THE DRAFT LAW SHOULD NOT GRANT STANDING TO FORECLOSE TO THE HOLDER OF A NEGOTIABLE INSTRUMENT.

Proposed §401(b)(1) creates a statutory basis for the holder of a negotiable instrument secured by a mortgage to foreclose that mortgage. In contrast, §401(b)(2) requires the obligee of a non-negotiable note to prove its note ownership in order to foreclose. When I ask people why the holder of a negotiable instrument should be *per se* entitled to foreclose, they typically say "the mortgage follows the note". When I ask the follow up question, does the mortgage follow the note to the holder or the owner, they often look at me as if I have three eyes. "Well of course it's the holder" is the common response. I expect that most people would be surprised to learn that in current practice, very often the holder and the owner are two different parties. The purpose of this paper is to demonstrate that when this split exists, the perfunctory answer does not hold up to careful analysis of the purposes of mortgage and negotiable instruments law.

Mortgages and negotiable instruments are both designed to facilitate the flow of credit, but they achieve this end through contradictory means. As will be shown, mortgages facilitate credit be allowing a borrower to pledge real property as collateral for his promise to pay. The lender takes on the added transaction costs associated with investigating the collateral, but in return receives the right to a remedy which increases the likelihood of repayment by liquidation. In contrast, negotiable instruments law enhances liquidity by centralizing the rights and obligations of the parties into one physical document. The lender's right to payment is more valuable because the lender can sell the obligation with very low transaction costs. The prospective purchaser of a negotiable instrument need not investigate the underlying transaction to know its rights. Because these two means of credit enhancement are based on different mechanisms, the remedies available to mortgagees and holders are different. The mortgagee, on the one hand, is bound by the rules of equity, where the holder is entitled to simplified methods

of enforcement. This paper will demonstrate that the fundamental differences between these two areas of the law expose the "Well of course it's the holder" response as not only conclusory, but simply wrong.

FORECLOSURE IS AN EQUITABLE REMEDY

Ultimately, foreclosure is an equitable remedy which becomes available solely as the result of a contract between a borrower and a lender.[1] At its essence, the mortgage is a contractual promise by the mortgagor to make his real estate available for appropriation if he fails to pay his debt to the mortgagee.[2] In creating policy with respect to any contract, this Committee should seek to maximize "economic efficiency". [3] Under this doctrine equitable remedies are ordinarily reserved for cases in which the obligee does not have an adequate remedy at law.[4] The mortgage contract contemplates that the lender's right to collect the debt at law may be inadequate. This may stem from the nature of the obligation—for example, the size of the debt may far exceed the borrower's non-real estate assets, or the borrower's ability to repay his the debt from current income may be insufficient. A mortgage facilitates the extension of credit by protecting a lender against its inability to collect its debt in an action at law. Nonetheless, since this remedy is equitable in nature, courts have traditionally circumscribed its use pursuant to the general rules of the courts of equity.[5]

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[1] That contract may take many forms: mortgage, deed of trust, security deed, etc., but for the purposes of clarity I will refer to all of these as mortgages. Also, foreclosure of non-voluntary liens is beyond the scope of this paper.

[2] See Restatement of the Law, Third, of Property (Mortgages) §1.1

[3] "The traditional goal of the law of contract remedies has not been compulsion of the promisor to perform his promise but compensation of the promisee for the loss resulting from breach ... In general, therefore, a party may find it advantageous to refuse to perform a contract if he will still have a net gain after he has fully compensated the injured party for the resulting loss." Restatement of the Law, Second, of Contracts Chapter 16, Remedies, Introductory Note.

[4] "During the development of the jurisdiction of courts of equity, it came to be recognized that equitable relief would not be granted if the award of damages at law was adequate to protect the interests of the injured party." Restatement of the Law, Second, of Contracts §359, Comment a.

