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Transferring Nonnegotiable Mortgage Notes

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TRANSFERRING NONNEGOTIABLE MORTGAGE NOTES

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INTRODUCTION

Since the advent of the Negotiable Instruments Law (the N.I.L.) in 1895, American commercial lawyers and their academic cousins have focused nearly all of their energy on instruments that are negotiable. There has been correspondingly little said or written about nonnegotiable instruments. This omission is unfortunate, for in the field of mortgage lending, nonnegotiable promissory notes continue to be widely used.

This article reviews what we know about transferring ownership and the right of enforcement of nonnegotiable notes. The focus will be on notes secured by mortgages, since this is likely the context in which most modern nonnegotiable notes are created. There has been a

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vast amount of litigation about the transfer of negotiable mortgage notes in the past half decade, greatly expanding our understanding, but there has been little development involving nonnegotiable notes. Hence, it is helpful to compare negotiable and nonnegotiable notes, with particular emphasis on how each is transferred. Perhaps ironically, this means that the bulk of this article discusses negotiable notes as a point of reference, despite the fact that its ultimate focus is nonnegotiable notes.

Part I of this article reviews the history of the definition of negotiability, and shows how our current understanding of negotiability came to be. Part II demonstrates how to tell the difference between negotiable and nonnegotiable notes, and why that difference is important. Part III discusses the meaning of "transfer" of a promissory note.[1] Part IV examines specifically how the right to enforce nonnegotiable notes can be transferred under present law, and considers whether changes are needed. Finally, this article concludes with a brief description of a proposed national mortgage registry that has the potential to make transfers of both negotiable and nonnegotiable mortgage notes far more efficient without disrupting the current legal regime.

I. A Brief History of Negotiability

A. The Functions of Negotiability in Nineteenth Century American Law

It is obvious that nonnegotiability can be understood only by way of comparison with negotiability, so that is where this article must begin. There are many varieties of negotiable instruments – bills of lading, warehouse receipts, bills of exchange, etc. – but only two types that represent promises or orders to pay money: checks and promissory notes.[2] Mortgage borrowers nearly always sign notes, so notes, rather than checks or other forms of instruments, are the focus here.

A negotiable note is a contract to pay money, of course, but it has characteristics that differ from those of other contracts involving payment of money. Typically, the most salient of those unique characteristics are understood as follows:

1. There are many aspects of nonnegotiable notes besides their transfer that might be discussed: the liabilities and defenses of parties, warranties of transferors, and waivers of defenses, to name a few. But these topics are not the subject of the present article. *See* William F. Willier, *Nonnegotiable Instruments*, 11 Syracuse L. Rev. 13 (1959).

2. See the definitions of "note" and "check" in U.C.C. § 3-104(e)-(f) (2014).

(1) The right to enforce payment on a negotiable note can be transferred by indorsement and delivery, or by delivery alone if the note was made to (or has previously been indorsed to) "bearer."
(2) If the transferee takes the note in good faith, without notice of defenses that the maker of the note might have, and pays value, the transferee will be deemed a "holder in due course" and will have immunity from certain defenses that the maker could otherwise raise.[3]

These characteristics were essential to the primary purpose of notes issued by banks in the United States prior to the Civil War: to serve as currency.[4] Until 1861, there was no government-issued paper money to serve as legal tender, and notes issued by private banks were the primary medium of exchange.[5] It is obvious that the features of negotiability mentioned above—transferability by delivery and immunity from the issuer's defenses—were indispensable to the use of private bank notes as currency. Transferability by delivery meant that no cumbersome "transaction" (such as indorsement or execution of a separate assignment) was necessary when the note changed hands; it could simply be handed over. Immunity from the issuer's defenses meant that one who accepted a bank note as currency did not need to worry about whether some defect in the process by which the note was issued would permit the bank to refuse to honor it.[6]

3. NELSON ET AL., REAL ESTATE FINANCE LAW §§ 5.28-29 (6th ed. 2014).

4. The concept of the negotiable note was derived from the English bill of exchange, which was widely used by merchants as early as the Seventeenth Century. The story of how bills of exchange were developed, and how their characteristics were transmuted to promissory notes, is omitted here, but is amply and entertainingly recounted in Kurt Eggert, *Held up in Due Course: Codification and the Victory of Form over Intent in Negotiable Instrument Law*, 35 CREIGHTON L. REV. 363, 377-400 (2002).

5. *See* Davis R. Dewey, *State Banking Before the Civil War*, FRASER (1910), https://fraser.stlouisfed.org/scribd/?title_id=656&filepath=/docs/historical/nmc/nmc_581_1910.pdf#scribd-open. It has been estimated that notes of between five and ten thousand banks were in circulation in the U.S. in 1861. *See also* OFFICE OF THE COMPTROLLER OF THE CURRENCY, A SHORT HISTORY, U.S. DEP'T OF THE TREASURY 6 (2011), http://www.occ.gov/about/what-we-do/history/OCC%20history%20final.pdf.

6. Technically, only "personal" and not "real" defenses were immunized, but this was sufficient to provide reasonable assurance of payment to those who accepted the notes as currency. The distinctions between the two categories of defenses are outlined in NELSON ET AL., *supra* note 3, at § 5.31. This is not to say that use of private bank notes as currency was a desirable or efficient system. Anyone accepting such a note was subject to the risk that the issuing bank might become insolvent, and since there were thousands of issuers, this was a very difficult risk to manage. Moreover, counterfeiting was rampant. Congress authorized the United States Treasury to issue paper money for the first time in 1861 in the form of non-interest bearing Treasury Notes called Demand Notes. Their principal purpose was to finance the expense of the Civil War. They were replaced with United States Notes, commonly called "greenbacks," in 1862. This new federal currency quickly became popular in preference to private bank notes because of its stability and wide acceptability, so the prac-

After the Civil War, the issuance of private bank notes gradually faded,[7] supplanted by federally-issued currency. Slowly, the focus of bank lending changed. Banks had always made business and farm loans, but consumer lending gradually began to occur in the second half of the Nineteenth Century.[8] Beginning in the 1920s, and accelerating in a major way after the Second World War, the banks made consumer and home mortgage lending an increasingly important part of their business model.[9] They were hugely successful. By the end of 2012, outstanding home mortgage loans stood at more than $9 trillion, with non-mortgage consumer debt more than an additional $2.5 trillion. The aggregate comprised more than one-fourth of all U.S. debt.[10]

This shift to a major emphasis on consumer and home mortgage lending had important implications for the characteristics of negotiable notes. When bank notes were used as currency, banks were the makers of notes and consumers were the holders. In consumer lending transactions, these roles were reversed: consumers were the makers, and banks the holders of the notes. This gave banks an incentive to use their political power to broaden the definition of negotiability and increase their rights as holders. As we will see below, that is precisely what they did.

B. The Evolving Definition of Negotiability

When the National Conference of Commissioners on Uniform State Laws was formed and began meeting in 1892, one of its first projects was the codification of the law of negotiable instruments. As a result, the "Negotiable Instruments Law" or "N.I.L." was approved by the Conference at its 1895 meeting, and was ultimately adopted by

tice of issuing it was continued after the end of the War. *See* ARTHUR L. FRIEDBERG & IRA S. FRIEDBERG, PAPER MONEY OF THE UNITED STATES 8 (8th ed. 1962).

7. A 2% tax on state bank notes was authorized in 1864 to encourage conversion to the new system. This number was increased the next year to 10%, and then to 20%. Private bank notes were essentially taxed out of existence, and banks turned to checking accounts as a device to make themselves profitable. *See* GARY B. GORTON, THE MAZE OF BANKING: HISTORY, THEORY, CRISIS 13 (2015).

8. Lendol Calder, *Beautiful Credit! The Foundation of Modern Society*, *in* FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 37 (2001).

9. *See* THOMAS A. DURKIN ET AL., CONSUMER CREDIT AND THE AMERICAN ECONOMY 5-6 (1st ed. 2014).

10. *Id.* Total debt of nonfinancial sectors of the U.S. economy stood at about $40 trillion at the end of 2012. *See also* U.S. GOV'T PUBL'G OFFICE, ECONOMIC REPORT OF THE PRESIDENT 388 (2014), http://www.gpo.gov/fdsys/pkg/ERP-2014/pdf/ERP-2014.pdf.

every state.[11] With some amendments in 1929,[12] it remained the essential source of law on the subject until the adoption of Article 3 of the Uniform Commercial Code in 1951. Article 3, in turn, was substantially revised in 1990, with additional (but more minor) revisions in 2002.

Under the original N.I.L, the definition of negotiability was simple indeed.[13] To be negotiable, the instrument had to satisfy four tests:

> First, It must be in writing and signed by the maker or drawer;
> Second, It must contain an unconditional promise or order to pay a certain sum in money;
> Third, It must be payable on demand or at a fixed or determinable future time;
> Fourth, It must be payable to order or to bearer. . . .[14]

This definition must have seemed adequate for the simple promissory notes of the Nineteenth Century. But when the banks increasingly became the payees rather than the makers of negotiable notes, the notes themselves began to grow drastically in length and complexity as bank lawyers inserted more and more language designed to assure payment and facilitate collection. In particular, consumer notes were often secured by liens on real or personal property of the debtor, a situation quite different than the unsecured bank notes that had served as currency before the Civil War. The banks wanted to ensure that there were provisions in the notes referring to the security property.

At the same time, the banks were eager for the notes they took from consumers to be regarded as negotiable. There were two obvious reasons for this. First, the N.I.L. gradually became uniform nationwide law, eliminating many of the often annoying and confusing differences in interpretation between one state and another that had previously prevailed. But this highly desirable uniformity was available only if the note was negotiable, since the N.I.L. did not apply to nonnegotiable notes. Second, only if a note was negotiable could the bank sell it to another investor on the secondary market with the assurance that the

11. By 1902, the N.I.L. had been adopted by twenty states. *See* Amasa M. Eaton, *The Negotiable Instruments Law: Its History and Its Practical Operation*, 2 MICH. L. REV. 260 (1904); *see also* Charles L. McKeehan, *The Negotiable Instruments Law. (A Review of the Ames-Brewster Controversy.) First Paper*, 50 AM. L. REGISTER 437 (1902).

12. *See* Roscoe B. Turner, *Revision of the Negotiable Instruments Law* (Yale Faculty Scholarship Series, Paper 4466, 1928).

13. References to the N.I.L. are found in ROBERT E. BUNKER, THE NEGOTIABLE INSTRUMENTS LAW WITH ANNOTATIONS (1905), https://ia801407.us.archive.org/3/items/negotiableinstr00britgoog/negotiableinstr00britgoog.pdf [hereinafter N.I.L.].

14. *Id.* at § 3. A fifth requirement, that where the instrument is addressed to a drawee he must be named or otherwise indicated with reasonable certainty, is omitted in the text because it is applicable only to checks and not to promissory notes.

investor would, under the Holder in Due Course doctrine, take free of any personal defenses the consumer might attempt to raise. This much-sought feature made notes a great deal more marketable in secondary transactions.

Historically, it was held that, to be negotiable, a note had to be free of extraneous promises – a "courier without luggage," as one famous opinion put it.[15] As notes became more complicated, the banks were faced with a dilemma: how could they preserve the benefits of negotiability while adding provisions that contravened the simplicity that was supposed to be its hallmark? This bit of legerdemain could be accomplished only by legislation. The banks persuaded the drafters of the N.I.L., and subsequently the U.C.C., to move matters in their direction.

Professor Kurt Eggert has recounted the history of this effort thoroughly, and it need not be repeated here in detail.[16] The original N.I.L. itself liberalized the definition of negotiability in at least two ways, as compared with prior state law. It authorized clauses obligating the maker of the instrument to pay costs of collection and attorney's fees, contrary to the preexisting rule in a number of states.[17] It recognized negotiability despite the presence of the maker's seal on the instrument, contrary to the law merchant and numerous cases.[18] Other N.I.L. provisions, while not contrary to the common law, were surely highly advantageous to the banking industry, including a proviso that a negotiable note could recite that it was secured by collateral, and that the collateral could be sold upon default in payment of the note.[19]

When the N.I.L. was transmuted into Article 3 of the Uniform Commercial Code in the late 1940s and early 1950s,[20] the drafters gave serious consideration to adopting a "two-track" system, in which negotiable notes made by consumers would give the makers rights and protections beyond those that would be available to commercial bor-

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15. "[A] negotiable bill or note is a courier without luggage. It is a requisite that it be framed in the fewest possible words, and those importing the most certain and precise contract." Overton v. Tyler, 3 Pa. 346, 347 (1846). The N.I.L. agreed in substance, providing "An instrument which contains an order or promise to do any act in addition to the: payment of money is nonnegotiable." N.I.L., *supra* note 13, at § 7.

16. Eggert, *supra* note 4, at 416-23.

17. N.I.L., *supra* note 13, at § 4 and comment 5.

18. *Id.* at § 8 and comment 4.

19. *Id.* at § 7 and comment 2.

