



# ALBANY LAW SCHOOL

## **Uneasy Intersections: The Right to Foreclose and the UCC**

**Elizabeth Renuart**  
*Associate Professor of Law*

Email: [erenu@albanylaw.edu](mailto:erenu@albanylaw.edu)

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**ABSTRACT**

*Historically, the practice of real property and foreclosure law was routine and noncontroversial. This legal landscape significantly altered during the spectacular growth of securitization deals involving trillions of dollars of residential mortgage loans. The National Conference of Commissioners on Uniform State Laws (NCCUSL) was a driving force behind one of these changes. It adopted amendments to Article 9 of the Uniform Commercial Code in 1998, at least in part, to facilitate securitization. These modifications included extending coverage to the sale of (not merely to a security interest in) promissory notes, declaring that the sale of the note also constitutes a sale of the mortgage without the need for a written assignment of the mortgage, and providing for automatic perfection of interests in both the note and the accompanying mortgage without the need to file.*

*Meanwhile, the behavior of a number of mortgage lending and securitization participants or their agents generated additional legal complications. Examples include the mishandling of loan notes and mortgages, the forging of indorsements or the submitting of fraudulent affidavits to courts in support of their purported right to foreclose, and the pressing of foreclosures without the necessary documentation.*

*Confusion about the roles of and intersections among Articles 3 and 9 of the UCC and the right to foreclose under state real property law followed in the wake of these changes. These misunderstandings spawned volumes of judicial rulings, many of which appear to be at odds with each other. In an effort to reduce the ensuing legal confusion about the intersections between the right to foreclose and the UCC, this Article provides a roadmap of the relevant rules in Articles 3 and 9 and the right to foreclose in state real property law. Further, it explores the tension developing over the last decade among Articles 3, 9, and the right-to-foreclose concept in state real property law.*

*This Article advances the literature concerned with the right to foreclose by categorizing recent state appellate court decisions that address this right by the type of analysis applied by those courts. The rulings from Arizona, California, and Georgia fall into one category and are the subject of special scrutiny because they dismiss the role of the UCC outright. Moreover, these three states have experienced some of the worst foreclosure rates in the nation and permit foreclosures to proceed nonjudicially. Hence, these decisions will affect a broad swath of homeowners in danger of losing their homes. The Article then applies statutory construction principles to determine whether those courts ruled out the UCC unnecessarily, proffering that foreclosure laws in those states could be harmonized with the UCC.*

*Finally, the Article concludes that where inconsistencies arise between the UCC and state real property law, applying statutory construction principles likely will result in creating a more uniform legal landscape throughout the nation, in protecting homeowners from unjustified foreclosures, and in reducing litigation costs and judicial resources in a distraught foreclosure system.*

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**UNEASY INTERSECTIONS:  
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*Elizabeth Renuart*<sup>1</sup>

**INTRODUCTION**

Historically, the practice of real property and foreclosure law was routine and noncontroversial.<sup>2</sup> Bank lawyers had little difficulty complying with the relatively simple and clear rules established in Article 3 of the Uniform Commercial Code (UCC) and state foreclosure law when proving their clients' rights to foreclose upon mortgages securing promissory notes.<sup>3</sup> This legal landscape significantly altered during the spectacular growth of securitization deals involving trillions of dollars of mortgage loans, a noteworthy percentage of which later tanked and triggered the foreclosure crisis.<sup>4</sup>

The National Conference of Commissioners on Uniform State Laws (NCCUSL) was a driving force behind one of these changes. It adopted amendments to Article 9 of the Uniform Commercial Code in 1998, at least in part, to facilitate securitization. These

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<sup>1</sup> Associate Professor of Law, Albany Law School. © Elizabeth Renuart. No part of this article may be reproduced without the express written consent of the author. I thank Frank Alexander, Thomas Cox, and Cathy Mansfield for sharing their expertise and providing insightful comments. Brian Zucco provided invaluable research assistance on this project. Any mistakes and errors are my own. The article's title was influenced by Adam Levitin's use of "uneasy coexistence" when referring to the relationship between Article 3 and land recordation systems in his article cited in note 20 below.

<sup>2</sup> Email from Thomas A. Cox (July 31, 2013) (on file with author) (confirming that it was the expectation of attorneys representing banks, as he did, that the foreclosing party have possession of the original note and be able to present it and all indorsements to the court at the time judgment was sought); *FDIC v. Bandon Associates*, 780 F. Supp. 60, 63 (D. Me. 1991) (noting the rule that possession and production of a validly executed note in a foreclosure action is necessary).

<sup>3</sup> 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, 22 (2013) (noting the absence of appellate decisions during that time and stating: "[M]ost lawyers familiar with the process of mortgage foreclosure in the United States would probably had regarded it as a satisfactory, if not somewhat dull, area of law. Foreclosures did not generate much appellate litigation, and those few lawyers who specialized in the field, mostly representing lenders, had little difficulty getting the results they needed from the mechanisms of foreclosure."); Deborah L. Thorne & Ethel Hong Badawi, *Does the Mortgage Follow the Note?*, Am. Bankr. L.J. 54 (May, 2011) (observing that the foreclosure requirements seemed "so simple, so black and white").

<sup>4</sup> Securitization is the process of utilizing mortgage loans to back investment instruments,

modifications include extending coverage to the sale of (not merely to a security interest in) promissory notes, declaring that the sale of the note also constitutes a sale of the mortgage without the need for a written assignment of the mortgage, and providing for automatic perfection of interests in both the note and the accompanying mortgage without the need to file.

The behavior of a number of mortgage lending and securitization participants or their agents generated additional legal complications in several ways. First, they often mishandled the loan notes and mortgages raising serious concerns about who possesses the right to foreclose, an issue under scrutiny in courts throughout the nation. Second, in order to fix document problems, some foreclosing parties (usually the trustee identified in the securitization contract) or their agents resorted to forging indorsements or submitting fraudulent affidavits to courts. Third, in nonjudicial foreclosure states, where forced sales proceed without judicial oversight, trustees pressed on without the necessary documentation until faced with homeowner objections. When called upon to account for the note and mortgage, the refrain presented to the courts was: “Judge, you just don’t understand how things work,” equating industry practices with legal compliance.<sup>5</sup> Finally, written arguments filed by some foreclosing parties obfuscate the rules found in the UCC and foreclosure law.<sup>6</sup>

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<sup>5</sup> *In re* Foreclosure Cases, No. 1:07CV2282, 2007 WL 3232430, at \*3 n.3 (N.D. Ohio Oct. 31, 2007).

<sup>6</sup> *E.g.*, Brief of Appellee at 10, Mortgage Elec. Registration Sys., Inc. v. Saunders, No. CUM-09-640 (Me. April 26, 2010) (trying to fit MERS into the definition of a person entitled to enforce in UCC § 3-301 by arguing that § 3-301 includes, in effect, an additional subsection covering a person who is not the owner of the instrument or is in wrongful possession of the instrument, such as a person who obtained enforcement authority by contract or through agency principles); Reply Brief of Appellant at 7, Mortgage Elec. Registration Sys., Inc v. Saunders, No. CUM-09-640 (March 8, 2010) (noting that the Appellee created a “fictitious” subsection and, in doing so, misread Maine’s UCC; discussing why MERS does not meet any of the criteria that would enable it to enforce the note). The court agreed with the Appellant, ruling that MERS did not qualify under any of the three subsections in UCC § 3-301 because MERS produced no evidence that it held the note, was in possession of it, or that the note was lost, stolen, and

Confusion about the roles of and intersections between Articles 3 and 9 of the UCC and the right to foreclose under state real property law followed in the wake of these changes. These misunderstandings spawned volumes of judicial rulings, many of which appear to be at odds with each other. Absent a careful assessment of the analysis used by the courts in these cases, the path through the thicket of rulings is unclear. The possibility of unnecessarily inconsistent outcomes is real and harmful to both the homeowners, litigants, and the integrity of the legal system.

In an effort to reduce the ensuing legal confusion about the intersections between the right to foreclose and the UCC, this Article provides a roadmap of the relevant rules in Articles 3 and 9 and the right to foreclose in state real property law. Further, it explores the tension developing over the last decade among Articles 3, 9, and the right-to-foreclose concept in state real property law. For the first time, recent state appellate court decisions addressing the right to foreclose are grouped together by the type of analysis applied by those courts. The Article highlights the decisions that fall into one category, those from Arizona, California, and Georgia, because these rulings dismiss the role of the UCC outright. In addition, these states have experienced some of the worst foreclosure rates in the nation and permit foreclosures to proceed nonjudicially. Hence, the

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destroyed. *Mortgage Elec. Registration Sys., Inc. v. Saunders*, 2 A.3d 289, 296 (Me. 2010). MERS is a controversial player utilized in many securitizations. The Mortgage Banker Association member companies created MERS in 1995 to operate a computer database on behalf of its members to track servicing and ownership rights in mortgages originated anywhere in the United States. A full discussion of MERS is beyond the scope of this article. Suffice it to say that the mere presence of MERS in a mortgage loan transaction increases the likelihood of legal challenges to the authority to foreclose and, potentially, to title to real property throughout the United States. *Culhane v. Aurora Loan Servs.*, 826 F. Supp. 2d 351, 360 (D. Mass. 2011) (“Nationwide, courts are grappling with challenges to MERS’s power to assign mortgages as well as its practice of deputizing employees of other companies to make assignments on its behalf.”). For a few of the many articles identifying the issues raised by the use of MERS in mortgages, see Donald J. Kochan, *Certainty of Title: Perspectives After the Mortgage Foreclosure Crisis on the Essential Role of Effective Recording Systems*, 66 Ark. L. Rev. 267 284-296 (2013); David E. Woolley & Lisa D. Herzog, *MERS: The Unreported Effects of Lost Chain of Title on Real Property Owners*, 8 Hastings Bus. L.J. 365 (2012); Christopher L. Peterson, *Two Faces: Demystifying the Mortgage Electronic Registration System’s Land Title Theory*, 53 WM. & MARY L. REV. 111 (2011).

consequences of these opinions affect a broad swath of homeowners in danger of losing their homes. The Article then applies statutory construction principles to determine whether those courts ruled out the UCC unnecessarily, concluding that foreclosure laws in those states could be harmonized with the UCC.

The Article begins by summarizing the evidence of document mishandling followed by a discussion of why the right-to-foreclose rules matter in Parts I and II. Part III details the enforcement rules governing negotiable and nonnegotiable loan notes, the respective roles of Articles 3 and 9 of the UCC in this context, the distinctions between the concepts of right to enforce and ownership, and enforcement obstacles reflected in judicial decisions. Part IV outlines the contours of the common law right to foreclose, as amended in some state statutes, and describes the differences between the foreclosure regimes in judicial and in nonjudicial foreclosure states. Next, this Part identifies the connections between the UCC and the right to foreclose. Finally, it places state appellate court decisions that define the right to foreclose into analytical groupings. Part V presents a guide to applicable statutory construction principles and applies them to the decisions released by Arizona, California, and Georgia appellate courts addressing the right to foreclose. Finally, the Article concludes that where inconsistencies arise between the UCC and state real property law, applying statutory construction principles likely will result in creating a more uniform legal landscape throughout the nation, in protecting homeowners from unjustified foreclosures, and in reducing litigation costs and judicial resources in a distraught foreclosure system.

## **I. SHODDY DOCUMENT HANDLING**

The crisis that severely weakened the economic security of the United States and millions of its residents over the last six years began when large numbers of homeowners defaulted on poorly underwritten subprime mortgage loans. The ensuing flood of foreclosures displaced millions of homeowners, promoted neighborhood blight, drove down housing prices, and sparked a severe recession.<sup>7</sup> A less publicized result is the failure to comply with the legal rules governing the transfer of mortgage loans.

Securitization contributed to this problem for two reasons: first, investors drove loan originations due to their demand for mortgage-backed securities, thus ramping up the origination (and paperwork) frenzy;<sup>8</sup> and, second, complex securitization deals required the physical transfer of the notes and mortgages among several different players, thus increasing the likelihood of transfer glitches.<sup>9</sup>

A detailed catalog of instances of negligent and intentional mishandling of these documents is beyond the scope of this article. The following summary is derived from numerous sources. The evidence reveals: the failure to deliver the original notes with

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<sup>7</sup> Mort. Bankers Ass'n, National Delinquency Survey Q2 (2011) (reporting that almost 3.5 million loans were seriously delinquent); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-433, MORTGAGE FORECLOSURES: DOCUMENTATION PROBLEMS REVEAL NEED FOR ONGOING REGULATORY OVERSIGHT 1, 41-42 (2011), available at [http://www.gao.gov/new\\_items/d11433.pdf](http://www.gao.gov/new_items/d11433.pdf) (describing the effect of foreclosures on communities, local governments, and the national economy).

<sup>8</sup> *Subprime Lending and Securitization and Government-Sponsored Enterprises (GSEs): Hearing before the Financial Crisis Inquiry Commission* 2-3 (April 7, 2010) (statement of Richard Bitner, Managing Director of Housingwire.com, <http://fcic.law.stanford.edu/hearings/testimony/subprime-lending-and-securitization-and-enterprises> (describing the “originate-to-distribute” model of lending and how securitization created a “renewable source of capital”); Douglas J. Whaley, *Mortgage Foreclosures, Promissory Notes, and the Uniform Commercial Code*, 39 W. State U.L. Rev. 313, 315 (2012) (describing the careless handling and sometimes intentional mistreatment of the promissory notes and opining that the collapse of the housing market was a direct consequence of “greedy and unwise business practices.”).

<sup>9</sup> Securitization deals usually require the transfer and sale of the notes and mortgages from the lender to a sponsor, seller, or arranger that in turn passes the documents to a depositor. The depositor transfers the documents to a special purpose vehicle (SPV), usually a trust that holds the loans for the benefit of the investors. Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 13-14 (2011). Additional moves occur when, for example, the lender obtains the mortgage loans from affiliates. *Id.* In the context of a securitization deal, this contract often is embodied in either a mortgage loan purchase and sale agreement or a pooling and servicing agreement depending on which parties to the securitization are transferring and receiving the mortgage loans. *Id.* at 13 n. 32-33.

proper indorsements to the trustee or its document custodian, the routine creation of unnecessary lost note affidavits, the destruction of the original notes, and the forging of necessary indorsements.<sup>10</sup> This behavior is widespread and reported in judicial decisions, the findings of a state's attorney general and a city recorder office's investigation, studies by law professors, news reports, Congressional testimony, and shareholder lawsuits.<sup>11</sup> As one former in-house counsel and securitization lawyer and her co-authors put it:

“Unfortunately, over the years procedural standards in mortgage securitizations appear to have deteriorated along with loan-underwriting standards. As a result, in some, if not many or most, cases, notes were neither indorsed nor delivered to the SPV [trust] or its agent in accordance with delivery instructions.”<sup>12</sup>

The consequences can be significant and include the failure of the foreclosing party to possess the right to foreclose, the wrongful removal of some homeowners from their homes, fraud upon the court in the case of forgery and false affidavits, and property title uncertainty.<sup>13</sup>

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<sup>10</sup> Alan M. White, *Losing the Paper—Mortgage Assignments, Note Transfers, and Consumer Protection*, 24 Loy. Consumer L. Rev. 468, 475 (2012) (describing these behaviors).

<sup>11</sup> Elizabeth Renuart, *Property Title Troubles in Nonjudicial Foreclosure States: The Ibanez Time Bomb?*, 4 Wm. & Mary Bus. L. Rev. 111, 119-28 (2013) (compiling evidence from these sources); White, *supra* note 10, at 473-76, 486-87 (reviewing some evidence and concluding that there was “a significant breakdown in the system of endorsement and delivery of mortgage notes in the pre-2007 period”; surveying 396 foreclosure cases in six judicial foreclosure states and finding mismatches between the plaintiff identified in the foreclosure complaint and the proper party listed in MERS about twenty percent of the time).

<sup>12</sup> Shaun Barnes, Kathleen G. Cully & Steven L. Schwarz, *In-House Counsel's Role in the Structuring of Mortgage-Backed Securities*, 2012 Wis. L. Rev. 521, 528 (2012); *see also* Renuart, *supra* note 11, at 179 (concluding that “[t]he sloppiness and hubris of parties to the securitization deals created and, in some cases, covered up the documentation problems chronicled in this Article.”); *see also* U.S. Bank Nat'l Ass'n v. Ibanez, 941 N.E. 2d 40, 55 (Mass. 2011) (noting “the utter carelessness with which the plaintiff banks documented title to their assets,” Cordy, J. concurring).

<sup>13</sup> Renuart, *supra* note 11, at 124-25, 127-28, 171-77 (discussing each of these consequences); *see also* Pino v. Bank of New York, \_\_So.3d\_\_, 2013 WL 452109 \*1 (Fla. Feb. 7, 2013) (noting that the issue of fraud on the court “arises out of a widespread problem associated with fraudulent documentation filed by various financial institutions seeking to foreclose on real property throughout the state...”, in the context of affirming the voluntary dismissal of the plaintiff's foreclosure complaint allegedly based upon fraudulent information when the defendant suffered no harm before the dismissal).

## II. WHY FORECLOSURE RULES MATTER

The foreclosure crisis and resulting deep recession were not provoked by greedy or fraudulent homeowners searching for easy credit who intentionally defaulted and walked away from the mess. Rather, the Financial Crisis Inquiry Commission, established in 2009 by Congress to examine the causes of the financial and economic crisis, pinned responsibility on a number of parties and practices. The Commission found widespread failures in financial regulation and supervision by key federal agencies, failures of corporate governance and heightened risk-taking, excessively leveraged financial institutions and high consumer debt loads, deterioration of mortgage-lending standards, loosening of due diligence standards applied in the securitization process, the re-packaging and sale of questionable mortgage-backed securities into collateralized debt obligations and the sale of credit default swaps to hedge against the collapse of these securities, failures of the credit rating agencies, and an unprepared government that responded inconsistently to the crisis.<sup>14</sup>

Certainly, not all homeowners are blameless for their overextended borrowing. Other homeowners faced foreclosure due to unemployment, not surprising since more than twenty-six million Americans had no job, could not find full-time work, or had given up search for work as of the beginning of 2011.<sup>15</sup> Most disturbing, a subset of

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<sup>14</sup> FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE U.S. xvii-xxviii, (2011) [hereinafter FCIC FINAL REPORT], available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>. *Id.* at xvii-xxviii; see also *FDIC Oversight: Examining and Evaluating the Role of the Regulator During the Financial Crisis and Today: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Fin. Servs. Comm.*, 112th Cong. 5-12 (2011) (statement of Sheila C. Bair), available at [http://financialservices.house.gov/UploadedFiles/052611\\_bair.pdf](http://financialservices.house.gov/UploadedFiles/052611_bair.pdf) (identifying the roots of the financial crisis—excessive reliance on debt and financial leverage, misaligned incentives in financial markets, failures and gaps in financial regulation, and erosion of market discipline due to “too big to fail”).

<sup>15</sup> FCIC Final Report, *supra* note 13, at xv.

homeowners lost their homes even though they had not defaulted on their payments.<sup>16</sup>

The prerequisites to foreclosure found in state laws are important, to the extent they are designed to prevent the illegal or unnecessary loss of the family home. The stakes are particularly high in nonjudicial foreclosure states where the borrower who mortgages her property can lose it without easy access to the courts.<sup>17</sup> In there, the burden and expense of litigating is shifted from the foreclosing party to the homeowner who must file an affirmative lawsuit to stop the process prior to the forced sale. State law also may require that the homeowner post a bond, limit the right to contest the sale to a narrow period of time before or after the sale, permit only narrow grounds to challenge the legality of the procedure, or apply a presumption of legality once the sale occurs.<sup>18</sup>

Taking care to ensure that foreclosures are carried out only by the parties that possess the legal right to do so is not a mere procedural detail. The rule requiring possession of the note in Article 3 of the UCC ensures that the homeowner does not face double liability which occurs when the wrong party sells the home and the note holder

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<sup>16</sup> The Office of the Comptroller of the Currency (“OCC”) created a procedure whereby homeowners who lost their homes could file a claim for damages after conducting examinations of the largest mortgage servicers and uncovering significant paperwork problems related to foreclosures. The fact that the agency established this remedy is significant because it recognizes that not all foreclosed homeowners were in default and not all foreclosures were lawful. OFFICE OF THE COMPTROLLER OF THE CURRENCY, INTERIM STATUS REPORT: FORECLOSURE-RELATED CONSENT ORDERS 7–10 (Nov. 2011), *available at* <http://www.occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-139a.pdf>.

