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Borrowers and Bankruptcy Trustees' Unsuccessful Attempts to Avoid a Mortgage Under the "Splitting-the-Note" Theory

Alana Friedberg

ST. JOHN'S UNIVERSITY
SCHOOL OF LAW

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Alana Friedberg, J.D. Candidate 2016

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Introduction

In 1993, the mortgage industry created the electronic database Mortgage Electronic Registration System ("MERS") in order to "track ownership interests in residential mortgages."[1] MERS "serves as the mortgagee in the land records for loans registered on the MERS System, and is a nominee (or agent) for the owner of the promissory note."[2] To date, MERS holds title to around 60 million home mortgages, about half of all home mortgages in the United States.[3]

Borrowers and bankruptcy trustees have attempted unsuccessfully to argue a mortgage or deed of trust is void if a third party, such as MERS, was designated as mortgagee because the third party does not hold the note.[4] It appears courts have universally rejected this "splitting-the-note" argument.

This Article discusses the viability of the splitting-the-note argument. Part I of this Article discusses cases from four jurisdictions that reject this argument and the similar approach

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[1] Bank of N.Y. v. Silverberg, 86 A.D.3d 274, 278 (N.Y. App. Div. 2d Dep't 2011) (quoting Matter of MERSCORP, Inc. v Romaine, 861 N.E.2d 81, 83 (N.Y. 2006).
[2] *Our Business*, MERSINC.ORG, https://www.mersinc.org/about-us/our-business (last visited Apr. 10, 2015).
[3] Michael Powell & Gretchen Morgenson, *MERS, the Mortgage Holder You Might Know*, N.Y. TIMES (Sept. 12, 2014, 11:46 PM), http://www nytimes.com/2011/03/06/business/06mers html?pagewanted=all.
[4] *See In re* Corley, 447 B.R. 375 (Bankr. S.D. Ga. 2011); *see also In re* D'Alessandro, 2013 Bankr. LEXIS 1357 (Bankr. D. Mass. Apr. 4, 2013); Martins v. BAC Home Loans Servicing, L.P., 722 F.3d 249 (5th Cir. 2013); Tapia v. U.S. Bank, N.A., 718 F. Supp. 2d 689 (E.D. Va. 2010), *aff'd*, 441 Fed. Appx. 166 (4th Cir. 2011).

they take. Part II of this Article discusses the implications of the jurisprudence on borrowers, bankruptcy trustees, and lenders.

I. The "Splitting-the-Note" Argument

The "splitting-the-note" theory posits that transferring a mortgage or deed of trust "by way of MERS 'splits' the note from the [mortgage or] deed of trust, thus rendering both null."[5] Borrowers and bankruptcy trustees have asserted this theory in an attempt to avoid a mortgage or a deed of trust. However, as discussed below, while not an exhaustive list of all the reported and unreported cases regarding the issue, the following four cases from Georgia, Massachusetts, Texas, and Virginia illustrate the typical reasoning courts apply when rejecting this argument.

a. Georgia Law

For example, in *In re Corley*,[6] a bankruptcy court in Georgia rejected the splitting-the-note argument and held that a note was fully secured because (1) the security deed was properly perfected at its inception; (2) despite the note and security deed being physically separated, "there was neither contractual language nor any statutory provision which stripped the security from the debt"; (3) the post-petition assignment of the security deed did not violate the automatic stay; and (4) the security deed designated MERS as grantee of the security deed.[7]

In *Corley*, the debtors took out a loan from and executed a note in favor of Citizens Bank of Effingham ("CBE") to purchase real property.[8] The debtors executed a security deed to secure the note.[9] The security deed, which was recorded in the county land records,[10] named MERS "as grantee and nominee for CBE and its successors."[11] The security deed also granted

[5] Martins v. BAC Home Loans Servicing, L.P., 722 F.3d 249, 254 (5th Cir. 2013).
[6] 447 B.R. 375.
[7] *Id.* at 380.
[8] *Id*. at 378.
[9] *Id*. at 379.
[10] *Id*. at 378.
[11] *Id*. at 377.

