Mortgage Foreclosures, Promissory Notes, and the Uniform Commercial Code

By Douglas J. Whaley[*]

INTRODUCTION

As is true of many things in life the Uniform Commercial Code's statutes concerning the role of promissory notes in a mortgage foreclosure are both simple and at the same time complicated. The purpose of this article is to draw out the matter in detail, but let's begin with the simple (and basic) rule first. Indeed let's call the Golden Rule of Mortgage Foreclosure: the Uniform Commercial Code forbids foreclosure of the mortgage unless the creditor

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possesses the properly-negotiated original promissory note. If this can't be done the foreclosure must stop.

Of course there are exceptions and situations in which problems with the note can be addressed and cleared up, and those will be explored as we progress. The difficulty is that all too often the Golden Rule of Mortgage Foreclosure is simply ignored and the foreclosure goes ahead as if the rule were not the statutory law of every jurisdiction in the United States.[2]

Why is that? The answer is almost too sad to explain. The problem is that the Uniform Commercial Code is generally unpopular in general, and particularly when it comes to the law of negotiable instruments (checks and promissory notes) contained in Article Three of the Code. Most lawyers were not trained in this law when in law school (The course on the subject, whether called "Commercial Paper" or "Payment Law," is frequently dubbed a "real snoozer" and skipped in favor or more exotic subjects), and so the only exposure to the topic attorneys have occurs, if at all, in bar prep studies (where coverage is spotty at best). Thus many foreclosures occur without it occurring to anyone that the UCC has any bearing on the issue.

Judges are frequently similarly unlearned when the matter arises, and loath to hear more. If the defendant's attorney announces that the Uniform Commercial Code requires the production of the original promissory note, the judge may react by saying something like, "You mean to tell me that some technicality of negotiable instruments law lets someone who's failed to pay the mortgage get away with it if the promissory note can't be found, and that I have to slow down my overly crowded docket in the hundreds of foreclosure cases I've got pending to hear about this nonsense?" It's a wonder the judge doesn't add, "If you say one more word about Article Three of the UCC you'll be in contempt of court!"

But the law is the law. If the judge doesn't like what the state statute says that is no excuse for ignoring it. If the statute reaches a bad result then the legislature should repeal the statute, and until that occurs the courts must follow

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it. As it happens there are good and sufficient rules for Article Three's mandates, as we shall see below.

THE LANDSCAPE OF THE MORTGAGE MESS

Let's begin with what a mortgage actually is. Properly defined it is a consensual lien placed by the home owner (called the "mortgagor") on the real estate being financed in order secure the debt incurred by the loan in favor of the lender/mortgagee. The debt is created by the signing of a promissory note (which is governed by Article Three of the Uniform Commercial Code); the home owner will be the maker/issuer of the promissory note and the lending institution will be payee on the note. There is a common law maxim that "security follows the debt." This means that it is presumed that whoever is the current holder of the promissory note (the "debt") is entitled to enforce the mortgage lien (the "security"). The mortgage is reified as a mortgage deed which the lender should file in the local real property records so that the mortgage properly binds the property not only against the mortgagor but also the rest of the world (this process is called "perfection" of the lien).[3]

What happens to the promissory note? In the good old days, the twentieth century, it was kept down at the bank so that when the time for payment arrived the bank could present it to the mortgagor when due, and, if it wasn't paid, the mortgagee could then use legal process (or in some states self-help) to foreclose on the mortgage lien. But during the feeding frenzy that the real estate mortgage community indulged in for the last decade, more bizarre things happened. The mortgages themselves were no longer kept at the originating bank, nor were the notes. Instead they were bundled together with many others and sold as a package to an investment banking firm, which put them in a trust and sold stock in the trust to investors (a process called "securitization".) The bankers all knew the importance of the mortgage, and supposedly kept records as to the identity of the entities to whom the mortgage was assigned. But they were damn careless about the promissory notes, some of which were properly transferred whenever the mortgage was, some of which were kept at the originating bank, some of which were deliberately destroyed (a really stupid thing to do), and some of which disappeared into the black hole of the financial collapse, never to be seen again.

In recent years the combination of subprime lending, securitization of mortgage loans, a housing market that first boomed then busted, rapacious predators who worked hard to take for themselves the equity people had built up in their homes, and foreclosure mills that operated with neither proper

3 The "mort" portion of the word mortgage comes from Latin for "death" (as in "mortician," "morgue," "mortal," etc.) because on the payment of the promissory note debt, the mortgage deed dies.

paperwork, nor attention to the rules of law, much less common decency, led to an explosion of laws and legal actions designed to deal with these matters.

The collapse of the housing market in 2008 was a direct consequence of these greedy and unwise business practices. Gullible consumers were encouraged to take out mortgages they could not afford on property that turned out to be worth far less than the mortgage indebtedness. Minority communities were particularly hard hit, often targeted by shady lenders because people of color are more likely to store their wealth in home equity in many USA communities. Things went fine until real property stopped appreciating in value and its worth dropped to alarmingly low levels, with a recession that engulfed the country and, indeed, the world. Not just subprime borrowers were affected; the recession reduced the value of almost all property, and perfectly responsible mortgagors (many of whom were also laid off from their jobs) began to struggle to make payments and avoid foreclosure. According to one monitoring agency, a record number of homes received foreclosure filings in 2010 (over 2.9 million).[4]

Ten years or so ago the bank that made the mortgage loan filed the mortgage deed in the local real property records so as to perfect its interest in the realty. But when the mortgages themselves began to be assigned, changing the real property records at the time of each transfer would be both expensive and awkward. Filing fees in real property record offices average $35 every time a new document is filed. The solution was the creation of a straw-man holding company called Mortgage Electronic Registration Systems [MERS]. MERS makes no loans, collects no payments, though it does sometimes foreclose on properties (through local counsel). Instead it is simply a record-keeper that allows its name to be used as the assignee of the mortgage deed from the original lender, so that MERS holds the lien interest on the real property. While MERS has legal title to the property, it does not pretend to have an equitable interest. At its headquarters in Reston, Va., MERS (where it has only 50 full time employees, but deputizes thousands of temporary local agents whenever needed) supposedly keeps track of who is the true current assignee of the mortgage as the securitization process moves the ownership from one entity to another.[5] Meanwhile the homeowner, who has never heard of MERS, is making

4 RealtyTrac Staff, *Record 2.9 Million U.S. Properties Receive Foreclosure Filings in 2010 Despite 30-Month Low in December*, http://www.realtytrac.com/content/press-releases/record-29-million-us-properties-receive-foreclosure-filings-in-2010-despite-30-month-low-in-december-6309 (last updated Jan. 12, 2011). This immediately followed late 2009, where the third quarter saw 937,840 homes receive some sort of foreclosure letter, which at that point was "'the worst three months of all time.'" Les Christie, *Foreclosures: 'Worst three months of all time'*, http://money.cnn.com/2009/10/15/real_estate/foreclosure_crisis_deepens/ (last updated Oct. 15, 2009).

5 *See HSBC Bank USA, N.A. v. Charlevagne*, 872 N.Y.S.2d 691 (table), 2008 WL 2954767 (N.Y. Sup. Ct. 2008) and *HSBC Bank USA, Nat. Assn. v. Antrobus*, 872 N.Y.S.2d 691 (table), 2008 WL 2928553 (N.Y. Sup. Ct. 2008) (Describing "possible incestuous relationship" between HSBC Bank,

payments to the mortgage servicer (who forwards them to whomever MERS says is the current assignee of the mortgage). If the payments stop, the servicer will so inform the current assignee who will then either order MERS to foreclose or will take an assignment of the mortgage interest from MERS so that it can foreclose in its own name. Amazingly, MERS Corporation holds title to roughly half of the home mortgages in the country, some 60 million of them![6]

THE UNIFORM COMMERCIAL CODE

Article 3 of the Uniform Commercial Code could not be clearer when it comes to the issue of mortgage note foreclosure. When someone signs a promissory note as its maker ("issuer"), he/she automatically incurs the obligation in UCC §3-412 that the instrument will be paid to a "person entitled to enforce" the note.[7] "Person entitled to enforce"—hereinafter abbreviated to "PETE"—is in turn defined in §3-301:

> "Person entitled to enforce" an instrument means (i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 or 3-418(d) . . . .

