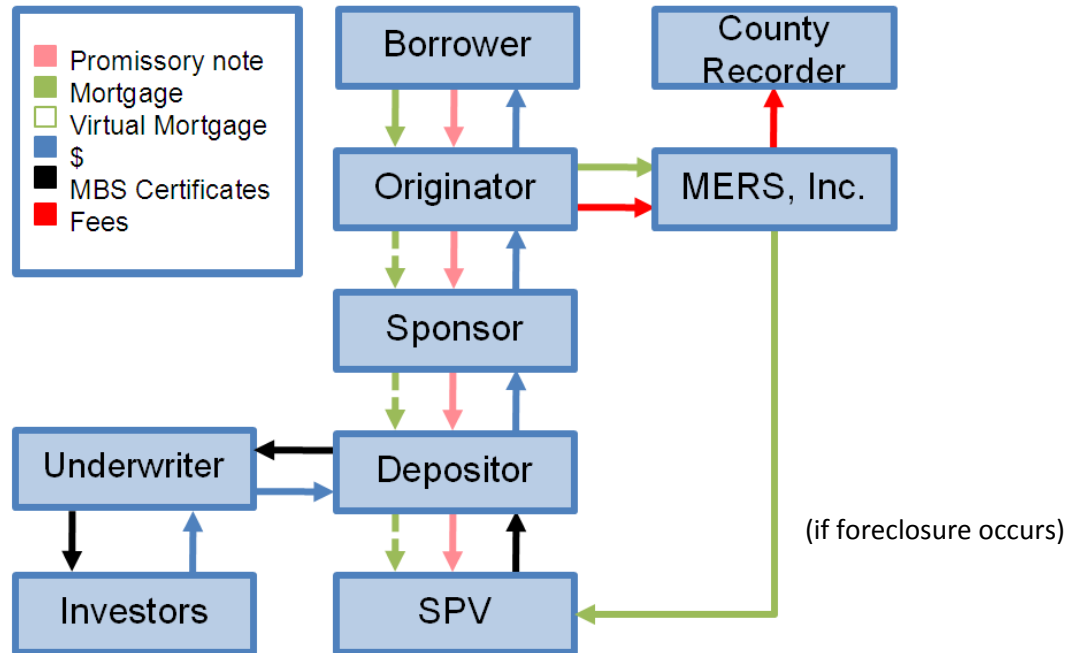
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<sup>225</sup> See MERSCORP, Inc. Rules of Membership, Rule 8 (July 2011). Prior to a rule change in summer 2011, MERS, Inc. would foreclose in its own name.

<sup>226</sup> See, e.g., Residential Funding Co., L.L.C. v. Saurman, 805 N.W.2d 183 (Mich. 2011) (MERS' interest in security lien authorized MERS to foreclose by advertisement); Savage v. U.S. Bank, N.A., 19 A.3d 302 (Del. 2011) (rejecting borrowers' contention that they were entitled to notice of mortgage assignment from MERS to foreclosing bank); RMS Res. Props., LLC v. Miller, \_\_\_ A.3d \_\_\_, 2011 WL 6033011 (Conn. Dec. 13, 2011) (rejecting borrowers' contention that MERS could not validly be named mortgagee because it was not the lender); Thomas v. BAC Home Loans Servicing, LLP, 2011 WL 6743044, at \*3 (Nev. Dec. 20, 2011) ("MERS as the nominee beneficiary holds the deed of trust for BAC's benefit").

<sup>227</sup> See, e.g., Bain v. Metropolitan Mortg. Group, Inc., 2012 WL 3513726 (Wash. Aug. 16, 2012), at \*2 (MERS, Inc. is not a lawful beneficiary under Washington Deed of Trust Act); HSBC Bank USA v. Gabay, 28 A.3d 1158 (Me. 2011) (rejecting MERS' claim to be able to assign note along with mortgage); MERS, Inc. v. Saunders, 2 A.3d 289 (Me. 2010) (MERS lacks standing to foreclose because it lacks an interest in the promissory note); Niday v. GMAC Mortg., LLC, 284 P.3d 1157, 1169 (Or. Ct. App. 2012) ("A beneficiary that uses MERS to avoid publicly recording assignments of a trust deed cannot avail itself of a nonjudicial foreclosure process that requires that very thing – publicly recorded assignments").

<sup>228</sup> See discussion *infra* Part V. D.1.



If MERS, Inc. enters bankruptcy because of the many lawsuits in which it is currently embroiled, Article 9 could become relevant to a contest over ownership of the MERS mortgages. The contest would be between the MERS, Inc. bankruptcy trustee charged with administering the estate in the interests of creditors, on one hand, and the securitization trusts to which the mortgages were supposed to have been conveyed, on the other. Assuming the securitization trusts purchased the notes under Article 9, the Code provisions we are discussing could strengthen their hand, because they provide that the trusts' interest is protected without recording. But the use of nominal consideration threatens this defense of the securitization trusts' position.



## 1. How MERS, Inc. Could Enter Bankruptcy

MERS, Inc. faces challenges to its solvency on a number of fronts.<sup>229</sup> As operational problems at MERS have become public,<sup>230</sup> officials have become increasingly hostile to the system.<sup>231</sup> Federal banking regulators determined in 2011 that MERS, Inc. and MERSCORP, Inc. employed “unsafe or unsound” practices,<sup>232</sup> and as a result the companies operate under a federal consent decree that requires operational improvements<sup>233</sup> and potentially additional capital contributions from MERS’ members.<sup>234</sup> It remains unclear whether the companies will be able to meet the requirements of that decree.

At least three types of claims have been brought against MERS, Inc. In one type, counties claim that MERS, Inc.’s claims to be a mortgagee or beneficiary under a deed of trust are fraudulent under state recording law. A lawsuit of this type brought by counties in Texas recently survived a motion to dismiss.<sup>235</sup> In a second type of suit, public plaintiffs claim that the MERS entities’ conduct in foreclosure litigation was fraudulent. For example, the State of New York claims that MERS, Inc. frequently started foreclosures when it had no right to do so,<sup>236</sup>

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<sup>229</sup> This material is discussed in greater detail in Hunt et al., *All in One Basket*, *supra* note 22.

<sup>230</sup> A review of foreclosure documents commissioned by the Assessor-Recorder of the City and County of San Francisco concluded that MERS apparently was wrong about the identity of the mortgage owner 58% of the time and that mortgages recorded on MERS generally had a higher rate of other compliance problems than non-MERS mortgages. *AEQUITAS*, *supra* note 30. Specifically, Aequitas reviewed 382 residential foreclosure sales in San Francisco from January 2009 to October 2011. *Id.* at 1. In 192 cases, the security instruments were recorded on MERS and MERS purported to have information about the mortgage owners (or “beneficiaries under the deed of trust” in California parlance). *Id.* at 13. In 112 of these cases, or 58%, the beneficiary recorded on MERS was different from the beneficiary named in the Trustee’s Deed upon Sale, the document transferring ownership of the foreclosed property to the new owner at the foreclosure sale. *Id.*

<sup>231</sup> *See, e.g.*, Letter from Senator Maria Cantwell to Attorney General Eric Holder, Dec. 15, 2011 (“The Mortgage Electronic Registration System should be shut down and dissolved.”).

<sup>232</sup> *See* Consent Order, *In re MERSCORP, Inc.*, O.C.C. No. AA-EC-11-20, April 13, 2011, at 2.

<sup>233</sup> *Id.* at 7-9.

<sup>234</sup> *Id.* at 8.

<sup>235</sup> *See* Motions Hearing Transcript, *Dallas County v. MERSCORP, Inc.*, No 3:11-CV-3722-) (N.D. Tex. May 23, 2012), at 81:10-20 (denying motion to dismiss as to recorders’ claims of fraudulent misrepresentation, unjust enrichment, conspiracy, and violation of Texas’ allegedly mandatory recording statute).