<sup>17</sup> See the description of the nonjudicial foreclosure procedure in text accompanying notes 154-166. Indeed, “foreclosure under a power of sale is not favored in the law, and its exercise will be watched with jealousy.” *In re* Foreclosure of Goforth Props., Inc., 432 S.E.2d 855, 859 (N.C. 1993) (internal quotations and citations omitted). Notably, one court described the Arizona foreclosure procedure as “draconian.” *Schrock v. Fed. Nat’l Mortgage Ass’n*, No. 11-CV-0567, 2011 WL 3348227, at \*6-8 n. 7 (D. Ariz. Aug. 3, 2011) (discussing in detail the draconian results of the legislative foreclosure regime in the context of recognizing the tort of wrongful foreclosure); see also Molly F. Jacobson-Greany, *Setting Aside Nonjudicial Foreclosure Sales: Extending the Rule to Cover Both Intrinsic and Extrinsic Fraud or Unfairness*, 23 EMORY BANKR. DEV. J. 139, 150-51 (2006) (describing the nonjudicial foreclosure process as “harsh”).

<sup>18</sup> Renuart, *supra* note 11, at 152-54, 164,167-68 (noting restrictions to homeowner challenges and presumptions upon sale in Arizona law; bond or payment requirement in Georgia law; and, short timeframe to challenging a completed sale and a showing that the homeowner did not breach any condition in the deed of trust in Nevada law).

later appears seeking full payment on the note. Moreover, a homeowner needs the certainty provided by Articles 3 and 9 of the UCC that any loan modification agreement or other negotiated alternative to foreclosure is entered into with the legally correct person.<sup>19</sup>

Professor Levitin provides a fresh insight into the role of the mortgage contract in this context.

The mortgage contract is not simply an agreement that the home may be sold upon a default on the loan. Instead, it is an agreement that if the homeowner defaults on the loan, the mortgagee may sell the property *pursuant to the requisite legal procedure*. A mortgage loan involves a bundle of rights, including procedural rights. These procedural rights are not merely notional; they are explicitly priced by the market. . . . Retroactively liberalizing the rules for mortgage enforcement creates an unearned windfall for mortgagees. Moreover, the ability to credibly push back against a foreclosure through a challenge to standing provides the homeowner leverage for a negotiated solution such as a loan modification or simply buys the

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<sup>19</sup> Whitman & Milner, *supra* note 3, at 62-63; *see also* David A. Dana, *Why Mortgage “Formalities” Matter*, 24 Loy. Consumer L. Rev. 505, 507-08 (2012) (identifying additional reasons why “formalities” matter: in some cases, the homeowner can stay in the home over the long haul; procedural rights represent the societal value that a home is central to the lives of its residents and to the vitality of the larger community; and, insistence on following these rules may help to prevent another foreclosure crisis in the future).

homeowner time to relocate, enabling a softer landing with  
fewer social dislocations and externalities.<sup>20</sup>

Finally, the important interests of purchasers and the property title systems existing in all states deserve some attention. If state law or the courts interpreting state law fail to ensure that the proper entity forecloses, defective title resulting from wrongful foreclosures can infect the title system.<sup>21</sup> Purchasers of foreclosed properties expect that title to the premises is clear and that the foreclosure sale process is valid and final.<sup>22</sup> The policy justifications behind property title recording systems include the paramount need for an authoritative source of ownership information “to protect property rights, encourage commerce, expose fraud, and avoid disputes.”<sup>23</sup>

### III. ENFORCEMENT OF LOAN NOTES

A “loan,” as used in common parlance, is represented in a piece of paper called a “note.” A note or “instrument” is any writing that evidences a right to payment of a monetary obligation.<sup>24</sup> An example of an instrument is a promissory note, the type of note typically used in transactions in which the loan is secured by residential real

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<sup>20</sup> Adam Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, \_\_\_Duke L.J. \_\_\_ (2013) (forthcoming) (manuscript on file with author at 10).

<sup>21</sup> Renuart, *supra* note 11, at 173-75 (discussing title headaches).

<sup>22</sup> Elizabeth Renuart, *Toward a More Equitable Balance: Homeowner and Purchaser Tensions in Nonjudicial Foreclosure States*, 24 Loy. Consumer L. Rev. 562, 570-74 (2012).

<sup>23</sup> Christopher L. Peterson, *Two Faces: Demystifying the Mortgage Electronic Registration System's Land Title Theory*, 53 WM. & MARY L. REV. 111 (2011). “A \$13 trillion residential mortgage market depends directly on clarity of mortgage title.” Levitin, *supra* note 20, at 5.

<sup>24</sup> Black's Law Dictionary 1162 (9<sup>th</sup> ed. 2009) (defining “note” to include an “instrument”); UCC § 9-102(a)(47) (1998) (defining “instrument” to include both negotiable and nonnegotiable writings that evidence a promise to pay a monetary obligation). Cf. UCC § 3-104(b) (1990) (stating that an instrument is a negotiable instrument); § 3-102(a) (1990) (applying Article 3 only to negotiable instruments).

property.<sup>25</sup> Thus, a “mortgage loan” consists of two distinct documents: a promissory note and a security agreement.<sup>26</sup> In many states, the agreement granting a security interest in real property takes one of two forms, a mortgage or deed of trust.<sup>27</sup>

If the note is negotiable, Article 3 of the UCC governs the identity of the party who possesses the right to enforce it. This is not a controversial principle. But if the negotiable note is transferred to a buyer or assignee, as opposed to “negotiated,” or the note is nonnegotiable, Article 9 of the UCC and contract law apply to determine ownership. The intersections between Articles 3 and 9 and the distinction between the right to enforce a note and ownership are not well understood. The next sections describe the conditions that a party must meet in order to enforce a negotiable note and provide examples of situations where foreclosing parties have failed to meet these standards. A similar discussion follows addressing nonnegotiable note.

#### *A. The Development and Role of Negotiable Instruments*

The English bill of exchange was the earliest form of a negotiable instrument developed to transport capital in the form of a document, rather than carrying tangible

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<sup>25</sup> UCC § 9-102(a)(65) (1998). If the note includes both a promise to pay a monetary obligation and a security interest, the note is chattel paper. § 9-102(a)(11).

<sup>26</sup> 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 5.27 (5th ed. 2007) [hereinafter NELSON & WHITMAN].

<sup>27</sup> 4 RICHARD R. POWELL, POWELL ON REAL PROPERTY § 37.03 (Michael Allan Wolfe ed., LexisNexis Matthew Bender 2010) [hereinafter 4 POWELL ON REAL PROPERTY]. A mortgage is a two-party contract that, most commonly, creates a lien on real property. In contrast, a deed of trust is three-party contract in which the trustor (borrower) conditionally conveys title to a third party trustee who holds it as security for the debt owed to the beneficiary (lender). See, e.g., Ariz. Rev. Stat. Ann. § 33-801 (2012) (defining the parties to a deed of trust). When the mortgage or deed of trust creates a security interest under state law, that state is considered a “lien theory” state. In a minority of states, the mortgage or deed of trust vests legal title in the mortgagee or beneficiary and, hence, are “title theory” states. Nelson & Whitman, *supra* note 26, at § 4.1 and text accompanying n. 11; § 4.2 and text accompanying n. 1. When a transaction involves a security deed in Georgia, that instrument also transfers title to the real estate. Frank S. Alexander, Georgia Real Estate Finance and Foreclosure Law § 8:1 (2011-2012 ed.). Georgia’s security deed is the subject of a larger discussion below in Section V.C.3 below.

valuables from place to place or to another country as payment for goods or services.<sup>28</sup>

Originally, these bills had four parties, the maker (or payer), the payee for whose benefit the payor made payment, the drawer (a third party to be paid by the payor), and the drawee (a bank or other entity instructed to pay the payee).<sup>29</sup> Bills of exchange provided a means of credit and became central to trade among merchants in the 1500s.<sup>30</sup> Later, both merchants and non-merchants used bills of exchange because an adequate supply of money did not exist in England and because they were easily transferred.<sup>31</sup> The promissory note, a two-party instrument, developed later and remains common today.<sup>32</sup>

The real value of negotiable instruments lies in their liquidity. They are easily transferable because the buyer need not search beyond the instrument itself to verify the power of the seller to transfer it.<sup>33</sup> Because they are easily transferable, the payee readily can obtain cash in exchange for the instrument. “By providing a ready source of cash, an active market for payment obligations aids the financial position of operating businesses that generate payment obligations when they sell things to their customers.”<sup>34</sup> For this reason, loan notes themselves become commodities to buy, sell, and securitize. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are the largest secondary mortgage purchasers of

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<sup>28</sup> 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 (2001-2002).

<sup>29</sup> *Id.* at 378.

<sup>30</sup> *Id.* at 379, 381-82.

<sup>31</sup> *Id.* at 282-83.

<sup>32</sup> *Id.* at 385-89.

<sup>33</sup> LYNN M. LOPUCKI, ELIZABETH WARREN, DANIEL KEATING & RONALD J. MANN, *COMMERCIAL TRANSACTIONS: A SYSTEMS APPROACH*, 725-26 (5th ed. 2012). One professor characterizes the current code covering negotiable instruments, Article 3 of the UCC, as a “note title system.” Levitin, *supra* note 20, at 16-19.

<sup>34</sup> Lopucki, *et al.*, *supra* note 33, at 725.

mortgage loans in the United States.<sup>35</sup> The uniform notes that they require lenders to use in residential mortgage transactions purport to be negotiable.<sup>36</sup>

The history of negotiable instrument law in the United States is beyond the scope of this article. The more recent part of the story began with the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI). These organizations commenced the process of drafting the Code in 1942. Professor Karl Llewellyn served as the Chief Reporter along with Professor Sonia Metschikoff, the Associate Chief Reporter. Committees of each organization reviewed various drafts of each article.<sup>37</sup> The full membership of both voted to adopt a version in 1951.<sup>38</sup> That draft encountered opposition leading to its revision and final adoption by NCCUSL and ALI in 1957. States began to enact the Code thereafter.<sup>39</sup> For example, Massachusetts adopted the UCC in 1957 and Kentucky in 1958. All other states followed in these footsteps over the next few years.<sup>40</sup> Negotiable instrument law now appears in Article 3 of that Code.

*B. Negotiable Instruments and the Concept of the Person Entitled to Enforce (PETE)*

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<sup>35</sup> Levitin, *supra* note 20, at 13-14.

<sup>36</sup> Fannie Mae, Selling Guide, Fannie Mae Single Family, § A2-2.1-03 (“Document Warranties”), April 9, 2013, at 22-23.

<sup>37</sup> *General Comment of the National Conference of Commissioners on Uniform State Laws and the American Law Institute*, in *Perspectives on the Uniform Commercial Code 7* (Douglas E. Litowitz ed., 2d ed. 2007).

<sup>38</sup> Robert Braucher, *Legislative History of the Uniform Commercial Code* in *Perspectives on the Uniform Commercial Code 22* (Douglas E. Litowitz ed., 2d ed. 2007).

<sup>39</sup> *Id.* at 23-25.

<sup>40</sup> *Id.* at 25.

In Article 3 nomenclature, the person who signs or is identified in a note as the person agreeing to pay is known as the “maker.”<sup>41</sup> The one named on the instrument as the person to whom the money is paid or payable is the “payee.”<sup>42</sup>

The right to enforce “negotiable” notes is governed by several provisions of Article 3.<sup>43</sup> Pursuant to section 3-104, a “negotiable instrument”: (1) contains an unconditional promise to pay a fixed amount of money; (2) is payable to bearer or to order at the time it is issued or first comes into possession of a holder; (3) is payable on demand or at a definite time; and (4) does not state any other undertaking or instruction by the promisor to do any action in addition to the payment of money. If any one of these conditions is not met, the loan note is not “negotiable.”<sup>44</sup> Negotiability is important because Article 3 creates rights to enforce the note only if it is negotiable.<sup>45</sup>

Article 3 creates three discrete paths to acquiring the right to enforce the loan note and, hence, to become a “person entitled to enforce” or a “PETE”. The first method is to become the “holder” of the note.<sup>46</sup> A holder is “the person in possession of a negotiable instrument that is payable either to bearer or to an identified person that is the person in

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<sup>41</sup> UCC § 3-103(a)(7) (1990). Interestingly, “payee” is not defined in Article 3. Most of us know the “maker” as the “borrower.”

<sup>42</sup> Black’s Law Dictionary 1243 (9<sup>th</sup> ed. 2009). Most of us know the “payee” as the “lender”.

<sup>43</sup> This discussion relies upon the 1990 version of Article 3. This version is effective in all states except New York (which essentially uses the original version it adopted in 1961) and those eleven states that have adopted the 2002 version of Article 3. See UNIFORM LAW COMMISSION, <http://www.uniformlaws.org/Legislation.aspx> Article 3, Negotiable Instruments (1990) (for information about the 1990 version) and <http://www.uniformlaws.org/Legislation.aspx> Article 3, Negotiable Instruments and Article 4, Bank Deposits (2002) (for information about the 2002 version).

<sup>44</sup> Many of these elements are discussed more fully in subsequent sections. UCC §§ 3-106, 3-108, 3-109, 3-112 (1990).

<sup>45</sup> UCC § 3-102(a) (1990) (stating that Article 3 applies only to negotiable instruments). However, the note maker (borrower) and the note payee (lender) could contract to apply Article 3 to nonnegotiable instruments. UCC § 3-104, cmt. 2 (1990).

<sup>46</sup> UCC § 3-301(i) (1990).

possession.”<sup>47</sup> When a negotiable note is “negotiated” to another party, the transfer must include delivery of the note containing the indorsement of the current holder (if the note is payable to an identified person).<sup>48</sup> If the instrument is payable to bearer, transfer by possession alone suffices.<sup>49</sup>

Alternatively, a “non-holder” may enforce a negotiable note if that person possesses both the note itself and the rights of a holder.<sup>50</sup> This situation occurs when the note “is delivered by a person . . . for the purpose of giving to the person receiving delivery the right to enforce the [note].”<sup>51</sup> The rights of the transferor must be proved because the transferee’s rights are derivative of the transferor’s rights.<sup>52</sup> Moreover, the person transferring the note or a person earlier in the chain of transfers must be a holder.<sup>53</sup> The crucial element common to both negotiation to a “holder” and a transfer to a “non-holder” is possession of the instrument.

The third path is distinctly different from the two described above. It arises when a person no longer possesses the note because it was lost, destroyed, or stolen.<sup>54</sup> Under the 1990 version of Article 3, the person seeking to enforce the note must have been

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<sup>47</sup> UCC § 1-201(b)(21)(A) (2001). Article 3 does not define “possession.” According to Black’s Law Dictionary, “possession” means “[t]he fact of having or holding property in one’s power; the exercise of dominion over property.” Black’s Law Dictionary 1281 (9<sup>th</sup> ed. 2009).

<sup>48</sup> UCC § 3-201(b) (1990); *see also* UCC § 3-204(a) (1990) (defining indorsement as the signature that is made for the purpose of negotiating the instrument). The UCC uses the word “indorsement,” not “endorsement.”

<sup>49</sup> UCC § 3-201(b) (1990); *Horvath v. Bank of New York, N.A.*, 641 F.3d 617, 621 (4<sup>th</sup> Cir. 2011) (describing this rule as “possession permits enforcement”). A note originally payable to bearer or to an identified payee may be indorsed in blank, rendering the note bearer paper, or indorsed payable to an identified person, called a special indorsement, rendering it payable only to that person. UCC § 3-205 (1990).

<sup>50</sup> UCC § 3-301(ii) (1990).

<sup>51</sup> UCC § 3-203(a) (1990).

<sup>52</sup> UCC § 3-203, cmt. 2 (1990).

<sup>53</sup> UCC §§ 3-301(ii) (1990); *see also* UCC § 3-203(b) (1990) (noting that the recipient of the note upon a qualified transfer receives the same right of the transferor to enforce the note).

<sup>54</sup> UCC § 3-301(iii); 3-309(a) (1990). UCC § 3-301(iii) also permits enforcement by a person not in possession of the note where the payment on the instrument was made or accepted by mistake, referencing § 3-418(d), a situation not relevant to the issues discussed in this article.

entitled to enforce it when loss of possession occurred for one of these three reasons.<sup>55</sup> In addition, that person must prove the terms of the note and the court must ensure that the maker is adequately protected against loss in the event that a holder later asserts its right to payment.<sup>56</sup>

### *1. Enforcement Obstacles*

Section I summarizes evidence of the nature and scope of the mishandling of notes and mortgages preceding and during the recent foreclosure crisis. This section compiles judicial rulings that illustrate the blocks on the path to enforcing a mortgage loan note.

#### *a. The Foreclosing Party Does Not Possess the Note*

The foreclosing party may not have obtained physical possession of the negotiable note at the relevant time and, therefore, have no authority to enforce it by foreclosure or otherwise. Examples of this situation abound in court decisions.<sup>57</sup>

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<sup>55</sup> UCC § 3-309(a) (1990). Some courts hold that the assignee of a promissory note that was lost while in the possession of the assignor also can enforce the note under § 3-309(a). *E.g.*, *Atlantic Nat'l Trust, LLC v. McNamee*, 984 So. 2d 375, 377-78 (Ala. 2007). The 2002 version permits enforcement of a lost, stolen, or destroyed instrument by a person who “directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred.” Only eleven states have adopted it to date. Uniform Law Commission, <http://www.uniformlaws.org/Act.aspx?title=UCC%20Article%203,%20Negotiable%20Instruments%20and%20Article%204,%20Bank%20Deposits%20282002%29>.

<sup>56</sup> UCC § 3-309(b), cmt. 1 (1990).

<sup>57</sup> *E.g.*, *Country Place Community Ass'n v. J.P. Mortgage Mortg. Acquisition*, 51 So.3d 1176, 1179 (Fla. Dist. Ct. App. 2010) (finding no evidence that plaintiff possessed the note when it filed its lawsuit and lacked standing); *Deutsche Bank Nat'l Trust v. Mitchell*, 27 A.3d 1229, 1235-36 (N.J. Super. Ct. App. Div. 2011) (vacating the sheriff's sale and remanding due to lack of evidence that the plaintiff possessed the loan note at the time of filing the foreclosure action); *Bank of New York v. Raftogianis*, 13 A.3d 435, 459 (N.J. Super. Ct. Ch. Div. 2010) (dismissing foreclosure complaint without prejudice because plaintiff could not prove it had possession of the note on the date it filed the complaint); *Bank of New York v. Silverberg*, 926 N.Y.S.2d 532, 538-40 (App. Div. 2011) (reversing the lower court's refusal to dismiss the foreclosure complaint where the assignee only obtained the mortgage from MERS and not the note); *HSBC Bank USA Nat'l Ass'n v. Miller*, 889 N.Y.S.2d 430, 432-33 (Sup. Ct. 2009) (dismissing the foreclosure because the plaintiff failed to show that the note was transferred to it before filing the foreclosure action); *In re Adams*, 693 S.E.2d 705, 710 (N.C. Ct. App. 2010) (ruling that the evidence of transfer of the note to the trustee bank was insufficient); *Federal Home Loan Mortg. Corp. v. Schwartzwald*, 979 N.E.2d 1214, 1216-17,

<sup>xt</sup> Possession by an agent on behalf of the owner of the note arguably can suffice.

An Official Comment on Article 3 suggests that possession of the note can occur “directly or through an agent.”<sup>58</sup> Some courts describe possession through an agent as “constructive possess.”<sup>59</sup>

In the context of a mortgage loan, a “servicer,” acting for the lender or its transferee, collects the payments, maintains the payment records, selects foreclosure attorneys in the event of defaults, and sometimes forecloses.<sup>60</sup> When a servicer seeks to enforce the note in its own name by, for example, filing a proof of claim in the borrower’s bankruptcy or initiating a foreclosure, the servicer must show that it is the PETE, or, at a minimum, has an agency relationship with the PETE that authorizes it to

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1220 (Ohio 2012) (holding that plaintiff did not have possession of the note and a valid assignment of it before filing the foreclosure complaint); *U.S. Bank, N.A. v. Moore*, 278 P.2d 596, 599 (Okla. 2012) (finding that plaintiff could not prove it had possession of the note at the time the complaint was filed); *U.S. Bank Nat’l Ass’n v. Kimball*, 27 A.3d 1087, 217-18 (Vt. 2011) (affirming summary judgment to the mortgagor when the bank failed to prove that it was the holder of the note);. *See also* *Anderson v. Burson*, A.3d 452, 454 (Md. 2011) (noting that mortgage transferors often lose or misplace mortgage documents and fail to properly transfer loan notes but affirming the ruling that the substituted trustee may enforce the note because the homeowner conceded the proffered version of the transfer history). Standing challenges to the filing of a motion to lift the automatic stay or of a proof of claim in bankruptcy proceedings where the alleged creditor did not possess the note arise with some frequency. *E.g. In re Miller*, 666 F.3d 1255, 1264 (10<sup>th</sup> Cir. 2012) (reversing and remanding judgment of Bankruptcy Appellate Panel because the current evidence did not prove that alleged holder or transferee had obtained possession of the note); *In re Veal*, 450 B.R. 897, 917-18 (B.A.P. 9<sup>th</sup> Cir. 2011) (holding that the party seeking to lift the automatic stay failed to show that it or its agent had actual possession of the note and, therefore, could not be a person entitled to enforce the note).