[5] The Restatement of the Law, Second, of Contracts, while acknowledging that the trend has been toward a more liberal approach in the application of equitable remedies, preserves this strict oversight by providing: "The objective of the court in granting equitable relief is to do complete justice to the extent that this is feasible. Under the rule

THE REMEDY OF FORECLOSURE IN HISTORICAL CONTEXT

At common law the mortgagor transferred the legal title to the real estate to the mortgagee on condition. Upon performance of the condition, the mortgagor had a right to petition the court of equity to be restored to full ownership in fee.[6] This right became known as the "equity of redemption". As late as 1797, in Connecticut, that right of redemption could last indefinitely.[7] The mortgagee's right to cut off the equity of redemption, in other words to "foreclose" did not exist in the courts of law, but could only be obtained in the courts of chancery.[8] A mortgagee would bring a bill in chancery naming all parties with an interest in the real estate asking the court to set a time limiting the rights of redemption—the "law date".[9] Upon the passing of the law date, the right of redemption would be terminated and title would vest absolutely in the mortgagee. Such appropriation would extinguish the debt owed to the mortgagee.[10]

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stated in Subsection (1), the court has the power to mold its order to this end. The form and terms of the order are to a considerable extent within the discretion of the court." *Id*. at §358, Comment a.

[6] The rights of the mortgagor and mortgagee where described thus: "[T]he equity of redemption upon a mortgage in fee, is an estate in fee, as effectual to confer a settlement, as a legal fee. … [T]he mortgagor, in such a case, is the owner of the land, and to be regarded, as such, at law, to every purpose, except the right of possession, which is at the controul of the mortgagee." *Barkhamsted v. Farmington*, 2 Conn. 600, 604-05 (1818).

[7] See for example *Sheldon v Bird*, 2 Root 509, 1797 Conn. App. LEXIS 9 (Circuit Court of Connecticut, Hartford County, 1797) where, upon failure of the condition stated, title became absolute in the mortgagee in 1773, the mortgagee taking possession in 1775, but the heirs of the mortgagor were allowed to redeem more than 21 years later since they had not been joined in the 1773 foreclosure proceeding.

[8] It was said: "He who has the legal estate [the mortgagee], upon principle, should be permitted to bar the equitable title by foreclosure; and he who has the equitable title [the mortgagor] may call for the legal estate upon payment of what is due to him or them in whom the legal title is vested." *Allyn v. Marsh*, 9 Conn. 151, 152 (1832).

[9] The foreclosure process has been described thus: "The object of the bill is to appropriate the pledge, and to cut off all right to redeem, and give a perfect title to the mortgagee. The decree effects this object. The mortgagor can never redeem, except by paying the incumbrance. When the time limited for the payment of the mortgage money has expired, the debt is extinguished, and the estate becomes absolute, according to the decision of our court. The bill proceeds on the ground of a debt due, and a valid collateral security, by a mortgage deed." *Palmer's Administrators v. Mead*, 7 Conn. 149, (1828), (Daggett, J., dissenting [internal quotations omitted]).

[10] See *M'Ewen v. Welles*, 1 Root 202, 1790 Conn. LEXIS 79, (Superior Court of Connecticut, Fairfield County, 1790), *The Derby Bank v. Landon*, 3 Conn. 62 (1819), *Bassett v. Mason*, 18 Conn. 131 (1846).

While the common law has long recognized that the mortgage "follows the debt",[11] that concept was always understood to be dealing with *ownership* of the underlying debt. The note is not the debt,[12] but merely evidence of it,[13] which debt can be proven by parol evidence when the note is lost or destroyed.[14] An obligee has two separate and distinct causes of action upon non-payment of the debt: he can sue on the note at law or he can pursue his equitable remedy of foreclosure.[15] The earliest Connecticut cases recognized that a bar to an action at law on the note would not prevent the mortgagee from exercising the equitable remedy of foreclosure.[16] Similarly, the early cases characterized the note and mortgage as two securities for the same debt.[17] Furthermore, the debt is secured by the mortgage regardless of the form into which it is made,[18] so where a mortgage was given as security for a maker's duty to indemnify his indorser,

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[11] See *Brownson v. Crosby*, 2 Day 425, 1807 Conn. LEXIS 5 (1807), *Burbank v. Austin*, 2 Day 474 (1807), *Judah v. Judd*, 1 Conn. 309 (1815).

[12] The differential between the note and the debt in foreclosure law is fundamentally at odds with the law of negotiable instruments which is based on the idea that the debt is reified into the negotiable instrument.