<sup>236</sup> Complaint. *New York v. JPMorgan Chase et al.*, Index No. 2768/2012 (N.Y. Sup. Ct. Kings Cty. Feb 3, 2012) [hereinafter *New York Complaint*]. Alleged foreclosure misconduct includes proceeding when MERS, Inc. lacked standing because it did not hold the promissory note, *New York Complaint* ¶¶60-73, falsely claiming to hold

thereby committing fraud<sup>237</sup> and violating the deceptive-practices statute.<sup>238</sup> A third type of case is the private action brought by borrowers who claim to have been injured by the MERS entities' allegedly fraudulent conduct in claiming to be a mortgagee or beneficiary under a deed of trust. Although the MERS entities have been quite successful to date in beating these cases,<sup>239</sup> the Washington Supreme Court recently opened the door to them in that state. It held that MERS, Inc. is not a lawful beneficiary of deeds of trust in Washington because it does not hold the associated promissory note,<sup>240</sup> and that designating MERS, Inc. as a beneficiary presumptively satisfies the "deception" and "public impact" elements of a private cause of action under Washington's Consumer Protection Act.<sup>241</sup> The court's analysis suggests that Washington borrowers who can prove that they were injured by MERS, Inc.'s designation as the beneficiary may have strong private claims against the company.<sup>242</sup>

## 2. MERS Bankruptcy, Article 9 and Mortgage Ownership

MERS, Inc. could become insolvent in several ways. One is that large judgments could be entered against MERS, Inc. as a result of the lawsuits above,<sup>243</sup> that the company does not pay the judgments, and that the plaintiffs commence an involuntary bankruptcy proceeding.<sup>244</sup> In

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the note, *id.* ¶ 65, falsely claiming to own and/or possess the note, *id.* ¶ 67, and other false claims about documents. *Id.* ¶¶60.73.

<sup>237</sup> *Id.* ¶¶ 125-27.

<sup>238</sup> *Id.* ¶¶ 128-30.

<sup>239</sup> *See, e.g.,* Cervantes v. Countrywide Home Loans, Inc., 656 F.3d 1034 (9th Cir. 2011) (upholding dismissal of purported class action alleging fraud and consumer protection violations in use of MERS); *In re MERS Litig.*, 2012 WL 4550189 (D. Ariz. Oct. 3, 2011) (dismissing 72 consumer-fraud cases against MERS).

<sup>240</sup> Bain v. Metropolitan Mortg. Group, Inc., 2012 WL 3517326, at \*13 (Wash. Aug 16, 2012).

<sup>241</sup> *Id.* at \*16-17.

<sup>242</sup> *Id.* at \*15 (listing elements of Consumer Protection Act claim: "(1) unfair or deceptive act or practice; (2) occurring in trade or commerce; (3) public interest impact; (4) injury to plaintiff in his or her business or property; (5) causation").

<sup>243</sup> MERS, Inc. also could become bankrupt by settling some lawsuits and losing others, or simply because its backers decided to stop paying its apparently considerable legal bills.

<sup>244</sup> *See* 11 U.S.C. § 303.

this case, a bankruptcy trustee with the powers of a judgment creditor of MERS, Inc.<sup>245</sup> and of a bona fide purchaser of real property interests from MERS, Inc.<sup>246</sup> will be appointed to administer MERS, Inc.'s bankruptcy estate for the benefit of creditors. The MERS, Inc. bankruptcy trustee could seek to bring the securitized mortgages that the company nominally owns into its bankruptcy estate<sup>247</sup> and administer the mortgages along with the other estate property for the benefit of MERS, Inc.'s creditors.

The investors in securities backed by MERS mortgages would lose if the bankruptcy trustee prevails. Securitization transactions are supposed to be designed so that the securitized mortgages are owned by securitization trusts, not the MERS, Inc. bankruptcy estate.<sup>248</sup> The trustees of the securitization trusts to which the mortgages supposedly were conveyed presumably would resist the securitization trustee.

The specific legal theories at issue are rather involved, and are discussed in full in our companion paper.<sup>249</sup> In brief, the bankruptcy trustee would argue that the mortgages should enter the bankruptcy estate because MERS, Inc. had legal title to the mortgages and acted in many ways like an owner and/or agent with authority to convey the mortgages, and because the securitization trustee's interest was unrecorded.

If Article 9 applies, the securitization trust obtained a perfected security interest in the mortgage as soon as it gave value for the note.<sup>250</sup> The trustees of the securitization trusts would argue that the trusts' ownership interests in the mortgages, though unrecorded, were perfected before the bankruptcy and therefore protected against the trustee. Security interests generally are

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<sup>245</sup> 11 U.S.C. § 544(a)(1)-(2).

<sup>246</sup> 11 U.S.C. §544(a)(3).

<sup>247</sup> See Hunt et al., *All in One Basket*, supra note 22.

<sup>248</sup> See Hunt et al., *All in One Basket*, supra note 22.

<sup>249</sup> See Hunt et al., *All in One Basket*, supra note 22.

<sup>250</sup> See discussion supra Part

given priority in order of perfection,<sup>251</sup> and the bankruptcy trustee's claims as hypothetical purchaser of real property and judgment lien creditor arise at the commencement of the bankruptcy case. Thus, if Article 9 applies and prevails over the real property recording statutes, that would help the securitization trust prevail over the bankruptcy trustee. The bankruptcy trustee could counter that only nominal consideration was given when the sponsor purported to transfer the mortgages to the depositor, so the depositor's security interest never attached and was never perfected. The trustee could argue that this defect in the chain of title gives the bankruptcy trustee priority over the trust or, more aggressively, that the trust took nothing at all.<sup>252</sup>

### 3. Resolution in MERS Bankruptcy Is Unclear

We cannot evaluate the proper resolution of the possible MERS, Inc. bankruptcy scenarios without more factual development, but a few observations are possible.

First, the plaintiffs would have prevailed in these cases because MERS, Inc. did something deceptive or fraudulent. Moreover, the counties and state authorities did not become creditors of MERS, Inc. because they voluntarily extended the company credit.<sup>253</sup> However, it does not seem that investors made a deliberate decision to transact with MERS either; the parties selling the mortgages chose whether to use the system for each mortgage.<sup>254</sup> Although investors may have benefited indirectly from passthrough of the recording-cost savings MERS offered, it

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<sup>251</sup> U.C.C. § 9-322(a)(1).

<sup>252</sup> See U.C.C. § 9-203(b)(2) (security interest does not attach unless debtor "has rights in the collateral or the power to transfer rights in the collateral to a secured party").

<sup>253</sup> Others have emphasized the importance of protecting involuntary creditors in bankruptcy, albeit in different contexts. See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 882-83 (1996); Dov Solomon, *The Rise of a Giant: Securitization and the Global Financial Crisis*, 49 AMERICAN BUSINESS LAW JOURNAL (forthcoming 2012).

<sup>254</sup> See Pooling and Servicing Agreement, GSAMP Trust 2006-HE3 Mortgage Pass-Through Certificates, May 1, 2006, § 1.01 (defining "MERS Designated Mortgage Loan" as one designated as a MERS loan by the "Original Loan Seller.")/

seems difficult at this stage to characterize them as active participants in the deceptive or fraudulent practices alleged in the lawsuits against the MERS entities.