MERS "the right to foreclose and sell the [p]roperty" for CBE and any of CBE's successors and assigns.[12] The note was subsequently transferred numerous times, "with different entities taking possession, ownership, and servicing rights."[13] Similarly, the security deed was "transferred at least once."[14] On or about April 29, 2009, almost three months after the debtors filed for bankruptcy, MERS transferred the security deed to Ocwen Loan Servicing, LLC ("Ocwen").[15] In August of 2009, Ocwen became the servicer of the loan.[16] Ultimately, after numerous transfers, the note and the security deed were physically united in Ocwen's possession.[17]

After the debtors filed for bankruptcy, the chapter 7 trustee "commenced an adversary proceeding to determine the extent, validity, and priority of the [s]ecurity [d]eed, asserting that the [n]ote was unsecured."[18] The trustee challenged the note and security deed on three principal grounds. First, the trustee argued that the note was unsecured because the note and the security deed were split. The trustee alleged "that the 'split' occurred because MERS (the security holder) did not hold the [n]ote" and Ocwen did not hold the security deed.[19] Second, the trustee argued "that the post-petition transfer of the [n]ote and the [s]ecurity [d]eed violated the automatic stay."[20] Third, the trustee argued that MERS could not be the "grantee" in the security deed because MERS did not receive payments for the loan on behalf of a grantor, and therefore, the security deed was unenforceable.[21]

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[12] *Id.* at 378.
[13] *Id*. at 377.
[14] *Id*.
[15] *Id.* at 379.
[16] *Id*.
[17] *Id.*
[18] *Id*. at 377.
[19] *Id*. at 382.
[20] *Id*. at 379.
[21] *Id*. at 381.

The *Corley* court rejected the trustee's arguments. First, the *Corley* court held that the note was secured.[22] Under Georgia law, which applied here, the court noted that when a security deed is transferred, "the accompanying indebtedness" also transfers.[23] Therefore, transferring the security deed did not as a matter of law split the security deed and the note.[24] While they were physically separated, "there was neither contractual language nor any statutory provision which stripped the security from the debt."[25] The *Corley* court concluded that the note was fully secured for three additional reasons: (1) the security deed "was properly perfected at its inception" since it was "recorded in the county where the land conveyed [was] located";[26] (2) the security deed was never released or cancelled since the debtors had not paid the debt in full nor did they produce a cancelled security deed;[27] and (3) the security deed language, naming MERS as nominee, created an agency relationship.[28]

Second, the *Corley* court held that the post-petition transfer of the note and the security deed[29] did not violate the automatic stay "because at the at the time of the transfer, the "debtors' only interests in the [p]roperty were the right of possession and the right to have the [s]ecurity [d]eed reconveyed upon repayment," and thus "they had no interest in the [s]ecurity [d]eed itself at the time of [the] post-petition transfer."[30] The *Corley* court explained that when the debtors executed a security deed to MERS, they conveyed legal title, which could only be reconveyed back to the debtors when they paid the note in full.[31] Third, the *Corley* court held that MERS was a grantee in the security deed because "plain and clear" language in the security deed

[22] *See id.* at 383–85.
[23] *Id.* at 383.
[24] *Id.*
[25] *Id*. at 380, 383.
[26] *Id*. at 380–81.
[27] *Id.*
[28] *See id*. at 381.
[29] *Id.* at 379.
[30] *Id.* at 385.
[31] *See id.*

designated MERS as grantee of the security deed and nominee for the lender on the note.[32] Additionally, the security deed provided that MERS, as grantee, retained the right to enforce the note regardless of who the noteholder was at any given point.[33] Therefore, the *Corley* court held that the note was fully secured, and thus enforceable.[34]

b. Massachusetts Law

Similarly, in *In re D'Alessandro*,[35] a bankruptcy court in Massachusetts held that one of the two mortgages against the debtor's home was not void even though (1) MERS, in its role as nominee of the original lender, only held the mortgage, but not the note that the mortgage secured; (2) the original lender no longer held the note; and (3) the servicer of the note and mortgage did not hold an assignment of the note and mortgage.[36]

In *D'Alessandro*, the debtors took out a loan from and executed a note in favor of GB Mortgage, LLC ("GB") in order to purchase real property.[37] The debtors' obligations under the note were secured by a mortgage granted to MERS as GB's nominee.[38] Subsequently, GB dissolved.[39] After the debtors filed for bankruptcy under chapter 7 of the Bankruptcy Code, the trustee commenced an adversary proceeding against the debtors, GB, and GMAC Mortgage, LLC ("GMAC"), seeking, among other things, a determination that the mortgage was void.[40] The trustee alleged that both the note and the mortgage may have been assigned to GMAC or

[32] *Id.* at 381.
[33] *Id*. at 383.
[34] *See id*. at 385–86.
[35] 2013 WL 1385745 (Bankr. D. Mass. Apr. 4, 2013).
[36] *See id*. at *4.
[37] *Id*. at *1.
[38] *Id.*
[39] *Id*.
[40] *Id*. at *4.

