

MEMORANDUM

UCC Article 3 and Holder in Due Course Doctrine

Jim Smith, Reporter

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1. Introduction

The core idea of negotiability is that certain purchasers of monetary obligations take free of defenses to payments that the obligor (maker) might raise against the original payee. This is known as the holder in due course doctrine. It is an exception to a basic tenet of property law, reflected by the Latin phrase, *Nemo dat quod non habet* (“no one gives what he does not have”). Negotiability is a type of bona fide purchaser doctrine. It grants a power to the original payee of a negotiable instrument to sell rights he did not have to a buyer, who qualifies as a holder in due course. The purpose and effect is to take property away from the obligor (maker) and allocate it to the holder/purchaser.

Our law of negotiable instruments dates back to 18th century English legal innovations. England’s law first recognized bills of exchange, and quickly thereafter promissory notes, as negotiable. The original function was to allow the development of money substitutes. Bills of exchange were issued by merchants, and notes by banks and other financial institutions, and those obligations were transformed into liquid assets (i.e., easily saleable to purchasers who did not have to inquire into the particular circumstances of their creation to determine whether the maker might assert a plausible defense to payment).

Early U.S. law followed the English pattern. Bank notes were the most important form of U.S. negotiable instruments prior to the federal government’s decision to begin issuing paper currency in 1862. In modern practice, a large percentage of promissory notes are issued by individuals and small businesses, and they do not function in the economy as money substitutes. Today banks and other financial institutions are the primary holders, rather than the primary issuers, of negotiable promissory notes.

The modern justification for treating privately-issued promissory notes as negotiable is not providing for a money substitute, but enhancing the credit markets. Purchasers of negotiable instruments are relieved from the transaction costs of having to investigate the particulars of loans documented by negotiable notes, and therefore in theory, are willing to pay more for those notes. Under a “trickle down” theory, arguably borrowers also realize some of the benefit of this credit enhancement by paying a lower interest rate, or lower fees.

The negotiable note, therefore, is more liquid and more valuable in the hands of the originating lender and the other parties to the transaction, including the maker and the subsequent holder. It is worth noting, however, that the secondary mortgage market is but one type of “receivables” financing; many other robust markets for receivables financing

– for example, automobile financing, accounts financings, credit-card receivables, and health-care insurance receivables – do not presently rely on negotiable paper to any appreciable extent.

2. Are Promissory Notes Secured by Mortgages Negotiable?

Article 3 of the Uniform Commercial Code applies only to negotiable instruments. Many promissory notes are negotiable instruments, but many are not, and non-negotiable promissory notes are completely outside the scope of UCC Article 3. They are generally governed by state common law, although some statutes are relevant, including UCC Article 9, which provides rules governing the sale of all forms of promissory notes and the creation of security interests in non-negotiable, as well as negotiable, promissory notes.

It is often hard to determine whether a particular note qualifies as a “negotiable instrument” under the Article 3 rules. Under Article 3, a promissory note is negotiable if it:

- (1) contains an “unconditional promise ... to pay a fixed amount of money, with or without interest or other charges described in the promise”;
- (2) “is payable to bearer or to order”;
- (3) “is payable on demand or at a definite time”;
- (4) “does not state any other undertaking or instruction by the person promising ... payment to do any act in addition to the payment of money, but the promise ... may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor”; and
- (5) does not contain “a conspicuous statement, however expressed, to the effect that the promise ... is not negotiable or is not an instrument governed by [Article 3].

UCC § 3-104(a), (d) (2002). Prior to the 1990 revision to Article 3, there was a split of opinion as to whether adjustable rate notes qualified as negotiable. The 1990 revision resolved the issue, added a section making variable-interest-rate notes negotiable; *see* UCC § 3-112(b). Today qualification of a secured note as a negotiable instrument usually turns on only one issue: whether the note says too much about the maker’s obligations with respect to the mortgaged property, so that it exceeds the bounds of the 4th element described above. Although one might conceivably interpret Section 3-104 to allow a note directly to incorporate a full range of standard mortgage covenants into the note, without destroying negotiability, conventional wisdom is that the drafter must avoid doing too much.

There is a growing body of cases indicating that the Fannie Mae/Freddie/Mac uniform promissory note – the overwhelmingly dominant form used in home mortgage financing – is a negotiable instrument. Most cases, however, reach that conclusion without providing any analysis. They do not bother to even mention the Article 3 requirements for a negotiable instrument. See 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) (making the same observation for 42 cases he studied, which were decided between 1989 and 2009). A few courts have provided analysis. An example is *HSBC Bank USA v. Gouda*, 2010 WL 5128666 (N.J. Super. Ct. App. Div. 2010). The *Gouda* court examined the uniform note’s prepayment clause, which provides:

4. BORROWER’S RIGHT TO PREPAY. I have the right to make payments of Principal at any time before they are due. A payment of Principal only is known as a “Prepayment.” When I make a Prepayment, I will tell the Note Holder in writing that I am doing so. I may not designate a payment as a Prepayment if I have not made all the monthly payments due under the Note.