Second, the argument that MERS mortgages should pass into the MERS, Inc. bankruptcy estate is in some tension with the premise of the underlying litigation against MERS, which is that MERS acted in a deceptive or fraudulent manner by claiming to be a mortgagee when in fact it was not a mortgagee. One theory relies on the existence of a MERS, Inc. interest in the mortgages, the other on the absence of such an interest. Even so, MERS, Inc. could become insolvent before a judgment is reached on the merits, or a court could simply rule that securitization trusts that benefited from MERS, Inc.'s claims of ownership in other contexts are estopped from denying them in bankruptcy.<sup>255</sup>

Third, the MERS, Inc. creditors who would be supporting the effort to bring the MERS mortgages into the bankruptcy estate because they are unrecorded would not themselves have relied on the property records in purchasing real property.<sup>256</sup> But the county plaintiffs are responsible for maintaining title records,<sup>257</sup> the state attorney general plaintiffs are responsible for enforcing the unfair-competition laws under which they are suing,<sup>258</sup> and the borrower plaintiffs would be claiming that they were injured by being unable to locate and communicate with noteholders because the mortgages were recorded in MERS' name.

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<sup>255</sup> See, e.g., *Parklane Hosiery v. Shore*, 439 U.S. 322 (1978) (discussing use of offensive nonmutual collateral estoppel); *In re McWhorter*, 887 F.2d 1564 (11th Cir. 1989) (insurance company "may well be" estopped from asserting ignorance of agent's fraudulent assertions to certain customers based on jury findings that company had been found aware of agent's similar misrepresentations to other customers).

<sup>256</sup> In any event, the Bankruptcy Code's scheme for deciding what real-property interests enter the estate is not based on whether the creditors in the case were in fact confused, but rather on whether a *hypothetical* party could purchase the interests from the debtor in good faith. See 11 U.S.C. § 544(a)(3); *Belisle v. Plunkett*, 877 F.2d 512, 516 (7th Cir. 1989).

<sup>257</sup> See, e.g., TEX. PROPERTY CODE § 11.004 ("Duty of Recorder") (requiring clerk to correctly record instruments); TEX. LOCAL GOV'T CODE § 193.003 (requiring clerk to maintain indices).

<sup>258</sup> See, e.g. N.Y. GEN. BUS. L. § 349(b) (authorizing attorney general to seek injunctive relief for violation of deceptive-practices law); *People ex rel. Spitzer v. Grasso*, 861 N.Y.S.2d 627, 646 (N.Y. App. Div. 2008) (recognizing New York Attorney General's status as "the State's chief law enforcement officer").

Perhaps most important, courts simply may be unwilling to disrupt the financial system by ruling that huge numbers of mortgages pass into the MERS, Inc. bankruptcy estate. Nevertheless, because the MERS system concentrates nominal ownership of so many mortgages in one place, it exposes the system to the risk of a single unusual ruling.<sup>259</sup>

#### 4. Use of Nominal Consideration Creates Risk

As with foreclosure litigation, the use of nominal consideration probably should not matter here. Nevertheless, the use of nominal consideration probably does increase the risk that the mortgages would enter the MERS, Inc. bankruptcy estate for the reasons explained above.<sup>260</sup>

#### *E. In Investor Litigation: Disputes Between Investors and Securitization Arrangers*

As shown, the use of nominal consideration produces a risk that investors will lose ownership of the mortgage to a MERS, Inc. bankruptcy trustee and that the mortgage will not be enforceable in foreclosure against a defaulting borrower. These risks to mortgage ownership and enforceability may make representations about the validity of transfers false or misleading, and investors already have brought fraud claims based on alleged misrepresentations and omissions about the legal validity of mortgage assignments.<sup>261</sup> Moreover, parties in the securitization chain, such as mortgage originators, sponsors, and depositors, typically give warranties that run to MBS investors<sup>262</sup> and that could be breached if the mortgages turn out to be unenforceable or end up in the hands of a bankruptcy trustee due to failure to record.<sup>263</sup>

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<sup>259</sup> See Hunt et al., *All in One Basket*, *supra* note 22.

<sup>260</sup> See discussion *supra* Part III. A.

<sup>261</sup> See *Summons, Sealink Funding Ltd. v. Goldman Sachs Group, Inc.* (N.Y. Sup. Ct. Aug. 13, 2012); *Summons, IKB International S.A. in Liquidation v. Bank of America Corp.* (N.Y. Sup. Ct. May 13, 2012).

<sup>262</sup> See, e.g., *Flow Mortgage Purchase and Warranty Agreement Between Goldman Sachs Mortgage Co., Purchaser, and Aames Capital Corp., Seller*, dated April 1, 2006, § 9.03 (representations and warranties of originator “inure to the benefit of” the sponsor and its “successors and assigns.”).

<sup>263</sup> See *id.* § 9.02(m) (“Seller is the sole owner of record and holder of the Mortgage Loan and the indebtedness evidenced by each Mortgage Note.”); *id.* §9.02(j) (“The Mortgage is a valid, subsisting, enforceable

If investors relied on securitization arrangers to create secure transaction structures that delivered enforceable mortgages without title defects and the securitizers undertook this duty and failed to perform it, reducing the value of the mortgages, then it seems that investors have a just claim for compensation. Investors have suffered loss to the extent securities' value reflects the chance that courts *might* find that securitization trusts are vulnerable to a MERS bankruptcy trustee or that the mortgages are unenforceable, even if courts *should not* reach this conclusion.

## VI. IMPLICATIONS FOR TRANSACTING PARTIES

Going forward, it appears that taking care to comply strictly with Article 9 requirements can reduce the risks faced by transacting parties at relatively low cost. Although we have focused on the requirement of “value,” Article 9 also requires that an authenticated security agreement describe the collateral<sup>264</sup> (or that the buyer possess the collateral),<sup>265</sup> and that the purported seller must have rights, or the power to transfer rights, in the collateral,<sup>266</sup> It does not appear that scholars or regulators have investigated specifically whether the documentation requirements were met. The general problems with recordkeeping in the mortgage securitization industry suggest that parties may not have identified the loans in the transaction documents.<sup>267</sup> Parties seeking to invoke Article 9's protections should make sure to comply with these requirements as well.

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and perfected, ... lien on the Mortgaged Property”); *id.* §9.02(u) (“Upon default by a Mortgagor on a Mortgage Loan and foreclosure on, or trustee's sales of, the Mortgaged Property pursuant to the proper procedures, the holder of the Mortgage Loan will be able to deliver good and merchantable title to the Mortgaged Property.”).

<sup>264</sup> U.C.C. § 9-203(b)(3)(A).

<sup>265</sup> U.C.C. § 9-203(b)(3)(B).

<sup>266</sup> U.C.C. § 9-203(b)(2).

<sup>267</sup> See Renuart, *supra* note 180, at 8-16; White, *supra* note 315, at 473-76, 484-88; Raymond H. Brescia, *Leverage: State Enforcement Actions in the Wake of the Robo-Sign Scandal*, 64 ME. L. REV. 18, 24-27 (2011) (summarizing issues with recordkeeping and alleged fraud in mortgage industry).

## VII. THE NEED FOR REFORM AND THE VALUE OF PUBLIC TITLE RECORDS

We have argued that Article 9 of the Uniform Commercial Code is unclear, both in its application to existing transactions and in its interaction with state laws governing mortgage recording. The result is that transacting parties and others have poor guidance as to their rights and responsibilities, as discussed above.

