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[27] Webster's Seventh New Collegiate Dictionary 618 (1969).
[28] Ataxingmatter.blogs.com, *Gender-Change Surgery: Medical Care or Cosmetic Surgery?* 8 (2007), http://ataxingmatter.blogs.com/tax/court_cases_of_interest/index.html
[29] *Al-Murshidi v. Comm'r*, T.C. Summary Opinion 2001-185, 5, quoting 136 Cong. Red. S15629, S15711 (1990).
[30] American Psychiatric Association, Diagnostic and Statistical Manual of Mental Disorders 536 (4th ed. 1994).
[31] Ataxingmatter.blogs.com at 9.
[32] *Id.* at 8 quoting Kenneth Vacovec, AP story.
[33] *O'Donnabhain v. Comm'r*, No.640206, (Tax Court filed March 31, 2006), at 4.
[34] *Id.* at 6.
[35] *Id.* at 7.
[36] *Id.*
[37] *Id.* at 5.
[38] *Id.* at 3.
[39] I.R.C. § 213(d)(1)(A).
[40] *Hess v. Comm'r*, T.C. Summary Opinion 1994-79 at 3.

POSSESSION, PERFECTION AND PRIORITY IN A FRAUDULENT ENVIRONMENT

by
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I. INTRODUCTION

Are fraudulent mortgage banking transactions on the rise? Today banks operate in an environment of increased competition, tightening credit restrictions due to the sub-prime mortgage lending fiasco, and a decreased volume of loans processed and sold. Their financial survival is in jeopardy. The purpose of this article is to examine the rights of innocent parties who are the victims of a scheme to defraud in transactions involving mortgage assignments.

A secured real property transaction consists of two documents: the mortgage document which creates a security interest in the real property, and the note which represents the debt that is secured by the mortgage.

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Since mortgage assignments create security interests in the notes and related proceeds, courts have had to address whether state real property law or the Uniform Commercial Code governs security interests in these instruments. When faced with assignees asserting competing claims of priority, there has been much uncertainty and conflict among the courts.

II. NEW YORK REAL PROPERTY LAW § 291

Section 291 of New York's Real Property Law governs the recording of conveyances of real property in this state. It is clear that the New York recording act protects a good faith purchaser for value from an unrecorded interest in real property, provided such a purchaser's interest is the first to be recorded.[1] Numerous courts have come to this conclusion.[2] In *Washington Mutual Bank v. Peak Health Club, Inc.,*[3] the New York Supreme Court applied Section 291 to a situation involving mortgage assignments. In this case, Merrill Lynch made a loan of approximately $5 million to defendant Peak. This loan was secured by a mortgage of real property, and was evidenced by a note in the same amount. Previously defendant Peak had executed and delivered a deed on the same property to defendant East Coast, who in turn executed and delivered a mortgage on the property to plaintiff Washington Mutual Bank ("WAMU").[4] Neither the deed to East Coast nor the mortgage to WAMU was recorded until after the mortgage to Merrill Lynch was recorded, and Merrill Lynch had no knowledge or notice of the previous transfers. The court concluded that, although the mortgage to WAMU was executed prior in time, it lost its priority to Merrill Lynch, who was a good faith lender for value who recorded first.[5]

In *Provident Bank v. Community Home Mortgage Corp.*[6] the court further analyzed case law construing Section 291 as it relates to mortgage assignments. The court found that prior decisions support the position that the first party to record an assignment has priority against all subsequent bona fide purchasers.[7] The Court emphasized, however, that not one of the prior cases involved the determination of the priority of claims where a party, other than the party recording the mortgage assignment, took possession of the note before the assignment was recorded.[8]

The *Provident Bank* case involved the execution of duplicate original notes and mortgages that were sold by the mortgage banker, Community Home Mortgage Corp. ("Community"), to Southwest Securities Bank ("Southwest") and RBMG, Inc. ("RBMG") pursuant to mortgage purchase agreements. These agreements were entered into separately with each of the companies without the knowledge of the other.[9] This "double booking" scheme involved not only having the borrower sign duplicate original notes and mortgages, but also the execution of duplicate original assignments in recordable form. This resulted in double funding to Community by these lenders. After the loan was sold, only one of the lenders would be paid in full. As a result of Community's fraud, there were nine loans sold to both Southwest and RBMG for which they each claim a priority interest.[10]

When Southwest and RBMG purchased the loans from Community they each took possession of an original note and assignment, and they recorded the assignments of the mortgages. Southwest took possession of the notes *after* RBMG in the case of all but one loan, which it received on the same day.[11] For five of the loans Southwest recorded its assignments of the mortgages *before* RBMG, and argued that it had a priority interest in these loans under Section 291. Community did not endorse any of the notes delivered to

