

The Transactional Lawyer

A Publication of the Commercial Law Center



Mortgage Foreclosure: Complex Laws and Sloppy Practice

Linda J. Rusch

Over the last two years or more, we have observed case after case concerning who has the right to foreclose a mortgage. A combination of complex practices in the securitization of mortgage loans and the immense volume of foreclosure generated by the combined effect of the downturn in real estate values and the economic recession has contributed to the high number of cases in which this became an issue. Sloppy record keeping practices and bad litigation tactics have also contributed to the volume of litigation.

Commercial lawyers are used to the idea that the person who has the right to collect on an obligation is entitled to pursue the collateral that secures that obligation. See U.C.C. §§ 9-607, 9-610. This simple premise is not so simple in practice when it comes to foreclosing on real estate collateral, particularly when the mortgage obligation has been transferred into a securitized pool of obligations. The varied real estate foreclosure laws concerning what has to be proven to commence a judicial foreclosure and what documents must be produced to commence a nonjudicial foreclosure have also contributed to confusion regarding this simple premise.

In an attempt to clarify how Uniform Commercial Code Articles 3 and 9 affect the mortgage foreclosure process, the Permanent Editorial Board for the Uniform Commercial Code issued a report on November 14, 2011. That report can be found on the American Law Institute's website at

<http://www.ali.org/00021333/PEB%20Report%20-%20November%202011.pdf>

While this report does not address all the issues that may arise in a mortgage foreclosure, it may help give guidance to all parties involved in a mortgage foreclosure to find through the many difficult issues that may arise in any particular proceeding.

Linda J. Rusch is a professor at Gonzaga University School of Law and co-director of the Commercial Law Center.



Limiting the Preference Exposure of Originators & Servicers

Stephen L. Sepinuck

Is the originator of a loan, who continued to administer the loan after selling 94.44% of it to participants, an "initial transferee" of payments it received for the benefit of the participants? This was the apparently novel question addressed in *In re Brooke Corp.*, [2011 WL 4543484](#) (Bankr. D. Kan. 2011). The court's analysis is instructive to those who would seek to escape liability in bankruptcy for an avoidable transfer.

The facts of the case were essentially these. In late 2007, Stockton National Bank made a \$4.5 million loan to Brooke Corporation. One the same date, Stockton sold fractional interests in the loan to eight other banks (the "participants"), whose participation Brooke had solicited. The participation agreements authorized Stockton to administer the loan and gave it some discretion in how to do so. However, the agreements also stated that payments received by Stockton "will be held for the benefit of" the participants until the payments are actually paid to and received by the participants and it required Stockton to forward payments within ten days of receipt.

Within the preference period, Stockton received approximately \$488,000 from the debtor, retained

Contents

<i>Mortgage Foreclosure: Complex laws And Sloppy Practice</i>	1
<i>Limiting the Preference Exposure of Originators & Servicers</i>	2
<i>UCC Section Captions</i>	3
<i>Recent Cases</i>	5

\$28,000, and distributed the remainder to the participants one day after receipt. In the debtor's bankruptcy case, Stockton filed a claim for the more than \$4 million that remained owing on the loan. The trustee sued Stockton and all the participants to recover the allegedly preferential transfers. Stockton conceded that it was the initial transferee of the \$28,000 it had received and retained but moved for summary judgment as to the \$460,000 it had distributed to the participants. As to this portion, Stockton claimed that it was a mere conduit, not a transferee. Several courts have acknowledged that not everyone who touches the money is a transferee; rather, "those who act as mere 'financial intermediaries,' 'conduits' or 'couriers' are not initial transferees under § 550." *In re Ogden*, [314 F.3d 1190](#), 1202 (10th Cir. 2002), quoting *Rupp v. Markgraf*, [95 F.3d 936](#), 941 (10th Cir. 1996). See also *In re Incommet, Inc.*, [463 F.3d 1064](#) (9th Cir. 2006); *In re Coutee*, [984 F.2d 138](#) (5th Cir. 1993); *Bonded Financial Services, Inc. v. European American Bank*, [838 F.2d 890](#) (7th Cir. 1988).

The participants opposed the motion. Presumably they did so in with the intention of arguing that, because they were subsequent transferees – not the initial transferees or the entities for whose benefit the transfer was made – they were immune from liability under § 550(b). That provision excepts from avoidance liability a subsequent transferee who takes for value, in good faith, and without knowledge of the voidability of the transfer.