20. Article 3 was formally adopted by the Uniform Laws Commission and the American Law Institute in 1952, and took effect in the first state to enact it, Pennsylvania, in 1954. *See* Andrew N. Farley, *Article 3 of the Uniform Commercial Code*, 4 GONZ. L. REV. 200, 200-01 (1969).

rowers. For example, the holder in due course doctrine might have been made inapplicable to consumer credit. Unsurprisingly, the banking industry vigorously opposed this notion, and the drafters ultimately rejected it out of concern for the enactability of the resulting statute.[21] Other potential consumer protections were also omitted. For instance, the courts, at the time Article 3 was drafted, were beginning to develop the "close connectedness" doctrine, under which a secondary market purchaser of a note would be denied holder in due course status if it had a close connection with the note's original payee.[22] But not a word of this concept was found in the text of either the original Article 3 or its subsequent revisions.[23] The U.C.C. also made notes negotiable even if they contained provisions for acceleration for default, a change that one commentator called "iconoclastic."[24]

The 1990 revision of Article 3 continued the drafters' tradition of deferring to banking interests. They made a number of changes to facilitate the operations of the credit industry. Adjustable interest rate notes were made negotiable (a step that had already been taken by several individual state legislatures by the time the 1990 revision of Article 3 was adopted).[25] Nonrecourse notes, under which payment could be compelled only from the collateral and not from the maker's other assets, became negotiable.[26] The "courier without luggage" concept was further weakened by the 1990 revision's provisions that a

21. Eggert, *supra* note 4, at 417-23. The author's own experience as a reporter and observer of the drafting of legislation by the Uniform Laws Commission suggests that this fear of the banking industry's political power remains pervasive. Frequently, there will be agreement among the members of a drafting committee that a particular legislative innovation would be desirable as a matter of policy, but the committee will nonetheless reject it on the ground that it would produce opposition from the banks, and that such opposition would almost certainly kill the act's chances of successful enactment.

22. *See, e.g.*, Vitols v. Citizens Banking Co., 10 F.3d 1227 (6th Cir. 1993). The classic case is Unico v. Owen, 232 A.2d 405 (N.J. 1967). But *Unico* found the seeds of the doctrine in pre-U.C.C. cases such as State Nat'l Bank of El Paso, Tex. v. Cantrell, 143 P.2d 592 (N.M. 1943); Buffalo Indus. Bank v. De Marzio, 296 N.Y.S. 783 (City Ct. 1937); and First & Lumbermen's Nat'l Bank of Chippewa Falls v. Buchholz, 18 N.W.2d 771 (Minn. 1945).

23. *See* Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 619 (1981).

24. *See* Note, *Acceleration Clauses in Time Paper Under the NIL and the Uniform Commercial Code*, 101 U. PA. L. REV. 835 (1953).

25. U.C.C. § 3-112(b) (1990 rev.). For background on this change, see Thomas B. Fiddler, *An Argument for the Alteration of the UCC to Include Variable Rate Notes As Negotiable Instruments*, 9 J.L. & COM. 115, 120 (1989).

26. Under prior case law, a nonrecourse note was regarded as a conditional promise to pay, and hence nonnegotiable. *See* United Nat'l Bank of Miami v. Airport Plaza Ltd. P'ship, 537 So. 2d 608, 610 (Fla. Dist. Ct. App. 1988). This view was reversed by U.C.C. § 3-106(b) (1990 rev.), providing that "[a] promise or order is not made conditional . . . because payment is limited to resort to a particular fund or source."

negotiable instrument could make reference to other documents "for a statement of rights with respect to collateral, prepayment, or acceleration,"[27] and could contain "an undertaking or power to give, maintain, or protect collateral to secure payment."[28] It is apparent that under these provisions, a note could include very extensive additional covenants without impairing its negotiability.

In 1975, the Federal Trade Commission disrupted this landscape. It published a final rule that, in substance, prohibited a creditor's use of the holder in due course doctrine in most non-housing consumer loan transactions.[29] It also forbade the use of express waivers of claims and defenses by consumers in those transactions.[30] Thus, a secondary market investor in consumer debt could be held to answer for fraud or misdealing by the originating lender. The credit industry, of course, decried this action and predicted that it would cause a vast reduction in the availability of consumer credit, but that did not ensue.

However, the FTC rule represented only a partial solution to the problem of assignee liability for originator misconduct. The rule covers only natural persons purchasing goods or services for personal, family, or household use,[31] and only purchases of $54,600 or less.[32] Real estate mortgages are affected only to the extent that they secure payment for goods and services, such as the purchase of siding, painting, or other home improvements.[33] The result is that a mortgage loan to buy a house or to refinance an existing purchase-money loan is untouched by the FTC rule. Of course, the vast majority of home mortgage loans would exceed the FTC's dollar ceiling, in any event.

Exempting home mortgage lending from the FTC rule was a major political victory for the mortgage industry. As its consequence, mortgage loans became the only important category of consumer lending that remains subject to the holder in due course rule. Calls for the

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27. U.C.C. § 3-106(b) (1990 rev.).

28. U.C.C. § 3-104(a)(3)(i).

29. *See* Preservation of Consumers' Claims and Defenses, Unfair or Deceptive Acts or Practices, 16 C.F.R. § 433.2 (1975).

30. *See* Michael M. Greenfield & Nina L. Ross, *Limits on a Consumer's Ability to Assert Claims and Defenses Under the FTC's Holder in Due Course Rule*, 46 BUS. LAW. 1135 (1991).

31. 16 C.F.R. § 433.1(b).

32. The dollar limitation arises by virtue of the reference in the FTC rule to the Truth in Lending Act and Regulation Z. *See* 16 C.F.R. § 433.1(d)-(e). Originally, the limitation was $25,000, but the Dodd-Frank Act raised it to $50,000, and provision was made for annual adjustment of the figure on the basis of fluctuations in the Consumer Price Index. The figure in the text represents the threshold for 2015. *See* Truth in Lending (Regulation Z), 79 Fed. Reg. 56483-01 (Sept. 22, 2014).

33. *See, e.g.*, Assocs. Home Equity Servs., Inc. v. Troup, 778 A.2d 529 (N.J. Super. Ct. App. Div. 2001).

FTC to modify its approach and sweep in mortgage lending have gone unheeded.[34] However, the mortgage lending industry's protection from the FTC rule was eroded a bit by Congress's adoption of the Home Equity and Ownership Protection Act of 1994 (HOEPA).[35] That statute defined "high cost" (loosely termed "predatory") home mortgage loans, and provided that "[a]ny person who purchases or is otherwise assigned a mortgage [covered by the HOEPA] shall be subject to all claims and defenses with respect to that mortgage that the consumer could assert against the creditor of the mortgage," unless the assignee could not reasonably have known that the loan was covered by HOEPA.[36] Thus, secondary market purchasers of HOEPA loans generally cannot raise the holder in due course doctrine to avoid borrowers' claims and defenses. However, the definition of mortgage loans covered by HOEPA in its original form was narrow, and the great bulk of home lending remained outside its scope. In 2010, the Dodd-Frank Act expanded the definition of HOEPA loans to a limited extent,[37] but as a practical matter, these changes to HOEPA were relatively unimportant. The various burdens and penalties associated with HOEPA loans are so onerous[38] that most mortgage lenders avoid making them like

34. *See, e.g.*, Lisa Keyfetz, *The Home Ownership and Equity Protection Act of 1994: Extending Liability for Predatory Subprime Loans to Secondary Mortgage Market Participants*, 18 LOY. CONSUMER L. REV. 151, 167-69 (2005).

35. *See* 15 U.S.C. § 1641(d)(1).

36. *Id.*

37. CONSUMER FINANCIAL PROTECTION BUREAU, 2013 HOME OWNERSHIP AND EQUITY PROTECTION ACT (HOEPA) RULE 10-18 (May 2, 2013), http://files.consumerfinance.gov/f/201305_compliance-guide_home-ownership-and-equity-protection-act-rule.pdf. Effective January 10, 2014, loans were covered by HOEPA if they met any of the following criteria (with the dollar figures adjusted annually for inflation):

(1) The transaction's annual percentage rate (APR) exceeds the applicable average prime offer rate by more than 6.5 percentage points for most first-lien mortgages, or by more than 8.5 percentage points for a first mortgage if the dwelling is personal property and the transaction is for less than $50,000;
(2) The transaction's APR exceeds the applicable average prime offer rate by more than 8.5 percentage points for subordinate or junior mortgages;
(3) The transaction's points and fees exceed 5 percent of the total transaction amount or, for loans below $20,000, the lesser of 8 percent of the total transaction amount or $1,000; or
(4) The credit transaction documents permit the creditor to charge or collect a prepayment penalty more than 36 months after transaction closing or permit such fees or penalties to exceed, in the aggregate, more than 2 percent of the amount prepaid.

The coverage of the Act and rules under it are discussed in detail in HOEPA. It applies only to loans secured by a consumer's principal dwelling. Mortgages secured by vacation or second homes are not covered. *See also* 78 Fed. Reg. 6855 (Jan. 31, 2013) (CFPB's final rule implementing the Dodd-Frank changes).

38. *See Consumer Information, High-Rate, High-Fee Home Loans*, FED. TRADE COMMISSION, https://www.consumer.ftc.gov/articles/0246-high-rate-high-fee-home-loans (last

the plague.[39] Hence, secondary market investors in the vast bulk of home mortgage loans made in the United States continue to have the protection of the holder in due course doctrine.

It should be noted that, in historic terms, applying the holder in due course concept to residential mortgage loans makes no sense at all. The purpose of the doctrine was to allow one who accepted the transfer of a note to do so without the need to inquire about the nature of the original transaction in which it was issued. This was a perfectly sensible and useful trait when bank notes were used as currency. But in the modern context, in which the note is secured by a mortgage on a residence, no one but an utter fool would accept it on the secondary market without investigating a great deal of information about the origins of the transaction, including the adequacy of the borrower's credit and the quality of the collateral. Thus, secondary market investors set up standards that must be met for every loan they buy. These standards include credit-worthiness, as represented by borrowers' credit scores and the ratio of their income to their mortgage debt service and overall consumer debt payment obligations. They also include extensive information about the real estate that serves as security, including appraisals, title insurance, casualty insurance, and evidence of recording of the relevant deeds and mortgages.[40] All of this is the standard "luggage" that accompanies each promissory note on its journey through the secondary market. The "courier without luggage" concept is laughable in this context.

What secondary market investors do not want to do, of course, is to be forced to police the practices of the originators from whom they buy mortgages. Instead, they want to decide for themselves how much effort to expend in making sure that originators refrain from fraud or other misbehavior. Fannie Mae and Freddie Mac, the two government-sponsored secondary market agencies, have always made very substantial efforts to ensure that the mortgage originators from whom they purchase loans adhere to high standards.[41] By contrast, private-

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visited Oct. 24, 2015) (listing many regulatory disadvantages to lenders in making loans covered by HOEPA).

39. *See* Joseph A. Woodruff & Christopher A. Driskill, *Say Goodbye to Small Loans*, Mortgage Banking Magazine, July 2013, at 2 ("Most mortgage lenders do not make HOEPA loans, and therefore the thresholds for high-cost loans have long acted as *de facto* limits for mortgage lending."). These authors predict that the new standards adopted for HOEPA loans under Dodd-Frank will be treated in the same way.

40. *See, e.g.*, Selling Guide Fannie Mae Single Family, 170-1031 (March 31, 2015), https://www.fanniemae.com/content/guide/sel033115.pdf (devoting 860 pages to these "underwriting standards").

41. *Id.* at 1183-1224. *See generally* Freddie Mac, Document Custody Procedures Handbook (Aug. 2015), http://www.freddiemac.com/cim/pdf/EntireManual.pdf.

label securitizers, during the heyday of the residential securitization markets from 2000 to 2007, made only meager efforts.[42] If the holder in due course doctrine was abrogated, and secondary market investors were forced to bear the risk of fraudulent conduct by their originators, their costs would doubtlessly rise, either to screen out the "bad apples," or to suffer the financial losses engendered by the originators' bad behavior.[43] If the private securitization industry, which has been virtually shut down since mid-2007,[44] manages to arise again,[45] its economics could be significantly affected by loss of the protection it has hither-to received from the holder in due course doctrine.

Nonetheless, sound economic policy strongly favors repeal or drastic modification of holder in due course. The reason hinges on the relative availability of information about the propensity of particular loan originators to engage in bad conduct. Consumer borrowers, who enter the mortgage market only at infrequent intervals and who typically have only a limited and unsophisticated understanding of its operations, have virtually no factual basis for identifying and avoiding originators who are apt to engage in fraud, and they cannot gain this

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42. Jeffrey Apraku Kyei, The Crisis in the United States Mortgage Market – Causes and Solutions 34-35 (2009) (unpublished Master of Science thesis), https://www.kth.se/polopoly_fs/1.159631!/Menu/general/column-content/attachment/464.pdf.

43. This is doubtlessly the reason for the industry's opposition to any change in the holder in due course doctrine. From 2011 to the present, the Uniform Laws Commission has pursued the drafting of the "Uniform Home Foreclosure Procedures Act." (The author has been an observer of the drafting process; the title of the Act has evolved during drafting and the title just given is the current, and presumably final, one). The drafting committee has given serious consideration to including a modification or partial repeal of the holder in due course doctrine for residential mortgages. In response to this threat, the Securities Industry & Financial Market Association (SIFMA), the trade association of the private-label securitization industry, provided a letter denouncing the proposal and vigorously urging that the committee "not include a repeal or limit of the Holder in Due Course Rule in the Draft." Letter from Christopher Killian, Managing Director of Securitization, SIFMA (approx. July 2013) (on file with author). It remains uncertain at this writing whether the proposed changes will survive the final drafting and approval process.