Southwest, but endorsed seven of the notes delivered to RBMG. Neither party knew of the previously issued or recorded assignments at the time of purchase.[12] If priority of these competing claims was determined under Section 291, it is clear that the first party to record the assignment has priority. However, under the principle that "the mortgage follows the note," the issue is whether Article 9 of the Uniform Commercial Code should govern in this case. The court concluded that prior case law analyzing Section 291 did not determine the issue of perfection of a security interest in the note, only perfection of a security interest in the mortgage, and turned its attention to Article 9.[13]

III. UNIFORM COMMERCIAL CODE ARTICLE 9

To perfect a security interest in a note under Article 9, the secured party must take possession of the note. Possession of the note perfects the right to payment, regardless of what actions are taken by a payee with respect to recording the mortgage or assignment.[14] Applying this principle, the court in the *Provident Bank* case determined that RBMG had priority with respect to the eight loans it took possession of prior to Southwest.[15] To determine who had priority with respect to the one loan that RBMG and Southwest took possession of on the same day, the court did not turn to Section 291 of the Real Property Law. Instead, the court examined the parties' rights under Article 3 of the Uniform Commercial Code relating to holders in due course.[16]

IV. UNIFORM COMMERCIAL CODE ARTICLE 3

Article 3 of the Uniform Commercial Code defines a holder in due course as a (1) holder (2) of a negotiable instrument (3) who took it for value, (4) in good faith, and (5) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of another.[17] The Court concludes that RBMG is a "holder" of the loan in question since they are in possession of the note, and the note has been endorsed to them. Both parties concede that the note is a negotiable instrument that has been purchased for value. RBMG meets the good faith requirement because "good faith" under Article 3 requires honesty only, and does not require the exercise of due care.[18] At the time that RBMG purchased the disputed loans from Community, it had no knowledge or notice of any claims or defenses against the enforcement of the notes and mortgages. RBMG also had no actual knowledge that Community had executed duplicate original notes for the same loans to Southwest. Thus RBMG purchased the note without notice of any claim, and is a holder in due course of the note.[19] Southwest cannot claim the status of holder in due course because the notes to Southwest were never endorsed. It is the endorsement on the note that vests RBMG with holder status. Southwest is merely a transferee, entitled only to the same rights that Community has in the instruments, and subject to the same defenses that could be asserted against Community.[20] Therefore, RBMG has priority with respect to the remaining loan under Article 3.[21]

The rights of a holder in due course were previously analyzed in the case *In re AppOnline.com, Inc.*,[22] In the this case plaintiff, Countrywide Home Loans, Inc., ("Countrywide") agreed to sell a parcel of land to Randy St. Louis, and St. Louis obtained a loan commitment from Island Mortgage Network, Inc. ("IMN"). At the closing National Settlement Services Corp. ("NSS") acted as settlement agent for IMN.[23] St. Louis executed a mortgage to secure the transaction and a promissory note payable to IMN. NSS issued a number of checks at the closing, including a check to Countrywide for the balance of the purchase price of the property. This check was not certified, nor a bank or teller's check. At the closing Countrywide delivered the deed to St. Louis, and the deed and mortgage were recorded.[24]

Prior to the closing, Residential Mortgages of Texas, Inc. ("RMST") had arranged to purchase the St. Louis loan. Pursuant to the terms of the mortgage purchase agreement, IMN endorsed the St. Louis note in blank and sent it to RMST. Three days after the closing RMST received the St. Louis note and a certified copy of the St. Louis mortgage.[25] The NSS check to Countrywide never cleared due to a stop payment order issued by NSS. RMST had no knowledge of the stop payment order and no notice of Countrywide's claim to the mortgage proceeds when it took possession of the St. Louis note.[26] In order to determine the rights between RMST and Countrywide, the court first had to determine whether RMST was a holder in due course under Article 3 of the Uniform Commercial Code.

There is no dispute that RMST is a "holder" of the St. Louis note as defined by Article 3; RMST is in possession of a note that has been endorsed to it.[27] What Countrywide contests is whether the St. Louis note qualifies as a negotiable instrument. To qualify as a negotiable instrument, a document must: (a) be signed by the maker or drawer; (b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by Article 3; (c) be payable on demand or at a definite time; and (d) be payable to order or to bearer.[28] Countrywide does not dispute that the note was signed by Randy St. Louis, but argues that the note failed to meet the requirements of subparts (b), (c) and (d) set forth above.