<sup>58</sup> UCC § 3-201, cmt. 1 (1990). The Permanent Editorial Board of the Uniform Commercial Code issued a report addressing selected issues relating to mortgage notes in 2011. There, the Board opined that a person in possession of the note can include possession by a third party that possesses it for the person. REPORT OF THE PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, APPLICATION OF THE UNIFORM COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTGAGE NOTES 5 (2011) [hereinafter PEB REPORT]. This Board is composed of members from the American Law Institute and the Uniform Law Commission. It monitors current drafting activities of the Uniform Commercial Code and prepares commentaries and advises its member organizations on further changes needed in the Uniform Commercial Code.

<http://www.uniformlaws.org/Committee.aspx?title=Permanent%20Editorial%20Board%20for%20Uniform%20Commercial%20Code>.

<sup>59</sup> *E.g., In re McFadden*, 471 B.R. 136, 175 (Bankr. D.S.C. 2012).

<sup>60</sup> Diane E. Thompson, *Foreclosing Modifications: How Servicer Incentives Discourage Loan Modifications*, 86 Wash. L. Rev. 755, 759-65 (2011).

foreclose on behalf of the PETE.<sup>61</sup> Servicers may be unable to prove PETE status when seeking to enforce notes on behalf of the trust in a securitization deal because they “did not always bother to take physical possession of [them] in accordance with state law.”<sup>62</sup>

*b. Broken Chain of Indorsements or No Indorsement to Transferee*

If the negotiable instrument requires an indorsement and does not bear the necessary indorsement to the party attempting to foreclose, the note is not payable to the transferee.<sup>63</sup> In that situation, the transferee is not a “holder” and must account for its possession of the instrument “by proving the transaction through which the transferee acquired it.”<sup>64</sup> Moreover, the transferee must show that it possesses the rights of a “holder.”<sup>65</sup> If this evidence is not available, the party may not foreclose.<sup>66</sup>

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<sup>61</sup> JOHN RAO ET AL., FORECLOSURES: DEFENSES, WORKOUTS, AND MORTGAGE SERVICING § 5.6 (National Consumer Law Center 4th ed. 2012) (relying on cases cited therein).

<sup>62</sup> Barnes, *et al.*, *supra* note 12, at 528.

<sup>63</sup> The necessary indorsements may appear on an allonge. UCC § 3-204(a) (1990). In that situation, the allonge must be affixed, that is, “actually attached to the instrument, meaning some form of physical connection securing the paper to the instrument.” Wells Fargo Bank, N.A. v. Settoon, \_\_So.3d\_\_, 2013 WL 2476563 \* 3-4 (La. App. Ct. June 7, 2013) (ruling, however, that the homeowner admitted that the allonge was affixed in his verified petition); Whaley, *supra* note 8, at 318-19 (noting the renewed attention to this issue in court decisions). *See also* Vidal v. Liquidation Prop., Inc., 104 So.3d 1274 (Fla. Dist. Ct. App. 2013) (reversing summary judgment to foreclosing party where it relied on an undated allonge to show that the note was indorsed in blank and failed to attach any proof that the note was transferred prior to the filing of the complaint); U.S. Bank Nat’l Ass’n v. Kimball, 27 A.3d 1087, 1092 (Vt. 2011) (finding that the allonge containing undated indorsements was not adequate to confer holder states at the time of filing the foreclosure complaint).

<sup>64</sup> UCC § 3-203, cmt. 2 (1990); Anderson v. Burson, 35 A.3d 452, 462 (Md. 2012) (relying on UCC § 3-203, cmt. 2).

<sup>65</sup> UCC § 3-301(ii) (1990); Anderson, 35 A.3d 452, 462 (“If there are multiple prior transfers, the transferee must prove each prior transfer... Once the transferee establishes a successful transfer from a holder, he or she acquires the enforcement rights of that holder.”).

<sup>66</sup> McLean v. JP Morgan Chase Bank Nat’l Ass’n, 79 So.3d 170, 174-75 (Fla. Dist. Ct. App. 2012) (reversing summary judgment as there was insufficient evidence to show that original note contained a special indorsement at the time of filing the lawsuit); J.P. Morgan Chase Bank, N.A. v. Eldridge, 273 P.3d 62, 66-67 (Okla. 2012) (dismissing foreclosure case without prejudice because plaintiff could not demonstrate that the note was indorsed to it; finding that an assignment of the mortgage does not constitute an assignment of the note and, hence, does not establish the purpose of delivery of the note to the transferee); Wells Fargo Bank, N.A. v. Heath, 280 P.3d 328, 333-34 (Okla. 2012) (reversing summary judgment to plaintiff because it did not show that the indorsement on the note occurred before the complaint was filed); U.S. Bank, N.A. *ex rel.* Credit Suisse First Boston Heat 2005-4 v. Alexander, 280 P.3d 936 (Okla. 2012) (reversing summary judgment for plaintiff where it produced an indorsement on an allonge over a year after it filed the complaint; MERS had no authority to indorse the note).

*c. Inability to Prove Lost Note Requirements*

The foreclosing party may not rely upon a lost note affidavit if it cannot show that it had the right to enforce the note at the time it lost possession.<sup>67</sup>

*C. Right to Enforce versus Ownership*

Ordinarily, the person entitled to enforce a negotiable note is also the owner.<sup>68</sup> The clearest example of this dual status arises when the payee listed in a loan note is the holder demanding payment. However, when mortgage loans are sold and resold on the secondary market, the buyers may not qualify as PETEs, due to the transfer problems noted previously.<sup>69</sup> These buyers may be owners but are not PETEs.<sup>70</sup>

In the context of Articles 3 and 9, ownership means the right to the economic value of the note.<sup>71</sup> Ownership rights in negotiable notes are determined by principles of property law, independent of Article 3 of the UCC.<sup>72</sup> The legal distinction between

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<sup>67</sup> UCC § 3-309 (1990); Fifth Third Mortg. Co. v. Fillmore, 2013 WL 425116 \*6 (Ohio Ct. App. Jan. 28, 2013) (ruling, in a priority dispute over which mortgage lienholder was in first position to foreclose, that the lost note affidavit filed by one party failed to establish that he was in possession of the note and entitled to enforce it when the loss of possession occurred; consequently, evidence of a debt to support the mortgage was lacking). See also discussion in note 55 above.

<sup>68</sup> UCC § 3-203, cmt. 1 (1990) (“[T]ransfer of an instrument might mean in a particular case that title to the instrument passes to the transferee...”); PEB Report, *supra* note 58 at 8 (“While, in many cases, the person entitled to enforce the note is also its owner, this need not be the case.”); *In Re Veal*, 450 B.R. at 912 (“While in many cases the owner of a note and the person entitled to enforce it are one and the same, this is not always the case...”).

<sup>69</sup> I use the words “sale” and “assign” interchangeably, relying on Black’s Law Dictionary 136, 1454 (9<sup>th</sup> ed. 2009) (defining “assignment” as the transfer of rights or property; defining “sale” as the transfer of property or title for a price). See also Nelson & Whitman, *supra* note 26 at § 5.27 (“When a lender, having originated a mortgage loan, sells it to another investor, a secondary market transaction is said to occur, and the transfer by the original mortgagee is loosely termed an ‘assignment.’ Three federally-sponsored agencies, Fannie Mae, Freddie Mac, and the Government National Mortgage Association (GNMA or ‘Ginnie Mae’), are actively involved in purchasing assignments of mortgages, primarily on residential properties, from local lenders throughout the nation.”) (emphasis added).

<sup>70</sup> See UCC § 3-309, cmt. 1 (1990) (“The rights stated are those of a ‘person entitled to enforce the instrument’ at the time of loss rather than those of an ‘owner’ as in former Section 3-804.”).

<sup>71</sup> *In re Veal*, 450 B.R. at 912 (defining economic value as the value of the maker’s promise to pay); Whitman, *supra* note zz at 25 (defining ownership as the right to the economic benefits of the note, including the monthly payment, proceeds in the event of a voluntary payoff, short sale, or foreclosure sale). See also *Bank of America, N.A. v. Cloutier*, 61 A.3d 1242, 1246 (Me. 2013) (noting that the “owner” of a mortgage note under the state’s foreclosure law is the economic beneficiary of the note).

<sup>72</sup> UCC § 3-203, cmt. 1 (1990).

ownership and PETE status has been widely misunderstood in the past and has been responsible for considerable confusion in judicial decisions and statutes.”<sup>73</sup> Part of the difficulty in understanding the scope and meaning of Article 9 resides in its language. Article 9 covers the sale of a variety of payment obligations (accounts, chattel paper, payment intangibles, and promissory notes), in addition to traditional security interests in personal property.<sup>74</sup> Nonetheless, the text refers to the buyer as the “secured party” and the seller as the “debtor” throughout.<sup>75</sup>

Articles 3 and 9 overlap and diverge in their coverage of negotiable notes. Both provide distinct parts of the law affecting negotiable notes that fit together. **Article 3 governs negotiability, transfer of PETE status, payment, right to collect and enforcement, and satisfaction of negotiable notes.**<sup>76</sup> Article 9 addresses the transfer of ownership of both negotiable and nonnegotiable notes.<sup>77</sup> As for nonnegotiable notes, once Article 9 creates ownership rights in the buyer, property and contract law in combination generate enforcement rights by the owner, as detailed in the next section.<sup>78</sup>

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<sup>73</sup> Whitman & Milner, *supra* note 3, at 26; Alvin C. Harrell, *Impact of Revised UCC Article 9 on Sales and Security Interests Involving Promissory Notes and Payment Intangible*, 55 Consumer Fin. L.Q. Rep. 144, 148 (Spring-Fall 2001) (“There is, however, some inevitable interplay (and potential for conflict) between the claims of the holder of a negotiable instrument under UCC Articles 3 and 9...”). *See also* *In re Veal*, 450 B.R. at 912 (“[O]ne can be an owner of a note without being a ‘person entitled to enforce.’ This distinction may not be an easy one to draw, but is one that the UCC clearly embraces.”); *Kemp v. Countrywide Home Loans, Inc. (In re Kemp)*, 440 B.R. 624, 633 (Bankr. D.N.J. 2010) (finding that the “attempted assignment of the note in the assignment of the mortgage document, together with the Pooling and Servicing Agreement, created an ownership issue, but did not transfer the right to enforce the note.”).

<sup>74</sup> UCC § 1-201(b)(35) (2001) (defining security interest); UCC § 9-109(a)(1) and (3) (1998) (applying Article 9 to security interests in personal property and to the sale of accounts, chattel paper, payment intangibles, and promissory notes). Professor Levitin notes that the applicability of Article 9 is not obvious, even to an “intrepid researcher.” Levitin, *supra* note 20, at 38.

<sup>75</sup> UCC §§ 9-102(a)(28), (a)(73) (2001) (defining debtor and secured party, respectively).

<sup>76</sup> *In re Veal*, 450 B.R. at 909. Regarding these distinctions, the court noted: “Article 3 does not necessarily equate the proper person to be paid with the person who owns the negotiable instrument. Nor does it purport to govern completely the manner in which those ownership interests are transferred. For rules governing those types of property rights, Article 9 provides the substantive law.”

<sup>77</sup> *Id.*

<sup>78</sup> **The terms of the sale contract governing enforcement apply because Article 1 recognizes that principles of contract law apply to UCC unless displaced by particular Code provisions.** UCC § 1-103

D. *Article 9, Ownership, and Nonnegotiable Notes*

A note is nonnegotiable when it fails to meet the requisites contained in Article 3. Nevertheless, ordinarily, it is a writing that contains a promise or order to pay money and that may “resemble[] a negotiable instrument in form and which, by its nature, is such that the original parties could reasonably contemplate its transfer.”<sup>79</sup> Professor Willier’s research into the common law revealed that, at least as of 1960, the courts often applied the same or similar transfer rules to nonnegotiable notes as they did to negotiable notes when the instruments were drafted in a similar fashion. For example, where the nonnegotiable instrument was payable to a named person, indorsement and delivery were required.<sup>80</sup> Possession of an indorsed nonnegotiable note was “presumptive of ownership and delivery,” although some courts required that words of assignment be present.<sup>81</sup> Moreover, “[a] proper transfer of a nonnegotiable instrument vest[ed] legal ownership...in the transferee.”<sup>82</sup> Events since the publication of Professor Willier’s article in 1960 resulted in trumping the common law addressing the transfer of nonnegotiable notes as he knew it. This story takes us to Article 9.

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(2001). It is important to note that Article 3 defers to Article 9 in the event of a conflict between the two. UCC § 3-102(b) (1990). However, there are no conflicts between the two on the issues relevant to this article. Levitin, *supra* note 20, at 42 (arguing that Article 9 itself does not contain any provisions for enforcement of notes); see also text accompanying notes 96-100 below.

<sup>79</sup> William F. Willier, *Nonnegotiable Instruments*, 11 Syracuse L. Rev. 13 (1959-1960) (discussing the similarities and differences between negotiable and nonnegotiable instruments).

<sup>80</sup> *Id.* at 14-15.

<sup>81</sup> Willier, *supra* note 82, at 14-15. See *Chicago Trust & Sav. Bank v. Chicago Title & Trust Co.*, 60 N.E. 586 (Ill. 1901) (holding that an indorsement and delivery of a nonnegotiable instrument, absent an actual assignment, does not pass title).

<sup>82</sup> *Id.* at 19. The owner of a nonnegotiable instrument ordinarily is subject to the defenses existing among the prior parties to the instrument at the time of transfer and before notice of the transfer is provided to the maker. *Id.* at 21-22. This latter principle approximates the common law rule that an assignee of a contract acquires all rights and is subject to all liabilities of the assignor upon the transfer. RESTATEMENT (SECOND) OF CONTRACTS § 336 (1981). By contrast, if the note is negotiable and the holder is a “holder-in-due-course,” the holder is not subject to most defenses to payment on the note. UCC § 3-305 (1990).

At its inception, Article 9 governed conventional security interests in personal property.<sup>83</sup> Revisions in 1972 extended Article 9 rules to the sale of accounts and chattel paper in order to recognize “historical forms of financing that had long been practiced in many industries called ‘factoring.’”<sup>84</sup> The residential mortgage-backed securitization market flourished in the ensuing decades.<sup>85</sup> In order to facilitate this type of financing and investment vehicle, NCCUSL and the ALI amended Article 9 in 1998.<sup>86</sup> As a result, **Article 9 now governs the sale of promissory notes.**<sup>87</sup> Next, the 2001 amendments to

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<sup>83</sup> The original version of Article 9 dates to 1962, although its drafting began in the 1940s. James J. White & Robert S. Summers, *Uniform Commercial Code* 1149 (6<sup>th</sup> ed. 2010). UCC § 9-101 (1998) [hereafter “White & Summers”]; Braucher, *supra* note 38, at 22.

<sup>84</sup> White & Summers, *supra* note 83, at 1170. Factoring was the practice of buying accounts and paying less than 100% of the account value. The factor’s profit was the difference between 100% of the account’s value and the purchase price. *Id.*

<sup>85</sup> *Id.* (recounting that following the 1972 Code, a more complex form of factoring burst forth—securitization); Robert M. Lloyd, *Article 9 and Real Estate Law: Practical Solutions for Some Bothersome Problems*, 29 Idaho L. Rev. 583, 587-88 (1992-1993) (describing the development of an enormous market in mortgage-backed securities due to the activities of Fannie Mae, Freddie Mac, and Ginnie Mae); INSIDE MORTGAGE FINANCE PUBLICATIONS, INC., *THE 2009 MORTGAGE MARKET STATISTICAL ANNUAL II*, at 174-177 (2009) (showing Freddie Mac outstanding mortgage-backed securitizations in dollar volume rising from \$515 billion in 1995 to \$646.5 billion in 1998 and showing Fannie Mae outstanding securitizations in dollar volume rising from \$582.8 billion in 1995 to \$834.5 billion in 1998). By 2008, when the foreclosure crisis was in full swing, Freddie Mac’s outstanding volume had risen to \$1.8 trillion while Fannie Mae’s outstanding volume had risen to \$3.1 trillion. *Id.* at 164. In addition, private securitizations that funded the subprime mortgage loan market rose from \$65 billion in 1995 to its peak of \$430 billion in 2006. *Id.* at 3-5.

<sup>86</sup> Steve L. Harris, and Charles W. Mooney, Jr., *How Successful Was the Revision of UCC Article 9: Reflections of the Reporters*, 74 Chi-Kent L. Rev. 1357, 1373-74 (1999) (confirming that the Drafting Committee gave little thought to the sale of instruments until the very end of the process and “did not spend much time considering the ramifications of its decision. Whether otherwise avoidable problems will arise as a consequence remains to be seen.”); Julian B. McDonnell & John Franklin Hitchcock, Jr., *The Sale of Promissory Notes under Revised Article 9: Cooking Securitization Stew*, 117 Banking L. J. 99, 99-100, 110 n. 8 (March/April 2000) (noting that the decision to apply Article 9 to the sale of promissory notes was made late in the drafting process and attributing the driving force to Donald J. Rapson, formerly Vice President and Special Counsel of the CIT Group, Inc. and a member of the UCC’s Permanent Editorial Board). Indeed, Mr. Rapson wrote a Memorandum to the Article Drafting Committee on February 2, 1998 promoting the inclusion of the sale of instruments in Article 9 and identifying securitization as the primary reason to take this action). Donald J. Rapson, Memorandum regarding Inclusion of Sales of Instruments (Negotiable and Nonnegotiable) in Article 9 (on file with author). Prior to Mr. Rapson’s suggestion, the Article 9 Drafting Committee, headed by its two reporters, Steven L. Harris and Charles W. Mooney, Jr., had proposed including the sale of general intangibles and credit card securities into Article 9. Steven L. Harris and Charles W. Mooney, Jr., *The Article 9 Study Committee Report: Strong Signals and Hard Choices*, 29 Idaho L. Rev. 561, 569-70 (1991-1993).

<sup>87</sup> The UCC drafters accomplished this by adding the buyer of promissory notes into the definition of “secured party,” defining “promissory note,” and adding the sale of promissory notes into the scope section. UCC §§ 9-102(a)(65), (73); 9-109(a)(3) (1998). The Uniform Law Commission released

Article 1 inserted the sale of promissory notes into the definition of “security interest.”<sup>88</sup>

Arguably, Article 9 and the sale contract now provide the exclusive method for determining ownership of nonnegotiable promissory notes.<sup>89</sup>

In order to sell promissory notes under Article 9, the seller and buyer must enter into a signed agreement that includes a description of the promissory notes, the buyer must give value, and the seller must have rights in the property being transferred.<sup>90</sup>

Alternatively, the seller can deliver the notes to the buyer pursuant to an oral agreement, so long as the buyer gives value and the seller has rights in the property being transferred.<sup>91</sup> Consequently, the buyer owns the notes and the right to enforce the sale

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additional revisions to Article 9 in 2010. Those changes generally are not relevant to this discussion. To date, approximately 29 states have adopted them. See UNIFORM LAW COMMISSION, <http://www.uniformlaws.org/Legislation.aspx> Article 9 Amendments (2010).

<sup>88</sup> UCC 1-201(b)(35) (2001). In forty-nine states, Article 9 covers the sale of promissory notes by relying upon this broader definition of a “security interest.” South Carolina has not adopted this expanded definition upon which Article 9 relies. PEB Report, *supra* note 58, at 9 n.31.

<sup>89</sup> UCC § 1-103(b) cmt. 2 (2001) (“In the absence of...[a specific provision that provides otherwise], the Uniform Commercial Code preempts principles of common law and equity that are inconsistent with either its provisions or its purposes and policies.”); Barnes, et al., *supra* note 12 at 527 (stating that Article 9 governs the sale of all promissory notes, whether or not they are negotiable). As previously discussed in this section, Article 9 provides the exclusive method for determining ownership of negotiable promissory notes when they are “transferred” under § 3-203, rather than “negotiated” under § 3-201. Article 3 alone determines when a party qualifies as a PETE. See UCC § 9-109 cmt. 5 (1998) (stating that a person entitled to enforce a negotiable promissory note may sell its ownership rights in the instrument).

<sup>90</sup> UCC § 9-203(b) (1998).