One way to clarify the law would be for the states to amend their title recording and foreclosure statutes to cede primacy to Article 9, embracing a regime based on identification of promissory notes in private contracts rather than public recording or filing. When the Code was first being considered, it was assumed that laws inconsistent with or displaced by the Code would have to be repealed affirmatively.<sup>268</sup> As a practical matter, it seems unlikely that this would happen on a nationwide basis in the near future, as the trend in state legislation since the beginning of the foreclosure crisis has been toward more emphasis on recording, not less.<sup>269</sup>

But we question whether Article 9's private regime is a good idea to begin with. Although it saves the transacting parties time and money, it deprives future parties of trustworthy public records of mortgage ownership. Say A sells a mortgage loan to B and B puts the sale agreement identifying the note in its vault. If A then through ignorance or mistake sells the mortgage to C, B will prevail over C even if B does not possess the note and never made any

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<sup>268</sup> See STATE OF NEW YORK, REPORT OF THE LAW REVISION COMMISSION FOR 1956: REPORT RELATING TO THE UNIFORM COMMERCIAL CODE 77-78 (1956) ("Enactment of the Uniform Commercial Code as part of the law of New York will obviously require the repeal of many existing laws .... [P]reparation of such a repealer section demands a survey of all the statute law of the state ... in order that all inconsistent provisions may be discovered and appropriately handled."). This discussion appears under the heading, "Repeals and Amendments That Would Be Require in Connection With Enactment of the Code." *Id.* at 77.

<sup>269</sup> See, e.g., NEV. REV. STAT. § 106.210 ("Any assignment of a mortgage of real property ... must be recorded in the office of the recorder of the county in which the property is located., .... If the beneficial interest under a deed of trust has been assigned, the trustee under the deed of trust may not exercise the power of sale ... unless and until the assignment is recorded ....") (effective Oct. 1, 2011); Calif. AB 278, § 6 (filed with Secretary of State July 11, 2012) (requiring servicer to advise borrower of right to request "a copy of any assignment, if applicable, of the borrower's mortgage or deed of trust required to demonstrate the right of the mortgage servicer to foreclose.").



public record of its interest anywhere.<sup>270</sup> As many scholars have pointed out,<sup>271</sup> the lack of an authoritative system for verifying ownership threatens the interests of transacting and potentially transacting parties. The C's of the world must be on their guard against fraudulent A's.

Public mortgage ownership records can protect borrowers as well as potential mortgage buyers. Borrowers may need to know with whom they must negotiate for a loan modification.<sup>272</sup> And there is a public interest in public records.<sup>273</sup> There is widespread agreement among commentators<sup>274</sup> and courts<sup>275</sup> that one major function of recording statutes is to create a public

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<sup>270</sup> See MCDONNELL & SMITH, *supra* note 4, §16.09 (“Revised Article 9 makes it as plain as possible that the secured party need not record an assignment of mortgage, or anything else, in the real property records in order to perfect its rights in the mortgage.”); Philip H. Ebling & Steven O. Weise, *What a Dirt Lawyer Needs to Know About New Article 9 of the UCC*, 37 REAL PROP. PROB. & TR. J. 191, 213 (2002) (“Neither filing nor possession is necessary or effective to perfect the security interest.”).

<sup>271</sup> See Douglas Baird & Thomas Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. LEGAL STUD. 299 (1984) (registration-based proof-of-ownership systems better than possession-based systems for valuable, nonfungible, immobile property that does not need to be transferred frequently and for which divided ownership is important); Baird & Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175, 187 (1983) (argument that transaction parties “should be able to allocate ownership rights between themselves as they please ... loses force when at stake are the rights of a third party who asserts a competing claim to the property.”). *But see* Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 211 (1989) (arguing that contractual-allocation system (such as that of Article 9) is “as effective ... and cheaper” than a filing requirement). Schwartz’s argument is based on the idea that a borrower (analogous here to a mortgage seller) can credibly disclose the absence of debt (analogous to the absence of a prior sale of the mortgage) using SEC filings and tax returns. *Id.* at 220-21. This argument does not apply in any clear way to the mortgage market, where SEC filings and tax returns do not disclose the sale *vel non* of individual mortgage loans.

<sup>272</sup> See *Stubbs v. Bank of America*, 844 F. Supp. 2d 1267, 1270 (N.D. Ga. 2012) (purpose of Georgia requirement of recorded assignment as prerequisite to foreclosure is “to avert any avoidable foreclosures” as well as to “protect the integrity of Georgia’s real property records”); White, *supra* note 315, at 494 (“In moving away from the old paper endorsement and delivery of note plus recorded mortgage assignment system, there are important consumer protection interests at stake”); Brescia, *supra* note 267, at 21-22 (describing recording statutes as an “important mechanism for protecting the rights of lenders, borrowers, and third parties”).

<sup>273</sup> This interest is not always benign. For example, Plymouth Colony apparently used title records “to keep out undesirable immigrants.” Joseph A. Beale, Jr., *The Origin of the System of Recording Deeds in America*, 19 GREEN BAG 335, 335 (1907).

<sup>274</sup> 1 JOYCE PALOMAR, PATTON & PALOMAR ON LAND TITLES § 4, at 14-15 (3d ed. 2003) (in addition to the “original purpose” of “securing prompt recordation of all conveyances” and the equitable purpose of protecting subsequent purchasers, recording acts serve the “constructive [purpose] of preserving an accessible history of each title, so that anyone needing the information may reliably ascertain in whom the title is vested and any encumbrances against it,” and therefore “provide a system of semi-public records that have the same dignity and evidentiary value that attaches to public records.”); SHELDON F. KURTZ, MOYNIHAN’S INTRODUCTION TO THE LAW OF REAL PROPERTY 225 (5th ed. 2011) (first-listed function of recording systems is “provid[ing] a public place where interested parties can search for documents affecting land titles”); John H. Scheid, *Down Labyrinthine Ways: A Recording Acts Guide for First-Year Law Students*, 80 U. DET. MERCY L. REV. 91, 101 (2002) “by encouraging filing, [they] promote the notoriety of land ownership and preserve the muniments, or evidences, of title”); Francis S. Philbrick, *Limits of Record Search and Therefore of Notice*, 93 U. PA. L. REV. 125, 137-38 (1944) (“[T]he primary object of the recording statutes was to rid conveyancing of livery of seisin but retain its publicital

record of land ownership and to make information available to anyone who needs it. Courts also have recognized that there is a cognizable public interest in encouraging recording.<sup>276</sup> Looking abroad, other systems do use recording rules for mortgages.<sup>277</sup>

Public title records, including mortgage records, are used not just by transactors and potential transactors in land but also by reporters,<sup>278</sup> academics,<sup>279</sup> political opposition researchers,<sup>280</sup> judgment creditors,<sup>281</sup> real-estate data-centered businesses like Zillow and Trulia,<sup>282</sup> and, of course, title insurers.<sup>283</sup>

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advantages.”); R.G. Patton, *Priorities, Recording, Registration*, in 4 AMERICAN LAW OF PROPERTY § 17.5, at 535 (1952). (“The very earliest recording acts show a desire on the part of the enacting bodies to secure a permanent record of landholding, and to prevent fraudulent claims to lands by concealment of transfers.”).

<sup>275</sup> See, e.g., *Union Planters Bank v. Hutson*, 210 S.W.3d 163, 168 (Ky. App. 2006) (statute requiring filing timely mortgage release intended to “promote ... accurate real estate records”); *Steele v. Duke*, 2012 WL 1034649, at \*3 (Tex. App. 2012) (“The purpose of recording statutes in Texas is to give notice to all persons of the existence of the instrument”); *Prouty v. Marshall*, 74 A. 550, 573 (Pa. 1909) (“The object of the recording acts is to give notice to the world of that which is spread upon the record.”).