[13] In pointing out the difference between the note and the debt, the Connecticut Supreme Court of Errors stated: "The whole argument proceeds upon a fallacy. The note and the debt are considered as the same thing; whereas, the note is but evidence of the debt." *Peters v Goodrich*, 3 Conn. 146, 155 (1819) (Chapman, J. concurring).

[14] "To constitute a mortgage, the conveyance must be made to secure the payment of a debt. But it is not necessary that, in all cases, there should be a personal liability for the payment of that debt, in addition to the security created by the mortgage." *Bacon v. Brown*, 19 Conn. 29, 34 (1848). This distinction between the note and the debt continues to be valid in Connecticut. See *New England Savings Bank v. Bedford Realty Corp*., 238 Conn. 745 (1996) holding that the obligee's inability to enforce a lost note in compliance with UCC §3-309 did not prevent it from foreclosing the mortgage securing the note, since the debt had not in fact been paid by the mortgagor.

[15] In Connecticut, this concept dates all the way back to 1787. See *Coit v. Fitch*, 1 Kirby 254, 1787 Conn. LEXIS 29 (Superior Court of Connecticut, Windham County, 1787) and continues as good law to this day. See *RMS Residential Properties, LLC v. Miller*, 303 Conn. 224 (2011).

[16] See *Bolles v. Chauncey*, 8 Conn. 389 (1826), holding that where the original note secured by the mortgage was redelivered to the maker/mortgagor, but was not in fact paid, the maker's grantee could not quiet title against the mortgagee because the debt was never paid, and the original note was only returned to the maker after because he signed a substituted note. See also *Baldwin v Norton*, 2 Conn. 709 (1817) where the statute of limitations barring an action at law on the note did not operate to bar the mortgagee from foreclosing on the mortgage securing the debt evidenced by the time-barred note. Accord, *Markham v. Smith*, 119 Conn. 355 (1935). See also, *New England Savings Bank v. Bedford Realty Corp*., supra, (inability to enforce a lost note pursuant to U.C.C. §3-309 not a bar to foreclosure).

[17] See *Belknap v. Gleason*, 11 Conn. 160 (1836).

[18] See *Belcher v. The Hartford Bank*, 15 Conn. 381, 382 (1843): "It is the debt which is to be protected, by the fund or security, first in the hands of the creditor, and ultimately in his hands who has paid it. No matter how it may be modified, or what shape it may have assumed, or into whose hands it may come, until it is paid, the pledge accompanies it, and remains for its redemption."

the mortgage was valid even though the original note was substituted by another note upon which the indorser's liability became due.[19]

From an economic efficiency perspective, the cases are consistent with the idea that a lender demands a mortgage and a borrower consents to its grant because the lender's remedy at law on the note may be insufficient. The cases also reflect that the courts of equity will always look at the substance of the transaction and not be bound by its form. In other words, rights or disabilities imposed at law may or may not apply in foreclosure actions depending on the demands of equity. The Connecticut Supreme Court of Errors stated it thus:

> "The nature of the estate granted by a mortgage deed, is not to be ascertained from its language. It purports to be an estate on condition, to become absolute upon non-performance. Apparently, the whole estate is transferred to the mortgagee; and the mortgagor can have nothing until re-invested with his original title, by performance of the conditions. When the day of redemption is passed, the right of the mortgagor is gone forever, according to the literal and plain import of the instrument, whatever may be its value in proportion to the debt or duty it was given to secure. Even then, the debt is not paid. ***The condition imposes a penalty, by which the mortgagor is forever divested of his interest. But its severity is mitigated, by the principles of equity***. By those principles, a species of security is made subservient to the interest of credit and commerce, ***which, by strict law, would be an engine of oppression, which no community could endure***."[20]

Thus, no remedy of foreclosure should lie without the protection of equitable principles.

NEGOTIABLE INSTRUMENTS DERIVE FROM LAW NOT EQUITY AND THEIR ENFORCEMENT DOES NOT INCLUDE EQUITABLE REMEDIES.