<sup>91</sup> UCC § 9-203(b), cmt. 4 (1998). The effect of provisions in § 9-203 can be varied by agreement, including the definitions of negotiable instrument, negotiation, and holder in due course. UCC § 1-302(a) and cmt.1 (2001). Comment 1 to this section implies that “effect of provisions” means changing the legal consequences that would otherwise flow from any given UCC provision. Furthermore, Comment 2 to § 3-104 permits the parties to a nonnegotiable note to agree that one or more provisions of Article 3 apply to that note. Arguably, the parties to a sale can agree to transfer by way of negotiation as defined in § 3-201 (indorsement plus possession or mere possession in the case of bearer paper). The securitization industry attempted to cover its bases by providing for both the negotiation of negotiable mortgage notes under Article 3 and the outright sale and assignment of the notes and mortgages under Article 9 in the PSAs used in each deal. AMERICAN SECURITIZATION FORUM, TRANSFER AND ASSIGNMENT OF RESIDENTIAL MORTGAGE LOANS IN THE SECONDARY MORTGAGE MARKET 3 (2010), [http://www.americansecuritization.com/uploadedFiles/ASF\\_White\\_Paper\\_11\\_16\\_10.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_White_Paper_11_16_10.pdf) (“Thus, whether the mortgage notes in a given securitization pool are deemed ‘negotiable’... or ‘non-negotiable’ will have little or no substantive effect under the UCC on the validity of the transfer of the notes.”). Arguably, if the note transfers do not comply with both Articles 3 and 9, the transfers are not defensible. *But see* Barnes, et al., *supra* note 12, at 523-26, 529-30 (arguing that the delivery instructions are not conditions to the sale).

agreement, both against the seller and against any third parties claiming an ownership right in the notes.<sup>92</sup>

*E. Article 9 and Negotiable Notes*

The major innovation of an Article 9 sale is that promissory notes can be sold without transfer of possession and “independently of the principles of Article 3.”<sup>93</sup> If the note qualifies as a negotiable instrument, Article 3 recognizes two types of transfers, those that qualify as “negotiations” and those that do not meet the requirements of negotiation.<sup>94</sup> In the latter case, Article 9 determines whether the transfer constitutes a sale and, if so, the identity of the owner.<sup>95</sup> However, the Article 9 buyer can only enforce a negotiable note against the maker (the homeowner) if it is a PETE under Article 3.<sup>96</sup> Significantly, under Article 3, the PETE, either a holder or nonholder, must have

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<sup>92</sup> *Id.* (“[A] security interest is enforceable against the debtor and third parties” if certain requirements are met.). UCC § 9-308(e) goes further and, in conjunction with § 9-203(g), provides that the buyer acquires the rights to any mortgage related to the note that is senior to the rights of a lien creditor. UCC § 9-203 cmt. 6 (1998).

<sup>93</sup> McDonnell & Hitchcock, *supra* note 86, at 99.

<sup>94</sup> UCC §§ 3-201; 3-203 (1990).

<sup>95</sup> UCC § 9-203(a) and (b) (1998).

<sup>96</sup> UCC § 9-308 cmt. 6 (1998) (“For example, if the obligation is evidenced by a negotiable note, then Article 3 dictates the person whom the maker must pay to discharge the note and any lien securing it. *See* Section 3-602.”); UCC § 3-203 cmt. 1 (“[A] person who has an ownership right to an instrument might not be the person entitled to enforce the instrument.”); UCC § 3-602(a) (“[A negotiable] instrument is paid to the extent payment is made by or on behalf of a party obligated to pay the instrument, and to a person entitled to enforce the instrument.”); UCC § 3-301 (defining under what circumstances a person is entitled to enforce an instrument); UCC § 9-607 cmt. 8 (“Of course, the secured party’s rights derive from those of its debtor. Subsection (b) would not entitle the secured party to proceed with a foreclosure unless the mortgagor also were in default or the debtor (mortgagee) otherwise enjoyed the right to foreclose.”). For additional support, *see* PEB REPORT, *supra* note 58, at 4 & nn.15, 8, 10 & nn.40–41, 11 & illus. 6, 7 & 8 (“The concept of ‘person entitled to enforce’ a note is not synonymous with ‘owner’ of the note.... The rules that determine whether a person is a person entitled to enforce a note do not require that person to be the owner of the note, and a change in ownership of a note does not necessarily bring about a concomitant change in the identity of the person entitled to enforce the note.”). The Board illustrated these points through fact patterns and concluded that the identity of the person entitled to enforce a negotiable instrument is determined by Article 3, not Article 9. *See also* NELSON & WHITMAN, *supra* note 26, § 5.28.

possession, even though, under Article 9, possession is not necessary to create ownership.<sup>97</sup>

At least one former securitization industry in-house counsel contends that Article 9 trumps Article 3 on the issue of enforcement of any note, negotiable or nonnegotiable, because the sale agreement covers both notes (personal property) and their accompanying mortgages (creating a security interest in real property).<sup>98</sup> This argument conflates the sale agreement with the loan note. Rather, these are two separate and distinct contracts involving different parties.

Ms. Cully relies upon UCC § 9-604(a). In a mixed personal and real property situation, section 9-604 permits a secured party to utilize Article 9 remedies as against only the personal property without prejudicing any rights related to the real property. Alternatively, the secured party may proceed as to both the real and personal property in accordance with real property law.<sup>99</sup>

Reliance upon this provision is misplaced when applying this language in the context of a sale agreement. Article 9 permits enforcement of the sale agreement by the secured party (buyer) against the debtor (seller) in the event of a default or breach of that agreement.<sup>100</sup> It does not address (and does not affect) the right of the buyer to enforce the notes and mortgages against the borrowers/mortgagors, who are not parties to the sale

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<sup>97</sup> *Tarantola v. Deutsche Bank Nat'l Trust Co. (In re Tarantola)*, 491 B.R. 111, 119-21 (Bankr. D. Ariz. 2013) (dismissing homeowner's argument that only Article 9 and the pooling and servicing agreement apply on the issue of the transfer of the note because the note is not negotiable; implicitly finding the promissory note subject to Article 3 and applying that Article to determine that the creditor is either a holder or a nonholder with the rights of a holder for purposes of standing). As discussed in the text accompanying notes 54-56, **possession is not required where the note is lost, destroyed, or stolen.**

<sup>98</sup> Kathleen G. Cully, "Transfer of Mortgage Loan to Securitization Trusts," Slide 25 (NCLC Mortgage Training Conference July 18, 2012), on file with author.

<sup>99</sup> UCC § 9-604(a)(2) and cmt.2 (1998).

<sup>100</sup> *See generally* UCC § 9-601 (1998) (enumerating the rights of a secured party (buyer) upon default by the debtor (seller)).

agreement. As described previously, if the notes are negotiable, the right to enforce the note inures only to the PETE.<sup>101</sup>

Instead, the relevant Article 9 remedies in the event that the note maker defaults on the note purchased by a buyer are listed in section 9-607.<sup>102</sup> This section allows the buyer to notify the maker (“person obligated on collateral”) to make payments to the buyer and to exercise the rights of the seller to render performance to it.<sup>103</sup> Additionally, if the buyer does not possess a recordable mortgage assignment and one is necessary under state law to commence a nonjudicial foreclosure, the buyer may record a copy of the sale agreement along with the buyer’s sworn affidavit that a default has occurred and that it is entitled to enforce the mortgage nonjudicially.<sup>104</sup>

#### F. Negotiable or Not?

##### 1. Home Equity Lines of Credit

The discussion of nonnegotiable notes secured by mortgages is not merely academic.<sup>105</sup> For example, homeowners may borrow against their homes to pay for

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<sup>101</sup> See note 96 and accompanying text. See also discussion in Section IV, *infra*, regarding the relationship between the right to enforce the note and the right to foreclose.

<sup>102</sup> PEB Report, *supra* note 58, at 14 (noting that the UCC contains four sets of rules that are relevant in the context of enforcement of mortgage notes, including § 9-607 because it “provides a mechanism by which the owner of a note and the mortgage securing it may, upon default of the maker of the note, record its interest in the mortgage in the realty records in order to conduct a nonjudicial foreclosure”). Significantly, the Report does not include § 9-604 among these four rules or identify § 9-604 in any way as a rule addressing enforcement of the note by the buyer against the maker.

<sup>103</sup> UCC § 9-607(a) (1998).

<sup>104</sup> UCC § 9-607(b) (1998).

<sup>105</sup> Courts often assume that the standard promissory note is negotiable without engaging in any analysis. *E.g.*, Chase Home Fin., LLC, 989 A.2d 606, 610-611 (Conn. App. Ct. 2010); Deutsche Bank Nat. Trust Co. v. Clarke, 87 So.3d 58, 60-61 (Fla. Dist. Ct. App. 2012); Leyva v. Nat’l Default Serv. Corp., 255 P.3d 1275, 1280 (Nev. 2011) (mentioning the elements of negotiability but concluding that “a mortgage note is a negotiable instrument” without analysis of the specific note at issue); Deutsche Bank Nat. Trust Co. v. Matthews, 273 P.3d 43, 46 (Okla. 2012); Arnold v. Palmer, 686 S.E.2d 725, 732 (W. Va. 2009); Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What to Do About It*, 37 PEPP. L. REV. 737, 754-56 (2010) (reviewing forty-two court decisions rendered during the twenty years prior to 2009 in which negotiability of mortgage notes was in issue and finding that in thirty-three cases, “the court either expressly assumed without analysis that the note or notes in question were negotiable, or implicitly assumed the same result by moving directly to an issue that depended on

home repairs, medical bills, a child's education, retire a credit card account, or for other reasons.<sup>106</sup> Rather than refinance a current fixed-term mortgage loan, the lender may offer the homeowner a home equity line of credit (HELOC). Between 2005 and 2009, the dollar volume of balances owed on HELOCs in the United States rose from approximately \$350 billion to over \$500 billion.<sup>107</sup>

A HELOC is similar to other mortgage loans in that both are secured by the homeowner's home, although the HELOC mortgage usually is subordinate to an existing mortgage.<sup>108</sup> A HELOC differs from a traditional mortgage loan in several ways. A traditional second mortgage loan provides the borrower with a fixed amount of money that is repayable over a fixed term, regardless of whether the interest rate is fixed or variable.<sup>109</sup> In contrast, a HELOC sets a credit limit, permits the homeowner to draw up to that limit in multiple advances, and may set a time limit to the draw period.<sup>110</sup> In

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negotiability without any mention of negotiability itself"); *see also* Fred H. Miller, *Promissory Notes, Mortgages, Assignments, Foreclosure, and Related UCC Issues*, 65 Consumer Fin. L.Q. Rep. 406, 409 (Fall/Winter 2011) ("Generally, the courts that have been addressing foreclosure issues have not engaged in an analysis of whether the promissory note at issue in the case is negotiable or nonnegotiable.").

<sup>106</sup> U.S. Census Bureau, *Home Equity Lines of Credit—Who Uses This Source of Credit?* 1 (Sept. 2007), [www.census.gov/prod/2007pubs/c2kbr-37.pdf](http://www.census.gov/prod/2007pubs/c2kbr-37.pdf).

<sup>107</sup> Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit* 7 (August 2010), [www.newyorkfed.org/householdcredit/historical-reports.html](http://www.newyorkfed.org/householdcredit/historical-reports.html) (click on 2010, Q2 report); *see also* INSIDE MORTGAGE FINANCE PUBLICATIONS, INC., *THE 2009 MORTGAGE MARKET STATISTICAL ANNUAL* 1, at 4 (2009) (showing home equity loans rising in volume on an annual basis from \$53 billion in 2000 to \$349 billion in 2007, before the foreclosure crisis fully hit); *Improving housing market helps revive HELOC originations*, *Mortgage Daily*, March 25, 2013, [www.mortgagedaily.com/MctHelocs032513LP.asp](http://www.mortgagedaily.com/MctHelocs032513LP.asp) (reporting almost \$700 billion in outstanding HELOCs in 2008).

<sup>108</sup> INSIDE MORTGAGE FINANCE PUBLICATIONS, INC., *THE 2009 MORTGAGE MARKET STATISTICAL ANNUAL* 1, at v (2009) (defining a home equity loans as a loan secured by a mortgage that is in second position which includes home equity lines of credit).

<sup>109</sup> The Federal Reserve Board, *What You Should Know about Home Equity Lines of Credit* 8 (2012), available at <http://www.consumerfinance.gov/learnmore>.

<sup>110</sup> *Id.*

essence, a HELOC is a revolving line of credit. Consequently, the note is not negotiable because it does not contain a provision requiring payment of a fixed amount of money.<sup>111</sup>

## 2. Payment Option ARMs

The lending industry began offering payment option or “pick-a-payment” adjustable rate mortgages in the early part of the last decade and they steadily gained market share.<sup>112</sup> Option ARM originations rose from \$145 billion in 2004 to the peak of \$255 billion in 2007.<sup>113</sup>

The complaint in one case succinctly describes the mechanics of a typical payment option ARM.

Ralston’s loan was offered at a low “teaser” interest rate of 1%. That rate lasted only thirty days, after which the rate was calculated by combining an index and a margin of 3.075%. Even if the index went down to zero, the combined total of the index and the margin always would be significantly higher than the teaser rate. However, the

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<sup>111</sup> UCC §§ 3-104(a); 3-112 cmt. 1 (1990) (clarifying that the requirement of a fixed amount of money applies to the principal); *see also* Heritage Bank v. Bruha, 812 N.W.2d 260, 270-71 (Neb. 2012) (ruling that a non-mortgage loan note permitting advances up to a set amount is not for a fixed amount of money because one cannot see how much the borrower had been advanced at any given time and is not negotiable); Diversified Fin. Systems, Inc. v. Hill, Heard, O’Neal, Gilstrap & Goetz, P.C., 99 S.W.3d 349, 357 (Tex. App. 2003) (holding that a non-mortgage secured note was not negotiable when it permitted multiple advances over time up to \$50,000).

<sup>112</sup> Andrew G. Pizer, *et al.*, *Mortgage Lending* § 2.6.2.1 (National Consumer Law Center 2012) (noting that payment option ARMs were common before 2008).

<sup>113</sup> INSIDE MORTGAGE FINANCE PUBLICATIONS, INC., THE 2009 MORTGAGE MARKET STATISTICAL ANNUAL 1, at 6 (2009). The top five producers of option ARMs in 2007, the peak year were: Countrywide Financial, Wells Fargo & Company, Washington Mutual Bank, Wachovia Corporation, and IndyMac Bank. INSIDE MORTGAGE FINANCE PUBLICATIONS, INC., THE 2008 MORTGAGE MARKET STATISTICAL ANNUAL 1, at 137 (2008). Only Wells Fargo survived the foreclosure crisis intact and purchased Wachovia Bank in the process. Sheila Bare, *Bull by the Horns* 96-105 (Free Press 2012). Bank of America bought Countrywide and its related companies in 2008. *Bank of America to Acquire Countrywide*, MSNBC.COM (Jan. 11, 2008), [http://www.msnbc.msn.com/id/22606833/ns/business-real\\_estate/t/bank-america-acquire-countrywide](http://www.msnbc.msn.com/id/22606833/ns/business-real_estate/t/bank-america-acquire-countrywide). Meanwhile, IndyMac Bank and Washington Mutual Bank failed on July 11, 2008 and September 25, 2008, respectively. FDIC Failed Bank List, <http://www.fdic.gov/bank/individual/failed/banklist.html>.

monthly payment schedule was calculated at the 1% rate.

Under the applicable payment cap, the monthly payment could be increased only by 7.5% each year. Thus Ralston's loan was certain to cause—indeed, it was *designed* to cause—negative amortization. Ralston was “locked in” to the loan by “a draconian prepayment penalty consisting of a prepayment charge equal to six months of interest.” Once the principal reaches 115% of the original loan amount, the monthly payment cap is eliminated and the monthly payments immediately are recast to fully amortizing payments of principal and interest. “To the extent that this built-in ‘payment shock’ is more than many Class Members can afford, they need to refinance 115% of the amount they initially borrowed (despite having made all of the required payments) or risk losing their homes to foreclosure.”<sup>114</sup>

Negative amortization occurs when the monthly payments are insufficient to cover the interest earned for that payment period. In that event, the loan note often provides that the earned and unpaid interest is added to the principal, a concept known as capitalizing the interest.<sup>115</sup> If the note makes clear that negative amortization and

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<sup>114</sup> Ralston v. Mortgage Investors Group Inc., 2010 WL 3211931 \* 2 (N.D. Cal. Aug. 12, 2010) (refusing to dismiss the class member’s fraudulent omission cause of action) (*quoting* complaint; citations to the record omitted).

<sup>115</sup> *Surviving Debt* 479, 484 (National Consumer Law Center 2013) (defining capitalization and negative amortization); Pizor, *et al.*, *supra* note 112 at §§ 2.6.2.2, 2.6.2.3, 2.6.2.4 (providing the mathematical calculations to prove how and negative amortization occurs based upon a loan of \$425,000 with terms similar to those described in the *Ralston* case). *See also* Amortization Schedule for Countywide Bank Adjustable Rate Note-Payment Caps Note and PayOption Rider April 8, 2005 (on file with author).

capitalization inevitably will occur, as alleged in the *Ralston* case, the note does not contain a fixed principle amount because the stated initial principal constitutes only a floor while the principal cap operates like the credit limit in a HELOC, that is, the maximum possible principle. The actual principal is never certain, rendering the note nonnegotiable.<sup>116</sup>

### 3. *Prepayment Penalty and Written Notice of Prepayment*

Professors Ronald Mann and Dale Whitman question whether the standard Fannie Mae and Freddie Mac notes widely used in mortgage loans transactions across the nation are negotiable.<sup>117</sup> Professor Mann focused on the prepayment provision and related writing requirement in these instruments, arguing that requiring the maker (borrower) to send a notice before a prepayment constitutes a requirement in addition to the payment of money which renders the note nonnegotiable pursuant to UCC § 3-104a(3).<sup>118</sup> Some homeowners recently have litigated this issue--so far, unsuccessfully.<sup>119</sup>

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<sup>116</sup> There appears to be only one case directly addressing the negotiability of a payment option ARM. In *Bank of New York v. Baldwin*, the Connecticut Superior Court failed to describe the terms of the particular loan at issue and misunderstood the concepts of amortization, negative amortization, and capitalization by stating that no note could be negotiable unless the principal remained constant throughout the loan term. 2009 WL 2962445 \*4 (Ct. Super. Ct. Aug. 13, 2009). Amortization of simple interest loans, such as promissory notes, occurs when each monthly payment is applied first to earned interest and next to principal resulting in a predictably *declining* balance. In this scenario, negative amortization can occur only by the act of the borrower in failing to make payments. In that event, unpaid interest may be added to the principal, that is, capitalized, and the principal increases, if capitalization is authorized in the note. In the case of option ARMs, negative amortization is guaranteed by the note and occurs regardless of whether the borrower makes all payments on time. Carolyn L. Carter, *et al.*, *Consumer Credit Regulation* § 5.3.1.1 (National Consumer Law Center 2012) (explaining simple interest); Pizor, *et al.*, *supra* note 112, at § 2.3.3.4 (defining negative amortization) and §§ 2.5.2.1- 2.6.2.4 (describing the effect of negative amortization in an option ARM).

<sup>117</sup> Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951, 962-73 (1996); Whitman & Milner, *supra* note 3, at 749-51 (observing that, at best, the negotiability of the notes used by the secondary market giants, Fannie Mae and Freddie Mac, is “uncertain”).

<sup>118</sup> Mann, *supra* note 117, at 971-73 (quoting from the standard note: “When I make a prepayment, I will tell the Note Holder in writing that I am doing so.”); *but see* Whaley, *supra* note 8, at 324-25 (disagreeing with Professor Mann on this point).

<sup>119</sup> *HSBC Bank USA Nat’l Ass’n v. Gouda*, 2010 WL 5128666 (N.J. Super. Ct. App. Div. Dec. 17, 2010) (holding that the right to prepayment is a voluntary option and the fact that the borrower must notify when opting to prepay is not a condition placed on the borrower’s promise to pay). Several courts

G. *The Enforcement of Nonnegotiable Notes*

Under Article 9, the right to enforce a nonnegotiable note provided for in the note can be transferred either by a written sale agreement or by delivery of the note accompanied by an oral agreement to transfer ownership.<sup>120</sup> Thus, section 9-203(b) permits the buyer to acquire ownership rights without indorsement or delivery of the notes, so long as its other requirements are met. Moreover, comments in the Restatement (Third) Property (Mortgages) explain that transfer of a contractual right obligation, such as that embodied in a nonnegotiable note, can occur by assignment.<sup>121</sup>

As a result of the intervention of Article 9 into the common law addressing the transfer of nonnegotiable promissory notes, its relevant provisions and the purchase and sale contract now determine ownership.<sup>122</sup> It is important to remember that the note itself is a separate contract between the maker and the original payee. When the payee sells the note, the immediate buyer and any subsequent buyers stand in the shoes of the seller who, in turn, stands in the shoes of its seller, extending back to the shoes of the original

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expressly adopt the *Gouda* court's view, including *In re Steinberg*, 2013 WL 2351797, at \*5-6, n. 34 (B.A.P. 10<sup>th</sup> Cir. May 30, 2013); *In re Walker*, 466 B.R. 271, 283 (Bankr. E.D. Pa. 2012); *Picatinny Fed. Credit Union v. Fed. Nat'l Mortg. Ass'n*, 2011 WL 1337507, at \*7 (D.N.J. April 7, 2011); *Edwards v. Deutsche Bank Nat'l Trust (In re Edwards)*, 2011 WL 6754073, at 5\* (Bankr. E.D. Wis. Dec. 23, 2011). Professor Whitman noted these decisions in a recent article and remarked that the courts' reasoning in these cases "is hardly overwhelming" and contends that the negotiability of Fannie Mae and Freddie Mac notes "remains uncertain." Whitman & Milner, *supra* note 3, at 29-29, n. 30.

