

Potential Issues for Warehouse Providers with Electronic Mortgage Notes

by Erik Detlefsen and Erin Bryan

Fannie Mae and Freddie Mac (the “GSEs”), working together with Mortgage Electronic Registry Systems (“MERS”), have been promoting the use of electronic mortgage notes (“eNotes”) in the residential mortgage industry. MERS, with input from the GSEs and other industry participants, has designed an “eRegistry” system that purports to provide a definitive record of the ownership of eNotes.

The use of eNotes and the eRegistry may bring substantial efficiencies to the residential mortgage market. However, the most recent iteration of the eRegistry does not fit neatly into the UCC perfection and priority scheme applicable to physical mortgage notes.

This eAlert addresses potential issues with eNotes and eRegistry, including:

1. The relationship between Article 9 of the Uniform Commercial Code (“UCC”) on the one hand, and the Uniform Electronic Transactions Act (“UETA”) and Electronic Signatures in Global and National Commerce Act (“e-Sign”) on the other hand, as it relates to the perfection of a warehouse provider’s interest in eNotes.
2. Whether physical mortgage notes are negotiable instruments under UCC Article 3. If eNotes would not be negotiable instruments if they were in physical form, the eRegistry is not effective to give a warehouse provider a first priority interest in eNotes.
3. Whether the eRegistry will properly provide for “control” under UETA and e-Sign. If the eRegistry does not provide “control,” it will be ineffective to give warehouse providers a first priority interest in eNotes.

Finally, this eAlert provides practical recommendations for warehouse providers, warehousing eNotes held through the eRegistry.

Current Perfection Practices—Physical Mortgage Notes

Current Article 9 provides for perfection by possession of physical mortgage notes. Physical mortgage notes are “instruments” under UCC Article 9 (“Article 9”). Warehouse providers typically take possession of the physical mortgage note. If they do so in good

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faith and without knowledge of the violation of another party's interest, possession ensures first priority. Also, warehouse providers can and do perfect their security interests in the physical mortgage notes by filing financing statements. However, a party that perfects solely by filing will be subject to the rights of another party who filed earlier in time, or a party that filed later or did not file but takes possession of the original mortgage note.

The secondary mortgage market has long operated on the assumption that (i) physical mortgage notes constitute "negotiable instruments" under UCC Article 3 ("Article 3"), and (ii) a party in possession of a mortgage note who meets the other requirements will be a "holder in due course" of the note. Under Article 3, a holder in due course is entitled to enforce a negotiable instrument free of most defenses that the maker of the negotiable instrument might have (although the protections of Article 3 have been substantially limited by state and federal consumer protection laws). A holder in due course takes priority over any conflicting security interest in the negotiable instrument, which is essentially the same protection that Article 9 gives a party in possession of a non-negotiable instrument.

However, because a standard Fannie Mae/Freddie Mac mortgage note is clearly an "instrument" under Article 9, and Article 9 gives a party in possession almost all of the protections that Article 3 gives to a holder in due course (after giving effect to consumer protections laws), the question of whether a standard Fannie Mae/Freddie Mac Mortgage is a negotiable instrument has not been tested in court.

Overview of the MERS eNotes eRegistry

MERS has created and operates the eRegistry, which is designed to serve as a comprehensive, national database identifying the location of, and holders of legal interests in, eNotes. eNotes will be located in "eVaults", which are set up by one or more third party service providers, rather than by MERS. The system permits registration of certain legal interests on the eRegistry, regardless of which eVault holds the eNote.

Absent application of UETA and e-Sign, under Article 9 of the UCC, interests in eNotes are "payment intangibles" and not "instruments." If an eNote is a payment intangible, the only way to perfect an interest in an eNote under Article 9 is by filing a financing statement. The party who files the first financing statement covering a particular eNote will have priority over subsequent secured parties.¹

The eRegistry is intended to document rights under UETA and e-Sign. Under Section 16(b) of UETA and Section 15 U.S.C. §7021(b) of e-Sign, a party can obtain "control" over an electronic document. If an eNote would satisfy the requirements of a "negotiable instrument" under Article 3 and the other requirements of a "transferrable record" under UETA and e-Sign, the party holding the interest in the eNote will have the status of a "holder" with first priority under Article 9-331(a).