44. *See* Brian Grow & Gaurav Singhania, *The Five Challenges Facing Private Label RMBS*, ASSET SECURITIZATION REPORT (Aug. 22, 2014), http://www.structuredfinancenews.com/news/residential_mbs/five-challenges-facing-private-label-rmbs-251826-1.html (pointing out that the private-label residential securitization industry has been virtually moribund for seven years).

45. Whether this will occur is doubtful. *See* Alex Kangelaris, *Seven Reasons Private-Label MBS Are Not Coming Back Any Time Soon*, NAT'L MORTGAGE NEWS (Apr. 1, 2015), http://www.nationalmortgagenews.com/blogs/hearing/seven-reasons-private-label-mbs-are-not-coming-back-any-time-soon-1041389-1.html; *see also* Adam Hodge, *Five Questions with Dr. Michael Stegman on the Private Label Securities Mortgage Market*, U.S. DEPT. OF THE TREASURY (June 26, 2014), http://www.treasury.gov/connect/blog/Pages/Five-Questions-with-Dr.-Michael-Stegman-on-PLS-Market.aspx (the U.S. Department of the Treasury has pursued the objective of reviving the private securitization industry as part of an overall program to reduce the government's footprint in the mortgage market).

sort of information at any reasonable cost. Secondary market investors (including securitizers), on the other hand, participate in the market on an ongoing or regular basis, and commonly buy loans by the thousands. Their costs in identifying and policing bad actors, when spread over a large number of loans, are likely to be quite modest. As a matter of sound economics, it is obviously more efficient to impose these risks on the parties who can best identify and avoid them. As a lawyer and an economist from the Federal Reserve Bank of Cleveland put it, if the holder in due course rule were abandoned, we could expect the following result:" By forcing the market to internalize the cost of consumer compliance and spread it across all consumers, the market's ability to adjust costs [would be] aligned with the incentive to minimize costs that result from a competitive marketplace."[46] In the absence of assignee liability, these incentives are not aligned. The holder in due course rule artificially lowers the cost of consumer compliance to the market, eliminating the incentive to minimize those costs through competition. Consumers, then, bear the risk of unlawful origination practices, but lack the ability to price them into credit.[47]

Nonetheless, the holder in due course doctrine remains for the present, and represents the sharpest distinction between negotiable and nonnegotiable notes. If the holder doctrine were eliminated for residential mortgage notes, one important difference between negotiable and nonnegotiable notes would shrink drastically in importance. With this fact in mind, this article now turns to a consideration of the consequences of the banking industry's successful preservation of the negotiability concept.

II. Identifying Negotiability

The banking industry's highly successful efforts to keep residential lending within the ambit of the negotiability concept, while at the same time broadening the definition of negotiability, have had several important consequences. First, as a wider variety of notes, with

46. Letter from Mark B. Greenlee & Thomas J. Fitzpatrick, IV, Federal Reserve Bank of Cleveland, to William R. Breetz, Jr., Chairman, Uniform Law Commission Drafting Committee on Residential Real Estate Mortgage Foreclosure Process and Protections (Mar. 28, 2013) (on file with author).

47. *See* Letter from Thomas J. Fitzpatrick, IV, & Mark B. Greenlee, Federal Reserve Bank of Cleveland, to William R. Breetz, Jr., Chair, Drafting Committee on Residential Mortgage Foreclosure Procedures Act (Mar. 28, 2013) (on file with author); *see also* Katherine M. Lehe, *Cracks in the Foundation of Federal Law: Ameliorating the Ongoing Mortgage Foreclosure Crisis Through Broader Predatory Lending Relief and Deterrence*, 98 Calif. L. Rev. 2049, 2081-84 (2010) (making a similar argument).

more and more extensive pro-lender provisions, became negotiable, interest in nonnegotiable notes tended to wither. As we have noted, little scholarship devoted to nonnegotiable notes was produced after the advent of the N.I.L. in 1895.

Indeed, modern courts have often acted as though negotiable notes are the only kind of notes that exist. In theory, one cannot determine whether a note is negotiable without first performing a comprehensive analysis of the note's language, comparing it with the complex standards for negotiability mentioned above and set out in U.C.C. Article 3.[48] In practice, however, courts – especially in recent years – have often concluded that notes before them were negotiable with only superficial analysis, or in some cases, none at all.[49] This attitude is understandable, if not justifiable. First, negotiability is indeed the correct answer most of the time, given the broad scope of negotiability that has evolved through the uniform law process. Second, if a note is negotiable, the right to enforce it is governed by a relatively clear and concise body of statutory law: U.C.C. Article 3. On the other hand, if it is not negotiable, the court will often be thrown into a morass of conflicting case law, most of it dating from the Nineteenth and early Twentieth Centuries.[50] Given this choice, it is easy to see why an unstated preference for negotiability has developed.

Second, since 2007, negotiability has become a target for foreclosure defense lawyers, who were often frustrated as the holder in due course doctrine blocked their efforts to raise defenses on behalf of their clients.[51] In particular, they vigorously attacked the negotiability of the standard Fannie Mae-Freddie Mac one-to-four-family residential note.[52] However, their arguments were usually obstructed by the broadened definition of negotiability brought about by successive revisions of the N.I.L and U.C.C. Article 3, combined with the practical

48. Dale A. Whitman, *How Negotiability Has Fouled up the Secondary Mortgage Market, and What To Do About It*, 37 PEPP. L. REV. 737 (2010).

49. *Id.*

50. *See* cases cited at *infra* notes 138-143.

51. *See, e.g.*, O. Max Gardner, III, *Obstacles to Negotiability of Residential Mortgage Notes* (June 27, 2011), http://thepatriotswar.com/wp-content/uploads/Obstacles-to-Negotiability-of-Residential-Mortgage-Notes.pdf; Oliver Gardner, *The Uniform Residential Mortgage Note is Not a Negotiable Instrument Under the UCC*, AVVO (Dec. 15, 2011), http://www.avvo.com/legal-guides/ugc/the-uniform-residential-mortgage-note-is-note-a-negotiable-instrument-under-the-ucc; Matthew D. Weidner, *Boom! Mortgage Promissory Notes Are NOT NEGOTIABLE INSTRUMENTS . . . ONE OF FLORIDA'S BEST JUDGES FINDS . . .*, WEIDNER LAW, http://mattweidnerlaw.com/boom-mortgage-promissory-notes-are-not-negotiable-instruments-one-of-floridas-best-judges-finds/ (last visited Oct. 24, 2015).

52. *See supra* note 51 and accompanying text.

preference of the courts for the finding of negotiability. Aside from achieving delays by litigation, they had little success.

Let us consider some recent cases in which courts have treated the issue of negotiability *vel non* seriously. A few of these cases have involved loans on commercial real estate, but those notes are usually hand-tailored or heavily negotiated to suit a particular transaction. Hence, they require an individualized analysis to determine their negotiability, and it has been quite common for the courts to find them nonnegotiable.[53] By contrast, first residential mortgage notes in the United States are nearly always written on the Fannie Mae-Freddie Mac one-to-four-family note form, or on variations of that form required by the Federal Housing Administration or the Department of Veterans Affairs.[54] Because that note form is so widely used, the question whether it is negotiable is of particular importance.

Surprisingly, until about 2010, it was difficult to find any case authority applying serious and careful analysis to this question.[55] Courts were (and sometimes still are) frequently guilty of uncritically assuming that such notes were negotiable.[56] In 1996, Professor Ronald Mann wrote an article in which he opined that the Fannie Mae-Freddie Mac note was nonnegotiable because, if the borrower wished to make a prepayment, the note required the borrower to notify the lender that she or he was doing so.[57] 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.[58]

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53. *See, e.g.*, Bankers Trust v. 236 Beltway Inv., 865 F. Supp. 1186, 1193 (E.D. Va. 1994) (note was nonnegotiable because it provided for parties to renegotiate interest rate); Marriott v. Harris, 368 S.E.2d 225, 238 (Va. 1988) (note was nonnegotiable because it incorporated another document to define terms of payment).

54. *See* Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 Mo. L. Rev. 1077, 1083-87 (2007) (estimating that more than 90% of residential loans in the United States are written on the standard Fannie Mae-Freddie Mac forms).

55. Whitman, *supra* note 48. Occasionally an exceptional earlier decision took the question seriously and provided a thoughtful analysis. *See, e.g.*, *In re* AppOnline.com, Inc., 321 B.R. 614 (E.D.N.Y. 2003); Bibler v. Arcata Invs. 2, LLC, 2005 WL 3304127 (Mich. Ct. App. 2005).

56. *See, e.g.*, Horvath v. Bank of New York, 641 F.3d 617, 622 (4th Cir. 2011) (the note "plainly constitutes a negotiable instrument under" the Virginia UCC, with no analysis); 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"); Deutsche Bank Nat'l Trust Co. v. Matthews, 273 P.3d 43 (Okla. 2012). Such decisions are badly flawed when they assume that negotiability can be determined without an analysis of the actual text of the note in question.

57. Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 U.C.L.A. L. Rev. 951, 971-72 nn. 65-70 (1997).

58. *See id.*

Mann's argument went untested in the courts for more than a decade. However, once they began addressing it, every court doing so has rejected Mann's speculation and held that the standard residential note is negotiable.[59] They typically reason that the prepayment notice requirement is not an "other undertaking" because (1) the borrower's decision to prepay principal is voluntary, and 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) there is no penalty if the borrower fails to give the notification.[60] Whether this is correct in any ultimate sense is hard to say; none of the decisions are from the highest court of a state. The prepayment notice obligation in the Fannie Mae-Freddie Mac form is, by its nature, conditional; it applies only if the borrower elects to make a prepayment. As a matter of general principle, it is uncertain whether such an obligation falls under Section 3-104's proscription against "other undertakings",[61] but thus far the courts have concluded that it does not.

A variety of other arguments have been made in attempts to classify the Fannie Mae-Freddie Mac residential note as nonnegotiable, but all of them have failed as well. For example, a New York Bankruptcy Court found the note negotiable despite the presence of (1) a reference to the mortgage for information concerning the order in which payments were to be applied to principle, interest, and other items; (2) a reference to the mortgage for the requirement that monthly payments must include escrows for taxes and insurance; (3) supposed ambiguity in the amount due because the date of disbursal of the loan

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59. The first of these cases seems to be HSBC Bank USA. v. Gouda, 2010 WL 5128666 (N.J. Super. Ct. App. Div. 2010) (not reported in A.3d). *See also* Horvath v. Bank of New York, 641 F.3d 617, 622 (4th Cir. 2011) (Virginia law, without analysis); *In re* Steinberg, 2013 WL 2351797 (B.A.P. 10th Cir. 2013) (Wyoming law); Picatinny Fed. Credit Union v. Fed. Nat'l Mortg. Ass'n, 2011 WL 1337507 (D.N.J. 2011) (unpublished); *In re* Sia, 2013 WL 4547312 (Bankr. N.J. 2013) (unpublished); Mesina v. CitiBank, 2012 WL 2501123 (Bkrtcy. N.J. 2012) (unpublished); *In re* Kain, 2012 WL 1098465 (Bankr. S.C. 2012) (unpublished); *In re* Edwards, 76 UCC Rep. Serv. 2d 220 (Bankr. E.D. Wis. 2011); *In re* Walker, 466 B.R. 271, 283 (Bankr. E.D. Pa. 2012); Thomas v. Wells Fargo Bank, 116 So. 3d 226 (Ala. Civ. App. 2012); Wells Fargo Bank v. Clegg, 2013 WL 452790 (Conn. Super. Ct. 2013); Deutsche Bank Nat'l Trust Co. v. Najar, 2013 WL 1791372 (Ohio 8th Ct. App. 2013) (not published in N.E.2d); JP Morgan Chase Bank v. Murray, 63 A.3d 1258 (Pa. Super. Ct. 2013) (with minimal analysis). *See generally* Kurt Eggert, *Not Dead Yet: The Surprising Survival of Negotiability*, 66 ARK. L. REV. 145 (2013).

60. *See* cases cited at *supra* note 59.

61. 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. The clause imposes numerous complex duties on the borrower who does so, but the decision to engage in the defeasance is that of the borrower; hence these duties are optional or conditional in nature.

was not stated; and (4) supposed uncertainty as to the amount of late charges that might be due.[62] In a similar vein, the Michigan Court of Appeals found that a

> reference in the note to a mortgage that secures its payment does not destroy the negotiability of the note. Further, additional conditions in the mortgage, such as maintenance of hazard insurance, escrowing tax and insurance payments, an occupancy requirement, or option to accelerate payment on the transfer or sale of the property, do not destroy the negotiability of the note.[63]

An additional complexity is introduced if the Fannie Mae-Freddie Mac note is used in a Federal Housing Administration (FHA) or Department of Veterans Affairs (VA) residential loan. Both of these agencies require modifications of the standard note, including the addition of a legend that notifies the borrower of the government's regulatory limitations on the lender's power to accelerate the loan for default. For example, FHA's mandatory legend reads as follows:

> If Borrower defaults by failing to pay in full any monthly payment, then Lender may, except as limited by regulations of the Secretary in the case of payment defaults, require immediate payment in full of the principal balance remaining due and all accrued interest. Lender may choose not to exercise this option without waiving its rights in the event of any subsequent default. In many circumstances regulations issued by the Secretary will limit Lender's rights to require immediate payment in full in the case of payment defaults. This Note does not authorize acceleration when not permitted by HUD regulations. As used in this Note, "Secretary" means the Secretary of Housing and Urban Development or his or her designee.[64]

The modifications usually made to the standard note for VA home loans are similar.[65] Foreclosure defense lawyers have argued vigor-

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62. *In re AppOnline.com, Inc.*, 321 B.R. at 622-24.