<sup>120</sup> UCC § 9-203(b)(3)(A) and (B), cmt. 4 (1998). Article 9 supports this view because it defines a promissory note as an "instrument" which is "of a type that in the ordinary course of business is transferred by delivery with any necessary indorsement or assignment." UCC § 9-102(a)(47) (1998) (emphasis added). Professor Whitman and Mr. Milner opine that transfer of the enforcement rights in a nonnegotiable instrument can occur by written assignment in a separate document or by delivery. "[A]nd beyond these principles, not much can be said." Whitman & Milner, *supra* note 3, at 31. They do not reference § 9-203(b) in this context, which, as noted in the text accompanying notes 91-93 above, requires more than mere transfer of possession.

<sup>121</sup> RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 cmt. b (1997) (contrasting a negotiable note which must be delivered)

<sup>122</sup> Unless provided elsewhere in the UCC, the effect of the provisions of the Code may be varied by agreement. UCC § 1-302(a) (2001). An Official Comment to this section states that "freedom of contract is a principle of the Uniform Commercial Code." Cmt. 1. This right is not limitless, however. Cmt. 1; UCC § 9-602 (1998) (containing explicit limitation on freedom of contract).

payee.<sup>123</sup> The rights of the buyer to enforce the note are co-extensive with those afforded the original payee as set forth in the note and other relevant law.

Article 9 intervenes into the actual enforcement of the underlying note in only two limited ways: first, if so agreed, the buyer may direct the note maker to make payment to it or perform other obligations; and second, the buyer may record a copy of the sale agreement and an affidavit indicating its right to foreclose if necessary to permit a buyer to foreclose nonjudicially.<sup>124</sup> Otherwise, Article 9 does not address the scope of the right to enforce the note itself or the right to foreclose on its accompanying mortgage.<sup>125</sup>

### *1. Enforcement Obstacles*

Although the Article 9 sale procedure appears straightforward, carelessness occurred in the securitization context. For example, the pooling and servicing agreement (PSA) may fail to meet the section 9-203(b) prerequisites to enforceability. The Massachusetts Supreme Judicial Court in *U.S. Bank Nat'l Ass'n v. Ibanez* reviewed two PSAs to determine whether they contained effective assignments of the mortgages to the trustee banks.<sup>126</sup> In one of the consolidated cases, the sale agreement did not constitute an actual sale of the notes or assignment of the mortgages. Rather, it represented only a desire to sell.<sup>127</sup> In both cases, the PSAs presented to the court failed to include an itemized list of the specific mortgage loans contained in the deal. Accordingly, the

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<sup>123</sup> See discussion in text accompanying notes 50-53 and in note 71 above.

<sup>124</sup> UCC § 9-607(a)(1), (3); § 9-607(b) (1998).

<sup>125</sup> The right to foreclose, as one enforcement mechanism, and Article 9's role are discussed in Section IV.D below.

<sup>126</sup> *U.S. Bank Nat'l Ass'n v. Ibanez*, 941 N.E.2d 40, 52 (Mass. 2011) (construing the contract and addressing whether the mortgages were assigned properly).

<sup>127</sup> *Id.*

mortgage were not assigned legally and the foreclosure sales by the trustee banks were void.<sup>128</sup>

The *Ibanez* court did not address the specific question of whether the PSA sale failed to meet the elements of an Article 9 sale. Its analysis, however, parallels two of the elements listed in sections 9-203(b): first, that the seller sign a written agreement to sell the mortgage loans; and second, that the agreement contain a description of the collateral (the notes being sold).<sup>129</sup>

Section 9-108 governs the sufficiency of the description of collateral in a sale agreement. Generally, the description is adequate if it reasonably identifies what is described.<sup>130</sup> This section includes examples of reasonable identification, for example, by a specific listing, category, type of collateral as defined in the UCC, quantity, or any other method “if the identity of the collateral is objectively determinable.”<sup>131</sup>

“Supergeneric descriptions of the collateral, such as “all the seller’s assets” or “all the seller’s personal property” or words of similar import are prohibited.”<sup>132</sup>

The PSA purportedly governing the Larace loan in *Ibanez* contains the following description the mortgage loans being sold:

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<sup>128</sup> The outcome in the *Ibanez* case prompted two attorneys practicing with the Barnes & Thornburg firm in its Finance, Insolvency, and Restructuring Department to published a list of best practices to ensure proper documentation prior to initiating any foreclosure action. Thorne & Badawi, *supra* note 3, at 84. They recommend that foreclosing parties and their counsel ensure that: 1) the purchase agreement for the note and mortgage include a specific intent to sell and a specific listing of each mortgage loan being sold, accompanied by granting language conveying the mortgage loans; 2) the note was properly transferred and indorsed; 3) the foreclosing party has possession of the note or a proper lost note affidavit is prepared; 4) verify that all required assignments of the mortgage have been recorded in the local land records office.

<sup>129</sup> UCC § 9-203(b) (1998) must be read together with UCC § 9-102(a)(74) (1998) (defining “security agreement” as an agreement that creates or provides for a security interest) and UCC § 1-201(b)(35) (2001) (defining “security agreement” to include the sale of promissory notes).

<sup>130</sup> UCC § 9-108(a) (1998).

<sup>131</sup> UCC § (b)(1)-(6) (1998).

<sup>132</sup> UCC § 9-108(c) (1998).

The Depositor, concurrently with the execution and delivery hereof, does hereby transfer, assign, set over and otherwise convey to the Trustee, on behalf of the Trust, without recourse for the benefit of the Certificateholders all the right, title and interest of the Depositor, including any security interest therein for the benefit of the Depositor, in and to (i) each Mortgage Loan identified on the Mortgage Loan Schedules...<sup>133</sup>

The parties to this transaction agreed to specifically list each mortgage loan, a legitimate form of collateral description in section 9-108(b). However, the parties failed to actually include the itemization in the PSA. Moreover, the use of the broad phrase “mortgage loans” does not reasonably identify the mortgage loans subject to this particular securitization or provide a method for objectively determining the relevant loans.<sup>134</sup> For these reasons, the sale agreement is not enforceable under Article 9 and the outcome is the same as in *Ibanez*.<sup>135</sup>

Having set the stage with a discussion of the enforcement of notes, we now turn to the relationship between the enforcement of notes and state foreclosure law.

#### **IV. THE RIGHT TO FORECLOSE UNDER REAL ESTATE LAW**

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<sup>133</sup> Asset Backed Funding Corporation, Option One Mortgage Corporation, and Wells Fargo Bank, N.A., Pooling and Servicing Agreement, ABFC 2005-OPT 1 Trust § 2.1 (Oct. 1, 2005), available at <http://www.sec.gov/Archives/edgar/data/1343316/000091412105002222/as871211-ex4.txt>.

<sup>134</sup> The parties to a PSA usually do not know at the time they sign it exactly which mortgage loans being originated by the lender or its affiliates will make it into that particular deal. Each deal contains a closing date which may post-date the contract.

<sup>135</sup> UCC § 9-203(b) (1998) (a sale agreement is not enforceable against the buyer and seller and third parties if the written agreement does not contain a description of the collateral).

A. *Common Law Rules*

“It is axiomatic that a mortgage is security for the performance of an act; that is the very nature of a mortgage.”<sup>136</sup> The required act that most commonly is the source of a default under mortgages is repayment of borrowed amount.<sup>137</sup> Historically, the loan note and mortgage traveled together. “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 is a nullity.”<sup>138</sup> Many state courts and legislatures have adopted this rule.<sup>139</sup> Moreover, if an Article 9 sale of promissory notes

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<sup>136</sup> Nelson & Whitman, *supra* note 26 at § 2.1 (citing Restatement (Third) of Property: Mortgages § 1.1 (1997)). The word “mortgage” refers to all types of residential real estate security agreements unless the text specifically states “deed of trust” or “security deed.”

<sup>137</sup> Before the housing market meltdown, the percentage of all outstanding residential mortgage loans in the nation ninety days or more delinquent on loan payments or in foreclosure (“seriously delinquent”) stood at 2.23% (or almost 980,000 loans). MORTG. BANKERS ASS’N, NATIONAL DELINQUENCY SURVEY Q1 (2007). This percentage rose dramatically to its peak of 9.67% (or almost 4.3 million loans) by the end of 2009. MORTG. BANKERS ASS’N, NATIONAL DELINQUENCY SURVEY Q4 (2009). A default of an obligation in the mortgage other than non-payment of the amounts due under the note can trigger the right to foreclose, depending on the terms of the mortgage contract. This Article limits its analysis to loan payment defaults.

<sup>138</sup> *Carpenter v. Longan*, 83 U.S. 271, 274–75 (1872); RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4(a) (1997) (applying this rule to the transfer of both negotiable and nonnegotiable notes in Illustrations 1 and 2 but recognizing that the methods of transfer differ depending on the type of note). 4 POWELL ON REAL PROPERTY, *supra* note 27, § 37.27[2]. When only the note is transferred, at minimum, an equity interest in the mortgage automatically follows. The transfer of the mortgage typically is completed upon the execution of a formal written assignment. *Id.* at §§ 37.27[2]–[3].

<sup>139</sup> Examples of state statutes include: Ala. Code § 8-5-24 (1975); Ariz. Rev. Stat. Ann. § 33-817 (2012); Conn. Gen. Stat. § 49-17 (2012) (as interpreted by *RMS Residential Properties, LLC v. Miller*, 32 A.3d 307, 313 (Conn. 2011); Utah Code Ann. § 57-1-35 (2012); *but see* Ga. Code Ann. § 44-14-64(b) (2013) (when the security deed is assigned, the note follows the deed); Kan. Stat. Ann. §58-2323 (codifying the opposite, that the note follows the mortgage; *but see* *U.S. Bank Nat’l Ass’n v. McConnell*, \_\_P.3d \_\_, 2013 WL 1850755 \*7 (Kan. Ct. App. May 3, 2013) (stating that the state statute that codifies the opposite, that the note follows the mortgage; but holding that the mortgage follows the note, relying on the RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4(a) (1997)). Examples of court decisions include: *Thomas v. Wells Fargo Bank, N.A.*, \_\_So.3d \_\_, 2012 WL 3764729 \* 3 (Ala. Civ. App. Aug. 31, 2012); *Coon v. Shry*, 289 P. 815, 816 (Cal. 1930); *Lindsey v. Wells Fargo Bank., N.A.* \_\_So.3d \_\_, 2013 WL 692825 \* (Fla. Dist. Ct. App. Feb. 27, 2013); *Prime Fin. Servs. LLC v. Vinton*, 761 N.W.2d 694, 703-04 (Mich. Ct. App. 2008); *Edelstein v. Bank of New York Mellon*, 286 P.3d 249, 257-58 (Nev. 2012); *U.S. Bank, N.A. v. Collymore*, 890 N.Y.S.2d 578, 580 (App. Div. 2009); *Wells Fargo Bank, N.A. v. Heath*, 280 P.3d 328, 333 (Okla. 2012); *Brandrup v. ReconTrust Co., N.A.*, \_\_P.3d \_\_, 2013 WL 2446517 \*5, 25 (Or. June 6, 2013); *Stimson v. Bishop*, 82 Va. 190, 1866 WL 2987 \* 7 (Va. 1886) (relied upon in *Horvath v. Bank of New York, N.A.*, 641 F.3 617, 623 (4<sup>th</sup> Cir. 2011); *Bain v. Metropolitan Mortg. Group, Inc.*, 285 P.3d 34, 44 (Wash. 2012); *Tobin v. Tobin*, 121 N.W. 144, 146 (Wis. 1909) (assignment of the mortgage alone does not transfer the note); *see also* Harrell, *supra* note 73 at 148 (stating that most courts recognize

secured by related mortgage loans occurs, the sale automatically includes the mortgages.<sup>140</sup>

The Restatement (Third) of Property (Mortgages) addresses the right to foreclose and states “[a] mortgage may be enforced only by, or on behalf of, a person who is entitled to enforce the obligation the mortgage secures.”<sup>141</sup> If the note and mortgage are split between different parties, the assignee of only the mortgage ordinarily holds a worthless piece of paper.<sup>142</sup>

### B. Statutory Wrinkles

State statutes enacted over the years have diverged from these common law principles. For example, statutes of frauds may mandate that transfers of interests in real property, including mortgages and their assignments, be in writing.<sup>143</sup> States also may insist upon the recordation of a mortgage assignment before a party can foreclose.<sup>144</sup>

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this common law rule); *cf.* *Eaton v. Federal Nat’l Mortg. Ass’n*, 969 N.E.2d 1118, 1125 (Mass. 2012) (confirming that the transfer of only the note vests in the note holder the right to obtain a conveyance of the mortgage in this title theory state; note holder only possesses a beneficial interest in the mortgage until a written assignment occurs); *Jackson v. Mortgage Electronic Registration Systems, Inc.*, 770 N.W.2d 487, 497 (Minn. 2009) (noting rule in Minnesota that an assignment of the note operates as an equitable assignment of the related security agreement; however, foreclosing party must possess both record and legal title).

<sup>140</sup> UCC § 9-203(g) and cmt. 9 (1998) (codifying the common law rule). In addition, the ownership interest of the buyer is perfected upon the sale in both the note and the accompanying mortgage. UCC §§ 9-308(e), 9-309(4) (1998).

<sup>141</sup> RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4(c) (1997).

<sup>142</sup> RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 cmt. e (1997); 4 POWELL ON REAL PROPERTY, *supra* note 27, at §§ 32.27[1]–[2]; *but see* *You v. JP Morgan Chase Bank, N.A.*, \_\_S.E.2d\_\_, 2013 WL 2152562 (Ga. May 20, 2013) (recognizing that in Georgia the note follows the security deed where the security deed alone is transferred).

<sup>143</sup> 4 POWELL ON REAL PROPERTY, *supra* note 27, at § 37.27[1].

<sup>144</sup> *Id.*; GA. CODE ANN. § 44-14-162(b) (2008); Mich. Comp. Law § 600.3204(3); Nev. Rev. Stat. § 106.210(1); Tex. Local Gov. Code § 192.007(a); Vt. R. Civ. P. 80.1(b)(1) (requiring the complaint to state the record date of the instrument upon which the foreclosing party relies and attaching copies of all original assignments of the mortgage); NELSON & WHITMAN, REAL ESTATE FINANCE LAW § 5.28 and text accompanying n. 71 (4th ed. 2001) (noting that a party cannot foreclose on a mortgage in many jurisdictions unless it has a recorded chain of title leading from the original mortgagee to it); *see also* *Kim v. JPMorgan Chase Bank, N.A.*, 825 N.W.2d 329 (Mich. 2012) (applying § 600.3204(3) and holding that failure to record all assignments of the mortgage render the sale voidable); *Miller v. Homecomings Fin., LLC*, 881 F. Supp. 2d 825, 830 (S.D. Tex. 2012) (stating that there are no reported cases interpreting Tex.

Moreover, some states require that the foreclosing party allege and prove “ownership” of the mortgage note and produce the note, mortgage, and all assignments of these instruments.<sup>145</sup>

*C. The Two Prevailing Foreclosure Procedures Used in the United States*

In the United States, most residential mortgages or deeds of trust are foreclosed by judicial or nonjudicial process.<sup>146</sup> The dominant form of foreclosure in the majority of states is the nonjudicial method.<sup>147</sup> In these latter states, judicial foreclosure is required in certain special circumstances.<sup>148</sup>

In judicial foreclosure states, the mortgage holder files a complaint in court in order to obtain a court decree authorizing a foreclosure sale.<sup>149</sup> Generally, the party

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Local Gov. Code § 192.007(a) and the legal consequences of noncompliance are “unclear”); *cf.* *Brandrup v. Reconstit Co., N.A.*, \_\_\_P.3d \_\_\_, 2013 WL 2446517 \* 15-18 (Or. June 6, 2013) (interpreting Or. Rev. Stat. § 86.735(1) to require recordation of all assignments of the deed of trust that are in recordable form before proceeding to foreclosure; excluding from the statute transfers of the deed of trust that occur by operation of law, such as when the note is transferred); *Calvo v. HSBC Bank USA, N.A.* 123 Cal. Rptr. 3d 803, 815 (Ct. App. 2011) (interpreting Cal. Civ. Code § 2932.5 that mandates recordation of an assignment of the mortgage or other encumbrance prior to exercising the power of sale applies to mortgages and not to deeds of trust).

<sup>145</sup> *E.g.*, ME. REV. STAT. Tit. 14, § 6321 (2012) (requiring the mortgagee to certify proof of ownership of the mortgage note and to produce evidence of the mortgage note, mortgage, and all assignments and endorsements of the mortgage note and mortgage); Mich. Comp. Law § 600.3204(1)(d) (2012) (permitting either the owner of the of the indebtedness or of an interest in the indebtedness to foreclose); *see also* 4 POWELL ON REAL PROPERTY, *supra* note, at § 37.38[2] (reprinting a complaint form used in Illinois pursuant to Ill. Comp. Stat 5/15-1504 which includes factual allegations that support the plaintiff’s capacity to bring the action and requires the plaintiff to attach a copy of the note and the mortgage). Maine’s highest court interpreted this Maine statute to mean that mortgagee to certify proof of ownership of the mortgage note to mean that the foreclosing party must own or be the economic beneficiary of the note or, if not the owner, then be entitled to enforce the note under UCC § 3-301. *Bank of America v. Clouthier*, 61 A.3d 1242, 1245-46 (Me. 2013)

<sup>146</sup> *Rao, et al.*, *supra* note 61 at § 4.2.1. A form of judicial process called “[s]trict foreclosure is allowed in only two states, Connecticut and Vermont” and will not be discussed in this Article. *Id.* § 4.2.4, at 111. For a description of this type of foreclosure, see *id.* § 4.2.4, at 111–12.

<sup>147</sup> *Jacobson-Greany*, *supra* note 17 at 144.

<sup>148</sup> *Nelson & Whitman*, *supra* note 26 at § 7.11 (highlighting the following examples of when a judicial foreclosure may be necessary: 1) the mortgage or deed of trust fails to include a power of sale provision; 2) there is a serious lien priority dispute; and 3) a deficiency judgment is prohibited when the party proceeds nonjudicially).

<sup>149</sup> *Rao, et al.*, *supra* note 61 at § 4.2.1, at 110, § 4.2.2 at 110.

seeking must establish its standing to foreclose and that it is the real party in interest.<sup>150</sup>

To prove these threshold matters, there must be a valid mortgage between the parties and the plaintiff must be the holder of the note and mortgage or, otherwise, is a proper party with authority to foreclose.<sup>151</sup> The homeowner may file an answer, raise defenses to the foreclosure, or otherwise to the lawsuit in a fashion similar to other civil cases.<sup>152</sup> The court may enter a judgment of foreclosure and order the sale to proceed, if the homeowner defaults or the plaintiff otherwise prevails.<sup>153</sup>

In nonjudicial foreclosure states, foreclosures proceed with little or no judicial oversight.<sup>154</sup> Lenders foreclose by exercising the power of sale contained in the mortgage contract.<sup>155</sup> In some of these states, the statutory scheme is detailed and extensive; whereas, in others, it is minimal.<sup>156</sup> Generally, following a default by the homeowner, the holder of the mortgage or the trustee named in a deed of trust must give notice according to the terms of the mortgage or deed of trust and applicable statutes before a sale can occur.<sup>157</sup> Typically, these notices include notification of default, of acceleration, and of the sale.<sup>158</sup> In addition, nearly all states require some form of public advertisement of the sale through a newspaper or posting.<sup>159</sup>

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<sup>150</sup> *Id.* § 5.1.2.2, at 153-54, § 5.1.2.3, at 155..

<sup>151</sup> *Id.* § 5.1.2.2, at 154.

<sup>152</sup> 4 POWELL ON REAL PROPERTY, *supra* note 27, § 37.38[2].

<sup>153</sup> *Id.* § 37.40.

<sup>154</sup> JOHN RAO & GEOFF WALSH, NAT'L CONSUMER LAW CTR., FORECLOSING A DREAM: STATE LAWS DEPRIVE HOMEOWNERS OF BASIC PROTECTIONS, 11 (Feb. 2009), *available at* [http://www.nclc.org/images/pdf/foreclosure\\_mortgage/state\\_laws/foreclosin\\_g-dream-report.pdf](http://www.nclc.org/images/pdf/foreclosure_mortgage/state_laws/foreclosin_g-dream-report.pdf). *Id.* at 11.

<sup>155</sup> *Id.*

<sup>156</sup> Jacobson-Greany, *supra* note 17, at 144-45.

<sup>157</sup> 4 POWELL ON REAL PROPERTY, *supra* note 27, § 37.42[4].

<sup>158</sup> *Id.* § 37.42[4].

<sup>159</sup> *Id.* § 37.42[4].