<sup>276</sup> *Belisle v. Plunkett*, 877 F.2d 512, 515 (7th Cir. 1989) (finding against defrauded investors in real property on ground that they failed to record their interest); *Jackson v. MERS*, 770 N.W.2d 487, 504 (Minn. 2009) (Anderson, J., dissenting) explaining that purpose of statute requiring recording of mortgage assignments “was to make the contents of the mortgage, and, so far as the statute goes, to make the title to the mortgage, matters of record; and ... it was important ... to subsequent incumbrancers, creditors, and contemplating purchasers, that some permanent and accessible evidence of the existence and contents of the mortgage, and of the title to the same, should be provided.”) (quoting *Backus v. Burke*, 51 N.W.2d 284, 286 (Minn. 1892)); *MERSCorp v. Romaine*, 861 N.E.2d 81, 88(N.Y. 2006) (Kaye, J. dissenting in part) (questioning majority’s decision to require county clerks to record documents listing MERS as nominee mortgagee on ground that “the MERS system will render the public record useless.”); *Landmark Bank v. Kesler*, 216 P.3d 158, 169 (Kan. App. 2009) (criticizing MERS for “creat[ing] a system in which the public has no notice of who holds the obligation of a mortgage”); *MERS v. Southwest Homes of Arkansas, Inc.*, 301 S.W.3d 1, 6 (2009) (foreclosing party is “entitled to rely on the record” and permitting MERS to participate in foreclosure action without being directed to do so by recorded lender “would wreak havoc on notice”).

<sup>277</sup> See Patrick A. Randolph, Jr. & Lou Jianbo, *Chinese Real Estate Mortgage Law*, 456 PLI/REAL 537, 568-70 (2000) (describing Chinese mortgage registration system and rule that mortgage assignee must change mortgage registration to be confident of ability to enforce note).

<sup>278</sup> See, e.g., Jacob Gershman, *Senator’s Property Records Highlight Gap*, WALL ST. J., at A15 (Aug. 6, 2012); Brooke Barnett, *Use of Public Record Databases in Newspaper and Television Newsrooms*, 53 FED. COMM. L.J. 557, 562 (2001) (noting that television newsrooms regularly use public “property, financial, and business information” for newsgathering).

<sup>279</sup> See, e.g., ALAN MACFARLANE, *RECONSTRUCTING HISTORICAL COMMUNITIES* 7 (1977) (recounting social anthropologists’ use of land records to study economic and social change in India and Sri Lanka).

<sup>280</sup> See DLCC, 2005 DLCC GUIDE TO COURTHOUSE RESEARCH, at 6 (opposition research manual with checklist including title records)

<sup>281</sup> See, e.g. THE RUTTER GROUP, CAL. PRAC. GUIDE ENF. J. & DEBT CH. 6B-1, 6B-3 (2012) (use of title records for judgment collection; creation of lien by filing abstract of judgment).

<sup>282</sup> See <http://www.zillow.com/howto/DataCoverageZestimateAccuracy.htm>;  
[http://www.trulia.com/trulia\\_estimates](http://www.trulia.com/trulia_estimates).

To be sure, public records have costs. Legitimate privacy interests must be accommodated.<sup>284</sup> Public title information can be used to devise frauds.<sup>285</sup> If the market standard moves to a single mortgage-and-note instrument to make matters less confusing for borrowers, as Alan White has proposed,<sup>286</sup> we will have to grapple with whether the information in the note should be included in the lien registry. The focus on costs to the transacting parties in the literature shortchanges these concerns as well.

It could be that the concerns raised here do not apply to recording specifically of mortgages, or more specifically of mortgage assignments. After all, when mortgage assignments are not recorded, the existence of a mortgage on the property may still be on the public record.<sup>287</sup> And even if the true owner of the mortgage were recorded, in the case of securitization the

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<sup>283</sup> See Christopher L. Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, 78 U. CIN. L. REV. 1359, 1366 (2010) (private insurers' title plants cannot function "without the law creating legal incentives to deposit records into the central government maintained system."). This group is especially important, as commentators have been arguing for at least forty years that title companies have more or less superseded the public record system. Charles S. Meyers, Book Review, 116 U. PA. L. REV. 742, 742-43 (1968) (reviewing JAN KRASNOWIECKI, *CASES AND MATERIALS ON OWNERSHIP AND DEVELOPMENT OF LAND* (1965)) ("Today the plain fact is that in most urban centers, and in large parts of the outlands as well, title work is done by title insurance companies.... About the only purpose I can see in a detailed examination of the recording acts and the operation of the state-maintained registry of deeds is as an object lesson to the profession." The "object lesson" the profession was supposed to draw was that the public system's "onerous" search rules, "creaky" grantor-grantee index, and failure to better protect users against mistakes led the title insurers to "come along with a better mousetrap."). More recently, authors have emphasized the promise of title insurance for developing countries. See Priya S. Gupta, *Ending Finders, Keepers: The Use of Title Insurance to Alleviate Uncertainty in Land Holdings in India*, 17 U.C. DAVIS J. INT'L L. & POL'Y 63, 108 (2010) ("The Indian experience has provided, I hope, a convincing account of the role that title insurance could play in achieving certainty and predictability in land holdings."). However, title insurance in the United States is at present built on the public system of land records. See Peterson, *supra*, at 1366; Interview with county clerk, Aug. 6, 2012. Perhaps title insurance could function just as well if there were no public records, but the claim is speculative.

<sup>284</sup> See, e.g., Fred H. Cate, *The Commodification of Information and the Control of Expression*, 3 NO. 7 PRIVACY & INFO. L. REP. 11 (2003) (in discussion of consumer privacy regulation, calling for "balancing laws that restrict information flows with the legitimate need for, and legal protection of, those flows."). Compare Eugene Volokh, *Freedom of Speech and Information Privacy: The Troubling Implications of a Right to Stop People from Speaking About You*, 52 STAN. L. REV. 1049, 1050 (2000) (arguing that noncontractual government-imposed information privacy rules are "not easily defensible under existing free speech law" and could create a slippery slope leading to other speech restrictions).

<sup>285</sup> ARRUNADA, *supra* note 316, at 127 (describing pursuit of wealthy heiresses by dowry-seeking bachelors, sale of vacant houses after learning owners' identities from title records, and identity theft).

<sup>286</sup> See White, *supra* note 315, at 497-99.

<sup>287</sup> See Whitman, *How Negotiability Has Fouled Up the Secondary Market Mortgage*, *supra* note 102, at 769.

mortgages are held in trust, so all the public record would disclose is something like, “LaSalle Bank, N.A., as trustee for 2006-HE6 GSAMP Trust.” However, that does provide at least some information to borrowers and others (as both consumer law professors<sup>288</sup> and practitioners<sup>289</sup> have pointed out).

Public records are important in fields beyond mortgage law. The privatization of litigation settlements has been criticized for its effect on the public record.<sup>290</sup> Moreover, public information about mortgage ownership creates an information commons. As the intellectual-property literature teaches us, such commons have value even if their use is not totally foreseeable when it is created.<sup>291</sup> Accordingly, patent law recognizes the value of information dissemination; frequently this is described as a bargain in which the government exchanges a limited monopoly for disclosure of the patent.<sup>292</sup> As Anupam Chander, Madhavi Sunder, and Uyen Le recently explained, the Supreme Court’s recent decision in *Golan v. Holder*<sup>293</sup> recognizes the value of dissemination in copyright law.<sup>294</sup>

Certainly, the costs and benefits of public title records are a legitimate subject for discussion and debate. But the Article 9 revisions were drafted in a process that may not have

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<sup>288</sup> See White, *supra* note 315, at 496 (“[T]here is a genuine consumer borrower interest in transparency of mortgage assignments so that the identity of the real counterparty is known.”).

<sup>289</sup> See Adam Leitman Bailey & Dov Treiman, *Moving Beyond the Mistakes of MERS to a Secure and Profitable National Title System*, PROBATE & PROPERTY, July/August 2012, at 40, 45.

<sup>290</sup> See Rex R. Perschbacher & Debra Lyn Bassett, *The End of Law*, 84 B.U. L. REV. 1 (2004).