63. Mary Margaret Bibler v. Arcata Invs. 2, LLC, 2005 WL 3304127, at *4 (Mich. Ct. App. 2005).

64. *Chapter 6, Section B. Mortgage and Note Forms*, http://portal.hud.gov/hudportal/documents/huddoc?id=4155-2_6_secB.pdf.

65. *See* U.S. DEP'T OF VETERANS AFFAIRS VETERANS BENEFITS ADMIN., VA LOAN ELECTRONIC REPORTING INTERFACE VA SERVICER GUIDE VERSION 1.2 59-89 (2009), http://www.benefits.va.gov/homeloans/documents/docs/va_servicer_guide.pdf. VA requires implementation of loss mitigation procedures prior to foreclosure. 38 C.F.R. § 36.4337 (providing that "[r]egulations issued under 38 U.S.C. chapter 37 and in effect on the date of any loan which is submitted and accepted or approved for a guaranty or for insurance thereunder, shall govern the rights, duties, and liabilities of the parties to such loan and any provisions of the loan instruments inconsistent with such regulations are hereby amended and supplemented to conform thereto."). This language is typically repeated in paragraph 12 of the VA note, although there seems to be no regulation or handbook provision requiring it to be incorporated into the note. *See also* LENDER'S HANDBOOK, VA PAMPHLET 26-7, REVISED §§ 9-1, 9-2,

ously that the addition of this sort of language makes the note nonnegotiable, on the basis that it constitutes an incorporation of a document (the HUD or VA regulation) that is not part of the note itself.[66] This is said to run counter to U.C.C. Article 3,[67] which provides that the note is regarded conditional if "rights or obligations with respect to the promise or order are stated in another writing."[68]

This argument is likely incorrect for two reasons. First, the legend inserted into the FHA note deals expressly with the power to accelerate the loan; it limits the lender's right to accelerate without first following the loss mitigation procedures spelled out in the applicable HUD regulations. However, under U.C.C. Section 3-106, a negotiable note may contain a reference to another document "for a statement of rights with respect to collateral, prepayment, or acceleration."[69] Thus, there is no objection to referring to the regulations for limitations on acceleration. Whether this same reasoning would apply to the VA legend is more debatable, since it is not limited to the context of acceleration, but rather provides more broadly that the VA's regulations "shall govern the rights, duties, and liabilities of the parties to such loan."[70]

The second reason that the argument for nonnegotiability of the FHA and VA note forms seems likely to fail is that their added legends are merely truisms and do not change the meaning of the notes at all. In substance, they say that applicable federal regulations govern the enforcement of the notes. But the truth of that statement is obvious,

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http://benefits.va.gov/WARMS/docs/admin26/pamphlet/pam26_7/Chap_9_April_2012_with_info_mapping.pdf (listing clauses that are required in the note, but making no reference to the language quoted above).

66. *See* Message of April Charney, legal services attorney, to DIRT listserve, Feb. 15, 2015 (arguing VA notes are nonnegotiable); Message of Richard F. Kohn to DIRT listserve, Feb. 14, 2015 (on file with author) (arguing FHA notes are nonnegotiable).

67. U.C.C. § 3-106(a)(ii). *See* Guniganti v. Kalvakuntla, 346 S.W.3d 242 (Tex. App. 2011) (stating that a note incorporating reference to guaranty was nonnegotiable); Holsonback v. First State Bank, 394 So. 2d 381 (Ala. Civ. App. 1980) (holding note "subject to terms of a contract of purchase" was nonnegotiable).

68. U.C.C. § 3-106(a)(iii). According to Official Comment 1"the holder of a negotiable instrument should not be required to examine another document to determine rights with respect to payment." HUD does not seem quite willing to commit itself with respect to the negotiability of the note as modified by FHA's requirements. Its handbook states, "[t]he note must be a negotiable instrument. The Model Note Form has not been reviewed for compliance with all state laws, which could affect negotiability." HUD HANDBOOK 4155-2, LENDER'S GUIDE TO THE SINGLE FAMILY MORTGAGE INSURANCE PROCESS, § 4155.2(6)(B)(3)(b), http://portal.hud.gov/hudportal/documents/huddoc?id=41552HSGH.pdf.

69. U.C.C. § 3-106(b) (1990 rev.). *See* Mesina v. Citibank, 2012 WL 2501123 (Bankr. D.N.J. 2012) (relating that reference in note to provisions of mortgage relating to acceleration and prepayment did not impair note's negotiability).

70. 38 C.F.R. § 36.4337.

and it would be equally true if the legends were not included in the notes. Because the legends add nothing to the legal meaning of the notes, they would probably be disregarded by the courts and treated as having no effect on negotiability.[71] Moreover, they do not violate the policy against incorporation of external documents into negotiable notes, because here the document being incorporated is not in private hands, but is a public regulation, available for all to see.

In sum, it seems likely, though not certain, that the standard Fannie Mae-Freddie Mac one-to-four-family residential note, including its variations for FHA and VA loans, is negotiable. On the other hand, when one considers notes used for commercial mortgage loans the question is much more open and fact-specific. There are plenty of ways that such a commercial note might be made nonnegotiable. For example, the note might contain a clause incorporating by reference all of the other loan documents (which might include a mortgage, a loan agreement, a guaranty of payment, an environmental indemnity, and perhaps several other documents). Such provisions are not unusual in commercial mortgage notes, and will surely destroy negotiability.[72] The drafter might insert other conditions or promises beyond the promise to pay money.[73] The note might contain a promise by the lender to make, and the borrower to repay, additional but unspecified advances in the future.[74] The method of calculation of interest might be stated in ambiguous or conflicting terms, making it impossible to determine the amount due.[75] The note might provide for repayment of

71. I am indebted to Prof. Neil Cohen of Brooklyn Law School for pointing out this argument. *But see* Bankers Trust (Delaware) v. 236 Beltway Inv., 865 F. Supp. 1186, 1193 (E.D. Va. 1994) (revealing the promissory note contained a clause providing that the parties could modify the note's interest rate in the future by mutual agreement and concluding that this provision prevented the note from stating a "sum certain" to be paid, and hence made it nonnegotiable). Since any note can always be modified by mutual agreement, the added language about future renegotiation made no meaningful change in the rights of the parties, and it should have been disregarded by the court. The opinion's reasoning is bizarre. *See also* N. Bank v. Pefferoni Pizza Co., 555 N.W. 2d 338, 342-45 (Neb. App. 1996) aff'd, 562 N.W. 2d 374 (Neb.1997) (showing that this opinion seems to make the same error, although the terms of the renegotiation clause were not as clear).

72. *See* U.C.C. § 3-106(a)(iii); Growth Equities Corp. v. Freed, 1991 WL 10200 (Cal. Ct. App. 1991) (stating note reciting that it was "subject to" partnership agreement was nonnegotiable); Jackson v. Luellen Farms, Inc., 877 N.E. 2d 848, 853-54 (Ind. Ct. App. 2007) (holding a note incorporating terms of mortgage was nonnegotiable).

73. DBA Enters. v. Findlay, 923 P.2d 298 (Colo. App. 1996) (stating a note that incorporated covenant not to compete was nonnegotiable).

74. *See* Nat'l City Bank v. Victor Bldg. Co., 2000 WL 1545096 (Ohio Ct. App. 2000) (explaining that the promise to make additional advances was in a separate agreement and hence did not render the note nonnegotiable).

75. *See* DH Cattle Holdings Co. v. Reinoso, 575 N.Y.S. 2d 203, 204 (1991); Sheppard v. Stanich, 749 N.E. 2d 609, 611 (Ind. Ct. App. 2001). *Cf.* Lakhaney v. Anzelone, 788 F. Supp.

a fluctuating line of credit.[76] The drafter might even be so careless as to omit the word "order" from the clause specifying to whom payment is to be made.

Thus, there are manifold ways of making a note nonnegotiable. None of the examples mentioned in the previous paragraph is particularly rare or unusual. They illustrate that the difference between negotiable and nonnegotiable notes can be subtle, complex, and difficult to determine, and that failure of negotiability can occur for many potential reasons. Hence, they make it amply clear that our inquiry here – how can nonnegotiable notes be transferred – is important and worthy of our consideration and analysis.

III. What is a Transfer?

The concept of transfer of a promissory note turns out to be more nuanced than many (including many lawyers) recognize. The reason is that, under the modern Uniform Commercial Code, there are two distinct sets of rights in a note that can be transferred.[77] One set of rights, commonly termed "PETE status," refers to the right to enforce the note; "PETE" is an acronym for "person entitled to enforce," a term used by UCC Section 3-301.[78] The transfer of PETE status is governed by Article 3, but only if the note is negotiable.[79] Hence, the discussion in Part II above concerning the distinction between negotiable and nonnegotiable notes is of critical importance in determining whether Article 3 will apply. If Article 3 is inapplicable, the transfer of PETE status is governed by common law principles, to be discussed in the next part of this article.

The other set of rights, usually termed "ownership" of the note, is governed by UCC Article 9 regardless of whether the note is negotia-

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160 (S.D.N.Y. 1992) (holding the method of computing interest was sufficiently clearly stated).

76. Yin v. Soc'y Nat'l Bank Indiana, 665 N.E. 2d 58, 62 (Ind. Ct. App. 1996).

77. *See* Permanent Editorial Board for the Uniform Commercial Code, Application of the Uniform Commercial Code to Selected Issues Relating to Mortgage Notes 8 (Nov. 14, 2011), http://www.uniformlaws.org/Shared/Committees_Materials/PEB UCC/PEB_Report_111411.pdf [hereinafter PEB report].

78. U.C.C. § 3-301 (2002).

79. This follows from U.C.C. § 3-104(b) ("'Instrument' means a negotiable instrument."). It is clear that Article 3 applies to negotiable notes even if they are secured by mortgages or other real estate security devices. *See* First Valley Bank v. First Sav. & Loan Ass'n, 412 N.E. 2d 1237 (Ind. App. 1980); Best Fertilizers of Arizona, Inc. v. Burns, 570 P. 2d 179 (Ariz. 1977).

ble.[80] Ownership refers to the right to economic benefits of the note, and includes monthly payments, the proceeds of a voluntary payoff or short sale, and foreclosure proceeds.[81] The significance of ownership brings to mind the well-known political aphorism "follow the money," for it is to the owner of the note that the money flows.

The significance of these two sets of rights, ownership and PETE status, is sharply distinct. PETE status refers to a relationship with the maker of the note—the borrower. Thus, a borrower can negotiate with the party having PETE status to modify the loan, accept a payoff for less than the face amount owed, or approve a "short sale" or a deed in lieu of foreclosure, and be assured that any agreement reached with the PETE in any of these negotiations will be binding. On the other hand, the borrower is typically unconcerned with the identity or separate existence of the owner—the party to whom the proceeds of the loan will ultimately be paid.[82] If the borrower pays the PETE, the borrower's obligation is satisfied. The borrower has no responsibility for ensuring that the money will get to the owner of the note. One court put it this way:

> [T]he rules that determine who is entitled to enforce a note are concerned primarily with the maker of the note. They are designed to provide for the maker a relatively simple way of determining to whom the obligation is owed and, thus, whom the maker must pay in order to avoid defaulting on the obligation. U.C.C. § 3–602(a), (c). By contrast, the rules concerning transfer of ownership and other interests in a note identify who, among competing claimants, is entitled to the note's economic value (that is, the value of the maker's promise to pay). 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.[83]

80. U.C.C. § 9-203(b) (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 a delivery of possession of the note to the transferee). *See* Morgan v. Farmers & Merchants 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).

81. *See* Dale Whitman, "THE PERSON ENTITLED TO ENFORCE:" LESSONS LEARNED FROM BAC HOME LOANS SERVICING V. KOLENICH, ABA REAL PROP. NEWS, Dec. 2012, at 1.

82. *See, e.g.*, *In re* Sia, 2013 WL 4547312 (Bankr. D.N.J. 2013) (showing holder of note can enforce it even if it is not the owner; ownership is irrelevant to the right to enforce and identity of owner is of no importance to maker of note).

