

Security Interests in Transferable Records

Evidencing Residential Mortgage Lending Transactions and the Rights of Warehouse Lenders



ANALYSIS AND PROPOSAL

**MBA Residential Technology
Steering Committee (ResTech)**

eMortgage Adoption Task Force

**SECURITY INTERESTS IN TRANSFERABLE RECORDS EVIDENCING
RESIDENTIAL MORTGAGE LENDING TRANSACTIONS AND THE RIGHTS
OF WAREHOUSE LENDERS: AN ANALYSIS AND PROPOSAL**

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INTRODUCTION

The residential mortgage lending industry is planning to use electronic records, rather than paper documents, for many future mortgage transactions. The drive to reduce the number of paper loan closings is a natural outgrowth of advances in computer and communications technology, as well as the industry's continuing quest to improve both efficiency and customer service. The industry expects that replacing paper with electronic records will result in benefits for lenders and consumers alike through improved convenience, quality control, and transaction speed.

The groundwork for transitioning the industry to electronic loan files was laid at the turn of the 21st Century with the widespread state adoption of the Uniform Electronic Transaction Act¹ ("UETA") and passage of the federal Electronic Signatures in Global and National Commerce Act² ("ESIGN"). These laws generally authorize the use of electronic records and signatures in many types of transactions where state and federal law would previously have required paper documents – including residential mortgage transactions.

However, there is more to the migration from paper loan files to electronic records than just a technological adjustment or passage of a general legal authorization to use electronic records. The residential mortgage lending industry operates under a wide range of agreements, practices, and ancillary legal rules that assume mortgage loan documents would be "in writing." In particular, the industry utilizes a series of uniform promissory note forms to evidence borrowers' debt obligations – these uniform notes are expressly drafted as "negotiable instruments", so that they may be quickly and easily transferred from lenders to investors. A variety of ancillary practices have grown up around the use of these negotiable instruments to both establish, and clear, claims by various intermediaries to an interest in the instruments as they pass from the originating lender to investors and document custodians.

A particular area of concern relates to the business of "warehouse lenders." Many loan originators borrow some or all the money they use to fund residential mortgage loans, intending to sell the loans quickly to investors in the secondary market. The funds for the loans are provided by warehouse lenders, who generally take the executed mortgage note as the primary collateral for the funds advanced. The warehouse lender expects to be repaid, with respect to each individual note, as the note is sold by the originating lender to an investor. Because the paper notes are usually negotiable instruments, warehouse lenders have protected themselves against unauthorized sales by taking possession of the original notes and delivering them to investors, pending payment, subject to special protections provided by existing secured transactions laws. These special protections will not apply to electronic promissory notes. If warehouse lenders are to be protected when taking electronic promissory notes as collateral, a new set of strategies must be developed and deployed to address their needs.

This paper will explore:

- The special rules associated with negotiable promissory notes;
- The creation of "transferable records" as an electronic equivalent to negotiable promissory notes under UETA and ESIGN;
- The interplay between the UETA, ESIGN, and Revised Article 9 of the Uniform Commercial Code ("UCC") with respect to transferable records; and
- A proposed solution to protect the interests of warehouse lenders when bridging the sale of transferable records from the originating lender to an investor.

¹ Uniform Electronic Transactions Act Official Text as Approved by the National Conference of Commissioners on Uniform State Laws (July 29, 1999).

² 15 U.S.C. § 7001 *et seq.*

SUMMARY OF PROPOSAL

Traditionally, warehouse lenders have protected their interest in negotiable promissory notes by transferring the original notes to investors under cover of a “bailee letter”, which acted to preserve certain of the warehouse lender’s rights in the promissory note against third party claims. The statutes sanctioning use of the bailee letter do not contemplate, or apply to, electronic negotiable instruments. However, it is possible for a warehouse lender to achieve the same level of protection with respect to electronic promissory notes by agreement or system rule.

MERS[®] has proposed a solution to the problem of protecting warehouse lenders which may be implemented either by agreement among the parties, or perhaps more efficiently, by a system rule agreed to by all the participants in the MERS[®] eRegistry system. Under this proposal, in the event a purchaser is offered, and accepts, control of a transferable record on the MERS[®] eRegistry system from a warehouse lender without first giving value for the record, then until such time as value is given, the transferee will hold the transferable record as designated custodian for the warehouse lender unless otherwise agreed. Until such time as the appropriate value has been given, the transferee will not qualify for the rights of a holder in due course or a purchaser for value. Upon paying value the transferee will no longer control the transferable record as designated custodian of the warehouse lender, but shall hold control as the purchaser for value of the transferable record – entitling the transferee to the rights of a holder in due course to the extent it otherwise qualifies for such rights.

