Borrowers and Bankruptcy Trustees’ Unsuccessful Attempts to Avoid a Mortgage Under the “Splitting-the-Note” Theory

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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 mostly 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


\(^3\) 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.

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 a transfer of a [mortgage or of a] deed of trust by way of MERS ‘splits’ the note from the deed of trust, thus rendering both null.” 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 of 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, a bankruptcy court in Georgia rejected the “splitting-the-note” argument and held that a note was fully secured because (1) “[t]he [n]ote was secured by the [s]ecurity [d]eed, which was properly perfected at its inception and was never released or cancelled”; (2) “[w]hen the [n]ote and [s]ecurity [d]eed were physically separated, there was neither contractual language nor any statutory provision which stripped the security from the debt”; (3) “[t]he physical separation of the [n]ote and [s]ecurity [d]eed affected, if anything, the standing of the noteholder to enforce the [n]ote and the deedholder to enforce the [s]ecurity [d]eed”; and (4) “[t]he post-petition assignment [of the security deed] did not violate the automatic stay.”

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. The debtors executed a security deed to

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5 Martins v. BAC Home Loans Servicing, L.P., 722 F.3d 249, 254 (5th Cir. 2013).
7 Id. at 380.
8 See id. at 378.
secure the note. The security deed, which was recorded in the county land records, named MERS “as grantee and nominee for CBE and its successors.” The security deed also granted MERS “the right to foreclose and sell the [p]roperty” for CBE and any of CBE’s successors and assigns. The note was subsequently reassigned several times, “with different entities taking possession, ownership, and servicing rights.” Similarly, the security deed was “transferred at least once.” On or about August 4, 2009, Ocwen Loan Servicing, LLC (“Ocwen”) became the servicer of the loan. On or about April 29, 2010, “almost three months after [the d]ebtors filed” for bankruptcy, MERS transferred the security deed to Ocwen. Ultimately, after numerous transfers, the note and the security deed were “physically united” in Ocwen’s possession.

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.” The trustee challenged the security deed and note 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. Second, the trustee argued “that the post-petition transfer of the [n]ote and the [s]ecurity [d]eed violated the automatic stay.” Third, the trustee argued that MERS could not be a “grantee” in the security deed.
deed because MERS did not receive payments for a loan on behalf of a grantor, and as a result, the security deed was “ineffectual.”

The *Corley* court rejected the trustee’s arguments. First, the *Corley* court held that the note was secured. Under Georgia law, which applied in this instance, the court noted that when a security deed is transferred, “the accompanying indebtedness” also transfers. Therefore, in Georgia, transferring a security deed does not as a matter of law split a security deed and a note. Thus, the *Corley* court found the trustee’s reliance on both the Restatement (Third) of Property (Mortgages) §5.4 and Missouri case law to be misplaced. In addition, the *Corley* court concluded that the note was secured because: (1) the note and the security deed were executed together at inception; (2) the security deed was properly perfected because it was recorded “in the county where the land conveyed is located”; (3) the security deed language, naming MERS as nominee, created an agency relationship; and (4) the “[s]ecurity [d]eed was [n]ever [e]xpressly [r]eleased or [c]ancelled” because the debtors had not paid the debt in full nor did they produce a cancelled security deed.

Second, the *Corley* court held “that the post-petition transfer of the [n]ote and the [s]ecurity [d]eed” 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

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21 *Id.* at 381.
22 *See id.* at 383–385.
23 *Id.* at 383.
24 *See id.*
25 *See* Restatement (Third) of Property (Mortgages) § 5.4 cmt. a (1997).
26 *See* Bellistri v. Ocwen Loan Servicing, LLC, 284 S.W.3d 619 (Mo.App. 2009).
27 *See id.* at 382.
28 *See id.* at 380.
29 *See id.* at 381 (noting “MERS can only act on behalf of CBE” thus making it “a limited agency”).
30 *Id.*
31 *Id.* at 379.
[d]eed itself at the time of [the] post-petition transfer." 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. Third, according to the Corley court, the trustee’s argument that MERS could not be a grantee in the security deed was “disingenuous.” The security deed’s “plain and clear” language designated MERS as grantee of the security deed and nominee for the lender on the note. Indeed, the security deed in relevant part:

1. A statement that it secures payment of a specified indebtedness.
2. A power of attorney authorizing the grantee or his assigns to sell the property upon default, applying the proceeds first to the satisfaction of his debt.
3. A statement that upon full payment of the debt, the grantee or his assigns will cancel the deed or reconvey the property to the grantor.

