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Washington Supreme Court Limits Remedy of Nonjudicial Foreclosure to Holders of Negotiable Instruments

*By Rhys W. Hefta, Kari L. Larson and Christian Scarlett**

In this article, the authors examine a recent court decision that concluded that only a “holder” of a negotiable instrument, as contemplated by the Uniform Commercial Code, can satisfy the prerequisites for conducting a nonjudicial trustee’s sale of a property under the Washington Deed of Trust Act.

The Washington Supreme Court has published a decision in the case of *Vargas v. RRA CP Opportunity Trust 1* that may have significant ramifications for residential and commercial real estate lenders in the State of Washington. In responding to questions certified to it by the U.S. District Court for the Western District of Washington, the court built upon a line of precedent, including the landmark *Bain v. Metro. Mortg. Grp., Inc.*,¹ to conclude that only a “holder” of a negotiable instrument, as contemplated by the Uniform Commercial Code (UCC), can satisfy the prerequisites for conducting a nonjudicial trustee’s sale of a property under the Washington Deed of Trust Act (DTA).

While the case in question arose in the context of a home equity line of credit (HELOC) and a section of the DTA specific to one-to-four unit residential properties, the logic of the court’s decision in *Vargas* would appear to extend to commercial financing as well, with substantial implications for a broad range of transactions.

At a fundamental level, the decision in *Vargas* appears to eliminate the remedy of nonjudicial foreclosure for deeds of trust securing credit agreements, bond indentures, derivative instruments, guaranties, and other non-promissory note debt instruments, as well as deeds of trust securing promissory notes evidencing construction loans, lines of credit and similar facilities with varying principal amounts, and any other promissory note that, inadvertently or by design, does not satisfy the strict criteria for a negotiable instrument under the UCC.

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¹ 175 Wn.2d 83, 92-93, 285 P.3d 34 (2012).

FACTS OF THE VARGAS CASE

Briefly, Gabriel Marquez Vargas obtained both a mortgage loan and a HELOC to finance the acquisition of a home in 2005. The HELOC had a 60-month draw period followed by a 180-month repayment period. In 2011, shortly following the expiration of the draw period, Marquez Vargas defaulted on the repayment of the HELOC. After several assignments of the HELOC and the deed of trust securing it, Real Time Resolutions Inc. (RTR), the servicer of the debt on behalf of RRA CP Opportunity Trust 1 (RRA), executed a beneficiary declaration confirming that RRA was the “holder” of the HELOC agreement. Such a declaration is a prerequisite to commencing a nonjudicial trustee’s sale under the DTA with respect to residential properties containing one to four units.² Marquez Vargas sued in federal court to block the sale.

CERTIFIED QUESTIONS

The District Court certified two questions to the Washington Supreme Court as follows:

- (1) Whether a typical HELOC agreement that has a closed draw period and specified maturity date is a negotiable instrument under Article 3 of Washington’s Uniform Commercial Code? . . .
- (2) Whether an alleged beneficiary under the Deed of Trust Act satisfies the requirement to show that it is ‘the holder of any promissory note or other obligation secured by the deed of trust,’ [RCW]³ 61.24.030(7)(a), by executing a declaration under penalty of perjury attesting that it is the holder of a HELOC agreement?”⁴

The Washington Supreme Court answered “No” to both of these questions.

THE WASHINGTON SUPREME COURT’S ANALYSIS

The court noted that the DTA does not include a definition of “Holder,” and then cited its own precedent, most notably *Bain*, for the proposition that the UCC is the appropriate source for this definition.

² See RCW 61.24.030, which reads “It shall be requisite to a trustee’s sale: . . . (7)(a) That, for residential real property of up to four units, before the notice of trustee’s sale is recorded, transmitted, or served, the trustee shall have proof that the beneficiary is the holder of any promissory note or other obligation secured by the deed of trust. A declaration by the beneficiary made under the penalty of perjury stating that the beneficiary is the holder of any promissory note or other obligation secured by the deed of trust shall be sufficient proof as required under this subsection.”

³ The Revised Code of Washington is referred to throughout this article as RCW.

⁴ A footnote contained in the quotation has been omitted.

The UCC definition of “Holder” is set forth in UCC 1-201(21)(A)⁵ as:

“Holder” with respect to a negotiable instrument, means:

(A) The person in possession of a negotiable instrument that is payable either to bearer or to an identified person that is the person in possession.

In this connection, the court notes the fact that the definition of Holder, while found in the general definitions section in Article 1 of the UCC, is used only in connection with negotiable instruments. As such, the court introduces the UCC definition of “Negotiable Instrument” from UCC 3-104(a)⁶ as follows:

An unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:

(1) Is payable to bearer or to order at the time it is issued or first comes into possession of a holder;

(2) Is payable on demand or at a definite time; and

(3) Does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise or order may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor, (iv) a term that specifies the law that governs the promise or order, or (v) an undertaking to resolve in a specified forum a dispute concerning the promise or order.

The court’s opinion discussed at length the history and function of negotiable instruments, the UCC principles countenancing a bifurcation between the ownership of a negotiable instrument and the right to enforce it, and its own recent precedent on the concept of “holder” under the DTA and the legislative history of amendments to the DTA in response to that precedent, among other things. Ultimately, though, the court’s decision turned on the straightforward definitional proposition that only a negotiable instrument can have a “holder.” As such, this article does not focus on that portion of the court’s analysis.

