2. Acquiring the Right to Payment under the Mortgage Note – The mortgage notes used in a securitization are either "negotiable instruments" governed by Article 3 of the Uniform Commercial Code (UCC)[2] or they are assignments governed by state assignment laws. UCC Article 3 governs the relationship between the person who makes the mortgage note (the borrower) and the person entitled to payment on it (initially, the originating bank and then the buyer or purchaser from that bank). A negotiable instrument is sold and transferred by a process known as negotiation. Negotiation means the mortgage note is delivered to the new owner with a special indorsement[3] or a blank indorsement. An indorsement looks like this: **"Pay to the order of _____________."** A special endorsement would have the name of a specific person written in. A blank endorsement is exactly what is shown above; an empty line where the name of a person should be. A blank indorsement makes the mortgage note payable to the person who received delivery of it. A blank indorsement also makes the mortgage note bearer paper. The bearer of the mortgage note further negotiates it either by special or blank indorsement. In either case, the borrower (also called the maker or obligor) on the mortgage note makes payment to the person identified through this negotiation process. From the perspective of Article 3 the person identified in a special indorsement is called the holder and is also called, the person entitled to enforce (the mortgage note). The person identified in a blank indorsement is also called a holder but in a more technical legal sense may be a non-holder in possession of the instrument with the rights of a holder.[4]

3. Acquiring Ownership of the Mortgage Note – When the bank sells the mortgage note to the purchaser, the purchaser will want to confirm that the seller and other third parties cannot claim they have any right to payment on the mortgage note. The process of acquiring an exclusive interest in the mortgage note and communicating this to others in a legally effective way is governed by UCC Article 9 rules. Article 9 requires the purchaser to do three
e the purchaser can take possession of the mortgage note

[1] See, Shadow Banking, Pozsar, Adrian, Ashcraft and Boesky, Federal Reserve Bank of New York, Staff Report No. 458, July 10, 2010, revised

[3] The word "indorsement" is not a misspelling of the word endorsement but reflects the spelling convention adopted in the UCC. The New Oxford American Dictionary (Oxford University Press 2001) define

under the seller's security agreement. Once these things are done the security interest "attaches" – this means the security interest becomes enforceable <u>but only against the seller.</u> To enforce its rights against third parties the purchaser of a mortgage note must go one step further and <u>perfect</u> the security interest. One perfects by: 1) filing notice in the designated state office, 2) taking possession of the mortgage note or 3) automatically when the security interest in the mortgage note attaches. Under the Article 9, a security interest in a promissory note is perfected

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would violate the tax law void and of no effect. This means it is possible that not all mortgage notes sold to the Trust will actually be effectively transferred to it.

6. Mortgage Foreclosure – If the borrower in the mortgage loan defaults, the Trust will have a right to proceed against the real estate. Proceeds from the foreclosure are then distributed to the tranche holders. Evidence that a person is entitled to foreclose on a mortgage is established by demonstrating ownership of the mortgage note. The PSA can only establish (through the attached Master Loan Schedule) what mortgage notes were identified for sale – not who owns that mortgage note. If a mortgage note sold in accordance with the UCC can be produced it is proof of ownership and establishes the right to foreclose because the mortgage follows the mortgage note. All that would then be required is recordation of the real estate interest in the real estate records. If the mortgage note cannot be produced or if it can be produced but is not endorsed as required by the PSA (for example does not show an unbroken chain of endorsements in a PSA that sets this as a requirement) the foreclosure may be prohibited because the Trust cannot establish it owns the mortgage note. The Trust can resort to the local mortgage record to show it is entitled to foreclose but it is possible that the legal requirement of filing a lien in the county records where the real estate is located was not followed when the sale to the Trust occurred. Article 9 provides that a secured party may record in the office in which the mortgage is recorded a copy of the security agreement transferring an interest in the note to it with the secured party's sworn affidavit in recordable form stating that default has occurred and that the secured party is entitled to enforce the mortgage without a court order. This may not be sufficient even in states that permit a foreclosure without a court order because some state laws say the lack of a recordable assignment precludes non-judicial foreclosure.[8]

7. US GAAP Accounting – Under SFAS 166 a true sale occurs when the transferor and its consolidated affiliates **surrender control** over the assets transferred and receives cash or other proceeds for them. Control is surrendered only if (1) the **assets have been legally isolated**; (2) the transferee has the ability to pledge or exchange the assets; and (3) the transferor otherwise no longer maintains effective control over the assets. To be legally isolated the transferred assets must be put beyond the reach of the transferor, its consolidated affiliate, and their creditors. This aspect of the accounting analysis is conducted against the applicable bankruptcy or receivership proceeding and often requires production of the true sale legal opinion discussed below. As in the (legal) recourse concept, (also discussed below) any agreement or practice between the parties gives the seller "control" over the assets and jeopardizes sales accounting. If sale accounting fails the transaction would be accounted for as a secured

[8] Debra Thorne and Ethel Badawi, Does "the Mortgage Follow the Note"?, Lessons Learned, Best Practices for Assignment of a Note

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borrowing but this accounting determination may not have as drastic an impact on the securitization as would a court decision re-characterizing the transaction.