The participants presented several arguments in support of their position. First, they claimed that Stockton had dominion and control over the funds paid because the participation agreement granted Stockton discretion to make additional advances for taxes and insurance or to pay expenses associated with collection. The court rejected this, noting that such discretion was unrelated to the payments received, over which Stockton had no discretion.

Next, the participants argued that Stockton was the initial transferee because it was the one with the debtor-creditor relationship with Brook and had filed a proof of claim for the entire loan balance. The court readily rejected these arguments. As to the first, the court noted that the proper focus is not on the relationship between the debtor and the recipient, but on the transfers themselves. Because each of the participants had been sold a fractional interest in the loan, Stockton was simply not a creditor with respect to the portion of the payments allocable to those participation interests. As for filing the proof of claim, the court observed that Stockton was merely fulfilling its duty under the participation agreement, which

required it to administer the loan "as though it were the sole owner" thereof.

Perhaps the participants' best argument – and the one that elicited the most interesting response from the court – was that Stockton should be treated as the initial transferee because it had commingled the funds received with its own before remitting payment to the participants. It cited *In re Liberty Livestock Co.*, [198 B.R. 365](#) (Bankr. D. Kan. 1996), for the proposition that when a funds recipient who is obligated to hold the funds in trust commingles the funds with its own, the recipient loses the status of a mere conduit. The court's main response to this was that Stockton had not agreed to hold the funds in trust. As a result, "[t]here was no trust relationship and therefore no basis to argue that there was improper commingling." This analysis is somewhat counter-intuitive. While one might be tempted to think that express trust language in the participation agreement would make the administrator *more* likely to be a conduit, the court essentially suggested the opposite, at least if the funds had been commingled.

The court then distinguished the Seventh Circuit's decision in *Paloian v. LaSalle Bank*, [619 F.3d 688](#) (7th Cir. 2010), on the same basis. In *Paloian*, the court held that the trustee of a securitized note, not the beneficial owners of the trust, was the initial transferee of allegedly fraudulent payments on the note. In other words, the trustee of the securities pool was the legal owner of the trust's assets, and hence the initial transferee of the payments received. This allowed the bankruptcy trustee to pursue a single entity, rather than suing thousands of investors who may have received avoidable transfers. However, in Brooke's case, the court ruled that Stockton was not a trustee and the participants, not Stockton, were the owners of the note that had been satisfied by the transfers to Stockton.

The implication of this for originators and servicers is that they should avoid any language of a trust relationship in their participation agreements and service agreements. For participants, there are countervailing considerations. Language creating a fiduciary relationship may be useful if the servicer experiences financial problems. In such a case, the language may help ensure that payments received but not yet distributed by the servicer are treated as the participants' property. On the other hand, if the documents avoid fiduciary language and the originator or servicer is thereby deemed to be a mere conduit, the participants would then presumably be the initial transferees. While the participants could not then avail themselves of limits on liability in § 550(b)(2), the bankruptcy trustee may conclude that pursuing

preference claims against each of the participants would be cumbersome, overly expensive, or barred by the *de minimus* exception of § 547(c)(9).

[Stephen L. Sepinuck](#) is a professor at Gonzaga University School of Law and co-director of the Commercial Law Center.



UCC Section Captions

Scott J. Burnham

I have long admired the pithiness of § 1-107, the shortest provision in the UCC. It provides in full:

Section Captions. Section captions are part of the Uniform Commercial Code.

While easy to overlook, the provision is nevertheless significant, for it differs from the general rule. A state legislature generally enacts the text of a law without section captions, which are then added by an administrative agency. Because they are not promulgated by the legislature, the section captions do not have the force of law. Montana Code § 1-11-103(5), for example, provides:

Unless specifically and expressly adopted as part of the law by the legislature, annotations, code commissioner notes, catchlines, or other editorial material included in the Montana Code Annotated may not be construed as part of the legislative text but are only for the purpose of convenience, orderly arrangement, and information.

In Montana, the section captions (or *catchlines* as they are called in that section – a word never again found in the Montana Code) are provided by the Legislative Council.

If section captions were part of the statutory text, strange results might follow. For example, the caption to Montana Code Annotated § 27-1-604 provides: “**Litigation and threat of litigation prohibited.**” While we might have all dreamed of a litigation-free Utopia, Montana’s ambitions were, alas, more modest. The statutory text is limited to prohibiting litigation based on a particular cause of action that was abolished. While that abolished cause of action appears from the caption to § 27-1-602 to be a cause of action

for “breach of promise,” the statute itself is limited to a cause of action for breach of contract to marry. The caption and statute provide:

Cause of action for breach of promise abolished-- right to damages for fraud and unjust enrichment preserved. All causes of action for breach of contract to marry are hereby abolished.

