

- Lynch buys a note from Crouch for \$1,475 cash
 - Note, dated Aug. 1, 2011, provides that Mitchell (maker) will pay Crouch \$1,500 + 10% interest on Sept. 1, 2011
 - Note is indorsed to Lynch, who takes possession
- September 1, 2011: Lynch presents the note to Mitchell and demands payment
 - Mitchell’s defense is: “I gave Crouch the note in payment for services that Crouch never provided.”
- Can Lynch enforce the note?

Nonnegotiable Promissory Note

- If note is not a negotiable instrument, its enforcement is governed by common law of contracts (not UCC Article 3)
 - Under contract law, an assignee of a contract right takes it subject to all real and personal defenses of the other party to the contract (derivative rights)
 - If the note is nonnegotiable, Lynch can’t collect from Mitchell, **if *Mitchell’s defense is in fact valid***

Negotiable Promissory Note

- If the note is a “negotiable instrument,” it is governed by UCC Article 3, incl. its “holder in due course” rule
- “Holder in due course” of a negotiable instrument takes it free of the maker’s personal defenses (e.g., failure of consideration) [UCC § 3-305(b)]
- Thus, if note is a negotiable instrument and Lynch is a HIDC, he can collect the note from Mitchell ***even if Mitchell’s defense against Crouch was valid***

Negotiable Instrument [§ 3-104(a)]

- Promissory note is “negotiable” if
 - It is an unconditional promise or order to pay a fixed amount of money (with or without interest)
 - It is payable “to bearer” or “to order” of a particular person
 - It is payable on demand or at a definite time, and
 - It does not state any other undertaking to do any act in addition to the payment of money (other than an undertaking to provide or maintain collateral to secure repayment of the note)



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- To be a holder in due course of a negotiable instrument [§ 3-302], Lynch must
 - Be a holder (i.e., indorsement + delivery)
 - Pay value to acquire the instrument
 - Take it in “good faith,” and
 - Take it “without notice” that the note is/has been (a) overdue or dishonored, (b) forged or altered, (c) subject to claim of another party, or (d) subject to defenses

“Real” and “Personal” Defenses

- | | |
|---|--|
| <ul style="list-style-type: none"> • Real defenses (even HIDC takes subject to) <ul style="list-style-type: none"> – Infancy – Lack of capacity – Duress – Forgery – Fraud in the factum – Bankruptcy discharge | <ul style="list-style-type: none"> • Personal defenses (HIDC takes free of) <ul style="list-style-type: none"> – Any defense to a simple contract (breach of warranty, failure of consideration) – Fraud in the inducement |
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Apponline [p. 492]

- Island Mortgage (IM) was a mortgage company (not a bank, it had no deposits to make loans)
- IM funded loans it made by using “warehouse” line of credit from Matrix Bank
 - Matrix would loan IM the money needed to fund mortgage loans to IM customers



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- How did IM make a profit?
 - Source 1: Fees charged to Borrowers (e.g., loan application fees)
 - Source 2: “Interest rate spread” (i.e., IM borrowed from Matrix Bank at lower rates than it was charging mortgage borrowers)
- When it pooled enough loans, IM would sell them to secondary market buyer, use sale proceeds to pay off warehouse line of credit from Matrix Bank

- Who was Broward, and what happened?
 - IM had agreed to loan money to Amarante (who was buying a home); Broward was handling the closing of the sale (closing/escrow agent)
 - Prior to closing, Matrix wired IM the money to fund the loan
 - IM then wrote Broward a check for \$115,117.61 (the loan proceeds); Broward would use these proceeds to pay off the Seller's existing mortgage, then pay the net proceeds to Seller

- What happened?
 - Broward deposited IM's check (not certified)
 - Broward paid off Seller's mortgage and paid net sale proceeds to Seller at closing, using its own funds
 - But IM's check bounced!
 - Broward should've insisted upon IM providing it with certified funds ("good funds" = certified check or wire transfer)
- Afterward, Broward claimed an "equitable lien" against the note (i.e., the right to collect the note payments due from Amarante)

- Court does recognize Broward as having an equitable lien on the Amarante note
- But Matrix Bank had taken an assignment of that note as collateral for the warehouse loan, and claims to be a HIDC
- Should Matrix prevail?



