

In re CHURCHILL MORTGAGE INVESTMENT CORP.
233 B.R. 61 (Bankr. S.D.N.Y. 1999)

ADLAI S. HARDIN, Jr., Bankruptcy Judge.

At issue on this motion for summary judgment is the disputed entitlement to real property located at 24 William Street, Ossining, New York (the "Property"), legal title to which was acquired by Churchill Mortgage Investment Corp. ("CMIC" or the debtor) upon its foreclosure of a mortgage it held against the Property. Upon an application by the Chapter 7 Trustee (the "Trustee") to sell the Property, eight investors (the "Objectants") claimed a superior ownership interest in the Property through devolution of certain fractional interests in the underlying note and mortgage purportedly assigned to them. On the documents and facts stipulated by the parties, I conclude that the Objectants' claims are for unsecured loans to the debtor, and that they have no right to or property interest in the underlying note and mortgage or the Property itself. Further, even if the Objectants, as collateral assignees, could be deemed to hold secured interests in the Property as proceeds of the foreclosed mortgage, such interests are unperfected and subordinate to the Trustee's rights as hypothetical lien creditor under 11 U.S.C. § 544(a).

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Factual Background

CMIC is one of several debtor companies owned or controlled by Gerald Hirsch which invested in real estate in New York. The Court takes judicial notice of the pervasive allegations throughout these Chapter 7 proceedings that Gerald Hirsch (who was indicted and has pleaded guilty to certain charges in the United States District Court for the Southern District of New York) operated the debtor entities in a manner analogous to a "Ponzi scheme." It is alleged, in substance, that numerous persons were induced to loan money to or invest money in the debtor entities in the belief that the loans or investments were secured or backed by real estate or real estate mortgages when, in fact, there were not....

In mid-January 1990 eleven investors (the "Original Investors") contributed a total of \$84,500 to CMIC which placed the funds as they were received in CMIC's main bank account commingled with other funds. On January 26, 1990 CMIC loaned \$84,500 to Lawrence and Nanette Fullwood, who executed a note (the "Fullwood Note") in favor of CMIC in the principal amount of \$84,500 secured by a mortgage on the Property in favor of CMIC (the "Fullwood Mortgage"). In April 1991, the Fullwoods defaulted on the Note. In October 1991 CMIC commenced an action to foreclose the Fullwood Mortgage captioned "on behalf of" all eleven of the Original Investors, resulting in an amended judgment of foreclosure and sale on July 7, 1993. In December 1993, CMIC purchased the Property at the foreclosure auction for \$1,000. The amount then outstanding on the Fullwood Note and Mortgage was \$106,761.92. The referee's sale deed, which was never recorded, was made out in the name of CMIC only.

.... Each Original Investor's relation with CMIC was governed by an "Investor's Agreement," described more fully below. The Original Investors received from CMIC purported

assignments (the “Assignments”) of their fractional interests in the Fullwood Note and Mortgage and the Assignments were filed with the County Clerk. Each of the Original Investors received a certificate entitled “Mortgage Note” Seven of the Original Investors are objectants on this motion. The other four Original Investors received full repayment of their investments Three of the Objectants made additional investments totaling \$19,500 and received Mortgage Notes referencing the Property, two of which were made in January 1992, after the default on the Fullwood Mortgage. The eighth Objectant ... invested \$10,000 with CMIC and received a Mortgage Note referencing the Property.... CMIC did not execute assignments with respect to the subsequent investments by ... the[se] “Subsequent Investors.”

CMIC never told any of the Investors about the Fullwoods’ default or the foreclosure sale. Although the Fullwoods defaulted in April 1991, CMIC did not default in its obligations to any of the Original or Subsequent Investors until February 1997, almost six years later. Thus, CMIC repaid the principal on their loans to four Original Investors when demanded and paid monthly interest to all of the Investors on their outstanding loans through January 1997. The annually adjusted interest rates paid to the Investors ranged from a high of 13% at the outset to a low of 8%. The interest rate under the Fullwood Note was 17%.

Discussion

Objectants argue, alternatively, either that they were outright owners by assignment of the Fullwood Mortgage, or that they were pledgees of and had a security interest in the Fullwood Mortgage. In either case, Objectants assert that CMIC (and, therefore, the Trustee) held the Fullwood Mortgage and, after foreclosure, the Property in a relationship of trust for the account of Objectants. The Trustee contests Objectants’ alternative claims of ownership or secured party status and, further, maintains that the Objectants’ putative security interest was unperfected and therefore subordinate to the Trustee’s position under 11 U.S.C. § 544 as hypothetical lien creditor....

