Daily Development for Tuesday, November 13, 2012
FORECLOSING PARTY MUST BE HOLDER OF NOTE, NOT OWNER

BAC Home Loans Servicing v. Kolenich, 2012 WL 5306059 (Ohio Court of Appeals 2012)

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(with thanks to Jim Durham of the University of Dayton for calling this case to my attention)

Synopsis: Mortgage can be foreclosed by holder of a negotiable note, even if the note is owned by a different party.

Everyone is familiar with the long-standing maxim that "the mortgage follows the note." In essence, this means that mortgage assignments are unnecessary for purposes of having the right to foreclose (though they are very useful for other purposes, such as ensuring to the mortgagee the right to notice of subsequent proceedings affecting the property, and protecting against a fraudulent release by the assignor).

(There are about ten states in which a mortgage or deed of trust assignment is required to foreclose by power of sale, but this is a statutory requirement, and except in Maine doesn't apply to judicial foreclosures.)

But there's an interesting and traditionally unresolved question about the mortgage following the note. It arises because, in the case of a negotiable note, there are two distinct rights to the note that can be transferred: ownership and "PETE status" (PETE being the abbreviation for "person entitled to enforce). Transfers of ownership are governed (for all notes, negotiable or not) by UCC Article 9. Ownership means the right to economic benefits of the note – to the proceeds of a payoff, monthly payments, foreclosure proceeds, etc. Transfers of PETE status are governed (for negotiable notes only) by UCC Article 3, and PETE status, as the abbreviation implies, means the right to enforce the note against the maker (borrower). PETE status is typically conferred by being a "holder" of the note, and one becomes a "holder" by getting possession of the original, but endorsed, note.

While these two rights may well be held by the same person, they can also be separated. For example, Fannie Mae normally delivers possession of the note to its servicer when it is necessary to foreclose. Hence, the servicer becomes the holder or PETE, while Fannie remains the owner, and will have the right to the proceeds of foreclosure.

Now, here's the question. If ownership and PETE status are separated, which of those rights does the mortgage follow? Or to put it differently, in order to have standing to foreclose a mortgage, does the foreclosing party need to be the owner, the PETE, or both?

It's not easy to find clear authority for this question. The distinction between ownership and holding (PETE status) has not been well understood by courts or legislators, and the two terms are often conflated in judicial opinions and statutes. The Nov. 2011 PEB report, *Application of the Uniform Commercial Code to Selected Issues Relating to Mortgage Notes,* makes the distinction between them clear, and we are now starting to get greater clarity from the courts as well.

The Kolenich case is a good example. It's a garden-variety foreclosure defense case, in which the borrowers (the Koleniches) argued that, as in the example above, Fannie Mae was the owner of the note and therefore that its servicer, BAC, to which the note had been delivered and which was therefore the holder, did not have standing to foreclose. The court rejected this view.

It is well-settled that the real party in interest in a foreclosure action is the current holder of the note and mortgage. The current holder of the note and mortgage is entitled to bring a foreclosure action against a defaulting mortgagor even if the current holder is not the owner of the note and mortgage. See R.C. 1303.31(A) (a " '[p]erson entitled to enforce' [a negotiable] instrument" includes "the holder of the instrument[,]") and R.C. 1303.31(B) ("[a] person may be a 'person entitled to enforce' the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument").

In this case, the evidence established that BAC is the current holder of the Koleniches' note and mortgage, and therefore BAC was entitled to bring a foreclosure claim against the Koleniches when they defaulted on their note. Downing testified in his deposition that the Koleniches' note, within days of its origination in 2004, was "bundled" or "pooled" with perhaps as many as several thousand others, and the total debt from the loans was sold to investors like Fannie Mae. The Koleniches' note and mortgage remained titled to Countrywide, which serviced the debt, until MERS, as Countrywide's nominee, assigned the note and mortgage to BAC. BAC, as the current holder of the note and mortgage, brought a foreclosure action against the Koleniches after they defaulted on the note. Contrary to what the Koleniches allege, while the debt associated with the note and mortgage was sold to Fannie Mae, the note and mortgage were never assigned to Fannie Mae. Moreover, the sale of the debt associated with the note and mortgage did not affect BAC's status as the current holder of the note. Therefore, BAC was entitled to bring the foreclosure action against the Koleniches to enforce the note and foreclose on the mortgage.

The case is significant for its very clear holding that the mortgage runs with "holder" or PETE status, and not with ownership of the note. This is surely the right answer, I think. After all, foreclosure is a method of enforcing the note. Here are a couple of other recent decisions that agree.

Edelstein v. Bank of New York Mellon, --- P.3d ----, 2012 WL 4461716 (Nev.2012):

"Indeed, to foreclose, one must be able to enforce both the promissory note and the deed of trust. Id.; NRS 107.086(4). Under the traditional rule, entitlement to enforce the promissory note would be sufficient to foreclose."

Eaton v. Federal Nat. Mortg. Ass'n, 969 N.E.2d 1118 (Mass.2012):

"We perceive nothing in the UCC inconsistent with our view that in order to effect a valid foreclosure, a mortgagee must either hold the note or act on behalf of the note holder. …It would appear that a foreclosing mortgage holder may establish that it either held the note or acted on behalf of the note holder at the time of a foreclosure sale by filing an affidavit in the appropriate registry of deeds."

While you can find numerous older cases that talk about the "owner" of the note being able to enforce the mortgage, don't rely on them; they're highly misleading. The owner can foreclose if she or he is also the holder (or has the rights of a holder, or is the agent of the holder), but not otherwise.

The Koleniches also argued that because Bank of America received TARP bailout money, it should be precluded from foreclosing against them. You can imagine how well that played in the Court of Appeals! They were litigating pro se, and perhaps had spent too much time studying law on the internet.