<sup>291</sup> See Mark A. Lemley, *Ex Ante versus Ex Post Justifications for Intellectual Property*, 71 U. CHI. L. REV. 129, 143 (2004) (because information cannot be used up, “rather than a tragedy, an information commons is a ‘comedy’ in which everyone benefits.”).

<sup>292</sup> See, e.g. *Eldred v. Ashcroft*, 537 U.S. 186, 216 (2003) (“our references to a quid pro quo typically appear in the patent context”); *Pfaff v. Wells Elecs., Inc.*, 525 U.S. 55, 63 (1998) (“[T]he patent system represents a carefully crafted bargain that encourages both the creation and the public disclosure of new and useful advances in technology, in return for an exclusive monopoly for a limited period of time.”) (Stevens, J., for unanimous court); Shubha Ghosh, *Patents and the Regulatory State: Rethinking the Patent Bargain Metaphor After Eldred*, 19 BERKELEY TECH. L.J. 1315, 1316 (2004) (criticizing “common” understanding of patent as bargain).

<sup>293</sup> 132 S. Ct. 873 (2012).

<sup>294</sup> Anupam Chander, Madhavi Sunder & Uyen Le, *Golan v. Holder*, 106 AM. J. INT’L L. 637, 641-42 (2012).

been fully inclusive<sup>295</sup> and apparently were not seriously debated in the state legislatures at adoption.<sup>296</sup> Subsequent events have shown that abandoning public title records may have been a mistake.

Policymakers should revisit the balance between party convenience and public records. They should do so conscious not just of the cost and delay that the traditional title recording system apparently imposed, but also of the value of public records of mortgage ownership. Specifically, policymakers should consider adopting a unified solution for land title law that brings the efficiency and security that transaction participants need together with the degree of transparency about real property interests that the public interest requires.

#### VIII. MOVING TOWARD PUBLIC MORTGAGE OWNERSHIP RECORDS

Mortgage recording traditionally has been cumbersome and relatively costly, but it produces records that are useful to the transacting parties, to other potential transacting parties, and to the public at large. The Article 9 regime, based on identifying the promissory note in a private security agreement that does not have to be publicly filed, is just the opposite: it is cheap and efficient for the parties to the transaction, but does not produce the public benefit of public records. Digital recording seems to offer the best of both: public records generated efficiently and cheaply.

Commentators already have noted that digitization undermines some chain-of-title doctrines,<sup>297</sup> and digitization also undermines the strongest justifications for Article 9's rules on mortgage transfer. If private authentication is no longer much cheaper, there is no need to

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<sup>295</sup> Edward J. Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*, 83 IOWA L. REV. 571, 631-32 (1998) (uniform law drafting process “unduly constricts” number of represented groups, among other problems).

<sup>296</sup> See McDonnell, *supra* note 4, at 241 (“There appears to be no organized opposition” to adoption of Article 9 revisions).

<sup>297</sup> See Bayer-Pacht, *supra* note 308, at 339-40.

subordinate public records to private ones in the name of efficiency.<sup>298</sup> Policymakers should consider replacing the Article 9 regime for mortgages with a recording regime in tandem with the expansion of digital recording.<sup>299</sup>

#### A. Legal Infrastructure for Mortgage Ownership Recording

The basic legal infrastructure for digital recording is already in place in many jurisdictions. Although it has not always been clear that state laws from the pre-digital era permit digital recording,<sup>300</sup> a uniform act promoting digital real property recording (the Uniform Real Property Electronic Recording Act (“URPERA”)) was proposed in 2005<sup>301</sup> and has been adopted in about half the states.<sup>302</sup> URPERA provides that electronic documents with electronic signatures can be recorded,<sup>303</sup> and that an electronic signature satisfies notarization and related requirements.<sup>304</sup>

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<sup>298</sup> Indeed, to the extent that digitization makes recording cheap and easy, recording systems become more attractive for all types of property, not just mortgages. Mortgages present a strong case for recording because of the historical public interest in land, but perhaps recording should be considered for other types of property claims that are currently governed by a private authentication regime. For example, registration of trademarks and copyrights is optional, and legal incentives for copyright registration generally have decreased over time. *See* Mose Bracey, *Searching for Substance in the Midst of Formality: Copyright Registration as a Condition Precedent to the Exercise of Subject-Matter Jurisdiction by Federal Courts over Copyright Infringement Claims*, 14 J. INTELL. PROP. L. 111, 123-33 (2006) (tracing evolution of registration and its generally declining importance). Unrecorded assignments of patents, 35 U.S.C. § 261, and of registered trademarks, 15 U.S.C. § 1060(a)(4), and copyrights, 17 U.S.C. § 205(d), are vulnerable to subsequent bona fide purchasers. Cheaper registration could suggest a basis for reversing the trend away from formality in this area if there is value to the registry itself. Although privacy and fraud-enabling concerns certainly are relevant in all contexts, this could be addressed on a property-type-by-property-type basis.

<sup>299</sup> This is by no means a new observation as applied to title records generally, although this is the first time the author is aware that it has been applied to the “mortgage follows the note” principle. *See* Dale A. Whitman, *Digital Recording of Real Estate Conveyances*, 32 J. MARSHALL L. REV. 227, 227-28 (1999) (advocating legislation to promote digitization of land title records in order to save costs); Dale A. Whitman, *Are We There Yet? The Case for a Uniform Electronic Recording Act*, 24 W. NEW ENG. L. REV. 245 (2002) (proposing Uniform Electronic Recording Act to facilitate electronic recording).

<sup>300</sup> *See* Whitman, *Are We There Yet?*, *supra* note 299, at 246.

<sup>301</sup> Uniform Real Property Electronic Recording Act, <http://www.uniformlaws.org/Act.aspx?title=Real Property Electronic Recording Act> (viewed Aug. 10, 2012).

<sup>302</sup> *See* <http://www.uniformlaws.org/Act.aspx?title=Real Property Electronic Recording Act> (viewed Aug. 10, 2012).

<sup>303</sup> URPERA §§ 3(a), 3(b), 4(b)(2).

<sup>304</sup> URPERA §3(c).

What is currently missing is a clear incentive for parties to maintain current records of mortgage loan ownership. Accordingly, we suggest that policymakers consider replacing the current muddled and confusing rules on mortgage loan ownership discussed earlier with a regime that clearly requires that interests in mortgage loans be recorded to be protected. The most straightforward vehicle for such a regime to do this would be to adopt either a uniform state act or a federal statute governing mortgage recording on either a national or a local registry, accompanied by conforming changes to the U.C.C., such as repealing Section 9-308(e) as applied to mortgages.<sup>305</sup> We discuss whether the registry should be national or local below.

Under our proposal, a party's ownership interest in a mortgage loan would be vulnerable to bona fide purchasers (potentially including bankruptcy trustees) until such time as the party recorded its interest in whatever public registry is adopted. Other state laws based on a party's status as mortgagee of record would be triggered by recording. An agent could register in the name of a principal, but the relationship would have to be disclosed. The statute could take the form of a "pure race," "race-notice," or "pure notice" rule; the key point is that there would once again be clear incentives to create public records of mortgage loan ownership.<sup>306</sup> The law could go farther and make recording on the registry a prerequisite to being able to enforce the mortgage, as Alan White has suggested.<sup>307</sup> This would increase the incentive to record but is not strictly necessary to our proposal.

As we have discussed, a regime providing incentives for mortgage recording would not be an innovation; most states already have laws on the books that do exactly that. The issue is

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<sup>305</sup> Section 9-203(g) provides that a note assignment gives an interest in the mortgage good as between the parties. Section 9-308(e) provides that the interest in the mortgage is good against the world automatically with no further action. The latter provision is the one potentially in conflict with real estate recording statutes and values.

<sup>306</sup> If putting ownership of mortgage loans at risk is deemed too harsh a penalty for failure to record, the statute could make recording mandatory and impose sanctions for failing to do so.