83. Veal v. Am. Home Mortg. Servicing Inc., (*In re* Veal), 450 B.R. 897 (9th Cir. BAP 2011).

The notion that ownership of the note and the right to enforce it are separate and distinct rights that may be held by different parties[84] is a modern idea. No clue to the distinction appeared in the old Negotiable Instruments Law, which spoke of transfers of title, did not identify the right to enforce as a separate right, and apparently assumed that ownership of title and the right to enforce were unitary.[85]

The distinction drawn in the Code between owning a note and being entitled to enforce it may initially seem artificial or confusing, but it is actually quite useful. In the context of outright purchases of mortgage loans, the buyer invariably wants both ownership and the right of enforcement. However, there are good reasons that the buyer may subsequently want to split the two rights. It is common for the owner of the note to designate a servicer to collect monthly payments, maintain payment records, maintain and make disbursements from tax and insurance escrow accounts, modify the loan's terms if needed, and pursue foreclosure if the borrower defaults and is unable to cure. If foreclosure is necessary, many jurisdictions will allow the servicer to proceed as an agent for the owner of the loan. But a few states require the foreclosure action to be pursued by the "real party in interest" rather than an agent,[86] and in other states the owner of the loan may prefer to have the servicer proceed in its own name for administrative or public relations purposes. To accomplish this, the loan's buyer may retain ownership but transfer the right of enforcement to its servicer. For example, Fannie Mae and Freddie Mac routinely deliver the note to the servicer in order to enable the servicer to foreclose in its own name as holder of the note. 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 the servicer becomes the PETE – the person entitled to enforce.[87]

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84. *See* Bank of America v. Inda, 303 P. 3d 696 (Kan. App. 2013).

85. *See, e.g.*, N.I.L., *supra* note 13, at § 51 ("Where the holder of an instrument payable to his order transfers it for value without indorsing it, the transfer vests in the transferee such title as the transferer had therein . . . ."); § 57 ("The title of a person who negotiates an instrument is defective within the meaning of this act when he obtained the instrument (by fraud or other unlawful means, etc.)"). *See also* N.I.L., *supra* note 13, at §§ 61, 67 (referring to title).

86. *See, e.g.*, U.S. Bank Nat'l Ass'n. v. Marcino, 908 N.E. 2d 1032, 1036 (Ohio Ct. App. 2009); Wells Fargo Bank v. Lupori, 8 A.3d 919, 922 (Pa. Super. Ct. 2010). Cases on this point often fail to distinguish accurately between ownership and the right to enforce the note.

87. This process is aptly described in Giles v. Wells Fargo Bank, 519 Fed. Appx. 576 (11th Cir. 2013); J.E. Robert Co. v. Signature Props., LLC, 71 A.3d 492 (Conn. 2013); Bank of America v. Inda, 303 P.3d 696 (Kan. App. 2013); and Deutsche Bank v. Brock, 63 A.3d 40

A. *Transferring the Right of Enforcement (PETE Status)*

The distinction between the two sets of rights, ownership and enforcement, arises from the peculiar structure of current U.C.C. Articles 3 and 9. Article 3 deals with the right of enforcement. Under Article 3, the person entitled to enforce (i.e., the PETE) is defined as either the holder of the instrument or a nonholder in possession of the instrument who has the rights of a holder.[88] To be a holder, a person must be in possession of the note, and either (i) the note must be payable to that person (because the person was the original payee or because the note has been indorsed to that person) or (ii) the note must be payable to bearer (because it was originally payable to bearer[89] or because it has been indorsed in blank by a previous holder).[90] To be a "nonholder with the rights of a holder," a person must be in possession of the note, but it need not have been indorsed to the person. However, the person seeking to enforce it must show that it was "delivered . . . for the purpose of giving to the person receiving delivery the right to enforce the instrument."[91] These definitions may seem dense, but the

(Md. 2013) (showing that the court was highly critical of this practice in JP Morgan Chase Bank v. Butler, 2013 WL 3359283 (Table) (N.Y. Sup. Ct. 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 UCC Article 3)).

88. U.C.C. § 3-301.

89. No endorsement is necessary if the note was originally payable to "bearer." *See* Bank of New York v. Raftogianis, 10 A.3d 236, 240 (N.J. Super. Ch. Div. 2010). But bearer notes are virtually never used in real estate financing.

90. U.C.C. § 1-201(b)(21)(A). *See* PEB Report, *supra* note 77, at 5.

91. U.C.C. § 3-203. *See* PEB Report, *supra* note 77, at 5-6; U.S. Bank v. Squadron VCD, LLC, 504 Fed. Appx. 30 (2d Cir. 2012) (finding note and mortgage enforceable even if endorsement was absent or improper); Robinson v. H & R Block Bank, 2013 WL 2356106 (E.D.N.Y. 2013) (same); Veal v. Am. Home Mortg. Servicing, Inc. (*In re* Veal), 450 B.R. 897, 911-12 (B.A.P. 9th Cir. 2011) (recognizing "nonholder with the rights of a holder" status, but finding that it did not exist in the absence of possession of note); Aum Shree of Tampa v. HSBC Bank USA (*In re* Aum Shree of Tampa, LLC), 449 B.R. 584, 593-94 (Bankr. M.D. Fla. 2011) (showing where foreclosing party proved possession of the note, it was at least a nonholder with the rights of a holder; it was not required to prove that it was a holder in due course); *In re* Wilhelm, 407 B.R. 392 (Bankr. D. Idaho 2009) (moving creditors were not "nonholders in possession of the instrument with rights of a holder" because they did not prove actual possession of the notes); J.E. Robert Co. v. Signature Props., LLC, 71 A.3d 492 (Conn. 2013) (finding note was delivered to servicer with intent to transfer right of enforcement); Ulster Sav. Bank v. 28 Brynwood Lane, 41 A.3d 1077, 1085 (Conn. App. 2013) (assignment and affidavits proved note was delivered to transfer right of enforcement); Miller v. Kondaur Capital Corp., 91 So. 3d 218 (Fla. App. 2012); Anderson v. Burson, 9 A.3d 870 (Md. App. 2010), *aff'd* 35 A.3d 452 (Md. 2011) (permitting enforcement where possessor of unendorsed note did not prove each prior transfer, but makers conceded that such transfers had occurred); Wells Fargo Bank v. Ford, 15 A.3d 327, 331 (N.J. Super. App. Div. 2011) (finding documents proving purpose for which note was delivered were not properly authen-

central point needed to be drawn from them is simple: the right to enforce a negotiable note can be transferred only by delivery of possession of the note itself. If the note has been properly indorsed to the person seeking to enforce it, that person's burden of proof is simpler, since without appropriate indorsements she or he may be put to the necessity of proving the purpose for which delivery was made to him or her. But either way, possession is the touchstone.[92]

Why does the law make possession critical? Because possession by the person seeking payment provides proof to the maker of the note that she or he is paying the right person. In theory, the borrower can demand to see the note before making payment, and can by this means verify that payment is being made to the PETE.[93] Of course, borrowers rarely demand production of the note, even when making a final payoff of the loan, but the right to make such a demand exists, and borrowers' counsel has exercised it fairly frequently in recent years in litigation attempting to defend foreclosures.[94]

Because ordinarily only one person can have possession of a note at any given time, the requirement that a PETE have possession acts as a mechanism to assure borrowers that they are dealing with the right party. This mechanism can be thought of as analogous to title assurance in real estate sale transactions. In an era when mass secondary market sales of mortgage notes are extremely common, some such mechanism is essential if the market is not to degenerate into chaos. There is, after all, no alternative form of assurance available to bor-

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ticated); Bank of New York v. Raftogianis, 13 A.3d 435, 450 (N.J. Super. Ch. Div. 2010) (possession of note required in order to be a nonholder with the rights of a holder); Wells Fargo Bank v. Freed, 2012 WL 6562819 (Ohio App. 2012) (not reported in N.E.2d); Bank of America 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 (N.C. App. 2010) (refusing to allow foreclosure by the party in possession of the note, apparently because it was not endorsed).

92. U.C.C. § 3-309(a)(3). An exception exists if the note has been "destroyed, its whereabouts cannot be determined, or it is in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process." The person seeking to enforce the note must still prove its terms and the right to enforce it, but obviously cannot and need not show possession of the original note. *See* § 3-309(b).

93. Indeed, if the note has been lost or destroyed and the person enforcing it employs the procedure outlined in U.C.C. § 3-309, the court may require "adequate protection," typically by a bond or indemnity, against the possibility that someone else may in fact have possession and may attempt to enforce the note. *See* U.C.C. § 3-309(b); Secy. of Veterans Affairs v. Leonhardt, 29 N.E.3d 1, 1 (Ohio Ct. App. 2015) (showing that no bond or indemnity required where VA had possession when the note was lost, had not transferred it to anyone else, and no other claimant had come forward in the five years since the note was lost).

94. *See, e.g.*, Murray v. HSBC Bank USA, 157 So. 3d 355, 356 (Fla. Dist. Ct. App. 2015); Leyva v. Nat'l Default Servicing Corp., 255 P.3d 1275 (Nev. 2011).

rowers. They cannot rely on the real estate recording system, the U.C.C. Article 9 financing statement records,[95] or any other existing system of records, for none of these govern the right to enforce promissory notes.

In light of the importance of possession in establishing PETE status, it is strange that possession was often treated in such a cavalier manner by secondary market investors during the heated era that preceded the 2007 collapse of the mortgage market.[96] Failure to get possession of the note, or to get it in a timely manner, was surprisingly common.[97] Indeed, there were reports of originators shredding or otherwise destroying original notes, so that it became impossible to transfer their possession.[98] It is hard to imagine the lack of basic understanding of Article 3 that must have accompanied such actions.

Before leaving Article 3 and PETE status, one additional point must be made. In the great majority of U.S. jurisdictions, whoever has PETE status also has the right to foreclose the mortgage or other land security device that accompanies the note. This principle, often stated as "the mortgage follows the note," is at least 200 years old.[99] The payment obligation is regarded as the principal thing being transferred,

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95. The Article 9 filing system is helpful to parties taking security interests in promissory notes, but it is of no value to borrowers in determining the identity of the PETE.

96. For a recounting of the collapse, see Lisa Prevost, *A Decline in Problem Mortgages*, N.Y. TIMES (Jan. 2, 2015), http://www.nytimes.com/2015/01/04/realestate/a-decline-in-problem-mortgages.html.

97. *See* Gretchen Morgenson, *If Lenders Say 'The Dog Ate Your Mortgage'*, N.Y. TIMES (Oct. 24, 2009), http://www.nytimes.com/2009/10/25/business/economy/25gret.html.

98. 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." Yves Smith, *FUBAR Mortgage Behavior: Florida Banks Destroyed Notes; Others Never Transferred Them*, NAKED CAPITALISM (Sept. 27, 2010), http://www.nakedcapitalism.com/2010/09/more-evidence-of-bank-fubar-mortgage-behavior-florida-banks-destroyed-notes-others-never-transferred-them.html (revealing that it is not clear how many notes were intentionally destroyed, but it seems obvious that in many cases the lost note affidavit process was employed simply to avoid the trouble of looking for the note). One Florida legal aid attorney estimated that eighty percent of the foreclosure complaints in his locality were accompanied by lost note affidavits. 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.

99. The classic statement is depicted in Carpenter v. Longan, 83 U.S. 271 (1872). *See* Green v. Hart, 1 Johns. Cas. 580 (N.Y. Sup. Ct. 1806). In perhaps a dozen states, this principle is not followed in nonjudicial foreclosure proceedings, and some other mechanism (typically a mortgage assignment) is necessary to transfer the right of nonjudicial foreclosure. *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 (2013).

with the interest in the land automatically attached to it in an extremely important, but subsidiary, capacity.[100] Hence, no separate assignment of the mortgage is needed to confer the right to foreclose. 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 it is still in existence.[101]

100. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 5.4 (1997). The classic statement is seen in Carpenter v. Longan, 83 U.S. 271 (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. D.N.J. 1982); Yanfag v. Cyfred, Ltd., 2009 WL 5214891 (Guam Terr. Dec. 9, 2009); Goetz v. Selsor, 628 S.W.2d 404 (Mo. Ct. App. 1982); Fidelity & Deposit Co. v. Ticor Title Ins. Co., 943 P.2d 710 (Wash. Ct. App. 1997); ELLIS & LOWRY, A COMPREHENSIVE NOTE PURCHASE GUIDE (WITH FORMS), PART I, PRAC. REAL ESTATE LAW 45 (1987); ELLIS & LOWRY, A COMPREHENSIVE NOTE PURCHASE GUIDE (WITH FORMS), PART II, PRAC. REAL ESTATE LAW 49 (Sept. 1987); Antonio R. Bautista & Frank R. Kennedy, *The Imputed Negotiability of Security Interests Under the Code*, 38 IND. L.J. 574 (1963); 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 (Mich. Ct. App. 2004).