Therefore, the Corley court held that the security deed was enforceable because the note and the security deed were not split since they were executed together at inception, the security deed was properly recorded, the security deed language, naming MERS as nominee, created an agency relationship, and the security deed had not been cancelled.

b. Massachusetts Law

Similarly, in In re D’Alessandro, a bankruptcy court in Massachusetts held that one of the two mortgages against the debtor’s home was not void even though (1) MERS did not hold the note secured by the mortgage given to MERS as nominee of the original lender; (2) the original lender no longer holds the note; and (3) the servicer of the note and mortgage were

32 Id. at 385.
33 See id.
34 Id.
35 Id.
36 Id. (citation omitted).
either assigned to a new party or the new party did not hold an assignment of the note or mortgage.  

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. The debtors’ obligations under the note were secured by a mortgage granted to MERS as GB’s nominee. GB dissolved. However, an assignment of the mortgage had not been recorded. 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, seeking, among other things, a determination that the mortgage was void. The trustee alleged that both the note and the mortgage may have been assigned to GMAC Mortgage, LLC (“GMAC”) or that GMAC might have been servicing the note.  

The *D’Alessandro* court rejected the trustee’s two arguments asserting that the mortgage was void. First, the *D’Alessandro* court held the mortgage was valid even if the mortgage had been split from the note. In particular, the court reasoned that unless the debtors had paid the note in full, the obligations arising under the note still existed. Moreover, the *D’Alessandro* court emphasized that the trustee alleged that MERS held the mortgage only as GB’s nominee, so that if GB dissolved, MERS would be “precluded from acting on behalf of GB’s successors or

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38 See id. at *2 (noting trustee alleged such facts).
39 See id. at *5.
40 See id. at *3.
41 See id.
42 See id.
43 See id.
44 See id. at *3–*4.
45 See id.
46 See id. at *13–*16.
47 See id. at *14.
48 See id.
assigns."⁴⁹ The D’Alessandro court 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 found that unless and until MERS takes action 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 a mortgage need not be recorded in order to be effective “except in the foreclosure context.”⁵² The D’Alessandro court concluded, however, that recording mortgage assignments is encouraged.⁵³ Therefore, the D’Alessandro court held that the mortgage was not void.

c. Virginia Law

The Fourth Circuit, in Tapia v. U.S. Bank,⁵⁴ affirmed a bankruptcy court, which held that MERS was authorized to foreclose on the debtors’ property pursuant to the deed of trust.⁵⁵ In Tapia, the debtors took out two loans from and executed two notes in favor of First Savings Mortgage Corporation to purchase real property.⁵⁶ The debtors executed two deeds of trust to secure their obligations under the notes.⁵⁷ Both deeds of trust named MERS as the beneficiary.⁵⁸ 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

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⁴⁹ Id. at *14.
⁵⁰ Id. (quoting In re Marron, 455 B.R. 1, 7 (Bankr. D. Mass. 2011)).
⁵² Id. at *15.
⁵³ See id.
⁵⁶ See id.
⁵⁷ See id.
⁵⁸ See id. at 693.
required of Lender including, but not limited to releasing and canceling this Security Instrument.\textsuperscript{59}

The deeds of trust also provided that the note could be sold without notifying borrower.\textsuperscript{60}