The *Gouda* court held that the prepayment clause was not a proscribed “other undertaking or instruction,” even though the clause obligated the maker to “tell the Note Holder in writing” that his payment was to be a prepayment. The court observed:

The right of defendants, under the note, to prepay part of the principal does not constitute an ‘additional undertaking or instruction’ that adversely affects the negotiability of the note. Quite the opposite, the right of prepayment is a voluntary option that defendants may elect to exercise solely at their discretion. . . . The fact that defendants must notify the lender in the event they opt for prepayment imposes no additional liability on them and is not a condition placed on defendants’ promise to pay. Rather, notification is simply a requirement of the exercise of the right of prepayment which, as noted, defendants are free to reject. This requirement does not render the note in issue non-negotiable.

Id. at *3. At least three other courts have also rejected the argument that the prepayment clause makes the note non-negotiable. See, e.g., *In re Walker*, 466 B.R. 271, 2012 WL 443014 (Bankr. E.D. Pa. 2012) (relying on *Gouda* to hold note is negotiable); *In re Edwards*, 76 UCC Rep. Serv. 2d 220, 2011 WL 6754073 (Bankr. E.D. Wis. 2011) (note is negotiable: “providing information regarding a prepayment to the lender is not an express condition to payment or subject to ‘another writing’ within the meaning of the statute”); *Picatinny Federal Credit Union v. Federal Nat. Mortgage Ass’n*, 2011 WL 1337507 (D.N.J. 2011) (relying on *Gouda*).

More recently, a bankruptcy court rejected a set of arguments that the Fannie Mae/Freddie Mac uniform note is non-negotiable, including the prepayment clause and the note’s explicit quotation of the due-on-sale clause set forth in the uniform mortgage (uniform security instrument). *Mesina v. Citibank, NA*, 77 UCC Rep. Serv. 2d 987, 2012

WL 2501123 (Bankr. D.N.J. 2012).

3. If the Note is Negotiable, How Does Article 3 Affect Identifying the Person Who Has the Right to Foreclose?

A key concept in Article 3 is a character known as a “*person entitled to enforce an instrument*,” defined in UCC § 3-301 (2002). The term replaced a simpler term, “*holder of an instrument*.” The “person entitled to enforce” includes not only holders, but also a person enforcing a lost note and a person who possesses a note but fails to qualify as a “holder” as defined in UCC Article 1. “Entitlement to enforce” means that the person has the right to demand payment from the maker, in accordance with the terms of the note, and to sue on the note if payment is not made.

Article 3 does not attempt to deal with *ownership of the obligation* embodied in a negotiable instrument (i.e., ownership of the promissory note). Often but not always the “person entitled to enforce” will also own the note. When “entitlement to enforce” and ownership are separated, by definition the “person entitled to enforce” will have an obligation to remit the proceeds it collects to the owner. That obligation may stem from an express agency relationship, another type of contract, or have another source, such as the law of restitution. Again, Article 3 does not attempt to define ownership of negotiable instruments, or to regulate the relationship between “persons entitled to enforce” and owners.

Article 3 does not address the rights of a “person entitled to enforce” to foreclose on collateral, in the event the negotiable note is secured by collateral. It provides no guidance as to whether the proper person to foreclose should be the “enforcer” or another person.

Under the existing law of some states, the person who is entitled to foreclose is the “person entitled to enforce” the note under Article 3 (assuming that the note meets the Article 3 rules for negotiability). This approach was taken by our Nov. 2012 draft, and it is the first of the two alternatives set forth in Section 401 (“Right to Foreclose”) of our Feb. 2013 draft. Ohio is one of several states adopting this approach. In *BAC Home Loans Servicing, LP v. Kolenich*, 2012 WL 5306059 (Ohio Ct. App. 2012), the court held that the plaintiff had the right to foreclose, as holder of the note, even though it had sold ownership of the debt through securitization to Fannie Mae. The court observed:

It is well-settled that the real party in interest in a foreclosure action is the current holder of the note and mortgage. *See, e.g., Everhome Mtge. Co. v. Rowland*, 10th Dist. No. 07AP-615, 2008-Ohio-1282, ¶ 12. The current holder of the note and mortgage is entitled to bring a foreclosure action against a defaulting mortgagor even if the current holder is not the owner of the note and mortgage. *See* R.C. 1303.31(A) (a “[p]erson entitled to enforce” [a negotiable] instrument” includes “the holder of the instrument[,]”) and R.C. 1303.31(B) (“[a] person may be a ‘person entitled

to enforce' the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument").