The St. Louis note contains a provision to make monthly payments of a certain amount, commencing on a specified date, at a fixed interest rate. The note also refers to the mortgage, and sets forth some of the conditions contained in the mortgage which may accelerate the amounts due under the note.[29] Countrywide alleges that this language destroys the negotiability of the note. However, N.Y.U.C.C. § 3-119 makes it clear that the existence of a separate agreement does not affect the negotiability of any instrument. In addition, N.Y.U.C.C. § 3-105(1) states that a promise or order that is otherwise unconditional is not made conditional because it refers to a separate agreement concerning rights to prepayment or acceleration. The St. Louis note does not state that it is "governed by" or "subject to" the mortgage, and clearly sets forth the dollar amount owed by the borrower. The references to the mortgage relate only to additional security provided to the lender, and are not meant to alter the obligation to pay under the note.[30] Numerous courts have ruled on this issue.[31]

Countrywide further argues that the St. Louis note is not payable on demand or at a definite time due to the acceleration language. N.Y.U.C.C. 3-105(1)(c) and the Official Commentary clearly state that referring to acceleration rights only destroys negotiability if the reference provides that payment must be made in accordance with the terms contained in the mortgage. An instrument is payable at a "definite time" if, by its terms, it is payable at a definite time, even if it states payment is subject to acceleration. The court found that New York case law is clear, and the possibility of acceleration does not destroy the negotiability of the note.[32] Countrywide also questioned whether the St. Louis note was payable to "order or bearer". N.Y.U.C.C. 3-110(1) states that an instrument is payable to order when it specifies the payee with reasonable certainty. The St. Louis note designated IMN as the lender, and is therefore clearly payable to order. Based on the above analysis, the court concluded that the St. Louis note is a negotiable instrument.[33]

In continuing its analysis as to whether RMST is a holder in due course, the court next examined whether RMST acquired the St. Louis note for value. It is undisputed that RMST paid IMN for the note, and therefore took the note for value. RMST also took the note in good faith, which requires honesty only. The court found that RMST met its burden of good faith with respect to this transaction.[34] Finally, the court examined whether RMST had notice of a claim or defense to the note. N.Y.U.C.C. 3-304(7) states that to construe notice of a claim or defense, the purchaser must have notice or knowledge of such facts that his action in taking the instrument amounts to bad faith. The court found that there was no evidence that RMST had the required notice or knowledge of any claims or defenses against the enforcement of the St. Louis note and mortgage. Therefore, RMST is a holder in due course.[35]

As a holder in due course of the note RMST is immune from the defense of failure of consideration, which Countrywide asserted, because RMST did pay value for its security interest in the St. Louis note.[36] Turning our attention to the mortgage, does RMST also take the St. Louis mortgage subject to Countrywide's claim of failure of consideration? Case law is clear that a holder in due course of a note secured by a mortgage is free from those defenses that could not be raised against the note itself.[37] Therefore, RMST holds both the St. Louis note and mortgage free of any claims or defenses on the part of Countrywide or St. Louis.

V. GOOD FUNDS STATUTES

To address the situation where a lender fails to fund a loan which has already closed, a number of states have enacted "Good Funds" statutes. Despite the fact that the provisions of these statutes vary from state to state, the purpose remains the same: to ensure that borrowers do not have a mortgage recorded against their property unless they receive the proceeds of the loan. Some statutes prohibit the mortgagee from recording the mortgage until the full amount of the proceeds of the loan have been delivered to the mortgagor.[38] Other statutes prohibit settlement agents from disbursing proceeds unless the proceeds are "collected funds" as defined by the statute.[39] The majority of states have not included specific consequences in their statutes for noncompliance, but noncompliance under some statutes results in the invalidity of all documents delivered at the time of closing, including the deed and loan documents, as well as provisions for penalities.[40] New York has not yet enacted a "Good Funds" statute.

VI. CONCLUSION

As the number of fraudulent banking transactions continue to rise, courts have had to determine the competing claims of innocent parties. The results, at times, are harsh. In some states, the enactment of "Good Funds" statutes has helped guide the courts and protect the consumer. The *Provident Bank* and *AppOnline* cases provide two examples of innocent parties who were victimized by unscrupulous mortgage lenders. In the *Provident Bank* case "Southwest" lost its priority and ability to collect the funds it advanced. In *AppOnline* Mr. St. Louis owes RMST repayment of a note for money he never received. In addition, Countrywide lost title to property it owned for which it was not fully compensated and is now subject to a mortgage held by RMST. The time has come for the enactment of "Good Funds" statutes and for the courts to consider a more equitable approach when deciding these cases.