ANATOMY OF A NEGOTIABLE PROMISSORY NOTE

What is a Negotiable Promissory Note?

A promissory note is a document containing an unconditional promise to pay money to another person on demand or at a specified time. There may well be additional terms in the note, including intermediate or recurring installment payments, interest rates and charges, notice provisions, waivers of defenses, and a declaration of controlling law, among others. A promissory note serves four principal purposes:

- It identifies the person or persons primarily responsible for paying the debt (sometimes called the “maker” or “obligor”);
- it identifies the person or persons to whom the debt is owed (sometimes called the “holder”);
- it establishes the maximum amount of the debt;³ and
- it describes the terms of repayment and interest charges.

By executing and delivering the note, the borrower agrees to repay the note according to its terms.⁴ Failure to repay the note as promised entitles the holder of the note to sue to recover. If a payment is made on the note, an amount of the debt equal to the payment is discharged.⁵

A primary characteristic of a promissory note is its status as “negotiable” or “non-negotiable.” In order to be treated as negotiable under current law, a promissory note must satisfy a specific set of objective criteria. It must be: (i) in writing, (ii) signed, (iii) an unconditional promise to pay a specified sum of money, (iv) payable on demand or at a definite time, and (v) payable to the order of a named payee or to the person in possession of the instrument.⁶

³ For a term loan, this will usually be the amount advanced at the time the loan is first made. For a revolving loan, on the other hand, where advances and payments are made repeatedly, the maximum amount of credit available to the borrower may never actually be loaned at all.

⁴ UCC Article § 3-412.

⁵ UCC Article § 3-310(b)(2).

⁶ UCC Article 3 § 3-104(a).

The note may also provide for the payment of interest on the outstanding balance.⁷ However, a negotiable note may not contain any promise by the borrower to do anything else, except it may include:

- An undertaking to give, maintain, or protect collateral to secure payment;
- an authorization to the holder of the note to confess judgment or realize on or dispose of collateral; and
- a waiver of the benefit of any law intended for the advantage or protection of a person liable on the note.⁸

Various other related matters may be covered in the note without impairing negotiability. The note may provide for interim or installment payments.⁹ It may provide for acceleration on default, the debtor's right to prepay the debt, and the holder's option to extend the time for repayment.¹⁰ Negotiable promissory notes are transferred by physical delivery of the original instrument with an "indorsement" (the signature of the named payee, sometimes accompanied by a written statement indicating that payment should be made to the transferee either on the document itself or attached to it).¹¹

What are the special rights associated with transfer of a negotiable promissory note?

A negotiable promissory note "reifies" the obligations it represents; that is, physical delivery of the note itself to the transferee, coupled with the transferor's signed declaration of an intent to transfer (either written on the document or attached to it), constitute almost absolute proof of the transferee's right to enforce the underlying obligation. This is because the physical transfer of the note provides the transferee, and others to whom the paper note is displayed, a high degree of confidence that the obligation is genuine and that the holder of the note is entitled to performance. The significance of negotiability is twofold; first, it creates an efficient mechanism for transferring performance rights to other transaction participants, and second, under the proper circumstances the transferee possessing such a paper document is granted certain special property rights under the law. These rights permit the transferee to:

- Enforce the note in spite of certain defenses the obligor may have against a prior transferor, and
- Avoid claims by third parties to own an interest in the note or a right to enforce the underlying obligation.

In summary, the hallmark of negotiability in the paper world is the transfer of the right to payment (*evidenced* by the note) by delivery of the paper note *itself*, along with any necessary indorsement. If the transferee gives good value for the transferred promissory note and is not aware of the claims of third parties or defenses to the borrower's obligation to pay, then the transferee becomes a "holder in due course." A holder in due course has two essential rights: (i) the right to receive payment free of most defenses the obligor may have which are based upon the actions of prior holders of the instrument, and (ii) the right to avoid most claims by other people to own the instrument, or to have an enforceable security interest in the instrument entitling them to receive payment.¹²

⁷ UCC Article 3 § 3-112.

⁸ UCC Article 3 § 3-104(a).

⁹ UCC Article 3 § 3-108(b).

¹⁰ UCC Article 3 § 3-108(b).

¹¹ UCC Article 3 §§ 3-202, 3-204. The spelling of "indorsement" is not accidental – as used in a negotiable instruments context, the word is spelled with an "i", not an "e." See UCC Article 3, *passim*.

¹² UCC Article 3 §§ 3-302, 3-305, 3-306; UCC Revised Article 9 §§ 9-330, 9-331,

The special rights granted to the transferee of a negotiable promissory note have significant commercial value. They simplify transactions and lower costs. They also provide the owner with liquidity, since the obligations may be easily and quickly converted into cash by sale to a transferee, who can purchase the negotiable note confident of its enforceability against the obligor.