that GMAC might have been servicing the note.[41] However, the assignment of the mortgage had not been recorded.[42]

The chapter 7 trustee commenced an adversary proceeding to determine the extent, validity, and priority of the mortgage, asserting that it was unenforceable.[43] The trustee challenged the mortgage on two grounds.[44] First, the trustee argued that the mortgage was void because MERS did not hold the note, and instead, only held the mortgage.[45] Second, the trustee argued that "there [was] no recorded mortgage assignment."[46]

The *D'Alessandro* court rejected the trustee's two arguments asserting that the mortgage was invalid.[47] First, the *D'Alessandro* court held the mortgage was valid even if the mortgage had been split from the note.[48] In particular, the court reasoned that unless the debtors had paid the note in full, the obligations arising under the note still existed.[49] The *D'Alessandro* court also noted that Massachusetts law provides that "other than in the foreclosure context, 'the holder of the note and mortgage may be different persons.'"[50] Therefore, the *D'Alessandro* court concluded that unless and until MERS seeks to foreclose its mortgage, MERS does not have to hold the note "unless it [is] acting on its own behalf rather than as the agent of the noteholder."[51] Second, the *D'Alessandro* court held that "except in the foreclosure context," a mortgage need not be recorded in order to be effective.[52] However, the *D'Alessandro* court noted that recording

[41] *Id*. at *1.
[42] *Id*.
[43] *Id.*
[44] *Id.* at *4–5.
[45] *See id*. at *4.
[46] *Id.* at *5.
[47] *See id*. at *4–5.
[48] *Id*. at *4.
[49] *See id*.
[50] *Id*. (quoting *In re* Marron, 455 B.R. 1, 7 (Bankr. D. Mass. 2011)).
[51] *Id*.
[52] *Id.* at *5.

mortgage assignments is encouraged.[53] Therefore, the *D'Alessandro* court held that the mortgage was not void.[54]

c. Texas Law

The Fifth Circuit, in *Martins v. BAC Home Loans Servicing, L.P.*,[55] affirmed a district court, which held that foreclosure was proper, rejecting the borrower's argument that combined the "splitting-the-note" theory and the "show-me-note" theory.[56] In *Martins*, the borrower refinanced his home mortgage with BSM Financial ("BSM") in 2003.[57] The borrower executed a mortgage to secure his obligations under the note, which named MERS "as the beneficiary and nominee for BSM and its assigns."[58] In 2010, MERS assigned the mortgage to BAC and recorded the transfer.[59] In 2011, after the borrower defaulted under the note, BAC foreclosed on his home.[60]

Following the foreclosure, the borrower "sued [BAC] in state court, claiming wrongful foreclosure, promissory estoppel, and negligent misrepresentations."[61] Specifically, the borrower claimed "that the note was not properly transferred to BAC" and that MERS's assignment to BAC "was 'robosigned' and therefore 'forged.'"[62] The borrower claimed that as a result, BAC could not foreclose on his home because it neither held the note nor owned the mortgage.[63] However, the court rejected this claim, holding that the mortgage assignment from

[53] *See id.*
[54] *See id.*
[55] 722 F.3d 249 (5th Cir. 2013).
[56] *See id*. at 256.
[57] *Id.* at 252
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] *Id.*

MERS to BAC was valid because the assignment document was signed, notarized, and recorded in the county land records.[64]

BAC removed to federal court and moved for summary judgment.[65] The district court granted BAC's summary judgment motion.[66] The borrower then appealed to the Court of Appeals for the Fifth Circuit, which affirmed the district court's ruling.[67]

The borrower argued that when MERS assigned only the mortgage to BAC, which "split the note from the deed of trust," and therefore precluded BAC from foreclosing because it "had a meaningless piece of paper rather than a debt on which it could foreclose."[68] The court noted that this argument merged two common theories, the "show-me-the-note" theory and the "splitting-the-note" theory.[69] The court rejected the "show-me-the-note" theory, which posits that in order to foreclose, "a party must produce the original note bearing a 'wet ink signature.'"[70] This theory is unsuccessful under Texas law, which permits a mortgagee to foreclose without possessing the original note, as long as the mortgagee produces a photocopy of the original note and "an affidavit in which the affiant swears that the photocopy is a true and correct copy of the original note."[71] The court also rejected the "splitting-the-note" theory, which posits that when a note and a deed of trust are split, both are void.[72] The theory further posits that "[i]n order to foreclose . . . a party must hold both the note and the deed of trust."[73] This theory is also unsuccessful under Texas law, which permits a mortgagee to foreclose