Designating the "person with the right to enforce" as the proper person to foreclose has the beneficial effect of ensuring that the mortgage debt is discharged to the extent of the foreclosure proceeds (assuming that the foreclosing party in fact is the "person entitled to enforce"). On the assumption that the mortgage debt is evidenced by a promissory note that meets the standards for negotiability set forth in UCC Article 3, the law of negotiable instruments may specify who is entitled to foreclose the mortgage.

Instead of this approach, a number of states have foreclosure laws that specify a person other than the "person entitled to enforce" as the person who has the right to foreclose. For example, in *Trotter v. Bank of New York Mellon*, 275 P.3d 857 (Idaho 2012), the court held that a trustee has the right to foreclose under the Idaho Deed of Trust Act by complying with the act's express requirements, which include recordation of the trust deed, recordation of any assignments of the trust deed, and recordation of a notice that the borrower has defaulted. In *Trotter*, after receiving the trustee's notice of the proposed foreclosure sale, the borrower brought an action to enjoin the sale, alleging that the trustee and other defendants, including MERS, lacking standing to foreclose. The court rejected the borrower's argument that the trustee must prove "it is the current owner of the note" or that it had "authorization from the beneficiary" to foreclose. *Id.* at 861. The court emphasized that standing rules did not apply because "the foreclosure process in the Act is not a judicial proceeding." *Id.* *Accord*, *Jackson v. Mortgage Electronic Registration Systems, Inc.*, 770 N.W.2d 487 (Minn. 2009) (under Minnesota "foreclosure by advertisement" statute, legal holder of mortgage is entitled to foreclosure without proof as to identity of holder or owner of promissory note).

Allowing foreclosure by a person other than the note holder (or its proven agent) raises particular difficulty if the promissory note is negotiable. In some cases, if the "person entitled to enforce" under Article 3 has not received the foreclosure proceeds from the person who forecloses, the "person entitled to enforce" may assert a plausible claim that there has been no discharge. In some cases, the maker may successfully defend that claim with proof of express agency, implied agency, estoppel, or similar theories, but all of that could easily get messy. In essence, the situation is analogous to the risk imposed upon the maker of any negotiable instrument of making a payment to the wrong person. A maker who mistakenly pays someone other than the holder (or "person entitled to enforce") does not get a discharge, and undertakes the risk of having to pay twice. The difference is that normally the maker's risk is associated with the maker's voluntary payment. Here, the problem arises due to an "involuntary payment" made on behalf of the maker due to the foreclosure.

If the uniform statute confers standing to foreclose on a person other than the "person entitled to enforce" when the note is negotiable, it seems advisable to draft provisions that protect borrowers from the risk that the foreclosure proceeds will not be applied to discharge their debt.

4. If the Note is Negotiable, May the Maker Still Assert Defenses in Foreclosure?

If the mortgage note is negotiable, transfer to a holder in due course allows the holder to bring an action to collect the note, free of any “personal defenses” that the maker might have against the original lender. Article 3 governs, and the statutory language directly calls for this result. UCC § 3-305.

However, Article 3 does not state rules with respect to a holder’s rights to foreclose on collateral. Thus, other law (usually state common law) determines whether the maker may assert personal defenses in mortgage foreclosure. The issue is usually framed in terms of whether the mortgage (or deed of trust) is negotiable. Does the fact that the note is negotiable make the mortgage negotiable? Shortly after U.S. states began holding that mortgage notes could qualify as negotiable instruments (late 19th- early 20th century), a few courts held the mortgage was not negotiable; in other words, the character of the note was not imputed to the mortgage.

The majority rule, however, extended the holder’s protection from defenses to its foreclosure on the collateral. Presently, the rule making the mortgage negotiable when the underlying note is negotiable, if not universally accepted, is close to universally accepted. E.g., *Colburn v. Mid-State Homes, Inc.*, 266 So. 2d 865 (Ala. 1972); *Wilson v. Steele*, 259 Cal. Rptr. 851 (Ct. App. 1989); *Carnegie Bank v. Shalleck*, 606 A.2d 389 (N.J. Super. Ct. 1992); 127 A.L.R. 190. No modern cases hold a maker may assert personal defenses against the holder in due course of a promissory note in the context of mortgage foreclosure.

Thus, a uniform statute that allows mortgagors to assert “personal defenses” such as fraud and misrepresentation in foreclosure proceedings, would not conflict with Article 3 law. It would, however, overturn other well-accepted state law.

It is also worth noting that the Article 3 section that cuts off defenses in favor of a holder in due course states an exception for “law other than this Article” that protects obligors in a “consumer transaction,” defined as a “transaction in which an individual incurs an obligation primarily for personal, family, or household purposes.” UCC §§ 3-305(e), (f); 3-103(a)(3) (2002). Therefore, a statute overriding the holder in due course doctrine as a general matter for homeowners would not conflict with Article 3.