How do you perfect a security interest in a negotiable promissory note?

Under Revised Article 9, a security interest in a negotiable promissory note may be perfected by filing.¹³ However, the rights of a holder in due course will take priority over an earlier security interest perfected by filing.¹⁴ In addition, a secured party or other purchaser who takes possession of the negotiable promissory note will generally take priority over a secured party whose interest is perfected only by filing.¹⁵

This structure creates a challenge for any warehouse lender who elects to take a security interest in a negotiable promissory note, but perfects only by filing.¹⁶ If the originating lender (the warehouse lender's debtor) negotiates the promissory note to a third party who pays value without actual notice of the warehouse lender's claim, then the purchaser becomes a holder in due course, and trumps any claim by the warehouse lender.¹⁷ If the originating lender grants a security interest to a second creditor, and that creditor takes possession of the negotiable promissory note in return for value and without actual notice of the filed creditor's claim, then the second creditor has priority over the warehouse lender.

For all these reasons, virtually all warehouse lenders elect to take possession of negotiable notes that serve as collateral. But this practice, in turn, creates a new challenge when it comes time for the note to be sold by the originating lender to an investor. In general, investors will not purchase a negotiable note without (1) first having the opportunity to inspect it and (2) having it in their possession, properly indorsed, before paying value. But if the warehouse lender relinquishes possession, then its super-priority claim to a perfected security interest is lost. For this reason, Revised Article 9 has a special rule that permits the warehouse lender to relinquish possession to the potential investor if the note is delivered accompanied by a letter instructing the investor to either (a) hold possession for the warehouse lender's benefit or (b) redeliver the note to the warehouse lender if the sale is not completed.¹⁸ These written instructions are commonly called a "bailee letter" in the residential mortgage lending industry.

¹³ UCC Revised Article 9 § 9-312(a).

¹⁴ UCC Revised Article 9 § 9-331(a).

¹⁵ UCC Revised Article 9 § 9-330(d), UCC Article 1 § 1-201(32) and (33). There is a subtle distinction in Revised Article 9 between the status of "purchaser for value" and status as a "holder in due course" of an instrument. In both cases the transferee must give value, but HDC status also requires that the transferee have no knowledge of any claim or defense to the instrument. On the other hand, a purchaser for value has priority over a prior security interest in the instrument that was perfected by a method other than possession even if the purchaser is aware of claims or defenses, so long as the purchaser does not have actual knowledge that the transfer violates the rights of the prior secured party. Merely being aware of the existence of the perfected security interest does not constitute knowledge that the transfer violates the secured party's interest, and does not require the purchaser to inquire. See Official Comment 7 to UCC Revised §9-330.

¹⁶ While this is theoretically possible, as a matter of general commercial practice warehouse lenders do not rely on filing without taking possession.

¹⁷ Note that merely being aware of the existence of the perfected security interest of the party who filed a financing statement does not constitute knowledge that the transfer violates the secured party's interest, and does not require the party taking possession for value to inquire. See Official Comment 7 to UCC Revised §9-330.

¹⁸ UCC Revised Article 9 § 9-313(h); Official Comment 9 to UCC Revised Article 9 § 313.

The warehouse lender who delivers a paper negotiable promissory note subject to a bailee letter retains constructive possession.¹⁹ This means that the warehouse lender preserves priority as against other claimants to an interest in the note, and as against any trustee in bankruptcy representing the estate of another claimant. The warehouse lender also has a claim for conversion against a bailee who further transfers the note to another person without first giving value for the transfer. However, the bailee, although not a holder in due course, is still a “holder” of the note under applicable law.²⁰ This means the bailee may transfer the note to a new holder, who becomes a holder in due course upon giving value without notice of claims or defenses.

TRANSFERABLE RECORDS UNDER THE UETA AND THE FEDERAL ESIGN ACT

What is the purpose of the UETA and ESIGN?

As written, the Uniform Electronic Transaction Act (“UETA”) applies to the use of electronic records and signatures in connection with a “transaction,” which is defined as “any action or set of actions occurring between two or more persons relating to the conduct of business, commercial, or governmental affairs.” The term “commercial” is meant in its broadest sense, encompassing virtually any transaction, which is related to or connected with trade and traffic or commerce in general. As such, both business to business and consumer transactions are covered. The Electronic Signatures in Global and National Commerce Act (“ESIGN”) has an equivalent definition covering business, commercial and consumer affairs. These new eCommerce laws were drafted with a specific set of goals and policy choices in mind.

First and foremost, these new laws were intended to level the legal “playing field” between paper-based documents and other information storage and communication technologies. They recognize the many legal purposes writings serve, including:

- Memorializing agreements
- Communicating information
- Preserving information for later reference
- Providing notice
- Undertaking obligations
- Transferring rights
- Confirming information

The UETA and ESIGN create a system of ground rules that preserve and further these purposes in an electronic environment, providing legal authorization for parties wishing to use electronic records in place of writings, and electronic signatures in place of traditional signatures.