Once the foreclosing entity complies with these procedural mandates, it schedules the sale usually with an auctioneer that it hires.<sup>160</sup> The burden is on the homeowner to initiate a judicial proceeding and seek an injunction and raise legal claims and defenses in order to stop this type of foreclosure.<sup>161</sup>

The power of sale process benefits lenders because it provides less expensive and swift remedy against allegedly defaulting homeowners.<sup>162</sup> The sale process can be completed in 20 to 120 days, depending upon state law.<sup>163</sup> However, the nonjudicial foreclosure process is harsh in its treatment of homeowners because the homeowners lose their homes without guaranteed prior judicial oversight.<sup>164</sup>

*D. Intersections Between the Right to Foreclose and the UCC*

The discussion in Section III outlines the law defining the right to enforce negotiable and nonnegotiable notes. If the note is unsecured, “enforcement” involves suing on the note and obtaining a money judgment. When the note is secured by a mortgage, the mortgagee may either sue on the note, foreclose on the mortgage, or both and obtain a judgment for the deficiency, if a deficiency permitted under state law.<sup>165</sup>

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<sup>160</sup> Jacobson-Greany, *supra* note 17, at 148–49. The sale may occur at the real estate or some other location permitted by law. *Id.*

<sup>161</sup> RAO ET AL., *supra* note 61, § 5.1.4.4. In this instance, court rules or state statutes may require the homeowner to post a bond or tender the arrearage or total amount due, a significant hurdle that may discourage or prevent some plaintiffs from pursuing an injunction. *Id.* § 5.1.4.5 Alternatively, a qualified homeowner may file a petition for bankruptcy and obtain a stay of the foreclosure sale. *See id.* § 10.1 to § 10.11 (detailing the steps the debtor must take to file and the possible benefits afforded by the bankruptcy forum); *see also* HENRY J. SOMMER, CONSUMER BANKRUPTCY LAW & PRACTICE VOL. ONE: CHAPTERS, §§ 6.1 to 6.2.1.6 (John Rao ed., 9th ed. 2009) (discussing when and how bankruptcy provides the best solution for consumer debtors).

<sup>162</sup> Jacobson-Greany, *supra* note 17, at 151.

<sup>163</sup> *Id.* at 150–51.

<sup>164</sup> *Id.*

<sup>165</sup> RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 8.2 (1997). Over thirty states have enacted statutes which prohibit or limit deficiency claims against the mortgagor. JOHN RAO ET AL., *supra* note 61 at §16.3.2, at 548. Some states limit the mortgagee’s remedy to foreclosure, compelling that party to exhaust the security before attempting to sue on the debt. This is called the “one action” rule. Nelson & Whitman, *supra* note 26 at § 8.2.

The connection between the right to foreclose and the UCC is one of the most common issues faced by courts over the last five years due primarily to the mishandling of the notes and mortgages and the foreclosing party's response to the lack of proper documentation. The Permanent Editorial Board of the UCC recently confirmed that "[t]he enforcement of real estate mortgages by foreclosure is primarily the province of a state's real property..."<sup>166</sup> The PEB identified four sets of rules from the UCC (and only these rules) that "are important in the context of enforcement of mortgage notes and the mortgages that secure them."

- First, in the case of a mortgage note that is a negotiable instrument, Article 3 of the UCC determines the identity of the person who is entitled to enforce the note and to whom the maker owes its payment obligation; payment to the person entitled to enforce the note discharges the maker's obligations, but failure to pay that party when the note is due constitutes dishonor.
- Second, for both negotiable and nonnegotiable mortgage notes, Article 9 of the UCC determines whether a transferee of the note from its owner has obtained an attached property right in the note.
- Third, Article 9 of the UCC provides that a transferee of a mortgage note whose property right has attached also

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<sup>166</sup> PEB Report, *supra* note 58, at 14. *See also* Harrell, *supra* note 73, at 148 ("the deference to real property law continues largely as before").

automatically has an attached property right in the mortgage  
that secures the note.

- Finally, Article 9 of the UCC provides a mechanism by which  
the owner of a note and the mortgage securing it may, upon  
default of the maker of the note, record its interest in the  
mortgage in the realty records in order to conduct a nonjudicial  
foreclosure.<sup>167</sup>

The PEB then articulated its view of the relationship between foreclosure law and the UCC when it concluded: “[P]roper application of real property law requires proper application of the UCC rules discussed in this Report.”<sup>168</sup> However, the PEB the thorny issues that arise foreclosure laws appear to conflict with the relevant Article 3 and 9 rules.<sup>169</sup>

When the issue of the right to foreclose arises in litigation, the courts have not consistently utilized Articles 3 and 9 when identifying the proper party to foreclose. I place the state appellate court decisions issued since 2007 into three categories based upon the type of analysis employed by the courts to address the contours of the right to foreclose on a mortgage loan. I refer to these case sets as: the UCC States; the Foreclosure-Statute-Definition States; and, the UCC- is-Not-Applicable States. I rely

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<sup>167</sup> PEB Report, *supra* note 58 at 14.

<sup>168</sup> *Id.*

<sup>169</sup> This Article provides this type of statutory reconciliation analysis in Part V.

upon decisions from state courts, rather than federal courts sitting in those states, because the state courts are the best arbiters of that state's law.<sup>170</sup>

Two recent articles catalog smaller collections of judicial right-to-foreclose decisions along other lines. In the first, Whitman and Milner spotlighted opinions by state and federal courts in nonjudicial foreclosure states utilizing deeds of trusts in the western states.<sup>171</sup> They summarized the emerging law on the issue of whether a party that does not have the right to enforce the note might, nonetheless, foreclosure on the deed of trust.<sup>172</sup> Next, they discussed rulings from a few non-western states in which deeds of trust are the predominant security instrument in residential real property secured transactions.<sup>173</sup> Whitman and Milner concluded that “in a number of nonjudicial-foreclosure states, the requirements of UCC Article 3 and the corresponding statutory framework procedures seem to exist in different universes.”<sup>174</sup>

The second article selected a subset of foreclosure decisions—those dealing with the “show me the note” defense.<sup>175</sup> The authors divided the state and federal court decisions into four categories using the following factors: whether or not the foreclosing party must prove ownership of the note and whether or not judicial or nonjudicial

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<sup>170</sup> Indeed, the federal courts may get it wrong. *E.g.*, *Miller v. Homecomings Fin., LLC*, 881 F. Supp. 2d 825, 831, n. 9 (S.D. Tex. 2012) (noting that the federal courts in Texas incorrectly hold that homeowners have no standing under state law to challenge an assignment of the security agreement; providing state court decisions to the contrary); *see also* *Martins v. BAC Home Loans Serv., L.P.*, \_\_\_F.3d \_\_\_, 2013 WL 3213633 (5<sup>th</sup> Cir. June 26, 2013) (recognizing the Texas appellate decisions cited in the following footnote holding that the foreclosing party must be the holder or owner of the note and relying on UCC §§ 3-301, 3-203); but disregarding these judicial decisions in favor of a statute that permits a mortgage servicer to act on behalf of the mortgagee in the context of deciding that the MERS can assign the deed of trust and that MERS' assignee can foreclose without certifying these issues to the Texas Supreme Court).

<sup>171</sup> Whitman & Milner, *supra* note 3, at 36-50.

<sup>172</sup> *Id.* at 36.

<sup>173</sup> *Id.* at 50-58.

<sup>174</sup> *Id.* at 60.

<sup>175</sup> Bradley T. Borden, David J. Reiss, & W. KeAupuni Akina, *Show Me the Note!* 19 Bank & Lender Liability 3 (Westlaw June 3, 2013), available at <http://ssrn.com/abstract=2274977>.

foreclosure procedures were employed in that state.<sup>176</sup> The authors conclude that this defense is largely unsuccessful in nonjudicial foreclosure states; on the other hand, courts routinely concern themselves with standing in judicial foreclosure states.<sup>177</sup>

The following sections explain the analysis applied by the courts in each category and list the relevant rulings by state and by type of foreclosure procedure employed in the jurisdiction.

1. *Category One: The UCC States*

The courts in these states explicitly join the right to foreclose on a mortgage that secures the negotiable note with the concept of a PETE and UCC § 3-301. They hold that only the PETE may foreclose.<sup>178</sup> These states usually, though not exclusively, are

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<sup>176</sup> The authors do not define “ownership” or referring to the UCC.

<sup>177</sup> *Id.* at 3, 7. These findings appear to simply represent the difference between the presence or absence of a judicial proceeding.

<sup>178</sup> **Alabama** (nonjudicial foreclosure state): *Perry v. Fed. Nat’l Mortg. Ass’n*, 100 S0.3d 1090, 1094-95 (Ala. Civ. App. 2012) (ruling that the a party’s right to foreclose arises when it accelerates the indebtedness and invokes the power of sale in the mortgage; the right to enforce a negotiable note is governed by UCC § 3-301); **Florida** (judicial foreclosure state); *U.S. Bank Nat’l Ass’n v. Knight*, 90 So.3d 824, 825-26 (Fla. Dist. Ct. App. 2012) (applying UCC § 3-301 to determine that the foreclosure plaintiff had standing to file the case because it was the holder of the note indorsed in blank and the mortgage necessarily followed); **Kansas** (judicial foreclosure state): *U.S. Bank Nat’l Ass’n*, \_\_ P.3d \_\_, 2013 WL 1850755 \*3-4 (Kan. App. Ct. May 3, 2013) (discussing the necessity that the foreclosing party hold the note before filing the foreclosure); **Maryland** (quasi-nonjudicial foreclosure state): *Anderson v. Burson*, 35 A.3d 452, 461-62 (Md. 2012) (applying a court rule that requires that the party docketing the foreclosure attach a copy of the note and ruling that the UCC determines the right of the foreclosing party to enforce the note, citing to §§ 3-203, 3-301); **Nevada** (nonjudicial foreclosure state): *Edelstein v. Bank of New York Mellon*, 286 P.3d 249, 255, n.7, 262 (Nev. 2012) (stating that to have standing in a foreclosure, the current holder of the promissory note and the current beneficiary of the deed of trust must be the same person; applying UCC Article 3 to determine the identity of the person entitled to enforce the note; discussing the legislative history surrounding the enactment of pre-foreclosure mediation program that equates the beneficiary of the deed of trust with the note holder); **New Jersey** (judicial foreclosure state): *Wells Fargo Bank, N.A. v. Ford*, 15 A.3d 327, 329-30 (N.J. Super. Ct. App. Div. 2011) (ruling that the party foreclosing must own or control the underlying debt; applying UCC Article 3 to determine whether the foreclosing party was a PETE, and, if so, that party owns or controls the note); **Ohio** (judicial foreclosure state): *Central Mortg. Co. v. Webster*, 978 N.E.2d 962, 967-68 (Ohio Ct. App. 2012) (requiring the real party in interest in a foreclosure action to be the current holder of the note and mortgage under the UCC; transfer of the note operates as a transfer of the mortgage under UCC § 9-203(g)); **Oklahoma** (judicial foreclosure state): *Wells Fargo Bank, N.A. v. Heath*, 280 P.3d 328, 333 (Okla. 2012) (finding that the foreclosing party must be a person entitled to enforce the note under UCC § 3-301 at the time it filed the foreclosure suit); **New York** (judicial foreclosure state): *GRP Loan, LLC v. Taylor*, 945 N.Y.S.2d 336, 338 (App. Div. 2012)

judicial foreclosure states.<sup>179</sup> This procedural distinction should not make any difference to the substantive analysis. The common thread appears to be that these courts implicitly and, sometimes, explicitly align themselves with the Restatement (Third) of Property (Mortgages) concept that a mortgage may be enforced only by or on behalf of a person entitled to enforce the obligation that the mortgage secures.<sup>180</sup> Addressing entitlement to enforce the note then takes the courts in these states directly into Article 3 of the UCC.

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(ruling that the plaintiff in a foreclosure action must be both the holder or assignee of the mortgage and the holder or assignee of the note; more specifically, stating that the plaintiff must show either a written assignment of the note or the physical delivery of the note prior to filing the complaint); *Bank of New York v. Silverberg*, 926 N.Y.S.2d 532, 537 (App. Div. 2011) (same; stating, in addition, that the mortgage automatically follows the note); *MERS, Inc. v. Coakley*, 838 N.Y.S.2d 622, 623 (App. Div. 2007) (applying Article 3 of the UCC to determine if MERS was a holder). Author's note: This standard, a written assignment or physical delivery, appears consistent with New York's 1962 version of Article 3. That version does not contain the definition of "transfer" that appears in the 1990 version. Compare N.Y. U.C.C. Law § 3-201 (McKinney 2013) with UCC § 3-203(a) (1990). "Transfer" means delivery and "delivery" is defined in Article 1 as the "voluntary transfer of possession." UCC § 3-203(a) (1990); UCC § 1-201(b)(15) (2001). Also missing from New York's UCC is the current version of § 3-301 which requires the PETE to possess the instrument, unless it was lost, stolen, or destroyed. UCC § 3-301 (1990). As a result, it appears that a negotiable note can be transferred by a written assignment without physical delivery of the note itself in New York. See discussion of the differences between these version of Article 3 in *The Bank of New York Mellon v. Deane*, \_\_N.Y.S.2d\_\_, 2013 WL 3480255 (Sup. Ct. July 11, 2013); **Texas** (nonjudicial foreclosure state): *Martin v. New Century Mortg. Co.*, 377 S.W.3d 79, 84-85 (Tex. App. Ct.-Houston 2012) (applying the rule that the foreclosing party must be the holder or owner of the note and relying on UCC §§ 3-301, 3-203); *Shepard v. Boone*, 99 S.W.3d 263, 265 (Tex. App. Ct.-Eastland 2003) (same); *Leavings v. Mills*, 175 S.W.3d 301, 309-10 (Tex. App. Ct. 2004) (same; but holding that the note is not negotiable and to prove ownership, foreclosing party must provide the note and show an unbroken chain of assignments from the original lender to it); **Vermont** (strict foreclosure state): *U.S. Bank Nat'l Ass'n v. Kimball*, 27 A.3d 1087, 1092 (Vt. 2011) (requiring the foreclosing party to show that it was a person entitled to enforce the note under the UCC at the time it filed the complaint; as assignment of the mortgage alone is not sufficient). **[NOTE: The published version of this article will update footnotes 180, 183, and 184 to make them as complete as possible].**

<sup>179</sup> The mere fact of a mandated judicial proceeding as a condition precedent to a sale necessarily results in a larger number of reported standing contest in those jurisdictions.

<sup>180</sup> RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4(c) (1997). The uniform Fannie Mae and Freddie Mac mortgage in a judicial foreclosure state, such as Pennsylvania, embodies the Restatement's position in the contract by defining "lender" as the "mortgagee," and "note" as the "promissory note" stating the amount owed to the lender, and the "loan" as the debt evidenced by the Note. "Lender," rather than "mortgagee" is used throughout. Further, the mortgage permits acceleration of the full amount of the indebtedness if a default is not cured followed by foreclosure by judicial proceeding. PENNSYLVANIA--Single Family--Fannie Mae/Freddie Mac UNIFORM INSTRUMENT, pp. 1-2, & 22 (Form 3039 1/01), available at <http://www.freddiemac.com/uniform/unifsecurity.html#highlights>. Interestingly, in a nonjudicial foreclosure state such as Alabama, the mortgage instrument contains identical definitions. The relevant acceleration provision is identical to that used in Pennsylvania with the exception that it permits the lender to invoke the power of sale and proceed to foreclose nonjudicially in accordance with applicable law. ALABAMA--Single Family--Fannie Mae/Freddie Mac UNIFORM INSTRUMENT, pp. 1-2, & 22 Form 3001 (1/01), available at <http://www.freddiemac.com/uniform/unifsecurity.html#highlights>.

2. *Category Two: The Foreclosure-Statute-Definition States*

In these states, the courts focus on relevant words in the state's foreclosure statute, such as "mortgagee" where mortgages are used, "beneficiary" where deeds of trust are used, "holder", or "owner." Next, they determine if that state's legislature intended that these designations refer to the note holder or the one with the right to act on behalf of the note holder. These courts may or may not reference the UCC in their decisions but the result generally is consistent with Articles 3 and 9 enforcement principles, that is, the foreclosing party must possess the right to enforce the negotiable note under Article 3 or own the nonnegotiable note under Article 9.<sup>181</sup> This type of inquiry occurs more often in nonjudicial foreclosure states.

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California's uniform deed of trust is similar to Alabama's mortgage with the exception that the trust deed includes three parties, the borrower (a/k/a the trustor), the lender (a/k/a the beneficiary), and the trustee, to whom the borrower irrevocably granted in trust with power of sale. CALIFORNIA--Single Family--Fannie Mae/Freddie Mac UNIFORM INSTRUMENT, pp. 1-2, 3, ¶ 22 (Form 3005 1/01) available at: <http://www.freddiemac.com/uniform/unifsecurity.html#highlights>.

<sup>181</sup> **Connecticut** (judicial/strict foreclosure state): *RMS Residential Properties, LLC v. Milner*, 32 A.3d 307, 313-14 (Ct. 2011) (interpreting "person entitled to receive the money secured thereby" in the state foreclosure statute to be the "holder" of a negotiable note under UCC Article 3; rejecting the homeowner's contention that the foreclosing party must be the note owner); **Maine** (judicial foreclosure state): *Mortgage Elec. Registration Sys., Inc. v. Saunders*, 2 A.3d 289, 295-96 (Me. 2010) (holding that the "mortgagee" or the entity that may foreclose refers to the mortgage creditor or lender, that is, the person entitled to enforce the debt; citing to the UCC § 3-301 to define a person entitled to enforce if the note is negotiable); *Bank of America v. Clouthier*, 61 A.3d 1242, 1245-46 (Me. 2013) (interpreting a 2009 statutory amendment that requires the mortgagee to certify proof of ownership of the mortgage note to mean that the foreclosing party must own or be the economic beneficiary of the note or, if not the owner, then be entitled to enforce the note under UCC § 3-301); **Massachusetts** (nonjudicial foreclosure state): *Eaton v. Fed, Nat'l Mortg. Ass'n*, 969 N.E.2d 1118, 1128-30, n.26 (Mass. 2012) (defining "mortgagee" in light of the state foreclosure provisions and common law to include the party who also holds the note or the one who is acting on behalf of the note holder; not relying on the UCC but noting that "nothing in the UCC is inconsistent with our view that in order to effect a valid foreclosure, a mortgagee must either hold the note or act on behalf of the note holder."); **North Carolina** (quasi-judicial foreclosure state): *In re Simpson*, 711 S.E.2d 165 (N.C. Ct. App. 2011) (applying the UCC definition of holder in Article 3 to the foreclosure statute's requirement that the foreclosing party must show it is the note holder, relying upon *In re Foreclosure of Connolly v. Potts*, 306 S.E.2d 123 (N.C. Ct. App. 1983)); **Oregon** (nonjudicial foreclosure state): *Brandrup v. Recontrust Co., N.A.*, \_\_P.3d \_\_, 2013 WL 2446517 \* 9, \*21 (Or. June 6, 2013) (defining the beneficiary of a deed of trust as the lender, that is, the person "who is entitled to repayment of the note and, thus, functionally is 'the person for whose benefit the trust deed is given,'" relying on, Or. Rev. Stat. § 86.705 and *U.S. Nat. Bank of Portland v. Holton*, 195 P. 823, 826 (Or. 1921); recognizing that the promissory note is the typical instrument that evidences the obligation secured by the deed of trust); *Niday v. GMAC Mortgage, LLC*, \_\_P.3d \_\_, 2013 WL 2446524 \*10, n. 8 (Or. June 6, 2013) (discussing the distinction between the person to

3. *Category Three: The UCC- Does-Not-Apply States*

The courts in these states reason that the state's foreclosure scheme is comprehensive, inclusive of the prerequisites to foreclose, or does not define the secured party as the one entitled to repayment on the secured monetary obligation. As a result, the UCC does not apply in any way to identify the party who possesses the right to foreclose.<sup>182</sup> To date, these decisions have arisen exclusively in nonjudicial foreclosure states.

The methodology utilized in Category 1 and 2 states properly harmonizes the relevant UCC rules with state foreclosure law. Category 3 states dismiss the UCC's role outright. It is these decisions that muddy the law and create inconsistent outcomes from

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enforce a negotiable note under UCC § 3-301 and the owner of the note; stating that most courts to date conclude that PETE status, not ownership, confers the right to foreclose); **Virginia** (nonjudicial foreclosure state): *Arnold v. Palmer*, 686 S.E.2d 725, 733 (W. Va. 2009) (holding that trustee can foreclose under deed of trust in the event of a default of the debt secured by the deed of trust; however, no contest about the identity of the beneficiary because the original lender never transferred the note); **Washington** (nonjudicial foreclosure states): *Bain v. Metropolitan Mortg. Group, Inc.*, 285 P.3d 34, 36, 44 (Wash. 2012) (deciding, in the context of whether MERS can qualify as a beneficiary under Washington's deed of trust statutes, that a beneficiary is the "holder of the instrument or document evidencing the obligations secured by the deed of trust . . .," citing Wash. Rev. Code § 61.24.005 (2013); only the beneficiary has the right to appoint the trustee to proceed with a nonjudicial foreclosure; relying on UCC Article 3 to define a "holder" of the note).

