

Anatomy of an eNote

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- The mortgage market's continued ability to lend money relies on the liquidity of promissory notes secured by real property.
- Paper promissory notes are indorsed "in blank" so that whoever has "possession" of the note is considered a holder, holder in due course, or purchaser.
- Electronic Note ("eNote") challenges:
 - » There is no such thing as an "original" eNote.
 - » You can't take "possession" of an eNote.
 - » How do you prove that you're the owner of an eNote?
 - » How do you prove that the eNote you have is the "original"?
- Warehouse lending challenges
 - » No bailee letters or agreements

- ESIGN and UETA's Basic Rules of Validity
 - » A record or signature may not be denied legal effect or enforceability solely because it is in electronic form;
 - » A contract may not be denied legal effect or enforceability solely because it is in electronic form;
 - » Any law that requires a "writing" will be satisfied by an electronic record; and
 - » Any signature requirement in the law will be met if there is an electronic signature
- Record – Information that is inscribed on an tangible medium or stored in electronic medium and retrievable in perceivable form.
- Electronic record – A record created, generated, sent, communicated, received or stored by electronic means.

- Promissory notes are negotiable under UCC § 3-104 if the note is:
 - » In writing;
 - » Signed;
 - » An unconditional promise to pay a specified sum of money;
 - » Payable on demand or at a definite time; and
 - » Payable to the order of a named payee or to the person in possession of the instrument.
- Note Transfer - Negotiable promissory notes can then be transferred by physical delivery of the note from the original payee to a third party with an indorsement and instruction to the borrower to make all future payments to the new note holder.
- Holder in due course – If a third party takes delivery of the note for (i) value; (ii) in good faith; and (iii) without notice of defenses to payment or claims of third parties to an interest in the note, the third party becomes a “holder in due course.”

- A “transferable record” and “control” are substitutes for the concepts of a paper negotiable instrument and possession.
- Transferable record definition – An electronic record that:
 - » would be a note under UCC Article 3 if the electronic record were in writing; and
 - » in which the issuer (i.e., borrower) of the electronic record has expressly agreed it will be treated as an electronic record.
 - » ESIGN additionally requires the electronic record to relate to a loan secured by real property.
- A person has “control” of a transferable record (“eNote”) if the system employed for evidencing the transfer of interests in the eNote reliably establishes that person as the person to whom the eNote was issued or transferred.

- “Control” gives the person the exclusive right to enforce or transfer ownership of the underlying debt obligation. Can be thought of as the equivalent of “possession” or “possession plus delivery and indorsement”.
- Provides a third party with the same rights and defenses analogous to those of a holder, holder in due course or purchaser under the UCC.
- If a third party transferee takes control for value, in good faith, and without notice of defenses, the third party transferee will enjoy the same rights and defenses as a “holder in due course” of an equivalent paper negotiable instrument under the UCC.

- Concept of control is a stand-alone provision, but there are six safe harbor provisions for determining that a system for transferring interests in an eNote reliably establishes control.
- Safe harbor - A person is deemed to have control if the eNote is created, stored and assigned in a manner that:
 - » A single authoritative copy (“AC”) exists that is unique, identifiable and unalterable without detection;
 - » The AC identifies the person asserting control as either to whom the transferable record was issued or the issuer;
 - » The AC 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 AC can be made only with the consent of the person asserting control;
 - » Each copy of the AC and any copy of a copy is readily identifiable as a copy and not the AC; and
 - » Any revision of the AC is readily identifiable as an authorized or unauthorized revision.

- Designed by and for the mortgage industry to be the system for establishing control of an eNote.
- Language in the eNote will specifically point to the MERS® eRegistry as the central location to identify the person in control “Controller” and the location of the AC of the eNote.
- The MERS® eRegistry also stores the “digital fingerprint” of the eNote so that investors can always check to see if an eNote they receive is the same eNote that was registered on the eRegistry.
 - » eNotes are tracked by MIN numbers (Mortgage Identification Number) on the eRegistry.
- MERS requires eNotes to be registered within one business day of execution and “digital fingerprinting”.

- Tamper-evident digital signatures can be affixed to an eNote such that if the eNote were altered, the alterations can be detected. Also called “tampersealing”
 - » MISMO recommends that the tamper-evident digital signature be applied with an organization certificate issued by a SISAC-accredited issuer.
- A "digital fingerprint" or "hash" consists of a series of letters and numbers that uniquely describe a document.
- If the document is altered in any way, the "hash" for the altered document will be different from that of the original document.

Paper World



Electronic World

Negotiable Instrument

Transferable Record (“eNote”)

Original Note

Authoritative Copy of eNote

Possession

Control

Investor/Holder

Controller

Custodian

Location (eVault)

Indorsement and Delivery

Transfer of Control

Chain of Indorsements

Transferable Record Audit trail

Servicer

Controller’s Delegatee

*Source: MERSCORP, Inc. Used with permission.

What is a Warehouse Lender?

Warehouse Lender: A short-term lender for mortgage bankers. Using the note as collateral, the warehouse lender provides interim financing until the mortgage is sold to a permanent investor.

Definition from Campus MBA Mortgage Banking Terms: A Working Glossary, 10th Edition

- Paper World - Bailee Agreements and Letters
 - » UCC Article 9 Perfection – Can perfect a security interest in a negotiable promissory note by filing, but a holder in due course or a secured party in possession of the note will take priority over an interest perfected by filing.
 - » UCC § 9-313(h) allows a warehouse lender to relinquish possession to an investor without losing priority if the note is accompanied by instructions to the investor to either (1) hold possession for the warehouse lender’s benefit or (2) redeliver the note to the warehouse lender if sale is not completed.
 - Bailee Agreement - Mutual agreement between 2 or more parties (e.g., warehouse lender and investor) which sets forth the terms of the bailee relationship.
 - Bailee Letters – Letter that accompanies delivery of the collateral to the investor stating the terms of the bailee relationship.
 - Use to defeat claims that the receiver may make as to being a “holder” or “holder in due course” of the collateral.
 - » Usually contains payment instructions – “Upon receipt of purchase proceeds, Lender’s lien and security interest will terminate and be cancelled and released.”

- Electronic World – Bailee agreements and letters are inapplicable to eNotes because ownership rights in the eNote are established by “control” not “possession.”
- Timing Challenges
 - » Investors: Will want control of eNote first, before paying warehouse lender.
 - » Warehouse lenders: Will want payment first, before transferring control of eNote.
- MBA ResTech eMortgage Adoption Task Force
 - » Task force is dedicated to resolving issues related to real and perceived barriers to eMortgage adoption.
 - » In July 2006, the MBA brought together mortgage lenders, warehouse lenders and investors to discuss the effect of eNotes on warehouse lending.
 - » White paper titled “Security Interests in Transferable Records Evidencing Residential Mortgage Lending Transactions and the Rights of Warehouse Lenders: An Analysis and Proposal,” was published on October 17, 2007.

Thank you!

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