The UCC, on the other hand, comes pre-packaged with section captions and is enacted *in toto*, captions and all, by the legislature. Thus, the UCC is the exception to the general rule that section captions are not part of the statute.

An exception to the exception is the subsection headings added for convenience in revised Article 9. These are found in brackets in the uniform version, indicating their limbo-like status: each jurisdiction must determine whether to adopt them. As noted in comment 3 to § 9-101:

This Article also includes headings for the subsections as an aid to readers. Unlike section captions, which are part of the UCC, see Section 1-109 [revised § 1-107], subsection headings are not a part of the official text itself and have not been approved by the sponsors. Each jurisdiction in which this Article is introduced may consider whether to adopt the headings as a part of the statute and whether to adopt a provision clarifying the effect, if any, to be given to the headings.

A problem in the subsection headings was discussed in a footnote in *In re Schwalb*, [347 B.R. 726](#) (D. Nev. 2006). Judge Markell raised the issue of whether § 9-625(c) penalties are available only in a “consumer-goods transaction,” as provided in the subsection heading, even though the text of the subsection itself refers to the broader transaction in which “the collateral is consumer goods.” The judge noted that the argument based on the subsection headings is unavailing because the subsection headings are not part of the Act – and in any event Nevada did not enact § 1-107! The error in the subsection heading to § 9-625(c) has been corrected in Amended Article 9.

California, Connecticut, Indiana, Louisiana, and Tennessee also omitted § 1-107 when enacting revised Article 1; Oregon enacted a nonuniform version of § 1-107 that specifically states that captions are not part of the law. Two states -- Michigan and Missouri – that have not enacted revised Article 1 omitted its predecessor § 1-109 from old Article 1. Kansas enacted a unique version of § 1-109 providing that

“section captions may be added in the construction of this act,” but the provision was replaced by uniform § 1-107.

There are a few cases in which section captions have been used for purposes of interpretation. The courts seem to have gotten it right by using the text of the caption to construe the meaning of the provision. In *Philbin v. Matanuska-Susitna Borough*, [991 P.2d 1263](#) (Alaska 1999), the issue concerned the interpretation of former § 1-107, now revised § 1-306. The plaintiff argued that a release was not effective because it was made *before* the breach and, although the text is silent on when the release has to be made, the caption refers to “Waiver or Renunciation of Claim or Right *After* Breach.” The court agreed with this interpretation. In *Bethlehem Steel Corp. v. Litton Industries, Inc.*, [468 A.2d 748](#) (Pa. Super. Ct. 1983), the court’s conclusion that Article 2 applied to a transaction even though the buyer had only an option to order goods was buttressed by the fact that the caption to § 2-311 refers to “Options and Cooperation Respecting Performance.”

The revision of Article 1 and the now withdrawn amendments to Article 2 did not change either of the captions involved in these cases. By contrast, the following Article 9 cases all arose under former Article 9 and the ambiguities that were raised have all been resolved in revised Article 9.

In *First National Bank & Trust Co. of Norman, Oklahoma v. Jim Payne Pontiac GMC, Inc.*, [1976 WL 23704](#) (Okla. Ct. App. 1976), a case decided under the pre-1972 version of Article 9, an automobile was sold by an owner in Texas, a certificate-of-title state, to a buyer in Oklahoma, which at the time was not a certificate-of-title state. The bank had perfected its interest in the Oklahoma debtor’s property by filing. The unpaid seller claimed that the bank’s security interest was not perfected because § 9-103 provided in pertinent part that “if personal property is covered by a certificate of title issued under a statute of this state or any other jurisdiction which requires indication on a certificate of title of any security interest in the property as a condition of perfection, then the perfection is governed by the law of the jurisdiction which issued the certificate.” If read literally, perfection would be governed by Texas law, which required notation on the certificate of title. But the court pointed out that the caption to § 9-103 provided: “Accounts, Contract Rights, General Intangibles and Equipment Relating to Another Jurisdiction; and Incoming Goods Already Subject to a Security Interest.” Since the automobile was not already subject

to a security interest in Texas, the rule did not apply. No such ambiguity exists in revised Article 9.