<sup>182</sup> **Arizona** (nonjudicial foreclosure state): *Hogan v. Washington Mutual Bank, N.A.*, 277 P.3d 781, 783-84 (Ariz. 2012) (deciding that the foreclosing beneficiary need not prove its authority or show the note before the trustee may commence a nonjudicial foreclosure under a deed of trust; stating, however, that the trust deed statute does not require compliance with the UCC before commencing a foreclosure; noting that Hogan did not allege that the foreclosing party had no right to enforce the note, rather that Hogan argued that the foreclosing party must demonstrate its rights before proceeding); **California** (nonjudicial foreclosure state): *Debrunner v. Deutsche Bank Nat'l Trust Co.*, 138 Cal. Rptr. 3d 830, 835-36 (Ct. App. 2012) (ruling that California's nonjudicial foreclosure regime is exhaustive and, in effect, trumps the provisions of Article 3 of the UCC; finding that the trust deed beneficiary need not possess any right to loan note before commencing a foreclosure); **Georgia** (nonjudicial foreclosure state): *You v. JP Morgan Chase Bank, N.A.*, \_\_S.E.2d\_\_, 2013 WL 2152562 (Ga. May 20, 2013) (finding that Georgia's nonjudicial foreclosure statutes do not define "secured creditor," the person required to give the "debtor" certain pre-sale notices; relying upon the legislative history of amendments to conclude that the legislature made no substantive changes in this regard over the years, which reinforces the ability of the security deed holder to exercise its rights under the security deed, independent of the note; recognizing that a transfer for the security deed transfers the secured indebtedness pursuant to Ga. Code Ann. § 44-14-64(b) (2012) and, therefore, rejecting the applicability of UCC Article 3 and the RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4(c) (1997)).

state to state. These cases raise the question of whether there is a principled method to evaluate and apply both the relevant UCC provisions (essentially uniform from state to state) and state foreclosure laws (variable from state to state). The next sections highlight how the UCC itself and general statutory construction principles point the way.

## V. A STATUTORY RECONCILIATION ROADMAP

Enactment and amendment dates can be important considerations when construing two statutory schemes together. NCCUSL and ALI adopted the first version of the UCC in 1957 and have amended Articles 3 and 9 from time to time since then.

Meanwhile, state judicial foreclosure procedures date from at least 1818.<sup>183</sup> Later, the majority of states adopted nonjudicial foreclosure statutes over an extended period of time. For example, California enacted its statute in 1872, whereas Arizona passed its deed of trust act in 1971.<sup>184</sup>

The following sections discuss relevant statutory construction principles and applies them to assess the relationship between foreclosure law and the UCC in the Category 3 states of Arizona, California, and Georgia.

### A. *The Statutory Construction Rule in Article 1*

Article 1 of the UCC is not a stand-alone, comprehensive set of provisions addressing a discrete area of the law, such as Article 2 which covers the sales of goods.

Rather, Article 1 “applies to a transaction to the extent that it is governed by another

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<sup>183</sup> Nelson & Whitman, *supra* note 26 at § 7.11 n. 2.

<sup>184</sup> Cal. Civ. Code § 2924 (2013). The Former Notes following the statute reveal that this power of sale and foreclosure provision was enacted in 1872 and amended numerous times since then. *See generally Trust Deeds and Mortgages in California*, 3 Cal. L. Rev. 381 (1914-15) (discussing the early law regarding the differences and similarities between these two instruments). As for Arizona, *see* Gary E. Lawyer, *The Deed of Trust: Arizona’s Alternative to the Real Property Mortgage* 15 Ariz. L. Rev. 194 (1973) (noting that the adoption of the deed of trust and the creditor’s right to elect a nonjudicial foreclosure occurred in 1971).

article of the Uniform Commercial Code.”<sup>185</sup> It contains rules that apply to each of the other articles, including instructions regarding construction of the code to promote its purposes and policies and the role of other law. Article 1 also includes definitions, principles of interpretation, and territorial application rules.

Article 1 articulates three purposes that the Code was designed to achieve, one of which is to make uniform the law governing commercial transactions among the various jurisdictions.<sup>186</sup> To foster this goal, Article 1 provides that provisions appearing elsewhere in the Code displace “principles of common law and equity that are inconsistent with either its provisions or its purposes and policies.”<sup>187</sup> On the other hand, principles of law and equity can supplement the UCC because the Code “was drafted against the backdrop of existing bodies of law.”<sup>188</sup>

The analysis changes, however, when construing and applying the UCC in relation to other state statutes. When that situation arises:

other interpretive principles addressing the interrelationship between statutes may lead the court to conclude that the other statute is controlling, even though it conflicts with the Uniform Commercial Code. This, for example would be the result in a situation where the other statute was specifically intended to

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<sup>185</sup> UCC § 1-102 (2001).

<sup>186</sup> UCC § 1-103(a)(3) (2001).

<sup>187</sup> UCC § 1-103(b) and cmt. 2 (2001). Section 1-103(b) provides a non-exhaustive list of common law principles, including, the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, and bankruptcy. *Id.* cmt. 4. The preemptive power of the UCC also applies to common law principles that have been codified. *Id.* cmt. 3.

<sup>188</sup> UCC § 1-103(b) and cmt. 2 (2001).

provide additional protection to a class of individuals engaging in transactions covered by the Uniform Commercial Code.<sup>189</sup>

Professors White and Summers suggest that this Comment addresses consumer concerns “to some extent” because most of consumer law is statutory.<sup>190</sup> However, the Comment is neutral on the type of statutes to which it refers. Nonjudicial foreclosure statutes, for example, are not typically considered to be consumer protection statutes.<sup>191</sup> Rather, state legislatures usually enacted the nonjudicial regimes as exceptions to existing judicial procedures.<sup>192</sup> Nonetheless, courts may attribute a consumer protection purpose to this process, such as the protection of the homeowner from wrongful loss of property.<sup>193</sup>

In the wake of the foreclosure crisis, many states incorporated new protections for homeowners into their foreclosure laws. Examples include required settlement conferences and optional mediation to encourage loan modifications and other resolutions that avoid foreclosure,<sup>194</sup> additional time before a notice of default can be sent or

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<sup>189</sup> U.S.C. § 1-103, cmt. 3 (2001).

<sup>190</sup> White & Summers, *supra* note 83, at § 1-2, p. 4 (noting that if the consumer protection statutes provide additional protections to consumers as a class, “they will not be preempted even if they do not have a provision that specifically grant them superiority over the UCC”).

<sup>191</sup> Jacobson-Greany, *supra* note 17 at 150-51 (concluding that nonjudicial foreclosures are “harsh remedies because debtors lose their property in a proceeding devoid of judicial oversight.”); Schrock v. Fed. Nat’l Mortg. Ass’n, No. CV 11-0567-PHX-JAT, 2011 WL 3348227, at \*6-8 n. 7 (D. Ariz. Aug. 3, 2011) (discussing the “draconian” Arizona nonjudicial procedure).

<sup>192</sup> Rao, *et al.*, *supra* note 61, at § 4.5, p. 120 (stating that “the deed of trust was developed as an alternative to the mortgage which traditionally had to be foreclosed judicially.”).

<sup>193</sup> Moeller v. Lien, 30 Cal. Rptr. 2d 777, 782 ((1994). See also Bain v. Metropolitan Mortg. Group, Inc., 285 P.3d 34, 44 (Wash. 2012) (construing Washington’s deed of trust act in favor of the homeowner “because of the relative ease with which lenders can forfeit borrowers’ interests and the lack of judicial oversight in conducting nonjudicial foreclosure sales,” quoting *Udall v. T.D. Escrow Servs., Inc.*, 154 P.3d 882, 890 (Wash. 2007)).

<sup>194</sup> GEOFFREY WALSH, NAT’L CONSUMER LAW CTR., STATE & LOCAL FORECLOSURE MEDIATION PROGRAMS: CAN THEY SAVE HOMES? (Sept. 2009), available at [http://www.nclc.org/images/pdf/foreclosure\\_mortgage/mediation/report-state-meditation-programs.pdf](http://www.nclc.org/images/pdf/foreclosure_mortgage/mediation/report-state-meditation-programs.pdf) (analyzing the strengths and weakness of twenty-five of these programs; GEOFFREY WALSH, NAT’L CONSUMER LAW CTR., STATE AND LOCAL FORECLOSURE MEDIATION PROGRAMS: UPDATES AND DEVELOPMENTS (Jan. 2010), available at

recorded;<sup>195</sup> heightened disclosures regarding the foreclosure process,<sup>196</sup> and information regarding the identity of the mortgage holder and its interest in the property.<sup>197</sup>

When a court must determine whether a provision of the UCC or another statute controls, Article 1 directs us to general principles of statutory construction. The following section discusses those principles.

*B. Relevant General Statutory Construction Principles*

Where statutes dealing with the same subject apparently conflict, courts will construe the provisions harmoniously in order to give effect to both.<sup>198</sup> Statutes are *in pari materia* when they have the same purpose or object, relate to the same activity, transaction, person or thing, or related to the same class of persons, things, or transactions.<sup>199</sup> Mere overlap, without more, does not constitute a conflict.<sup>200</sup> If the attempt to harmonize fails because the statutes irreconcilably conflict, three general statutory construction rules provide guidance: first, the more specific statute controls over the more general; second, the newer statute controls; or, third, one statute is determined to be an exception to the general rule stated in the other statute.<sup>201</sup>

The doctrine of implied repeal arises when the court cannot harmonize the provisions at issue. In this case, the later act controls to the extent of the inconsistency

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[http://www.nclc.org/images/pdf/foreclosure\\_mortgage/mediation/report-state-mediation-programs-update.pdf](http://www.nclc.org/images/pdf/foreclosure_mortgage/mediation/report-state-mediation-programs-update.pdf) (discussing several additional mediation programs created in 2009).

<sup>195</sup> *E.g.*, Cal Civ. Code § 2923.5(a) (2013) (prohibiting the trustee, beneficiary, or mortgage servicer from recording the notice of default until at least thirty days from contact with the borrower in person or by telephone in order to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure).

<sup>196</sup> *E.g.*, Cal. Civ. Code § 2923.3 (2013) (requiring that the notice of default attach an extensive “summary of key information” in English and in other specified languages regarding the foreclosure process).

<sup>197</sup> Rao, *et al.*, *supra* note 61, at § 5.10 (outlining these new protections).

<sup>198</sup> Norman J. Singer & J.D. Shambie Singer, 2B SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION § 51.2 (7<sup>TH</sup> ED. 2012) (HEREAFTER “SUTHERLAND STATUTORY CONSTRUCTION”).

<sup>199</sup> *Id.* at § 51.3.

<sup>200</sup> 1A SUTHERLAND STATUTORY CONSTRUCTION § 23.9.

<sup>201</sup> 2B SUTHERLAND STATUTORY CONSTRUCTION § 51.2.

between the provisions relevant to the substance of the dispute, even in the absence of a specific repealing clause. Legislative intent is critical in making this determination and courts will examine the legislative history to determine whether repeal was intended.<sup>202</sup> In addition, the later act will displace the former where the legislature clearly intended it to occupy the entire field addressed in the prior act.<sup>203</sup> Finally, courts apply a presumption against repeal by implication because the legislature is assumed to be cognizant of the existing statutory law at the time of new enactments. The presumption is overcome only by a showing of clear repugnance between the two provisions.<sup>204</sup>

C. *Application of These Principles to the Decisions from the Category 3 States*

1. *Harmonizing Foreclosure Law and the UCC*

The starting point in the analysis is whether the foreclosing party (the mortgagee, assignee, or agent in mortgage states) or the party with the power to direct the trustee to foreclose (the beneficiary in a deed of trust state) must possess the right to enforce the note. One of three scenarios arises, depending upon a given state's law: 1) the UCC is relied upon to provide the result (represented by the Category 1 states); 2) other state law and the UCC are applied together explicitly or implicitly (represented by the Category 2 states); and, 3) state law appears to answer this question and, potentially conflicts with the UCC (represented by the Category 3 states).

Category One states embrace the UCC principles explicitly while Category Two jurisdictions explicitly or implicitly utilize UCC rules in the context of defining "mortgagee", "beneficiary", "holder", "owner", or other critical terms in the state

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<sup>202</sup> 1A SUTHERLAND STATUTORY CONSTRUCTION §§ 23.9, 23.10.

<sup>203</sup> 1A SUTHERLAND STATUTORY CONSTRUCTION § 23.9.

<sup>204</sup> 1A SUTHERLAND STATUTORY CONSTRUCTION § 23.10.

foreclosure statutes. Since there is no incompatibility between the definition of authority to foreclose and the right to enforce the note in these states, the analysis stops at that stage.

When the non-UCC law supplies the answer and that resolution does not conflict with the UCC, as in Category 2 states, the examination ends there. Where a conflict arises between the non-UCC law resolution and the UCC resolution, statutory construction principles must be applied to determine the result.

The rub arises in the three and, potentially growing number of jurisdictions in which the courts have refused to apply the UCC in this context: Arizona, California, and Georgia.<sup>205</sup> These states experienced some of the highest rates of delinquency and foreclosure among the jurisdictions utilizing nonjudicial foreclosure in the country during the height of the foreclose crisis.<sup>206</sup> Consequently, the judicial rulings in these states affect the ability of an enormous number of homeowners from contesting foreclosures.

*a. Arizona*

In *Hogan v. Washington Mutual Bank, N.A.*, the homeowner argued that the trustee of the deed of trust must demonstrate possession of the note or its right to enforce the note before exercising the power of sale (the “show-me-the-note” argument).<sup>207</sup>

Unfortunately, the court did not limit its ruling to this narrow issue which would have

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<sup>205</sup> See discussion in Section zz above.

<sup>206</sup> Renuart, *supra* note 11, at 150, 155, 160 (Arizona—89,262 mortgage loans seriously delinquent as of the second quarter of 2011; California—462,714 mortgage loans seriously delinquent as of the second quarter of 2011; Georgia—124,125 mortgage loans seriously delinquent as of the second quarter of 2011; see also Greg Bluestein & Arielle Kass, *Foreclosures too easy, Georgia Supreme Courts says*, Atlanta Journal Constitution (May 20, 2013), <http://www.ajc.com/news/business/foreclosure-too-easy-georgia-supreme-courts-says/nXxhn> (stating that “Georgia was battered by the foreclosure crisis that followed the housing bust, with thousands of repossessed homes on the market driving down values for all homeowners.”).

<sup>207</sup> *Hogan*, 277 P.3d at 783. (emphasizing that nothing in the nonjudicial foreclosure regime imposes an obligation to demonstrate their rights to enforce the note before proceeding with a foreclosure and noting that Hogan failed to allege that the foreclosing party was not entitled to enforce the note)

yielded an unremarkable ruling because, generally, neither the beneficiary nor mortgagee must prove this fact in advance or at the time of initiating a nonjudicial foreclosure.<sup>208</sup>

Perhaps because Hogan failed to allege that the beneficiary was not entitled to enforce the note, the court never tackled the threshold issue of the definition of “beneficiary” and that person’s role in the foreclosure process. Instead, the court unnecessarily observed that the UCC does not govern liens on real property and the deed of trust act does not require compliance with the UCC before commencing the nonjudicial process.<sup>209</sup> Although noting that the note and deed of trust are distinct documents that serve different purposes, the opinion never delved into the deed of trust act or the contracts themselves to enunciate the powers and roles of each. If it had, the outcome in the case likely would have remained unchanged due to the pleading problem but the analysis should have been more nuanced on the issue of the UCC’s role.

For example, “beneficiary” is defined by statute to “mean the person named...in a deed of trust as the person for whose benefit a trust is given, or the person’s successor in interest.”<sup>210</sup> The trustor is the “person conveying trust property by a deed of trust as security for the performance of a contract...or the successor in interest of such person.”<sup>211</sup>

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<sup>208</sup> *Id.* (emphasizing that nothing in the nonjudicial foreclosure regime imposes an obligation to demonstrate their rights to enforce the note before proceeding with a foreclosure and noting that Hogan failed to allege that the foreclosing party was not entitled to enforce the note); *see generally* Rao, *et al.*, *supra* note 61., at § 4.2.3, p.110-11. In a quasi-nonjudicial state, such as Maryland, the statute and rules of court require the docketing of an order to foreclose no sooner than forty-five days after the notice of intent to foreclose is sent to the homeowner. Md. Code Ann. Real Prop. § 7-105.1(c)(1) (2013). Among other things, the order to docket must include the deed of trust and any assignments and a copy of the note accompanied by an affidavit certifying ownership of the note. § 7-105.1(e)(2) (2013). The matter subsequently proceeds nonjudicially until the point where the court ratifies the sale upon review of an audit. Md. Rule 14-215.

<sup>209</sup> *Hogan*, 277 P.3d at 783. Interestingly, the court agreed that the RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4(c) (1997) applies which states that the deed of trust can be enforced only by or on behalf of the person entitled to enforce the note. *Id.* However, the court did not connect the dots between the Restatement and Article 3 of the UCC which addresses the definition of PETE.

<sup>210</sup> Ariz. Rev. Stat. Ann. § 33-801(1) (2013).

<sup>211</sup> Ariz. Rev. Stat. Ann. § 33-801(11) (2013).

The trustee's duties to the trustor and beneficiary are those specified by statute and listed in the deed of trust.<sup>212</sup> The trustor can begin the foreclosure process pursuant to the power of sale provisions in the trust deed only after a breach or default in the contracts for which the trust property is conveyed as security and, in that event, only at the option of the beneficiary.<sup>213</sup>

Arizona codified the common law rule that the deed of trust follows the note.<sup>214</sup> Since the deed of trust act incorporates the duties of the trustor into the statute, the contract itself is highly relevant. The uniform deed of trust used by the secondary mortgage giants, Fannie Mae and Freddie Mac, defines the "beneficiary" as the lender; the "trustor" as the "borrower," the "note" as the promissory note between the borrower and lender which states the principal amount owed, and "loan" as the debt evidenced by the note.<sup>215</sup> Arizona's uniform deed of trust "secures to Lender...the repayment of the Loan, and all renewals, extensions and modifications of the Note...and...the performance of Borrower's covenants and agreements under this Security Instrument and the Note."<sup>216</sup>

Both Arizona's deed of trust act and the uniform deed of trust define the beneficiary in a way that supports a ruling that the beneficiary must possess the right to enforce the note. Reading the statute and deed of trust together, the beneficiary is the "person for whose benefit a trust is given" and the trust is given to the lender.<sup>217</sup> Because the lender is the entity to whom the payment obligation on the note is due, the

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<sup>212</sup> Ariz. Rev. Stat. Ann. § 33-801(10) (2013).

<sup>213</sup> Ariz. Rev. Stat. Ann. § 33-807(A) (2013).

<sup>214</sup> Ariz. Rev. Stat. Ann. § 33-817 (2013). *See also* Hill v. Favour, 84 P.2d 575, 578-79 (Ariz. 1938) (holding that an assignment of the deed of trust without the debt transfers no right upon the assignee).

<sup>215</sup> Arizona Single Family-FannieMae/Freddie Mac Uniform Instrument, Form 3003 at 1-2 (6/02), available at <http://www.freddie.com/uniform/unifsecurity.html#highlights>.

<sup>216</sup> *Id.* at 3.

<sup>217</sup> *Compare* Ariz. Stat. Rev. Ann. § 33-801(1) (2013) and Arizona Single Family-FannieMae/Freddie Mac Uniform Instrument, Form 3003 at 1-2 (6/02).

UCC is triggered. This analysis harmonizes the UCC with the nonjudicial foreclosure statute.

*b. California*

In the seminal case to date, the Sixth District Court of Appeals in *Debrunner v. Deutsche Bank Nat'l Trust Co.* held that the statutory scheme: “broadly allows a trustee, mortgagee, beneficiary, or any of their agents to initiate nonjudicial foreclosure.”<sup>218</sup> The court found nothing in the statutes mandating possession of a beneficial interest in both the note and the deed of trust by the beneficiary.<sup>219</sup> Because the California nonjudicial foreclosure is specific and comprehensive, according to the court, the UCC does not displace its provisions.<sup>220</sup>

In reaching this result, the court failed to discuss other precedents in California law. Although the “beneficiary” is not defined by statute, court decisions fill the gap and hold that the beneficiary is the party to the deed of trust that is owed the debt and whose economic interests are at risk when the existence or priority of the deed of trust is challenged.<sup>221</sup> The trustee’s authority to exercise the power of sale is subject to the beneficiary’s express declaration of default and instructions to the trustee to sell the property.<sup>222</sup> Moreover, because a deed of trust is a contract, the courts will construe it,

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<sup>218</sup> 138 Cal. Rptr. 3d 830, 836 (Cal. Ct. App. 2012) (apparently considering it significant that the trustee is listed in the statute).