Ocwen Loan Servicing, Delta Funding Corporation, and Mortgage Electronic Registration Systems, Inc., due to the fact that the entities all share the same office space at 1661 Worthington Road, Suite 100, West Palm Beach, Florida. HSBC also supplied affidavits in support of foreclosure from individuals who claimed simultaneously to be officers of more than one of these corporations.).

6 Things would have gone better for MERS if it had done its job more thoroughly, but in the speed and volume that was necessitated by the boom/bust economy, it became sloppy, its records often confused, and eventually courts started blowing the whistle. There are decisions reaching all possible results, but recently many courts (and particularly bankruptcy ones) are questioning whether MERS has standing to foreclose on any of the mortgages it holds. The Supreme Court of Arkansas has even ruled that since it makes no loans MERS cannot be the mortgagee on a deed filed in the Arkansas property records; *see Mortg. Elec. Registration Sys., Inc. v. S.W. Homes of Ark.*, 2009 Ark. 152 (2009). In one Utah trial court decision, reported in news articles, a judge ruled that MERS couldn't prove up its records and granted the home owner's petition to quiet title and remove the MERS deed from the records. No one could find the promissory note (on which further liability depends), so that particular home owner is a major beneficiary of the MERS mess. MERS has been under much greater attacks lately. News articles have reported that in early February, 2012, the New York Attorney General filed suit against the major banks charging that their use of MERS was an "end run" around the property recording system, which was designed so that the identity of the true mortgagee would be a public record. In 2012, Merscorp, Inc., which operates MERS, was sued by the Delaware Attorney General who alleged it initiated foreclosures for which "the authority has not been fully determined and may not be legitimate."

7 Unif. Commercial Code §3-412. Obligation of Issuer of Note or Cashier's Check. ("The issuer of a note . . . is obliged to pay the instrument (i) according to its terms at the time it was issued . . . . The obligation is owed to a *person entitled to enforce* the instrument . . . . ") (emphasis added).

Three primary entities are involved in this definition that have to do with missing promissory notes: (1) a "holder" of the note, (3) a "non-holder in possession who has the rights of a holder, and (3) someone who recreates a lost note under §3-309.[8] Let's take them one by one.

"Holder"

Essentially a "holder" is someone who possesses a negotiable instrument payable to his/her order or properly negotiated to the later taker by a proper chain of indorsements. This result is reached by the definition of "holder" in §1-201(b)(21):

> (21) "Holder" means:
>
> (A) the person in possession of a negotiable instrument that is payable either to bearer or to an identified person that is the person in possession . . . .

and by §3-203:

> (a) "Negotiation" means a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes its holder.
>
> (b) Except for negotiation by a remitter, if an instrument is payable to an identified person, negotiation requires transfer of possession of the instrument and its endorsement by the holder. If an instrument is payable to bearer, it may be negotiated by transfer of possession alone.

The rules of negotiation follow next.

"Negotiation"

A proper negotiation of the note creates "holder" status in the transferee, and makes the transferee a PETE. The two terms complement each other: a "holder" takes through a valid "negotiation," and a valid "negotiation" leads to "holder" status. How is this done? There are two ways: a *blank* endorsement or a *special* endorsement by the original payee of the note.

8 Unif. Commercial Code §3-418(d) is also referenced in the PETE definition but it has to do with recreating the rights of indorsers in instrument paid by mistake, which is not something that arises in mortgage foreclosure cases.

With a blank endorsement (one that doesn't name a new payee) the payee simply signs its name on the back of the instrument. If an instrument has been thus indorsed by the payee, anyone (and I mean anyone) acquiring the note thereafter is a PETE, and all the arguments explored below will not carry the day. Once a blank endorsement has been placed on the note by the payee, all later parties in possession of the note qualify as "holders," and therefore are PETEs.[9]

If the payee's endorsement on the back of the note names a new payee ("pay to X Company"), that's called a "special endorsement." Now only the newly nominated payee can be a "holder" (a status postponed until the new payee acquires the note—you have to hold to be a holder). The special endorsee, wishing to negotiate the note to a new owner, may now sign in blank, creating a bearer instrument, or may make another special endorsement over to the new owner. Only if there is a valid chain of such endorsements has a negotiation taken place, thus creating "holder" status in the current possessor of the note and making that person a PETE. With the exception mentioned next, the endorsements have to be written on the instrument itself (traditionally on the back).

The Allonge

Sometimes the endorsement is not made on the promissory note, but on a separate piece of paper, called an "allonge," which is formally defined as a piece of paper attached to the original note for purposes of endorsement.[10] An allonge has an interesting history, traceable to the days in which instruments circulated for long periods before being presented for payment. Consider, for example, the early period in United States history before it was even a country. People living in the Americas frequently had their banks back in Great Britain. If they drew up drafts ("check") on these banks and gave them to another American, that person was unlikely to immediately send it across the Atlantic to the mother country. Instead, the payee would simply indorse it over to one of the payee's creditors, who would do the same. In those days drafts would circulate, more or less like money, for extended periods of time. But the drafts quickly ran out of room on which to place endorsements, so a separate piece of paper, called an "allonge" was glued to the original draft and the new

9 *See e.g. Riggs v. Aurora Loan Services*, 36 So. 3d 932 (Fla. 4th Dist. App. 2010).

10 *See* Unif. Commercial Code § 3-204, Official Comment 1.

endorsements were placed on the allonge. There are cases from Great Britain where the allonge had over a hundred endorsements before finally being presented to the drawee for payment.[11]

The Uniform Commercial Code still allows the use of an allonge, and given the large number of transfers that some mortgage promissory notes have had in the last few years, there are many new cases dealing with the allonge. These cases frequently reveal problems with negotiation that give the current holder of the instrument difficulties in trying to establish "holder" status. For example, the allonge must be "affixed to the instrument" per §3-204(a)'s last sentence. It is not enough that there is a separate piece of paper which documents the transfer unless that piece of paper is "affixed" to the note.[12] What does "affixed" mean? The common law required gluing. Would a paper clip do the trick? A staple?[13]

Thus a contractual agreement by which the payee on the note transfers an interest in the note, but never signs it, cannot qualify as an allonge (it is not affixed to the note), and no proper negotiation of the note has occurred. If the endorsement by the original mortgagee/payee on the note is not written on the note itself, there must be an allonge or the note has not been properly negotiated, and the current holder of that note is not a PETE (since there is no proper negotiation chain).

Another difficulty with allonges that has bothered a number of courts occurs in the following fact pattern. The promissory note apparently has a valid endorsement of the payee's name either on the back of the note or on the accompanying allonge, but the evidence shows that when the note was transferred to the current possessor that signature was not then on the note.

11 L.S. Presnell, *Country Banking In The Industrial Revolution* 172-73 (Oxford 1956) (discussed in J. Rogers, *The End Of Negotiable Instruments: Bringing Payment Systems Law Out of the Past* 32 (Oxford 2011)).

12 *See Adams v. Madison Realty & Dev., Inc.*, 853 F.2d 163, 167 (3d Cir. 1988) (Mere folding of the alleged allonge around the note insufficient—$19.5 million lost because of this legal error!); **Error! Main Document Only.***HSBC Bank USA v. Thompson*, 940 N.E.2d 986 (Ohio App. 2nd Dist. 2011) (unattached pages cannot be an allonge); *In re Weisband*, 427 B.R. 13, 20 (Bankr. D. Ariz. 2010) (same).