Preliminarily, it is important to take note of the obvious. Objectants do not claim that they were granted title to or a security interest in *the Property* by either the Fullwoods or by CMIC. There is no such document. The Objectants’ claim to the Property derives from and depends upon their alleged interests in the Fullwood Note and Mortgage. The claim is that by reason of the recorded Assignments to the Original Investors from CMIC, CMIC granted the Original Investors either an ownership interest or a security interest in the Fullwood Note and Mortgage, which interest attached to the Property after the Mortgage was foreclosed.

It is also significant that the Fullwoods owed no obligation to the Investors, only CMIC did. The Fullwood default in 1991 was not a default as to the Objectants. Thus, the Objectants lack a fundamental predicate to their claim – a default by CMIC in its payment obligations to the Investors at any time before the foreclosure. Objectants could not have exercised any right of foreclosure against the Property based on the Assignments to them of the Fullwood Mortgage because CMIC maintained its payment obligations to all the Investors through January 1997, more than three years after the foreclosure of the Fullwood Mortgage.

* * *

As a matter of fact and law, the Original Investors had no ownership interest in the Fullwood Mortgage – their sole interest resulting from their investments in CMIC was that of a lender to CMIC. Since the Original Investors including the Objectants had no ownership interest in the Fullwood Mortgage, they had no ownership interest in the Property which was the subject of the Fullwood Mortgage either before or after the foreclosure sale.

* * *

As an alternative to outright ownership by assignment, Objectants argue that they had a security interest in the Fullwood Mortgage

While the matter is not free from doubt, for purposes of decision this Court will assume, without deciding, that the purpose and effect of the Investor’s Agreement and the recorded Assignments was the grant by CMIC to the Original Investors of a security interest in the Fullwood Note and Mortgage. It will further be assumed that the Property may be regarded as the proceeds of CMIC’s foreclosure of the Fullwood Note and Mortgage.

The threshold issue, then, is whether the Objectants’ security interest in the Fullwood Note and Mortgage was converted to a security interest in the Property as proceeds of the foreclosed Fullwood Mortgage. The answer turns on Section 9-[315(a)] of the New York Uniform Commercial Code, under which [only an unsecured] security interest attaches to proceeds unless the security interest in the foreclosed collateral was perfected....

[The court, applying the pre-1999 version of Article 9, found that the Original Investors failed to perfect their security interest in the Fullwood Note and Mortgage because the Original Investors never took possession of the Fullwood Note and Mortgage. Because they did not have a perfected security interest in the collateral, the Original Investors thus did not have a perfected security interest in the Property as proceeds of the Fullwood Note and Mortgage.]

Objectants’ argument that “since this Court is being asked to decide the rights of the parties to real property, UCC Article 9 is inapplicable” has been considered and expressly rejected by the courts....

Although ultimately we are concerned here with real property, the issue turns upon whether the Objectants have a security interest in the proceeds of a foreclosed mortgage, and that issue turns on whether the Objectants had a perfected security interest in the Fullwood Mortgage and Note which are personalty governed by Article 9 of the UCC. Although the UCC does not apply to security interests in real estate, *see* UCC § 9-[109(d)(11)], Article 9 does apply where a note and mortgage (*i.e.*, “instruments”) are the collateral which is pledged to secure a debt. *See* UCC § 9-[109(b)] and Official Comment [7] thereto

To summarize, even assuming that Objectants had a valid lien against the Fullwood Mortgage to secure their loans to CMIC, that lien did not and could not attach to the Property as proceeds of the Fullwood Mortgage as a matter of law. Objectants’ alleged security interests in the Fullwood Mortgage were governed by Article 9 ... under UCC § 9-[109(b)]....

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Objectants never had ownership of or legal title to the Property. They had no contractual relationship with the Fullwoods. They had no right to ownership of or legal title to either the Fullwood Mortgage or the Property under the Investor's Agreement and the Mortgage Note, which defined their rights respecting their loans to CMIC. To the extent that the Original or Subsequent Investors had any equitable or other right or expectation as against CMIC with respect to the Property, that equitable right or expectation as against CMIC with respect to the Property, that equitable right or expectation did not mature until CMIC's default in February 1997. Assuming that the Investors' undocumented equitable right or expectation with respect to the Property could somehow be characterized as a security interest, that security interest was unperfected, unknown and unknowable to the world at large, and it would be subject to the Trustee's power of avoidance under 11 U.S.C. § 544(a)....