In *In re San Juan Packers, Inc.*, [696 F.2d 707](#) (9th Cir. 1983), applying Washington law, a secured party argued that a security interest did not remain attached to goods that were commingled but not processed. This argument was based on the caption to pre-1972 § 9-315, which read, “Priority When Goods Are Commingled or Processed,” although the *or* in that caption made clear that the goods do not need to be processed for the section to apply. This rule is now found in revised § 9-336, which is simply captioned “Commingled Goods” and which, unlike its predecessor, contains a definition of *commingled goods*.

In *Medi-fi Two Inc. v. Riordan*, [390 N.E.2d 1](#) (Ill. Ct. App. 1979), an accounts financier claimed that debtor was liable to it for a “deficiency” in payments from a third party. The financier cited to the rule of former § 9-504(2), which provided that “the debtor is liable for any deficiency.” However, the court cited the caption to § 9-504, which stated, “Secured Party’s Right to Dispose of Collateral After Default; Effect of Disposition,” to indicate that the rule applied only when there was a disposition of the collateral after default. Revised § 9-615 makes clear that the deficiency rules apply following a disposition of collateral and revised § 9-608(a)(4) and (b) specify when a debtor is liable for a deficiency after collection.

In *Executive Bank of Ft. Lauderdale v. Tighe*, [429 N.E.2d 1054](#) (N.Y. 1981), the issue was whether the bank had to give notice of a bankruptcy sale. The governing law, former § 9-504(3), provided that the secured party must give the debtor notice of a sale. But the court held that because the caption refers to “Secured Party’s Right to Dispose of Collateral After Default,” the notice provision applies only when the secured party is conducting the sale. This provision is clarified in revised § 9-611(b), which provides that “a secured party that disposes of collateral under Section 9-610 shall send ... notification of disposition.”

An article in a subsequent edition of this newsletter will discuss the use and misuse of captions in written agreements.

Scott J. Burnham is the Frederick N. & Barbara T. Curley Professor of Commercial Law at Gonzaga University School of Law. He is grateful for the research assistance of Erik Kukuk, a third-year student at Gonzaga University School of Law.



Recent Cases

SECURED TRANSACTIONS

In re Siskey Hauling Co., Inc.,

[456 B.R. 597](#) (Bankr. N.D. Ga. 2011)

Lender that acquired third security interest in debtor's accounts and whose loan was used to pay off the creditor with the first security interest was not entitled to be subrogated to that creditor's rights because the transaction was structured as a payoff, not an assignment, and because the lender was guilty of inexcusable neglect since it knew of the second security interest but failed to take the steps necessary to give it a superior position.

In re HT Pueblo Properties, LLC,

[2011 WL 5041767](#) (Bankr. D. Colo. 2011)

Security agreement that described the collateral to include "[a]ll accounts, general intangibles. . . [and] rents . . . arising out of a sale, lease, consignment or other disposition of any of the . . . Collateral" did not cover room rents of hotel because there was no disposition of the property, merely operation of the property. Deed of trust that purported to grant a UCC security interest in "all present and future rents revenues, income, . . . and other benefits derived from the [subject] Property" does not clearly grant a security interest in the fees, charges, accounts, or other payments for the use or occupancy of rooms and in any event such an interest is in personalty and is governed by Article 9, and therefore must be created in the security agreement, not in ancillary documents.

In re Alaska Fur Gallery, Inc.,

[2011 WL 4527342](#) (Bankr. D. Alaska 2011)

Cross-collateralization clause in bank's commercial security agreement unambiguously covered future loans, even if unrelated, and therefore the borrower's inventory, equipment, accounts, chattel paper, and general intangibles secured subsequent real estate loans. Revised Article 9 rejects any requirement that the loans have a related purpose, which had previously been the law in Alaska, although that rule may still apply in consumer transactions.

Camelot Entertainment Inc. v. Incentive Capital LLC,

[2011 WL 4477317](#) (C.D. Cal. 2011)

Mandatory forum selection clause in security agreements was binding even though the debtor's note contained a non-exclusive forum selection clause and the parties' escrow agreement contained no forum selection clause because the debtor's claim related to the collateral and was therefore inextricably bound up with the security agreements.

Symetra Life Insurance Co. v. Rapid Settlements, Ltd.,

[2011 WL 4807901](#) (S.D. Tex. 2011)

Obligor on structured settlements had claim for tortious interference with contractual relations against assignee of structured settlement payments that attempted to use arbitration to avoid state statutes requiring court approval of the transfers because the assignee had no colorable argument that arbitration could be used in such a manner.