13 I know of no paper clip cases, but it does seem unlikely a court would hold that such a clip would "firmly affix" one piece of paper to another. As for staples, *see Lamson v. Commercial Credit Corp.*, 187 Colo. 382 (1975) ("Stapling is the modern equivalent of gluing or pasting. Certainly as a physical matter it is just as easy to cut by scissors a document pasted or glued to another as it is to detach the two by un-stapling."); *accord S.W. Res. Corp. v. Watson*, 964 S.W.2d 262, 263 (Tex. 1997). I tell my law students that they'll know they've hit the big time if they're in the Colorado Supreme Court arguing about whether a staple firmly affixes an allonge to the original instrument. One court has also blessed the use of an Acco fastener; *see Fed. Home Loan Mortg. Corp. v. Madison*, 2011 WL 2690617 (D. Ariz. July 12, 2011).

Instead it is clear that the current possessor, realizing the problem, went back to the payee and had it indorse the note over to the current possessor, thus clearing up the negotiation issue. But some courts have disallowed such a late negotiation by the original payee on the theory that by the time the payee's signature was added to the note, the payee no longer had an "ownership" interest in the note and thus no title to convey, which supposedly invalidates the late endorsement.[14] This is simply wrong, and is a misunderstanding of the difference between ownership and the rules of negotiation. The Code never requires the person making an endorsement to have an ownership interest in the note[15] (though of course the payee normally does have such an interest), but simply that he/she is the named payee, and the Code clearly allows for correction of a missing endorsement. Section 3-203(c) provides for it specifically:

> (c) Unless otherwise agreed, if an instrument is transferred for value and the transferee does not become a holder because of lack of indorsement by the transferor, the transferee has a specifically enforceable right to the unqualified indorsement of the transferor, but negotiation of the instrument does not occur until the indorsement is made.

And Official Comment 3 explains: "The question may arise if the transferee has paid in advance and the indorsement is omitted fraudulently or through oversight. . . . Subsection (c) provides that there is no negotiation of the instrument until the indorsement by the transferor is made. Until that time the transferee does not become a holder . . . ."

If the allonge is not in order, or there are other problems with the negotiation of the note (the original payee's name is missing, for example), the person suing on the instrument will have to rely on the "shelter rule" to become a PETE, and so let's turn to that rule.

The Shelter Rule

[14] The leading (misleading?) case is *Anderson v. Burson*, 424 Md. 232 (2011).

[15] Unif. Commercial Code § 3-201 (Thieves can qualify as a "holder" of a negotiable instrument and thereafter validly negotiate same to another); *See also* Unif. Commercial Code § 3-201, Official Comment 1 (giving an example involving a thief).

It has always been a basic rule in commercial law that the sale of anything vests in the buyer whatever rights the seller had in the object sold. Phrased another way, the buyer takes "shelter" in the rights of the seller. Even legal rights can pass in this way, including "holder" status. Say, for example, that the payee fails to indorse the note (so no "negotiation" takes place) but instead sells the note to a new owner. The new owner is not a "holder" (since there has not been an indorsement by the payee), but the new owner takes shelter in the holder status of its buyer, and thus is a PETE according to both §§3-301 (defining PETE) and 3-203(b) (the shelter rule itself). In this case, the burden of proving proper possession is on the person in holding the instrument, and until that is done no liability on the note arises (since the maker of the note's obligation to pay it under §3-412, see above, only runs to a PETE). The shelter rule even acts to pass on the original holder's rights completely down the chain as long as the current possessor of the note can prove the validity of all previous transfers in between.

The shelter rule can be hugely useful to the foreclosing entity. Say that the original payee on the note was First Bank, which never indorsed the note at all. The note was then transferred into the hands of Second Bank, which is the plaintiff in the current foreclosure action. Second Bank, using the shelter rule, is a PETE as long as it proves the chain of transfers of the note, obtaining the "holder" status of First Bank even without proper indorsements on the note or an allonge. The courts have had no problem reaching this result.[16]

Lost Notes

If the note has been lost, §3-309 of the UCC allows for the re-creation of lost or destroyed notes. It states:

> (a) A person not in possession of an instrument is entitled to enforce the instrument if (i) the person was in possession of the instrument and entitled to enforce it when loss of possession occurred, (ii) the loss of possession was not the result of a transfer by the person or a lawful seizure, and (iii) the person cannot reasonably obtain possession of the

[16] *See In re Veal*, 450 B.R. 897 (9th Cir. BAP 2011); *Anderson v. Burson*, 424 Md. 232 (2011); *Leyva v. National Default Servicing Corp.*, 255 P.3d 1275 (Nev. 2011); *In re Kang Jin Hwang*, 396 B.R. 757 (Bankr. C.D. Cal. 2008).

> instrument because the instrument was 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.
>
> (b) A person seeking enforcement of an instrument under subsection (a) must prove the terms of the instrument and the person's right to enforce the instrument. If that proof is made, Section 3-308 applies to the case as if the person seeking enforcement had produced the instrument. The court may not enter judgment in favor of the person seeking enforcement unless it finds that the person required to pay the instrument is adequately protected against loss that might occur by reason of a claim by another person to enforce the instrument. Adequate protection may be provided by any reasonable means.[17]

Note that (b) places the burden of proving a right to payment on the person claiming the right to enforce the lost instrument. Nothing is presumed. The plaintiff must show the validity of each transfer of the instrument from the original payee to the current plaintiff, and explain how and why the note cannot be produced.[18] The last sentence in §3-309 (see above) does allow the court to rule in favor of the entity claiming under a lost note if there is a bond or other security posted to protect the payor from the risk of double payment to a later party producing the note.

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[17] Unif. Commercial Code §3-309. The 2002 version has slightly different wording of (a):

(a) A person not in possession of an instrument is entitled to enforce the instrument if:

(1) the person seeking to enforce the instrument:

(A) was entitled to enforce the instrument when loss of possession occurred; or

(B) has directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred;

(2) the loss of possession was not the result of a transfer by the person or a lawful seizure; and

(3) the person cannot reasonably obtain possession of the instrument because the instrument was 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 2002 rewrite of (a) was to allow an *assignee* of the entity which lost the note to enforce it, a result that most courts reached even without this clarification. *See Atlantic Nat. Trust, LLC v. McNamee*, 984 So.2d 375 (Ala. 2007).

[18] *See In re Carter*, 681 S.E.2d 864 (N.C. App. 2009) (In one major misstep, a bank in Florida, in a "paper reduction effort" is reputed to have deliberately put the notes through a paper shredder after making photocopies of them! Any attorney who approved such a practice should be disbarred.).

The Golden Rule of Mortgage Foreclosure Under the UCC

As stated in the first paragraph of this article, the Golden Rule of Mortgage Foreclosure: the Uniform Commercial Code forbids foreclosure of the mortgage unless the creditor possesses the properly-negotiated original promissory note. If this can't be done the foreclosure must stop. The maker who signs a promissory note is only liable per §3-412 to a "person entitled to enforce" (PETE) the note, a term described in §3-301 so that only someone in possession of a validly negotiated note qualifies. As we saw above, defects in negotiation frequently defeat the ability to be a PETE, and therefore stop the foreclosure from being successful.[19] Let's now turn to the *possession* requirement, which is emphasized over and over in §3-301's definition of PETE and its accompanying Official Comment.

An assignee of the mortgage who does not have the promissory note is not allowed to foreclose on the mortgage[20] Without the note, the foreclosing entity does not have "standing" to sue (and/or—a civil procedure distinction that is not my forte—is not the "real party in interest").[21] As United States District Judge Christopher Boyko explained throwing out a number of mortgage foreclosure cases, attempts to slide past the jurisdictional issue that arises from filing without the necessary paperwork is unacceptable:

> Plaintiff's, "Judge, you just don't understand how things work," argument reveals a condescending mindset and quasi-monopolistic system where financial institutions have traditionally controlled, and

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19 *See* 255 P.3d at 1275; *In re David A. Simpson, P.C.*, 711 S.E.2d 165 (N.C.App. 2011); *Schwartzwald*, 194 Ohio App. 3d at 644; *U.S. Bank Nat. Ass'n v. Kimball*, 27 A.3d 1087 (Vt. 2011).