<sup>307</sup> See White, *supra* note 315, at 499.

simply removing the confusing and potentially conflicting Article 9 provisions so that industry participants have clear guidance about what the law requires. The new system and its associated legal framework would eliminate not just Article 9's reliance on the nebulous concept of consideration, but also the confusing interaction between Article 9 and the real-property laws, replacing both with a unified system of mortgage ownership.

### *B. Institutional Infrastructure for Mortgage Ownership Recording*

In order for a recording-based legal regime to make sense in the era of securitization, there must be a practical way to record quickly and at low cost. Fortunately, public recording systems are already moving in this direction. Commentators have noted a “consistent trend”<sup>308</sup> toward computerized systems that offer non-chronological search, often including searches on property location rather than just grantors and grantees.<sup>309</sup> As early as 2002, Salt Lake County, Utah; Orange County, California; Maricopa County, Arizona, and many others stored documents in digital form and permitted online searches, although they did not yet permit recording of original digital documents.<sup>310</sup> Although not all jurisdictions have adopted any form of digital recording, the technology continues to spread.<sup>311</sup> At least in some jurisdictions, some digitally recorded documents are scanned paper documents and others never existed in paper form but were originated digitally.<sup>312</sup> Practitioners have noted and applauded the trend toward digital property records, calling for leadership at the state level to develop modern digitized title

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<sup>308</sup> Emily Bayer-Pacht, *The Computerization of Land Records: How Advances in Recording Systems Affect the Rationale Behind Some Existing Chain of Title Doctrine*, 32 CARDOZO L. REV. 337, 357 n.118 (2010).

<sup>309</sup> *Id.* at 358-60.

<sup>310</sup> See Whitman, *Are We There Yet?*, *supra* note 299, at 247. New York County's ACRIS system permits online index searches and viewing digital copies of deeds. See Bailey & Treiman, *supra* note 289, at 42, 46; Bayer-Pacht, *supra* note 308, at 360. San Bernardino County, California permitted electronic recording as early as 1992. E-mail from Ben Weber, Aug. 11, 2012.

<sup>311</sup> San Francisco County plans to implement electronic recording in late 2012. E-mail from Ben Weber, Aug. 11, 2012.

<sup>312</sup> E-mail from Ben Weber, Aug. 11, 2012.



systems and pointing out the potential benefits to borrowers, lenders, and title insurers of doing so.<sup>313</sup>

1. Alternative 1: Authoritative National Lien Registry

a. Description of the Authoritative National Lien Registry and Its Legal Infrastructure

Policymakers should consider a national, authoritative electronic mortgage lien registry. Real-property title scholars,<sup>314</sup> consumer law scholars,<sup>315</sup> comparative institutional economists,<sup>316</sup> and the governors of the Federal Reserve System<sup>317</sup> all have called for some kind of national, authoritative registry of mortgage liens. In related work we have compared such a system favorably to alternatives.<sup>318</sup> We provide a preliminary description of such a system and of some of the issues involved in implementing it.

By “authoritative,” we mean a registry that would supplant both the Article 9 rules for mortgage ownership perfection and the state real-property law of mortgage recording, as described above. By “national,” we mean that there should be a unified way for transacting parties to record and assign mortgages on property located anywhere in the United States. A national solution avoids the inefficiency of differing and potentially conflicting state and local rules and practices. Although it would be possible to create a system that is uniform for users

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<sup>313</sup> See Bailey & Treiman, *supra* note 289, at 45-46.

<sup>314</sup> See Tanya Marsh, *Foreclosures and the Failure of the American Land Title Recording System*, 111 COLUM. L. REV. SIDEBAR 19 (2011) (proposing gradual shift to federal system through private opt-in to national registry).

<sup>315</sup> Alan M. White, *Losing the Paper: Mortgage Assignments, Note Transfers and Consumer Protection*, 24 Loy. Consumer L. Rev. 468, 497-98 (2012).

<sup>316</sup> See BENITO ARRUÑADA, INSTITUTIONAL FOUNDATIONS OF IMPERSONAL EXCHANGE 284 (2012)

<sup>317</sup> See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE U.S. HOUSING MARKET: CURRENT CONDITIONS AND POLICY CONSIDERATIONS 24-25 (2012).

<sup>318</sup> See Hunt et al., *All in One Basket*, *supra* note 22.

while retaining local control, as we discuss below, a national system is the most straightforward way to achieve uniformity.<sup>319</sup>

Our proposal is not simply to legitimize MERS, as some have suggested.<sup>320</sup> MERS is not public. Instead, it is owned by the mortgage industry (including the government-sponsored housing entities), and thus may tend to favor inexpensive recording over publicity of records. MERS' behavior to date suggests that it is not oriented toward maintaining high-quality publicly available records. Although representatives of MERS claim a borrower can find out who is registered on the system as her mortgage holder, they do not claim that this information is public.<sup>321</sup> Moreover, MERS does not seem to provide a strong incentive to keep transfer records current. Although failing to update records to reflect transfers is currently a violation of MERS rules,<sup>322</sup> we are not aware that MERS has enforced these rules.<sup>323</sup> There does not appear to be

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<sup>319</sup> Our proposal for a national lien registry has some similarities to that of Tanya Marsh. *See* Marsh, *supra* note 314, for a discussion of possible local opposition to a national system and a proposal for gradual transition. Marsh has suggested a uniform act that would permit parcels of real property to move permanently out of the local title recording system into a new federal system. *See id.* at \*25. However, Marsh does not address the relationship between title recording and the U.C.C. or the common-law rule that the mortgage follows the note. The interaction between the new federal recording system and these other bodies of law remains unclear under her proposal. Moreover, we are unsure that it is advisable to replace local land records for all purposes (rather than just for mortgages). It is possible to imagine separate, parallel systems for mortgage and other claims. Although such a setup is probably inefficient, others have embraced a separate registry for real estate liens without expressly calling for abandonment of the traditional county-based system, *see* White, *supra* note 315, at 498-99; BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *supra* note 317, at 24-25. We also are unsure that the migration to a new system should happen on a parcel-by-parcel, as opposed to county-by-county, state-by-state, or national basis. Whatever the scope of the national registry, it seems more efficient for migration to happen on a county-by-county, state-by-state, or even national basis. Although a transition period undoubtedly would be needed, a parcel-by-parcel approach does lengthen the period that two systems are operating for any given geographic region. Relatedly, we do not necessarily embrace the individual-choice aspect of Marsh's proposal. Owner's choice is inconsistent with a more efficient region-by-region migration, and as we have discussed many of the crucial issues with title records are public rather than private.

<sup>320</sup> *See* Dustin A. Zacks, *Standing in Our Own Sunshine: Reconsidering Standing, Transparency, and Accuracy in Foreclosures*, 29 QUINNIPIAC L. REV. 551, 610 (2011) ("MERS itself could be strengthened and regulated to form the foundation of a new, alternative national recording system.").

<sup>321</sup> *See* Declaration of William C. Hultman, ¶ 11, *In re Agard*, No. 10-77338-REG (Bankr. E.D.N.Y. Dec. 22, 2010).

<sup>322</sup> MERS System Rules of Membership, Rule 2, § 3(c)-(e) (March 2012).

<sup>323</sup> Indeed, as of late 2009, MERS' CEO testified that MERS "does not so much ... expect" that members enter transfers on the system as "operate a system that offers that capability." Deposition of R.K. Arnold,

any other incentive to register assignments on the system. MERS does not appear to have been designed and run as a system in which publicity of records was an important value, and it is unclear whether regulation can change this.<sup>324</sup> Moreover, as we have pointed out elsewhere, the corporate entities housing MERS could go bankrupt, with potentially distressing consequences.<sup>325</sup>

#### b. Implementation Issues with Authoritative National Lien Registry

There are two major potential obstacles to adopting national lien recording. The first is the cost of setting up a national title registry, including its legal infrastructure, and making conforming changes to state law. An analysis of these costs is beyond the scope of this Article but clearly would be a crucial step in deciding to move forward with the proposal.