101. Horvath v. Bank of New York, 641 F.3d 617, 623 (4th Cir. 2011) (wherein "a transfer of a secured debt carries with it the security without formal assignment or delivery"); UMLIC VP LLC v. Matthias, 234 F. Supp. 2d 520 (D.V.I. 2002), *aff'd*, 364 F.3d 125 (3d Cir. 2004) (noting a transfer of note automatically carries mortgage with it, even if transferee is unaware that the note is secured); Roisland v. Flagstar Bank, 989 F. Supp. 2d 1095 (D. Or. 2013) (showing transfer of note to new holder automatically assigned deed of trust, without formal assignment); *In re* Bryant, 452 B.R. 876, 880 (Bankr. S.D. Ga. 2011) (under South Carolina law, "the assignment of a note secured by a mortgage carries with it an assignment of the mortgage"); U.S. Bank v. McConnell, 305 P.3d 1 (Kan. Ct. App. 2013); *In re* Gemini Services, Inc., 350 B.R. 74 (Bankr. S.D. Ohio 2006) (beneficial interest in mortgage went to secondary market investor to whom note was delivered, although mortgage was assigned to MERS); Domarad v. Fisher & Burke, Inc., 76 Cal. Rptr. 529 (Cal. Ct. App. 1969); Columbus Invs. v. Lewis, 48 P.3d 1222 (Colo. 2002); J.E. Robert Co. v. Signature Props., LLC, 71 A.3d 492 (Conn. 2013); Margiewicz v. Terco Props., 441 So. 2d 1124 (Fla. Dist. Ct. App. 1983); Fed. Nat'l Mortg. Ass'n v. Kuipers, 732 N.E.2d 723 (Ill. Ct. App. 2000); Moore v. Lewis, 366 N.E.2d 594 (Ill. Ct. App. 1977); Bank of America v. Inda, 303 P.3d 696 (Kan. Ct. App. 2013); Svrcek v. Rosenberg, 40 A.3d 494, 507-08 (Md. 2012); Deutsche Bank 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."); Deutsche Bank v. Pietranico, 928 N.Y.S.2d 818 (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 America v. Draper, 746 S.E.2d 478 (S.C. Ct. App. 2013); Commonwealth Prop. Advocates, LLC v. Mortg. Electronic Registration Sys., Inc., 263 P.3d 397 (Utah Ct. App. 2011); Fidelity & Deposit Co. v. Ticor Title Ins. Co., 943 P.2d 710 (Wash. Ct. App. 1997); Dow Family, LLC v. PHH Mortg. Corp., 838 N.W.2d 411 (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. INST. J. 54 (May 2011), http://www.btlaw.com/files/Uploads/Documents/Publications/Thorne%20-%20Mortgage%20Follows%20the%20Note.pdf.

This principle is simple enough when PETE status and ownership of the note are regarded as unitary. Now that it is recognized that they can be separated, the question arises: With which set of rights (enforcement or ownership) does the mortgage run? A complete discussion of this issue will have to wait until the completion of this paper's consideration of transfers of ownership, but at this point a narrower question can be answered: Which set of rights – enforcement or ownership – carries with it the right to *foreclose* the mortgage? Most of the older judicial opinions do not recognize or understand the distinction between ownership and PETE status, and hence are useless in resolving this issue, and this is sometimes true with modern case opinions as well.[102] In recent years, however, a number of courts have addressed the question knowledgably, and their answers are consistent: PETE status, and not ownership *per se*, confers the right to foreclose the mortgage.[103] In other words, the right to enforce the mortgage follows

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102. Some older cases recognize the 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 sometimes continue to confuse the concepts of PETE and ownership. *See, e.g.*, U.S. Bank v. McConnell, 305 P.3d 1 (Kan. Ct. App. 2013) (perpetuating the long-time Kansas muddling of the two terms); Servedio v. U.S. Bank, 40 So. 2d 1105 (Fla. Dist. Ct. App. 2010); Deutsche Bank v. Mitchell, 27 A.3d 1229 (N.J. Super. Ct. App. Div. 2011) ("[A] party seeking to foreclose a mortgage must own or control the underlying debt"); U.S. Bank v. Kimball, 27 A.3d 1087, 1092 (Vt. 2011) ("[T]o foreclose a mortgage, a plaintiff must demonstrate that it has a right to enforce the note, and without such ownership, the plaintiff lacks standing.").

103. The decisions often use the term "holder" as synonymous with PETE, although, as we have already seen, being a holder is only one way of being a PETE. *See* J.E. Robert Co. v. Signature Props., LLC, 71 A.3d 492 (Conn. 2013) (showing that "to enforce a note, one need not be the owner of the note"); BAC Home Loans Servicing, LP v. Kolenich, No. CA2012-01-001, slip op. 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."); Edelstein v. Bank of New York Mellon, 286 P.3d 249, 257 (Nev. 2012) ("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 . . .") (citation omitted)). *See also In re* Tikhonov, BAP No. CC 11-1698-MKBePa, slip op. at 7-8 (B.A.P. 9th Cir. Dec. 14, 2012) (explaining that a party must show it is the holder of the note in order to have standing to seek relief from an automatic stay of foreclosure in bankruptcy); Roisland v. Flagstar Bank, 989 F. Supp. 2d 1095 (D. Or. 2013) (showing that under Oregon law, holder of note automatically became holder of deed of trust and could appoint successor trustee to commence nonjudicial foreclosure); *In re* Martinez, 455 B.R. 735 (Bankr. D. Kan. 2011) (Kansas law stating that "the holder of an instrument whether or not he is the owner may enforce payment in his own name" and hence may foreclose); U.S. Bank v. Thomes, 69 A.3d 411 (Me. 2013) (foreclosing party must show entitlement to enforce the note if it is not the note's owner); *In re* Kemp, 440 B.R. 624 (Bankr. D.N.J. 2010) (showing a party seeking foreclosure, though owner of 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

entitlement to enforce the note, not its ownership. This result is perfectly sensible, since 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 owed on the note, and if foreclosure results in payment in full, the note is discharged.[104] Hence, to view the power to foreclose the mortgage as dependent on a creditor's right to enforce the note – or PETE status – is entirely logical.

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 v. Morcom, 125 So. 3d 320 (Fla. Dist. Ct. App. 2013) ("[T]he person having standing to foreclose a 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."); Bank of America v. Inda, 303 P.3d 696 (Kan. Ct. App. 2013) (holding that "because [servicer] was the holder of the Note, [servicer] was also the holder of the Mortgage"); Bank of America v. Cloutier, 61 A.3d 1242 (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 v. Brock, 63 A.3d 40 (Md. 2013) (indicating that a party entitled to enforce note is also entitled to foreclose 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 v. Burns, 406 S.W.3d 495 (Mo. Ct. App. 2013) (The court concluded that the facts "qualify U.S. Bank as the holder of the Note under the UCC . . . . As such, U.S. Bank is . . . therefore entitled to enforce the Deed of Trust."); Bank of America v. Limato, 2012 WL 2505725 (N.J. Super. Ct. App. Div. 2012) (not reported in A.3d) (foreclosing party provided insufficient proof of entitlement to enforce note); Bank of New York Mellon v. Deane, 970 N.Y.S.2d 427 (N.Y. Sup. Ct. 2013); CPT Asset Backed Certificates v. Cin Kham, 278 P.3d 586, 591 (Okl. 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 (Or. 2013) (agreeing in dictum with this conclusion); JP Morgan Chase Bank v. Murray, 63 A.3d 1258 (Pa. Super. Ct. 2013); Bank of America v. Draper, 746 S.E.2d 478 (2013); Wells Fargo Bank Minnesota v. Rouleau, 46 A.3d 905 (Vt. 2012); Bain v. Metro. Mortg. Group, 285 P.3d 34, 44 (Wash. 2012) (relying on the definition of PETE in U.C.C. § 3-301). Some courts were evidently slightly confused. *See* RMS Residential Props., LLC v. Miller, 32 A.3d 307 (Conn. 2011) (holder of note is presumed to be owner of debt, and unless the presumption is rebutted, has standing to foreclose). *But see* JPMorgan Chase Bank v. Erlandson, 821 N.W.2d 600 (Minn. Ct. App. 2012) (a bizarre 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 subsequently acquires it prior to judgment, is its lack of initial standing cured, or must it file a new action? There is little clear authority on the point. *See* Focht v. Wells Fargo Bank, 124 So. 3d 308 (Fla. Dist. Ct. App. 2013) (certifying this issue for review to the Florida Supreme Court). The New York view requires 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).

104. PEB Report, *supra* note 77, 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").

B. Transferring Ownership

As we will see, U.C.C. Article 9 governs ownership of notes as well as security interests in ownership rights. It plainly applies to all mortgage notes, regardless of whether they are negotiable,[105] but for the moment we will focus our analysis on negotiable notes – those covered by Articles 3 and 9. The original Article 9 covered the creation of security interests in notes, along with many other forms of personal property.[106] But the 1998 revision of Article 9 made a radical change; for the first time, outright sales of notes were also covered.[107] This change was highly significant and took many lawyers unaware because of the complex language in which it was couched.[108] The following paragraph examines that language.

Article 9's scope statement provides that "this article applies to . . . a sale of . . . promissory notes."[109] The U.C.C.'s overall definitions section provides that "Security interest" includes "any interest of . . . a buyer of . . . a promissory note in a transaction that is subject to Article 9."[110] Thus, the right of a note buyer – what in ordinary parlance we would call "title" or "ownership" – is a "security interest" in Article 9 terminology. Article 9 then provides that a security interest "attaches" (that is, ownership passes to the buyer in the case of an outright sale) when the security interest becomes enforceable against the "debtor" – that is, the transferor. Article 9 then goes on to prescribe the methods

105. Article 9 uses the term "instrument," defined in U.C.C. § 9-102(a)(47) as a document of a "type that in ordinary business is transferred by delivery with any necessary indorsement or assignment." This definition covers all promissory notes, irrespective of their negotiability. *See* Morgan v. Farmers & Merchants Bank, 856 So. 2d 811, 818 (Ala. 2003); McFarland v. Brier, 850 A.2d 965, 976 (R.I. 2004) (discussing whether a certificate of deposit that is, by its terms, nontransferable is thereby disqualified from being an "instrument" under Article 9).

106. *See, e.g.*, *In re* Southern Oregon Mortg. Co., 125 B.R. 625 (Bankr. D. Or. 1991).

107. Further amendments to Article 9 were adopted in 2010, but they are mainly technical in nature and do not affect the issues under consideration here.

108. An outright sale of a note is, rather confusingly, termed the creation of a "security interest" by Article 9 – a sort of definitional leftover from the days when the Article 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 "the collateral." *See* U.C.C. § 9-102(a)(28)(B) (2012) (defining "debtor"); § 9-102(a)(72)(D) (defining "secured party"). The rights transferred may be full ownership or some lesser ownership interest, such as a security or collateral interest, provided that the transferor "has rights in the collateral or the power to transfer rights in the collateral to a secured party." UCC § 9-203(b)(2).

109. U.C.C. § 9-109(a)(3). *See* Dale Whitman, *Transfers of Mortgage Notes Under New Article 9*, http://dirt.umkc.edu/files/newart9i.htm (last visited Oct. 24, 2015).

110. U.C.C. § 1-201(b)(35).

by which the security interest will become enforceable.[111] Thus, "attachment" of a "security interest" against a "debtor" becomes a proxy for the plain English phrase, "sale of ownership rights." The terminological complexities are daunting, but the ultimate principle is clear: outright sales of ownership rights in notes, including those secured by mortgages, are governed by Article 9.

The current version of Article 9 provides two different mechanisms for transferring outright ownership of notes. Assuming that the transferor has rights in the note and that value is given, a security interest "attaches" (and ownership is transferred, in the case of an outright sale) when either (1) the buyer has taken possession of the note pursuant to an agreement of sale[112] with the seller or (b) the seller has signed a security agreement, written or electronic, that describes the note.[113] In simplified terms, one might say ownership of notes can be transferred either by delivery of the notes or by a written document, such as an assignment of the notes. But that is a bit too simple. If the transfer is done by delivery of possession, there must also be an agreement of sale – although not necessarily one that is signed, or even in writing, since there is no requirement that the agreement be "authenticated."[114] Thus, an oral agreement of sale will do. On the other hand, if there is a written, signed ("authenticated") agreement, such as an executed assignment of the notes, ownership will pass without delivery of possession.

One immediately notices important differences between Article 9's process for transferring ownership and Article 3's process for transferring the right of enforcement. Under Article 3, delivery of possession of the notes is essential, unless they have been lost or stolen and the lost note procedure is available. Under Article 9, delivery is optional – it is merely one way to carry out the transaction. Another difference lies in the significance of indorsement. Article 3 requires either indorsement of the notes (unless they were originally to bearer) or proof

111. U.C.C. § 9-203.

112. The text says "security agreement," however, under U.C.C. § 9-102(74), "security agreement" means an agreement that creates or provides for a security interest. Additionally, in U.C.C. § 1-201(b)(35), "security interest" includes the interest of a buyer in notes. Hence, in the context of an outright sale, "security agreement" can only mean a sale agreement.

113. U.C.C. § 9-203(b) (showing that, in the context of an outright sale, "security agreement" must be taken to mean a contract of sale, bill of sale, assignment, or other document of transfer).