20 *In re Miller*, 666 F.3d 1255 (10th Cir. 2012); 450 B.R. at 914; *In re Foreclosure Cases*, 2007 WL 3232430 (N.D.Ohio Oct. 31, 2007); *In re Vargus*, 396 B.R. 511 (Bankr. C. D. Cal. 2008); *Norwood v. Chase Home Finance LLC*, 2011 WL 197874 (W.D.Tex. Jan. 19, 2011); 194 Ohio App.3d at 644; *Manufacturers and Traders Trust Co. v. Figueroa*, 2003 WL 21007266 (Conn. Super. April 22, 2003); 711 S.E.2d at 165; 27 A.3d at 1087 ("It is neither irrational nor wasteful to expect a foreclosing party to actually be in possession of its claimed interest in the note, and to have the proper supporting documentation in hand when filing suit.").

21 666 F.3d at 1255; 450 B.R. at 914; 2007 WL 3232430; *In re Sheridan*, 2009 WL 631355 (Bankr. D. Idaho Mar. 12, 2009) (a moving party which has the burden of proof must make a showing that it is actually a party in interest to the proceedings); *In re Wilhelm*, 407 B.R. 392 (Bankr. D. Idaho 2009); *In re Weisband*, 427 B.R. 13 (Bankr. D.Ariz. 2010); *In re Jacobson,* 402 B.R. 354 (Bankr. W.D.Wash. 2009) (where movants attempted to show that they were a party in interest with a deed rather than a note, but the court held that "[h]aving an assignment of the deed is not sufficient, because the security follows the obligation secured, rather than the other way around." *Id.* at 367 (citations omitted)). *accord* I.C. § 45–911 ("The assignment of a debt secured by mortgage carries with it the security.")

still control, the foreclosure process. Typically, the homeowner who finds himself/herself in financial straits, fails to make the required mortgage payments and faces a foreclosure suit, is not interested in testing state or federal jurisdictional requirements, either *pro se* or through counsel. Their focus is either, "how do I save my home," or "if I have to give it up, I'll simply leave and find somewhere else to live."

In the meantime, the financial institutions or successors/assignees rush to foreclose, obtain a default judgment and then sit on the deed, avoiding responsibility for maintaining the property while reaping the financial benefits of interest running on a judgment. The financial institutions know the law charges the one with title (still the homeowner) with maintaining the property.

There is no doubt every decision made by a financial institution in the foreclosure process is driven by money. And the legal work which flows from winning the financial institution's favor is highly lucrative. There is nothing improper or wrong with financial institutions or law firms making a profit-to the contrary, they should be rewarded for sound business and legal practices. However, unchallenged by underfinanced opponents, the institutions worry less about jurisdictional requirements and more about maximizing returns. Unlike the focus of financial institutions, the federal courts must act as gatekeepers, assuring that only those who meet diversity and standing requirements are allowed to pass through. Counsel for the institutions are not without legal argument to support their position, but their arguments fall woefully short of justifying their premature filings, and utterly fail to satisfy their standing and jurisdictional burdens. The institutions seem to adopt the attitude that since they have been doing this for so long, unchallenged, this practice equates with legal compliance. Finally put to the test, their weak legal arguments compel the Court to stop them at the gate.

The Court will illustrate in simple terms its decision: "Fluidity of the market"-"X" dollars, "contractual arrangements between institutions and counsel"-"X" dollars, "purchasing mortgages in bulk and securitizing"-"X" dollars, "rush to file, slow to record after judgment"-"X" dollars, "the jurisdictional integrity of United States District Court"-"Priceless."[22]

[22] 2007 WL 3232430 at *n. 3, 3.

Nor will a mere *copy* of the note suffice.[23] There could be 100 copies of the original note, but that would not create a right of foreclosure in 100 plaintiffs. To the bank's argument that a copy of the promissory note should be enough, ask any banker if he/she would be willing to accept a copy of *check*.

There are good practical reasons for the possession requirement. If the maker of the note pays a "person not entitled to enforce," he/she is not discharged from liability on the note, and faces the prospect of having to pay the true owner when that person surfaces with proof of ownership of the note (see §§3-601 and 3-602 above).[24] Courts must take special care not to expose the maker to such double liability.

Is the Promissory Note Negotiable?

This is a thorny issue. First of all, as the debtor's attorney, *don't raise the issue yourself*. Why not? Because if the note is not technically "negotiable" under the rigid rules of UCC §3-104 then arguably the Uniform Commercial Code does not apply, and all of the statutory provisions examined above are not the law. Thus the attorney for the foreclosing entity may think of this and want to argue it (on the other hand, most attorneys would rather slaughter hogs than contemplate the elements of negotiability), so what happens if it does comes up?

There have been serious scholarly arguments that most mortgage notes are not technically negotiable.[25] The typical issue concerns what is called the "courier without luggage" requirement: the note must not contain promises or obligations (with certain exceptions) other than a bald promise to pay the debt to the order of a named person or bearer.[26] Pennsylvania's Chief Justice John Gibson once said that a negotiable instrument must be a "courier without luggage."[27] This oft-repeated description means that the instrument must not be

[23] 450 B.R. at 897 (dueling creditors attempting to foreclose each held only a copy of the note, but not the original); *In re Adams*, 204 N.C. App. 318 (2010) (copy of note sufficient as long as possession of the original note is alleged, but if possession challenged it must be proven, along with a valid chain of indorsements to demonstrate proper negotiation).

[24] *See* 255 P.3d at 1275; 204 N.C. App. at 318; ***Error! Main Document Only.****HSBC Bank USA v. Thompson*, 2010 WL 3451130 (Ohio App. Sept. 3, 2012).

[25] *See* Neil Cohen, *The Calamitous Law of Notes*, 68 OHIO ST. L.J. 161 (2007); Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951, 962-985 (1997).

[26] Unif. Commercial Code §§3-104(a)(3) and §3-106.

[27] *Overton v. Tyler*, 3 Pa. 346, 347 (1846).

burdened with anything other than the simple and clean unconditional promise or order; it cannot be made to truck around other legal obligations. If the maker of a note adds any additional promises to it, the note becomes non-negotiable because the prospective holder is then given notice that the note is or may be conditioned on the performance of the other promise. Section 3-104(a)(3) specifies the few additional items that may be mentioned in an instrument without destroying its negotiable character.[28] Since most mortgage notes are cluttered with extraneous promises by the maker, the contention is at these notes are not "negotiable instruments" as that term is defined in the UCC. In the article mentioned in footnote 23, Professor Ronald Mann argues that a promise in the typical mortgage note provides that on electing to make a prepayment, the maker of the note must give a written notice to that effect to the holder of the note. Is this an extraneous promise forbidden in a "negotiable" note? He argues it is, but that seems wrong to me. UCC §3-106(b) allows a references to another document for rights as to prepayment, and while that is not exactly what is happening here, it is an indication that the Code drafters were unconcerned with prepayment issues when it came to negotiability (the reason being that prepayment *aids* the maker, so the rules should be construed to protect that bias). So far the courts have not agreed that such promises destroy negotiability.[29]

Further, what is the harm by so minor a promise, that it should strip away the protection of the only uniform treatment of the law from what all parties intended to be a promissory note? Official Comment 2 to §3-104 states that a major test on whether the parties *intended* to create a negotiable instrument is the inclusion vel non of "order or bearer" language in the note. Since the typical note is payable to the "order" of a named payee, that should settle it that the parties did intend for the UCC to apply to their transaction. The same Official Comment goes on to provide that where the parties intended to create a negotiable instrument but made some minor misstep, Article 3 could be applied by *analogy* (since it is the current best thinking of how instruments should be legally governed—amended most recently in 2002). Courts have been receptive to this analogy argument.[30]

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28 *See also* Unif. Commercial Code §3-106.

