

**WHAT WE HAVE LEARNED
FROM THE MORTGAGE CRISIS
ABOUT TRANSFERRING MORTGAGE LOANS**

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Editors' Synopsis: The vast expansion of the secondary mortgage market posed great challenges to the legal principles governing the mortgage transfer system. Not only were parties not adhering to the rules set forth under the Uniform Commercial Code, but even some courts were conflating basic principles such as the difference between ownership and entitlement to enforce. This Article analyzes several critical legal principles of the transfer process, discusses what led to the system's dysfunction during the mortgage crisis, while proposing a more user-friendly system for both lenders and borrowers.

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I. INTRODUCTION

The mortgage crisis that began in mid-2007, and is only now finally dissipating, has been a learning experience at many levels. It demonstrated that greed is a powerful motivator of business behavior and that many people behave badly, creating serious hardships for others in order to enrich themselves.¹ It proved that giving private, profit-making firms a federal government guarantee of their debts (even an implicit guarantee) is, in the long run, a concept of dubious merit, and that managers of those firms are likely to misuse such a privilege if it is granted to them.² It illustrated that self-regulation of the market for residential mortgage originations is not likely to be effective, and that

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¹ See generally RICHARD BITNER, *CONFESSIONS OF A SUBPRIME LENDER: AN INSIDER'S TALE OF GREED, FRAUD, AND IGNORANCE* (2008). See also THE FINANCIAL CRISIS INQUIRY REPORT, FIN. CRISIS INQUIRY COMM'N xxii-xxiii (2011) (“[T]o pin this crisis on mortal flaws like greed and hubris would be simplistic. It was the failure to account for human weakness that is relevant to this crisis.”); Leslie Marshall, *Greed Caused the Subprime Mortgage Crisis, Not ACORN*, U.S. NEWS & WORLD REP. (Oct. 16, 2009, 12:07 PM), <http://www.usnews.com/opinion/articles/2009/10/16/greed-caused-the-subprime-mortgage-crisis-not-acorn>.

² The firms referred to are Fannie Mae and Freddie Mac, together termed government sponsored enterprises (GSEs). On their role in the crisis, see THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at xxvi. See also Paul Krugman, Op-Ed, *Fannie, Freddie, and You*, N.Y. TIMES (July 14, 2008), <http://www.nytimes.com/2008/07/14/opinion/14krugman.html?>

some governmental oversight is necessary to prevent abusive behavior by originators.³

These lessons, however, are not the subject of the present Article, although all of them have close relevance to it. This Article outlines what we have learned during the past 7 years about the legal principles that govern the transfer of mortgage loans. Mortgage transfers, or specifically the outright sale of mortgages by originators to investors and from one investor to another—the transactions we call the “secondary mortgage market”—were absolutely integral to the mortgage crisis. Without sales of mortgages, originators would have been forced to retain the loans they made, which, in turn, would have made them far more conscientious than they were about ensuring the credit quality of those loans. The fact that credit risk could be transferred to others is what induced originators to act irresponsibly.

When the crisis began, one might have suspected that there was little to learn. After all, mortgage law has been established since the beginnings of the American republic. How important could 7 years be, even if they were years filled with the most intense debate and litigation about mortgage transfers that the nation has even seen? The answer is that people have learned a great deal, and that nearly everyone involved in the market before the crisis began was surprisingly ignorant of (or at least acted with surprising indifference to) some basic principles of law.

In achieving the clarity that has come during this period, we owe a debt to the coterie of foreclosure defense lawyers who represented residential borrowers and attempted to stave off the loss of their houses. The debt exists not because of the merits of the legal positions these defense lawyers took; for the most part, their arguments lacked merit and sometimes bordered on the frivolous.⁴ Indeed, it is hard to imagine that

³ Such re-regulation was one of the objectives of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). *See* Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. § 5301 (2006)); *e.g.*, Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 12 C.F.R. pt. 1026 (2013) (implementing section 1412 of the Dodd-Frank Act that “establishes certain protections from liability under this requirement for ‘qualified mortgages’”); Joseph J. Reilly & Shara M. Chang, *An Overview of the CFPB’s Ability-To-Repay/Qualified Mortgage Rule*, BANKING & FIN. SERVS. POL’Y REP., July 2013, at 1.

⁴ Courts have described defense counsel’s arguments as frivolous in plenty of cases. *See, e.g.*, *Deutsche Bank Trust Co. Ams. v. Sims*, No. 1-13-0543, 2014 WL 258643, at *2 (Ill. App. Ct. Jan. 21, 2014); *Dempsey v. JPMorgan Chase Bank, N.A.*, No. 49A02-1303-PL-218, 2013 WL 5533140, at *3 (Ind. Ct. App. Oct. 7, 2013); *Anderson v. Barclays*

they usually expected their positions to prevail. Rather, their suits were aimed at delaying foreclosure, imposing legal expenses on the holders of the mortgages, and thereby exerting pressure on mortgage holders and their servicers to engage in loan modifications that, in turn, permitted some borrowers to keep their houses.

Often the arguments of defense counsel were based on deficiencies, real or imagined, in the secondary market transfers of their clients' loans. Hence, in the process of fighting this delaying strategy, defense lawyers forced judges to clarify their (and our) understanding of the basic principles that govern mortgage transfers. In a sense, they have performed a genuine public service by doing so, in addition to whatever benefits they may have gained for some of their clients.

II. HOW MORTGAGES ARE TRANSFERRED

This section describes the functioning of the system of mortgage transfers currently in use for residential loans in the United States. Readers who are already familiar with the system may wish to skip this section. The description is idealized in the sense that in practice, particularly during the heated market of the early and mid-2000s, participants sometimes omitted some of these steps or performed them carelessly.

Mary and John Morgan, our hypothetical mortgagors, want to borrow money to buy a house, or to refinance an existing loan on their house. They (or sometimes a real estate agent assisting them) will approach a local retail lender and file a loan application. The lender may be a financial institution (a bank, credit union, or savings association), a mortgage banker, or a mortgage broker.⁵ If the mortgagor uses a mortgage broker, she or he will not make the loan directly, but instead

Capital Real Estate, Inc., No. 2012-CA-00736-COA, 2013 WL 5976621, at *2 (Miss. Ct. App. Nov. 12, 2013); Bank of Am., N.A. v. Merlo, No. 2012-T-0103, 2013 WL 6228276, at *4 (Ohio Ct. App. Dec. 2, 2013). Of course, pro se litigants can file frivolous actions as well. See, e.g., Balch v. HSBC Bank, USA, N.A., 128 So. 3d 179, 181 (Fla. Dist. Ct. App. 2013).

⁵ For the first quarter of 2013, eight of the ten largest originators by volume were banks or bank-affiliated mortgage companies. Wells Fargo Bank was by far the largest originator, with 21% of the market, and Chase Bank and Bank of America followed with 11.5% and 6.3% respectively. The two nonbank-affiliated originators in the top ten were Quicken Loans and PennyMac. See *Residential Lenders Ranked by Total Volume in 2014Q1*, MORTG. STATS, http://mortgagestats.com/residential_lending/ (last visited June 1, 2014).

will arrange a loan with a wholesale lender and receive a commission for doing so.⁶

When the loan is disbursed, Mary and John will sign two documents of primary importance: a promissory note, promising to repay the loan and specifying the interest rate and repayment terms, and a mortgage (or in about thirty states, a deed of trust,⁷ a functionally equivalent instrument), imposing a security interest on the real estate to collateralize the repayment obligation.

The person handling the closing of the loan will ensure that the mortgage is recorded in the local real estate records, thus protecting its priority against subsequent liens or other interests in the property. A policy of title insurance will be issued to the lender, insuring the lender with respect to the title on which the mortgage is based (mortgagee policy or loan policy). A policy insuring Mary and John's title to the property (owner's policy) may also be issued at the same time.⁸ The note, however, is not recorded; since it is not a conveyance of an interest in land, the note is probably not eligible for recording.⁹

If the original lender is to retain the loan, no further steps are necessary; the lender simply begins collecting monthly payments and credits them against the borrower's obligation. In the past—particularly before the late 1960s—most mortgage loans were held “in portfolio” in this manner.¹⁰ However, as the secondary mortgage market began to grow, an increasingly greater proportion of loans were sold (usually

⁶ On the role of mortgage brokers, see James R. Hagerty, *Mortgage Brokers: Friends or Foes?*, WALL ST. J., http://finance.yahoo.com/news/pf_article_103075.html (last updated May 24, 2007, 12:01 AM).

⁷ The deed of trust differs from the mortgage in that it names a third party as trustee who typically has the authority to foreclose the security interest by means of a nonjudicial procedure. In most states, a mortgage must be foreclosed by judicial action, although a few jurisdictions permit nonjudicial foreclosure of mortgages by the mortgagee. Aside from the available foreclosure procedures, little significant difference exists between mortgages and deeds of trust. See GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW §§ 1.1, 7.21 (5th ed. 2007) [hereafter cited REAL ESTATE FINANCE LAW].

⁸ For an in depth discussion of the role of title insurance in real estate sales and financing, see BARLOW BURKE, LAW OF TITLE INSURANCE (3d ed. 2000).

⁹ For a discussion of the recording process and its significance, see WILLIAM B. STOECK & DALE A. WHITMAN, THE LAW OF PROPERTY §§ 11.9-11.11 (3d ed. 2000).

¹⁰ See Daniel J. McDonald & Daniel L. Thornton, *A Primer on the Mortgage Market and Mortgage Finance*, 90 FED. RES. BANK OF ST. LOUIS REV. 31, 36 (2008), available at <http://research.stlouisfed.org/publications/review/08/01/McDonald.pdf>.

within a few days or weeks of their origination) to other investors.¹¹ After the privatization of Fannie Mae in 1968 and the creation of Freddie Mac in 1971, these two congressionally-chartered corporations—often called government sponsored entities (GSEs)—became increasingly important purchasers of mortgages.¹² Beginning in the late 1980s, private securitizers, including banks and investment banking firms, began purchasing mortgage loans and issuing securities collateralized by pools of mortgages that they had acquired.¹³ Thus, by the early 2000s, the great majority of residential loans originated in the United States were being sold on the secondary mortgage market.

What are the mechanics of such a sale? Several steps are involved in each transfer. The original lender will endorse the promissory note and physically deliver it to the secondary market investor or to a custodian designated by the investor. At the same time, a separate document assigning the mortgage will be executed, recorded in the local real estate records, and then delivered to the investor or its custodian.

These steps need to be repeated with each successive transfer of the mortgage loan from one investor to another. For example, in a simple case, when a mortgage banker originates a loan and immediately sells it to Fannie Mae, there may be no successive transfers at all. But loans often pass through the hands of several investors over time. Private-label securitizations, in particular, involve multiple steps. The originator may sell the loans to an “aggregator” who assembles a pool large enough for securitization.¹⁴ The aggregator may then become the “sponsor” of the securitization (the party taking responsibility for creation of the securitization), or may transfer the loans to a separate sponsor.¹⁵ The sponsor will then transfer the loans to a “depositor,” a special purpose entity that is designed to be bankruptcy-remote and to protect the pool of loans against potential claims of a trustee in bankruptcy of the sponsor,

¹¹ *See id.*

¹² *See generally* FED. HOUS. FIN. AGENCY: OFFICE OF INSPECTOR GEN., A BRIEF HISTORY OF THE HOUSING GOVERNMENT-SPONSORED ENTERPRISES, *available at* <http://fhfa.ig.gov/Content/Files/History%20of%20the%20Government%20Sponsored%20Enterprises.pdf> (last visited June 1, 2014).

¹³ *See* THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 3–10 (describing the development of private-label securitization).

¹⁴ *See* Adam J. Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 DUKE L.J. 637, 672 (2013).

¹⁵ *See id.*

aggregator, or originator.¹⁶ Finally, the “depositor” will transfer the loans to the securitization trustee—usually a bank—that will hold the loans for the benefit of the purchasers of the securities. Thus, it is common for four or five distinct transfers to occur as this process unfolds.¹⁷

Beginning in the mid-1990s, the Mortgage Electronic Registration System (MERS) began to play a role in the transfer process.¹⁸ MERS was created by the major secondary market players to eliminate the necessity of repeatedly recording mortgage assignments in the local real estate records—a procedure that many viewed as cumbersome and costly.¹⁹ MERS works as follows: The original mortgage is made directly to MERS as mortgagee, or alternatively, once recorded in the name of the originating lender, the mortgage is immediately assigned to MERS.²⁰ MERS then acts as nominee holder of the mortgage, in effect serving as an agent for whoever may hold the promissory note from time to time.²¹ MERS maintains an electronic database of the note-holders of its mortgages.²² Upon request, MERS will make an assignment to anyone designated by the holder of the note.²³ For example, if the servicer is to foreclose the loan, MERS will usually execute and record an assignment to the servicer. MERS does not take possession of the corresponding

¹⁶ See *id.* at 673 n.144.

¹⁷ See *id.* at 671–74; see also Anderson v. Burson, 35 A.3d 452, 455–56 (Md. 2011); Christopher L. Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, 78 U. CIN. L. REV. 1359, 1370–71 (2010). On the role of the depositor as a special purpose entity, see Charles Abrams, *FASB's Failure to Regulate Off-Balance Sheet Special Purpose Entities and the Downfall of Securitization*, 12 ASPER REV. INT'L BUS. & TRADE L. 39, 45–46 (2012). See also Thomas E. Plank, *Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique*, 30 CARDOZO L. REV. 617, 621 (2008).

¹⁸ See Christopher L. Peterson, *Losing Our Homes, Losing Our Way, Or Both? Foreclosure, County Property Records, and the Mortgage Electronic Registration System*, 40 CAP. U. L. REV. 821, 829 (2012) [hereinafter *Losing Our Homes*] (describing MERS operations in highly critical terms); Christopher L. Peterson, *Two Faces: Demystifying the Mortgage Electronic Registration System's Land Title Theory*, 53 WM. & MARY L. REV. 111, 116 (2011) [hereinafter *Two Faces*].

¹⁹ See *Losing Our Homes*, *supra* note 18, at 830.

²⁰ See *id.*

²¹ See *id.* at 832.

²² See *Two Faces*, *supra* note 18, at 117.

²³ See *id.*

promissory notes or have any involvement with them; its only duty is to serve as the nominal holder of the mortgage.²⁴

When the originator sells a mortgage loan on the secondary market, the secondary-market investor will designate a servicer.²⁵ In effect, the servicer represents the face of the investor to the borrowers. The borrowers will make their regular payments to the servicer, who will then remit the funds to the investor.²⁶ The servicer will also keep payment records, maintain an “escrow” or “impound” account to collect payments from the borrowers for the purpose of paying property taxes and casualty insurance premiums, and make sure that these obligations are actually paid when due.²⁷ If the borrowers miss payments, the servicer will send them reminders or dunning notices. If the borrowers need to restructure their loans or modify their obligations, the servicer will represent the investor in negotiating the changes pursuant to policies the investor has adopted.²⁸ If local law requires participation in some sort of mediation or other facilitation process as a precondition to foreclosure, the servicer will represent the investor in that process. If foreclosure is necessary, the servicer will handle it by hiring the necessary counsel, making other needed arrangements, and typically bidding at the foreclosure sale. Finally, if the servicer acquires the property at the foreclosure, it will be responsible to the investor for managing and disposing of it.

A foreclosure will often involve one more transfers of the note and mortgage. In some states, the servicer may initiate the foreclosure as an agent representing the investor,²⁹ but in other states, the “real party in

²⁴ An exception exists for mortgage loans that are originated electronically under the Electronic Signatures in Global and National Commerce Act (E-Sign). These loans are delivered electronically to MERS, which takes “control” of the note—essentially similar to taking possession of a paper note. *See* FANNIE MAE, HOW TO IMPLEMENT eMORTGAGE 19 (2007). However, such loans represent only a tiny fraction of all mortgages assigned to MERS.

²⁵ On the role of servicers, see Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 15–16 (2011). *See also* Margaret R.T. Dewar, Comment, *Regulation X: A New Direction for the Regulation of Mortgage Servicers*, 63 EMORY L.J. 175, 181–83 (2013); Jessica Silver-Greenberg & Michael Corkery, *Loan Complaints by Homeowners Rise Once More*, N.Y. TIMES (Feb. 18, 2014, 9:16 PM), http://dealbook.nytimes.com/2014/02/18/loan-complaints-by-homeowners-rise-once-more/?_php=true&_type=blogs&_r=0.

²⁶ *See* Levitin & Twomey, *supra* note 25, at 23.

²⁷ *See* Dewar, *supra* note 25, at 182.

²⁸ *See* Levitin & Twomey, *supra* note 25, at 23.

²⁹ *See, e.g.*, TEX. PROP. CODE ANN. § 51.002(d) (West 2013) (authorizing a servicer to commence a nonjudicial foreclosure proceeding); CWC Capital Asset Mgmt., LLC v.

interest” must commence foreclosure.³⁰ If the real party must commence the action, the investor will usually transfer the loan to the servicer so that the servicer becomes the real party in interest, rather than a mere agent, and can conduct the foreclosure.³¹ The investor may prefer to transfer the loan to the servicer and have the foreclosure proceed in the servicer’s name even if applicable law would permit the servicer to act as the investor’s agent.³²

Of course, the majority of mortgage loans are not foreclosed, but are paid off at or (usually) prior to their maturity. Here again, the servicer takes responsibility, arranging to have a release executed by the investor and recorded in the local real estate records, and to have the note marked “paid” and forwarded to the borrowers.³³

As this description illustrates, multiple transfers of mortgage loans are a prominent feature of the modern mortgage market. Of course, mortgage transfers are not a new phenomenon. However in the past, transfers were relatively uncommon and frequently occurred between

Chi. Prop., LLC, 610 F.3d 497, 501–02 (7th Cir. 2010) (holding that the authority granted by the pooling and servicing agreement was sufficient to make servicer the real party in interest); *Arabia v. BAC Home Loans Servicing, L.P.*, 145 Cal. Rptr. 3d 678, 685–86 (Cal. Ct. App. 2012); *J.E. Robert Co. v. Signature Props., LLC*, 71 A.3d 492, 504–05 (Conn. 2013) (holding that the authority granted by the servicing agreement was sufficient to give servicer standing to foreclose in its own name).

³⁰ See, e.g., *Elston/Leetsdale, LLC v. CWCapital Asset Mgmt. LLC*, 87 So. 3d 14, 17–18 (Fla. Dist. Ct. App. 2012) (holding that a servicer has standing to foreclose only if the holder of the loan joins in or ratifies the action).

³¹ See, e.g., *Deutsche Bank Nat’l Trust Co. v. Mitchell*, 27 A.3d 1229, 1235 (N.J. Super. Ct. App. Div. 2011) (holding that the servicer lacked standing to pursue foreclosure when it could not show the note had been transferred to it).

³² The investor may believe it can avoid some litigation and reputational risks by having foreclosure pursued in the servicer’s name. See Stephen F.J. Ornstein, Scott D. Samlin & William W. Carpenter, *OCC Guidance Regarding Foreclosed Residential Properties*, 66 CONSUMER FIN. L. Q. REP. 147, 153–54 (2012). State courts have sometimes pushed back against this preference. See, e.g., *U.S. Bank, N.A. v. Guillaume*, 38 A.3d 570, 583 (N.J. 2012) (holding that the bank violated the state’s foreclosure act by listing the name and address of the servicer rather than the name of the lender in the notice of foreclosure).

Until mid-2011, when the practice was discontinued, foreclosures were frequently brought in the name of MERS, resulting in a large volume of litigation contesting the practice. See *Galiastro v. Mortg. Elec. Registration Sys., Inc.*, 4 N.E.3d 270, 279–82 (Mass. 2014); Dustin A. Zacks, *Standing in Our Own Sunshine: Reconsidering Standing, Transparency, and Accuracy in Foreclosures*, 29 QUINNIPIAC L. REV. 551, 585–89 (2011).

³³ See David E. Worsley, *Loan Servicing, Default, and Enforcement Issues*, 61 CONSUMER FIN. L. Q. REP. 499, 509 app. (2007).

local firms when the transferor and transferee were acquainted with one another or had a long-term business relationship. The vast scale and nationwide scope of mortgage transfers occurring today is a recent development, and the law has taken some time to catch up with the industry's practices. This set of legal developments is what this Article proposes to discuss.

III. WHAT WE HAVE LEARNED: A SUMMARY

This section begins by summarizing seven legal principles that were often not well understood before the crisis began but are now clearly established. In seven subsequent sections, this Article analyzes each of these principles, describes their present status, and presents critiques of each of them. Each principle is identified by the part of the article discussing it.

A. Ownership of the Note and Mortgage Must be Distinguished from the Right of Enforcement

Ownership refers to the economic benefits of a promissory note (including a note secured by a mortgage) and is governed by Article 9 of the Uniform Commercial Code (U.C.C.). The right to enforce the note, on the other hand, is governed by Article 3 if the note is negotiable and by the common law if the note is non-negotiable. Ordinarily, a secondary market investor wants both sets of rights, but their transfer is governed by different legal principles. Speaking of the transfer of a note and mortgage without specifying which set of rights is being transferred can be misleading or even meaningless.

B. The Right to Enforce Negotiable Notes Can be Transferred Only by Delivery

If a note is negotiable, and hence its right of enforcement is governed by Article 3, that right can be transferred only by delivery of possession of the original note to the transferee. Since the mortgage follows the note, delivery of the note is likewise essential to a transfer of the right to foreclose the mortgage. An exception to the delivery requirement exists if the note has been lost, destroyed, or is in the possession of someone who is unknown or cannot be found.

C. Negotiability Matters

Since Article 3 governs the transfer of the right of enforcement of negotiable notes, while the common law governs the transfer of non-

negotiable notes, determining whether a particular note is negotiable or not is potentially critical. However, this distinction is subtle, depends on complex rules, and cannot always be resolved with certainty.

D. The Mortgage Follows the Right to Enforce the Note

The transfer of the promissory note is of critical importance. If the note is properly transferred, the mortgage will follow automatically. The mortgage follows the right of enforcement, not the right of ownership. Arguments based on the supposition that the mortgage and the note have been separated and that this separation makes the mortgage unenforceable are virtually always groundless.

E. Note Endorsements are Helpful but Usually Not Essential

If a note is negotiable, and hence its right of enforcement is governed by Article 3, that right can be transferred (by delivery of possession of the note)³⁴ without endorsement. However, a proper endorsement is helpful to the transferee since it simplifies the transferee's burden of proof. Endorsement is also necessary to constitute the holder as one "in due course," which can be a helpful status in some cases. An endorsement may be written on the note or may be attached to the note by an allonge, but technical rules must be followed for allonges to be effective.

F. Mortgage Assignments are Irrelevant to the Right to Foreclose by Judicial Proceeding

Because the mortgage follows the note, no separate assignment of the mortgage (recorded or unrecorded) is necessary to transfer it. A recorded mortgage assignment may be helpful for other reasons, but recordation is not needed to confer the right of judicial foreclosure on the note's holder. If foreclosure by nonjudicial process is contemplated, however, a chain of assignments (perhaps recorded) may be necessary, depending on the jurisdiction's statutes.

G. Many Nonjudicial Foreclosure Statutes are Weak and Inadequate

All American states, as a matter of common law, permit judicial foreclosure of mortgages, but about thirty states also have statutes authorizing nonjudicial foreclosure by means of a sale conducted by the mortgagee or by a separate trustee. Unfortunately, some of these statutes

³⁴ See discussion *supra* Part III.B.

are completely inadequate in their treatment of foreclosure by transferees, primarily because most of the statutes were enacted when secondary mortgage market transfers were uncommon. These issues might have been (and in some states have been) resolved simply by applying common law mortgage foreclosure concepts and the U.C.C. as an “overlay” to the statutes. However, in eight states the courts have failed to adopt these concepts, leaving nonjudicial foreclosures muddled and unsatisfactory.

IV. DETAILED EXAMINATION OF EACH OF THE PRINCIPLES

A. Ownership of the Note and Mortgage Must be Distinguished from the Right of Enforcement

When we speak of “selling” or “transferring” a mortgage loan,³⁵ what do we mean? The question is more subtle than may first appear. The reason is that the promissory note is the most significant document,³⁶ and the note contains two distinct sets of rights that can be transferred. To a great extent U.C.C. Articles 3 and 9 specify the methods of transfer, at least when the obligation in question is a promise to pay money.³⁷

Viewed from the perspective of the U.C.C., promissory notes (including those secured by mortgages) have two aspects: Ownership and entitlement to enforce. Distinguishing between them is critical, and courts and commentators have written a great deal of misleading nonsense because of the failure to do so. Article 9 deals with the way sales and security transfers of notes occur. It governs *ownership* of notes

³⁵ This Article focuses on outright sales of mortgage loans. Collateral transfers, in which the mortgage loan becomes security for some other obligation, are also common and raise interesting issues, but they are outside the scope of this Article. See REAL ESTATE FINANCE LAW, *supra* note 7, at 396–409.

³⁶ See *Best Fertilizers of Ariz., Inc. v. Burns*, 571 P.2d 675, 676 (Ariz. Ct. App. 1977), *rev'd*, 570 P.2d 179 (Ariz. 1977) (“Among the ‘gems’ and ‘free offerings’ of the late Professor Chester Smith of the University of Arizona College of Law was the following analogy. The note is the cow and the mortgage the tail. The cow can survive without a tail, but the tail cannot survive without the cow.”).