114. PEB Report, *supra* note 77, at 10.

of the purpose for which they were delivered. Article 9 pays no direct attention at all to indorsement *per se*; it is irrelevant.[115]

As we have already seen, Article 3's concern with possession is justified as a borrower-protection device; it helps assure note makers that they are paying the correct person – the PETE. Buyers of ownership rights in notes have legitimate concerns about title as well. Assume that Acme Mortgage Company originates a mortgage loan, but finds itself short of cash or under financial stress. It may be tempted to "double-sell" the loan to two different secondary market investors.[116] If a sale could be accomplished only by delivery of the note, double-selling would be very difficult to pull off.[117] But since delivery is not necessary, Acme can simply enter into two different, written, signed note sale agreements with the two investors, taking care not to let either of them know about the other. Which of them will prevail? On the basis of what we have seen thus far, the first buyer, whom we will call Investor A, appears to own the note simply because he or she obtained it first. This result would appear to follow even if Investor A does not take possession of the note (as Investor A need not do to make the transfer "attach"). Thus the note may be left in Acme's hands, and Acme can exhibit or even deliver it to Investor B.[118]

In most situations, Article 9 resolves conflicts among secured parties (and recall that note buyers are classified as "secured parties") by means of the concept of perfection. In essence, a secured party who perfects his or her security interest will be protected against later se-

115. Conceivably, the language and signature on an indorsement could satisfy the "authenticated security agreement" requirement of U.C.C. § 9-203(b). *See* Partney v. Reed, 889 S.W.2d 896, 900 (Mo. Ct. App. 1994) (in which the indorsing transferor wrote words of assignment into the indorsement). Indorsement may also be indirectly relevant to the issue of ownership of a negotiable note, as follows. Under U.C.C. § 9-331(a), Article 9 defers to Article 3 to the limited extent that Article 3 determines ownership. Under U.C.C. § 3-306, a person having rights of a holder in due course takes free of claims to property or possessory rights in the instrument. Thus, since indorsement is relevant to a determination of holder in due course status, it may indirectly affect property or ownership claims.

116. Another possibility is that Acme will "double-pledge" the note, giving collateral security interests in it to two different creditors, or that it will pledge the note to one party and sell it to another. These alternative scenarios are interesting, but to keep our discussion simple, and because our focus is on outright sales of notes, we will set them aside.

117. This premise is not quite impossible. *See* Provident Bank v. Cmty. Home Mortg. Corp., 498 F. Supp. 2d 558 (E.D.N.Y. 2007) (discussing a case in which the loan originator had borrowers sign two identical original promissory notes, and subsequently sold them to two different secondary market investors. The court treated them as a single note and found that the first secondary market purchaser to take possession had thereby perfected the transfer, and hence prevailed.).

118. *See* Barbara M. Goodstein, *The Dilemma of Transferability of Mortgage Loans*, N.Y.L.J. (Apr. 2, 2015), http://www.newyorklawjournal.com/id=1202722306457/The-Dilemma-of-Transferability-of-Mortgage-Loans?slreturn=20150308211720.

curity interests created by the same debtor. However, when outright sales of notes are involved, the ordinary rules of perfection under Article 9 do not help Investor B, for they provided that a sale of a promissory note is perfected when it attaches.[119] This concept of automatic perfection applies whether attachment is by written assignment or by delivery of possession. Hence, in the example above, it still appears that Investor A's interest will be perfected immediately upon taking the assignment,[120] and Investor A will prevail over Investor B, even if Investor B buys the note with no knowledge of Investor A's claim, and even if Acme retains possession of the note after the transaction with Investor A. The assignor's retention of possession does not of itself defeat the transfer of ownership.

But under Article 9, not all perfections are created equal. Section 9-330(d) creates a sort of super-priority[121] that will trump the priority given by ordinary perfection in some circumstances. It provides that "a purchaser of an instrument has priority over a security interest in the instrument perfected by a method other than possession if the purchaser gives value and takes possession of the instrument in good faith and without knowledge that the purchase violates the rights of the secured party."[122] Thus, if Investor B takes possession of the note, has no knowledge of Investor A's claim,[123] and buys in good faith, Investor B will get title to the note despite Investor A's automatic perfection by attachment. The Official Comment to Section 9-330(d) makes it clear that possession by Investor B will prevail, assuming that Investor B satisfies the lack of knowledge and good faith tests, no

119. U.C.C. § 9-309(4). Under § 9-312(a), a security interest in notes can be perfected by filing a financing statement as well, but in light of the automatic perfection of outright sales of notes, there appears to be little incentive to do so. Conceivably, perfection by filing might be accomplished at an earlier date than perfection by attachment.

120. This rule is very convenient to Investor A above if the debtor-transferor files bankruptcy, since it means that the investor need not take any other action to be fully protected against the trustee in bankruptcy's strong-arm powers as a perfected lien creditor under Bankruptcy Code § 544. Indeed, the apparent purpose of Article 9's "automatic perfection" provision for notes was to insulate issuers of mortgage-backed securities and other securitization vehicles from attacks by the trustees in bankruptcy of original payees of the obligations in question.

121. *See* Steven L. Harris & Charles W. Mooney, Jr., *Using First Principles of UCC Article 9 to Solve Statutory Puzzles in Receivables Financing*, 46 GONZAGA L. REV. 297, 347 (2010) (Harris and Mooney, the reporters for revised Article 9, use the term "super-priority" to refer to the operation of § 9-330.).

122. U.C.C. § 9-330(d).

123. Only actual knowledge will defeat Investor B's claim under § 9-330(d), since under U.C.C. § 1-202(b), knowledge means actual knowledge. *See* Merrill Lynch Bus. Fin. Servs., Inc. v. Kupperman, 2010 WL 2179181, at *27 (D.N.J., May 28, 2010), *aff'd*, 441 F. App'x 938 (3d Cir. Aug. 3, 2011).

matter what method of perfection Investor A used.[124] Hence, the filing of a financing statement by Investor A will not improve his or her position.[125] The only safe way for Investor A to avoid the risk of loss from Acme's misconduct is to get possession of the note so that Acme will not be able to deliver it to a subsequent buyer. If neither party takes possession, Investor A will win by virtue of automatic perfection by attachment, but if either party takes possession, that party will prevail.[126]

If we look at Articles 3 and 9 in the aggregate, taking possession of the note kills two birds with one stone. Possession is essential to constitute the note buyer a holder, a PETE, and potentially a holder in due course under Article 3, and, at the same time, it will give the buyer protection against competing buyers or security interest holders from the same seller under Section 9-330(d). We saw earlier that one can buy ownership of a note under Article 9 either by taking possession or by taking a separate document of assignment.[127] It is now apparent that the first of these two methods is by far the safer course for a note buyer. Not only does it eliminate problems of enforcement if the note is negotiable,[128] but it also eliminates the risk of losing ownership through the misconduct by the note's seller.

C. *Getting the Economic Benefits of the Mortgage*

When the note is secured by a real estate mortgage, the note buyer obviously wants the benefits of the mortgage as well as the note. Prior to the adoption of the 1998 version of Article 9, there was considerable confusion as to what steps needed to be taken by the note buyer to obtain and perfect ownership of the mortgage. But under the current version, this issue is resolved by the text of the Code itself and is no longer debatable. It states both that the *attachment* of a security interest to an obligation secured by real estate operates to attach the security interest to the underlying interest in real estate,[129] and that "*perfection* of a security interest in a right to payment or performance also perfects a security interest in a security interest, mortgage, or

124. U.C.C. § 9-330(d), cmt. 7 (2000).

125. *Id.*

126. *See* Julian B. McDonnell & John Franklin Hitchcock, Jr., *The Sale of Promissory Notes Under Revised Article 9: Cooking Securitization Stew*, 117 BANKING L.J. 99, 111-13 (2000).

127. U.C.C. § 9-203(b).

128. *See supra* text accompanying notes 86-93.

129. U.C.C. § 9-203(g). Remember that the term "security interest" includes transfers of outright ownership. U.C.C. § 1-201(b)(35).

other lien on personal or real property securing the right."[130] Thus, no separate act (such as executing and delivering a mortgage assignment or recording it in the real estate records) is necessary to ensure perfection with respect to the mortgage.[131]

Commentators often say that this language implements the "mortgage follows the note" concept of the common law.[132] But the reality is a bit more complex and requires further explanation; we must make it clear which aspect of the mortgage we are talking about. We have already seen that the right of *enforcement* of the mortgage—that is, foreclosure—follows the right of *enforcement* of the note.[133] That connection between the note and mortgage is a common law principle, and because it deals with enforcement rather than ownership, it has nothing at all to do with Article 9.

On the other hand, the Article 9 provisions just mentioned,[134] which ensure that attachment and perfection of ownership in the note will extend to the mortgages as well, are *ownership* provisions. Ownership determines who is entitled to the economic benefits of the note, and by the extension of these provisions, the mortgage. Thus, a fair summary of the overall connection between notes and mortgages is the following: the right of enforcement (i.e., foreclosure) of the mortgage follows the right of enforcement of the note as a matter of common law. The right to the economic benefits of the mortgages (i.e., the proceeds of foreclosure) follows the right to the economic benefits of the note by virtue of the attachment and perfection provisions of Article 9. These principles are straightforward and simple, although they often seem to be misunderstood.

Taking possession of the note is not mandatory, but it is the only sensible course for wise secondary mortgage market investors. This is not to say that taking possession is easy or convenient. It is not. Particularly in a market in which massive loan transfers take place, with hundreds or thousands of notes changing hands on a continual basis, possession is burdensome and costly. Most investors use separate custodians to hold their notes, but this necessitates contracting

130. U.C.C. § 9-308(e).

131. U.C.C. § 9-308, Legislative Note recommends that the state's recording act be amended to make it clear that real estate recording is unnecessary in this setting.

132. *See, e.g.*, Douglas J. Whaley, *Mortgage Foreclosures, Promissory Notes, and the Uniform Commercial Code*, 39 W. St. U. L. Rev. 313 (2012).

133. *See supra* text accompanying notes 95-102. Exceptions exist in about a dozen states in which other or additional requirements for standing to foreclose are imposed by specific foreclosure statutes. *See* Whitman & Milner, *supra* note 24.

134. U.C.C. §§ 9-203(g), 9-308(e).

with, establishing standards for, and compensating the custodians.[135] If the note is sold and the buyer wishes to continue to use the same custodian, records must be kept to show that authority to direct the custodian has been transferred. An actual note need be produced for purposes of borrower examination or litigation on only relatively rare occasions, but there must be an established procedure for doing so. The system requires moving tangible pieces of paper around the country and keeping track of them. It seems outdated, even archaic. But, it can be made to work, and it can consistently produce satisfactory legal results.

IV. Transferring Nonnegotiable Notes

At last we arrive at the principal point of this article: how are nonnegotiable notes to be transferred? We begin with the proposition that, just as with negotiable notes, the transfer of nonnegotiable notes must be considered under two separate headings: transfers of the right of enforcement and transfers of ownership.

Of course, the bifurcation of ownership and enforcement is forced upon us for negotiable notes by the structure of the Uniform Commercial Code, as discussed in detail above. The Code does not compel a similar bifurcation for nonnegotiable notes, since it says nothing at all about transfers of the right to enforce nonnegotiable notes. Moreover, one will look in vain in the case law of nonnegotiable notes for any clue that ownership and the right to enforce are distinct from one another. But that should not deter our inquiry. The one fixed position, from which we cannot vary in the absence of a wholesale revision of the Code, is that Article 9 tells us how ownership of all notes is transferred, whether they are negotiable or not.[136] If the common law rules for transferring the right of enforcement of nonnegotiable notes are different than the Article 9 rules for transferring their ownership, then

135. On the widespread use of custodians, see American Securitization Forum, Transfer and Assignment of Residential Mortgage Loans in the Secondary Mortgage Market 3-4 (2010), https://www.mersinc.org/media-room-docman/52-asf-white-paper-11-16-10/file.

136. *See* U.C.C. § 9-102(a)(47). This follows from the definition of "instrument" in U.C.C. § 9-102(a)(47), as a document of a "type that in ordinary business is transferred by delivery with any necessary indorsement or assignment." There is universal agreement that this covers all notes, irrespective of their negotiability. Indeed, nonnegotiable notes are sometimes termed "Article 9 notes" for this reason. It must be conceded that in a sense the definition is circular: Article 9 defines an instrument as a document that is customarily transferred by delivery, and then goes on, in § 9-203, to affirmatively state that instruments can be transferred by delivery. But the definition is supported by very lengthy past practice and custom.

ownership and the right of enforcement are bifurcated, whether anyone says so overtly or not.

Everything Article 9 tells us about notes applies irrespective of their negotiability:[137] how to transfer their ownership (either by written document of assignment or by delivery of possession),[138] how to perfect when they are sold (perfection is automatic),[139] and how to attach and perfect transfers of real estate security along with them (once again, it's automatic).[140] The super-priority given to buyers who take possession of notes under Section 9-330(d) works in the same manner whether the notes are negotiable or not. These matters are settled. Hence, there is less to talk about on the topic of transferring nonnegotiable notes than we might have expected. The only real issue remaining is how to deal with transfers of the right to enforce, or even whether such transfers ought to receive separate treatment from transfers of ownership at all.

A. *Judge-Made Law on Transfers of the Right to Enforce Nonnegotiable Notes*

Since there is no uniform statute or code governing transfers of the right of enforcement of nonnegotiable notes, we must turn to case law.[141] As we have already noted, the cases are mostly old (i.e., the late Nineteenth to mid-Twentieth Centuries) and draw no distinction between ownership and the right of enforcement, but consistently treat the two sets of rights in a unitary manner. But even though they regard ownership and the right to enforce as coextensive,[142] we focus here on the cases addressing the right of enforcement, rather than cases in which ownership is the issue.

The overwhelming impression one gains from these cases is that all agree that the right to enforce a nonnegotiable note can be transferred in exactly the same way as a negotiable note – by indorse-

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137. The one exception to this statement is the deference given by § 9-331(d) to Article 3 and the holder in due course concept. *See supra* note 115.