29 *See HSBC Bank USA, Nat. Ass'n v. Gouda*, 2010 WL 5128666 (N.J.Super. App. Div. Dec. 17, 2010); *In re Edwards*, 2011 WL 6754073 (Bankr.. E.D.Wis. Dec. 23, 2011).

30 450 B.R. at 897; s*ee also* Fred H. Miller & Alvin C. Harrell, *The Law of Modern Payment Systems* §

Destroying the negotiability of the promissory note is not always a good thing for the foreclosing entity. If the note is not negotiable, then there can no holder in due course of that note who will take free of defenses to the note. Such a status is reserved only for negotiable instruments. A non-negotiable instrument is merely a contract, and like all contracts it travels with its defenses whenever assigned from one entity to another.[31] There is no such thing as a holder in due course of a non-negotiable instrument. This is important to foreclosing entities where the homeowner has defenses to payment that can be asserted in contract actions, but which are not assertable against a holder in due course.[32] Say, for example, that the homeowner was tricked by fraud into signing the mortgage due to extravagant lies told by the lender (which often happened, particularly in the sub-prime market).[33] Such a defense would not be good against a holder in due course, who could foreclose and take the home free of the fraud allegation. This is happening over and over.[34]

Finally, if all else fails and the note is deemed nonnegotiable, then the common law would apply, and the common law routinely required possession of a promissory note before foreclosure could proceed, though that's going to take some library research to prove up state by state.[35]

THE DIFFERENCE BETWEEN THE NOTE AND THE MORTGAGE

Faced with these daunting UCC provisions, but not possessing the original promissory note, some entities foreclosing have turned to the mortgage

1.03(1)(b) (2003).

31 *See* RESTATEMENT (SECOND) OF CONTRACTS §336 (1981) (Defenses Against an Assignee).

32 Per Unif. Commerical Code §3-305, a holder in due course is free of "person" defenses, and only subject to the short list of "real" ones, which do not include common law fraud.

33 Michael W. Hudson, The Monster: *How a Gang of Predatory Lenders and Wall Street Bankers Fleeced America and Spawned a Global Crisis* (Times Books 2012). (This work details how these mortgages came to be).

34 The most egregious case is *Brown v. Carlson*, 26 Mass.L.Rptr. 61 (2009), in which the mortgage fraud was perpetrated on "a retired crossing guard, widowed and in her sixties, with an eighth grade education," who lost her home to a holder in due course. See also *In re Carmichael*, 443 B.R. 698 (Bankr. E.D.Pa. 2011); *In re Dixon-Ford*, 76 UCC Rep.Serv.2d 247 (Wis. Lab. Ind. Rev. Com. Dec. 21, 2011).

35 *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §5.4. For a historical discussion of the reification of the underlying obligation in the physical form of a bill or note, *see* James Steven Rogers, *The End of Negotiable Instruments: Bringing Payment Systems Law Out of the Past* 24 – 39 (Oxford University Press 2011).

contract itself, and tried to use the failure of the home owner to make the payments required by that contract as a ground for the foreclosure. "We can prove that the mortgage was assigned to us, so we'll use it as the grounds for foreclosure," is their mantra. Let's explore why that possibility won't work.

When the purchaser of real property attends the closing and signs paper after paper the three primary legal documents that are involved in a later foreclosure are (1) the promissory note by which the new homeowner, called the maker of the note, promises to pay the lender (the payee) the amount being borrowed to finance the mortgage, (2) the mortgage contract which promises the same thing and has a large number of additional contractual obligations and duties, and (3) the mortgage deed which transfers title to the real estate involved from the homeowner ("mortgagor") to the lending institution ('mortgagee"). The lender keeps the note and the mortgage contract, and files the mortgage deed in the real property records so as to create a lien on the property which must be satisfied before the property could later be transferred to someone else.

"Security Follows the Debt"

The common law was clear that the mortgage contract and the mortgage deed are mere "security" for the payment of the promissory note (the "debt"). It is a common law maxim that "security follows the debt."[36] This means the mortgage travels along with the promissory note, and that the note is the important item, not the mortgage itself. Thus whoever has the promissory note is the only entity that can enforce the mortgage. The courts are more or less unanimous on this.[37] The United States Supreme Court established the basic rule early in the 1873 case of Carpenter v. Longan:[38] "The note and mortgage are inseparable; the former as essential, the latter as an incident. An assignment of the note carries the mortgage with it, while an assignment of the latter alone

[36] *In re Williams*, 395 B.R. 33, 47 (Bankr. S.D. Ohio 2008); *Manufacturers and Traders Trust Co. v. Figueroa*, 2003 WL 21007266 at *2 (Conn. Super. Apr. 22, 2003).

[37] "For nearly a century, Ohio courts have held that whenever a promissory note is secured by a mortgage, the note constitutes the evidence of the debt and the mortgage is a mere incident to the obligation." *U.S. Bank Natl. Assn. v. Marcino*, 181 Ohio App. 3d 328, 337 (7th Dist. 2009) (citing *Edgar v. Haines,* 109 Ohio St. 159, 164 (1923).) "Therefore, the negotiation of a note operates as an equitable assignment of the mortgage, even though the mortgage is not assigned or delivered." *Marcino,*181 Ohio App. 3d at 337.

[38] 83 U.S. 271, 274 (1872).

is a nullity. . . . The mortgage can have no separate existence. When the note is paid the mortgage expires. It cannot survive for a moment the debt which the note represents. This dependent and incidental relation is the controlling consideration . . . ." A purported assignment of a mortgage to a bank is not proof of a transfer of a promissory note secured by the mortgage, since the mortgage follows the note but not vice versa.[39]

Indeed, Article 9 of the Uniform Commercial Code codifies this idea. Section 9-203(g) provides that whoever has a perfected interest in the note automatically has a perfected interest in the underlying mortgage ("security follows the debt"). But Article 9 says nothing about who is entitled to enforce the note when it comes due, which is left to Article 3; thus the plaintiff in the foreclosure must still prove it is a PETE, as that term is defined in Article 3. Moreover, even if §9-203(g) works its magic to transfer the mortgage interest to the possessor of the note, that does not mean that foreclosure can be had without satisfying the court (in judicial foreclosures) that the state foreclosure laws requiring a clear chain of mortgage assignments have been met. In non-judicial foreclosure state, UCC §9-607(b) provides that "if necessary to enable a secured party [including the buyer of a mortgage note] to exercise the right of [its transferor] to enforce a mortgage non-judicially," the secured party may record in the office in which the mortgage is recorded (i) a copy of the security agreement transferring an interest in the note to the secured party and (ii) the secured party's sworn affidavit in recordable form stating that default has occurred and that the secured party is entitled to enforce the mortgage non-judicially.[40] For a complete discussion of these issues, see the UCC's Permanent Editorial Board's official explanation: http://www.ali.org/00021333/PEB%20Report%20-%20November%202011.pdf

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39 *Deutsche Bank Nat. Trust. Co. v. Byrams*, 275 P.3d 129 (Okla. 2012).

40 Various provisions in Article 9, see §§9-203(b), 9-309(3), provide that the creation of a security interest (that is, ownership rights) in a promissory note that is being sold (as opposed to being used as collateral) does not require the buyer of the note to take possession of the note if the sale is made pursuant to an agreement reflected in a writing or other record. Some lawyers seem to think that this gets rid of the need to possess the note for foreclosure purposes. It doesn't, and confuses apples with oranges. The Article 9 rules have nothing to do with the homeowner who is the maker of the promissory note, but apply only to regulate rights between later parties claiming ownership in the note as it passes from one hand to another. The Article 9 rules were written so that the note can be sold by contracts without being physically moved around (thus allowing the note to be warehoused somewhere). That has nothing to do with the Article 3 rules discussed in the body of this law review article. For a complete discussion of these issues, see the UCC's Permanent Editorial Board's official explanation: http://www.ali.org/00021333/PEB%20Report%20-%20November%202011.pdf.