³⁷ A mortgage may secure an obligation other than the payment of money, provided that the obligation can be reduced to a monetary equivalent. See REAL ESTATE FINANCE LAW, *supra* note 7, § 2.2, at 20–21. Examples include a mortgage to secure an obligation to provide personal support and care and a mortgage to secure a guaranty of performance of a contract. But such mortgages are only a tiny fraction of all mortgage transactions, and for obvious reasons, essentially no secondary market exists for them.

as well as security interests in ownership rights.³⁸ Article 9 applies to *all* mortgage notes, whether they are negotiable or not.³⁹

Article 3, on the other hand, governs the *entitlement to enforce* a note or PETE status—“person entitled to enforce.” PETE status is a quality that mortgage investors and their servicers would seemingly want when foreclosing a mortgage and that mortgage borrowers need to know about.⁴⁰ However, by its terms, Article 3 applies only to negotiable notes.⁴¹

The distinction drawn in the U.C.C. between owning a note and being entitled to enforce it may seem strange at first blush but is actually quite useful. Entitlement to enforce a note focuses on the relationship between the maker of the note (the mortgagor, in the case of a mortgage note) and the person enforcing it. One who is entitled to enforce the note

³⁸ This statement follows from Article 9’s scope statement: “[T]his article applies to . . . a sale of . . . promissory notes . . .” U.C.C. § 9-109(a)(3) (amended 2013). Under Article 9 an outright sale of a note is, rather confusingly, termed the creation of a security interest—a sort of definitional left-over from the days when Article 9 applied only to actual security interests. Similarly, in an outright transfer, the transferor is known as the “debtor,” the transferee is called the “secured party,” and the rights transferred are termed “collateral.” See *id.* § 9-102(a)(28) (defining debtor); *id.* § 9-102(a)(73) (defining secured party); *id.* § 9-102(a)(12) (defining collateral). The debtor may transfer full ownership or some lesser ownership interest, such as a security or collateral interest, provided that the debtor “has rights in the collateral or the power to transfer rights in the collateral to a secured party . . .” *Id.* § 9-203(b)(2).

The fact that Article 9 governs outright sales of notes is surprising to many people. Prior to the 1998 revision, Article 9 applied only when notes (whether negotiable or non-negotiable) were pledged as security for other indebtedness.

³⁹ Under Article 9, instrument covers all promissory notes, irrespective of their negotiability. See *id.* § 9-102(a)(47) (“‘Instrument’ means a negotiable instrument . . . or any other writing that evidences a right to the payment of a monetary obligation . . . and is of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment.”). Because of this inclusive definition, nonnegotiable notes are sometimes called “Article 9 notes.”

⁴⁰ See, e.g., *Armacost v. HSBC Bank USA*, No. 10-CV-274-EJL-LMB, 2011 WL 825151, at *12 (D. Idaho Feb. 9, 2011) (concluding that the foreclosing party was required to establish its entitlement to enforce the note, irrespective of its holding of an assignment of the deed of trust). Unfortunately, the Idaho Supreme Court subsequently rejected this sensible view in *Trotter v. Bank of New York Mellon*, 275 P.3d 857 (Idaho 2012).

⁴¹ Article 3 provides that an “‘instrument’ means a negotiable instrument.” U.C.C. § 3-104(b) (amended 2002). Article 3 clearly applies to a negotiable note, notwithstanding that the note is secured by a mortgage. See *First Valley Bank v. First Sav. & Loan Ass’n*, 412 N.E.2d 1237, 1241 (Ind. Ct. App. 1980); see also *Best Fertilizers of Ariz., Inc. v. Burns*, 570 P.2d 179, 180 (Ariz. 1977).

can sue on it or, if other applicable foreclosure requirements are met, foreclose the mortgage that secures it. The party most concerned with who is entitled to enforce the note is the maker of the note because the concept is designed to protect the maker against having to pay twice or defend against multiple claims on the note. If the maker pays the person entitled to enforce the note and that party accepts the proffered funds as payment in full, the note is discharged and the mortgage that secures the note is extinguished.⁴² Thus, a borrower can negotiate with the party having PETE status (or its agent) to modify the loan, accept a payoff for less than the face amount owed, or approve a “short sale” (in which less than the full balance owing on the note is accepted as payment in full) or a deed in lieu of foreclosure. The borrower can be assured that any agreement reached with the PETE in any of these negotiations will be binding.

Ownership of the note, on the other hand, is a concept that deals with who is entitled to the economic fruits of the note—for example, who is entitled to the proceeds if the note is enforced or collected.⁴³ The owner is entitled to money produced from a payoff of the loan, short sale, or foreclosure.

While ownership and the right to enforce commonly reside in the same party, separating them is also entirely possible.⁴⁴ In the mortgage context, one obvious application of the distinction is that servicer of a mortgage in a securitized pool might well be entitled to enforce the note (if it met the applicable requirements of Article 3), but the trustee of the securitized trust, as owner, would be entitled to have the proceeds of the enforcement action remitted to it. This is a common situation. For example, when a foreclosure is necessary, Fannie Mae and Freddie Mac routinely deliver the note to the servicer so that the servicer can foreclose in its own name. Yet, obviously the proceeds of the foreclosure are intended to flow, by the terms of the servicing agreement, back to Fannie or Freddie. Thus, Fannie or Freddie remains the owner of the note, while

⁴² See PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, APPLICATION OF THE UNIFORM COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTGAGE NOTES 4 (2011) [hereinafter PEB REPORT], available at http://www.uniformlaws.org/Shared/Committees_Materials/PEBUCC/PEB_Report_111411.pdf.

⁴³ For further discussion of the requirements for transferring ownership under Article 9, see *infra* text accompanying notes 47–56, 58–59.

⁴⁴ See, e.g., *Bank of Am., N.A. v. Inda*, 303 P.3d 696, 703 (Kan. Ct. App. 2013) (finding that Bank of America was entitled to enforce note although Freddie Mac owned it).

the servicer becomes the PETE.⁴⁵ One court, which got it exactly right, explained as follows:

Under established rules, the maker should be indifferent as to who owns or has an interest in the note so long as it does not affect the maker's ability to make payments on the note. Or, to put this statement in the context of this case, the [borrowers] should not care who actually owns the Note—and it is thus irrelevant whether the Note has been fractionalized or securitized—so long as they do know who they should pay.⁴⁶

In light of the fact that these two sets of rights—ownership and the right to enforce—can exist independently of one another, which of them does a secondary market purchaser of a mortgage loan want and intend to obtain? Ordinarily, the answer is both. A secondary market investor needs ownership to be entitled to the proceeds of the loan's repayment, and it needs the right to enforce in order to sue on the note or foreclose against the maker-mortgagor. Hence, when we think of a sale of the loan, we customarily think of both rights as being transferred simultaneously. But keeping in mind the distinction between the two sets of rights is important, for their transfer is governed by two different articles of the U.C.C., and acts that are sufficient to transfer one set of rights will not necessarily transfer the other.

The remainder of this Part will deal with transfers of ownership, a process that is relatively simple and straightforward. The next Part will discuss transfers of the right to enforce, a topic that is considerably more complex and has been the subject of a great deal more litigation.

Under Article 9, a purchaser⁴⁷ of an instrument (that is, a promissory note, whether negotiable or not)⁴⁸ can acquire ownership by complying

⁴⁵ See *Giles v. Wells Fargo Bank, N.A.*, 519 F. App'x 576, 578–79 (11th Cir. 2013); *J.E. Robert Co. v. Signature Props., LLC*, 71 A.3d 492, 498–99 (Conn. 2013); *Inda*, 303 P.3d at 703; *Deutsche Bank Nat'l Trust Co. v. Brock*, 63 A.3d 40, 48 (Md. 2013). The court was highly critical of this practice in *JP Morgan Chase Bank, N.A. v. Butler*, No. 1686/10, 2013 WL 3359283, at *7 (N.Y. Sup. Ct. July 5, 2013), describing it as deceptive and as a way for the owner of the note to evade its responsibility to be identified as the foreclosure plaintiff. The criticism seems overwrought; the holder is simply taking advantage of the principles set out in Article 3.

⁴⁶ *Veal v. Am. Home Mortg. Servicing, Inc. (In re Veal)*, 450 B.R. 897, 912 (B.A.P. 9th Cir. 2011).

⁴⁷ In describing the transfer of ownership, the author has translated the terminology of Article 9 into terms that are ordinarily used in describing outright sales of notes.

with the following rules, as recently summarized by the Permanent Editorial Board of the U.C.C.:

Section 9-203(b) of the Uniform Commercial Code provides that three criteria must be fulfilled The first two criteria are straightforward—“value” must be given⁴⁹ and the debtor/seller must have rights in the note or the power to transfer rights in the note to a third party.⁵⁰ The third criterion may be fulfilled in either one of two ways. Either the debtor/seller must “authenticate”⁵¹ a “security agreement”⁵² that describes the note⁵³ or the secured party must take possession of the note pursuant to the debtor’s security agreement.⁵⁴

⁴⁸ See U.C.C. § 9-102(a)(47), quoted in footnote 39 *supra*.

⁴⁹ PEB REPORT, *supra* note 42, at 9 n.33 (citing U.C.C. § 9-203(b)(1)). U.C.C. section 1-204 provides that giving “value” for rights includes not only acquiring them for consideration but also acquiring them in return for a binding commitment to extend credit, as security for or in complete or partial satisfaction of a preexisting claim, or by accepting delivery of them under a preexisting contract for their purchase.

Id.

⁵⁰ *Id.* at 9 n.34 (citing U.C.C. § 9-203(b)(2)) (“Limited rights that are short of full ownership are sufficient for this purpose. See Official Comment 6 to [U.C.C. section] 9-203.”).

⁵¹ *Id.* at 9 n.35 (“This term is defined to include signing and its electronic equivalent. See [U.C.C. section] 9-102(a)(7).”).

⁵² *Id.* at 9 n.36 (“A ‘security agreement’ is an agreement that creates or provides for a security interest (including the rights of a buyer arising upon the outright sale of a payment right). See [U.C.C. section] 9-102(a)(73).”). In the present context, then, the security agreement would ordinarily be a written assignment of the mortgage notes, a contract of sale of the notes, or some other document indicating the parties’ agreement to transfer ownership.

⁵³ *Id.* at 9 n.37 (“Article 9’s criteria for descriptions of property in a security agreement are quite flexible. Generally speaking, any description suffices, whether or not specific, if it reasonably identifies the property. See [U.C.C. section] 9-108(a)-(b). A ‘supergeneric’ description consisting solely of words such as ‘all of the debtor’s assets’ or ‘all of the debtor’s personal property’ is not sufficient, however. [U.C.C. section] 9-108(c). A narrower description, limiting the property to a particular category or type, such as ‘all notes,’ is sufficient. For example, a description that refers to ‘all of the debtor’s notes’ is sufficient.”).

⁵⁴ *Id.* at 10 n.39 (citing U.C.C. § 9-203(b)(3)(A)-(B)). Subsection (B), which deals with attachment (that is, the creation of an effective transfer), adopts U.C.C. section 9-313, which on its face deals only with perfection. The logic is unfortunately convoluted, but it works. Note that a delivery of possession, standing alone, will not carry out the

Thus, either a delivery of possession of the note pursuant to a written agreement, or the execution of a written document of assignment of the note, can serve to transfer its ownership. Moreover, under U.C.C. section 9-203(g), the transfer of “a right to payment or performance secured by a security interest or other lien on personal or real property is also attachment of a security interest⁵⁵ in the security interest, mortgage, or other lien.”⁵⁶ This provision seems reminiscent of the common law principle that the mortgage follows the note.⁵⁷ But this provision is emphatically *not* the same principle; the common law deals with the right to enforce the note, or PETE status, and provides that whoever has the right to enforce the note can enforce (for example, foreclose) the mortgage as well.⁵⁸ On the other hand, Article 9, and particularly section 9-203(g), deal only with ownership; in essence, Article 9’s message is that whoever has the economic benefits of the note is entitled to the economic benefits of the mortgage (for example, the proceeds of foreclosure)⁵⁹ as well.⁶⁰

Identifying who can foreclose and who has the economic benefits of foreclosure are entirely distinct issues and should not be confused with one another. No reason exists to regard U.C.C. section 9-203(g) as

transfer of ownership; possession must be transferred “pursuant to the [transferor’s] security agreement; . . .” U.C.C. § 9-203(b)(3)(B).

In addition, U.C.C. section 9-309 provides that the rights of a buyer in the sale of a promissory note are “perfected when they attach.” Hence, as against a competing purchaser or a subsequent trustee in bankruptcy of the seller, an outright buyer of promissory notes need not take any other action to be fully perfected—perfection is automatic.

⁵⁵ Because of Article 9’s use of the term “security interest” to encompass outright sales, section 9-203(g) is more readily understood in the context of sales of mortgage notes by rewriting it to read: the transfer of ownership of a promissory note secured by a mortgage on real property is also a transfer of ownership of the mortgage. *See* case cited *supra* note 31 and accompanying text.

⁵⁶ U.C.C. § 9-203(g).

⁵⁷ *See infra* text accompanying notes 121–145, 147–152.

⁵⁸ Article 3 says nothing about this principle at all; it is purely a common law principle.

⁵⁹ On rare occasions a mortgage may be the source of proceeds other than from foreclosure. For example, the holder of the mortgage may sue the mortgagor for waste or for breach of some other covenant in the mortgage. *See* REAL ESTATE FINANCE LAW, *supra* note 7, § 4.4. But, foreclosure is by far the largest generator of mortgage proceeds.

⁶⁰ Of course, in many cases the owner and the PETE are the same party. *See* RMS Residential Props., LLC v. Miller, 32 A.3d 307, 314 (Conn. 2011) (“[A] holder of a note is presumed to be the owner of the debt, and unless the presumption is rebutted, may foreclose the mortgage . . .”).

supplanting the common law with respect to the right to enforce or foreclose. That right is governed by Article 3 (supplemented with respect to the mortgage by the common law) if the note is negotiable and by the common law alone if the note is not.⁶¹ U.C.C. section 9-203(g) says nothing whatever about these issues; it deals purely with ownership, and ensures that whoever is entitled to the proceeds of enforcement of the note is entitled to proceeds of enforcement of the mortgage as well.⁶²

The author leaves this Part with a stern reminder. Statements and arguments about the transfer of mortgage notes are apt to be confused and misleading if they do not specify which set of rights—enforcement or ownership—is being transferred. Lapsing into a generalized discussion about “transferring the note” or “selling the loan” is all too easy (even the author has done it). This generalization is fine for casual conversation, but when one demands precision, it simply will not do. If the rights about which we are concerned are not specifically identified, falling into confusion and error is almost certain.

B. The Right to Enforce Negotiable Notes Can be Transferred Only by Delivery

Under Article 3, a note may either be negotiable or nonnegotiable, depending on factors discussed in Part IV.C. of this Article. Both types of notes are commonly used in mortgage loan transactions, and thus, examining the note to determine whether the note is negotiable or not is critically important.

The transfer of the right to enforce nonnegotiable notes is governed by the common law of contracts.⁶³ But if a negotiable note is involved, Article 3 controls,⁶⁴ and it narrowly constrains the modes of transfer of the right to enforce the note.⁶⁵ The methods available to do so are described here briefly, but the Report of the Permanent Editorial Board⁶⁶

⁶¹ See *infra* text accompanying notes 121–146, 149–154.

⁶² See U.C.C. § 9-203(g) (amended 2013).

⁶³ See *infra* text accompanying notes 114–120.

⁶⁴ Article 3 also controls whether the transferee is to become a holder in due course. See REAL ESTATE FINANCE LAW, *supra* note 7, § 5.31 (discussing the advantages of holder in due course status). The fact that the note is secured by a mortgage does not affect its negotiability. See *Swindler v. Swindler*, 584 S.E.2d 438, 440–42 (S.C. Ct. App. 2003).

⁶⁵ See Douglas J. Whaley, *Mortgage Foreclosures, Promissory Notes, and the Uniform Commercial Code*, 39 W. ST. U. L. REV. 313, 318–24 (2012).

⁶⁶ See PEB REPORT, *supra* note 42.

and Article 3 itself provide details and relevant citations. A transfer of the right of enforcement occurs in three ways:

(1) Becoming a holder. This transfer will occur if the note has been delivered to and is in the possession of the person enforcing it, with an appropriate endorsement—either in blank, which makes the note a bearer note, or specially, which specifically identifies the person to whom the note is delivered. These actions will constitute the person who takes the note a holder, entitling him or her to enforce the note.⁶⁷

(2) Becoming a nonholder who has the rights of a holder.⁶⁸ This type of transfer will occur if the note has been delivered to and is in the possession of the person enforcing it, without an endorsement. In the absence of an endorsement, the person taking delivery cannot be a holder, but can still get the right of enforcement if the delivery was made for the purpose of transferring that right.⁶⁹ The latter requirement may

⁶⁷ See U.C.C. § 3-301 (amended 2002) (defining “person entitled to enforce”). Article 3 does not require the holder of the note to prove the details of all prior transfers. See *Mesina v. Citibank, N.A. (In re Mesina)*, No. 10-2304 RTL, 2012 WL 2501123, at *1 (Bankr. D.N.J. June 27, 2012). However, some jurisdictions require proof of the details of the delivery to the present holder. See *Homecomings Fin., LLC v. Guldi*, 969 N.Y.S.2d 470, 474 (N.Y. App. Div. 2013). See generally *In re Walker*, 466 B.R. 271 (Bankr. E.D. Pa. 2012) (finding that a note was endorsed in blank and delivered to a securitized trustee, thus constituting the trustee as a holder); *In re David A. Simpson, P.C.*, 711 S.E.2d 165 (N.C. Ct. App. 2011) (holding that though the securitized trustee had possession of the note, the trustee was not a holder, because the note was not endorsed either to the trustee or in blank); *U.S. Bank, N.A. v. Marcino*, 908 N.E.2d 1032 (Ohio Ct. App. 2009) (finding that an affidavit that included a sworn attestation of a bank’s status as a holder, and an authenticated allonge endorsed in blank, adequately proved the derivation of the bank’s holder status).

No endorsement is necessary if the note was originally payable to bearer. See *Bank of N.Y. v. Raftogianis*, 13 A.3d 435, 439 (N.J. Super. Ct. Ch. Div. 2010). But bearer notes are virtually never used in real estate financing.

⁶⁸ This phrase appears in U.C.C. section 3-301. See PEB REPORT, *supra* note 42, at 5.

⁶⁹ See, e.g., *U.S. Bank, N.A. v. Squadron VCD, LLC*, 504 F. App’x 30, 34 (2d Cir. 2012) (finding a note and mortgage enforceable even if the endorsement was absent or improper); *Veal v. Am. Home Mortg. Servicing, Inc. (In re Veal)*, 450 B.R. 897, 911–12 (B.A.P. 9th Cir. 2011) (recognizing the nonholder with the rights of a holder status, but finding that it did not exist in the absence of possession of the note); *Robinson v. H & R Block Bank, FSB*, No. 12-Civ-4196 (SMG), 2013 WL 2356106, at *4 (E.D.N.Y. May 29, 2013); *Aum Shree of Tampa, LLC v. HSBC Bank USA, N.A. (In re Aum Shree of Tampa, LLC)*, 449 B.R. 584, 593–94 (Bankr. M.D. Fla. 2011) (finding that when a foreclosing party proved possession of the note, that party was at least a nonholder with the rights of a holder and was not required to prove that it possessed holder in due course status); *In re Wilhelm*, 407 B.R. 392, 402–03 (Bankr. D. Idaho 2009) (moving creditors were not nonholders in possession of the instrument with the rights of a holder because

complicate enforcement or foreclosure because the party in possession may have the burden of proving exactly how it acquired the note and providing specific evidence that the transfer to it was made for the purpose of conveying the right of enforcement.⁷⁰ Avoidance of this burden is the primary reason that endorsement of the note is wise and desirable.

(3) Providing a “lost note affidavit.” Under U.C.C. section 3-309, a person who does not qualify to enforce the note under (1) or (2) because of a lack of possession may still enforce the note by providing proof of the right to enforce, typically by means of a “lost note affidavit.”⁷¹

they did not prove actual possession of the notes); *J.E. Robert Co. v. Signature Props., Inc.*, 71 A.3d 492, 503–04 (Conn. 2013) (finding that a note was delivered to a servicer with the intent to transfer the right of enforcement); *Ulster Sav. Bank v. 28 Brynwood Lane, Ltd.*, 41 A.3d 1077, 1085 (Conn. App. Ct. 2013) (finding that an assignment and affidavits proved that a note was delivered to transfer the right of enforcement); *Miller v. Kondaur Capital Corp.*, 91 So. 3d 218, 219 (Fla. Dist. Ct. App. 2012); *Anderson v. Burson*, 9 A.3d 870, 878–81 (Md. Ct. Spec. App. 2010), *aff’d*, 35 A.3d 452 (Md. 2011) (permitting enforcement when a possessor of an unendorsed note did not prove each prior transfer, but the makers conceded that such transfers had occurred); *Wells Fargo Bank, N.A. v. Ford*, 15 A.3d 327, 331 (N.J. Super. Ct. App. Div. 2011) (finding that documents proving the purpose for which a note was delivered were not properly authenticated); *Raftogianis*, 13 A.3d at 450 (requiring possession of the note to be a nonholder with the rights of a holder); *Wells Fargo Bank, N.A. v. Freed*, No. 5-12-01, 2012 WL 6562819, at *6 (Ohio Ct. App. Dec. 17, 2012); *Bank of Am., N.A. v. Kabba*, 276 P.3d 1006, 1009 (Okla. 2012) (“Delivery of the note would still have to occur even though there is no negotiation.”). *But cf. In re Adams*, 693 S.E.2d 705, 709–710 (N.C. Ct. App. 2010) (refusing to allow a foreclosure by the party in possession of the note, apparently because the note was not endorsed).

⁷⁰ See U.C.C. § 3-203(a); *e.g.*, *Fed. Deposit Ins. Corp. v. Houde*, 90 F.3d 600, 605–08 (1st Cir. 1996) (dismissing the case as a matter of law when the F.D.I.C. failed to provide sufficient proof that the note was delivered to it for the purpose of transferring the right of enforcement); *In re Dorsey*, 491 B.R. 464, 470–71 (Bankr. E.D. Ky. 2013), *aff’d*, No. 13-8036, 2014 WL 888917 (B.A.P. 6th Cir. 2014); *Svrcek v. Rosenberg*, 40 A.3d 494, 505–06 (Md. Ct. Spec. App. 2012) (finding satisfactory proof of transfer); *Leyva v. Nat’l Default Servicing Corp.*, 255 P.3d 1275, 1281 (Nev. 2011) (requiring the servicer to provide specific affirmative proof that the lender delivered the note for the purpose of transferring the right of enforcement); *In re David A. Simpson*, 711 S.E.2d at 173 (finding insufficient proof); *Fed. Home Loan Mortg. Corp. v. Schwartzwald*, 957 N.E.2d 790, 801 (Ohio Ct. App. 2011), *rev’d on other grounds*, 979 N.E.2d 1214 (Ohio 2012) (finding that the mortgage assignments proved that the purpose of delivering the note was to transfer the right of enforcement); *NTEX Realty, LP v. Tacker*, 275 P.3d 147, 149 (Okla. 2012) (remanding the case for findings of fact as to the circumstances in which the party seeking to foreclose had acquired possession of the unendorsed note).

⁷¹ See, *e.g.*, *Allen v. U.S. Bank, N.A. (In re Allen)*, 472 B.R. 559, 567 (B.A.P. 9th Cir. 2012) (holding that the lost note affidavit was sufficient to sustain the note holder’s

However, the requirements for the affidavit are quite strict: the note must have been destroyed, its whereabouts not discoverable, or it must be in the wrongful possession of an unknown person or a person who cannot be served. Before accepting such an affidavit, a court might well demand evidence as to the person's efforts to locate the note.⁷² In addition, the court can require the enforcing party to provide assurance (typically in the form of a bond or an indemnity agreement) against the possibility that the borrower will have to pay twice.⁷³

claim in bankruptcy); *Svrcek*, 40 A.3d at 506 (holding that the lost note affidavit was sufficient to permit enforcement of the note); *Bobby D. Assocs. v. DiMarcantonio*, 751 A.2d 673, 675–76 (Pa. Super. Ct. 2000) (finding the assignee of the lost note may enforce it by means of a lost note affidavit).

Section 3-309 does not literally require an affidavit; rather, it provides that the person seeking enforcement must “prove” the right of enforcement. An affidavit is the common means of proof, but evidence presented in open court could also suffice. Under section 3-604, a person entitled to enforce the note may cancel and discharge it by intentionally destroying it, but a mistaken or accidental destruction will not discharge the debt. *See Steinberger v. McVey ex rel. Cnty. of Maricopa*, 318 P.3d 419, 438–39 (Ariz. Ct. App. 2014); *G.E. Capital Mortg. Servs. Inc. v. Neely*, 519 S.E.2d 553, 556 (N.C. Ct. App. 1999).

Under section 3-309(b), the person seeking enforcement must prove the terms of the note. Hence, if the original note is lost and no photocopy of it can be produced, a lost note affidavit may be insufficient for purposes of enforcement because determining the terms of the original note may be impossible. *See JPMorgan Chase & Co. v. Casarano*, 963 N.E.2d 108, 110–11 (Mass. App. Ct. 2012) (finding that the terms of the note could not be proven with sufficient certainty); *In re Carter*, No. COA08-1503, 2009 WL 2370097, at *2–3 (N.C. Ct. App. Aug. 4, 2009). *But cf. Deutsche Bank Nat'l Trust Co. v. Giallombardo*, No. 07 CH34558, 2009 WL 1935918, at *3 (Ill. Cir. Ct. June 16, 2009) (holding that while no copy of note could be produced, other documents sufficiently established its essential terms).

⁷² *See Silicon Valley Bank v. Miracle Faith World Outreach, Inc.*, 60 A.3d 343, 348 (Conn. App. Ct. 2013) (finding that when a holder testified of efforts made to locate the note, the holder was not required to explain exactly how the note was lost); *Correa v. U.S. Bank, N.A.*, 118 So. 3d 952, 955 (Fla. Dist. Ct. App. 2013) (finding an affidavit insufficient when a foreclosure plaintiff did not prove the content of the note or the circumstances under which the note was lost); *Beaumont v. Bank of N.Y. Mellon*, 81 So. 3d 553, 554–55 (Fla. Dist. Ct. App. 2012) (holding that a foreclosure complaint was properly dismissed when plaintiff failed to prove who lost the note or when it was lost, offered no proof of anyone's right to enforce the note when it was lost, and produced no evidence of ownership of the note). While inability to file a lost note affidavit complying with section 3-309 is a major barrier to enforcement, it does not destroy or change the priority of the mortgage itself. *See Arvest Bank v. Bank of Am., N.A.*, No. CA12-612, 2013 WL 624130, at *3 (Ark. Ct. App. Feb. 20, 2013).