The second, and probably more important, potential obstacle is political. We see three important groups of stakeholders who might either support or oppose the proposal. The first is government actors. Local recorders might resist the loss of revenue and authority that a national registry would bring, although at least some local recorders probably would prefer to concentrate on election duties and not land title records. The change could accompany a move of the title recording function from the local to the state<sup>326</sup> or national level.<sup>327</sup> Moreover, states might

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Henderson v. MERSCORP, Inc., Civ. No. CV-08-900805.00 (Montgomery Cty., Ala. Cir. Ct. Sept. 25, 2009), at 178: 9-17.

<sup>324</sup> A related point is that MERS, Inc. is a private entity. If the electronic registry is to be made mandatory, parties will be required to transact with a private entity in order to transfer mortgages. As the struggle over the Affordable Care Act's individual mandate indicates, forcing transactions with private entities can create political resistance. *See generally* National Fed. of Indep. Bus. v. Sebelius, 132 S.Ct. 2566 (2012).

<sup>325</sup> John Patrick Hunt et al., *supra* note 22.

<sup>326</sup> *See* Whitman, *Digital Recording*, *supra* note 182, at 260; Whitman, *Are We There Yet?*, *supra* note 299, at 269-70 (suggesting that local land recorders should have control over, or at least input into, any statewide electronic recording agency); Bailey & Treiman, *supra* note 289, at 46.

<sup>327</sup> *See* Whitman, *Are We There Yet?*, *supra* note 299, at 262. URPERA provides two alternatives for adopting standards for electronic recording. One provides for a commission in which recorders are a majority, and the other provides for implementation by a state agency. URPERA, § 5.

resist the national registry as a threat to their sovereignty and authority over land,<sup>328</sup> although existing challenges to MERS have focused on the concrete matter of fees and not abstract questions of sovereignty.

The second group is MERS' members. They have invested in MERS as an alternative to mortgage assignment recording and might prefer to keep the system in place. However, it is at least conceivable that removing the legal uncertainty around MERS could motivate these stakeholders to support our proposal.

The third group is participants in the title industry. Title insurers, for example, have invested in the creation of plant records that reorganize the information contained in official title records in a more user-friendly manner.<sup>329</sup> Centralizing title records in a single searchable national registry (or improving the usefulness of official records in any respect) might undermine this investment and create resistance. More generally, title insurers might resist any large-scale overhaul of an environment in which they have adapted to thrive. But the industry might be persuaded to support the new approach; as others have noted, title companies could profit from representing public records in more efficient and user-friendly ways.<sup>330</sup> In any event, the interests of the title industry should not in themselves derail efforts to explore an improved recording system.

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<sup>328</sup> See, e.g., *Idaho v. Coeur d'Alene Tribe of Idaho*, 521 U.S. 251, 282 (1997) (to “diminish” Idaho’s control over lands and waters in its territory would cause “offense to Idaho’s sovereign authority and its standing in the Union”).

<sup>329</sup> See, e.g., CEB, *CALIFORNIA TITLE INSURANCE PRACTICE* §4.10 (2d ed. 2011).

<sup>330</sup> See Bailey & Treiman, *supra* note 289, at 45-46 (“[t]itle companies could make money, and increase efficiency by designing computer programs that could access the publicly published land records, and analyze and index in any variety of creative new ways that could, in effect, produce a rudimentary title report in a matter of seconds.”).

## 2. Alternative 2: Upgrading Local Recording Systems

Although a national system enjoys widespread support among commentators and seems to be the most efficient alternative, the political obstacles could be significant. States and localities simply may not be willing to cooperate in transferring responsibilities that have been theirs for centuries. Moreover, recording fees are a source of revenue that local governments may not want to give up, as recent county recorder lawsuits against MERS to recover unpaid fees suggest.<sup>331</sup>

These political issues with a national system suggest that policymakers should consider a second-best alternative: widespread upgrades to local systems to handle electronic mortgage assignments.<sup>332</sup> A local approach, once universally adopted, could be almost as efficient as a national one. Local courts<sup>333</sup> and tax authorities<sup>334</sup> already transact electronically, presumably reaping efficiency benefits, without unifying these functions at the state or national level. It is true that national entities such as the GSEs would have to deal with different local authorities, but it seems likely that the process of recording could be made uniform across counties through the use of common software standards. Moreover, different counties' systems could be reached through a common portal. If all counties adopt compatible forms of electronic recording, in the end the user might not notice the difference between local and national control.

The biggest difficulty with a local approach is the likelihood that there will be a period in which there is a patchwork, with some counties using electronic recording and others using

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<sup>331</sup> See Motions Hearing Transcript at 81:10-20, *Dallas County v. MERSCORP, Inc.*, No. 3:11-CV-2733-O (N.D. Tex. July 13, 2012) (denying in part motion to dismiss lawsuit brought by three Texas counties to recover recording fees).

<sup>332</sup> Under this proposal, the U.C.C.'s private authentication provisions could be dropped on a state-by-state basis once all the counties in a given state have adopted electronic recording. The U.C.C. provisions potentially could be repealed if a supermajority of counties in the state adopt recording.

<sup>333</sup> See, e.g., [www.occourts.org/online-services/efiling/efiling-general-questions](http://www.occourts.org/online-services/efiling/efiling-general-questions) (providing for electronic filing of documents in Orange County Superior Court).

<sup>334</sup> See, e.g., <http://www.yolocounty.org/Index.aspx?page=1661> (providing for online payment of Yolo County property taxes).

traditional paper-based recording. Unlike federalization of land records, it seems unlikely that states and localities will resist switching from paper to electronic recording as a matter of principle. Rather, it seems that the key issue likely would be funding, particularly for less affluent and/or rural counties.<sup>335</sup> But mortgage recording now has been revealed as a national problem for the federal government and mortgage industry, so federal authorities and industry participants should consider shouldering some of the burden of funding upgrading local mortgage systems.

## IX. CONCLUSION

The ambiguities that currently afflict mortgage transfer law increase risk both for parties who transact in mortgages and for borrowers. The doubts about whether key provisions of Article 9 even apply to many existing securitizations are one example, and the doubts about how Article 9 interacts with recording law are another. Greater clarity is needed, but we suggest that greater clarity should accompany a change in the substantive direction of the law. The most recent major development in mortgage transfer law, the mortgage-transfer rules in the 1998 revisions to Article 9, seem to have been aimed at doing away with any legal reason to maintain public records of mortgage assignments. The mortgage-transfer rules are of a piece with the Mortgage Electronic Registration System of approximately the same vintage. Both reflect a preoccupation with reducing the cost and burden of recording mortgage transfers with local authorities. The focus seems to have been exclusively on the cost of maintaining public records of mortgage ownership.

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<sup>335</sup> See, e.g., Lisa R. Pruitt, *The Forgotten Fifth: Rural Youth and Substance Abuse*, 20 STAN. L. & POL'Y REV. 359, 388 n.181 (noting "digital divide between rural and urban residents").

We seek to refocus the discussion on the benefits side of the ledger, to remind the reader that public records have value. To that end, we recommend that policymakers reconsider the balance between private efficiency and convenience on the one hand and public records on the other. In so doing, they should consider the cost reduction that the spread digital recording makes possible. Digitization pushes the balance between economy and publicity toward publicity. It is time to consider a legal regime that gives transacting parties incentives to record their interests in mortgages, and in so doing to reach an appropriate balance between public and private.