There has been an attack on this concept recently in a way that might aid homeowners. In U.S. Bank v. Ibanez,[41] handed down on January 7, 2011, the Massachusetts Supreme Judicial Court ruled that a mortgage cannot be assigned in blank (a common practice in the securitization of mortgages), so that the holder of a blank mortgage assignment was not the proper entity to foreclose. “We have long held that a conveyance of real property, such as a mortgage, that does not name the assignee conveys nothing and is void,” the court said. When the assignee argued that it held the promissory note, which automatically gave it the appropriate ownership interest in the mortgage ("security follows the debt"), the court disagreed, saying that a more formal assignment of the mortgage was necessary for a clear real estate title. “In Massachusetts, where a note has been assigned but there is no written assignment of the mortgage underlying the note, the assignment of the note does not carry with it the assignment of the mortgage.” The court then added that a holder of the note could file a lawsuit to obtain the mortgage. Without a properly assigned mortgage the mortgage holder remains unchanged, which is why the banks lacked the power to foreclose. The court refused to apply its decision only to future cases, thus creating a legal mess in Massachusetts that could undo foreclosures held years ago. Bank stocks fell instantly. The Massachusetts Supreme Judicial Court did not consider the effect of UCC §9-203(g), which clearly states that possession of the promissory note automatically creates a security interest in the mortgage even without a formal assignment of same. Why didn't the court discuss this very relevant statute? My guess is that no one (not the parties, not the law clerks, not the judges) came across it in preparing the case or the decision (so here the UCC law professor emits a sad sigh). The obligation giving rise to the mortgage is reified in the promissory note, and only the current possessor of the promissory note can bring suit thereon (regardless of who is the assignee of the mortgage).

Interestingly, in Utah some homeowners have been successful in bringing quiet title actions to strip off the mortgage where no entity can prove a valid chain of assignments of the mortgage. Doing that would rid the property of the mortgage lien and permit subsequent sale, though it would not excuse the mortgagor's liability on the promissory note should it finally surface in the hands of a PETE.

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[41] *U.S. Bank Nat. Assn. v. Ibanez*, 458 Mass. 637 (2011); *see also* http://www.businessweek.com/news/2011-01-08/massachusetts-top-court-hands-foreclosure-loss-to-u-s-bancorp.html. (last accessed Jan. 8, 2011)

The Merger Rule

It has always been a basic rule of negotiable instruments law that once a promissory note is given for an underlying obligation (like the mortgage contract), the underlying obligation is merged into the note and is suspended while the note is still outstanding. Discharge on the note would (due to the rule that the two are merged) result in discharge of the underlying obligation. This makes sense: paying the note would also pay the obligation. Because of the merger rule, the underlying obligation is not available as a separate cause of action until the note is dishonored.

This merger rules, with its suspension of the underlying obligation until dishonor of the note, is codified in §3-310(b) of the UCC:

> (b) Unless otherwise agreed and except as provided in subsection (a), if a note or an uncertified check is taken for an obligation, the obligation is suspended to the same extent the obligation would be discharged if an amount of money equal to the amount of the instrument were taken, and the following rules apply:
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> * * *
>
> (2) In the case of a note, suspension of the obligation continues until dishonor of the note or until it is paid. Payment of the note results in discharge of the obligation to the extent of the payment.

Thus until the note is dishonored there can be no default on the underlying obligation (the mortgage contract). All foreclosure statutes, whether permitting self-help or requiring the involvement of a court, forbid foreclosure unless the underlying debt is in "default." That means that the maker of the promissory note must have failed to make the payments required by the note itself, and thus the note has been dishonored. Under UCC §3-502(a)(3) a promissory note is dishonored when the maker does not pay it when the note first becomes payable.[42]

[42] The Code's dishonor rules do not create a right of physical "presentment" of the note, but §3-501 does create such a right if the maker so demands. Section 3-501(a) defines “presentment” as a demand to pay the instrument made by a “person entitled to enforce an instrument” [the PETE], and

However, as discussed above, the promissory note itself is owed to a PETE, and only that person can show that the debt was not paid when due, thus creating a "dishonor" and severing the note from the underlying mortgage obligation, so as to permit foreclosure under the latter theory. Both the Official Comments to §§3-502 and to 3-310 make it clear that a dishonor can only occur if the person who wishes to sue is a "holder," i.e., someone in possession of the instrument. Official Comment 3 to §3-502 states "This [section] allows holders to collect notes in ways that make commercial sense without having to be concerned about a formal presentment on a given day," and Official Comment 3 to §3-310 explains: "If the check or note is dishonored, the [other party] may sue on either the dishonored instrument or [the underlying contract] if [that person is in] *possession* of the dishonored instrument and is the *person entitled to enforce* it" (emphasis added).

Putting this altogether, were I a mortgagor's attorney, on getting notice of the intent to foreclose, I would demand that my client be presented with the original promissory note and that the note was is the hands of a PETE when failure to pay the note occurred.[43] Failing that the mortgagor is not in default since he/she has not dishonored the note. Until that happens, §3-310 *suspends the entire mortgage obligation*. The contractual obligation to pay has merged into the note, and until the note is dishonored it's unavailable as a separate cause of action. Thus if the entity trying to foreclose cannot produce the promissory note, it cannot prove that payment was not made to the PETE, meaning that no "dishonor" of the note has occurred under 3-502, and thus the underlying mortgage obligation is still merged into the note.

There are some federal cases supposedly applying California law which state that production of the original promissory note is not required in California since it is not mentioned in the comprehensive California statute

under subsection (b)(2) adds that "Upon demand of the person to whom presentment is made, the person making presentment must (1) exhibit the instrument" [emphasis added]. Most promissory note have a standard clause *waiving* the right of presentment, and that would be effective to obviate the effect of a demand under §3-501—which is why this discussion of "presentment" is relegated to a mere footnote.

43 If the foreclosing bank says that the original promissory note had a clause waiving the right of presentment, I would demand to see the note as proof of that assertion. If the foreclosing entity cannot produce the original promissory note, how do we know what it says? Even if the court is convinced that the right of presentment was waived, that does not have anything to do with the other requirement of *dishonor* of the note in the hands of a *PETE*. Until such a dishonor occurs per §3-502, the underlying obligation is still suspended as an independent cause of action.

detailing foreclosure procedure in this non-judicial foreclosure state[44] (there are federal California decisions to the contrary[45]). I looked up the California foreclosure statute. Cal.Civ.Code §2924(a) clearly states that the power of foreclosure is "to be exercised after a breach of the obligation for which that mortgage or transfer is a security." If no dishonor of the note has occurred then there has not yet been such a breach, and the California statute would not permit foreclosure. The obligation in the statute is either the obligation of the maker of the promissory note (UCC §3-412), which obligation only runs to a PETE, or the mortgage obligation which is suspended as a cause of action per §3-310 until dishonor of the note in the hands of the PETE. Either way there is no "breach of the obligation for which the mortgage or transfer is a security" without the original promissory note being involved.[46]

Arizona has a similar dismal history with this issue, where once again some federal courts have misconstrued Arizona's foreclosure statute so as to permit foreclosure without production of the promissory note.[47] The Arizona Supreme Court has recently adopted this line of reasoning. In the *Hogan v. Washington Mutual Bank*, 277 P.3d. 781 (Ariz. 2012), the Arizona Supreme Court held that the Arizona statute allowing non-judicial foreclosure of a deed of trust does not require the foreclosing entity to “show the note.” The decision contains one mistake after another in the court’s reading of the Uniform Commercial Code. The court separates the note from the mortgage, in violation of the “security follows the debt” rules carefully codified in Article 9, and then casually states that the Uniform Commercial Code does not apply to real property liens. The latter statement is just plain wrong. Article 3 of the Code on Negotiable Instruments applies to all notes, including those generated by the creation of a mortgage lien,[48] and Article 9 then applies the “security follows the debt” rules

[44] *See Tina v. Countrywide Home Loans, Inc.*, 2008 WL 4790906 (S.D. Cal. Oct. 30, 2008); *Castaneda v. Saxon Mortg. Serv., Inc.*, 687 F.Supp.2d 1191 (E.D. Cal. 2009). Interestingly, I can find no state cases from California agreeing with this federal analysis of the California foreclosure statute.