Second, the UETA and ESIGN are intended to be technology neutral. They do not enshrine a particular methodology for satisfying any of their rules. Electronic records may take a wide variety of forms, and be retained on any commercially viable storage media. Electronic signatures may be anything from a simple typed symbol to a complex, highly secure system of encryption. Rules for record access do not presume a particular access method or file format.

Third, the UETA and ESIGN are both minimalist, procedural statutes. They offer a simple set of rules in an accessible structure. They do not attempt to provide a complete regulatory scheme, with detailed rules covering as many anticipated permutations and special situations as possible. Instead, they recognize the inherent flexibility and adaptability of the common law, as well as the wide variety of substantive statutes that already exist and are just as applicable to electronic records as they are to written documents.

¹⁹ UCC Revised Article 9 §9-313(h).

²⁰ It is industry practice to indorse residential mortgage notes “in blank”, so that any person in possession becomes a holder. UCC Article 1 §1-201(20).

In other words, these new eCommerce laws generally take a passive approach to amending existing law; they validate the use of electronic records and signatures, but do not create new property rights or substantive rules for enforcing those rights. For example, the rights and obligations of a purchaser of goods under Article 2 of the UCC remain the same whether the sales contract is in writing or is an electronic record. The eCommerce laws permit an electronic record to serve as the sales Agreement, but do not invent a new type of sales contract or any new substantive rights in the seller or purchaser. However, in order to create legal parity for electronic transactions involving negotiable promissory notes, a more proactive approach was required – one that created a new set of property rights associated with an electronic record with special characteristics.

How do UETA and ESIGN create an electronic equivalent to a negotiable promissory note?

Accommodating the law of negotiability is one of the most significant challenges faced by any scheme to replace writings with electronic records. By definition, a unique electronic record cannot be physically transferred via telecommunication; any transmission of the record results in a new record at the receiving end, not the physical transfer of the original, with no certainty that the original has been destroyed. Transferring physical possession of the media storing an electronic record offers no help; first, resorting to physical transfer of the storage media undermines the principle reasons for using electronic records in the first place, and second, since an electronic record can be copied repeatedly without any ability to distinguish the original from the copies, physically turning over a copy of the record provides no guarantee that an indistinguishable copy has not been retained by the transferor. For these reasons, the assumptions underlying existing rules for negotiability do not work well in an electronic environment. Mere possession of a copy of an electronic promissory note, with an electronic statement of transfer, does not provide the same level of confidence associated with a paper note.

The UETA provides for treating an electronic record as the equivalent of a negotiable promissory note in certain respects if:

- The electronic record contains only the same terms and conditions that are permitted in a paper negotiable note;
- The electronic record is signed;
- The issuer of the record has agreed that it should be treated as a transferable record under the UETA; and
- The method used to record, register, or evidence a transfer of interests in the transferable record reliably establishes the identity of the person entitled to “control” (meaning control the transfer of) the transferable record.²¹

If these conditions are met, the record is called a “transferable record” under the UETA and a person identified as in control of the transferable record becomes the equivalent of a “holder” under Article 3. In essence, this structure provides a statutory alternative to the three physical attributes of a negotiation: delivery, indorsement and possession.

The UETA provides “safe harbor” standards for establishing the integrity of the record and the identity of the person in control of the record. The standards are quite strict. To qualify for control, the record or records comprising the transferable record must be created, stored, and assigned in such a manner that:

- a single authoritative copy of the record or records exists which is unique, identifiable, and (except for permitted revisions under the UETA) unalterable;²²

²¹ UETA § 16.

²² The term “unalterable” should not be taken too literally. Practically speaking, no record is unalterable. Ordinary writings may be altered, and so may almost any type of electronic record. All records are also subject over time to decay and deterioration. The requirement that a transferable record be unalterable is modified by UETA § 16(c)(6), which permits revisions which are readily identified as authorized or unauthorized. In other words, the UETA does not require that a transferable record be unalterable in a metaphysical sense, but only that it be unalterable without detection.

- the authoritative copy identifies the person asserting control as either the person to which the transferable record was issued or the person to which the transferable record was most recently transferred;
- the authoritative copy is communicated to and maintained by the person asserting control or its designated custodian;
- copies or revisions that add or change an identified assignee of the authoritative copy can be made only with the consent of the person asserting control;
- each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and
- any revision of the authoritative copy is readily identifiable as an authorized or unauthorized revision.²³

How is control managed under the MERS® eRegistry Model?

