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Hold onto Your Notes!

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In the context of mortgage loans, the principal protection available to a lending institution to ensure that its investment is protected is the ability to foreclose on its security interest. The current foreclosure crisis has spawned a plethora of challenges to banks' ability to foreclose on their mortgages, including purely technical challenges not even remotely contesting whether the borrower owes the debt. In that vein, New Jersey's federal and state courts have rendered several recent decisions making it clear that a lender seeking to foreclose on a property must show that it is in possession of the promissory note at the time the foreclosure complaint is filed. If this is not done, the lender can pay a heavy price, ranging from dismissal of his suit, loss of status as a holder in due course, and even the loss of the ability to enforce the note and mortgage. This article addresses those cases against New Jersey's statutory scheme for negotiable instruments.

NEW JERSEY'S STATUTORY SCHEME FOR NOTES AND MORTGAGES

A bank debt is evidenced by a note, which can be either nonnegotiable or negotiable. Transfers of negotiable notes, or "negotiation," must comply with the provisions of the Uniform Commercial Code (UCC) as codified in New Jersey in N.J.S.A. 12A:3-101 et. seq. Nonnegotiable notes are transferred outside of the strictures of the UCC by way of an assignment. The case law at issue relates only to negotiable notes.

It is axiomatic that a bank must own or control the underlying debt to be entitled to foreclose on a mortgage. Without proof of such ownership or control, a bank does not have standing to foreclose on the property, and their complaint will be dismissed.

Under N.J.S.A. 12A:3-301, the ability to enforce a negotiable instrument depends on one's status and how that status was acquired. Those entitled to enforce negotiable instruments are either the holder of the instrument, "a non-holder in possession of the instrument who has the rights of the holder, or a person not in possession of the instrument who is entitled to enforce the instrument" (N.J.S.A. 12A:3-301).

The first class of persons entitled to enforce a note are holders. When a bank makes a loan to a borrower and retains the note, its possession of the note alone makes it the holder. However, when that bank transfers its note, the "ownership or possession" of the note does not, in and of itself, entitle the transferee to the status of a holder. To be classified as a "holder," the note must be properly negotiated to the transferee (N.J.S.A. 12A:3-201(a)). When a bank transfers or sells a loan, the proper negotiation of its note requires both a "transfer of possession of the instrument, and its endorsement by the" initial bank (N.J.S.A. 12A:3-201(b)). However, notes that are endorsed in blank become payable to the institution with possession of the notes (N.J.S.A. 12A:109(c); N.J.S.A. 12A:205(b)).

Upon negotiation of the note, the transferee bank becomes a "holder in due course," so long as that bank has no knowledge of any infirmities with the note, takes it in good faith through the observance of reasonable commercial standards, and pays value for the note (see N.J.S.A. 12A:3-302). A holder in due course is immune from many of the defenses that a party to the instrument may assert, except for the defenses of incapacity, duress, illegality of the transaction, fraud in the inducement, or "discharge of the obligor in insolvency proceedings" (N.J.S.A. 12A:3-305).

The second class of persons entitled to enforce a note are non-holders in possession who have the rights of a holder. Non-holders in possession are transferees of a note that has not been endorsed (N.J.S.A. 12A:3-203). N.J.S.A. 12A:3-203 grants these transferees the right to enforce an instrument even without negotiation. A transfer occurs when the note is "delivered for the purpose of giving the" recipient the right to enforce it by the physical transfer of possession. A non-holder in possession may also be entitled to assert the rights of a holder in due course if the instrument was transferred to it by a holder in due course (i.e., a transferee with a properly-endorsed note) and the transferee did not "engage in fraud or illegality affecting the instrument."

The third class of persons entitled to enforce a note are those that are not in possession who are nonetheless entitled to enforce it because they were in possession of the note "and entitled to enforce it when the loss of possession occurred" (N.J.S.A. 12A:3-301; N.J.S.A. 12A:3-309). Recent case law discussed herein seeks to expand this group to transferees who purchase a lost note in good faith even though the transferee never possessed same.

The proper transfer or negotiation of notes and the status created in the transferee is crucial in determining whether that transferee may foreclose on the property securing its note. Lenders and their transferees must be mindful of the statutory provisions delineating the narrow category of persons entitled to enforce a note and ensure that proper procedures are used when transferring them.

POSSESSION OF THE NOTE: A CRITICAL ELEMENT TO FORECLOSURE

Recent case law has established that the inability of a lender in foreclosure to prove their possession of the note will, in

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many cases, result in their complaint being dismissed, at a minimum. Moreover, the bank must establish its possession of the note as of the time the foreclosure complaint is filed by competent proofs.