⁷³ *See, e.g., Worthington v. Fuller*, No. G046018, 2013 WL 29383, at *4 (Cal. Ct. App. Jan. 3, 2013) (holding that an indemnity by the party enforcing note provided the maker with sufficient protection); *First Constr. Co. v. Tri-S. Mortg. Investors*, 308

Fannie Mae and Freddie Mac have developed careful procedures for maintaining custody of mortgage notes.⁷⁴ As a result, lost notes are rare for loans they hold. But some other secondary market investors have not been so scrupulous, and it is all too common in foreclosure cases for neither the investor nor any designated custodian to have possession of the note. Hence the lost note affidavit procedure is extremely important.⁷⁵ Little doubt exists that the procedure has sometimes been the subject of serious abuse, with foreclosing parties using it not because the original note was impossible to find, but merely because it was inconvenient.

N.W.2d 298, 299 (Minn. 1981). The “adequate protection” concept of section 3-309(b) is flexible, and a court may be persuaded that the risk of double enforcement of the note is so minor that no bond or indemnity is needed. *See, e.g.*, VIII-Hotel II P Loan Portfolio Holdings, LLC v. Zimmerman, No. K12C-06-023, 2013 WL 5785290, at *4–5 (Del. Super. Ct. June 24, 2013). Virginia has adopted by statute a unique lost note procedure applicable to nonjudicial foreclosure of deeds of trust. *See* VA. CODE ANN. § 55-59.1 (West 2009). The procedure parallels U.C.C. section 3-309, providing for mailed notice to the borrower that the note has been lost, and permitting the borrower to apply to the circuit court for adequate protection against the risk that some other party will later attempt to enforce the note. *See* O’Dell v. Deutsche Bank Nat’l Trust Co., No. 1:12-CXI-985 (JCC/IDD), 2013 WL 2389874, at *9 (E.D. Va. May 30, 2013) (describing and approving the procedure).

⁷⁴ *See generally* FANNIE MAE, REQUIREMENTS FOR DOCUMENT CUSTODIANS (2013) (providing detailed information on what is required of institutions that are providing document custody services), *available at* https://www.fanniemae.com/content/eligibility_information/document-custodians-requirements.pdf; FREDDIE MAC, DOCUMENT CUSTODY PROCEDURES HANDBOOK (2012) (providing guidelines for meeting document custody requirements), *available at* <http://www.freddiemac.com/cim/handbook.html>.

⁷⁵ The need for such affidavits appears to be widespread because in some areas of the nation it appears that firms destroyed the original notes as a matter of policy. For example, a letter to the Florida Supreme Court from the Florida Bankers Association in 2009 observed: “The reason many firms file lost note counts as a standard alternative pleading in the complaint is because the physical document was deliberately eliminated to avoid confusion immediately upon its conversion to an electronic file.” Comments of the Florida Bankers Association at 4, In re: Amendments to Rules of Civil Procedure and Forms for Use with Rules of Civil Procedure, No. 09-1460 (Fla. 2009) (citation omitted) (internal quotation marks omitted), *available at* http://www.floridasupremecourt.org/clerk/comments/2009/09-1460_093009_Comments%20%28FBA%29.pdf. Although the number of notes that were intentionally destroyed is unclear, it seems obvious that in many cases firms have employed the lost note affidavit process simply to avoid the trouble of looking for the note. One Florida legal aid attorney estimated that 80% of the foreclosure complaints in her locality were accompanied by lost note affidavits. *See* Bob Ivry, *Banks Lose to Deadbeat Homeowners as Loans Sold in Bonds Vanish*, BLOOMBERG (Feb. 22, 2008), www.bloomberg.com/apps/news?pid=newsarchive&sid=aejJZdqodTCM.

Prior to adopting the 2002 amendments to section 3-309, some courts, beginning with the *Dennis Joslin*⁷⁶ case in 1997, construed the code to require that the party attempting to enforce the note aver that it lost the note *itself*. Hence, a loss of the note by its predecessor—for example, the originator of the note—would not count.⁷⁷ A roughly equal number of decisions disagreed, usually on the theory that the purported assignment of the lost note acts as an assignment of the right to file a lost note affidavit, enabling the successor of the party who lost the note to file.⁷⁸ The 2002 amendments to Article 3 reversed *Dennis Joslin*'s narrower interpretation of section 3-309, and the amended version allows a person to enforce the note if he or she “has directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred.”⁷⁹ However, by

⁷⁶ *Dennis Joslin Co. v. Robinson Broad. Corp.*, 977 F. Supp. 491, 494–95 (D.D.C. 1997).

⁷⁷ See, e.g., *Premier Capital, LLC v. Gavin (In re Gavin)*, 319 B.R. 27, 32–33 (B.A.P. 1st Cir. 2004); *Marks v. Braunstein*, 439 B.R. 248, 251 (Bankr. D. Mass. 2010); *In re Box*, No. 10-20086, 2010 WL 2228289, at *5 n.28 (Bankr. W.D. Mo. June 3, 2010) (dictum); *Kemp v. Countrywide Home Loans, Inc. (In re Kemp)*, 440 B.R. 624, 632 (Bankr. D.N.J. 2010); *State St. Bank & Trust Co. v. Lord*, 851 So. 2d 790, 791–92 (Fla. Dist. Ct. App. 2003); *Cadle Co. of Conn., Inc. v. Messick*, No. CV 00092983, 2001 WL 822231, at *4 (Conn. Super. Ct. June 26, 2001); see also *EquiCredit Corp. of Am. v. Provo*, No. L-03-1217, 2006 WL 2192856, at *2 (Ohio Ct. App. Aug. 4, 2006) (finding that the foreclosing party had provided satisfactory proof that it had possession of the note at the time the note was lost, thus complying with the rule of *Dennis Joslin*).

⁷⁸ See, e.g., *Caddo Parish-Villas S., Ltd. v. Beal Bank, S.S.B. (In re Caddo Parish-Villas S., Ltd.)*, 250 F.3d 300, 302 (5th Cir. 2001); *Se. Invs., Inc. v. Clade*, No. Civ. A. 3:97-CV-1799-L, 1999 WL 476865, at *3 (N.D. Tex. July 7, 1999), *aff'd*, 212 F.3d 595 (5th Cir. 2000) (unpublished table decision); *Atl. Nat'l Trust, LLC v. McNamee*, 984 So. 2d 375, 376 (Ala. 2007); *NAB Asset Venture II, L.P. v. Lenertz, Inc.*, No. C4-97-2181, 1998 WL 422207, at *3 (Minn. Ct. App. July 28, 1998); *YYY Corp. v. Gazda*, 761 A.2d 395, 400–01 (N.H. 2000); *Bobby D. Assocs. v. DiMarcantonio*, 751 A.2d 673, 675–76 (Pa. Super. Ct. 2000); *JPMorgan Chase Bank, N.A. v. Stehrenberger*, 2014 WL 1711765 (Wash.Ct.App. 2014); see also *Bank of Am., N.A. v. Alvarado*, No. BER-F-47941-08, 2011 WL 145639 (N.J. Super. Ch. Div. Jan. 7, 2011) (permitting a party to enforce a missing note on an unjust enrichment theory even though it was lost by a predecessor, despite the fact that New Jersey had not adopted the 2002 amendments to Article 3). Professor Zinnecker explains the arguments well. See Timothy R. Zinnecker, *Extending Enforcement Rights to Assignees of Lost, Destroyed, or Stolen Negotiable Instruments Under Article 3: A Proposal for Reform*, 50 U. KAN. L. REV. 111, 113–19 (2001); see also Adam Leitman Bailey & Rachel Sigmund, *Using the Judicial System to Abate the Foreclosure Crisis*, PRAC. REAL EST. LAW., Mar. 2013, at 5, 6.

⁷⁹ U.C.C. § 3-309(a)(1)(B) (amended 2002); see also *Feltus v. U.S. Bank, N.A.*, 80 So. 3d 375, 377 (Fla. Dist. Ct. App. 2012) (quoting FLA. STAT. ANN. § 673.3091(1)(a))

2014 only twelve states had adopted the 2002 amendments to U.C.C. section 3-309.⁸⁰ Therefore, in much of the nation, a secondary market purchaser may still be in serious trouble if the note was lost or destroyed by its predecessor.⁸¹

To return to the first two methods of becoming “entitled to enforce,” while they require that the enforcing party possess the note (if the note is negotiable),⁸² they do not literally insist that the party produce the note in court. For example, the foreclosing party could prove that it had possession of the note by other means, such as oral testimony or affidavits.⁸³ But it is easy to understand why courts in judicial

(West Supp. 2014)) (holding that even under the 2002 amendments to U.C.C. section 3-309, the complaint was insufficient because it “failed to allege that [the alleged holder of the note] ‘was entitled to enforce the instrument when loss of possession occurred, or has directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred’”).

⁸⁰ See U.C.C. § 3-309. Only Alabama, Arkansas, Florida, Hawaii, Indiana, Iowa, Kentucky, Minnesota, Mississippi, Montana, North Dakota, Oklahoma, South Carolina, Tennessee, and Texas have substantially adopted the language in section 3-309(a)(1)(B).

⁸¹ See, e.g., Abigail Field, *Countrywide’s Mortgage Document Errors May Doom Bank of America*, DAILY FIN. (Nov. 22, 2010, 1:30 PM), <http://www.dailyfinance.com/story/credit/bank-of-america-mortgage-document-errors-trouble-countrywide/19728402/>.

⁸² See, e.g., *HSBC Bank USA v. Hernandez*, 939 N.Y.S.2d 120, 122 (N.Y. App. Div. 2012) (denying foreclosure because the foreclosing party did not prove it had possession of the note); *Deutsche Bank Nat’l Trust Co. v. Barnett*, 931 N.Y.S.2d 630, 632 (N.Y. App. Div. 2011) (stating that the holder failed to submit affidavits showing when and how it received the note); *Deutsche Bank Nat’l Trust Co. v. Matthews*, 273 P.3d 43, 47 (Okla. 2012) (“It is a fundamental precept of the law to expect a foreclosing party to actually be in possession of its claimed interest in the note . . .”).

⁸³ See, e.g., *GMAC Mortg., LLC v. Ford*, 73 A.3d 742, 751 (Conn. App. Ct. 2013) (holding that an affidavit of possession of a note is sufficient evidence for summary judgment of foreclosure); *Parkway Bank & Trust Co. v. Korzen*, 2 N.E.3d 1052, 1066 (Ill. App. Ct. 2013) (stating that the attachment of a copy of a note to a foreclosure complaint is prima facie evidence that the plaintiff has possession); *Dobson v. Substitute Tr. Servs., Inc.*, 711 S.E.2d 728, 730–31 (N.C. Ct. App. 2011), *aff’d*, 716 S.E.2d 849 (N.C. 2011); *In re Adams*, 693 S.E.2d 705, 710 (N.C. Ct. App. 2010); *Howard v. PNC Mortg.*, 269 P.3d 995, 997 (Utah Ct. App. 2012) (holding that the trial court correctly accepted a photocopy of a note as proof of the note’s possession when the mortgagor admitted that the note had been transferred and the photocopy showed that the note had been properly endorsed); *Dow Family, LLC v. PHH Mortg. Corp.*, 838 N.W.2d 119, 124–25 (Wis. Ct. App. 2013) (stating that possession may be proven by an affidavit of a person with personal knowledge). *But cf.* *Deutsche Bank Nat’l Trust Co. v. Mitchell*, 27 A.3d 1229, 1237 (N.J. Super. Ct. App. Div. 2011) (holding that the purported note holder’s affidavits were insufficient because they failed to state how and when the holder acquired possession of the note); *U.S. Bank, N.A. v. Baber*, 280 P.3d 956, 958–59 (Okla. 2012) (vacating summary judgment, despite the purported note holder’s affidavit that it

foreclosure states sometimes demand that the note itself be produced—if a party has the note, why not show it to the judge?⁸⁴

Unless a holder or a nonholder with the rights of a holder uses the lost note procedure, the note must be physically transferred into the hands of the party proposing to enforce it.⁸⁵ The use of a separate

held the note and production of a copy of the note); *U.S. Bank, N.A. v. Kimball*, 27 A.3d 1087, 1093 (Vt. 2011) (conflicting affidavits were insufficient to establish that the purported note holder possessed the note on the date the foreclosure commenced).

⁸⁴ See, e.g., *5-Star Mgmt., Inc. v. Rogers*, 940 F. Supp. 512, 520–21 (E.D.N.Y. 1996); *In re Wilhelm*, 407 B.R. 392, 404 (Bankr. D. Idaho 2009) (having a mortgage assignment from MERS is no substitute for delivery of the note). Even if the note is nonnegotiable, a court may demand production of it as proof that the note has been transferred to the party that filed the foreclosure action. This idea is an ancient one and is not confined to negotiable notes. See, e.g., *Sheehy v. Mandeville*, 11 U.S. (7 Cranch) 208, 218 (1812) (“The practice of this country is to require that the note should be produced, or its absence accounted for, and the rule is a safe one.”). See generally William M. Howard, Annotation, *Necessity of Production of Original Note Involved in Mortgage Foreclosure—Twenty-First Century Cases*, 86 A.L.R. 6th 411 (2013 & Supp. 2014) (collecting twenty-first century cases regarding when producing the original note involved in a mortgage foreclosure is necessary).

⁸⁵ See U.C.C. § 1-201(14) (2000) (defining delivery as a “voluntary transfer of possession”); see also *5-Star Mgmt.*, 940 F. Supp. at 520 (finding that a majority of jurisdictions require the original note unless the original has been destroyed); *In re Am. Equity Corp. of Pinellas*, 332 B.R. 645, 649 (Bankr. M.D. Fla. 2005); *Century Mortg. Co. v. George*, 646 A.2d 226, 229 (Conn. App. Ct. 1994). The rationale for the delivery requirement is explained in U.C.C. section 3-203:

[A negotiable] instrument is a reified right to payment. The right is represented by the instrument itself. The right to payment is transferred by delivery of possession of the instrument by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument.

U.C.C. § 3-203 cmt. 1 (amended 2002) (internal quotation marks omitted); see also *In re United Home Loans, Inc.*, 71 B.R. 885, 890–91 (Bankr. W.D. Wash. 1987); *Sec. Pac. Nat’l Bank v. Chess*, 129 Cal. Rptr. 852, 856 (Cal. Ct. App. 1976).

Delivery to the transferee’s agent is effective. See *Saul, Ewing, Remick & Saul v. Provident Sav. Bank*, No. CIV.A. 14013, 1999 WL 182566, at *1 (Del. Ch. Mar. 18, 1999). The delivery of the note to a custodian representing the party to whom the right of enforcement is being transferred is common, and such a delivery should pose no problem in terms of compliance with Article 3. See, e.g., *Thomas v. Wells Fargo Bank, N.A.*, 116 So. 3d 226, 232 (Ala. Civ. App. 2012) (approving such an arrangement); *Bank of N.Y. v. Raftogianis*, 13 A.3d 435, 444 (N.J. Super. Ct. Ch. Div. 2010) (“The actual delivery of the notes to [the custodian] would presumably constitute constructive delivery to the [purported holder].”); cf. *Nicholson v. Washington Mut., F.A.*, No. 13-00-394-CV, 2001 WL 1002418, at *3 (Tex. App. Aug. 31, 2001) (finding that the purported holder of the note did not prove that the custodian was its agent or authorized to act on its behalf in possessing the note).

document of assignment is not objectionable, but it cannot substitute for delivery of the note.⁸⁶ If the delivery is accompanied by an endorsement of the note, the transfer is known as a negotiation and the transferee (if otherwise qualified) may become a holder in due course.⁸⁷ If the note is not endorsed, the transfer can still vest the right of enforcement in the transferee as nonholder with the rights of a holder, but he or she cannot be a holder in due course.⁸⁸

In sum, delivery of possession is highly desirable in a transfer of the right of enforcement of a note. The lost note procedure is not a very

The Federal Rules of Evidence provide specific requirements that must be met by a custodian in order to introduce proof of possession of a document; see *In re McFadden*, 471 B.R. 136 (Bankr. D. S.C. 2012); *In re Sia*, 81 UCC Rep.Serv.2d 578, 2013 WL 4547312 (Bankr. D. N.J. 2013) (proper foundation laid, testimony admitted); *Bank of America v. Greenleaf*, 2014 WL 2988236 (Me. 2014) (inadequate foundation, testimony rejected). An effective delivery can occur without physically moving the note, if the custodian's agency relationship is transferred from one holder to another; *Kohler v. U.S. Bank N.A.*, 80 UCC Rep.Serv.2d 1135 (E.D. Wisc. 2013).

⁸⁶ See *State St. Bank & Trust Co. v. Lord*, 851 So. 2d 790, 791–92 (Fla. Dist. Ct. App. 2003) (holding that the assignee of a mortgage could not enforce the mortgage or note without proof that the assignee had obtained possession of the note); *Bank of N.Y. Mellon v. Deane*, 970 N.Y.S.2d 427, 435 (N.Y. Sup. Ct. 2013) (disagreeing with some prior New York Appellate Division decisions that appear to regard a written assignment of the note as sufficient to confer the right of enforcement, such as *Deutsche Bank Nat'l Trust Co. v. Whalen*, 969 N.Y.S.2d 82 (N.Y. App. Div. 2013)); *Shepard v. Boone*, 99 S.W.3d 263, 266 (Tex. App. 2003) (holding that the assignment of the mortgage did not effectively assign the negotiable promissory note because possession of the note was not transferred to the purported assignee). Some Ohio decisions (but not all) seem to mistakenly assume that a separate assignment of the note or mortgage can transfer the right of enforcement. See *Fed. Home Loan Mortg. Corp. v. Schwartzwald*, 957 N.E.2d 790, 801 (Ohio Ct. App. 2011), *rev'd on other grounds*, 979 N.E.2d 1214 (Ohio 2012); *HSBC Bank USA, N.A. v. Sherman*, No. C-120302, 2013 WL 5436540, at *2 (Ohio Ct. App. Sept. 27, 2013).

⁸⁷ Endorsement of the note is not necessary for a negotiation if the note is made to bearer rather than a named payee, but bearer notes are rarely employed in real estate financing. Normally, a mortgage note will be payable to the originating mortgagee, so its endorsement is necessary for negotiation. See *Second Nat'l Bank v. G.M.T. Props., Inc.*, 364 So. 2d 59, 60–61 (Fla. Dist. Ct. App. 1978); *cf. Fannie Mae v. Trahey*, No. 12CA010209, 2013 WL 3534475, at *2 (Ohio Ct. App. July 15, 2013) (refusing summary judgment as to the right of the party in possession to foreclose because the note bore two conflicting endorsements). If a note is endorsed in blank, it becomes in effect a bearer note, and no further endorsements are necessary to transfer the right of enforcement by subsequent deliveries; see); U.C.C. §3-205(b); *Bank of New York v. Romero*, 320 P.3d 1, 6 (2014).

⁸⁸ See *infra* text accompanying notes 163–173 (discussing why holder in due course status is so desirable).

satisfactory substitute and may not even be available if the loss occurred before the transfer to the present claimant. Even if this procedure is not a barrier to enforcement, the enforcing party is at risk of being called upon to prove how and when the loss occurred and may be required to post a bond or give an indemnity against double enforcement. These are not happy prospects. Handling the note with care greatly reduces the risks and is a better way to ensure delivery to the transferee.

C. Negotiability Matters

Article 9, which governs ownership, applies to all mortgage notes. On the other hand, Article 3, governing the transfers of the right of enforcement, applies only if the note in question is negotiable; otherwise the common law governs. Hence, in order to determine what law applies to transfers of enforcement rights, it becomes critically important to be able to examine the note in question and determine whether the note is negotiable or not.

Article 3 spells out the requirements of negotiability. The fact that the note is secured by a mortgage is of no consequence *per se*. Such notes can still be negotiable.⁸⁹ But to be negotiable, the instrument must meet the following criteria:

- (a) an unconditional promise to pay a fixed amount of money,⁹⁰ with or without interest or other charges . . . , if it:
 - (1) is payable to bearer or to order . . . ;⁹¹
 - (2) is payable on demand or at a definite time; and
 - (3) does not state any other undertaking or instruction . . . to do any act in addition to the payment of money⁹²

⁸⁹ See, e.g., *In re Green*, Nos. CC-11-1374-MKHHa, ND 09-11614-RR, 2012 WL 4857552, at *6–7 (B.A.P. 9th Cir. 2012); *JP Morgan Chase Bank, N.A. v. Murray*, 63 A.3d 1258, 1265 (Pa. Super. Ct. 2013).

⁹⁰ For example, in *Persky v. Bank of America, N.A.*, the New York Court of Appeals held that a promise to pay principle and interest, and also to pay any taxes levied, made the note nonnegotiable because the taxes were not a “sum certain,” in the words of the old Negotiable Instruments Law. 185 N.E. 77, 78–79 (N.Y. 1933).

⁹¹ See *Lakhany v. Anzelone*, 788 F. Supp. 160, 163 (S.D.N.Y. 1992); *Smith v. McKeller*, 638 So. 2d 1192, 1195 (La. Ct. App. 1994); *Bremen Bank & Trust Co. v. Muskopf*, 817 S.W.2d 602, 606–07 (Mo. Ct. App. 1991).

⁹² U.C.C. § 3-104(a)(3) (amended 2002).

Notwithstanding the foregoing, a note can be negotiable even though it contains:

- (i) an undertaking or power to give, maintain, or protect collateral . . . ,
- (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or
- (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor.⁹³

Finally, a note is considered conditional if it states either an express condition, that the note is subject to or governed by another writing, or that rights or obligations with respect to its promise are stated in another record.⁹⁴ However, negotiability is not impaired by “a reference to another record for a statement of rights with respect to collateral, prepayment, or acceleration,”⁹⁵ or by the fact that “payment is limited to resort to a particular fund or source.”⁹⁶

From these rules, one can see that care must be taken in including references to mortgages in the notes they secure. A general statement that the note is secured by the mortgage is permissible⁹⁷ because the statement is merely a “statement of rights with respect to collateral.”⁹⁸ Incorporating by reference in the note any specific terms of the mortgage that deal with “rights and obligations concerning collateral, prepayment, or acceleration” is also acceptable.⁹⁹ But a general incorporation of the

⁹³ *Id.*

⁹⁴ *See id.* § 3-106(a).

⁹⁵ *Id.* § 3-106(b).

⁹⁶ *Id.*

⁹⁷ *Wilson v. Toussie*, 260 F. Supp. 2d 530, 543 (E.D.N.Y. 2003); *Apponline.com, Inc. v. Louis (In re Apponline.com, Inc.)*, 290 B.R. 1, 9 (Bankr. E.D.N.Y. 2003) (holding that references to the mortgage in the note for the purpose of advising the borrower that the mortgage provided the lender with security for payment of the debt did not affect negotiability of note); *First Fed. Sav. & Loan Ass’n v. Gump & Ayers Real Estate, Inc.*, 771 P.2d 1096, 1098 (Utah Ct. App. 1989) (holding that the note was negotiable despite its statement that “reference is made to the Purchase and Security Agreement”).

⁹⁸ U.C.C. § 3-106(b).

⁹⁹ *Id.* § 3-106(b) cmt. 1; *see also Knigge v. SunTrust Mortg., Inc. (In re Knigge)*, 479 B.R. 500, 505 (B.A.P. 8th Cir. 2012) (undertakings such as occupying the property, refraining from wasting or destroying the property, maintaining insurance on the property, and giving notice to lender of any losses related to the property were all within this code language and did not impair negotiability); *Mesina v. CitiBank, N.A., (In re Mesinna)*, No. 10-2304 RTL, 2012 WL 2501123, at *1 (Bankr. D.N.J. June 27, 2012); *Ascot Mortg., Inc. v. MLA, Inc. (In re Ascot Mortg.)*, 153 B.R. 1002, 1013 (Bankr. N.D. Ga. 1993) (reference in note to requirement that VA approve any loan assumption did not

mortgage into the note will destroy negotiability,¹⁰⁰ because section 3-106 provides that the note is regarded as conditional if “rights or obligations with respect to the promise or order are stated in another record.”¹⁰¹ The same is true of incorporation of other sorts of documents.¹⁰²

Nonrecourse notes, which provide that the maker has no personal liability and that the debt may be collected only from the real estate, were long regarded as nonnegotiable on the ground that the promise to pay

impair note’s negotiability); *First W. Nat’l Bank v. Corona*, No. D036331, 2002 WL 276141, at *4 (Cal. Ct. App. Feb. 27, 2002); *Burns v. Resolution Trust Co.*, 880 S.W.2d 149, 153–54 (Tex. App. 1994) (finding that the note’s requirement that the maker pay taxes on the real property was a promise relating to the collateral and did not impair note’s negotiability); *Marriott v. Harris*, 368 S.E.2d 225, 238 (Va. 1988) (finding that reference in the note to an acceleration clause in the mortgage did not impair the note’s negotiability).

¹⁰⁰ See U.C.C. § 3-106(a)(ii); see also *Guniganti v. Kalvakuntla*, 346 S.W.3d 242, 249 (Tex. App. 2011) (concluding that a note incorporating reference to guaranty was nonnegotiable). The inclusion of other conditions in the note will also render it nonnegotiable. See, e.g., *Roa v. Miller*, 784 P.2d 826, 829 (Colo. App. 1989) (finding that condition that the broker transfer real estate title to the maker made the note nonnegotiable); *Calfo v. D.C. Stewart Co.*, 717 P.2d 697, 700–01 (Utah 1986) (finding a note nonnegotiable because it was conditioned on an option to purchase real estate); *Jackson v. DeWitt*, 592 N.W.2d 262, 267 (Wis. Ct. App. 1999) (finding a note nonnegotiable because of a condition that the maker purchase a swimming pool). Real estate installment sale contracts routinely contain numerous conditions and promises in addition to the promise to pay the purchase price, and thus are usually not negotiable. See *In re Holiday Interval*, 94 B.R. 594, 597–98 (Bankr. Mo. 1988), *aff’d*, 931 F.2d 50 (8th Cir. 1991). The same is true of consumer installment contracts for the sale of goods. See *Geiger Fin. Co. v. Graham*, 182 S.E.2d 521, 525 (Ga. Ct. App. 1971).

¹⁰¹ U.C.C. § 3-106(a)(iii). As Official Comment 1 says, “the holder of a negotiable instrument should not be required to examine another document to determine rights with respect to payment.” *Id.* § 3-106 cmt. 1.