COMMERCIAL CONTRACTING

Silverhawk, LLC v. KeyBank,

[2011 WL 5120703](#) (Wash. Ct. App. 2011)

Borrower that paid the amount the bank requested for early termination of a swap agreement had no cause of action against the bank for failure to compute the fee pursuant to the terms of the swap agreement because the borrower had not provided the notification that invoked the early termination clause and the parties had therefore entered into an accord and satisfaction.

Bank of America v. Jill P. Mitchell Living Trust,

[2011 WL 5386379](#) (D. Md. 2011)

Fixed-rate loan agreement that required the borrowers, upon prepayment, to also pay a breakage fee defined as "the cost or expense incurred by the Bank as a result of the payment," was ambiguous as to whether the fee included the prospective loss the bank incurs due to a decline in interest rates and the resulting inability to re-lend the funds at the fixed rate.

Salmons, Inc. v. First Citizens Bank & Trust Co.,

[2011 WL 4738656](#) (E.D. Va. 2011)

Borrower alleged a cause of action for unfair and deceptive practices against bank that, in an apparent effort to obtain additional collateral and after having already made several loans to the borrower to meet certain margin calls, inserted in the final loan and security agreement a new condition that prohibited the use of funds for margin calls and failed to disclose that condition, while knowing that the borrower's purpose for the funds was to make margin calls.

Mims v. Global Credit and Collection Corp.,

[2011 WL 3586056](#) (S.D. Fla. 2011)

Debt collector could not enforce arbitration clause in contract between debtor and creditor, even though the clause purported to cover the creditor's "successors, assigns, agents and/or authorized representatives." The debt collector was not a successor or assign, it was not a third-party beneficiary, and because its agreement with the creditor expressly declared it to be an independent contractor, not "the agent or legal representative of" the creditor, it was also not an authorized representative.

Permar v. Spectra Watermakers, Inc.,

[2011 WL 5320989](#) (N.D. Cal. 2011)

Court-approved settlement in which the defendant purchased a patent from the plaintiff with payments due over time and which provided that, upon a default in payment, the defendant would forfeit the patent back to the plaintiff provided adequate remedies for the defendant's default and therefore plaintiff's additional demand that the defendant execute a security agreement and financing statement was unnecessary and beyond the terms of the settlement. No discussion of whether the lack of a security agreement and financing statement left the plaintiff vulnerable to future assignees or secured parties.

Follow the link below for prior issues of

[*The Transactional Lawyer*](#)

BANKRUPTCY

In re Indian Capitol Distributing, Inc.,

[2011 WL 4711895](#) (Bankr. D.N.M. 2011)

Debtor's unauthorized use of cash collateral to pay vendor for goods sold post-petition was not avoidable because there was no injury and thus no case or controversy for the court to have jurisdiction over. Disagrees with *In re Delco Oil, Inc.*, [599 F.3d 1255](#) (11th Cir. 2010).

In re Goldstein,

[2011 WL 5240335](#) (Bankr. N.D. Ill. 2011)

Even though lender's security agreement expressly provided that the debtor car dealership held proceeds of inventory in trust for the lender, the debtor's failure to remit the proceeds of vehicles to the lender did not render the debt nondischargeable under § 523(a)(4). Inclusion of trust language in a security agreement does not change the debtor-creditor relationship into a fiduciary one and *In re Strack*, [524 F.3d 493](#) (4th Cir.2008), is unpersuasive on this point. Even if a fiduciary relationship could be created, the agreement here did not require the debtor to segregate the vehicle proceeds and turn them over to the lender; it merely required the debtor to pay down the secured obligation within 48 hours of a sale of collateral.

Edited By:

[Stephen L. Sepinuck](#)

Professor, Gonzaga University School of Law
Co-director, Commercial Law Center

[Linda J. Rusch](#)

Professor, Gonzaga University School of Law
Co-director, Commercial Law Center

[Scott J. Burnham](#)

Frederick N. & Barbara T. Curley Professor
Gonzaga University School of Law

For questions or to submit content to *The Transactional Lawyer*, please contact Vicky Daniels at vdaniels@lawschool.gonzaga.edu

This newsletter is intended to provide accurate information on the subjects covered. The newsletter is provided for informational purposes only; its publication and distribution do not constitute the provision of legal or professional advice or services by either the authors or the publisher. If legal or professional services are required, the services of a competent professional should be sought.