Issues With eNotes under Article 9

Nothing in eSign or UETA, however, adopts Article 9's requirements for perfection of security interests. As a result, in order to ensure perfection of a security interest in an eNote, which includes an outright assignment of payment intangibles², a warehouse provider must comply with the requirements of Article 9 for payment intangibles. For security interests that are not outright assignments (i.e., the interests of warehouse providers that are not using a "true sale" structure), this requires filing of a financing statement. In addition, priority will be determined under the Article 9 rules (i.e., first to file or perfect) unless the eNote satisfies the requirements to be deemed a "negotiable instrument" under UETA and eSign, and the warehouse provider satisfies the requirements to be a "holder in due course" under Article 3.³

But eNotes may not be negotiable instruments. The legal analysis underlying the eRegistry assumes that eNotes are "negotiable instruments." However, most mortgage notes include more terms than the select few allowed under Article 3's definition of "negotiable instrument." On the other hand, market practice has long treated mortgage notes as negotiable instruments. Since there are no court decisions either way, a party in control of an eNote may or may not have the benefits of UETA and e-Sign. If not, priority will be governed under Article 9's rules for payments intangibles (first to file or perfect).

Issues with Control of eNotes and the MERS eRegistry System

MERS's eRegistry attempts to bring eNotes, held in a contractually related eVault, into the legal regime created by UETA and e-Sign.

The current iteration of the eRegistry works as follows:

- When an eNote is originated, it will be stored by the originator, the warehouse provider or another party in an "eVault" set up by one of the providers of this service.
- The eVault will need to satisfy the "single authoritative copy" requirement of UETA and e-Sign.
- The eVault will be contractually linked to the eRegistry, so that interests in the eNotes held in the eVault will be determined by reference to the eRegistry.
- The interests of the various parties (originator; warehouse provider; third-party servicer, if any; secondary market investor) will be entered in the eRegistry.
- The eRegistry will contain rules designed to mimic the current system for holding physical notes. In particular, the party that would have possession of a physical note under the current system will have "control" over an eNote on the eRegistry.

In order for the eRegistry to accurately identify the controller and location of the authoritative copy, the eRegistry must be contractually tied to each of the eVaults in a way that "works" under UETA and e-Sign. This requires that each eVault meet the requirements of UETA and e-Sign for a "single authoritative copy" of the eNotes held, and that the contracts between the eRegistry and each of the eVaults correctly make registration on the eRegistry is sufficient to create "control" of eNotes in that eVault. This will involve thousands of contracts. With numbers that large, errors are always possible.

In its current iteration, the eRegistry labels the originator and the secondary market

purchaser of an eNote as the “controller,” and labels a warehouse provider as a “secured party.” The term “secured party” was borrowed from the UCC, and the term “controller” was borrowed from e-Sign and UETA. The intent of MERS is that the secured party, not the controller, will have actual “control” of the eNote under e-Sign and UETA. However, the mixing of terms may create confusion. It might be hard to convince a judge that the “secured party”—and not the “controller”—has “control” of the eNote, with the result that the application of e-Sign and UETA to eNotes registered on the eRegistry may be different than MERS anticipates.

Suggested Couse of Action for Warehouse Providers

Given the uncertainty described above, for now, the safest course of action for a warehouse provider warehousing eNotes is to (i) perfect under Article 9 by filing first against the mortgage originator and (ii) obtain control under the eRegistry. If another party’s earlier filing arguably covers the warehouse provider’s collateral, an intercreditor agreement will be required. In addition, warehouse providers who finance eNotes should be diligent to determine whether the eVaults in which those eNotes are held and the eRegistry, together, meet the requirements of e-Sign and UETA. This will require review of the contracts tying the eVaults used by a warehouse provider to the eRegistry to make sure registration as the “secured party” on the eRegistry sufficient to give the warehouse provider “control” of the eNotes. Until the legal ambiguities described in this eAlert are resolved, prudent warehouse providers should take precautions to ensure that—regardless of which way the courts resolve the ambiguities of e-Sign and UETA—the warehouse provider will be found to have a perfected, first-priority interest in its eNotes.

¹ Warehouse providers typically file financing statements covering all mortgage loans “funded by Provider, identified for funding on any request for funding, or otherwise identified for sale or pledge to Provider, or for which the related note has been delivered to or has otherwise come into the possession, custody or control of Provider or a third party acting on Buyer’s behalf.” In the absence of fraud, this language should not cover a mortgage loan funded by another warehouse provider. But history demonstrates that it is not safe to presume there will not be fraud.

² UCC Section 9-309(2).

³ UCC Section 9-331(a) incorporates the protections of a holder in due course under Article 3.