¹⁰² See *Johnstone v. Mills*, (*In re Columbia Pac. Mortg., Inc.*), 22 B.R. 753, 754 n.1 (Bankr. Wash. 1982); *Resolution Trust Corp. v. 1601 Partners, Ltd.*, 796 F. Supp. 238, 240 (N.D. Tex. 1992); *Holly Hill Acres, Ltd. v. Charter Bank of Gainesville*, 314 So. 2d 209, 211 (Fla. Dist. Ct. App. 1975); *Ngo v. Park*, 623 S.E.2d 369 (N.C. Ct. App. 2006) (unpublished table decision) (holding that a note incorporating deed and settlement agreement was nonnegotiable); *Guniganti*, 346 S.W.3d at 249; see also *Growth Equities Corp. v. Freed*, 277 Cal. Rptr. 848, 851 (Cal. Ct. App. 1991) (holding that notes stating that they were “subject to” the terms of a partnership agreement were nonnegotiable); *DeBry v. Cascade Enterprises*, 879 P.2d 1353, 1357 (Utah 1994) (holding that a note “subject to” the terms of escrow agreement was nonnegotiable). Additional conditions added in the endorsement of the note, as distinct from the original note itself, have no bearing at all on negotiability. See *Partney v. Reed*, 889 S.W.2d 896 (Mo. App. Ct. 1994).

was not unconditional.¹⁰³ However, the 1990 Official Text of Article 3 reverses that rule, providing instead that the promise is viewed as unconditional despite the fact that “payment is limited to resort to a particular fund or source.”¹⁰⁴

These rules may seem unduly technical. They arise out of the idea that the holder of a negotiable instrument should be able to ascertain all of its essential terms from its face. In the mortgage context today this rationale makes little sense; no intelligent transferee would take the note without inspecting both the note itself and the mortgage securing it, and probably a number of other documents as well—for example, the title insurance policy, the appraisal, and the survey. Hence, it is difficult to accept any policy rationale that prevents full incorporation of the mortgage into the note or even against the combination of the note and mortgage on the same piece of paper. Still, the law is clear and easy enough to observe; the price of a violation is the loss of negotiability.

Prior to the adoption of the current version of Article 3 in 1990, a persistent question arose concerning notes that provided for a variable or adjustable interest rate (typically keyed to some external index of market rates) or to the particular lender’s “prime” rate. Such notes were widely used in mortgage transactions, but arguably those notes did not fulfill the sum certain requirement, and hence were not negotiable.¹⁰⁵ Little basis in

¹⁰³ See *Lyons Sav. & Loan Ass’n v. Geode Co.*, 641 F. Supp. 1313, 1322 (N.D. Ill. 1986) (discussing the effect of a note to be paid only out of “net cash flow” of real estate); *United Nat’l Bank of Miami v. Airport Plaza Ltd. P’ship*, 537 So. 2d 608, 609–10 (Fla. Dist. Ct. App. 1988); *Inland Real Estate Corp. v. Oak Park Trust & Sav. Bank*, 469 N.E.2d 204, 208–09 (Ill. App. Ct. 1983); *Hinckley v. Eggers*, 587 S.W.2d 448, 450 (Tex. App. 1979).

¹⁰⁴ U.C.C. § 3-106(b)(ii).

¹⁰⁵ Compare *Carnegie Bank v. Shalleck*, 606 A.2d 389, 398 (N.J. Super. Ct. App. Div. 1992) (finding a New Jersey amendment to the U.C.C. retroactive, making an adjustable rate note executed before the statute’s amendment negotiable), and *Goss v. Trinity Sav. & Loan Ass’n*, 813 P.2d 492, 495 (Okla. 1991) (finding an adjustable rate note negotiable under the pre-1990 version of the U.C.C.), and *Amberboy v. Societe de Banque Privee*, 831 S.W.2d 793, 793 (Tex. 1992) (finding a note tied to a bank’s prime rate negotiable under the pre-1990 version of the U.C.C.), with *Desmond v. Fed. Deposit Ins. Corp.*, 798 F. Supp. 829, 840–41 (D. Mass. 1992) (finding adjustable rate notes nonnegotiable), and *Resolution Trust Corp. v. Maplewood Invs.*, 31 F.3d 1276, 1289 (4th Cir. 1994) (finding the Virginia amendment to the U.C.C. was not retroactive, and therefore, an adjustable rate note executed prior to the amendment was nonnegotiable). See generally Thomas B. Fiddler, Comment, *An Argument for the Alteration of the UCC to Include Variable Rate Notes as Negotiable Instruments*, 9 J.L. & COM. 115 (1989) (discussing how the U.C.C. does not reflect the predominant use of variable rate notes);

good policy existed for this view, and the 1990 Official Text included a new section, section 3-112(b), providing:

Interest may be stated in an instrument as a fixed or variable amount of money or it may be expressed as a fixed or variable rate or rates. The amount or rate of interest may be stated or described in the instrument in any manner and may require reference to information not contained in the instrument.

The controversy over the negotiability of adjustable rate notes has thus been laid to rest.¹⁰⁶ However, notes with a variable or uncertain *principal* amount are another matter. Such “line of credit” loans, in which the balance depends on the amount the borrower chooses to draw down or repay from time to time, are plainly not negotiable.¹⁰⁷

To create a negotiable note, it must be payable to bearer or to order.¹⁰⁸ Bearer notes are rare in mortgage transactions; the note is ordinarily payable to the originating mortgagee. Hence for negotiability, the note must include order language, such as “I promise to pay to the order of John Mortgagee,” or “I promise to pay to John Mortgagee or order.” Order is a magical term in this context. It acts as a switch, turning negotiability on if the term is included, and off if the term is omitted. In effect, the word order warns the mortgagor that he or she is signing a negotiable instrument, which brings with it potential liabilities. Perhaps most mortgagors have no idea what the word means, but the rule is clear all the same.¹⁰⁹

Whether the standard Fannie Mae-Freddie Mac 1-to-4-family residential note is negotiable is of great importance because of its wide usage—nearly universally so in residential mortgage loans in the United States. Surprisingly, until about 2010 finding any case authority applying

Jay M. Zittler, Annotation, What Constitutes “Fixed Amount of Money” for Purposes of [Rev] § 3-104 of Uniform Commercial Code, 76 A.L.R.5th 289 (2000).

¹⁰⁶ See, e.g., *In re McFadden*, 471 B.R. 136, 169 (Bankr. D.S.C. 2012).

¹⁰⁷ See *Yin v. Soc’y Nat’l Bank Ind.*, 665 N.E.2d 58, 62–63 (Ind. Ct. App. 1996).

¹⁰⁸ See U.C.C. §§ 3-104(a)(1), 3-109; see also *Sirius LC v. Erickson*, 156 P.3d 539, 543 (Idaho 2007); *Yin*, 665 N.E.2d at 63; Zittler, *supra* note 105.

¹⁰⁹ See U.C.C. § 3-104 cmt. 2. *But see* *Coop. Cent. Raiffeisen-Boerenleenbank B.A. v. Bailey*, 710 F. Supp. 737, 739 (C.D. Cal. 1989) (stating that a note payable to order “to” payee rather than “of” payee was negotiable).

serious and careful analysis to this question was difficult.¹¹⁰ Courts were (and sometimes still are) frequently guilty of uncritically assuming that such notes are negotiable.¹¹¹ In 1996 Professor Ronald Mann wrote an article in which he opined that these notes were nonnegotiable because if the borrower wished to make a prepayment, the notes required the borrower to notify the lender of his or her intention of doing so. This obligation, Mann speculated, would be regarded as an “other undertaking” beyond the promise to pay the money, and hence would deprive the note of negotiability.¹¹²

Until the collapse of the mortgage market in 2007, Mann’s argument went untested in the courts. However, every case since that time addressing the issue has rejected Mann’s speculation and held that the standard residential note is negotiable.¹¹³ These cases typically provide several reasons why the prepayment notice requirement is not an other

¹¹⁰ See Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What To Do About It*, 37 PEPP. L. REV. 737, 740, 749 (2010). Occasionally, an exceptional earlier decision took the question seriously and provided a thoughtful analysis. See, e.g., *Apponline.com, Inc. v. Matrix Capital Bank (In re AppOnline.com, Inc.)*, 321 B.R. 614, 621–25 (E.D.N.Y. 2003); *Bibler v. Arcata Invs. 2, LLC*, No. 263024, 2005 WL 3304127 (Mich. Ct. App. Dec. 6, 2005).

¹¹¹ See, e.g., *Michael D. v. GMAC Mortg., LLC*, 763 F. Supp. 2d 1091, 1110 (W.D. Mo. 2011) (“A mortgage loan is a promissory note and thus a negotiable instrument governed by the UCC”), *abrogated by* *Washington v. Countrywide Home Loans, Inc.*, 655 F.3d 869 (8th Cir. 2011); *Deutsche Bank Nat’l Trust Co. v. Matthews*, 273 P.3d 43, 47 (Okla. 2012). Such decisions are seriously off the mark to the extent that they assume that negotiability can be determined without an analysis of the actual text of the note.

¹¹² See Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 U.C.L.A. L. REV. 951, 970–72 nn.67–70 (1997).

¹¹³ The first of these cases seems to be *HSBC Bank USA, N.A. v. Gouda*, No. F-20201–07, 2010 WL 5128666, at *2 (N.J. Super. Ct. App. Div. Dec. 17, 2010). See also *Steinberg v. Bank of Am., N.A. (In re Steinberg)*, No. 12-20554, 2013 WL 2351797, at *3 (B.A.P. 10th Cir. May 30, 2013); *Picatunny Fed. Credit Union v. Fed. Nat’l Mortg. Ass’n*, No. 09-1295 (GEB), 2011 WL 1337507, at *6–7 (D.N.J. Apr. 7, 2011); *Mesina v. CitiBank, N.A. (In re Mesinna)*, No. 10-2304 RTL, 2012 WL 2501123, at *1 (Bankr. D.N.J. June 27, 2012); *In re Walker*, 466 B.R. 271, 283 (Bankr. E.D. Pa. 2012); *In re Kain*, No. 08-08404-HB 2012, WL 1098465, at *4–5 (Bankr. D.S.C. Mar. 30, 2012); *Edwards v. Deutsche Bank Nat’l Trust Co. (In re Edwards)*, No. 11–23195, 2011 WL 6754073, at *3–4 (Bankr. E.D. Wis. Dec. 23, 2011); *Thomas v. Wells Fargo Bank, N.A.*, 116 So. 3d 226 (Ala. Civ. App. 2012); *Wells Fargo Bank, N.A. v. Clegg*, No. CV116019620S, 2013 WL 452790, at *3 (Conn. Super. Ct. Jan. 7, 2013); *Deutsche Bank Nat’l Trust Co. v. Najjar*, No. 98502, 2013 WL 1791372, at *11 (Ohio Ct. App. Apr. 25, 2013); *JP Morgan Chase Bank, N.A. v. Murray*, 63 A.3d 1258, 1265. See generally Kurt Eggert, *Not Dead Yet: The Surprising Survival of Negotiability*, 66 ARK. L. REV. 145 (2013).

undertaking: (1) the borrower's decision to prepay principal is voluntary, not required; (2) the prepayment notification requirement imposes no additional financial liability on the borrower, and adds nothing to the promise to pay the debt; and (3) no penalty is incurred if the borrower fails to give the notification. Whether these reasonings are correct in any ultimate sense is hard to say—none of the decisions is from the highest court of a state. The prepayment notice obligation in the Fannie Mae-Freddie Mac form is, by its nature, conditional because it applies only if the borrower elects to make a prepayment. As a matter of general principle, whether or not such an obligation falls under section 3-104's proscription against "other undertakings" is uncertain.¹¹⁴ But for the present, at least, it seems reasonable to assume that the standard residential note is negotiable.

While the standard Fannie Mae-Freddie Mac residential mortgage note may well be negotiable, many notes used in commercial mortgage loan transactions are clearly not.¹¹⁵ What law governs transfers of their right of enforcement? They are left to the common law of contracts.¹¹⁶ Moreover, little modern case law concerning their transfer exists, perhaps because courts tend to assume (often with little or no analysis) that the notes before them are negotiable.¹¹⁷ This tendency is understandable because it provides the court with a relatively clear body

¹¹⁴ A similar issue could be raised with respect to defeasance clauses in commercial mortgage notes, which permit the borrower under certain circumstances to replace the real estate with other collateral, such as U.S. Treasury obligations. Such a clause imposes numerous complex duties on the borrower who replaces the real estate, but the decision to engage in the defeasance is the borrower's choice; hence these duties are optional or conditional in nature.

¹¹⁵ Often the reason is that commercial loan documents throw around the notion of incorporation by reference with wild abandon. A good example is a commercial loan in which the author represented the borrower, and the note (drafted by the lender, of course) contained the following language: "All of the terms, definitions, conditions and covenants of the Loan Documents are expressly made a part of this Note by reference in the same manner and with the same effect as if set forth herein at length." This language is quite an effective way to kill negotiability.

¹¹⁶ See, e.g., *JPMorgan Chase & Co., Inc. v. Casarano*, No. 07 MISC 344419 (AHS), 2010 WL 3605427, at *6 (Mass. Land Ct. Sept. 16, 2010) (finding a note nonnegotiable, and hence governed by the common law, when the note had been lost and no one could remember whether it was a demand note or for a definite term), *aff'd*, 963 N.E.2d 108 (Mass. App. Ct. 2012); see also Alan M. White, *Losing The Paper Mortgage Assignments, Note Transfers and Consumer Protection*, 24 LOY. CONSUMER L. REV. 468, 473 (2012).

¹¹⁷ See Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What To Do About It*, 37 PEPPERDINE L. REV. 737 (2010).

of law to govern transfer instead of the murky recesses of the common law. In other words, figuring out whether a given note is negotiable can be hard, while deciding whether a given negotiable note was properly transferred is relatively easy.

What are the rules governing the transfer of nonnegotiable notes to which Article 3 does not apply? The term “negotiation” has no significance with respect to a nonnegotiable note.¹¹⁸ The right to enforce it can be transferred by assignment, which may be carried out in any of several ways: by endorsement on the note by the original payee-mortgagee; by the use of a separate document that the payee-mortgagee executes, stating that rights under the note are transferred to the assignee; or even by an oral statement to the assignee that a transfer is being made.¹¹⁹ To assign a nonnegotiable note, passing the possession of the note itself to the transferee is unnecessary, although the delivery of

¹¹⁸ See U.C.C. § 3-201(a) (amended 2002) (“‘Negotiation’ means a transfer of possession . . . of an instrument by a person other than the issuer to a person who thereby becomes its holder.”). Section 3-104(b) in turn defines “instrument” to mean a negotiable instrument. Hence, the concept of negotiation is simply inapplicable to nonnegotiable notes.

¹¹⁹ Arguably, all assignments of notes secured by real estate mortgages must be in writing, since the assignment of the note automatically conveys an interest in land simultaneously, and therefore should comport with the real estate statute of frauds. A similar argument can be raised with regard to the necessity of delivery, which is ordinarily a prerequisite to an effective conveyance of an interest in realty. Here as in other areas, the dual nature of the debt and security creates a conflict, but by far the most common resolution, at least in equity, is to disregard the real estate requirements of writing and delivery if the debt itself is properly transferred and if no rights of third parties are prejudiced. *Hebrew Home for Orphans & Aged v. Freund*, 144 N.Y.S.2d 608, 611 (N.Y. Sup. Ct. 1955); *Thatcher v. Merriam*, 240 P.2d 266, 269 (Utah 1952); *Braidwood v. Harmon*, 187 N.W.2d 559 (Mich. App. 1971) (valid gift by delivery of note and mortgage without writing); *Hall v. O’Brien*, 112 N.E. 569, 570–71 (N.Y. 1916); William O. Gilbreath, Note, *A Mortgage as a Gift: The Problem in General*, 36 KY. L.J. 121, 121–24 (1947).

No special or technical words are necessary to transfer either the non-negotiable note or the mortgage. See *In re Stralem*, 758 N.Y.S.2d 345, 347 (N.Y. App. Div. 2003) (“No particular words are necessary to effect an assignment [of a mortgage]; . . . the correct test to determine the validity of an assignment is whether the assignor intended to transfer some present interest.”) (internal quotation marks omitted).

A different issue is raised by oral *contracts* to assign notes and/or mortgages. Such contracts are governed by U.C.C. section 1-206, which provides that “a contract for the sale of personal property is not enforceable . . . beyond five thousand dollars . . . unless there is some writing which indicates that a contract for sale has been made . . .” U.C.C. § 1-206 (2000); see also *Dairyland Fin. Corp. v. Fed. Intermediate Credit Bank*, 852 F.2d 242, 244 (7th Cir. 1988).

possession can be used to transfer the right to enforce the note if the parties elect that method.¹²⁰ Thus, the methods of transferring nonnegotiable notes are extremely flexible.¹²¹

Incidentally, one will look in vain for any indication in the common law cases involving nonnegotiable notes that there is a distinction between transferring the right of enforcement and transferring ownership. That distinction seems never to have occurred to anyone until the 1998 revision of Article 9, which created a specific procedure for transferring the ownership of notes. However, there seems to be no reason whatever that ownership and the right to enforce a nonnegotiable note could not be vested in separate parties. A simple contractual agreement between the parties allocating these rights is all that would be necessary.

Since negotiability *vel non* determines whether Article 3 or the common law governs the transfer of a note's right of enforcement, that determination can be of crucial importance, particularly if a note's enforceability has been transferred in a way that would satisfy the common law but not Article 3. While it would be highly desirable to have simple and authoritative guidelines for distinguishing between negotiable and nonnegotiable notes, there is no immediate prospect of

¹²⁰ See *Poirot v. Gundlach*, 1 N.E.2d 801, 804 (Ill. App. Ct. 1936); *Hayter v. Dinsmore*, 265 P. 1112, 1113 (Kan. 1928); *Va. Lee Homes, Inc. v. Schneider & Felix Const. Co.*, 395 P.2d 99, 100–02 (Wash. 1964); see also James Steven Rogers, *THE END OF NEGOTIABLE INSTRUMENTS: BRINGING PAYMENT SYSTEMS LAW OUT OF THE PAST* 24–39 (2011) (discussing the development of the common law concept that the note reifies the obligation, and hence that delivery of the note will transfer the right of enforcement).

¹²¹ See *In re JLL, Inc.*, 115 B.R. 324, 329–330 (Bankr. Ala. 1990) (finding a rubber-stamp signature of the mortgagee, affixed to note by her attorney in fact, was sufficient to transfer ownership of note and mortgage without transfer of possession); *Lawyers Title Ins. Co. v. Novastar Mortg., Inc.*, 862 So. 2d 793, 798 (Fla. Dist. App. Ct. 2004) (discussing a note that was assigned both by endorsement and separate assignment); *Margiewicz v. Terco Props.*, 441 So. 2d 1124, 1125 (Fla. Dist. Ct. App. 1983) (finding that no endorsement of a note is required—separate assignment is sufficient); *In re Stralem*, 758 N.Y.S.2d at 345; *Felin Assoc. v. Rogers*, 326 N.Y.S.2d 413, 415 (N.Y. App. Div. 1971); *Davin v. Isman*, 126 N.E. 257, 257 (N.Y. 1920). See also *Tackett v. First Sav. of Arkansas*, 810 S.W.2d 927, 929 (Ark. 1991) (stating that the ownership of notes may be conveyed either by transfer of possession or by written document of assignment). If the evidence of indebtedness is not a negotiable note, a photocopy of the debt instrument is acceptable evidence of its existence. See *Braut v. Tarabochia*, 17 P.3d 1248, 1250–51 (Wash. Ct. App. 2001). Possession of the document is unnecessary to enforce it if the note is nonnegotiable. See *YYY Corp. v. Gazda*, 761 A.2d 395, 400 (N.H. 2000). Of course, a wrongful acquisition of possession will not transfer ownership of the note. See *Shapiro v. Family Bank*, 538 So. 2d 944, 945 (Fla. Dist. Ct. App. 1989).

that occurring. For the present, we will have to continue to struggle with the definitions in Article 3. Its rules governing negotiability are complex, multifaceted, and are sometimes difficult to apply with any confidence. That such uncertainty could exist with respect to what body of law governs the roughly 10 trillion dollars in outstanding residential mortgage notes in the United States is appalling. However, that uncertainty is a fact, and has not yet been fully resolved. For the present, the struggle with the definitions in Article 3 will continue.

Thinking about the role of foreclosure defense lawyers in this context is interesting. Do they prefer to show that the notes their clients signed are negotiable or nonnegotiable? The answer depends on the defense that counsel wishes to raise in a particular case. If the defense is based on the failure of the parties in a secondary market sale to deliver the note, then the defense lawyer will need to show that the note was negotiable, for under the common law delivery is unnecessary. On the other hand, if defense counsel wishes to raise a defense based on fraud in the inducement in the origination of the loan, counsel will probably have to show that the note is nonnegotiable, for fraud in the inducement is a personal defense that cannot be raised against the holder in due course of a negotiable note. Hence, a determination that the note is negotiable or not may open up some defenses while closing off others. In a sense, the very uncertainty in the application of the rules of negotiability is an advantage to lawyers trying to stave off foreclosure because the uncertainty allows them to argue either for or against negotiability as the facts of the case may dictate.

D. The Mortgage Follows the Right to Enforce the Note

For well beyond 200 years, American law has been clear that a transfer of the secured obligation will automatically transfer the mortgage.¹²² Yet surprisingly, some significant new applications of this concept have occurred in the past half-decade. First, discussion of the time-honored concept itself is necessary. The basic notion is that the obligation is regarded as the principal thing being transferred, with the interest in the land automatically attached to it in an extremely important,

¹²² See *Johnson v. Hart*, 3 Johns. Cas. 322, 329 (N.Y. 1802) (“[W]herever the note goes, it will carry the charge upon the land along with it.”); see also 2 GERRARD GLENN, MORTGAGES: DEEDS TO TRUST, AND OTHER SECURITY DEVICES AS TO LAND § 314 (The Michie Co. et. al. eds., 1943).

but subsidiary, capacity.¹²³ This notion is of fundamental importance. It means that ordinarily, whoever can establish a claim to the obligation automatically gets with it the security interest in the land, provided the interest is still in existence.¹²⁴ This rule is well-nigh universal except in a

¹²³ See RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.4 (1997). The classic statement is found in *Carpenter v. Longan*, 83 U.S. 271, 275 (1872): “All the authorities agree that the debt is the principal thing and the mortgage an accessory.” See *In re Vargas*, 396 B.R. 511, 516–17 (Bankr. C.D. Cal. 2008); *First Nat’l Bank v. Larson*, 17 B.R. 957, 965 (Bankr. N.J. 1982); *Yanfag v. Cyfred, Ltd.*, No. CVA08-013, 2009 WL 5214891, at *7 (Guam Dec. 28, 2009); *Goetz v. Selsor*, 628 S.W.2d 404, 406 (Mo. Ct. App. 1982); *Fidelity & Deposit Co. of Md. v. Tigor Title Ins. Co.*, 943 P.2d 710, 712–13 (Wash. Ct. App. 1997); Antonio R. Bautista & Frank R. Kennedy, *The Imputed Negotiability of Security Interests Under the Code*, 38 IND. L.J. 574 (1963); Billie J. Ellis & Daniel L. Lowry, *A Comprehensive Note Purchase Guide*, (Part I, PRAC. REAL ESTATE LAW), July 1987, at 45; Billie J. Ellis & Daniel L. Lowry, *A Comprehensive Note Purchase Guide*, (Part II, PRAC. REAL ESTATE LAW), at 49 (Sept. 1987); William T. Swigert, Note, *Transfer of the Mortgagee’s Interest in Florida*, 14 U. FLA. L. REV. 98 (1961). Likewise, if the note has been fully paid, the mortgage is a nullity and an assignment of it is meaningless. See *Burkhardt v. Bailey*, 680 N.W.2d 453, 462 (Mich. Ct. App. 2004).

¹²⁴ *Horvath v. Bank of N.Y.*, 641 F.3d 617, 623 (4th Cir. 2011) (“[A] transfer of a secured debt carries with it the security without formal assignment or delivery.”) (citation omitted) (internal quotation marks omitted); *Gemini Servs., Inc. v. Mortg. Elec. Registration Sys.* (*In re Gemini Servs.*), 350 B.R. 74, 83 (Bankr. S.D. Ohio 2006) (stating that a beneficial interest in the mortgage went to secondary market investor to whom the note was delivered, although mortgage was assigned to MERS); *Roisland v. Flagstar Bank*, No. 3:13-cv-0588-MO, 2013 WL 6061590, at *5 (D. Or. Nov. 15, 2013) (stating that a transfer of a note to a new holder automatically assigned the deed of trust without a formal assignment); *In re Bryant*, 452 B.R. 876, 880 (Bankr. S.D. Ga. 2011) (stating that under South Carolina law “the assignment of a note secured by a mortgage carries with it an assignment of the mortgage”); *Domarad v. Fisher & Burke, Inc.*, 76 Cal. Rptr. 529, 539 (Cal. Ct. App. 1969); *Columbus Invs. v. Lewis*, 48 P.3d 1222, 1226 (Colo. 2002); *J.E. Robert Co., Inc. v. Signature Props., LLC*, 71 A.3d 492, 498–99 (Conn. 2013); *Margiewicz v. Terco Props.*, 441 So. 2d 1124, 1125 (Fla. Dist. Ct. App. 1983); *Fed. Nat’l Mortg. Ass’n v. Kuipers*, 732 N.E.2d 723, 729 (Ill. App. Ct. 2000); *Bank of Am., N.A. v. Inda*, 303 P.3d 696, 703 (Kan. Ct. App. 2013); *U.S. Bank, N.A. v. McConnell*, 305 P.3d 1, 8 (Kan. Ct. App. 2013); *Svrcek v. Rosenberg*, 40 A.3d 494, 507–08 (Md. Ct. Spec. App. 2012); *Pitman Place Dev., LLC v. Howard Invs., LLC*, 330 S.W.3d 519, 536 (Mo. Ct. App. 2010) (incorrectly limiting the principle to negotiable notes); *Deutsche Bank Nat’l Trust Co. v. Codio*, 943 N.Y.S.2d 545, 546 (N.Y. App. Div. 2012) (“A written assignment of the underlying note . . . is sufficient to transfer the obligation, and the mortgage passes with the debt as an inseparable incident”) (citations omitted) (internal quotation marks omitted); *Deutsche Bank Nat’l Trust Co. v. Pietranico*, 928 N.Y.S.2d 818, 829 (N.Y. Sup. Ct. 2011) (“[A]s the note changes hands, the mortgage remains connected to it legally even though it is not physically attached”); *Cent. Mortg. Co. v. Webster*, 978 N.E.2d 962, 968 (Ohio Ct. App. 2012); *Bank of Am., N.A. v. Draper*, 746 S.E.2d 478, 482–83 (S.C. Ct. App. 2013); *Commonwealth Prop. Advocates, LLC v.*

few title-theory states.¹²⁵ The security is virtually inseparable from the obligation¹²⁶ unless the parties to the transfer expressly agree to separate them. The reason is that the security is worthless in the hands of anyone except a person who has the right to enforce the obligation; it cannot be foreclosed or otherwise enforced.¹²⁷ Hence, separating the security and the obligation is ordinarily foolish because it will leave one person with an unsecured debt and the other with a security instrument that cannot be enforced.¹²⁸ This result is the origin of the widely-stated aphorism that “the mortgage follows the note.”¹²⁹

Mortg. Elec. Registration Sys., Inc., 263 P.3d 397, 403 (Utah Ct. App. 2011); *Fidelity & Deposit Co.*, 943 P.2d at 712–13; *UMLIC VP LLC v. Matthias*, 234 F. Supp. 2d 520, 523 (V.I. 2002), *aff'd*, 364 F.3d 125 (3d Cir. 2004) (stating that the transfer of a note automatically carries the mortgage with it, even if the transferee is unaware that the note is secured); *Dow Family, LLC v. PHH Mortg. Corp.*, 838 N.W.2d 119, 127 (Wis. Ct. App. 2013). *See generally* Deborah L. Thorne, Ethel Hong Badawi, *Does “the Mortgage Follow the Note”?: Lessons Learned, Best Practices for Assignment of a Note and Mortgage*, AM. BANKR. L. J., May 2011, at 54.