Note that the safe harbor rules focus on outcomes. The UETA and ESIGN do not endorse any particular technology solution or approach to achieve those outcomes. Rather, any solution that satisfies the requirements of the safe harbor is acceptable. As a result, a number of different structures and strategies have been developed for managing transferable records. These include:

- Unitary systems, where the authoritative copy of the note, and the records concerning control and transfer, are all managed within a single computer network, which is accessed by all the various parties to the transaction;
- Multiple interactive systems, where each transferor/transferee manages its own computer network for protecting the authoritative copy of the transferable record and identifying the person in control, and a transfer of control is accomplished by moving the authoritative copy from one party's system to another; and
- A registry system, where the transfers of control and location of the authoritative copy are noted and tracked on a central registry.

The use of a registry system for identifying the party in control of a transferable record was expressly contemplated by the drafters of the UETA.²⁴ The primary preconditions for an effective registry are:

- All parties interested in creating and transferring control in the electronic record would agree to use the centralized registry to track control.
- Each electronic promissory note must:
 - Contain language placing anyone viewing it on notice that its true controller must be determined by reference to the central registry, and
 - State that all copies that are not at the location referenced in the registry are non-authoritative.
- The registry must (a) identify the controller, and (b) reference the location of the transferable record's current authoritative copy.^{25, 26}
- A transfer of control is accomplished by receipt of a secure authorization to transfer from the transferor, and a secure authorization of transfer from the transferee.²⁷

²³ UETA § 16(c).

²⁴ See Reporter's Comment 3 to UETA §16.

²⁵ These elements are drawn from a presentation given by John A. Richards, Associate General Counsel of Fannie Mae, at the American Bar Association's 2002 Annual Meeting, and are reproduced with the permission of the author.

²⁶ Note that the "location spotting" function of the registry could be accomplished in one of two ways – either by specifying the location in the registry, or by providing information on the identity of the custodian holding the authoritative copy and directing the inquiring party to the custodian for further information on the authoritative copy's precise location.

²⁷ It is also possible, as part of this process, to test the transferable record against an encrypted hash of the original record created by the MERS® eRegistry at the time of registration. This permits the

- The party maintaining custody of the authoritative copy is either the current owner of the transferable record or the current owner's designated custodian.

Because the transferable record itself points to the registry, a party looking at any copy of the transferable record would be on inquiry notice as to the identity of the control party.

The transferable record must also be held in such a manner that the controller or the controller's custodian is able to distinguish the authoritative copy from other copies.

The investor community for the mortgage industry has adopted and is using the registry model as the most efficient solution for the industry – it has become the de facto standard. Lenders and investors are already registering and transferring control in transferable records in the MERS® eRegistry -- which acts as an industry utility -- at the time of origination, in order to comply with the safe harbor and establish control.²⁸ In the MERS® eRegistry model, control of the electronic record, and the location of its authoritative copy, are determined solely by reference to the registry.

The unique characteristic of the authoritative copy of the transferable record is established within the controlled system storing the record. The authoritative copy is held by the controlling party or its authorized custodian, and is logically associated with a registry entry of the identity of the control party and the location of the authoritative copy. The registry is referenced in the electronic record itself. Control may only be transferred with the consent of the current controlling party, and the authoritative copy may not be altered, once executed, without detection.

Note that the inclusion in the transferable record of an agreement recognizing that the MERS® eRegistry designates the party in control should not violate the requirement that the transferable record contain only those terms and conditions permissible for a negotiable promissory note under Article 3 of the Uniform Commercial Code.²⁹ UCC §3-104(a)(3) provides that a negotiable instrument may not contain an undertaking or instruction by the payee *to do any act* in addition to the payment of money. The agreement concerning registration of control does not require the payee to take any action, and furthers the purposes of UETA §16 and ESIGN §201. The inclusion in the transferable record of supplemental agreements furthering the purpose of the statute was expressly contemplated by the UETA's drafters.³⁰

What are the special rights and obligations established by the UETA and ESIGN for transferable records?

The UETA establishes a number of rights and obligations with respect to the transferable record:

- The holder of the transferable record has the same rights as a holder in due course if the statutory requirements under UCC Article 3 (other than delivery, possession and indorsement) are met.
- The holder can also enjoy the rights of a good faith purchaser for value under U.C.C. Article 9.
- The obligor receives a warranty from the person receiving payment under the transferable record, and all prior transferors of the record, that the warrantor is, or was at the time of transfer, entitled to receive payment.
- The obligor is entitled to the same rights and defenses as an obligor on a written

potential transferee to be confident that the record has not been altered since it was first registered.

²⁸ MERS® has obtained an opinion of counsel from Covington and Burling which opines that the MERS® eRegistry meets the requirements of the safe harbor and may be used to establish control under Section 16 of the UETA and Section 201 of ESIGN.