The debtors claimed that only the lender could foreclose on the property.\textsuperscript{61} However, the court rejected this argument because, as noted above, the deed of trust “authorized MERS to foreclose [and sell] the [p]roperty” if the debtors defaulted on their loan.\textsuperscript{62} Indeed, the debtors agreed to this when they signed the deeds of trust.\textsuperscript{63} Therefore, MERS was authorized to foreclose on the debtors’ property.\textsuperscript{64}

d. Texas Law

The Fifth Circuit, in \textit{Martins v. BAC Home Loans Servicing, L.P.},\textsuperscript{65} held that foreclosure was proper, rejecting the borrower’s argument that combined the “splitting-the-note” theory and the “show-me-note” theory.\textsuperscript{66} In \textit{Martins}, the borrower refinanced his home mortgage loan with BSM Financial (“BSM”) in 2003.\textsuperscript{67} As part of such refinancing, the debtor executed a note in favor of BSM.\textsuperscript{68} The debtor executed a mortgage to secure his obligations under the note, which named MERS “as the beneficiary and nominee for BSM and its assigns.”\textsuperscript{69} In 2010, “MERS assigned the mortgage to BAC,” and the transfer was recorded.\textsuperscript{70} In 2011, after the debtor defaulted under the note, BAC foreclosed on his home.\textsuperscript{71}

\textsuperscript{59} Id. at 693.
\textsuperscript{60} See id.
\textsuperscript{61} See id. at 696.
\textsuperscript{62} Id. at 697.
\textsuperscript{63} See id.
\textsuperscript{64} See id. at 692.
\textsuperscript{65} Martins v. BAC Home Loans Servicing, L.P., 722 F.3d 249 (5th Cir. 2013).
\textsuperscript{66} See id. at 256.
\textsuperscript{67} See id. at 252.
\textsuperscript{68} See id.
\textsuperscript{69} Id.
\textsuperscript{70} Id.
\textsuperscript{71} See id.
Following the foreclosure, the debtors “sued [BAC] in state court, claiming wrongful foreclosure, promissory estoppel, and negligent misrepresentations.”\textsuperscript{72} Specifically, the debtor claimed “that the note was not properly transferred to BAC” and that MERS’s assignment to BAC “was ‘robosigned’ and therefore ‘forged.’”\textsuperscript{73} The debtor claimed that as a result, BAC could not foreclose on his home because BAC neither held the note nor owned the mortgage.\textsuperscript{74} However, the court rejected this claim, holding that the mortgage assignment from MERS to BAC was valid because it was “a signed, notarized assignment document” that was recorded in the county land records.\textsuperscript{75}

BAC removed to federal court and moved for summary judgment.\textsuperscript{76} The district court granted BAC’s summary judgment motion.\textsuperscript{77} The debtors then appealed to the Court of Appeals for the Fifth Circuit, which affirmed the district court’s ruling.\textsuperscript{78}

The debtor argued that when MERS assigned the mortgage to BAC, it “split the note from the deed of trust,” and thus “BAC could not foreclose because BAC had a meaningless piece of paper rather than a debt on which it could foreclose.”\textsuperscript{79} The court noted that this argument merged two common theories, “the show-me-the-note” theory and the “splitting-the-note” theory.\textsuperscript{80} 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.’”\textsuperscript{81} Under Texas law, this theory has been unsuccessful because a mortgagee is permitted to foreclose even if the mortgagee does not possess the original note, so long as the mortgagee produces a photocopy of
the original note accompanied by an affidavit.\textsuperscript{82} The court also rejected the “splitting-the-note” theory, which posits that when a note and a deed of trust are split, both are considered null.\textsuperscript{83} Under Texas law, this theory mortgagees are permitted to foreclose without holding or owning the note.\textsuperscript{84} And since MERS qualified as a mortgagee, MERS was permitted to foreclose without holding or owning the note.\textsuperscript{85} Therefore, BAC was authorized to foreclose on the debtors’ home.\textsuperscript{86}

II. “There is No Such Thing as a ‘Free House’”\textsuperscript{87}

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.”\textsuperscript{88} 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,\textsuperscript{89} which in turn would threaten the lender’s recovery if the borrower defaults.

\textsuperscript{82} See id. (citation omitted).
\textsuperscript{83} See id. at 254.
\textsuperscript{84} See id. at 255.
\textsuperscript{85} See id.
\textsuperscript{86} See id.
\textsuperscript{87} In re Marron, 455 B.R. 1 (Bankr. D. Mass. 2011).
\textsuperscript{88} 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.
\textsuperscript{89} See In re Cash, 2013 WL 1191745 (Bankr. N.D. Tex. 2013).
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.

**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.