¹²⁵ *See, e.g.*, *U.S. Bank, N. A. v. Ibanez*, 941 N.E.2d 40, 54 (Mass. 2011). However, the note holder has a right to compel assignment of the mortgage in equity. *See text infra* at notes 135–37.

¹²⁶ Under the Restatement, the note and mortgage can be separated if the parties to the transfer expressly agree. *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.4(a)-(b) (1996). The preferable view adopts the Restatement and finds that for the note holder to reacquire the right to foreclose, the holding of the note and the mortgage must be reunited in the same party. *See* *Edelstein v. Bank of N.Y. Mellon*, 286 P.3d 249, 252 (Nev. 2012). However, some case law seems to disagree, holding that separation is literally impossible. *See, e.g.*, *Carpenter v. Longan*, 83 U.S. 271, 274 (1872) (“The note and mortgage are inseparable An assignment of the note carries the mortgage with it, while an assignment of the latter alone is a nullity.”); *BAC Home Loans Servicing, L.P. v. White*, 256 P.3d 1014, 1017 (Okla. Civ. App. 2010) (“[I]n Oklahoma it is not possible to bifurcate the security interest from the note. An assignment of the mortgage to one other than the holder of the note is of no effect.”). This view is unnecessarily restrictive if the parties have clearly expressed their intent to cause a separation.

¹²⁷ *See* *5-Star Mgmt., Inc. v. Rogers*, 940 F. Supp. 512, 520–21 (E.D.N.Y. 1996); *Ascot Mortg., Inc. v. MLA, Inc. (In re Ascot Mortg.)* 153 B.R. 1002, 1013 (Bankr. N.D. Ga. 1993); *Assoc. of Selma, Inc. v. Whetstone*, 628 So. 2d 578, 580–81 (Ala. 1993); *S.C. Nat’l Bank v. Halter*, 359 S.E.2d 74, 77–78 (S.C. Ct. App. 1987).

¹²⁸ *See In re Atlantic Mortg. Corp.*, 69 B.R. 321, 325 (Bankr. E.D. Mich. 1987); *Swinton v. Cuffman*, 213 S.W. 409, 410 (Ark. 1919); *MetLife Home Loans v. Hansen*, 286 P.3d 1150, 1154 (Kan. Ct. App. 2012); *Stribling v. Splint Coal Co.*, 5 S.E. 321, 325–26 (W. Va. 1888); *Multicircuits, Inc. v. Grunsted*, 809 N.W.2d 900 (Wis. Ct. App. 2012) (unpublished table opinion) (holding that when a mortgage was assigned without transfer of the note, the mortgage became unenforceable).

¹²⁹ Several states have statutes expressing the same position. *See, e.g.*, ALA. CODE § 8-5-24 (2013) (“The transfer of a . . . note given for the purchase money of lands . . .

Are there circumstances in which the parties to the transfer might not desire this result, and might wish to separate the note from the mortgage that secures it, placing them in the hands of two different persons? Yes, but they are very rare. Here is an example: Suppose a mortgagee holds two notes secured by a single mortgage on land, and wishes to sell one of the notes on the secondary market while retaining the other. The investor who is purchasing the note being sold insists on having the mortgage security in full, and is unwilling to share it. In this setting, the mortgagee may find it advantageous to “strip” the security from the note being retained, and transfer it all with the note being sold. If the parties expressly agree to this result, the retained note will thus become unsecured.¹³⁰

In ordinary cases, in which there is a single note and mortgage, lien theory jurisdictions usually hold that an attempt by the mortgagee to transfer the security interest in the land while expressly reserving the obligation (or vice versa) simply does not work; the purported separate transfer of the mortgage is held to be a nullity.¹³¹ In title jurisdictions,

passes to the transferee the lien of the vendor of the lands.”); ARIZ. REV. STAT. § 33-817 (2013) (“The transfer of any contract or contracts secured by a trust deed shall operate as a transfer of the security for such contract or contracts.”); CAL. CIV. CODE § 2936 (West 2012) (“The assignment of a debt secured by a mortgage carries with it the security.”); CONN. GEN. STAT. § 49-17 (2013), *construed in* Chase Home Fin., LLC v. Fequiere, 989 A.2d 606, 610–11 (Conn. App. Ct. 2010) (“The statute codifies the common-law principle of long standing that the mortgage follows the note”) (citations omitted); UTAH CODE ANN. § 57-1-35 (2010) (“The transfer of any debt secured by a trust deed shall operate as a transfer of the security therefor.”).

¹³⁰ The facts and the result are based upon *Crosby v. First Bank of Beverly Hills*, 77 F. Supp. 2d 1, 5–6 (D.D.C. 1999) and the RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.4 cmt. b (1996). The note holder could wish to release or discharge the mortgage because the property is contaminated by hazardous waste or is otherwise undesirable, yet the holder could still wish to sue on the note. There can be no legal objection to doing so, but this decision ordinarily has nothing to do with a transfer of the note *per se*.

¹³¹ See, e.g., *Hill v. Favour*, 84 P.2d 575, 578 (Ariz. 1938) (“The mortgage, being a mere incident of the debt, cannot be assigned separately from it, so as to give any beneficial interest.”); *Bryan v. Easton Tire Co.*, 561 S.W.2d 79, 79 (Ark. 1978); *Domarad v. Fisher & Burke, Inc.*, 76 Cal. Rptr. 529, 535–36 (Cal. Ct. App. 1969); *Commercial Prods. Corp. v. Briegel*, 242 N.E.2d 317, 321 (Ill. App. Ct. 1968); *Edelstein*, 286 P.3d at 252 (holding that a note and deed of trust may be separated, but must be brought into the hands of the same party prior to foreclosure); *U.S. Bank, N.A. v. Sharif*, 933 N.Y.S.2d 293, 296 (N.Y. App. Div. 2011) (“[A]ssignment of the mortgage without assignment of the underlying note . . . is a nullity.”) (citation omitted) (internal quotation marks omitted); *Halter*, 359 S.E.2d at 77–78; see also *United States v. Hoffman*, 826 P.2d 340, 343 (Ariz. Ct. App. 1992) (assignment of a mortgage does not automatically include an interest in the promissory note secured by the mortgage), *overruled on other grounds by*

mortgagees can technically transfer the real estate interest and keep the obligation.¹³² This transfer may happen, for example, if the mortgagee dies and the land (including the security interest represented by the mortgage) descends to the heirs, while the promissory note passes to the personal representative.¹³³ But whoever takes the realty interest in this fashion cannot assert it in any way—for example, the taker cannot foreclose on the interest even if the obligation is in default.¹³⁴ Moreover, equity will compel a transfer of the security to the holder of the obligation if he or she requests it.¹³⁵ In fact, whoever holds the obligation may accomplish this transfer by a proceeding in equity to foreclose the mortgage;¹³⁶ if the holder of the realty interest is named as a party, the court will impress a constructive or resulting trust on his or her interest and foreclose it on behalf of the note holder.¹³⁷ Hence, even in title-theory jurisdictions, the mortgage follows the note, although its journey may be slightly more circuitous.

A person who acquires the right to enforce the debt will get the benefit of the security even if he or she acquired it without realizing that

Rodney v. Ariz. Bank, 836 P.2d 434 (Ariz. 1992). There is even some authority, surely erroneous, that an attempted transfer of the security interest alone extinguishes it.

See *Best Fertilizers of Ariz., Inc. v. Burns*, 571 P.2d 675, 676 (Ariz. Ct. App. 1977), *rev'd*, 570 P.2d 179 (Ariz. 1977) (“Among the ‘gems’ and ‘free’ offerings of the late Professor Chester Smith of the University of Arizona College of Law was the following analogy. The note is the cow and the mortgage the tail. The cow can survive without a tail, but the tail cannot survive without the cow.”); *Teas v. Republic Nat’l Bank of Dallas*, 460 S.W.2d 233, 243–44 (Tex. App. 1970).

¹³² See *Second Nat’l Bank v. Dyer*, 184 A. 386, 387–88 (Conn. 1936); *Stewart v. Crosby*, 50 Me. 130, 134–35 (1863).

¹³³ See *Demarest v. Wynkoop*, 3 Johns. Ch. 129, 145 (N.Y. Ch. 1817).

¹³⁴ Only the person who can enforce the debt, or his or her agent, can foreclose the mortgage that secures it. See, e.g., *In re Atlantic Mortg. Corp.*, 69 B.R. 321, 325 (Bankr. E.D. Mich. 1987); *Swinton v. Cuffman*, 213 S.W. 409, 410 (Ark. 1919); *Stribling v. Splint Coal Co.*, 5 S.E. 321, 325–26 (W. Va. 1888).

¹³⁵ See *Eaton v. Fed. Nat’l Mortg. Ass’n*, 969 N.E.2d 1118, 1125 (Mass. 2012) (referring to a party who holds the mortgage separately as having a “resulting trust” in favor of the note holder).

¹³⁶ See *Pettus v. Gault*, 71 A. 509, 512 (Conn. 1908); *Rembert v. Ellis*, 17 S.E.2d 165, 166 (Ga. 1941); *Boruchoff v. Ayvasian*, 79 N.E.2d 892, 894 (Mass. 1948); *Kinna v. Smith*, 3 N.J. Eq. 14, 16 (N.J. Ch. 1834) (holding that an heir who receives a mortgage from a decedent holds it in trust for the personal representative to whom the secured note passes).

¹³⁷ See *Barrett v. Hinckley*, 14 N.E. 863, 868 (Ill. 1888) (“Such title exists for the benefit of the holder of the mortgage indebtedness, and it can only be enforced by an action in furtherance of his interests; . . .”).

the debt was secured.¹³⁸ To hold otherwise would give a windfall to the mortgagor, since no one but the holder of the debt could assert the security—simply because no one else could experience a default. Of course, the rule stated gives a windfall, in a sense, to the assignee of the debt, but it has the advantage of consistency and predictability. The debt-holder would usually be able to execute a judgment on the land in any event,¹³⁹ so the real significance of his or her ability to foreclose the mortgage is its priority against subsequent lienors or encumbrancers. They will have had notice of the mortgage from the chain of title, and therefore cannot complain.

All of this preceding discussion is commonplace. But the litigation that ensued from the mortgage crisis proves that the notion of the mortgage following the note is somewhat more complex than was recognized in the past. The reason is that the note carries two distinct sets of rights that can be transferred. One set of rights, commonly termed PETE status, refers to the right to enforce the note.¹⁴⁰ The other set of rights, termed ownership, is governed by Article 9 regardless of whether the note is negotiable.¹⁴¹

Since different parties may hold these two sets of rights, potential bifurcation of the note raises the following question: given the truth of the aphorism that the mortgage follows the note, if ownership and PETE status are separated, which of those rights does the mortgage follow? Or to put it differently, in order to be entitled to foreclose a mortgage, does a transferee need to be the owner, the PETE, or both? Until recently, finding case authority on this question was not easy. Most of the older

¹³⁸ See *Campbell v. Warren*, 726 P.2d 623, 625 (Ariz. Ct. App. 1986) (holding that an assignment of a portion of the payments from a promissory note automatically transfers a pro tanto interest in the mortgage that secures the note); *First Nat'l Bank of Mankato v. Pope*, 89 N.W. 318, 319 (Minn. 1902); *Betz v. Heebner*, 1 Pen. & W. 280, 280 (Pa. 1830); *UMLIC VP LLC v. Matthias*, 234 F. Supp. 2d 520, 523 (V.I. 2002), *aff'd*, 364 F.3d 125 (3d Cir. 2004); GLENN, *supra* note 121, § 314, at 1305.

¹³⁹ The mortgagor could possibly file a homestead declaration on the property and thereby defeat the debt-holder's execution, but there can hardly be a public policy favoring such a result if the mortgage was given at a time when no homestead was on file.

¹⁴⁰ See *supra* notes 38, 40–42 and accompanying text.

¹⁴¹ See U.C.C. § 9-203(b) (amended 2013) (providing that a security interest is enforceable only if the transferee gives value, the transferor holds the rights being transferred, and there is either a written agreement of transfer or the note is delivered to the transferee); *Morgan v. Farmers & Merchs. Bank*, 856 So. 2d 811, 825–26 (Ala. 2003) (holding that a nonnegotiable note may be considered an instrument for purposes of Article 9 so that a security interest in it could be perfected by possession).

judicial opinions (and even some modern opinions as well) did not recognize or understand the distinction between ownership and PETE status, and hence are useless in resolving this issue.¹⁴² Starting in 2010, however, a number of courts have addressed the question knowledgeably, and their answers are consistent: PETE status, and not ownership per se, confers the right to foreclose.¹⁴³ In other words, the

¹⁴² Some older cases almost seem to recognize this point. In 1923, the Oklahoma Supreme Court noted that “the mortgage securing the payment of a note is merely an incident and accessory to it, and the indorsement and delivery of a note carries with it the mortgage without any formal assignment thereof.” *Chase v. Commerce Trust Co.*, 224 P. 148, 149 (Okla. 1923). On the other hand, modern decisions continue to confuse the concepts of PETE and ownership, often so badly as to make the reader cringe. *See, e.g.*, *Servedio v. U.S. Bank, N.A.*, 46 So. 3d 1105, 1107 (Fla. Dist. Ct. App. 2010); *U.S. Bank, N.A. v. McConnell*, 305 P.3d 1, 3–4 (Kan. Ct. App. 2013) (perpetuating the long-time Kansas muddling of the two terms); *Deutsche Bank Nat’l Trust Co. v. Mitchell*, 27 A.3d 1229, 1234–35 (N.J. Super. Ct. App. Div. 2011) (“[A] party seeking to foreclose a mortgage must own or control the underlying debt.”); *U.S. Bank, N.A. v. Kimball*, 27 A.3d 1087, 1092 (Vt. 2011) (“[To] foreclose a mortgage, a plaintiff must demonstrate that it has a right to enforce the note, and without such ownership, the plaintiff lacks standing; . . .”).

¹⁴³ The decisions often use holder synonymously with PETE, although being a holder is only one way of being a PETE. *See supra* notes 67–70 and accompanying text; *see also* *J.E. Robert Co. v. Signature Props., LLC*, 71 A.3d 492, 499 n.14 (Conn. 2013) (“To enforce a note, one need not be the owner of the note.”) (citation omitted); *Edelstein v. Bank of N.Y. Mellon*, 286 P.3d 249, 257 (Nev. 2012) (citation omitted) (“Indeed, to foreclose, one must be able to enforce *both* the promissory note *and* the deed of trust. Under the traditional rule, entitlement to enforce the promissory note would be sufficient to foreclose”); *BAC Home Loans Servicing, LP v. Kolenich*, No. CA2012-01-001, 2012 WL 5306059, at *6 (Ohio Ct. App. Oct. 29, 2012) (“The current holder of the note and mortgage is entitled to bring a foreclosure action against a defaulting mortgagor even if the current holder is not the owner of the note and mortgage.”); *cf. In re Tikhonov*, No. CC 11 1698 MKBePa, 2012 WL 6554742, at *7–8 (B.A.P. 9th Cir. Dec. 14, 2012) (explaining that a party must show that it holds the note to have standing to seek relief from an automatic stay of foreclosure in bankruptcy); *Roisland v. Flagstar Bank*, No. 3:13-cv-0588-MO, 2013 WL 6061590, at *5 (D. Or. Nov. 15, 2013) (finding that under Oregon law, the holder of a note automatically becomes the holder of the deed of trust and can appoint a successor trustee to commence nonjudicial foreclosure); *In re Martinez*, 455 B.R. 755, 763 (Bankr. D. Kan. 2011) (holding that under Kansas law, “the holder of an instrument whether or not he is the owner may . . . enforce payment in his own name” and hence may foreclose); *In re Kemp*, 440 B.R. 624, 634 (Bankr. D.N.J. 2010) (holding that the party seeking foreclosure, despite owning the note, cannot enforce it without possession); *Nelson v. Fed. Nat’l Mortg. Ass’n*, 97 So. 3d 770, 779 (Ala. Civ. App. 2012) (“[T]he owner of the debt may foreclose on property that is the subject of a mortgage securing that debt if the owner is the holder of the promissory note at the time the owner initiates foreclosure proceedings.”); *Wells Fargo Bank, N.A. v. Morcom*, 125 So. 3d 320, 321 (Fla. Dist. Ct. App. 2013) (“[T]he person having standing to foreclose a

mortgage follows entitlement to enforce, not ownership. This result is perfectly sensible because foreclosure is simply one way for a creditor to realize payment of the debt that the note represents. Any payment received by virtue of the foreclosure must be applied against the balance

note secured by a mortgage may be either the holder of the note or a nonholder in possession of the note who has the rights of a holder.”) (citation omitted) (internal quotation marks omitted); *Bank of Am., N.A. v. Inda*, 303 P.3d 696, 703 (Kan. Ct. App. 2013) (holding that “because [servicer] was the holder of the Note, [servicer] was also the holder of the Mortgage”); *Bank of Am., N.A. v. Cloutier*, 61 A.3d 1242, 1246 (Me. 2013) (“[A] foreclosure plaintiff [must] identify the owner or economic beneficiary and, if it is not itself the owner, prove that it has power to enforce the note.”); *Deutsche Bank Nat’l Trust Co. v. Brock*, 63 A.3d 40, 49 (Md. 2013) (concluding that a note holder is also entitled to foreclose the deed of trust); *Eaton v. Fed. Nat’l Mortg. Ass’n*, 969 N.E.2d 1118, 1129 (Mass. 2012) (“[W]e construe the term ‘mortgagee’ in [the foreclosure statute] to mean a mortgagee who also holds the underlying mortgage note.”); *U.S. Bank, N.A. v. Burns*, 406 S.W.3d 495, 499 (Mo. Ct. App. 2013) (holding that the facts “qualify U.S. Bank as the holder of the Note under the UCC . . . [A]s such, U.S. Bank is . . . therefore entitled to enforce the Deed of Trust.”); *Bank of Am., N.A. v. Limato*, No. F-61880-09, 2012 WL 2505725, at *5 (N.J. Super. Ct. App. Div. July 2, 2012) (holding that a foreclosing party provided insufficient proof of entitlement to enforce note); *Bank of N.Y. Mellon v. Deane*, 970 N.Y.S.2d 427, 431–33 (N.Y. 2013); *CPT Asset Backed Certificates v. Cin Kham*, 278 P.3d 586, 591 (Okla. 2012) (“To commence a foreclosure action in Oklahoma, a plaintiff must demonstrate it has a right to enforce the note”); *Niday v. GMAC Mortg., LLC*, 302 P.3d 444, 454 n.8 (Or. 2013) (en banc); *JP Morgan Chase Bank, N.A. v. Murray*, 63 A.3d 1258, 1265–66 (Pa. Super. Ct. 2013); *Bank of Am., N.A. v. Draper*, 746 S.E.2d 478, 482–83 (S.C. Ct. App. 2013); *Wells Fargo Bank Minn., N.A. v. Rouleau*, 46 A.3d 905, 909–10 (Vt. 2012); *Bain v. Metro. Mortg. Grp., Inc.*, 285 P.3d 34, 44 (Wash. 2012) (relying on the definition of PETE in U.C.C. section 3-301); *Trujillo v. Northwest Trustee Services, Inc.*, 326 P.3d 768 (Wash.Ct.App. 2014) (holding that the UCC, “properly read, does not require [the holder] to also be the owner of the note”). A few recent cases display some confusion on the distinction between ownership and the right to enforce. *See RMS Residential Props., LLC v. Miller*, 32 A.3d 307, 314 (Conn. 2011) (arguing that the holder of the note is presumed to be the owner of the debt, and unless the presumption is rebutted, the holder has standing to foreclose); *U.S. Bank, N.A. v. Thomes*, 69 A.3d 411, 414–15 (Me. 2013) (concluding that a foreclosing party must show entitlement to enforce the note if the party is not the note’s owner). *But see JPMorgan Chase Bank, N.A. v. Erlandson*, 821 N.W.2d 600, 609 (Minn. Ct. App. 2012) (holding that proof of the right to enforce the note is not necessary, even to pursue a judicial foreclosure).

If the plaintiff does not have possession of the note when the foreclosure proceeding is commenced but acquires it prior to judgment, is the initial lack of standing cured or must it file a new action? Very little clear authority on the point exists. *See Focht v. Wells Fargo Bank, N.A.*, 124 So. 3d 308, 312 (Fla. Dist. Ct. App. 2013) (certifying this issue for review to the Florida Supreme Court). For the New York view, requiring possession (or a mortgage assignment) at the time of filing, see Mark C. Dillon, *Unsettled Times Make Well-Settled Law: Recent Developments in New York State’s Residential Mortgage Foreclosure Statutes and Case Law*, 76 ALB. L. REV. 1085, 1092–94 (2013).

owed on the note, and if foreclosure results in payment in full, the note is discharged.¹⁴⁴ Hence, to view the power to foreclose as dependent on a creditor's right to enforce the note, or PETE status, is entirely logical.

One important implication of the notion that the mortgage follows the debt is that, to confer the right to foreclose judicially, no independent assignment of the mortgage itself is necessary.¹⁴⁵ Mortgage assignments may be useful for a variety of reasons,¹⁴⁶ but transferring the right to foreclose judicially is not one of them. Nonjudicial foreclosures are

¹⁴⁴ See PEB REPORT, *supra* note 42, at 4 (“(1) [T]he maker’s obligation on the note is to pay the amount of the note to *the person entitled to enforce the note*; (2) the maker’s payment to *the person entitled to enforce the note* results in discharge of the maker’s obligation; and (3) the maker’s failure to pay, when due, the amount of the note to *the person entitled to enforce the note* constitutes dishonor of the note.”).

¹⁴⁵ See, e.g., *Knigge v. SunTrust Mortg., Inc. (In re Knigge)*, 479 B.R. 500, 505 (B.A.P. 8th Cir. 2012); *Millon v. JPMorgan Chase Bank, N.A.*, No. 11-0410-CV-W-ODS, 2012 WL 1854785, at *4 (W.D. Mo. May 21, 2012); *Ayres v. Parker*, No. SA-12-CV-621-XR, 2013 WL 4048328, at *10 (W.D. Tex. July 29, 2013); *Edwards v. Deutsche Bank Nat’l Trust Co. (In re Edwards)*, No. 11-23195, 2011 WL 6754073, at *3-4 (Bankr. E.D. Wis. Dec. 23, 2011); *Thomas v. Wells Fargo Bank, N.A.*, 116 So. 3d 226, 229-230 (Ala. Civ. App. 2012); *CitiMortgage, Inc. v. Gaudiano*, 68 A.3d 101, 106 (Conn. App. Ct. 2013); *Rose v. Wells Fargo Bank, N.A.*, 73 A.3d 1047, 1052 (D.C. 2013); *Wells Fargo Bank, N.A. v. Morcom*, 125 So. 3d 320, 322 (Fla. Dist. Ct. App. 2013); *U.S. Bank, N.A. v. McConnell*, 305 P.3d 1, 3 (Kan. Ct. App. 2013); *Deutsche Bank Nat’l Trust Co. v. Matthews*, 273 P.3d 43, 46 (Okla. 2012); *Dow Family, LLC v. PHH Mortg. Corp.*, 838 N.W.2d 119, 124-25 (Wis. Ct. App. 2013); see also GLENN, *supra* note 122, § 314, at 1305-1310 (arguing that the mortgage transfers automatically with the transfer of the note “although there has been no assignment of the mortgage”).

Maine seems to be an exception with respect to judicial foreclosure. See ME. REV. STAT. tit. 14, § 6321 (2013) (“The mortgagee shall . . . produce evidence of the mortgage note, mortgage and all assignments and endorsements of the mortgage note and mortgage.”); see also *id.* § 6203-A (providing a statutory form of foreclosure notice that requires a recitation of the foreclosing party’s mortgage recording information and states, “if by assignment . . . give reference”). The Maine Supreme Court seems to require proof of each link in the chain of mortgage assignments. See *Deutsche Bank Nat’l Trust Co. v. Wilk*, 76 A.3d 363, 368-69 (Me. 2013); *U.S. Bank, N.A. v. Thomes*, 69 A.3d 411, 414 (Me. 2013); *Wells Fargo Bank, N.A. v. deBree*, 38 A.3d 1257, 1259 (Me. 2012).

In New Jersey, a court rule, N.J. Ct. R. 4:64, has been generally understood to require a recorded chain of assignments as a precondition to foreclosure, although the rule does not explicitly so require and there appears to be no legal basis for such a requirement. The rule merely states that the foreclosure complaint must include, “if the plaintiff is not the original mortgagee or original nominee mortgagee, the names of the original mortgagee and a recital of all assignments in the chain of title.” Hence, a literal reading would not require that such assignments exist, but merely that they must be recited in the complaint if they do exist. See Robert E. Nies and Michael R. Caruso, A Standing Dilemma, 212 N.J.L.J. (June 2, 2013).