²⁹ UETA §16(a)(1); ESIGN §201(a)(1)(A).

³⁰ See Reporter's Comment 2 to UETA §16 (Transferable record itself may include agreement to treat record as transferable record).

- promissory note, except as modified by the UETA.
- The obligor is entitled to reasonable proof that the person requesting payment is the person in control or is otherwise entitled to payment, including access to the authoritative copy of the transferable record sufficient to review its terms and identify the person in control.³¹

The federal ESIGN Act, drawing directly and explicitly from the UETA, adopts the same set of rules for a transferable record that is secured by an interest in real property. The approach taken by the new eCommerce laws is noteworthy in that it does not attempt to insert the concept of transferable record *into* Article 3 or Article 9 of the U.C.C. Instead, the UETA pulls *out* of Articles 3 and 9 those concepts that are still valuable in an electronic environment, while leaving the balance of the rules applicable to a transferable record to agreement, system rule, or other law. Unlike the other sections of the UETA and ESIGN, which are procedural rules for transactions, Section 16 of the UETA and Section 201 of ESIGN create a new type of property and a new set of property rights that are enforceable against any other claims to an interest in the transferable record or the underlying debt obligation. The Reporter's Comments to the UETA explicitly address this issue:

*[Section 16 of the UETA] is a stand-alone provision. Although references are made to specific provisions in Article 3, Article 7, and Article 9 of the Uniform Commercial Code, these provisions are incorporated into this Act and made the applicable rules for purposes of this Act. The rights of parties to transferable records are established under subsections (d) and (e) [of Section 16]. Subsection (d) provides rules for determining the rights of a party in control of a transferable record. The subsection makes clear that the rights are determined under this section, and not under other law, by incorporating the rules on the manner of acquisition into this statute. The last sentence of subsection (d) is intended to assure that requirements related to notions of possession, which are inherently inconsistent with the idea of an electronic record, are not incorporated into this statute.*³²

How do UCC Revised Article 9, the UETA and ESIGN interact?

Questions have been raised concerning the treatment under Revised Article 9 of a UETA/ESIGN transferable record evidencing a purchase money obligation and secured by the purchased real property.

A person who has obtained control of a transferable record under Section 16(b) of the UETA, or Section 201(b) of ESIGN, *in good faith and for value* has all of the same rights under Revised Article 9 as a good faith purchaser of a negotiable promissory note.³³ This includes the right to take ownership of the transferable record free and clear of a properly perfected security interest held by a person without control.³⁴

Some confusion has arisen on this point because both the UETA and ESIGN provide that transactions are excluded from coverage to the extent the transaction is covered by UCC Revised Article 9.³⁵ It has been suggested that this means that a person claiming a perfected security interest in the transferable record under Article 9 is not subject to the claims of a party in control under the UETA or ESIGN. However, as already noted above, Section 16 of the UETA and Section 201 of ESIGN are not merely

³¹ UETA § 16.

³² Reporter's Comment 6 to Section 16 of the UETA (emphasis added).

³³ UETA §16(d); ESIGN §201(d).

³⁴ UCC Revised §§9-330(d) and 9-331(a). This is true unless the control party had actual knowledge, at the time of transfer, that the transfer violated the other secured party's rights. As noted in Footnote 15, *supra*, merely being aware of the existence of the perfected security interest does not constitute knowledge that the transfer violates the secured party's interest, and does not require the control party to inquire. See Official Comment 7 to UCC Revised §9-330.

³⁵ UETA §3(b)(2); ESIGN §103(a)(3).

procedural rules governing a transaction – they establish a new set of property rights that are enforceable against all other claims to the same property, including those that may arise under a separate Article 9 transaction. In other words, the UETA and ESIGN do not prevent or affect the Article 9 transaction, but do create a separate set of property rights that are superior to any rights created by that transaction. The Reporter’s Comments to the UETA discuss this juxtaposition of rights and claims in detail:

If a person establishes control [of a transferable record, Section 16(d) provides that that person is the “holder” of the transferable record which is equivalent to a holder of an analogous paper negotiable instrument. More importantly, if the person acquired control in a manner which would make it a holder in due course of an equivalent paper record, the person acquires the rights of a HDC. *The person in control would therefore be able to enforce the transferable record against the obligor regardless of intervening claims and defenses...*

Further, it is important to understand that a transferable record under Section 16, while having no counterpart under Article 3 of the Uniform Commercial Code, would be an “account,” “general intangible,” or “payment intangible” under Article 9 of the Uniform Commercial Code [depending on the circumstances]. Accordingly, two *separate* bodies of law would apply to that asset of the obligee. A taker of the transferable record under Section 16 may acquire purchaser rights under Article 9 of the Uniform Commercial Code; however, those rights may be defeated by a trustee in bankruptcy of a prior person in control unless perfection under Article 9 of the Uniform Commercial Code by filing is achieved. *If the person in control also takes control in a manner granting it holder in due course status, of course that person would take free of any claim by a bankruptcy trustee or lien creditor.*³⁶

Therefore, a party with holder in due course status or purchaser for value status under UETA or ESIGN has priority over a secured party without control but with a filed financing statement covering the transferable record.