[45] *See e.g., In re Doble*, 2011 WL 1465559 (Bankr. S.D. Cal. Apr. 14, 2011).

[46] In any event, the California statutes do not allow the wrong party to foreclose, so someone attempting to do so must establish PETE status (thus having standing to sue), and that, as we've seen from the discussion of the merger rule, requires dishonor of the note. There are California bankruptcy decisions so saying; *See Id.*

[47] *See, e.g., Diessner v. Mortg. Elec. Registration Sys.*, 618 F.Supp.2d 1184 (D. Ariz. 2009); *Mansour v. Cal-Western Reconveyance Corp.*, 618 F.Supp.2d 1178 (D. Ariz. 2009). Happily the more recent decision by the 9th Circuit Bankruptcy Appellate Panel gets it right in *In re Veal*, 450 B.R. 897 (Bankr. App. 9th Cir. 2011) (Arizona law does not allow foreclosure without production of the original promissory note).

[48] See, for example, Official Comment 7 to §3-605 noting that that section applies “whether the collateral is personalty or realty, whenever the obligation is in the form of a negotiable instrument.”

to such notes.[49] The Arizona Supreme Court pays no attention at all to the merger rule of §3-310, which would prevent any foreclosure on the mortgage debt until the note itself has been dishonored. The court offered a policy reason for its decision: "Requiring the beneficiary to prove ownership of a note to defaulting trustors before instituting non-judicial foreclosure proceedings might again make the "mortgage foreclosure process ... time-consuming and expensive," . . . and re-inject litigation, with its attendant cost and delay, into the process." That may be true, but it does not justify ignoring statutes enacted by the Arizona legislature that clearly call for a different result. Arizona Revised Statutes §33-807 permits a foreclosure sale "after a breach or default in performance of the contract or contracts, for which the trust property is conveyed as security, or a breach or default of the trust deed." As above, no such breach or default can exist until there is a failure to pay the promissory note in the hands of a PETE.[50]

HOW TO RESOLVE THESE MATTERS

There are substantial equities in favor of the foreclosing party, and judges should work hard to preserve these equities. The debtor did take out the mortgage and sign the promissory note promising to pay off the mortgage amount, and, on failing to do so, must surrender the real property that is the security for this debt. Further, the foreclosing entity has paid good money for the right to foreclose, and this investment must be protected. The bank that is foreclosing may protest that if some technicality (i.e., the rules that are explained in this article) forbids foreclosure the homeowner might escape from having to pay anyone the mortgage debt, but still retain possession of the mortgaged property.

Of course these equities presume that the foreclosing entity really is the owner of the debt and can prove it according the standard rules of law, and that the debt truly is in default. At the symposium presentations that resulted in this issue of the law review, one of the attorneys in the audience came to the microphone with a horror story about a client who had missed some payments

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49 See §9-203(g).

50 *Compare Ernestberg v. Mortg Investors Group*, 2009 WL 160241 (D. Nev. Jan. 22, 2009), *with* the relevant Nevada foreclosure statute, which only allows foreclosure "after a breach of the obligation for which the transfer is security" [N.R.S. 107.080].

but then, faced with foreclosure, worked out a repayment agreement with the current holder of the mortgage, never missed a payment, but was considerably surprised one day to have the doorbell ring and be faced with the "new owner" of his property which had been purchased at a California non-judicial sale of which the current owner was unaware. Many homeowners are caught in a trap whereby one part of the foreclosing bank is engaged in working out an agreement to save the property, while the other is sending out a foreclosure notice. Basic rules of contract and estoppel can lead a court of equity to refuse foreclosure in these situations.[51]

If a court rules that the bank can't foreclose, does that mean that the home owner gets away without paying the mortgage? Not quite. The mortgage deed is still filed in the real property records, and unless it's removed the property can *never* be sold, not even if the home owner dies and the heirs want to dump it. The home remains collateral for the debt, and that won't go away until the mortgagee agrees to remove it from the records. Thus the homeowner has an interest in working things out with the entity threatening to foreclose.

If the foreclosing bank cannot prove valid ownership and hence is forbidden the possibility of foreclosure, the only remedy left for the bank is to pass liability back to the entity from which the obligation was purchased, and so on until we find a person who really is entitled to enforce. The common law creates a warranty from the assignor to the assignee that the obligation assigned exists and is subject to no defenses,[52] and this is the remedy the disappointed assignee should seek if it is not a PETE. If the chain of transactions cannot be undone (the records are lost, a major player has ceased to exist, or whatever), well, life is hard and sometimes you purchase a worthless asset. You certainly shouldn't buy something unless your seller can prove good title.

If the foreclosing bank wins the lawsuit but doesn't have proper documentation, any *subsequent* sale of the property foreclosed upon is going to be problematic and risky for the new purchaser (and this should be pointed out to judges before they rule). Issues like this present new difficulties. Consider title insurance companies. At all real estate closings the buyer has to pay for such insurance, but it's not common for title insurance companies to actually have to pay off; the title normally is flawless. But if judges start invalidating foreclosures and ruling that the house belongs to the original owner, buyers of

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51 *See PHH Mortg. Corp. v. Barker*, 190 Ohio App.3d 71 (2010).

52 *See* RESTATEMENT (SECOND) OF CONTRACTS §333(b) (1981).

foreclosure homes are going to be filing claims. Title insurance companies might have to pay out millions, leading them to raise rates, cut down policies, layoff employees, or declare bankruptcy. Certainly no respectable title insurance company is going to issue a policy for the resale of a foreclosed-upon home where there are legal issues about missing notes or improper documentation in the foreclosure proceeding, and, without title insurance available, what will the foreclosing bank do with an unsalable property?[53]

If the client wants to pay the mortgage debt, but is leery of paying the wrong entity, he/she should pay the debt into an escrow account and advise the putative assignee of the mortgage that the amount deposited will be available on production of the promissory note or the signing of an indemnity agreement. Such a deposit would be the equivalent of tender of the amount due, so as to avoid late charges. The amount could also be paid into court in an interpleader action in appropriate circumstances.

The true solution to the mortgage mess that results from missing notes, inadequate documentation of mortgage assignment, confusion at the bank, and robo-signing of required affidavits, is for the foreclosing entity to make sure it has the proper documentation *before* it files the foreclosure, and to have contacted the debtor before foreclosing to see if (a) the debt is really in default, (b) there are no defenses to foreclosure (such as an existing workout arrangement), (c) the debtor can pay the debt without the necessity of foreclosure), or (d) some option to foreclosing exists. The banks are overwhelmed by the ownership of worthless homes on which they have foreclosed. In truth it would be smarter for the foreclosing banks to put their money into creating a negotiation program that takes troubled transactions and works them out by mutual agreement with the home owner, so that the title can be cleared and the property resold. These negotiations might include a voluntary waiver of the home owner's rights in return for forgiveness of the mortgage debt, or renegotiated payments on the mortgage, or whatever the parties can construct as a compromise. With all of the above defenses on the

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[53] Sometimes, faced with such ownership, the foreclosing entity will conduct the sale, but never record its deed, thus leaving the now-homeless former owner with continued liability for taxes and other major expenses. Since he/she can't afford these, the properties just deteriorate further. Urban blight is already a major problem in many communities, even upscale ones, as house after house sits abandoned, leading to dropping real estate value of others, and a vicious cycle of neighborly collapse. What do municipalities do about the resulting crime, fire hazards, disease, etc.? They can’t raise taxes in today’s economy. Chapter Nine of the United States Bankruptcy Code provides for municipal bankruptcies, but we never teach those rules in law school because actual cases were rare in the past.

table, the home owner has some leverage to make the bank listen to his/her concerns and not just steamroller over them in the rush to foreclose. Judges faced with foreclosing entities that do not have the original promissory note should at least use the mechanism for lost notes described above and require the foreclosing entity to post bond protecting the homeowner form later claimants to the property who do possess the original note.

