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ARTICLES & INSIGHTS

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Landmines: Useless Liens in Mortgage Lending

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Lenders who make loans secured by residential mortgages often prefer to follow standardized business practices. Mortgage lending is a complex business. Today's regulatory environment is not likely to make it simpler. Standardized forms are an accepted part of mortgage lending. Those forms usually include "fill-in-the-blank" loan notes from national suppliers. They also include plenty of "boilerplate" text.

At least one national source of pre-printed mortgage loan notes has included boilerplate language in its forms, amounting to a land-mine with an unreliable detonator. The language is not only useless but potentially the source of involuntary loan re-writes in Ch. 13 bankruptcies. Read on to learn what it is, where it is and how to defuse it.

The Land Mine: Escrows and Minimum Share Deposits

The land mine is planted in one of at least two ways: "security interests" in escrow accounts and "security interest" in deposit accounts. Either is equally explosive and sometimes both are present. It appears that "security interests" in deposit accounts are the more insidious because they are harder to find.

"You are giving us a security interest in your real estate to secure this loan. *You are also giving us a security interest in your shares and/or deposits to secure this loan."* [Italics for emphasis]. I just copied those two sentences straight from a pre-printed "Note and Disclosure Statement" on a credit union's residential mortgage documents. They are buried in the boilerplate, but they are there. The first sentence is harmless. That *second* sentence (in *italics*) is the problem. It should not exist in the document. It serves no useful purpose whatsoever, *and it is toxic to the lender.* Here's why:

"Security interests" in Deposit Accounts: Redundant and Ineffective –at best

The second sentence provides the credit union with nothing more than it already had by statute. There is no reason the second sentence should ever appear in any mortgage loan note to any credit union.

1. By law, every *federally*-chartered credit union already possesses a lien on all deposits in every borrower's account, against all debts that borrower owes the credit union. 12 USC Sec. 1757(11). The lien arises automatically, upon deposit (except for IRA's, 401k's, etc.) That makes the suspect "second sentence" above redundant.

2. By law, every *state*-chartered credit union in NC already possesses the same lien on all deposits in every borrower's account. In NC, that law is found at NCGS Sec. 54-109.59 and 04 NCAC 06C.1205. Every other state in the US affords its state-chartered credit unions an equivalent lien (except DE, SD & WY). This lien also arises automatically, upon deposit (except for IRAs, 401(k)s, etc.). State law makes the suspect "second sentence equally redundant.

3. The "second sentence" is not supported by the Uniform Commercial Code. Consumers cannot grant a valid security interest in deposit accounts under the UCC. Article 9 of the UCC (adopted in all 50 states) defines what a "security interest" is, as well as when and whether it is granted. UCC Article 9 does not apply to consumers' grant of liens in their deposit accounts. Such "voluntary liens" are expressly excluded from the UCC. In NC, the statute excluding them is found at NCGS 25-9-109(13). The "second sentence" cannot confer a security interest under the UCC because the UCC excludes them. There is no other statutory source for valid security interests except the UCC.

   So, not only is the effort to grant a security interest in a consumer's deposit account redundant to an existing statutory lien, but it is also invalid from the outset. What about it makes it "toxic to lenders"?

   "Security Interests" in Mortgage Loans: Toxic – at Worst

   The toxin lies buried in the Bankruptcy Code, at 11 USC Sec. 1322(b)(2). That statute is all that stands between a credit union's mortgage and a "cram-down" or involuntary re-write in a Ch. 13 bankruptcy. Here is how the toxin escapes:

   Borrowers seeking to avoid repossession often resort to Ch. 13 bankruptcy. There, they can unilaterally re-write the loan note, on terms they choose. For example, they can provide that a car loan interest rate is reduced, or the amount of principal is reduced, or the term of the car loan is extended. Borrowers seeking to avoid a residential foreclosure have no such rights – *provided the lender's only collateral is their residential mortgage.* There lies the beauty of Sec. 1322(b)(2); mortgage lenders are protected from cramdowns and involuntary loan modifications. If the bankrupting debtor wants to keep the residence, (s)he must resume and maintain payments *according to the original contract terms.* No unilateral changes by the borrower are permitted, unlike car loans.