138. *See supra* text accompanying notes 111-12.

139. *See supra* text accompanying notes 117-18.

140. *See supra* text accompanying notes 124-27.

141. To a considerable degree, this discussion relies upon Willier, *supra* note 1, which appears to be the only thorough treatment of the topic published in the Twentieth Century.

142. For one of many examples, see Krieg v. Palmer Nat'l Bank, 111 N.E. 31, 33 (Ind. App. 1916) ("The effect of these unrestricted indorsements and the delivery of the certificate to appellee was to invest appellee with the legal title to and the possession of the certificate, with the consequent right to recover thereon . . . .").

ment (if the note is not bearer paper)[143] and delivery.[144] Beyond this, however, the cases diverge. A few take the view that indorsement and delivery is the only way the transfer can be accomplished,[145] but a substantial majority also recognize the validity of a transfer by a separate document of assignment, without indorsement or delivery of the note itself.[146] Indeed, there is a minority line of cases holding that an assignment of the mortgage will also transfer the note automatically[147] –

143. It is unclear to what extent modern courts would apply the "nonholder with the rights of a holder" concept of U.C.C. § 3-301 to allow transfer of a non-bearer nonnegotiable note without indorsement; there is simply too little indication in the existing cases. However, RESTATEMENT (SECOND) OF CONTRACTS § 332, cmt. c and illus. 4 suggest that a gratuitous delivery of a nonnegotiable note will transfer the right to enforce it, even without indorsement. *See, e.g.*, Partney v. Reed, 889 S.W.2d 896, 900 (Mo. Ct. App. 1994) (recognizing that the right of enforcement of a nonnegotiable certificate of deposit could be transferred by delivery without indorsement); Hileman v. Hulver, 221 A.2d 693, 698 (Md. 1966) (recognizing a savings account passbook could be transferred by delivery without indorsement).

144. First Nat'l Bank of San Diego v. Falkenhan, 29 P. 866, 866-67 (Cal. 1892) (payee becomes liable in same manner as an indorser of a negotiable note); Dollar v. Int'l Banking Corp., 109 P. 499, 502 (Cal. Ct. App. 1910) (regarding a deposit receipt); Birmingham Trust & Sav. Co. v. Jackson Cnty. Mill Co., 27 So. 43, 43 (Fla. 1899) (nonnegotiable note; under Florida statute, transfer may be by indorsement or by assignment); Krieg v. Palmer Nat'l Bank, 111 N.E. 31, 34-36 (Ind. App. 1916) (nonnegotiable certificate of deposit); Gidden Motor Co. v. Johnston, 124 So. 367, 368 (Miss. 1929) (certificate of claim on bank issued by state banking department); Sebring v. Fagin, 141 P.2d 792, 793 (Okl. 1943) (state warrant); Wood v. Sparks, 42 S.W.2d 142, 144 (Tex. Civ. App. 1931), *rev'd on other grounds*, 59 S.W.2d 361 (Tex. Comm'n App. 1933) (note evidencing mechanics lien); Swedish-Am. Bank of Minneapolis v. Koebernick, 117 N.W. 1020, 1021 (Wis. 1908) (nonnegotiable note).

145. Bonhiver v. State Bank of Clearing, 331 N.E.2d 390, 397 (Ill. App. 1975) (nonnegotiable certificate of deposit); Bouton v. Cameron, 68 N.E. 800, 807 (Ill. 1903) (but transfer by separate assignment is enforceable in equity); Lowrey v. Danforth, 69 S.W. 39, 41 (Mo. App. 1902); Plattsmouth State Bank v. Redding, 258 N.W. 661 (Neb. 1935) (requiring delivery along with assignment). *But see* Kaw Valley State Bank & Trust v. Commercial Bank of Liberty, 567 S.W.2d 710, 712 (Mo. Ct. App. 1978) (recognizing a collateral pledge of a note effectuated by both delivery and a separate assignment).

146. Tackett v. First Sav. of Arkansas, 810 S.W.2d 927, 930 (Ark. 1991); Dollar v. Int'l Banking Corp., 109 P. 499, 503 (Cal. Ct. App. 1910); Moses v. Woodward, 140 So. 651, 653 (Fla. 1932), *aff'd*, 147 So. 690 (Fla. 1933); Allen v. Commercial Credit Co., 117 S.E. 650, 651 (Ga. 1923); Felin Assocs. v. Rogers, 326 N.Y.S.2d 413, 415 (N.Y. App. Div. 1971); Nw. Nat'l Ins. Co. v. Crockett, 857 S.W.2d 757, 758 (Tex. App. 1993); Thatcher v. Merriam, 240 P.2d 266, 270-71 (Ut. 1952) (assignment treated as a "constructive delivery" of note). This conclusion is consistent with RESTATEMENT (SECOND) OF CONTRACTS § 324 (1981), which provides that an assignment of a contract right may be made if the obligee "manifest[s] an intention to transfer the right to another person without further action or manifestation of intention by the oblige."

147. Berhe v. Fed. Nat'l Mortg. Ass'n, 2013 WL 5234301 (D. Nev. Sept. 16, 2013); Seabury v. Hemley, 56 So. 530 (Ala. 1911); Lawyers Title Ins. Co. v. Novastar Mortg., Inc., 862 So. 2d 793 (Fla. App. 2004); Andrews v. Townshend, 1 N.Y.S. 421 (N.Y. 1888); Fed. Home Loan Mortg. Corp. v. Rufo, 983 N.E.2d 406, 413 (Ohio App. 2012); Fed. Home Loan Mortg. Corp. v. Koch, 2013 WL 5532836 (Ohio App. Oct. 7, 2013); Reynolds v. Bank of America, 2013 WL 1904090 (N.D. Tex. May 8, 2013) (Texas law stating that "any transfer of the deed

a proposition that can only be true if the note is nonnegotiable, of course, since the right to enforce a negotiable note can be transferred only by delivery.[148]

B. Is There a Problem Here?

Should the law allow transfers of the right to enforce nonnegotiable notes by separate written assignment? One might argue formalistically that, since Article 9 allows ownership to be transferred by assignment, there is no logical objection to permitting transfers of the right of enforcement by assignment as well. Of course, permitting it creates a sharp distinction between negotiable and nonnegotiable notes, but it is arguable that there is nothing inherently wrong with that.

Still, recognizing that PETE status for nonnegotiable notes can be transferred without delivery of possession means that something important is missing. Recall our previous discussion of the "title assurance" function of the requirement of delivery of possession for negotiable notes.[149] Because, by the majority view, the law does not require delivery in order to transfer the right of enforcement of nonnegotiable notes, this "title assurance" function of delivery is lost if the note is nonnegotiable. In other words, possession is not a reliable indicium of the right to enforce nonnegotiable notes, as it is for negotiable notes. At first blush, this seems like a serious problem.

But things are not as bad as they seem. Even though the common law of nonnegotiable notes provides no incentive for note buyers to take possession, we have already seen that Article 9 does, since it is only by taking possession that a note buyer can gain the immensely valuable super-priority benefits of Section 9-330(d).[150] Since investors in the secondary mortgage market ordinarily want both ownership and the right of enforcement, they routinely demand possession of the nonnegotiable notes they buy for the purpose of satisfying Section 9-330(d). For this reason, a buyer in the position of Investor B in our illustration above, if knowledgeable or well-advised, will insist upon

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of trust without the note automatically passes the debt."); W.D. Rollison, *Priorities in the Law of Mortgages*, 9 NOTRE DAME L. REV. 50, 86 (1933); Phillip C. Ransdell, Note, *Effect of Assignment Without Assigning the Debt—Formalities Necessary to Transfer the Mortgagee's Title to the Mortgaged Property*, 36 N.C. L. REV. 225 (1958) (discussing Gregg v. Williamson, 98 S.E.2d 481 (N.C. 1957)).

148. *See* RESTATEMENT (THIRD) OF PROP. MORTGAGES § 5.4(b) (1997) (providing that such a transfer of the note will take effect only if U.C.C. Article 3 does not preclude it).

149. *See supra* text accompanying note 91.

150. *See supra* text accompanying notes 120-22.

production of the original note, even if it is nonnegotiable, and will refuse to enter into the purchase if the note cannot be delivered. Thus, as a practical matter, being able to deliver possession is the touchstone of the power to sell the note. It is Article 9, not the common law of notes, that produces this result. As a practical matter, although not in express terms, Article 9 provides the mechanism to validate a transfer of the right of enforcement of a nonnegotiable note that the common law of notes lacks. If a nonnegotiable note's owner offers to sell the note, but is unable to deliver its possession, the owner may in theory still have a right of enforcement to transfer, but as a practical matter that right is likely to be unsalable.

The conclusion, then, is that the missing requirement of delivery of possession for transferring the right to enforce nonnegotiable notes is not really much of a problem. In effect, PETE status for nonnegotiable notes "piggy-backs" on the possession advantage of Section 9-330(d). As a practical matter, there is little functional difference between secondary market sales of negotiable and nonnegotiable notes, despite the formal distinctions outlined above between Article 3 and the common law. The system works as well for nonnegotiable notes as it does for negotiable notes.

Conclusion

There is no need to revise the law for nonnegotiable notes *per se*. But as we have already observed, our system for transferring *all* notes, negotiable and nonnegotiable, is archaic and unwieldy. In an age when virtually all other financial instruments are transferred and stored electronically, it seems little short of bizarre that we continue to package up paper notes and ship them around the nation. The process is costly and fraught with potential error. The sloppiness with which the system operated during the fevered days before the crash of the mortgage market in 2007 has provided a great deal of grist for the foreclosure defense bar, but it also affords ample proof that the system needs reform. Surely we can, and should, do better.

There is hope that an alternative can be fashioned. Under the leadership of the Federal Reserve Bank of New York, a statute is being drafted that would create a national mortgage registry. If such a statute is enacted, it will allow market participants to eliminate the physical movement of paper notes, at least those secured by real estate.[151] It will allow electronic registration of every transfer of every

151. The characteristics attributed to the statute in the text are, of necessity, somewhat speculative, since it has not been presented for enactment, much less passed. The author

mortgage loan. It will apply equally to negotiable and nonnegotiable notes. It will disclose upon request the identity of the person in legal possession of each registered mortgage note. In this way, it will provide an immediately accessible on-line record of the right to enforce the note.

Those working on the design of this system believe it could be implemented with virtually no change in or preemption of either Article 3 or Article 9, except to provide that electronic registration has the legal effect of possession of the note. Use of the registration system would be voluntary, but its advantages would be so obvious that it would likely become predominant or even nearly universal in use within a short time.

How would such a system work? When a loan was originated, the mortgage would be recorded in the local real estate records as at present, since this would be necessary to establish the mortgage's priority as against other real property interests. Immediately thereafter, the note would be registered in the national system, and an entry would made in the local records to indicate that this had been done and to provide the public with the loan's unique identifying number in the national registry. From that point forward, all secondary market transactions would be shown only in the registry. Transfers within the registry would be deemed public notice, so that recording of mortgage assignments locally would be unnecessary. If the loan was paid off in due course, the registry would provide a certificate recordable in the local real estate records so indicating, thus discharging the mortgage of record. If a foreclosure became necessary, the registry would issue a certificate, usable in the local foreclosure process, showing the identity of the current registrant and thus attesting to that party's standing to foreclose.

When a loan was registered in the national system, the original note would be destroyed, but as mentioned above, registration would be deemed the equivalent of possession of the note. When a registrant transferred the note, it might or might not be indorsed at the parties' election (as at present), but the electronic transfer would be deemed to pass possession to the new registrant, and to have been made for the purpose of transferring the right of enforcement. Thus, at a minimum, the new registrant would be entitled to claim "nonholder with the

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serves as a consultant to the Federal Reserve Bank of New York on the drafting project described in the text. For some earlier thoughts on the structure of such a statute, see Dale A. Whitman, *A Proposal for a National Mortgage Registry: MERS Done Right*, 78 MO. L. REV. 1 (2013).

rights of a holder" status,[152] and thereby to be the PETE. Any registrant, by virtue of being deemed in possession of the note, would also be entitled to ownership under Article 9 if a suitable agreement of sale existed, and to have the special super-priority rights granted to note possessors by section 9-330(d), as discussed above.[153]

Thus this system could completely eliminate the need for both delivery of possession of original notes and the recording of interim mortgage assignments, replacing both with a simple electronic transfer process. It could do so with only the barest minimum of intrusion into the present legal regime represented by Articles 3 and 9. For purposes of transferring both PETE status and ownership, no difference would exist in this system between negotiable and nonnegotiable notes. However, the registry process would not change the holder in due course concept and (assuming it is not changed by other law), only notes that were originally negotiable could confer holder in due course status on registrants.

Thus far, this is only an incipient proposal, being circulated among industry participants for comment and feedback, and not yet presented to any legislative body, state or federal. It is my view that enactment would best come from Congress rather than state legislatures. Either way, gaining adoption of such a statute, particularly in the current polarized political environment, is a daunting task. Let us hope that in the not-so-distant future, the touchstone of both ownership and the right of enforcement of mortgage notes will be electronic, rather than physical, possession.

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152. *See supra* text accompanying note 80.
153. *See supra* text accompanying notes 120-22.