However, subject to the rights of a control party under UETA or ESIGN, it is still possible to obtain a perfected security interest in transferable records by filing and without control. As with all perfection and priority issues under Revised Article 9, a proper analysis begins with correct classification of the collateral. Transferable records are personal property, not real property, and therefore are within the general scope of Revised Article 9.³⁷ A transferable record secured by real property is not “chattel paper,” because the collateral securing the payment obligation is not specific goods or software.³⁸ It also is not an “account,” because accounts do not include a debt owed to repay funds advanced, or “investment property,” because it does not qualify as either a “security” or “security entitlement.”³⁹ It also is not an “instrument.” Rather, under Revised Article 9 a transferable record secured by real property is a “payment intangible”⁴⁰ Therefore, a security interest in the transferable record may be perfected by filing a financing statement.⁴¹

³⁶ Reporter’s Comment 6 to UETA §16 (emphasis added).

³⁷ UCC Revised Article 9 §9-109(a).

³⁸ UCC Revised Article 9 §9-102(11).

³⁹ UCC Revised Article 9 §§9-102(a)(2) and 9-102(a)(49); UCC §§8-102(15) and 8-102(17).

⁴⁰ UCC Revised Article 9 §§9-102(42), 9-102(47) and 9-102(61); UCC §3-104. A “payment intangible” is a general intangible that primarily evidences an obligation to repay money. A “general intangible” is any personal property that does not fall into one of the other collateral classifications in Revised Article 9. An “instrument” is a negotiable instrument or other writing customarily transferred by delivery of possession with any necessary indorsement. Therefore, a transferable record is not an “instrument” for purposes of perfection and priority, because it is not in writing.

⁴¹ UCC Revised Article 9 §§9-310(a) and 9-312(a).

So, in general a secured party who has perfected by filing will have priority over any secured party who (i) does not have a filed financing statement covering the transferable record or (ii) whose filing is later in time.⁴² The secured party should also take priority over any transferee who does not take control of the transferable record.⁴³

How may a warehouse lender protect its rights in a transferable record?

Therefore, a warehouse lender who is filed first-in-time with respect to the transferable record, but does not have control, runs the risk that control may be transferred by the originating lender to another party who takes control in good faith for value, trumping the warehouse lender's filing. For this reason, a warehouse lender is likely to take control of a transferable record in order to establish its rights and prevent an unauthorized transfer to a third party. However, this arrangement still leaves the warehouse lender in a quandary – presumably, an investor seeking to purchase the transferable record will want to (i) inspect the record and test it against the MERS[®] eRegistry hash before purchase, and (ii) take control before transmitting payment. If the warehouse lender surrenders control, it is the functional equivalent of surrendering possession of a paper negotiable promissory note, and exposes the warehouse lender to all the same risks.

Unfortunately, it does not appear possible for a warehouse lender in this situation to protect itself by using a bailee letter. By its terms, UCC Revised Article 9 authorizes possession as a method of perfection only with respect to certain types of tangible property, including instruments (which would include, by definition, negotiable promissory notes and certain other types of written obligations).⁴⁴ So, use of a letter or instruction preserving the warehouse lender's claim to "possession" of a transferable record would accomplish nothing under Revised Article 9, since a security interest in a transferable record can't be perfected by possession in the first place.

In response to the potential conflict between the interests of a warehouse lender in control and the needs of an investor seeking to purchase, MERS[®] has proposed a solution which may be implemented either by agreement among the parties, or perhaps more efficiently, by a system rule agreed to by all the participants in the MERS[®] eRegistry system. A copy of the proposed MERS System Rule is attached as Appendix A. Under this proposal, in the event a party is offered, and accepts, control of a transferable record on the MERS[®] eRegistry system from a warehouse lender without first giving value for the record, then until such time as value is given, the transferee will hold the transferable record as designated custodian for the transferor as provided for under the UETA and ESIGN, unless the transferor and transferee agree otherwise.⁴⁵ Until such time as value has been given, the transferee will not qualify for the rights of a holder in due course or a purchaser for value. Upon paying value the transferee will no longer control the transferable record as designated custodian of the transferee, but shall hold control as the purchaser for value of the transferable record, and shall be entitled to the rights conferred under the UETA and ESIGN to the extent it otherwise qualifies for such rights.⁴⁶

⁴² UCC Revised Article 9 §9-322.