8. Protecting the Securitization from Bankruptcy

a. General Insolvency Concerns – The objectives of a securitization (keeping assets for the exclusive use of a defined group of investors) conflicts with the policy objectives of the bankruptcy process (ensuring all creditors receive a fair share of the debtor's assets). This makes it especially important that the collateral held in trust in a securitization not be characterized as possibly belonging to the seller or to a parent or affiliate of the SPV.

b. The Insolvency Framework

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d. Proofing the Securitization Against Attack – A variety of processes are employed to protect a securitization against the risks discussed above which we will refer to by the phrase bankruptcy remoteness. A core concern of bankruptcy remoteness is insulating the SPV against the risk of a voluntary or involuntary bankruptcy filing and isolating the mortgage notes from the seller so that they cease to be the property of the seller and become the property of the buyer. The risk that the SPV can or will voluntary file depends on its ability to incur liabilities it cannot repay and also by the risk that it will ignore corporate and related formalities that expose it to piercing and or substantive consolidation attacks. The first is commonly addressed by proper funding and by limiting the ability of the SPV to create debts or other obligations to third parties. The second is addressed by building required procedures that cause the SPV to observe a separate and arms relationship to parents and subsidiaries. The risk that an SPV may be drawn into an involuntary filing depends on parents or affiliates that have run into financial difficulties. Defeating the risk posed by the judicial doctrines of piercing and of substantive consolidation is managed by careful observance of corporate formalities, by putting in place procedures that ensure that transactions between affiliated entities are economic and at arms-length. Isolating the mortgage notes from the seller is concerned with defeating attempts at re-characterization. This involves conducting a **true sale**[13] - defined *as a transfer of an asset by a seller for fair value in an arms-length transaction with the result that all of the benefits and risks commonly associated with ownership are transferred to the buyer*. What could upset characterization as a true sale is the degree of **recourse** to the seller. Recourse, broadly speaking refers to *continued involvement by the seller in the assets* that are the subject of the sale. Recourse can exist for very legitimate business reasons and so its presence is not – by itself – an indication that a true sale was not intended or did not occur. A legal attack on the transfer of the mortgage note requires the court to identify the degree of recourse and to determine whether it is inconsistent with a true sale. If a bankruptcy court holds a true sale did not occur the implication is that the seller still owns that property, presumably subject to some interest of the buyer. If the court concludes that only a secured borrowing was intended (or resulted) the Trust is not the owner of the assets but if it complied with UCC Article 9 it still has rights in the collateral as a secured party. Re-characterization risk is managed by minimizing recourse, documenting the business logic for recourse and compensating for the performance of the activities characterized as recourse. The Trust should always have a perfected security interest in the collateral as a backstop to recharacterization. Vulnerability of a securitization to the kind of attacks is typically discussed in legal opinions.

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the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, 64, The Business Lawyer, 411, February 2009.

[13] See, Pantaleo, Edelman, Feldkamp, Kravitt, McNeill, Plank, Morrison, Schwarcz and Zaretsky, Rethinking the Role of Recourse in the Sale of Financial Assets, 52 The Business lawyer, 159, 1996; Steven L. Schwarcz, Structured Finance: The New Way to Securitize Assets, 11 Cardozo Law Review, 607, at 618; Baxter Dunaway, Law of Distressed Real Estate, Baxter Dunaway, Part H. (Miscellaneous Rights and Liabilities); Subpart H3 (Financial and Securities Concerns), Chapter 56. (Asset Securitization and Commercial Mortgage-Backed Securities) V. Special Purpose Entity (SPE/SPV) and Bankruptcy Remoteness, Law Database updated May 2013; West's Legal Forms, Commercial Transactions, Lawrence R. Ahern, III , Part 5 - Transactions under Article 9 of the Uniform Commercial Code H. Transactions in Rights to Payment and Other Intangibles, Chapter 23. Subordination, Participation and Securitization, Section 23:27 -"True sale" opinion to accompany securitization transaction, Database Updated December 2012.

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