ENDNOTES

1 N.Y. Real Property Law 291 (McKinney 2006).

2 *Doyle v. Lazarro,* 33 A.D.2d 142, 144, (3rd Dept 1970) 306 N.Y.S.2d 268, 270, granting title to a subsequent purchaser who recorded his deed, over the holder of an unrecorded tax lien; *Household Fin. Realty Corp. v. Emanuel,* 2 A.D.3d 192, 193 (1st Dept 2003), 769 N.Y.S.2d 511, holding that a prior mortgage lost its priority to a subsequent mortgage that was recorded first by a good faith lender for value without knowledge of the prior loan; *Builders Equity, Inc. v. Lockport Bldg. Corp.,* 17 Misc.2d 967, 1969 (1959), 185 N.Y.S.2d 595, 596-97, the purchase of the mortgage that was first recorded was held to have a prior and superior lien where the mortgagor executed two mortgages on the same property.

3 *Washington Mutual Bank v. Peak Health Club, Inc.,* 2005 N.Y. Misc. LEXIS 3392, 233 N.Y.L.J. 123 (N.Y. Sup. Ct. 2005), *aff'd,* 48 A.D.3d 7932 (2nd Dept 2008), 853 N.Y.S.2d 112.

4 *Id.*

5 *Id.*

6 *Provident Bank v. Community Home Mortgage Corp,* 498 F.Supp.2d 558 (E.D.N.Y. 2007).

7 *Id.* at 568.

8 *Id.* at 569.

9 *Id.* at 563.

10 *Id.*

11 *Id.* at 564.

12 *Id.*

13 *Id.* at 569.

14 N.Y.U.C.C. 9-304(1) (McKinney 2002).

15 *Provident Bank v. Community Home Mortgage Corp.,* 498 F.Supp2d 558, 572 (E.D.N.Y. 2007).

16 *Id.* at 573.

17 N.Y.U.C.C. 3-302(1) (McKinney 2001).

18 *Provident Bank v. Community Home Mortgage Corp.,* 498 F.Supp2d 558, 574 (E.D.N.Y. 2007).

19 *Id.* at 574-75.

20 *Id.* at 576.

21 *Id.*

22 *In re AppOnline.com, Inc.,* 290 B.R. 1 (Bankr. E.D.N.Y. 2003).

23 *Id.* at 4.

24 *Id.*

25 *Id.*

26 *Id.* at 5.

27 N.Y.U.C.C. 3-302(1) (McKinney 2001).

28 N.Y.U.C.C. 3-104(1) (McKinney 2001).

29 *In re AppOnline.com, Inc.,* 290 B.R. 1, 11 (Bankr. E.D.N.Y. 2003).

30 *Id.*

31 *Enoch v. Brandon,* 249 N.Y. 263, 267, 164 N.E. 45, 47 (1928); *Felin Associates, Inc. v. Rogers,* 38 A.D.2d 6, 9, 326 N.Y.S.2d 413 (1st Dep't 1971); *First Nat. City Bank v. Valentine,* 62, Misc.2d 719, 720, 309 N.Y.S.2d 563, 564 (Sup. Ct. Nassau Co. 1970); and *Gramatan Co., Ltd. v. D'Amico,* 50 Misc.2d 233, 234, 269 N.Y.S.2d 871, 872 (Sup. Ct. Suffolk Co. 1966).

32 *In re AppOnline.com, Inc.,* 290 B.R. 1, 15 (Bankr. E.D.N.Y. 2003).

33 *Id.* at 16.

[34] *Id.* at 16-17.

[35] *Id.* at 18.

[36] *Id.* at 19.

[37] *Id.* at 21.

[38] Mass. Gen. Laws ch. 183, §63B (1994).

[39] Ga. Code Ann. tit. 44, § 14-1 (2008); Ohio U.C.C. 1349.21 (1996); Colo.Rev.Stat. §38-35-125 (1987); Neb. Rev. Stat. §44-19, 116 (2003); Wis. Stats. §708.10 (1995).

[40] N.C. Gen. Laws ch. 45A (1995); Tenn. Code Ann. ch. 47-32 (2005).

THE DEMANDING FIDUCIARY DUTIES OF NOT-FOR-PROFIT DIRECTORS AND OFFICERS

by
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INTRODUCTION

The presidents and boards of United Way[1] and Adelphi University[2] acted in manners which indicated that they either did not care or did not know the fiduciary standards which they needed to exercise. President William Aramony of the United Way of America spent the time of his tenure from 1970 through 1992 at this not-for-profit enterprise using its funds and resources in many cases for his own personal benefit. He appointed board members who were his friends, rewarded family members with jobs, rented limousines, took transatlantic flights and awarded contracts with scant thought of benefit to United Way. Adelphi University's president, Peter Diamandopoulos, in like manner, ruled the governing board of this not-for-profit entity during his tenure from 1985 through 1995. He misappropriated funds and lavished expenditures upon himself.

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