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> *Monterrey S.P. Partnership v. W.L. Bangham, Inc.*, 777 P.2d 623, 627 (Cal. 1989).

<sup>222</sup> Cal. Civ. Code § 2924(a)(1)(B) and (C) (2013) (permitting the notice of default to be recorded by the trustee, mortgagee, beneficiary, or an authorized but stating that it is the beneficiary who elects to sell the property and who provides the information in the default notice that a breach of an obligation for which the deed of trust is security has occurred and the nature of each breach). See also Harry D. Miller & Marvin B. Starr, 3 Cal. Real Estate § 10:4 (2012). The California Single Family-FannieMae/Freddie Mac Uniform Deed of Trust tracks § 2924:

If *Lender* invokes the power of sale, *Lender* shall execute or cause Trustee to execute a written notice of the occurrence of an event of default and of *Lender's* election to cause

together with the note and any agreement of sale, using rules of contract interpretation.<sup>223</sup>

In addition, decades ago the Fourth District Court of Appeals noted that the deed of trust must be foreclosed by the owner of the note.<sup>224</sup> However, in an unpublished opinion, that court recently adopted the *Debrunner* holding without mentioning its previous decision in *Santens*.<sup>225</sup>

It is difficult to reconcile the *Debrunner* court's ruling with the existing judicial definition of "beneficiary" and with the central role that the beneficiary plays under the deed of trust. The fact that a trustee is listed along with the beneficiary as one of the parties who can record the notice of default, thereby commencing the process leading to a sale, should not be dispositive. The trustee is powerless to sell the real property without

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the Property to be sold. Trustee shall cause this notice to be recorded in each county in which any part of the Property is located. Lender or Trustee shall mail copies of the notice as prescribed by Applicable Law to Borrower and to the other persons prescribed by Applicable Law. Trustee shall give public notice of sale to the persons and in the manner prescribed by Applicable Law. After the time required by Applicable Law, Trustee, without demand on Borrower, shall sell the Property at public auction to the highest bidder at the time and place and under the terms designated in the notice of sale in one or more parcels and in any order Trustee determines. Trustee may postpone sale of all or any parcel of the Property by public announcement at the time and place of any previously scheduled sale. Lender or its designee may purchase the Property at any sale.

California Single Family-FannieMae/Freddie Mac Uniform Instrument, Form 3005 ¶ 22 (1/01), available at <http://www.freddiemac.com/uniform/unifsecurity.html#highlights> (emphasis added).

<sup>223</sup> Miller & Starr, *supra* note 222, at § 10:5.

<sup>224</sup> *Santens v. L.A. Fin. Co.*, 204 P.2d 619, 621 (Cal. Ct. App. 1949) (resolving, in an action to quiet title, who had a superior interest in the property at issue—a judgment creditor who executed or the owner of the note and deed of trust—and deciding in favor of the owner of the note and deed of trust because he acquired his rights before the judgment creditor); *see also* *Cockerell v. Title Ins. & Trust Co.*, 267 P.2d 16, 20 (Cal. 1954) (approving the holding in *Santens* that the deed of trust can only be foreclosed by the owner of the note).

<sup>225</sup> *St. James v. JPMorgan Chase Bank, N.A.*, 2012 WL 3089275 \*3-4 (Cal. Ct. App. July 31, 2012). The First and Second District Courts of Appeals also approved the *Debrunner* ruling in unpublished decisions. *Taasan v. Family Lending Servs., Inc.*, 2012 WL 2774967 \*6-7 (Cal. Ct. App. July 10, 2012) (not mentioning *Santens*); *Solis v. EMC Mortg.*, 2012 WL 2949787 \*4 (Cal. Ct. App. July 20, 2012) (same)

instructions from the beneficiary.<sup>226</sup> Moreover, a deed of trust is considered incident to the note and follows the note when the latter is transferred.<sup>227</sup>

The distinct roles of the parties to a deed of trust are defined by contract. The uniform deed of trust used by the secondary mortgage giants, Fannie Mae and Freddie Mac, defines the “beneficiary” as the lender; the “trustor” as the “borrower,” the “note” as the promissory note between the borrower and lender which states the principal amount owed, and “loan” as the debt evidenced by the note.<sup>228</sup> The deed of trust explicitly secures “the repayment of the Loan, and all renewals, extensions and modifications of the Note...and...the performance of Borrower’s covenants and agreements under this Security Instrument and the Note.”<sup>229</sup> Thus, where the California statutes fail to provide pivotal definitions, the deed of trust fills those gaps. The *Debrunner* court could have defined the beneficiary as the party possessing the right to enforce the note and harmonized the UCC with the nonjudicial foreclosure statute.<sup>230</sup>

In light of the general principles of statutory construction enunciated earlier in this article, the *Debrunner* court should have analyzed whether there exists a clear and irreconcilable conflict between the UCC and the nonjudicial foreclosure statutes. If the court finds a conflict, then the other statutory construction principles enunciated above become relevant, *i.e.*, whether one statute is more specific or comprehensive than

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<sup>226</sup> Cal. Civ. Code § 2924(a)(1)(B) and (C) (2013); California Single Family-FannieMae/Freddie Mac Uniform Instrument, Form 3005 at § 22 (1/01), available at <http://www.freddie.com/uniform/unifsecurity.html#highlights>.

<sup>227</sup> *Coon v. Shry*, 289 P. 815, 816 (Cal. 1930).

<sup>228</sup> California Single Family-FannieMae/Freddie Mac Uniform Instrument, Form 3005 at 1-2 (1/01), available at <http://www.freddie.com/uniform/unifsecurity.html#highlights>.

<sup>229</sup> *Id.* at 3.

<sup>230</sup> Moreover, the amended complaint admitted to a chain title of the note by way of assignment to the foreclosing beneficiary. *Debrunner*, 138 Cal. Rptr. 3d at 833. The court could have used these facts to support the outcome it reached, affirmance of the dismissal of the complaint, and, at the same time, acknowledged the UCC’s rightful role.

another, the timing of enactment of each, and whether one statutory scheme is an exception to the other are irrelevant considerations. The failure to tie the right to foreclose to the right to enforce the note (to which the deed of trust is incident) will result in unwarranted foreclosures. “The trustee is thus represented by the Debrunner reasoning as a sort of Don Quixote, foreclosing on his or her own initiative when a default is discovered. The result is potential legal chaos!”<sup>231</sup>

c. *Georgia*

Before discussing the decision in *You v. JP Morgan Chase Bank, N.A.*, it is important to highlight that Georgia’s most commonly used instrument to secure a real estate related loan is the security deed.<sup>232</sup> The security deed is a two-party instrument that conveys title of, not merely a security interest in, real property to secure a debt and requires the creditor to re-convey the property upon payment of the debt.<sup>233</sup> The uniform security deed used in Georgia by Fannie Mae and Freddie Mac labels the homeowner-grantor as the “borrower.” The grantee is referred to as the “lender.”<sup>234</sup> Despite conveying title, the security deed refers to itself as the “Security Instrument” and “secures

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<sup>231</sup> Whitman & Milner, *supra* note 3, at 38. Professor Whitman opines that the real explanation for the court’s position in *Debrunner* is that deficiency judgments on deeds of trust foreclosed nonjudicially are barred in California. As a result, the likelihood that another party holding the note would attempt to enforce it against the borrower on some future date is “extremely unlikely.” *Id.* at 41. He responds, however, that different lenders and their servicers offer a varying set of forbearance, modification, mediation, short sale, or other mitigation options to avoid foreclosure. “As a matter of orderly process and fundamental fairness, should not borrowers be eligible to know that the party depriving them of their real estate is legally entitled to do so and to have the opportunity to claim whatever foreclosure mitigation procedures that particular lender has adopted? We think they should.” *Id.*

<sup>232</sup> ALEXANDER, *supra* note 27, at § 8:1.

<sup>233</sup> GA. CODE ANN. § 44-14-60 (2013) (permitting the use of “security deeds” and stating: “[s]uch conveyance shall be held by the courts to be an absolute conveyance, with the right reserved by the grantor to have the property reconveyed to him upon the payment of the debt or debts intended to be secured agreeably to the terms of the contract, and shall not be held to be a mortgage”). Consequently, Georgia is a title theory state where the parties to a transaction employ a security deed. Georgia does not prohibit the use of a mortgage which is deemed to be a lien but the more common instrument appearing in residential real estate loans is the security deed. Alexander, *supra* note 27, at § 8.1.

<sup>234</sup> Georgia—Single Family—Fannie Mae/Freddie Mac Uniform Instrument Form 3011, p. 1-2, 1/01, available at <http://www.freddie.com/uniform/pdf/3011.pdf> (last visited July 5, 2013).

to Lender...the repayment of the Loan, and all renewals, extensions and modifications of the Note...and ...the performance of Borrower’s covenants and agreements under this Security Instrument and the Note.”<sup>235</sup>

In the *You* opinion, Georgia’s Supreme Court decided two of the questions addressing “unsettled” questions of Georgia law certified to it by a federal district court to which a suit based upon allegations of wrongful foreclosure had been removed.<sup>236</sup> The first question is relevant here: “Can the holder of a security deed be considered a secured creditor, such that the deed holder can initiate foreclosure proceedings on residential property even if it does not also hold the note or otherwise have any beneficial interest in the debt obligations underlying the deed?”<sup>237</sup> In response, the court observed that Georgia’s nonjudicial power of sale foreclosure dates to the 1800s, that contract law primarily governs this process, and that the statutory law is “scant.”<sup>238</sup>

In answering the certified question in the negative, the court examined the words “debtor” and “secured creditor” in the foreclosure provisions, noting that “secured creditor” is not defined.<sup>239</sup> The legislature added this term into the statute in 1981, at a time when the common law “appeared” to allow nonjudicial foreclosure by one who held title to the property but not the note.<sup>240</sup> The court rejected the argument that Article 3 of the UCC is relevant to identify the party possessing the right to enforce the note for two reasons. First, the court commented that the foreclosing party is not seeking to enforce the note. Rather, that entity is enforcing the security deed which is not a negotiable

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<sup>235</sup> *Id.* at 3. This language is similar to that included in the Arizona and California’s deeds of trust.

<sup>236</sup> *You*, 2013 WL 2152562 \*1-2 (May 20, 2013).

<sup>237</sup> *Id.* at \*2.

<sup>238</sup> *Id.* (noting that the statutes primarily address the manner and content of notices to the debtor).

<sup>239</sup> *Id.* at \*3 (May 20, 2013).

<sup>240</sup> *Id.* at \*3-4.

instrument and, hence, not subject to the UCC.<sup>241</sup> Second, when the security deed is assigned, the note follows the deed by statute.<sup>242</sup> The court implied that this provision trumps the transfer rules in the UCC when it concluded: “This Code section further supports the conclusion that the deed holder possesses full authority to exercise the power of sale upon the debtor’s default, regardless of its status with respect to the note.”<sup>243</sup>

Despite these unique characteristics of Georgia law, the court could have harmonized the UCC and the nonjudicial foreclosure statutes, at least to a certain extent. Although the foreclosure statute does not specifically define “secured creditor,” the function of the security deed provides important guidance. A security deed secures a debt to any person loaning or advancing the grantor any money.<sup>244</sup> Moreover, title to the property is held by the grantee until the grantor pays the debt under the terms of the contract.<sup>245</sup> The uniform security deed embodies these concepts. Thus, the term “secured creditor” is equivalent to the lender listed in the security deed, *i.e.*, the person loaning money and holding title until repayment of the loan.

Even though the note may follow the security deed, if the note alone is transferred, Georgia law also states that the transferee holds an equitable interest in the security itself.<sup>246</sup> The transferee of the note may enforce this equitable interest by

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<sup>241</sup> *Id.* at \*5.

<sup>242</sup> GA. CODE ANN. § 44-14-64(b) (2013); *You*, 2013 WL 2152562 \*5 (May 20, 2013) (rejecting the common law articulated in RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4(c) (1997)). Immediately following its rejection of the Restatement, the court acknowledged Ga. Code Ann. § 10-3-1 (2013) which codifies the common law rule in title theory states that the transfer of the note conveys to the transferee the “benefit of the security.” The court does not interpret these two statutes together. *But see* *Cummings v. McDade*, 45 S.E. 479, 480 (Ga. 1903) (suggesting that the security deed follows the note but decided before the Legislature enacted § 44-14-64(b)).

<sup>243</sup> *You*, 2013 WL 2152562 \*5 (May 20, 2013).

<sup>244</sup> GA. CODE ANN. § 44-14-60 (2013).

<sup>245</sup> *Id.*

<sup>246</sup> GA. CODE ANN. § 10-3-1 (2013). The *You* court refers to the homeowner’s concern that he or she could face double liability and cites to this statute but does not examine whether it should have any impact

obtaining a declaration from a court sitting in equity that a lien in favor of the transferee exists on the property.<sup>247</sup> Applying this provision to the situation where a negotiable note is transferred or sold without a written assignment of the deed of trust should result in the application of Article 3 to identify the person entitled to enforce the note. Where the note is nonnegotiable and is transferred without a written assignment of the security deed, Article 9 should determine ownership. Moreover, under Georgia's Article 9, the security deed follows the note.<sup>248</sup>

The *You* court never addressed the UCC's role in these situations, perhaps because it appeared to focus upon a transfer of the security deed without a separate transfer of the note.<sup>249</sup> As a result, the opinion leaves open the possibility of the UCC's relevance when the note alone is transferred or where written transfers of the note and security deed occurred; whereas, the court dismisses the UCC's applicability when the security deed alone is transferred--creating a confusing result.

*2. Applying statutory construction principles when foreclosure laws and the UCC irreconcilably conflict*

Once a court decides that two statutes irreconcilably conflict on the same issue, it can proceed to the next level of inquiry: whether the more general statute defers to the more specific statute, the newer statute controls, or one statute is determined to be an exception to the general rule stated in the other statute.<sup>250</sup> The courts in Arizona and California never tackled the threshold issue of whether a conflict existed. Not

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upon its answer to the certified question. *You*, 2013 WL 2152562 \*5 (May 20, 2013) ("Because this issue is not directly presented here, however, we need not resolve it.).

<sup>247</sup> *Alley v. First Nat'l Bank*, 168 S.E. 317 (Ga. Ct. App. 1933).

<sup>248</sup> UCC § 9-203(g) (1998).

<sup>249</sup> In fact, the assignment of the security deed included an assignment of the note. *You*, 2013 WL 2152562 \*1 (May 20, 2013). In those circumstances, Ga. Code Ann. § 44-14-64(b) arguably is inoperable and the court could have applied Article 3 to determine the PETE status of the foreclosing party. UCC §§ 3-301, 3-203 (1990).

<sup>250</sup> 2B SUTHERLAND STATUTORY CONSTRUCTION § 51.2.

surprisingly, therefore, these courts never considered these ancillary principles. The Georgia court at least implied the existence of an irreconcilable conflict. However, it failed to take the next analytical step.<sup>251</sup>

Utilizing these statutory construction principles does not ensure more uniform outcomes from state to state. For example, the original enactment of Articles 3 and 9 (starting in the late 1950s and ending in the early 1960s) postdated California's and Georgia's nonjudicial foreclosure statutes but predated Arizona's deed of trust act.<sup>252</sup> A deeper dive into the legislative history of the statutory regimes contained the UCC and the foreclosure statutes just raises more issues because both sets of laws have been amended over the years in these states (and likely all states), usually not in tandem. For example, Georgia's note-follows-the-security-deed provision predates Georgia's enactment of the 1998 version of Article 9 that codified the opposite rule.<sup>253</sup>

This question naturally arises: does Article 9 trump Ga. Code Ann. § 44-14-64(b) in the context of the sale of promissory notes? Professor Levitin observes: “[I]t is hard to imagine that when states adopted the Article 9 revisions that *any* member of a state's legislature thought that the revision was changing state real property conveyance law.”<sup>254</sup> On the other hand, for transactions to which it applies, Article 9 declares that its rules control except where an “applicable rule of law...establishes a different rule for

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<sup>251</sup> The Georgia Supreme Court applied at least one of the ancillary principles in a previous decision. *Patrick v. Head*, 424 S.E.2d 615, 616 (Ga. 1993) (adopting the principle that more contemporary statute prevails).

<sup>252</sup> Regarding Arizona and California, see text accompanying note 184 above. Regarding Georgia, see Alexander, *supra* note 27, at § 1:5 (noting that the dominant statutory framework in Georgia for almost 150 years has been a title theory state through the use of the security deed).

<sup>253</sup> The Brief Reference following the statute in Westlaw indicates that § 44-14-64 was enacted in 1967 and amended in 1980 and 1989. Section 44-14-64 predated the 1998 revisions to Article 9 and specifically § 9-203(g) that codified the common law mortgage-follows-the-note rule.

<sup>254</sup> Levitin, *supra* note 20, at 42 (making this observation in the context of a potential conflict between Article 9 rules regarding the description of mortgage notes in a sale agreement under § 9-109 and state real property law that likely requires a high level of specificity).

consumers” or where the state legislature explicitly inserted references to additional rule.<sup>255</sup>

On the question of which statute is “general” and which is “specific,” the answer is not clear. Arguably, both are specific, at least in relation to the topics covered. Article 3 is the comprehensive set of provisions addressing the enforcement of negotiable instruments. In the vast majority of states where the deed of trust or mortgage automatically follows the transfer of the note, Article 3 should control on the question of identifying the PETE for negotiable notes and Article 9 and the contract should control on the issue of ownership and enforcement for nonnegotiable notes. This conclusion is even stronger in states that apply the RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) which states: “[a] mortgage may be enforced only by, or on behalf of, a person who is entitled to enforce the obligation the mortgage secures.”<sup>256</sup> Nonetheless, the *Debrunner* court characterized the California nonjudicial foreclosure regime as “comprehensive” and dismissed the UCC as not relevant.

An Official Comment to Article 1 of the UCC suggests that a court may conclude that the other statute is controlling, even though it conflicts with the Uniform Commercial Code, in the situation “where the other statute was specifically intended to provide additional protection to a class of individuals engaging in transactions covered by the Uniform Commercial Code.”<sup>257</sup> As discussed in Section V.B., nonjudicial foreclosure statutes generally are not considered to provide additional protections to homeowner. This assessment can vary from state to state, however. Many of the homeowner protections enacted by state legislatures since the foreclosure crisis began are intended to

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<sup>255</sup> UCC § 9-201(b) and (c) (1998).

<sup>256</sup> RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4(c) (1997).

<sup>257</sup> U.S.C. § 1-103, cmt. 3 (2001).

protect homeowners. **These provisions may trump the UCC if they relate to the same subject matter as the UCC and conflict with a UCC rule.**

The authors of a recent article examined these questions in the context of how Article 9 interacts with relevant real estate recording laws.<sup>258</sup> They concluded that the resolution of potential and real conflicts between the two likely will vary from state to state due to differences among the statutory schemes which will be construed in light of “each state’s policies and the legislative history of the relevant enactments.”<sup>259</sup>

The application of statutory construction principles will not guarantee uniformity in outcomes from state to state. It should ensure, however, that state courts harmonize the two legal regimes whenever possible. Where irreconcilable conflicts do arise, the courts can apply traditional principles to select which aspects of the UCC or the foreclosure statute controls.

## CONCLUSION

This Article highlights the complexities introduced into the legal standards governing foreclosure law due to the 1998 amendments to Article 9 and the mishandling of notes and mortgages by parties to securitization deals. In an attempt to bring order to a growing group of judicial decisions, this Article groups state appellate opinions into three categories based on the analysis applied by the courts. Doing so clarifies that the courts in Category 1 and 2 states will likely reach similar results when called upon to identify which party possesses the right to foreclose in cases involving the same facts.

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<sup>258</sup> John Patrick Hunt, Richard Stanton, & Nancy Wallace, *Rebalancing Public and Private in the Law of Mortgage Transfer*, 20-23 (2013) (unpublished manuscript), available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2117555](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2117555).

<sup>259</sup> *Id.* at 23.

The Category 3 states—Arizona, California, and Georgia—represent the greatest challenge to the systematic application of the law addressing the right to foreclose. First, these opinions were all released very recently and may represent a trend. These states account for a significant number of foreclosures in relation to the total in the United States. By dismissing the relevance of the UCC, these rulings threaten to relegate the UCC to the closet unnecessarily and heighten the potential for unjustified foreclosures. When properly applied and harmonized with foreclosure law, the UCC provides the best chance to increase the uniformity of outcomes in these cases from state to state.<sup>260</sup>

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<sup>260</sup> In the absence of a more consistent application of legal principles, the call for legislative reform at the state and federal level will intensify. Perhaps that horse has already left the gate. The NCCUSL formed a drafting committee in 2012 to undertake draft a uniform foreclosure law. The Committee presented a draft of the Home Foreclosures Procedure Act at the NCCUSL annual meeting in July 2013. For information about this draft and its status, see <http://www.uniformlaws.org/Committee.aspx?title=Home%20Foreclosure%20Procedures%20Act>. At the federal level, [add in PATH Act]. A critique of these proposals is beyond the scope of this article.