Where equity is concern with substance, negotiable instruments law is entirely based on formalities.[21] When a promissory note meets the formal requirements of U.C.C. §3-104, the

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[19] See *Pond v. Clarke*, 14 Conn. 334 (1841). The condition of the deed stated: "If we shall save entirely harmless our said indorsers from all indorsements, and shall well and truly ourselves pay up all said notes, drafts and obligations, as they fall due, and shall moreover fully pay said book debts to the persons aforesaid to whom due, then this deed shall be void, otherwise in full force." The mortgagees were able to foreclose even though all the notes which existed at the time of the mortgage were taken up by substituted notes. The important issue for the court was that the debt represented by the substituted notes was the same debt for which the mortgage was pledged.

[20] *Porter v. Seeley*, 13 Conn. 564, 572-73 (1840) [Emphasis added].

[21] See Frederick M. Hart, Erik F. Gerding, and William F. Willier, *Negotiable Instruments under the Uniform Commercial Code* §1B.04 (Matthew Bender, Second Ed.) See also, Official Comment 2 to U.C.C. §3-103 (Pre-

instrument is negotiable and a series of rules apply to the note.[22] These rules allow the separation of the ownership of the debt from the right to enforce the note.[23] Such a separation is strictly a matter of form over substance. The right to enforce a negotiable note at law is given to parties who may not have paid value for the note.[24] At the extreme, it has been said that a thief can enforce a note.[25]

Negotiable instruments law effects a change in normal rules of conveying a right to payment, the rule of *nemo dat quod non habet*.[26] It does this by centralizing the right to payment into one physical document—the negotiable note.[27] Originally, this centralization was done to increase the liquidity of the payment obligation, and early negotiable instruments were "couriers without luggage."[28] It has been said that "… subsequent holders can take and transfer the instrument without plumbing the intricacies of individual relationships or payback schemes."[29] Professor Mann says:

> "Th[is] approach enhances liquidity by reducing the costs a prospective purchaser incurs in acquiring two related types of information about the asset: information about claims

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Revision Art. 3) *Uniform Commercial Code, Official Text and Comments*, The American Law Institute, National Conference of Commissioners on Uniform State Laws, West, 2010-2011 Edition: "It will be noted that the formal requisites of negotiability (U.C.C. § 3-104) go to matters of form exclusively ...." Accord, Lary Lawrence, *An Introduction to Payment Systems*, Aspen Law & Business (1997): "Negotiable instruments law chose to have the form of the writing be the distinguishing mark between negotiable writings and writings that are not negotiable. There is no middle ground; with rare exception, all writings that comply with the required form are negotiable, whereas all writings that do not comply are not negotiable."

[22] U.C.C. Article 3 only applies to negotiable instruments. See *Negotiable Instruments under the Uniform Commercial Code, supra* §2.03. See also *Branch Banking & Trust Co. v. Creasy*, 301 N.C. 44, 269 S.E.2d 117, 30 U.C.C. Rep. Serv. 545 (1980).

[23] See Official Comment 1 to §3-203, *Uniform Commercial Code, Official Text and Comments*, The American Law Institute, National Conference of Commissioners on Uniform State Laws, West, 2010-2011 Edition.

[24] See U.C.C. §3-301 indicating that a "holder" is entitled to enforce a negotiable note. To be a "holder" U.C.C. §1-201(21)(A) merely requires possession of the instrument if it is indorsed in blank (See also §§3-201, 204 and 205).

[25] See Official Comment 1 to §3-201, *Uniform Commercial Code, Official Text and Comments, supra*: "[I]f an instrument is payable to bearer and it is stolen by Thief or is found by Finder, Thief or Finder becomes the holder of the instrument when possession is obtained."

[26] Literally: "no one gives what he doesn't have."

[27] See Ronald Mann, *Searching For Negotiability In Payment and Credit Systems* 44 UCLA Law Rev. 951, 958 (1997).

[28] See *Overton v. Tyler*, 3 Pa. 346 (1846).

[29] *Cobb Bank & Trust Co. v. American Mfrs. Mut. Ins. Co.*, 459 F. Supp. 328, 333 (N.D. Ga. 1978).