¹⁴⁶ See *infra* notes 183-189 and accompanying text.

another matter. By statute in a number of states, a chain of mortgage assignments (perhaps recorded, perhaps not) may be a prerequisite to commencing a nonjudicial foreclosure proceeding. These matters are covered in detail below.¹⁴⁷

E. Note Endorsements are Helpful, but Usually Not Essential

As noted earlier in Part IV.A,¹⁴⁸ a distinction exists between being the holder of a negotiable note and being a nonholder with the rights of a holder.¹⁴⁹ The significance of this clumsy phrase lies in existence or absence of a chain of valid endorsements on the note. A holder must have a chain of endorsements, while a nonholder with the rights of a holder need not. Either status allows the possessor of the note to enforce it (and to foreclose the accompanying mortgage, of course), but if the chain of endorsements is absent or incomplete, the possessor of the note has a heavier burden of proof; for it must show that the instrument was delivered “for the purpose of giving to the person receiving delivery the right to enforce the instrument.”¹⁵⁰

Such proof of the purpose of the delivery should not be impossible to adduce. It might take the form of a servicing contract or (in the case of a securitized loan) a pooling and servicing agreement (PSA).¹⁵¹ The possessor might also prove the purpose by affidavits or certifications of the note possessor’s employees¹⁵² or by the language in accompanying

¹⁴⁷ See *infra* notes 220–222, 227 and accompanying text.

¹⁴⁸ See *supra* notes 58–60 and accompanying text.

¹⁴⁹ See U.C.C. § 3-301 (amended 2012).

¹⁵⁰ *Id.* § 3-203(a).

¹⁵¹ See, e.g., *J.E. Robert Co. v. Signature Props., LLC*, 71 A.3d 492, 503 n.18 (Conn. 2013). *But cf.* *Anderson v. Burson*, 35 A.3d 452, 463 (Md. 2011) (holding that a PSA was insufficient proof of purpose of delivery because it did not include a schedule of loans transferred); *In re David A. Simpson, P.C.*, 711 S.E.2d 165, 173 (N.C. Ct. App. 2011) (holding that PSA did not provide proof of purpose of delivery when the agreement was not attached to court documents). The *Anderson* opinion points out that when there have been multiple transfers of the loan without endorsements, the purpose of each delivery of the note must be proved.

¹⁵² See, e.g., *Berkshire Bank v. The Hartford Club*, No. HHDCV136042955S, 2014 WL 565173, at *2 (Conn. Super. Ct. Jan. 13, 2014) (holding that affidavits proved a note had been transferred by corporate merger of transferor into transferee); *Hampton Island, LLC v. Asset Holding Co. 5, LLC*, 740 S.E.2d 859, 863 (Ga. Ct. App. 2013); *First Equity Assets II, LLC v. Samay*, No. F-14854-09, 2014 WL 183915, at *9 (N.J. Super. Ct. App. Div. Jan 17, 2014).

mortgage assignments.¹⁵³ But whatever method is employed, proving the purpose of a note delivery (or a series of deliveries, if there have been multiple transfers) is a burden that no foreclosing party wants to shoulder and one that is often discharged ineffectively. Having holder status with a chain of valid endorsements is much simpler!

1. *The Use of an Allonge*

An endorsement may be written on the note itself or on a paper—an allonge—attached to the note.¹⁵⁴ Allonges are usually more convenient to

¹⁵³ See, e.g., *Wells Fargo Bank, N.A. v. Burek*, 81 A.3d 330, 332 (Me. 2013); *Self Help Ventures Fund v. Jones*, No. 2012-A-0014, 2013 WL 942513, at *3 (Ohio Ct. App. Mar. 11, 2013); *Umpqua Bank v. Santwire*, No. 68832-4-I2013, 2013 WL 4000917, at *3-4 (Wash. Ct. App. Aug. 5, 2013) (finding that the purpose of the transfer was proved by the FDIC purchase and assumption agreement); cf. *Veal v. Am. Home Mortg. Servicing, Inc.*, (*In re Veal*), 450 B.R. 897, 911-12 (B.A.P. 9th Cir. 2011) (finding the proof of purpose insufficient); *Wright-Patt Credit Union, Inc. v. Byington*, No. E-12-002, 2013 WL 5211503, at *4-5 (Ohio Ct. App. Sept. 13, 2013) (finding that the affidavits concerning documents and assignments were incomplete and insufficient); *CPT Asset Backed Certificates v. Cin Kham*, 278 P.3d 586, 591 (Okla. 2012) (finding the proof of purpose of delivery of a note insufficient).

¹⁵⁴ The requirements for an endorsement are highly flexible: “[A] complete signature is not necessary. Authentication may be printed, stamped or written; it may be by initials or by thumbprint. It may be on any part of the document and in appropriate cases may be found in a billhead or letterhead.” U.C.C. § 1-201(39) cmt. (2000); see also *In re Bass*, 738 S.E.2d 173, 176 (N.C. 2013) (upholding a rubber-stamped endorsement). The signature on an endorsement is presumed valid and the party attacking it has the burden of producing evidence of falsity. See *In re Phillips*, 491 B.R. 255, 272 (Bankr D. Nev. 2013).

The U.C.C. does not require a date on an endorsement, whether on the note or on an allonge. See, e.g., *Buchanan v. HSBC Mortg. Servs., Inc.*, 993 N.E.2d 275, 278-279 (Ind. Ct. App. 2013); *Wells Fargo Bank, N.A. v. Settoon*, 120 So. 3d 757, 760 (La. Ct. App. 2013); *Bank of Am., N.A. v. Princeton Park Assoc., L.L.C.*, No. F-49373-09, 2012 WL 5439006, at *7 (N.J. Super. Ct. App. Div. Nov. 8, 2012). However, an undated endorsement may raise a question as to whether the right to enforce the note had been transferred prior to the filing of the foreclosure action (as is usually required). See, e.g., *Gonzalez v. Deutsche Bank Nat’l Trust Co.*, 95 So. 3d 251, 253 (Fla. Dist. Ct. App. 2012); *Anderson v. Burson*, 35 A.3d 452, 457 (Md. 2011) (failing to date the allonge contributed to confusion as to its actual date); *Ntex Realty, LP v. Tacker*, 275 P.3d 147, 149 (Okla. 2012) (remanding the case for findings of fact as to the date the endorsement was made). The use of allonges on negotiable notes is authorized by U.C.C. section 3-204, providing that “for the purpose of determining whether a signature is made on an instrument, a paper affixed to the instrument is a part of the instrument.” However, an allonge may be employed with a nonnegotiable note as well, although different technical rules might be applied in such a case. See, e.g., *Bishop v. Chase*, 56 S.W. 1080, 1084 (1900) (holding, under common law principles, that an allonge was improper because the note itself had sufficient space for the endorsement).

prepare from a mechanical point of view, and hence are very commonly used. Under earlier versions of Article 3, use of an allonge was permissible only if the original note had insufficient space for the endorsement,¹⁵⁵ but this limitation is no longer in effect.¹⁵⁶ An effective allonge requires affixation to the note.¹⁵⁷ The decisions are surprisingly technical on this point. Case law has made it clear that merely placing the allonge in the same file folder or envelope with the note is insufficient.¹⁵⁸ Gluing, pasting, or (probably) stapling is acceptable,¹⁵⁹ but use of a paper clip or pin is not.¹⁶⁰ If the allonge was stapled to the note, but became detached in the process of photocopying it, the cases are divided as to its

¹⁵⁵ See, e.g., *Tallahassee Bank & Trust Co. v. Raines*, 187 S.E.2d 320, 322 (Ga. Ct. App. 1972); *Crossland Sav. Bank FSB v. Constant*, 737 S.W.2d 19, 21 (Tex. App. 1987).

¹⁵⁶ See U.C.C. § 3-204 cmt. 1 (amended 2002) (“An indorsement on an allonge is valid even though there is sufficient space on the instrument for an indorsement.”); see also *In re McFadden*, 471 B.R. 136, 145 (D.S.C. 2012); *Thomas v. Wells Fargo Bank, N.A.*, 116 So. 3d 226, 229–30 (Ala. Civ. App. 2012). New York has not adopted the current version of Article 3, and the “sufficient space” doctrine may still be a concern in New York. See Lawrence Safran & Joshua Stein, *Getting Attached: When Do Allonges Meet the Requirements of the New York UCC?*, N.Y. L. J., Nov. 27, 2006, at 1, available at http://www.lw.com/upload/pubContent/_pdf/pub1713_1.pdf.

¹⁵⁷ See *JP Morgan Chase Bank, N.A. v. Murray*, 63 A.3d 1258, 1265 (Pa. Super. Ct. 2013) (finding that a loose allonge is insufficient to act as an endorsement). Previous versions of section 3-204 required that the allonge be so firmly affixed to the note “as to become a part thereof,” but this language was omitted from the current version.

¹⁵⁸ See *Adams v. Madison Realty & Dev., Inc.*, 853 F.2d 163, 167 (3d Cir. 1988); *In re Weisband*, 427 B.R. 13, 19 (Bankr. D. Ariz. 2010); *Big Builders, Inc. v. Israel*, 709 A.2d 74, 77 (D.C. 1988); *Town of Freeport v. Ring*, 727 A.2d 901, 904 (Me. 1999); *Wells Fargo Bank, N.A. v. Freed*, No. 5–12–01, 2012 WL 6562819, at *5 (Ohio Ct. App. Dec. 17, 2012). A separate written assignment of the note or the mortgage plainly does not qualify. See *Bremen Bank & Trust Co. of St. Louis v. Muskopf*, 817 S.W.2d 602, 607 (Mo. Ct. App. 1991); *Bank of N.Y. Mellon v. Deane*, 970 N.Y.S.2d 427, 437–38 (N.Y. Sup. Ct. 2013).

¹⁵⁹ *Wells Fargo Bank, N.A. v. Settoon*, 120 So. 3d 757, 760–61 (La. Ct. App. 2013) (stating that the paper must be “actually attached to the instrument, meaning some form of physical connection securing the paper to the instrument”); *In re McFadden*, 471 B.R. at 145 (stapling is sufficient); *Lamson v. Commercial Credit Corp.*, 531 P.2d 966, 968 (Colo. 1975) (en banc); *Sw. Resolution Corp. v. Watson*, 964 S.W.2d 262, 264 (Tex. 1997).

¹⁶⁰ *Bailey v. Mills*, 58 So. 2d 446, 448 (Ala. 1952); *Wells Fargo Bank, N.A. v. Bohatka*, 112 So. 3d 596, 599 (Fla. Dist. Ct. App. 2013); *HSBC Bank USA, N.A. v. Roumiantseva*, No. 22274/2009, 2013 WL 2500829, at *6–7 (N.Y. Sup. Ct. June 11, 2013).

validity.¹⁶¹ Because of the risk that a stapled allonge can easily become detached from the note because of photocopying or handling, an allonge that refers specifically to the note to which the allonge is attached is highly desirable. Such a reference can easily make a difference in a court's determination that the allonge constitutes an effective endorsement.¹⁶² But this reference requires hand-tailoring of allonges; based upon the descriptions of allonges in reported cases, this hand-tailoring is not often done.

2. *Holder in Due Course*

One additional reason lends significance to the presence or absence of an endorsement: the infamous holder in due course (HDC) doctrine. Books and articles have thoroughly covered the doctrine, making it unnecessary to treat it in depth here.¹⁶³ In brief, if the right of enforcement of a negotiable note¹⁶⁴ is negotiated to a party that qualifies as a HDC, the holder can enforce the note (and foreclose the mortgage)¹⁶⁵ without reference to certain personal defenses that the maker of the note might wish to raise. Those defenses include breach of contract or breach of warranty, lack or failure of consideration, fraud in the inducement, illegality (if of a type that would make the transaction voidable rather than void), and unadjudicated mental incapacity. The

¹⁶¹ Finding the endorsement insufficient in such a case. See *Palo Verde Mgmt. & Fin. Servs. Co. v. Nash (In re Nash)*, 49 B.R. 254, 261 (Bankr. D. Ariz. 1985). Upholding the endorsement despite multiple staple holes indicating that the allonge had been detached for photocopying, See *In re McFadden*, 471 B.R. at 145; *SKW Real Estate Ltd. P'ship v. Gallicchio*, 716 A.2d 903, 907 (Conn. App. Ct. 1998).

¹⁶² A sticker on the allonge, identifying it with the note, was significant to the court's upholding of the endorsement in *Gallicchio*. See 716 A.2d at 907.

¹⁶³ See REAL ESTATE FINANCE LAW, *supra* note 7, § 5.31; Kurt Eggert, *Not Dead Yet: The Surprising Survival of Negotiability*, 66 ARK. L. REV. 145, 165 (2013); Alex M. Johnson, *Preventing a Return Engagement: Eliminating the Mortgage Purchasers' Status as a Holder-In-Due-Course: Properly Aligning Incentives among the Parties*, 37 PEPP. L. REV. 529 (2010).

¹⁶⁴ The HDC doctrine has no application to nonnegotiable notes. See *United Nat'l Bank of Miami v. Airport Plaza Ltd. P'ship*, 537 So. 2d 608, 609–10 (Fla. Dist. Ct. App. 1988).

¹⁶⁵ The principle is well established that if the holder of the note is a HDC, the holder may foreclose the mortgage free of the same defenses as would be unassertable against the note itself. See *Gramatan Co. v. D'Amico*, 269 N.Y.S.2d 871, 872 (N.Y. Sup. Ct. 1966); *Barbour v. Finke*, 201 N.W. 711, 711 (S.D. 1924).

HDC is not immune from all defenses—the maker of the note can assert so-called “real” defenses even against a HDC.¹⁶⁶

If the maker of the note has no personal defenses to raise, HDC status is irrelevant to the note holder’s right to foreclose or enforce the debt. As a practical matter, the most common personal defense raised by mortgagors is almost certainly fraud in the inducement—that is, the loan originator is alleged to have lied to the borrower, typically about the terms of the loan, the way that interest changes would be implemented in the future, the maximum payments the borrower might be required to make, or the like.¹⁶⁷ To be a HDC, and thereby to take the note with immunity from this sort of defense, the transferee must have taken the note for value, in good faith, and without notice that the note is overdue, has been dishonored, or is subject to any defense or claim to it on the part of any person.¹⁶⁸

¹⁶⁶ The real defenses include forgery, fraud in the execution, material alteration, discharge in insolvency, minority, illegality (if it would make the transaction void), adjudicated mental incapacity, and extreme duress. *See* U.C.C. § 3-305(2) (amended 2002); *Deutsche Bank Trust Co. Ams. v. Samora*, 321 P.3d 590, 598 (Colo. App. 2013) (noting that fraud in the inducement is a personal defense, while fraud in the factum is a real defense). *See generally* Clayton P. Gillette, *Rules, Standards, and Precautions in Payment Systems*, 82 VA. L. REV. 181, 238–39 (1996).

¹⁶⁷ There are numerous examples in case law of an HDC who was held to take free of the defense of fraud in the inducement. *See, e.g.*, *James v. Nationsbank Trust Co.* (Fla.) N.A., 639 So. 2d 1031, 1032–33 (Fla. App. Dist. Ct. 1994); *Ocwen Fed. Bank, FSB v. Russell*, 53 P.3d 312, 326 (Haw. Ct. App. 2002) (denying motion for summary judgment because issues of fact existed as to whether holder was a HDC); *Audsley v. Allen*, 774 S.W.2d 142, 143–45 (Mo. 1989) (en banc); *HSBC Bank USA, N.A. v. Gouda*, No. F-20201-07, 2010 WL 5128666, at *4 (N.J. Super. App. Div. 2010); *Carnegie Bank v. Shalleck*, 606 A.2d 389, 393 (N.J. Super. App. Div. 1992); *Countrywide Home Loans Servicing, L.L.P. v. Heck*, No. OT-10-011, 2011 WL 281148, at *3–4 (Ohio Ct. App. 2011). If the party enforcing the note is unable to prove HDC status, all of the maker’s defenses can be raised. *See Wells Fargo Bank, LLC v. Heritage New London, LLC*, No. CV126012860, 2013 WL 3802395, at *3 (Conn. Super. Ct. 2013); *Davis v. Starling*, 799 So. 2d 373, 375 (Fla. Dist. Ct. App. 2001); *Chamberlin v. Twin Ports Dev. Co.*, 261 N.W. 577, 579 (Minn. 1935); *Miller v. Diversified Loan Serv. Co.*, 382 S.E.2d 514, 517–19 (W. Va. 1989).

Technically, there is one additional advantage to being an HDC: Under U.C.C. § 3-302(b) the HDC holds the note free of adverse *claims* to it. (Such claims are issues of ownership, which are ordinarily covered by Article 9 rather than Article 3.) However, cases in which this issue has arisen are rare indeed. For one example, see *In Re Apponline.com, Inc.*, 290 B.R. 1 (Bankr. E.D.N.Y. 2003).

¹⁶⁸ *See* U.C.C. § 3-302(a)(2); *Russell*, 53 P.3d at 326. The holder must also have no notice that the instrument contains an unauthorized signature or has been altered. Knowledge that interest on the note is delinquent will not negate HDC status; *Bank of*

For present purposes, however, we need to emphasize another requirement: to qualify as a HDC, the transferee must be a *holder*. The Code defines a holder as “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.”¹⁶⁹ Since bearer notes are virtually never used in mortgage loan transactions, the practical effect of this definition is that the note must either bear an indorsement in blank (so as to make it bearer paper)¹⁷⁰ or a chain of special endorsements from the originator to the present holder.¹⁷¹ Otherwise, its holder cannot be a HDC.¹⁷² However, one must be careful not to make too much of this requirement. In general, a holder does not need to be a HDC in order to enforce a note or foreclose its accompanying mortgage.¹⁷³ Only when the debtor raises a personal defense does the enforcing party’s HDC status become relevant.

New Glarus v. Swartwood, 725 N.W.2d 944, 954–55 (Wis. Ct. App. 2006) (denying summary judgment because a question of fact existed as to whether the assignee of the note had notice that the note was overdue—such notice would negate HDC status). *See* U.C.C. § 3-304(c); *Wilson v. Steele*, 259 Cal. Rptr. 851, 857 (Cal. Ct. App. 1989); *see also* *Ga. Railroad Bank v. Doolittle*, 252 S.E.2d 556, 557–58 (S.C. 1979) (holding that no evidence that the assignee bank was an HDC, but the contract of sale, which expressly gave it same rights as HDC, was valid).

Once the maker has alleged a defense, the holder has the burden of establishing that he or she is a HDC. *See, e.g., Williams v. Aries Fin., LLC*, No. 09-CV-1816 (JG) (RML), 2009 WL 3851675, at *4 (E.D.N.Y. Nov. 18, 2009) (stating that the burden of proof is on party claiming HDC status); *cf. Kreutz v. Wolff*, 560 S.W.2d 271, 276 (Mo. Ct. App. 1977). *But see* *Robbins v. Walker*, No. 2:07CV371 KS-MTP, 2008 WL 4635374, at *5 (S.D. Miss. Oct. 17, 2008) (seeming to place the burden of proof on the party attacking the holder’s HDC status); *Ocwen Loan Servicing, LLC v. Branaman*, 554 F. Supp. 2d 645, 648 (N.D. Miss. 2008).

¹⁶⁹ U.C.C. § 1-201(21) (2000).

¹⁷⁰ *See* U.C.C. § 3-205(b) (“When indorsed in blank, an instrument becomes payable to bearer and may be negotiated by transfer of possession alone until specially indorsed.”).

¹⁷¹ A “special endorsement” identifies the person to whom it makes the instrument payable. *See* U.C.C. § 3-205(a) (“When specially indorsed, an instrument becomes payable to the identified person and may be negotiated only by the indorsement of that person.”).

¹⁷² *See, e.g., Second Nat’l Bank of North Miami v. G.M.T. Props., Inc.*, 364 So. 2d 59, 60–61 (Fla. Dist. Ct. App. 1978) (holding that holder took a note without endorsements and therefore could not be a HDC).

¹⁷³ Foreclosure defense counsel sometimes argue that the absence of HDC status will per se bar a mortgage holder from foreclosing, but the courts invariably disagree. *See Taylor v. Deutsche Bank Nat’l Trust Co.*, 44 So. 3d 618, 623 (Fla. Dist. Ct. App. 2010) (finding that in the absence of any personal defense by a maker, a holder may enforce the

In sum, when a mortgage loan is transferred on the secondary market, ensuring that the note is endorsed is important for two reasons. First, an endorsement makes proof of the purpose of the note's delivery unnecessary, and thus makes enforcement of the note or foreclosure of the accompanying mortgage easier and more efficient. Second, if the borrower raises a personal defense, such as fraud in the inducement, the party enforcing the note can escape the defense only if the note has been appropriately endorsed. In most cases, however, neither of these reasons is of critical importance. Normally, proving that the note was delivered for the purpose of transferring the right of enforcement is entirely possible (if perhaps inconvenient), and most borrowers have no personal defenses to raise. Hence, only on relatively rare occasions will the absence of appropriate endorsements be a problem for secondary market investors.

F. Mortgage Assignments are Irrelevant to the Right to Foreclose by Judicial Proceeding

The notion that a secondary market investor who wishes to foreclose a mortgage must prove the existence of a chain of (perhaps recorded) mortgage assignments from the original mortgagee to the current investor is often assumed to be true.¹⁷⁴ However, if foreclosure is conducted by a judicial proceeding, this notion is simply wrong. As between the parties to a transfer, only the note needs to be transferred. Having any separate document purporting to transfer or assign the mortgage on the real estate is unnecessary, for as previously discussed, it will follow the right to enforce the obligation automatically.¹⁷⁵

note and mortgage irrespective of whether the holder is a HDC); *Arcanum Nat'l Bank v. Hessler*, 433 N.E.2d 204, 206 (Ohio 1982).

¹⁷⁴ Foreclosure defense counsel often argue for this position, but virtually always lose. *See, e.g.*, *Rose v. Wells Fargo Bank, N.A.*, 73 A.3d 1047, 1052–53 (D.C. 2013); *HSBC Bank USA, N.A. v. Sage*, 977 N.Y.S.2d 446, 447–48 (N.Y. App. Div. 2013); *Brandrup v. ReconTrust Co., N.A.*, 303 P.3d 301, 318 (Or. 2013) (en banc); *Wells Fargo Bank Minn., N.A. v. Rouleau*, 46 A.3d 905, 910 (Vt. 2012).

¹⁷⁵ *See supra* notes 123–124 and accompanying text; *see also* *Robinson v. H & R Block Bank, FSB*, No. 12-Civ-4196 (SMG), 2013 WL 2356106, at *4 (E.D.N.Y. May 29, 2013); *Unsecured Creditors' Comm. v. Shawmut Worcester Cnty. Bank, N.A. (In re Ivy Props., Inc.)*, 109 B.R. 10, 12–14 (Bankr. D. Mass. 1989); *Domarad v. Fisher & Burke, Inc.*, 76 Cal. Rptr. 529, 539 (Cal. Ct. App. 1969); *Deutsche Bank Nat'l Trust Co. v. Bialobrzanski*, 3 A.3d 183, 187–88 (Conn. App. Ct. 2010); *Deutsche Bank Nat'l Trust Co. v. Lippi*, 78 So. 3d 82, 84–85 (Fla. Dist. Ct. App. 2012); *Miller v. Frederick's Brewing Co.*, 92 N.E.2d 108, 111–12 (Ill. 1950); *Jones v. Titus*, 175 N.W. 257, 259 (Mich. 1919). Some states have codified this principle. *See, e.g.*, ALA. CODE § 8-5-24 (2013) (“The transfer of a . . . note given for the purchase of lands . . . passes to the transferee the lien

Nonjudicial foreclosures are another matter. About a dozen states require assignments, usually recorded, as a prerequisite to exercise the

of the vendor of the lands.”). Courts sometimes confuse this principle. *See, e.g.*, *Deutsche Bank Nat’l Trust Co. v. Gilbert*, 982 N.E.2d 815, 819, 821 (Ill. App. Ct. 2012) (stating that standing to foreclose is based on being “the holder of an indebtedness,” or its agent being “in possession of its claimed interest in the note,” “own[ing] the indebtedness,” holding the mortgage, and having an “assignment of a mortgage”).

The sole exception may be Maine, where the courts seem to require a recorded chain of assignments as a prerequisite to judicial foreclosure. *See* ME. REV. STAT. tit. 14, § 6321 (2013). The statute does not clearly require assignments; it merely provides that the foreclosing mortgagee shall provide, with its complaint, “evidence of the mortgage note, mortgage and all assignments and endorsements of the mortgage note and mortgage.” *Id.* The Maine Supreme Court appears to believe that assignments are required to foreclose if the loan has been transferred. *See Deutsche Bank Nat’l Trust Co. v. Wilk*, 76 A.3d 363, 368–69 (Me. 2013); *Wells Fargo Bank, N.A. v. deBree*, 38 A.3d 1257, 1259 (Me. 2012). But traditional Maine authority does not require assignments: “When the mortgage is not legally assigned with the debt, the assignee of the debt has a right to use the name of the mortgagee in a suit to enforce the mortgage; and he is not required to resort to the court in equity for that purpose unless the mortgagee refuses to permit his name to be used.” *Holmes v. French*, 70 Me. 341, 344 (Me. 1879). Whether the Maine statute requiring a recorded chain of assignments was intended to reverse this view is unclear.

We have already noted that a New Jersey court rule is often regarded as adopting this concept, although it does not literally do so; see note 145 *supra*. Some Florida cases seem to require a chain of assignments, but their language and reasoning is muddled. *See, e.g.*, *Gee v. U.S. Bank, N. A.*, 72 So. 3d 211, 213 (Fla. Dist. Ct. App. 2011). The better view is that if the note is transferred in Florida, the mortgage will indeed follow automatically without an express assignment. *See Balderrama v. Deutsche Bank Trust Co. Ams. (In re Balderrama)*, 451 B.R. 185, 190 (Bankr. M.D. Fla. 2011).