⁴³ UCC Revised Article 9 §9-201(a).

⁴⁴ UCC Revised Article 9 §9-313(a). As noted above, one may also perfect in a promissory note by filing, but that type of perfection is not preserved by delivery of a note indorsed in blank along with a bailee letter.

⁴⁵ UETA §16(c)(3); ESIGN §201(c)(3). Note that the proposed rule is a default rule – a transferor and transferee could avoid its application by agreeing otherwise, either with respect to the specific transaction or as part of a master agreement.

⁴⁶ Note that while the transferee that has not given value is not a holder in due course or purchaser for value, it still has the rights of a "holder", as defined in Article 1 of the UCC, which means that the transferee can transfer control to a third party, who can establish status as a holder in due course or purchaser for value. That third party will take free and clear of the warehouse lender's interest, but the original transferee will be liable to the warehouse lender for conversion of the warehouse lender's property.

The proposed rule would not attempt to determine when or how “value” is paid or who it should be paid to. As with existing law, determining when value has been paid would be determined in accordance with (i) the transferee’s external agreements with the transferor and any other party having an interest in the transaction, (ii) applicable law, and (iii) the specific circumstances.⁴⁷ The MERS rule would specifically note that disputes over the appropriate amount or recipient of value are to be resolved outside of the MERS dispute resolution process.⁴⁸

Under the proposed solution payment instructions will be established between the parties, and will usually occur through a separate agreement, frequently in the form of investor seller guides. The historical tendency to include payment information in the bailee letter was presumably for convenience -- Under Revised Article 9 the mere delivery of the payment instructions in the bailee letter, in and of itself, created no duty on the part of the bailee to abide by the included instructions.⁴⁹ In the future, it is conceivable that electronic notes may be delivered with accompanying electronic payment instructions, or that MERS® will provide delivery of payment instructions as an additional service in connection with a transfer of control on the MERS® eRegistry.⁵⁰

Functionally, this structure leaves the warehouse lender who transfers control to an investor pending payment in at least as good a position as the warehouse lender who delivers a paper note under a bailee letter. By retaining control through use of a designated custodian, the warehouse lender preserves priority as against other claimants to an interest in the note, and as against any trustee in bankruptcy representing the estate of another claimant. The warehouse lender also has a claim for conversion against the custodian who further transfers the note to another person without first giving value for the transfer. As in the paper world, the transferee/custodian, although not a holder in due course, is still a “holder” of the note under applicable law.⁵¹ This means the custodian may transfer the note to a new holder, who becomes a holder in due course upon giving value without notice of claims or defenses.

⁴⁷ For an example of how agreement, law and circumstances may interact in determining when and to whom value should be delivered, see *Pioneer Commercial Funding Corp. v. American Financial Mortgage Corp*, 579 Pa. 275, 855 A.2d 818 (Pa. 2004).

⁴⁸ Because the rule is a default rule, it is subordinate to any negotiated agreement between the parties concerning transfer and value. Parties with significant relationships and frequent transfers may wish to enter into specific master transfer agreements, somewhat analogous to today’s master bailee agreements, to address issues related to transfer, calculating value, and appropriate delivery instructions.

⁴⁹ UCC Revised Article 9 §9-313(i).

⁵⁰ Nothing in the proposed rule would prevent a transferee from agreeing to pay value in advance of the transfer of control. Several pending software products would facilitate either prior or simultaneous delivery of value in return for control transfer. In such a case, under the proposed rule the transferee would simply take immediately as purchaser, rather than as custodian.

⁵¹ UETA Section 16(d).

APPENDIX A

PROPOSED MERS® EREGISTRY SYSTEM RULE

Except as otherwise agreed by the Transferor and Transferee, in the event a Transferee accepts Control of an eNote without first giving value for the transfer, then until such time as value is given with respect to the eNote, the Transferee shall hold the eNote as designated custodian for the Transferor as provided for under 15 USC 7021(c)(3) and Section 16(c)(3) of the UETA, as applicable. Upon giving value, the Transferee shall no longer Control the eNote as designated custodian for the Transferor, but shall hold Control as the purchaser of the eNote, and shall be entitled to the rights conferred under Section 15 USC 7021(d) and Section 16(d) of the UETA, as applicable, to the extent it otherwise qualifies for such rights. Whether or not value has been given shall be determined in accordance with the agreements between the relevant parties and applicable law. Disputes concerning the whether value has been given, including without limitation disputes concerning the amount of value to be given, the proper method of delivery, or the person to whom value should be delivered, are not eligible for resolution under the MERS dispute resolution process. As used in this rule, UETA means the Official Text of the Uniform Electronic Transactions Act as promulgated by the National Conference of Commissioners on Uniform State Laws, July 30, 1999.