[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *Id.* at 253.
[69] *See id.*
[70] *Id.* (citation omitted).
[71] *Id.* at 253–54.
[72] *Id.* at 254.
[73] *Id.*

without holding or owning the note.[74] And since MERS qualified as a mortgagee, MERS was permitted to foreclose without holding or owning the note.[75] Therefore, BAC was also permitted to foreclose without holding or owning the note because the assignment from MERS to BAC "explicitly included the power to foreclose by the deed of trust."[76]

d. Virginia Law

The Fourth Circuit, in *Tapia v. U.S. Bank*,[77] affirmed a district court, which held that MERS was authorized to foreclose on the borrowers' property pursuant to the deed of trust.[78] In *Tapia,* the borrowers took out two loans from and executed two notes in favor of First Savings Mortgage Corporation to purchase real property.[79] The borrowers executed two deeds of trust to secure their obligations under the notes.[80] Both deeds of trust named MERS as the beneficiary.[81] Each of the deeds of trust provided, in relevant part:

> Borrower understands and agrees that MERS holds only legal title to the interests granted by Borrower in this Security Instrument, but, if necessary to comply with law or custom, MERS (as nominee for Lender and Lender's successors and assigns) has the right: to exercise any or all of these interests, including, but not limited to, the right to foreclose and sell the Property; and to take any action required of Lender including, but not limited to releasing and canceling this Security Instrument.[82]

The deeds of trust also provided that the note could be sold without notifying borrower.[83]

The borrowers claimed that only the lender could foreclose on the property.[84] However, the court rejected this argument because, as noted above, the deed of trust "authorized MERS to

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[74] *See id.* at 255.
[75] *See id.*
[76] *Id.*
[77] 718 F. Supp. 2d 689 (E.D. Va. 2010), *aff'd*, 441 Fed. Appx. 166 (4th Cir. 2011).
[78] 718 F. Supp. 2d at 692.
[79] *Id.*
[80] *Id.*
[81] *Id.* at 693.
[82] *Id*. at 693.
[83] *Id.*
[84] *Id.* at 696.

foreclose [and sell] the [p]roperty" if the borrowers defaulted on their loan.[85] Indeed, the borrowers agreed to this when they signed the deeds of trust.[86] Therefore, MERS was authorized to foreclose on the borrowers' property.[87]

II. "There is No Such Thing as a 'Free House'"[88]

The decisions discussed above rejecting the "splitting-the-note" theory are particularly important because MERS "hold[s] title to roughly half of all the home mortgages in the nation."[89] If courts accepted the "splitting-the-note" argument, borrowers and bankruptcy trustees would arguably be unjustly enriched because such borrowers would essentially receive a free house even though they originally agreed to grant a mortgage securing their obligations under the note they executed in connection therewith. If a court were to adopt the rule that a third party, such as MERS, could not hold and enforce a mortgage or a deed of trust on the lender's behalf, it would likely lead to a substantial increase in litigation seeking to invalidate the mortgage or deed of trust since, as noted above, MERS holds title to so many mortgages. Therefore, adopting the proposed rule under the "splitting-the-note" theory could result in millions of home loans becoming unsecured loans,[90] which in turn would threaten the lender's recovery if the borrower defaults.

Yet, since the courts have consistently rejected these arguments, borrowers and bankruptcy trustees should be aware that it is extremely unlikely that they will be able to invalidate the mortgage against a borrower's home on the basis that the mortgage designates a third party, such as MERS, as mortgagee even though the mortgagee does not hold the note.

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[85] *Id*. at 697.
[86] *Id.*
[87] *Id.* at 692.
[88] *In re* Marron, 455 B.R. 1 (Bankr. D. Mass. 2011).
[89] Michael Powell & Gretchen Morgenson, *MERS, the Mortgage Holder You Might Know*, N.Y. TIMES (Sept. 12, 2014, 11:46 PM), http://www nytimes.com/2011/03/06/business/06mers html?pagewanted=all.
[90] *See In re* Cash, 2013 WL 1191745 (Bankr. N.D. Tex. 2013).

Conclusion

Many borrowers and bankruptcy trustees have attempted to avoid home mortgages or deeds of trust under the "splitting-the-note" theory, asserting that they are unenforceable. Courts, however, have repeatedly rejected this argument because it is permissible to designate a third party as mortgagee to act on behalf of a noteholder. Thus, future borrowers and bankruptcy trustees will likely be unsuccessful in avoiding a mortgage under the "splitting-the-note" theory.