   Borrowers and their bankruptcy lawyers despise that inconvenient section of the Code. Many Bankruptcy Judges despise it too. It thwarts many an effort to cram down valuation, lower interest rates, and extend repayment periods. Canny lawyers have found the toxic "second sentence" in credit union mortgage notes – to their gleeful delight.

If the lender takes a security interest in anything else as collateral, then it sacrifices the special protections provided to it by Sec. 1322(b)(2) of the Bankruptcy Code. That means the only proper collateral for a residential mortgage loan to a homeowner is a mortgage on the residential property itself. Trying to take a "security interest" in anything else (including a consumer's deposit accounts) is always a mistake.

The Land Mine Detonates

A borrower confronted by a looming foreclosure of a mortgage loan, or one looking to shed as much debt as possible, resorts to a bankruptcy lawyer. Either from his client or the lender by use of a "Qualified Request for Information", the lawyer acquires a copy of the complete loan note. In it, the lawyer strikes upon the "security interest" granted by the borrower in all his deposit accounts, or the security interest granted in the escrow account held for taxes and insurance. Detonation! Now it is clear the lender holds something other than or something more than just a mortgage on the borrower's residential real estate. The protections of 11 USC Sec. 1322(b)(2) are excluded. Success in Ch. 13 bankruptcy is now assured. If the lender does not agree voluntarily to re-write the note to suit the debtor, his Ch. 13 bankruptcy plan will do it involuntarily. Down comes the interest rate, down comes the total of payments, down comes the principal recouped, and up go the losses.

Worse, the lender's reputation for "contaminated" mortgage-loan collateral escapes onto any number of lawyers-only listservs and chatrooms. Now its new reputation as a target in Ch. 13 is earned. It may well expect that every borrower with a mortgage loan will try the same tactic.

Admittedly, most borrowers do not default. If they default, they do not all file bankruptcy. If they bankrupt, they do not all file Ch. 13. But enough of them do, that the sacrifice of special protections in exchange for a $25.00 minimum share account deposit is a foolish bargain.

Defusing the Land Mine

The remedy will cost a lender one piece of stationery, an envelope, and a first-class postage stamp. Scrub your mortgage loan portfolio for toxic security interests in deposit accounts or escrow accounts. If you find one, there are plenty more. Mail a letter to every mortgage borrower, containing the following language, or something similar:

> "WE HEREBY RELEASE AND FOREGO PERMANENTLY ANY SECURITY INTEREST YOU HAVE GRANTED OR THAT WE ACQUIRED FROM YOU IN ANY AND ALL DEPOSIT ACCOUNTS OF EVERY KIND, AS WELL AS ANY SECURITY INTEREST IN ANY ESCROW ACCOUNT HELD BY US, AS ADDITIONAL SECURITY FOR ANY LOAN YOU OWE US THAT IS OTHERWISE SECURED BY YOUR RESIDENTIAL REAL ESTATE. WE RETAIN INTACT ONLY THE VOLUNTARY LIEN OVER THAT REAL ESTATE, TO SECURE

YOUR LOAN BALANCE. ALL REPAYMENT TERMS OF THE LOAN REMAIN UNCHANGED."

Mail the letter separately addressed to every mortgage borrower. There is no need to send it by certified mail. Use instead a USPS Form PS 3817 "Certification of Mailing", so you can prove it was sent. Keep a copy in the records of the loan account, until it is repaid. You are not sacrificing a statutory lien on shares. You are simply releasing any possible "collateral" you may hold in anything but the residence.

Can a lender choose unilaterally to release a mortgage securing a loan, even if the loan is not yet repaid, even without the borrower's permission? Of course, it can. It examiner may suffer apoplexy, but it can. A lender has the right to forego or release any security for any loan whenever it chooses. It does not need a borrower's permission release. Sending the above does no more and no less. It "scrubs" a mortgage loan of any collateral other than the residential mortgage itself. It defuses the landmine. If the borrower later files a Ch. 13, a cram-down or involuntary modification is not inevitable. Send a copy to your lawyer, and recommend 11 USC Sec. 1322(b)(2) to her reading.

Conclusion

The word is already out among lawyers who represent borrowers in Bankruptcy Court. Credit unions are especially well-known for taking "security interests" or "pledges" in deposit accounts. Act now, and you afford yourself protection. Fail to act, and you risk expensive tuition at the School of Experience later.

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