In 2010, the District of Columbia Attorney General asserted that recordation of all intervening assignments was a prerequisite to the right to foreclose a deed of trust in the District. *See Attorney General Issues Statement on Foreclosures in DC*, D.C. OFFICE OF ATTORNEY GEN. (October 27, 2010), available at oag.dc.gov/release/attorney-general-issues-statement-foreclosures-dc. However, the D.C. Court of Appeals subsequently disagreed, holding that the deed of trust will follow the note under common law principles whether or not formal assignments are made or recorded. *See Rose v. Wells Fargo Bank, N.A.*, 73 A.3d 1047, 1053 (D.C. 2013).

However, trial judges do not always understand the principle that a formal mortgage assignment is unnecessary. For example, in much discussed 2007 mortgage foreclosure cases in the Northern District of Ohio, Judge Boyko required the foreclosing parties to produce mortgage assignments. *See generally* David R. Greenberg, Comment, *Neglected Formalities in the Mortgage Assignment Process and the Resulting Effects on Residential Foreclosures*, 83 TEMP. L. REV. 253, 256–68 (2010) (describing the cases). But Ohio law has no such requirement; rather, it has always held that “the negotiation of a note operates as an equitable assignment of the mortgage, even though the mortgage is not assigned or delivered.” *Cent. Mtg. Co. v. Webster*, 978 N.E.2d 962, 969 (Ohio App. Ct. 2012); *see also Lundy v. Messer*, 167 N.E.2d 278, 283–84 (Ill. App. Ct. 1960).

nonjudicial foreclosure procedure.¹⁷⁶ This requirement does not seem to serve any important policy rationale, since the existence of a mortgage assignment is no proof that the foreclosing party has the right to enforce the note. Indeed, several other jurisdictions have expressly held that recorded assignments are unnecessary to foreclose nonjudicially.¹⁷⁷

Some commentators seem to believe that recorded assignments are (or ought to be) required for all foreclosures. Presumably their rationale is that recording is helpful to borrowers who can supposedly look up the identity of the current holders of their mortgages in the local public records.¹⁷⁸ Indeed, commentators have criticized MERS because its users, in effect, record their assignments with MERS rather than in local recorders' offices.¹⁷⁹

¹⁷⁶ See CAL. CIV. CODE § 2932.5 (West 2012); GA. CODE ANN. § 44-14-162(b) (Supp. 2013); IDAHO CODE ANN. § 45-1505(1) (Supp. 2013); MASS. GEN. LAWS ANN. ch.183, § 21 (2014) (stating that assignments are required but they need not be recorded); MICH. COMP. LAWS. § 600.3204(c) (Supp. 2014); MINN. STAT. § 580.02(3) (2013); NEV. REV. STAT. ANN. § 107.086(4) (LexisNexis 2013); OR. REV. STAT. § 86.735 (2013); S.D. CODIFIED LAWS § 21-48-2 (2013); WYO. STAT. ANN. § 34-4-103 (2013). The Supreme Court of Oregon held that the statute applies only to formal written mortgage assignments and not to an equitable assignment of the mortgage that occurs when the note is transferred. See *Niday v. GMAC Mortg., LLC*, 302 P.3d 444, 451–52 (Or. 2013) (en banc); *Brandrup v. ReconTrust Co., N.A.*, 303 P.3d 301, 318 (Or. 2013) (en banc). Whether the California statute applies to both mortgages and deeds of trust, or only to mortgages, is a subject of dispute. Compare *Calvo v. HSBC Bank, USA, N.A.*, 130 Cal. Rptr. 3d 815, 818 (Cal. Ct. App. 2011) (mortgages only), with *Cruz v. Aurora Loan Servs. LLC (In re Cruz)*, 457 B.R. 806, 818 (Bankr. S.D. Cal. 2011) (mortgages and deeds of trust). See, e.g., *U.S. Bank, N.A. v. Ibanez*, 941 N.E.2d 40, 53–55 (Mass. 2011) (requiring a chain of assignments, but not necessarily recorded, to foreclose nonjudicially in Massachusetts); *Sobh v. Bank of Am., N.A.*, No. 308441, 2013 WL 2460022, at *3 (Mich. Ct. App. June 6, 2013) (requiring a complete chain of recorded assignments to foreclose nonjudicially in Michigan).

¹⁷⁷ See CONN. GEN. STAT. § 49-17 (2014), construed in *Bankers Trust Co. of Cal., N.A. v. Vaneck*, 899 A.2d 41, 42 (Conn. App. Ct. 2006); *In re Tucker*, 441 B.R. 638, 644–45 (Bankr. W.D. Mo. 2010); *Harton v. Little*, 57 So. 851, 851–52 (Ala. 1911); *Vasquez v. Saxon Mortg., Inc. (In re Vasquez)*, 266 P.3d 1053, 1055 (Ariz. 2011) (en banc).

¹⁷⁸ See *What is an Assignment of a Mortgage?*, STOP FORECLOSURE FRAUD, <http://stopforeclosurefraud.com/what-is-an-assignment-of-mortgage/> (last visited June 1, 2014) (“If borrowers receive a notice in the mail indicating that their mortgage has been transferred, they should call their lenders to confirm the sale and ask who the mortgage was sold to. It is also advisable to check the records office to confirm that an assignment of the mortgage has been followed.”).

¹⁷⁹ See, e.g., *Peterson*, *supra* note 17, at 1403. Numerous suits have been filed by or on behalf of local recorders against MERS, asserting that MERS has somehow undermined the public recording process. However, courts have dismissed virtually all of

But this criticism is fallacious at two levels. First, no state requires contemporaneous recording of assignments, even for a nonjudicial foreclosure. Therefore, nothing prevents a secondary market investor from obtaining a chain of assignments, but delaying recording it until (and only if) foreclosure is necessary. In fact, this is precisely the policy Fannie Mae, Freddie Mac, and many other secondary investors have followed for several decades.¹⁸⁰ Nearly 30 years ago, two knowledgeable commentators wrote:

Although assignment[s] must be executed and delivered, recordation for some buyers [of mortgage loans] is not necessary unless it is required by law to perfect the buyer's ownership interest or is commonly required in the region by other mortgage buyers.¹⁸¹

the suits. *See* Christian Cnty. Clerk *ex rel.* Kem v. Mortg. Elec. Registration Sys., Inc., 515 F. App'x. 451, 455 (6th Cir. 2013); Brown v. Mortg. Elec. Registration Sys., Inc., 903 F. Supp. 2d 723, 727 (W.D. Ark. 2012); Fuller v. Mortg. Elec. Registration Sys., Inc., 888 F. Supp. 2d 1257, 1275 (M.D. Fla. 2012); Macon Cnty., Ill. *ex rel.* Ahola v. MERSCORP, Inc., 968 F. Supp. 2d 959, 969 (C.D. Ill. 2013); Cnty. of Ramsey v. MERSCORP Holdings, Inc., 962 F. Supp. 2d 1082, 1087 (D. Minn. 2013); Jackson Cnty. *ex rel.* Nixon v. MERSCORP, Inc., 915 F. Supp. 2d 1064, 1068 (W.D. Mo. 2013); Town of Johnston v. MERSCORP, Inc., 950 F. Supp. 2d 379, 382–83 (D.R.I. 2013); *see also* Dallas Cnty., Tex. v. MERSCORP, Inc., No. 3:11-cv-02733-O, 2013 WL 5903300, at *6–7 (N.D. Tex. Nov. 4, 2013) (holding that references to MERS as “beneficiary” of deeds of trust did not give rise to fraud claim by the county recorder).

¹⁸⁰ *See* FANNIE MAE, SELLING GUIDE: FANNIE MAE SINGLE FAMILY 936 (2012), available at <http://www.mooreeducation.com/wp-content/uploads/2011/08/Fannie-Mae-Selling-Guide.pdf> (“Lenders must prepare an assignment of the mortgage to Fannie Mae for any mortgage that is not registered with MERS, although the assignment should not be recorded. If the mortgage seller is not going to service the mortgage, the unrecorded assignment to Fannie Mae must be executed by the servicer.”); FREDDIE MAC, SINGLE-FAMILY SELLER/SERVICER GUIDE, ch. 22.14 (2009), available at <http://www.freddiemac.com/sell/guide/> (“The Seller/Servicer is not required to prepare an assignment of the Security Instrument to the Federal Home Loan Mortgage Corporation (Freddie Mac). However, Freddie Mac may, at its sole discretion and at any time, require a Seller/Servicer, at the Seller/Servicer’s expense, to prepare, execute and/or record assignments of the Security Instrument to Freddie Mac. If an assignment of the Security Instrument to Freddie Mac has been prepared, Seller/Servicer must not record it unless directed to do so by Freddie Mac.”).

¹⁸¹ CHARLES L. EDSON & BARRY G. JACOBS, SECONDARY MORTGAGE MARKET GUIDE § 9.03[1][c] (1986). Note that investors widely followed this sort of policy long before the advent of MERS.

Yet obviously, an assignment that is not recorded when the loan is assigned is worthless in terms of providing transparency to borrowers, making the supposed benefits of the recording system entirely illusory.

In addition, any reliance on recorded assignments is potentially misleading because the existence of an assignment proves nothing about the transfer of the right to enforce the note to the mortgage assignee, to someone else by the assignee or its predecessor, or to anyone at all. Yet, the right to enforce the note is what confers the power to foreclose the mortgage.¹⁸² Thus, for foreclosure purposes, the information provided by the recording of mortgage assignments is essentially useless. The public records have never been a reliable basis for discovering who holds a mortgage loan. The incentives necessary to induce market participants to record their ownership of mortgages on a current basis simply do not exist, and in any event, evidence of ownership of a mortgage proves nothing about who holds the note.

1. *Mortgage Assignments as a Means of Gaining Notice*

Despite the fact that mortgage assignments are not essential to the right to foreclose, they have two other valuable purposes. To illustrate the first, assume a mortgage is the subject of one or more unrecorded assignments. Then a different party—for example, the holder of another mortgage on the property, whether prior or subsequent to the one that has been assigned—institutes litigation that may affect the rights of the holder of the assigned mortgage. Upon whom will this plaintiff serve process? Ordinarily, the plaintiff will look in the public records, will there discover the identity of the original mortgagee of the assigned mortgage, and will serve that party. Unless the plaintiff has actual knowledge of the unrecorded assignment, he or she has no way of knowing the assignee's identity, and hence the assignee will not be notified of the litigation. Moreover, the original mortgagee may disregard the service of process, feeling that it no longer has any interest in the matter, and may fail to pass the notice along to the assignee. Nonetheless, the assignee will almost certainly be held bound by the outcome of the case.¹⁸³ More than 100 years ago, the Ohio Supreme Court said that when an

¹⁸² See sources cited *supra* notes 143–144 and accompanying text.

¹⁸³ *Lang v. Butler*, 483 P.2d 994, 996 (Colo. App. 1971); *Citimortgage, Inc. v. Barabas*, 950 N.E.2d 12, 18 (Ind. Ct. App. 2011), *vacated*, 975 N.E.2d 805 (Ind. 2012); *Pinney v. Merchants' Nat'l Bank of Defiance*, 72 N.E. 884, 887–88 (Ohio 1904); *Fifth Third Bank v. NCS Mortg. Lending Co.*, 860 N.E.2d 785, 788–89 (Ohio Ct. App. 2006).

assignee fails to have his assignment so entered of record, and a senior mortgagee of the same premises brings an action to foreclose, he is, in the absence of notice or knowledge that the junior mortgagee has parted with his interest, justified in regarding the record as showing that the junior mortgagee remains the absolute holder of the mortgage, and in bringing him in as a party to the action.¹⁸⁴

Hence, if the case is a foreclosure action filed by a senior mortgagee, the unrecorded assignee of the junior mortgage will have its security destroyed.

Other types of actions may not be so catastrophic, but they can have a direct and harmful effect on the property's value or usefulness. For example, a local government may sue to enforce a zoning ordinance or a housing or building code. A neighbor may file a nuisance action. A government agency may sue to force cleanup of hazardous waste. Other possibilities include an eminent domain action, a government forfeiture proceeding, or a quiet title action. A mortgage assignee has a great interest in learning of these proceedings and making sure that a vigorous defense is presented. But if the assignment is not recorded, and if the mortgagor-owner fails to alert the mortgagee to the proceeding, the mortgagee will probably have no opportunity to do so. While facts like these may not occur frequently, they certainly suggest that recording of the assignment is a wise precaution.

When MERS was created, its architects believed that a recorded assignment to MERS would fulfill the same function in ensuring notice of subsequently-filed proceedings. Parties filing such actions, and finding in the public records that the subordinate mortgage was assigned to or held by MERS, would have a duty to give MERS notice of the litigation. MERS operates a "mailbox" function to pass such notices along to the holders of the loans. Ironically, several appellate courts have found that because MERS is a mere nominee and not the real party in interest, MERS is not entitled to notice.¹⁸⁵ Such a conclusion seems bizarre, and it seriously undercuts a main objective of MERS' existence.

¹⁸⁴ *Pinney*, 72 N.E. at 885.

¹⁸⁵ See *Mortg. Elec. Registration Sys., Inc. v. Sw. Homes of Ark.*, 301 S.W.3d 1, 5 (Ark. 2009); *Barabas*, 950 N.E.2d at 18; *Landmark Nat'l Bank v. Kesler*, 216 P.3d 158, 169–170 (Kan. 2009). *Contra* *Mortg. Elec. Registration Sys., Inc. v. Bellistri*, No. 4:09-CV-731 CAS, 2010 WL 2720802, at *12 (E.D. Mo. July 1, 2010) (holding that MERS was entitled to notice of redemption from tax sale under Missouri law).

2. *Recording an Assignment as a Tool to Prevent Wrongful Satisfaction or Subordination by the Original Mortgagee*

Recording assignments provides a second important benefit. Suppose a mortgage securing a negotiable note is assigned to a new holder who does not record the assignment. Then the original mortgagor and mortgagee engage in a bit of skullduggery. The mortgagor induces the mortgagee (quite wrongfully) to execute and record the customary form of discharge or satisfaction of the mortgage, even though the mortgagor has not paid the debt.¹⁸⁶ Having now ostensibly cleared the title, the mortgagor sells or mortgages the land to a bona fide purchaser who supposes that the mortgage has been properly discharged.

This case presents a fundamental conflict between the U.C.C., which protects a holder of the note (and by the usual extension, the mortgage also), and the innocent land buyer who has relied on the public records. The cases uniformly resolve the conflict in favor of the innocent land buyer, or bona fide purchaser, who takes free of the mortgage.¹⁸⁷ If the original mortgagor, who was far from innocent, was personally liable on the note, she or he remains so, but the debt is no longer secured by the

¹⁸⁶ As between the mortgagor and the assignee, the satisfaction or cancellation of the mortgage is entirely ineffective. *See* McKinley v. Lamar Bank, 919 So. 2d 918, 928–29 (Miss. 2005); Black v. Adrian, 80 S.W.3d 909, 914–15 (Mo. Ct. App. 2002). If the note has been negotiated, the ploy described in the text will be impossible or at least difficult in the few states which require the note to be presented to the recorder for cancellation before the mortgage can be satisfied of record. *See, e.g.,* MO. ANN. STAT. § 443.060(1) (prior to its amendment effective January 1986); Pioneer Enters., Inc. v. Goodnight, 561 So. 2d 824, 828 (La. Ct. App. 1990).

¹⁸⁷ *See* Ameribanc Sav. Banks v. Resolution Trust Corp., 858 F. Supp. 576, 583 (E.D. Va. 1994); *In re* Beaulac, 298 B.R. 31, 36 (Bankr. D. Mass. 2003) (finding that pursuant to strong-arm powers, a trustee in bankruptcy is a bona fide purchaser); Kan. City Mortg. Co. v. Crowell, 239 So. 2d 130, 131 (Fla. Dist. Ct. App. 1970); Federal Nat'l Mortg. Ass'n v. Kuipers, 732 N.E.2d 723, 726–27 (Ill. App. Ct. 2000); Brenner v. Neu, 170 N.E.2d 897, 899 (Ill. App. Ct. 1960); Henniges v. Johnson, 84 N.W. 350, 353 (N.D. 1900); Kalen v. Gelderman, 278 N.W. 165, 170 (S.D. 1938); Fannin Inv. & Dev. Co. v. Neuhaus, 427 S.W.2d 82, 89 (Tex. Civ. App. 1968); Marling v. Milwaukee Realty Co., 106 N.W. 844, 845 (Wis. 1906); *cf.* Northup v. Reese, 67 So. 136, 137 (Fla. 1914); *see also* Notes, 5 U. CHI. L. REV. 151 (1937); 16 MINN. L. REV. 126 n.19 (1932). The same principle applies when the bona fide purchaser takes a mortgage rather than a deed—the purchaser will gain priority over the previous mortgage. *But see* Lloyd v. Chi. Title Ins. Co., 576 So. 2d 310, 312 (Fla. Dist. Ct. App. 1990) (reaching a result contrary to that described in the text on the ground that the satisfaction was apparently not executed by the mortgagee, but merely forged by the mortgagors, and hence was a nullity). *See* the thorough discussion in Ann M. Burkhardt, *Third Party Defenses to Mortgages*, 1998 B.Y.U. L. REV. 1003, 1020–22 nn.43–51.

mortgage.¹⁸⁸ Obviously the opposite result would seriously jeopardize the usefulness of the entire recording system. Moreover, the note's holder could easily have prevented the problem from arising by recording the assignment.

Variations on this scenario are possible in which the original mortgagee engages in bad behavior, with or without the connivance of the mortgagor. Instead of a release of the mortgage, the mortgagor may procure a subordination from the original mortgagee, thereby enabling the mortgagor to obtain a new (and ostensibly first) mortgage loan. Alternatively, the mortgagee may fraudulently obtain from the mortgagor a renewal note and mortgage, purporting to supersede the original loan documents, and may then assign them to a bona fide purchaser. Also, the mortgagee could possibly proceed to foreclose the mortgage (assuming the note is in default), thereby passing title to a bona fide purchaser at the foreclosure sale, or by buying the property at the foreclosure sale and later selling it to a bona fide purchaser. In yet another possible variation of the story, the mortgagee, while pretending to hold the note and mortgage after in fact assigning them, may induce the defaulting mortgagor to give a deed in lieu of foreclosure. On the face of the record, all interests in the property have now merged in the same person—the mortgagee—who proceeds to sell the land to a bona fide purchaser. In all of these cases the courts prefer the bona fide purchaser, who has relied on the land records and the absence of any recorded mortgage assignment, over the secondary market purchaser who has failed to record an assignment.¹⁸⁹

Does this parade of horrors give sufficient reason to persuade a mortgage investor to record? Perhaps not. After all, these scenarios will only eventuate if the assignor of the mortgage engages in dishonest or fraudulent behavior. The secondary market purchaser may feel that the risk of fraud is slight, while the inconvenience of recording is great; or the mortgage purchaser may simply be unaware of the legal principles upon which this risk depends.

In summary, even though judicial foreclosure does not require the recording of assignments, two important reasons exist for a mortgage investor to record an assignment: to ensure receipt of notice of suits or other actions affecting the land or the mortgage, and to prevent

¹⁸⁸ The land was represented to the grantee as being debt-free; therefore the grantee assuming personal liability on the debt in the situation is an improbable result.

¹⁸⁹ For a more detailed discussion of these narratives and the case authority governing them, see REAL ESTATE FINANCE LAW, *supra* note 7, § 5.34.

fraudulent misbehavior on the part of the party from whom the mortgage was purchased. Note well that, for recording to fulfill these purposes, it must be contemporaneous recording; it does the investor no good in terms of these risks to wait until just before foreclosure to record.

It is worth mentioning that MERS does exactly what the servicer was designed to do in the context of these risks. Recording an assignment to MERS fulfills the investor's purposes just as well as an assignment directly to the investor—except in those unfortunate states where the courts have held that MERS is not really the holder of the mortgage, and hence is not entitled to notice of proceedings filed against the land or the mortgage.¹⁹⁰

G. Many Nonjudicial Foreclosure Statutes are Weak and Inadequate

Nonjudicial foreclosure in the United States is comparatively new; it became popular in the United States over the course of the twentieth century.¹⁹¹ Nonjudicial foreclosures were developed to afford a quicker, cheaper, and more efficient process than was provided by the traditional method of judicial foreclosure, which originated in England.¹⁹² Nonjudicial foreclosure is now authorized in thirty-five states and the District of Columbia.¹⁹³ In twenty-three of those jurisdictions, the preferred (usually the only) security instrument is the deed of trust, while the remaining thirteen states permit the use of a mortgage with a power of sale—that is, a power to foreclose—vested in the mortgagee.¹⁹⁴ While

¹⁹⁰ See cases cited *supra* note 185 and accompanying text.

¹⁹¹ California seems to have adopted the earliest U.S. nonjudicial foreclosure statute in 1872. See CAL. CIV. PRO. CODE § 726 (Deering 1872) (amended 1903). The most recent state to adopt nonjudicial foreclosure is New Mexico. See H.B. No. 254, 47th Leg., 2d Reg. Sess. (N.M. 2006).

¹⁹² Nonjudicial foreclosures undoubtedly achieve these objectives. One study, based on 2010 data, found that the average time to process a residential foreclosure in nonjudicial states was 141 days, compared with 504 days in judicial states. See BEACON ECONS., LLC, FORECLOSURE REFORM IN CALIFORNIA: AN ECONOMIC ANALYSIS 8 (2012). The same study found that foreclosure rates toward the end of the period of 2007 to 2012 had declined much faster in nonjudicial states than in judicial states. See *id.* at 12.

¹⁹³ See AM. COLL. OF MORTG. ATTORNEYS, MORTGAGE LAW SUMMARY (2012).

¹⁹⁴ See *id.* All of the states where deeds of trust are authorized by statute permit nonjudicial foreclosure. Arkansas is counted here as a mortgage with power of sale state, but Arkansas is actually agnostic as to the use of mortgages or deeds of trust. See ARK. CODE ANN. § 18-50-102 (2003 & Supp. 2011). Georgia uses the “security deed,” classified here as a mortgage. GA. CODE ANN. § 44-14-162.2 (Supp. 2013). Maine and Vermont restrict the use of a mortgage with power of sale to nonresidential properties. See ME. REV. STAT. tit. 14, § 6203-A(1) (2013); VT. STAT. ANN. tit. 12, § 4961 (2013).

nonjudicial foreclosure presents a number of challenging and interesting questions,¹⁹⁵ this Article deals with only one: what sort of proof, evidence, or documentation must a secondary market purchaser show to foreclose nonjudicially?

With respect to the question of who can instigate a foreclosure, one might expect nonjudicial foreclosures to operate under the same concepts as judicial foreclosures. After all, the principle that a mortgage or deed of trust can only be foreclosed by a party with the right to enforce the secured obligation seems universal in its application.¹⁹⁶ Moreover, every American jurisdiction has enacted Article 3, and its requirements for transferring the right to enforce a negotiable note are the same everywhere.¹⁹⁷

However, eight states have construed their nonjudicial foreclosure statutes to disregard this requirement, and have held that the foreclosing party need not demonstrate or establish in any way its right to enforce the obligation.¹⁹⁸ These decisions are often described as rejecting the “show me the note” defense. States taking this step include Alabama,¹⁹⁹ Arizona,²⁰⁰ California,²⁰¹ Georgia,²⁰² Idaho,²⁰³ Michigan,²⁰⁴ Minnesota,²⁰⁵

Other restrictions may also apply. For example, nonjudicial foreclosure is limited to nonagricultural property in Arkansas and to parcels of forty acres or less in Montana. *See* ARK. CODE ANN. § 18-50-116; MONT. CODE ANN. § 71-1-302 (2013).

¹⁹⁵ For one set of answers to many of these challenges, see UNIF. NONJUDICIAL FORECLOSURE ACT (2002), available at http://www.uniformlaws.org/shared/docs/nonjudicial%20foreclosure/nonjudicial_foreclosure_final_02.pdf. No state has adopted this uniform act.

¹⁹⁶ *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.4(c) (1996) (emphasis added) (“[A] mortgage may be enforced only by, or *in behalf of*, a person who is entitled to enforce the obligation the mortgage secures.”).

¹⁹⁷ New York alone has not adopted the current version of Article 3, and continues to operate under the previous version. But arguably (and strongly so), the requirements for transferring the right to enforce are essentially identical under either version. *See* Bank of N.Y. Mellon v. Deane, 970 N.Y.S.2d 427, 431–33 (N.Y. Sup. Ct. 2013).

¹⁹⁸ *See* Dale A. Whitman & Drew Milner, *Foreclosing on Nothing: The Curious Problem of the Deed of Trust Foreclosure Without Entitlement to Enforce the Note*, 66 ARK. L. REV. 21, 36–47 (2013).

¹⁹⁹ *See* Douglas v. Troy Bank & Trust Co., 122 So. 3d 181, 183–84 (Ala. Civ. App. 2012).

²⁰⁰ *See* Hogan v. Wash. Mut. Bank, N.A., 277 P.3d 781, 783 (Ariz. 2012) (en banc); *see also* Zadrozny v. Bank of N. Y. Mellon, 720 F.3d 1163, 1170 (9th Cir. 2013); Mansour v. Cal-W. Reconveyance Corp., 618 F. Supp. 2d 1178, 1181 (D. Ariz. 2009); Varbel v. Bank of Am., N.A., No. 1 CA–CV 12–0263, 2013 WL 817290, at *2 (Ariz. Ct. App. March 5, 2013).

and Texas.²⁰⁶ A number of other jurisdictions take the opposite approach, holding that a party must have PETE status and must provide at least some evidence of that fact (usually in the form of an affidavit) in order to foreclose nonjudicially. These states, which usually have plainer statutory language, include Arkansas,²⁰⁷ Colorado,²⁰⁸ Maryland,²⁰⁹ Massachusetts,²¹⁰ Missouri,²¹¹ Nevada,²¹² North Carolina,²¹³ Washington,²¹⁴ and arguably Virginia.²¹⁵

²⁰¹ See *Debrunner v. Deutsche Bank Nat'l Trust Co.*, 138 Cal. Ct. Rptr. 3d 830, 836 (Cal. Ct. App. 2012).

²⁰² See *You v. JP Morgan Chase Bank, N.A.*, 743 S.E.2d 428, 433 (Ga. 2013); see also *Watkins v. Beneficial, HSBC Mortg.*, No. 1:10-CV-1999-TWT-RGV, 2010 WL 4318898, at *4 (N.D. Ga. Sept. 2, 2010).