> that undermine the value of the payment obligation that the instrument represents, and information about title to the payment obligation."[30]

Thus, negotiability enhances liquidity by reducing "due diligence" costs. It provides a simplified method of enforcement—the party entitled to enforce the note need not demonstrate its provenance,[31] is entitled to a presumption that signatures on the note are authentic,[32] and, under certain circumstances, can cut off personal defenses of the maker.[33]

CONCLUSION

The tension between mortgage and negotiable instruments law can be most clearly seen in the following example.[34] Suppose the lender requires the borrower to execute two original notes at closing, and assume that those notes qualify as negotiable instruments. The lender then negotiates each note to a different purchaser in transactions which makes each purchaser a holder in due course.[35] In a legal action on either note the purchaser would be immune to the borrower's lack of consideration defense pursuant to U.C.C. §3-305. As harsh as the result may be, there is no legal basis to prevent both holders from demanding payment in full. The law of negotiable instruments accepts this risk, but choses to apply the holder in due course doctrine anyway so as to enhance the liquidity of the instruments.[36] In a foreclosure action however, the court would seek to do complete justice. Only one debt exists and while the borrower has pledged his real estate as security for the debt, that property would only be available to repay one

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[30] *Searching For Negotiability In Payment and Credit Systems, supra*.
[31] U.C.C. §3-301.
[32] U.C.C. §3-308.
[33] U.C.C. §3-305.
[34] The basic facts are taken from the case of *Provident Bank v. Cmty. Home Mortg. Corp.*, 498 F. Supp. 2d 558 (E.D.N.Y. 2007).
[35] U.C.C. §3-302.
[36] This corresponds to Article 3's method of enhancing liquidity—i.e., the reduction of due diligence costs. Had the purchaser needed to inquire as the original transaction, it presumably would have discovered the execution of multiple notes by the borrower.

of the subsequent purchasers of the note. The law of mortgages does not accept the harsh outcome demanded by U.C.C. Article 3.

The method mortgage law utilizes to enhance the flow of credit has always been tempered by equitable principles.[37] Equity has long considered the substance of the transaction over its form. When a negotiable note is secured by a mortgage and the holder is different from the owner, equity demands that the court look at the real relationship of the parties. Often the holder is a mortgage servicer who is not concerned with how much of the debt will be paid back in a foreclosure action.[38] Only the owner of the debt is actually concerned with how much will be realized upon liquidation.[39] The court of equity should look past the form, i.e., the negotiable note and the rights appurtenant thereto, and only provide the equitable remedy of foreclosure where the party before it is entitled to be paid the debt. Ultimately that party is the owner.

Negotiable instruments law, on the other hand, should not be burdened with equitable principles. Its purposes are advanced when a negotiable note can be enforced pursuant to Article 3 using the mechanisms provided by that law. U.C.C. §3-203(b) describes what rights are vested in a transferee of an instrument:

> "Transfer of an instrument, whether or not the transfer is a negotiation, ***vests in the transferee any right of the transferor to enforce the instrument***, including any right as a holder in due course, but the transferee cannot acquire rights of a holder in due course by a transfer, directly or indirectly, from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument."[40]

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[37] *Porter v. Seeley,* supra.
[38] See Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 Yale J. on Reg., 1, 71 (2011) arguing that "Servicers' compensation structures also mean that the servicer has no interest in maximizing the value of the loan for investors. Instead, the servicer's interest is in maximizing its fee revenue and minimizing its nonreimbursable expenses."
[39] See *Report of the Permanent Editorial Board for the Uniform Commercial Code*, November 2011, explaining that the owner of the note is the party entitled to the "economic value" it represents.
[40] U.C.C. §3-203(b) [Emphasis added].

Nothing in this section vests in the transferee the right to foreclose any security agreement securing the instrument, nor does it impose equitable limitations upon its enforcement.[41]

As Connecticut courts have consistently held for over two hundred years, in a secured financing transaction, the obligee has two securities, the note and the mortgage. He may pursue his claim to be paid his debt on either contract. If he brings his action at law, and the note is negotiable, he is entitled to all the benefits conferred by Article 3,[42] but he is bound by all the obligations imposed thereby.[43] On the other hand, he may seek foreclosure on the mortgage and be entitled to protection from statutes of limitations and defenses related to substitution of notes and claims of discharge by surrender, destruction, mutilation or cancellation of the note. The court will rightfully look to the substance of the transaction and ask whether the debt has in fact been paid. As a corollary, if he seeks foreclosure, he will be bound by the principles of equity and the court must ask whether or not he has the right to receive the proceeds of the foreclosure. If he does not, where he is merely the holder of the note but not its owner, the court must look past the form and bar the remedy so as to do complete justice.[44] A thief can enforce a note at law, but §401(b)(1) would let a thief foreclose a home. That result is unacceptable.