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- Held: Matrix Bank is a HIDC, as it did not have notice of Broward's claim to the note
 - Matrix Bank didn't have knowledge of the fact that IM had bounced the check to Broward
 - Matrix didn't take assignment of note in bad faith
 - By contrast, Broward could have insisted upon receiving "good funds" from Island Mortgage before it closed the Amarante transaction

Rationale for HIDC Rule?

- Promotes commercial activity by facilitating the availability of credit for business activity on more favorable terms
 - Policy argument: “Investors would be less likely to buy promissory notes (or lenders would be less likely to lend using notes as collateral) if they were subject to the maker’s defenses or third party claims. Or, they would demand higher returns (because they’d have greater costs).”



Holder in Due Course

- The doctrine has been largely abolished in the consumer credit context (other than mortgage loans), under the Uniform Consumer Credit Code, the FTC rule, and other state laws
- This abolition was based, in part, on the perception of substantial abuses/frauds in the making and transfer of consumer loans

UCCC § 3.404(1)

- “With respect to a consumer credit sale or consumer lease, an assignee ... is **subject to all claims and defenses of the consumer against the seller or lessor arising from the sale or lease of property or services**, notwithstanding that the assignee is a holder in due course of a negotiable instrument”
 - E.g., assignee of installment car sale contract would take subject to car buyer’s warranty defenses

FTC Rule

- Consumer credit contract for \$25,000 or less must say:

“NOTICE. ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED WITH THE PROCEEDS HEREOF.”

 - Assignee of note bearing this legend can’t qualify for HIDC status under Article 3
 - It is an “unfair trade practice” to enter into a consumer credit contract without this notice



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- Does holder in due course doctrine make sense as applied to the modern secondary mortgage market, in which securitizing mortgages is common?



- Securitized loan doesn't involve an "active lender" (issuer of MBS is merely a passive entity); it's a really a "lenderless loan"
 - A regular mortgage lender (holding mortgage for its own portfolio) has strong incentive to maintain rigorous underwriting standards and to make sure loans are made properly
 - Abolition of HIRC status might give investors more incentive to create/adhere to rigorous standards for the origination/purchase of mortgage loans

Practical Problems w/Securitization

- As securitization has become more widespread, many problems have arisen, such as:
 - Lack of recorded mortgage assignments
 - How does mortgagor get a release of the mortgage after paying it off?
 - Where's the note? Although Article 3 requires delivery of possession of negotiable note, that's a record-keeping hassle [note is often placed in distant storage, or perhaps even lost/shredded!]

Problem 5: Payment/Discharge

- Mitchell borrows \$100K from Bowman, signs note, secured by mortgage on Mitchell's land
 - Bowman later negotiates the note to Uphoff
 - Mitchell wins lottery and, unaware of Bowman's sale of note to Uphoff, tenders \$100K to Bowman
 - Bowman (who, by right, should turn over the money to Uphoff) disappears with the money
- Can Uphoff enforce the note v. Mitchell, or is Mitchell's obligation on the note discharged?



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- Negotiable instrument is discharged upon “payment,” which must be made “to a person entitled to enforce the instrument” [§ 3-602(a)]
 - This means payment must be made to (a) the holder of the note or (b) someone entitled to assert the holder’s rights [§ 3-301]
 - In Problem 5, that’s Uphoff, not Bowman
 - Payment to Bowman **did not discharge debt** and thus Uphoff can collect from Mitchell!



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- Same rule is applied to nonnegotiable notes, under common law of contracts
- Restatement § 5.5 rejects the payment rule and instead provides that maker of the note is entitled to pay the original mortgagee, until the maker receives notice of assignment of the note
 - No court decisions as yet adopting § 5.5



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- Revised Art. 3 changes payment rule [p. 513]
 - Under revised § 3-602(b), Mitchell would be discharged b/c he paid Bowman before receiving notice of assignment to Uphoff
 - Problem: Revised Article 3 adopted only in 10 states (and NOT in Missouri)!
 - In other states (incl. MO), Mitchell is at risk of making double payment unless (a) he gets return of the original note at time of payment, or (b) he can confirm Bowman is authorized to receive payment

- Exam: Tuesday, May 14, 1:30 p.m to 4:45 p.m.
 - Short Essay: 4 questions, 100 minutes total
 - Multiple Choice: 23 questions/65 minutes
 - Unallocated time: 30 minutes
- There are late takers, so don’t discuss exam w/other class members after you’ve taken it
- I will post cover page (w/instructions) on course web page