⁵ Codified in Washington at RCW 62A.1-201(21).

⁶ Codified in Washington at RCW 62A.3-104.

The HELOC in question in *Vargas* did not constitute “[a]n unconditional promise or order to pay a fixed amount of money,” because the principal amount of the HELOC was variable and dependent on whether the borrower requested and received advances. While the principal amount of the HELOC was in fact fixed at the time of the default, by virtue of the draw period having expired, the court rejected the argument that this rendered the HELOC a negotiable instrument. Since it was not a negotiable instrument when made, and since the payment terms were not ascertainable solely from the four corners of the document, it could never be a negotiable instrument. The court cited a prior appellate decision for the proposition that “[n]egotiability is determined from the face, the four corners, of the instrument at the time it is issued without reference to extrinsic facts.”⁷

Because the HELOC in *Vargas* could not satisfy the criteria for negotiability necessary to be classified as a negotiable instrument under the UCC, the beneficiary of the deed of trust securing the HELOC could never make the declaration that it was the “holder” of the obligation secured by the deed of trust as required under RCW 61.24.030. By extension, the beneficiary could never satisfy the prerequisite for a trustee’s sale under the DTA. The beneficiary in *Vargas*, then, would appear to be left with the option of pursuing a judicial foreclosure instead.

IMPLICATIONS

The application of *Vargas* in the residential context is quite clear, as any deed of trust securing a HELOC or similar residential or consumer debt instrument in Washington will no longer be susceptible to nonjudicial foreclosure. But that does not appear to be the end of the likely far-reaching application of this decision. While the court, responding to the specific questions certified by the trial court, focused on the beneficiary declaration requirement of RCW 61.24.030(7)(a), which is only applicable to one-to-four unit residential properties, it is important to note that the DTA defines the beneficiary for all purposes, residential and commercial, as “the *holder* of the instrument or document evidencing the obligations secured by the deed of trust, excluding persons holding the same as security for a different obligation.”⁸ The court cited *Bain* for the proposition that “holder” for purposes of the DTA should be defined in accordance with the UCC, and the decision in *Bain* turned on this very definition of beneficiary, and whether a party that was not the holder of a

⁷ *Bucci v. Nw. Tr. Servs., Inc.*, 197 Wn. App. 318, 329, 387 P.3d 1139 (2016), itself citing early sources as set out in full in *Vargas*.

⁸ RCW 61.24.005(2) (emphasis added).

note had the power to direct a trustee to commence a nonjudicial foreclosure. *Vargas* appears to simply extend the reasoning in *Bain* by looking not just to the identity of the purported holder but to the nature of the instrument purported to be held. There is no reason to think that this definitional analysis would be limited to the usage of “holder” in the narrow residential context of RCW 61.24.030(7)(a) when the definition of “beneficiary” applies to the entirety of the DTA.

Assuming that the logic of *Vargas* will extend to commercial transactions as well, there would appear to be a number of broad classes of indebtedness and other obligations in Washington traditionally secured by deeds of trust that would likely not qualify as negotiable instruments under the UCC. These would include deeds of trust securing:

- Credit agreements containing broad covenants and other obligations and with no separate promissory note;
- Bond indentures, derivative instruments, letters of credit, guaranties, indemnities, private liens, and other non-promissory note debt instruments;
- Construction loans, lines of credit, multiple advance notes, and other instruments that, by their nature, provide for a variable principal amount that cannot be specified at the inception of the instrument;
- Registered notes, which are transferable only by recordation in a centrally maintained registry and are therefore not negotiable;
- Notes that contain additional nonpayment obligations that are not permitted under UCC 3-104(a)(3); and
- Notes that broadly defer to a loan agreement or other separate document for full payment terms.

The most apparent option available to a lender holding one of the above instruments is a judicial foreclosure of the deed of trust as a mortgage under RCW 61.12 (Washington’s judicial foreclosure statute). While a full analysis of the positives and negatives of judicial foreclosures in Washington is beyond the scope of this article, there are certain drawbacks to this approach. The cost and time necessary to complete a judicial foreclosure and resulting sheriff’s sale of the property will generally be greater, and this can be expected to be exacerbated if the judiciary and sheriffs’ offices become burdened by increased volume as a result of *Vargas*. Perhaps more notably, borrowers in Washington are entitled to a one-year right of redemption following completion of the sale — meaning the borrower may reacquire the property by paying the outstanding debt as of the time of sale, plus interest, taxes, and certain assessments — even if the property

has been sold to a third party. With very limited exceptions, the owner of the property during the redemption period is not entitled to recompense for any additional investment made into the property during that interim period.⁹ This is a significant drawback to judicial foreclosure for properties that require operational or capital investment, or for ongoing construction projects that require additional funds for completion.

Another potential option that lenders may consider is seeking the appointment of a general receiver with power of sale. Under RCW 7.60, a court may appoint a general receiver to “take possession and control of substantially all of a person’s property with authority to liquidate that property. . . .”¹⁰ Subject to the court’s approval, any such sale would be made free and clear of liens and rights of redemption pursuant to RCW 7.60.260. Again, a full analysis of the positives and negatives of such an approach is beyond the scope of this article, but it seems likely that lenders confronting the realities of a judicial foreclosure following *Vargas* will find receivership to be an attractive option.

⁹ See RCW 6.23.020.

¹⁰ RCW 7.60.015.