²⁰³ See *Trotter v. Bank of N.Y. Mellon*, 275 P.3d 857, 862 (Idaho 2012).

²⁰⁴ See *Hargrow v. Wells Fargo Bank, N.A.*, 491 F. App'x. 534, 536-38 (6th Cir. 2012); *Residential Funding Co. v. Saurman*, 805 N.W.2d 183, 183 (Mich. 2011); *Sallie v. Fifth Third Bank*, 824 N.W.2d 238, 240 (Mich. Ct. App. 2012).

²⁰⁵ See *Stein v. Chase Home Fin., LLC*, 662 F.3d 976, 981 (8th Cir. 2011) (relying on *Jackson v. Mortg. Elect. Registration Sys., Inc.*, 770 N.W.2d 487 (Minn. 2009)); see also *JPMorgan Chase Bank, N.A. v. Erlandson*, 821 N.W.2d 600, 607-08 (Minn. Ct. App. 2012) (refusing to require proof of possession of the note even in a judicial foreclosure proceeding).

²⁰⁶ *Martins v. BAC Home Loans Servicing, L.P.*, 722 F.3d 249, 253-54 (5th Cir. 2013); *Green v. JPMorgan Chase Bank, N.A.*, 937 F. Supp. 2d 849, 856 (N.D. Tex. 2013); *Thomas v. Bank of N.Y. Mellon*, No. 3:12-CV-4941-M-BH, 2013 WL 4441568, at *4 (N.D. Tex. Aug. 20, 2013); *Bierwirth v. BAC Home Loans Servicing, L.P.*, No. 03-11-00644-CV, 2012 WL 3793190, at *3-4 (Tex. App. Aug. 30, 2012).

²⁰⁷ See ARK. CODE ANN. § 18-50-103(2) (2003 & Supp. 2011) (requiring that the notice initiating the foreclosure include a "true and correct copy of the note with all required endorsements, the name of the holder," and the physical location of the original note).

²⁰⁸ See COLO. REV. STAT. § 38-38-101(1)(b)(II) (2013).

²⁰⁹ See *Deutsche Bank Nat'l Trust Co. v. Brock*, 63 A.3d 40, 48-49 (Md. 2013); *Anderson v. Burson*, 35 A.3d 452, 460-62 (Md. 2011).

²¹⁰ See *Eaton v. Fed. Nat'l Mortg. Ass'n*, 969 N.E.2d 1118, 1128 (Mass. 2012). The *Eaton* case is significant because the Massachusetts nonjudicial foreclosure statute makes no express reference to holding the note or the right to enforce it. The court, however, cited the familiar principle that having the right to enforce the note was an essential element of common-law judicial foreclosures in Massachusetts. It then recognized the implicit assumption in the statute that "the holder of the mortgage note and the holder of the mortgage are one and the same." *Id.* (citing MASS. GEN. LAWS ch. 244, § 178 (2014)). Hence, the court concluded that holding the note was essential to the right to foreclose.

²¹¹ See *In re Washington*, 468 B.R. 846, 853 (Bankr. W.D. Mo. 2011); *In re Box*, No. 10-20086, 2010 WL 2228289, at *4-5 (Bankr. W.D. Mo. June 3, 2010). However, the trustee of the deed of trust apparently has no obligation to investigate whether the

The decisions that disregard Article 3's requirements are hard to accept. One way to try to justify them is to assert that foreclosing a mortgage or deed of trust is not a method of enforcing the promissory note²¹⁶—a proposition that seems absurd on its face. An alternative justification is that the particular state's nonjudicial foreclosure statute must be read as the sole source of information regarding the foreclosure process, and if it does not mention the necessity for having the right of enforcement of the note, Article 3's requirements are thereby superseded.²¹⁷ Both of these rationales seem far-fetched and

foreclosing party has the note and no duty to report any findings to the borrower. *See Singleton v. Wells Fargo Home Mortg.*, No. 12-0230-CV-W-ODS, 2012 WL 1657345, at *3 (W.D. Mo. May 9, 2012).

²¹² *See* NEV. REV. STAT. § 107.080(2)(c)(2) (2013) (“The beneficiary . . . causes to be recorded . . . a notice of the breach [that] . . . includes a notarized affidavit of authority . . . [t]hat the beneficiary under the deed of trust, the successor in interest of the beneficiary or the trustee is in actual or constructive possession of the note secured by the deed of trust . . .”); *Edelstein v. Bank of N.Y. Mellon*, 286 P.3d 249, 252 (Nev. 2012).

²¹³ *See In re David A. Simpson, P.C.*, 711 S.E.2d 165, 173 (N.C. Ct. App. 2011).

²¹⁴ *See* WASH. REV. CODE § 61.24.030(7)(a) (2014) (“A declaration by the beneficiary made under the penalty of perjury stating that the beneficiary is the actual holder of the promissory note or other obligation secured by the deed of trust shall be sufficient proof” of standing to foreclose); *Bain v. Metro. Mortg. Grp., Inc.*, 285 P.3d 34, 36 (Wash. 2012) (en banc); *see also Allen v. U.S. Bank, N.A. (In re Allen)*, 472 B.R. 559, 569 (B.A.P. 9th Cir. 2012).

²¹⁵ *See* VA. CODE ANN. 55-59.1 (2009). The Virginia statute provides that “[i]f a note or other evidence of indebtedness secured by a deed of trust is lost or for any reason cannot be produced[,]” the trustee of the deed of trust must obtain a lost note affidavit from the lender as a prerequisite to foreclosure and advise the borrower that he or she may petition the circuit court for an order requiring a bond or other protection. *Id.* § 55-59.1(B). This wording implies, but does not explicitly state, that the trustee should verify that the foreclosing party possesses the note. The federal cases have not imposed any such duty on the trustee, and have declined to require the trustee to disclose the results of investigation to the borrower. *See Gallant v. Deutsche Bank Nat'l Trust Co.*, 766 F. Supp. 2d 714, 720 (W.D. Va. 2011); *see also Buzbee v. U.S. Bank, N.A.*, No. CL 2010-1139, 2012 WL 7960035, at *2 (Va. Cir. Ct. May 2, 2012) (internal quotation marks omitted) (“Show me the note cases are contrary to Virginia's non-judicial foreclosure laws, which do not require secured creditors to come before the court to prove their authority to foreclose on secured property.”).

²¹⁶ *See Reardean v. CitiMortgage, Inc.*, No. A-11-CA-420-55, 2011 WL 3268307, at *3 (W.D. Tex. July 25, 2011) (“Texas courts have refused to conflate foreclosure with enforcement of a promissory note.”).

²¹⁷ *See Debrunner v. Deutsche Bank Nat'l Trust Co.*, 138 Cal. Rptr. 3d 830, 836 (Cal. Ct. App. 2012) (California statute establishes a comprehensive and exhaustive statutory framework to govern nonjudicial foreclosure sales, and California courts “have refused to read any additional requirements into the . . . statute”).

unconvincing. A much more sensible approach is to read Article 3 and the foreclosure statute in *pari materia* with Article 3, consequently adding a requirement to the foreclosure statute that the foreclosing party must at least aver its right of enforcement of the note. Indeed, that approach is precisely what the Massachusetts Supreme Judicial Court took in 2012 in *Eaton v. Federal National Mortgage Association*.²¹⁸ Yet we still have eight jurisdictions in which this simple and obvious step seems to have been foreign to the courts' thinking.

Moreover, if holding the note is not the relevant indicium of the right to foreclose (or in the case of a deed of trust, to instruct the trustee to foreclose), what is? Surely there is *some* form of evidence that must exist to confer the right to foreclose—even when no court is involved to address such right unless the borrower brings an action to enjoin the foreclosure. The recent decisions, in the first group of states identified above, often do not make this question easy to answer. Depending on the jurisdiction, the answer may be a photocopy of the note,²¹⁹ a chain of assignments (possibly recorded,²²⁰ possibly not),²²¹ or perhaps either a chain of assignments or possession of the note.²²² Additionally, in a

²¹⁸ 969 N.E.2d 1118, 1128 (Mass. 2012).

²¹⁹ See *Wells Fargo Bank v. Stratton Jensen, LLC*, 273 P.3d 383, 384–85 (Utah Ct. App. 2012).

²²⁰ See *Murphy v. Aurora Loan Servs., LLC*, 699 F.3d 1027, 1033–34 (8th Cir. 2012); *Residential Funding Co. v. Saurman*, 805 N.W.2d 183, 184 (Mich. 2011); *Ruiz v. 1st Fid. Loan Servicing, LLC*, 829 N.W.2d 53, 57–59 (Minn. 2013); see also statutes cited *supra* note 176.

²²¹ See *Vasquez v. Saxon Mortg., Inc.*, (*In re Vasquez*), 266 P.3d 1053, 1085–86 (Ariz. 2011); *Calvo v. HSBC Bank*, 130 Cal. Rptr. 3d 815, 818–19 (Cal. Ct. App. 2011); *U.S. Bank, N.A. v. Ibanez*, 941 N.E.2d 40, 53 (Mass. 2011). Compare *Varbel v. Bank of Am., N.A.*, No. 1 CA–CV 12–0263, 2013 WL 817290, at *2 (Ariz. Ct. App. March 15, 2013) (stating that a chain of assignments, recorded or not, is unnecessary to the right to foreclose), with *Steinberger v. McVey ex rel. Cnty. of Maricopa*, 318 P.3d 419, 438–39 (Ariz. Ct. App. 2014) (stating that a chain of valid assignments is necessary to assert the right to foreclose). Thus, the method of qualifying to foreclose nonjudicially in Arizona remains opaque.

²²² This option seems to be the situation in Texas. See *Reinagel v. Deutsche Bank Nat'l Trust Co.*, 735 F.3d 220, 224–25 (5th Cir. 2013) (stating that a borrower has standing to challenge assignments if void, but not if merely voidable); *Calderon v. Bank of Am., N.A.*, 941 F. Supp. 2d 753, 765 (W.D. Tex. 2013) (stating that the foreclosing party does need to show an assignment of the mortgage, if the foreclosing party has possession of the note). A vigorous debate exists as to whether the borrower has standing to challenge a defect in the chain of assignments in Texas. See *Smith v. Wells Fargo Bank, N.A.*, No. 3:12–cv–4633–K–BN, 2013 WL 3324195, at *5–6 (N.D. Tex. June 28, 2013); *Scott v. Bank of Am., N.A.*, No. SA–12–CV–00917–DAE, 2013 WL 1821874, at

number of states the borrower simply has no way—short of filing a suit and engaging in discovery—to determine whether the applicable requirements have been satisfied, and hence whether the party purporting to foreclose nonjudicially has the right to do so.

Ultimately, the problem described above results from a fault in drafting. When most states adopted their nonjudicial foreclosure statutes, secondary market sales of mortgages were relatively uncommon. The drafters simply did not give enough thought to the existence of the secondary mortgage market and the need to address its transactions. They typically provided that the mortgagee (or in the case of a deed of trust, the beneficiary) could commence foreclosure without saying what those terms would mean in the context of a loan that had been sold to a secondary market investor.

Ordinarily, when a statute contains a gap of this sort, we expect the courts to fill it with a plausible interpretation, but the courts in the eight states mentioned above have struggled unsuccessfully to do so.²²³ Arizona provides a good example. In *Hogan v. Washington Mutual Bank, N.A.*,²²⁴ the Arizona Supreme Court conceded that, in principle, a deed of trust could be foreclosed only by one with the right to enforce the note,²²⁵ but nonetheless held that the foreclosure statute imposed no obligation on a foreclosing party to assert in any way (much less to prove) that it had the right to enforce the note. Subsequently, the Arizona Court of Appeals in *Steinberger v. McVey ex rel. County of Maricopa*,²²⁶ was forced to decide what to make of this holding. Could it mean that a party could instruct the trustee of the deed of trust to foreclose without any allegation or evidence that it had any connection with the original loan? Such a holding would be absurd. Surely the court must have thought that some form of evidence was necessary to show that the loan had been transferred to the foreclosing party. The obvious and logical

*3 (W.D. Tex. Apr. 29, 2013); *Amaro v. U.S. Bank, N.A.*, No. 3:12-3776-B, 2013 WL 1187284, at *2-3 (N.D. Tex. Mar. 22, 2013) (stating that possession of the note is not required, but apparently a chain of assignments is necessary, although borrower had no standing to challenge them); *Miller v. Homecomings Fin., LLC*, 881 F. Supp. 2d 825, 829-30 (S.D. Tex. 2012) (foreclosing party may establish its standing either by possession of the note or a chain of assignments); *see also* *Green v. JPMorgan Chase Bank, N.A.*, 937 F. Supp. 2d 849, 857-58 (N.D. Tex. 2013) (stating that assignments are effective whether recorded or not).

²²³ *See* cases cited *supra* notes 199-206.

²²⁴ 277 P.3d 781 (Ariz. 2012).

²²⁵ *See id.* at 783.

²²⁶ 318 P.3d 419 (Ariz. Ct. App. 2014).

connection would have been evidence that the foreclosing party held the note, but the Arizona Supreme Court's opinion in *Hogan* seemed to preclude that reading. The Arizona court of appeals held instead that the foreclosing party must have a legal chain of mortgage assignments.²²⁷ Such a requirement appears nowhere in the foreclosure statute, but the court of appeals must have decided that the chain was the only reasonable alternative in light of *Hogan*.

Perhaps the *Steinberger* court's resolution of this issue is better than nothing, but the resolution is surely inferior to the common law under which foreclosure requires a showing of the right to enforce the note.²²⁸ This point is not minor or a mere technicality. Article 3 requires delivery of the original note to the party claiming the right to enforce it because delivery provides a simple but effective method to ensure the borrower knows that he or she is paying, negotiating with, or mediating with the correct party. The borrower, after receiving proof that the foreclosing party holds the note, is ensured against double enforcement²²⁹—that is, no one else will turn out to possess the note and try to sue on it later. Given the confusion and maladministration that characterized secondary mortgage transactions during the past decade, it seems quite reasonable that borrowers should be able to make this verification. If the note is not to serve this purpose, what is? A chain of mortgage assignments simply does not do it, for it tells the borrower nothing about who has possession of the note and hence the right to enforce it.

The Arizona Supreme Court in *Hogan* dismissed this concern, asserting that double enforcement could never occur because the Arizona statutory antideficiency rule would bar a later action on the note.²³⁰ That holding was accurate on the actual facts of *Hogan* because the statute bars deficiency judgments on one or two-family houses on 2.5 acres or less.²³¹ But what of nonjudicial foreclosures of other types of property in Arizona? Should the court read the same foreclosure statute differently in

²²⁷ *Id.* at 439.

²²⁸ See RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.4(c) (1996) (“A mortgage may be enforced only by, or in behalf of, a person who is entitled to enforce the obligation the mortgage secures.”).

²²⁹ The North Carolina Court of Appeals makes this point nicely in *In re Bass*, 720 S.E.2d 18, 24 (N.C. Ct. App. 2011), *rev'd on other grounds*, 738 S.E.2d 173 (N.C. 2013). Cf. JPMorgan Chase Bank, N.A. v. Erlandson, 821 N.W.2d 600, 607–08 (Minn. Ct. App. 2012). The Minnesota court failed to understand this double-enforcement risk.

²³⁰ See *Hogan v. Wash. Mutual Bank*, 277 P.3d 781, 784 (Ariz. 2012) (en banc).

²³¹ See ARIZ. REV. STAT. § 33-814(G) (2013).

such cases? The court's treatment of this issue is disingenuous at best. It may be true that where a complete bar to deficiency liability is available under the foreclosure statute (as it is in California),²³² the risk of double liability disappears. But none of the other states that disregard Article 3's requirements, including Arizona, fully prohibit deficiency judgments in all circumstances.

1. *The Role of the Trustee under a Deed of Trust*

One might expect a significant distinction between deeds of trust and mortgages with power of sale in the context of nonjudicial foreclosure. Foreclosure of a mortgage with power of sale typically involves no one except the borrower and the mortgage holder, and little reason exists to expect the latter to take the former's interests into account except so far as specifically required by the applicable statute. A deed of trust foreclosure, on the other hand, is conducted by the trustee—a third party that is nominally independent of the holder of the debt and the security instrument, and has at least minimal duties of fairness and evenhandedness.²³³ In deed of trust states that have given the borrower no mechanism to verify the foreclosing party's PETE status,²³⁴ must the trustee do so, in effect acting as the borrower's surrogate? This idea is plausible, but none of those jurisdictions have imposed such a duty on the trustee. Thus, as matters have developed, the presence of the trustee in the foreclosure process has contributed little value in helping

²³² See CAL. CIV. PROC. CODE § 580d (West 2011 & Supp. 2012); see also REAL ESTATE FINANCE LAW, *supra* 7, § 8.3.

²³³ See, e.g., *Madden v. Alaska Mortg. Grp.*, 54 P.3d 265, 270 (Alaska 2002) (stating that a trustee has a duty “to conduct a fair sale in the event of the trustor's default”); *Hatch v. Collins*, 275 Cal. Rptr. 476, 480 (Cal. Ct. App. 1990) (citation omitted) (internal quotation marks omitted) (“[A] trustee has a general duty to conduct the sale fairly, openly, reasonably, and with due diligence, exercising sound discretion to protect the rights of the mortgagor and others.”); *Peterson v. Black*, 980 S.W.2d 818, 822 (Tex. App. 1998) (“[T]he trustee has no duty to take affirmative actions beyond that required by statute or the deed of trust to ensure a fair sale.”); cf. *Sparks v. PNC Bank*, 400 S.W.3d 454, 458 (Mo. Ct. App. 2013) (citation omitted) (internal quotation marks omitted) (stating that a trustee has “equal duty of fairness and impartiality to both parties,” but “may proceed without making any affirmative investigation unless the trustee has actual knowledge of anything which should *legally* prevent the foreclosure”).

²³⁴ These states are Alabama, Arizona, California, Idaho, and Texas. The other three states that have found no duty by the foreclosing party to aver the right to enforce the note—Georgia, Minnesota, and Michigan—use mortgages (or in the case of Georgia, security deeds) rather than deeds of trust. See cases cited *supra* notes 199–206.

borrowers to assess the foreclosing party's right to enforce the note and the mortgage.

2. *Lost Notes in Nonjudicial Foreclosures*

Under section 3-309 of the U.C.C., a person who does not have possession of a negotiable note may still enforce it by providing a lost note affidavit.²³⁵ This section of Article 3 was obviously drafted with judicial enforcement of notes in mind. It says that the party seeking to enforce the note must “prove” the note's terms and the party's right to enforce, and it provides that “the court may not enter judgment unless [the court] finds” that the borrower is adequately protected against double liability.²³⁶

How do these requirements apply in the context of a nonjudicial foreclosure? If the jurisdiction is one where the foreclosing party is not required to show entitlement to enforce the note, the question is irrelevant, of course. But what of the states in which possession of the note is generally required? Common sense suggests that a creditor should have the same opportunity to use the lost note procedure (and the borrower should be given the same protections when the procedure is used) whether enforcement of the note is through a lawsuit on the note or a nonjudicial foreclosure of the mortgage or deed of trust.

However, for the most part any process for accomplishing this result is notably absent in the nonjudicial foreclosure context. The author has identified only three states that have addressed this issue in their foreclosure statutes: Virginia, Colorado, and Arkansas. The Virginia provision was obviously drafted by analogy to section 3-309 of the U.C.C., stating that if the note has been lost, the foreclosing party must submit an affidavit to the foreclosure trustee, notify the borrower that the foreclosure will proceed after a fourteen-day delay, and provide notification that during this period the borrower may petition the circuit court for an order providing “adequate protection” against the risk of double liability on the note.²³⁷ Thus, Virginia's foreclosure statute recognizes the legitimacy of the U.C.C. lost note affidavit process, and it provides borrowers with essentially the same benefits in a nonjudicial

²³⁵ See *supra* text accompanying notes 71–79.

²³⁶ U.C.C. § 3-309(b) (amended 2002).

²³⁷ VA. CODE ANN. § 55-59.1(B) (2009). Adequate protection requires the foreclosing party to provide a bond or an indemnity against the risk of double enforcement of the note.

foreclosure that they would have in a judicial action to enforce the note²³⁸ (except that in the nonjudicial foreclosure context the borrower must take the initiative to present the issue to a judge).

Colorado's statutory approach is more straightforward, but may be less effective. If the foreclosing party does not have original evidence of the debt, the party is simply "deemed to have agreed to indemnify and defend any person liable for repayment of any portion of the original evidence of debt in the event that the original evidence of debt is presented for payment"²³⁹ This approach assumes, of course, that an indemnity from the foreclosing party will continue to be enforceable in the future, and neglects the possibility that the party may go out of business or become judgment-proof. The Arkansas statute is much weaker. It provides that the foreclosing party shall "provide a statement that the document is lost or otherwise unavailable, and shall recite the good faith efforts the beneficiary or mortgagee has made to locate the document,"²⁴⁰ but it makes no provision for a bond or indemnity to protect the maker against double enforcement.

No other state legislature seems to have thought about this problem. In states employing deeds of trust, a foreclosure trustee might, *sua sponte*, require the foreclosing party to provide a lost-note affidavit if the note is missing, and it might forward that affidavit to the borrower. Of course, nothing in the statutes (except in Virginia and in Colorado, where the trustee is a public official) directly requires the trustee to address this issue, and many trustees might be inclined simply to ignore it. In any event, a foreclosure trustee is not a judge and is not likely to feel comfortable telling the foreclosing party that a bond or indemnity must be provided to give the borrower adequate protection against double liability. A borrower who becomes aware that the note is lost might

²³⁸ The Virginia statute, however, is not perfect. The grounds for its use are far broader than for use of U.C.C. section 3-309. The statute is available if the note "is lost or for any reason cannot be produced." *Id.* This breadth suggests that foreclosing parties might simply send a "lost note letter" routinely in every case in order to avoid the inconvenience of locating the original note. *See Gallant v. Deutsche Bank Nat'l Trust Co.*, 766 F. Supp. 2d 714, 720 (W.D. Va. 2011). The statute's language may encourage this sort of conduct, as it provides that "[f]ailure to comply with the requirements of notice contained in this section shall not affect the validity of the sale" VA. CODE ANN. § 55-59.1(c); *see also Vazzana v. Citimortgage, Inc.*, No. 7:12CV00497, 2013 WL 2423092, at *3 (W.D. Va. June 4, 2013). Indeed, if the sale's validity is not affected, one might well ask why bother with the lost note letter at all.

²³⁹ COLO. REV. STAT. § 38-38-101(2)(a) (2013).

²⁴⁰ ARK. CODE ANN. § 18-50-103(2)(B) (2003 & Supp. 2011).

apply to a court for such protection, but in the absence of statutory guidance, it is uncertain how a court would react to such a request arising out of a nonjudicial foreclosure. The whole situation is murky and unpredictable.

These complications are worse in states that use mortgages with power of sale rather than deeds of trust. There, no foreclosure trustee is present to act as an arbiter or insist on the production of a lost note affidavit in the first place. It beggars belief that mortgage holders will voluntarily prepare such affidavits and send them to borrowers; lenders are not specifically required to do so by statute, and doing so would obviously complicate the foreclosure process and risk incurring added cost and delay. That volunteering simply is not going to happen.

In sum, the lost-note problem is one more illustration of the failure of most state legislatures to think through the need to coordinate the nonjudicial foreclosure process with the requirements of Article 3 and the secondary mortgage market. Legislative amendment is needed to address these issues.

V. CONCLUSION

The principles discussed in this Article are clear: the original, physical promissory note is a reification of the obligation to pay the debt, the delivery of possession of the note is the essential indicium of the right to enforce it, and the mortgage follows the note whether assigned (and whether an assignment is recorded) or not. Unfortunately, they result in a system that is highly dysfunctional to both lenders and borrowers.

From the viewpoint of note holders, the system forces them to use antiquated methods to move physical pieces of paper around the country, or to rely on custodians to do this movement for them. This process is extremely cumbersome, which is why in the early and mid-2000s, many secondary market participants and securitizers did not bother to do it. It introduces risks that the paper will be lost, mislaid, or destroyed. It completely fails to take advantage of available electronic technology that is used to track virtually all other forms of financial instruments today.

The system is also highly undesirable from the viewpoint of borrowers, because it is almost completely nontransparent. In theory, a borrower who wishes to determine whether X holds his or her promissory note can demand that X exhibit the note. But in practical terms, complying with such a demand is virtually impossible. X may indeed possess the note, but in this era of nationwide mortgage trading

the note is likely in the vault of a custodian many miles distant, so that exhibiting it to the borrower would result in prohibitive costs. Perhaps this sort of proof of the right to enforce notes made sense 50 years ago, when securitization had not been invented, secondary market transfers were relatively rare, and most of them were local in nature. Today, the system is absurd from the viewpoint of both borrowers and lenders. The whole concept of the original paper document as a reified form of the obligation itself is nonsensically inconvenient in the modern world.

Commentators sometimes complain that local real estate recording systems should be made into a functional and transparent means of keeping track of the right to enforce mortgage loans. But this is a hopelessly poor idea. Notes are not recorded, nor can they be in most states. Yet the note is what is critical to the right to enforce the mortgage. Assignments of the mortgage (which can be recorded) are largely irrelevant to the right to enforce the note or foreclose the mortgage. And even if the real estate recording system were to be drastically revised to permit recording of notes, the burdens of using it for that purpose would be oppressive, with more than 3,000 local recording jurisdictions, each with its own fee schedule, document standards, and geographic coverage. Surely such a fractionated and diverse set of record-keepers should not be imposed on the national secondary mortgage market.

What is needed is a nationwide, authoritative electronic records system, chartered by Congress with authority to preempt and override state law. Congress could design such a system so that it would be simple and straightforward for secondary market participants to use, and would be transparent to borrowers, so that all borrowers could identify the holders of their mortgages by a quick inquiry on the internet. It could eliminate, for purposes of foreclosure, the distinction between negotiable and nonnegotiable notes. It could also make the presence or absence of recorded mortgage assignments, and the issue of lost notes, completely irrelevant. No such system exists at present, but perhaps its advent is not far away.²⁴¹

²⁴¹ See generally Dale A. Whitman, *A Proposal for a National Mortgage Registry: MERS Done Right*, 78 MO. L. REV. 1 (2013).