POSTSCRIPT—REQUIRING COURTS TO DETERMINE NEGOTIABILITY WILL RESULT IN NEEDLESS LITIGATION WITH UNSATISFACTORY RESULTS

Most catastrophically of all, by granting standing to the *holder* of a negotiable instrument, but to the *owner* of a non-negotiable note, the draft law requires foreclosure judges in

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[41] It should be noted that not only does mortgage foreclosure law impose equitable obligations upon mortgagees, but U.C.C. Article 9 imposes similar burdens upon creditors secured by personal property. See Article 9, Part 6. The lack of any such burdens upon the holders of negotiable instruments in Article 3 indicates a legislative intent to limit the "enforcement" of instruments to actions at law and not to include foreclosures within the holder's enforcement rights.

[42] For example: statutory standing based on §3-301, presumption of the authenticity of signatures based on §3-308 and protection from personal defenses based on §3-305.

[43] For example: applicable statutes of limitations, cancellation under §3-604 or the limitations on the enforcement of lost instruments contained in §3-309.

[44] The Connecticut Supreme Court has held exactly that—a mere holder who is not the owner does not have standing to foreclose a mortgage. *RMS Residential Properties, LLC v. Miller*, supra.

judicial foreclosure states, and private parties in non-judicial states, to assess the negotiability of the notes in question. This is a recipe for disaster. Judges, and even more so, private parties, are ill-equipped to make that determination.[45] While many mortgage industry participants use the standard Fannie Mae Uniform Note in their transactions, and the few courts which have reviewed that note have found it to be negotiable, strong arguments can and have been made against the negotiability of this note. Furthermore, many other types of notes are in use with questionable negotiable status.[46] Even if a judicial consensus were to develop that the Fannie Mae note is negotiable, making foreclosure standing turn on negotiability will lock that note into stasis, where no further commercially reasonable development is possible since the parties will not want to risk litigation over the negotiable status of their modified mortgage note.

Ultimately, §401 must be revised. As currently drafted it represents a vast shift which, while intuitively pleasing, does not comport with the history of mortgage or negotiable instrument law. Furthermore, by making standing conditional upon the negotiable status of the note in question, it invites endless litigation in an area which neither judges nor attorneys are equipped to handle competently, or in the alternative, it will freeze commercial agreements in place so as to avoid such litigation. I respectfully request the Committee revise §401.

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[45] See Dale Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What to Do About It*, 37 Pepp. L. Rev. 737, 752 (2010), where Professor Whitman laments: "… cases are quite rare in which courts analyze the negotiability of a mortgage note carefully." Whitman also notes that a twenty-year survey of cases nationwide turning on negotiability returned exactly 42 results, but in only two cases did the courts provide a thorough analysis of the negotiability of the note! *Id.*, at p. 754 [Exclamation point Whitman's]. Professor Whitman repeated his frustration with courts' inability or unwillingness to engage in a thoughtful analysis of negotiability writing: "I have not found a single reported judicial opinion anywhere in the nation that fully and competently analyzes the negotiability of the standard Fannie Mae/Freddie Mac 1-to-4-family residential note." See "The PEB Report on Mortgage Notes", available online at http://www.americanbar.org/content/dam/aba/publications/rpte_ereport/2011/Dec_2011/rp_whitman.authcheckdam.pdf

[46] The standard FHA note may not be negotiable because arguably it is "subject to" FHA servicing regulations and incorporates those by reference into the note. The toxic pay-option-ARMs (so called "pick-a-pays") may not be negotiable because they allow an increase in the principal balance which may violate the "fixed amount of money" element of §3-104(a). Home Equity Lines of Credit should clearly be non-negotiable for the same reason although it is conceivable that a court could find otherwise based on the complete lack of competency in this area among judges and attorneys.

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