There are tons of unintended consequences from the current procedures. If you are a respectable bank official caught up in all this, how many new mortgages would you be willing to make to people who are not already well off? Then, without readily available mortgage loans, what will happen to the whole idea of home ownership? Or the ability to move to take a job in another town? Or the economy? Or the American Dream of a better life than one's parents? If you are a consumer considering buying a new home, think again. Doing so can be asking for trouble even if you can afford to pay cash—will the neighborhood self-destruct? Could you sell it if you want to? How good is the title on this new property?

For troublesome transactions (the paperwork is a mess, the note is missing, the home owner alleges he/she has defenses) it's time to sit everybody around a table and work out a satisfactory solution through negotiation. Judges might well order this. All involved need a resolution that will end in a resumption of the payments, or an agreed-upon foreclosure with indemnities to the home owner against future troubles (say from the real owner of the original promissory note), or some contractual arrangement that ends up with a salable property in the local community.

CONCLUSION

This article has not gotten into a host of other issues affecting mortgage foreclosures, and those matters must be dealt with elsewhere. Here is a brief list of some legal difficulties: proof the assignment of the mortgage,[54] robo-signing and foreclosure mills,[55] proof of business records establishing the right

[54] The assignment itself may have difficulties with a chain of title, and that should be investigated with vigor. The leading case requiring a clear chain of title in assignments is *U.S. Bank Nat. Assn. v. Ibanez*, 458 Mass. 637 (2011).

[55] Affidavits of those filing foreclosure actions that the debts have been reviewed and verified must, of course, be true. In the foreclosure mills these swearings are often pro forma and, due to the volume involved, frankly impossible, being done by humans acting like robots. Where this can be proven, the

to foreclose,[56] and fraud.[57] The footnotes give some guidance to these difficulties, which have little or nothing to do with the Uniform Commercial Code.

The truth is that the current lending mess was sloppily run for years, with greed as the fuel, and no one paid any attention to details, and increasingly complex transactions led to the loss of a paper trail. But now the orgy has ended with major hangovers for the participants who paid no attention to the basic rules. The borrowers (who also have had to battle this problem at their end, when they can't figure out who is the proper party to negotiate with over repayment issues or settlement discussions), have done nothing wrong. They do

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lawsuit should be dismissed, and, indeed, massive publicity over this practice led to the suspension of many foreclosures nationwide in 2010. Notary stamps are required on assignments in many states or the assignment is invalid, and if the evidence demonstrates the stamp was added much later, that is fraud [see http://4closurefraud.org/2010/08/04/mother-jones-andy-kroll-exclusive-fannie-and-freddies-foreclosure-barons/]. Indeed there is out and out fraud in many foreclosures as phony documents are created, signatures forged, false affidavits of lost instruments sworn to, and newly “discovered” allonges solve negotiation difficulties. If the lawsuit was filed by someone who didn’t have standing and the attorney who filed it should have known that, he/she should be reported to the bar association, and the misfiling should also be called to the judge’s attention as a reason to dismiss. This is also criminal conduct, of course, and should be prosecuted, including as a defendant any attorney participating in deception of the court. Recently the Florida courts have become disgusted by improper documentation and have insisted upon it, causing major foreclosures to be abandoned and the courts to strip the properties from their mortgages (!): *See* http://www.squattable.com/news/040311/foreclosure-crisis-fed-judges-dismissing-cases-giving-homes-back-homeowners-and-boldly-a. On April 6, 2011, the Ohio Supreme Court dismissed a complaint filed by lawyers against three trial court judges who recently began requiring lawyers to personally verify the authenticity of all documents used in foreclosures. The judges have refused to grant summary or default judgments without such certification, though a trial can still go forward. The attorneys are not happy.

56 Assignees are required to prove up the business records that are the basis of the assignment, and such evidence is an exception to the hearsay rule only where the person proffering the business records can testify to their authenticity. Assignees to whom such records are transferred in the ordinary course of business do not have the requisite personal knowledge of the records creation and preservation, and hence cannot so testify to their validity. This rule of evidence can be a major stumbling block to foreclosure actions and other collection efforts. *See Asset Acceptance v. Lodge*, 325 S.W.3d 525 (Mo. App. E. Dist. 2010); *Chase Bank USA, N.A. v. Herskovits*, 28 Misc. 3d 1202(A) (table), 2010 WL 2598198 (N.Y. Civ. Ct. 2010); *DNS Eq. Group, Inc. v. Lavallee*, 907 N.Y.S.2d 436 (table), 2010 WL 682466 (N.Y. Dist. Ct. 2010); *Palisades Collection LLC v. Kalal*, 781 N.W.2d 503 (Wis. App. 2010); *Riddle v. Unifund CCR Partners*, 298 S.W.3d 780 (Tex.App.—El Paso 2009); *Unifund CCR Partners v. Bonfigil*, 2010 Vt. Super. LEXIS 24 (Vt. Super. Ct. May 5, 2010); *but see Simien v. Unifund CCR Partners*, 321 S.W.3d 235 (Tex. App. –Hous. [1st Dist.] 2010).

57 Outside of the UCC, attorneys should consider filing a lawsuit charging fraud (misrepresentation of a material fact made with knowledge of its falsity or a reckless disregard of its truth, on which there was justifiable reliance causing damages) if it’s indeed present and you can be proven. Fraud is the civil action for lying, an ugly thing to charge someone with, creating great headlines for the media. If fraud has been at work, well, that's good news for the plaintiff in a lawsuit. The common law maxim is that “fraud vitiates all transactions,” so that nothing can hide fraud. Those guilty of fraud cannot sue on the contract, which is now void for "illegality"(as that word is used in the law of contracts: void as a matter of public policy), and punitive damages, including attorney’s fees are also a possibility. Nor is unjust enrichment in favor of the evil-doer a possibility since guilty parties to an illegal contract lose all rights to sue on any theory—they are truly “outlaws” in the literal meaning of that term.

owe the debt and the house is still the collateral, so they are not off the hook at all. But the courts won't let someone foreclose just because that someone thinks they are the right entity to do it, or *really, really, really* wants to foreclose. They have to prove they are a PETE by clear evidence. Wishing that they had that evidence is not enough. Indeed, as discussed above, if the buyer pays the wrong person, he/she still owes the debt.[58]

The UCC rules are not just fusty technicalities. They reflect common sense: you can't sue or foreclose unless you can prove you are entitled to sue or foreclose. What could be more basic in our law than that idea? I tell the Legal Aid lawyers who call me that if the trial judge hates the UCC and wants to duck all of this, remind him/her that it is the statutory law of this jurisdiction (indeed, all jurisdictions in the USA have identical UCC provisions to those quoted above). And, as explained above, the common law is no different from the UCC, so dodging the UCC does not help the plaintiff trying to foreclose without having possession of the note.

When the consumer agrees to buys a new home and goes to the closing, the lending bank overwhelms the new homeowner with legal paper, after legal paper, after legal paper which the borrower must sign or the loan will not go through. At this end of the transaction the bank is very careful to make sure everything is in apple pie order and that every "i" is dotted and every "t" is crossed. Call me a madcap fool if you will, but I think that at the other end of the transaction when banks are attempting to take someone's home, they ought to be required to follow the law then too. As the Third Circuit has commented in a case where the foreclosing bank could not produce the necessary proof, "Financial institutions, noted for insisting on their customers' compliance with numerous ritualistic formalities, are not sympathetic petitioners in urging relaxation of an elementary business practice."[59]

58 Unif. Commercial Code § 3-602.
59 853 F.2d at 169.