The latter requirement was enunciated in *Bank of New York v. Raftogianis*, No. A-1384-09T1, 2010 N.J. Super. LEXIS 221 (Ch. Div. June 29, 2010). In that case, the defendants' note and mortgage were pooled and securitized and transferred to the foreclosing bank. The borrower defaulted on the note and the bank filed a foreclosure suit. The borrower, however, challenged the bank's standing to bring the suit. The court agreed and held that the bank failed to show that it possessed the note at the time the complaint was filed and dismissed the complaint without prejudice. In doing so, the court held that, while the bank was able to produce an endorsed copy of the note at oral argument, "no competent proofs were offered as to when the note was endorsed," when it was delivered, and what had been done with the note.

In *Wells Fargo Bank, N.A. v. Ford*, No. A-3627-06T1, 2011 N.J. Super. LEXIS 13 (App. Div. Jan. 28, 2011), the Appellate Division addressed the quantum of proof that was sufficient to demonstrate that a bank was entitled to enforce the note in foreclosure. In that case, the defendant's mortgage and note were assigned to the foreclosing bank via a document that stated that "it was an assignment of 'the described mortgage, together with the certain note.'" The defendant defaulted on the note and the bank filed a foreclosure action. At trial, the defendant argued that the mortgage and note were invalid because the original lender engaged in predatory lending and fraud. Nevertheless, the trial court granted summary judgment to the foreclosing bank, holding that it was immune from such defenses as a holder in due course.

However, on appeal the Appellate Division held that the bank failed to establish its standing to even pursue the foreclosure action and remanded the case to the trial court for further discovery. The court first noted that the bank admittedly could not qualify as a "holder," as there was no evidence of the note's endorsement by the original lender.

The court then analyzed whether the bank could enforce the note as a non-holder in possession. To support this status, the bank relied on the assignment from the original lender and a certification stating that it was the holder and owner of the note and mortgage. Copies of the note and mortgage were also attached to the certification. The court, however, found that if these documents were properly authenticated, they could be sufficient to establish the bank's status as a non-holder in possession, giving it the right to enforce the note. But they were not.

Specifically, the certification did not allege that it was based on personal knowledge nor did it indicate the source of the "alleged knowledge that the attached mortgage and note [were] 'true copies.'" Further, the assignment of the mortgage, which also must be produced to maintain a foreclosure action, was not authenticated. In guiding further proceedings in the trial court, the court commented that the bank could properly establish its standing to pursue the foreclosure action as a holder if the original lender endorses the note. Nevertheless, a subsequent endorsement would not entitle the bank to the status of a holder in due course because it was now aware of the defenses. Thus, the date of an endorsement is critical because, among other things, the status of a holder in due course can only be achieved if the holder acquired the note without notice of the defenses (N.J.S.A. 12A:3-302).

In *In re Kemp*, No. 08-18700-JHW, 2010 Bankr. LEXIS 4085 (Bankr. D.N.J. Nov. 16, 2010), the court had occasion to analyze the ability of a creditor to enforce a note in bankruptcy. In that case, the debtor's mortgage and note were pooled with others and sold as a package to the foreclosing bank. However, the original lender never transferred possession of the note to the foreclosing bank. The original lender, as the servicer for the foreclosing bank, filed a proof of claim for the notes and mortgages. The debtor argued that the bank could not enforce the debt. The court agreed and held that the claim could not be enforced, because the bank did not have possession of the note, and the original lender, as its agent, had no greater right than its principal.

The court also rejected an argument that an assignment of mortgage, which purportedly assigned both the mortgage and note to the bank, was sufficient to transfer the note. In so doing, the court noted that, "although the document may be effective to give the [assignee] a claim to ownership of the instrument, [the assignee] is not a person entitled to enforce the instrument until [it] obtains possession of [it]."

Finally, the bank attempted to introduce a certification stating that the original note was lost. The court, however, disregarded the certification because it conflicted with other evidence presented. The court ultimately concluded that the foreclosing bank could not enforce the note under N.J.S.A. 12A:3-309 because it never possessed it. Thus, the court held that the bank could not enforce the note at all.

ALL IS NOT LOST

The literal reading of N.J.S.A. 12A:3-309 in the *Kemp* judgment, coupled with the presumption that the UCC preempts common law remedies, leads to the conclusion that no one other than the person who originally lost the note may enforce it. Courts in other jurisdictions have recognized that, while such a conclusion leads to an illogical and inequitable result, they are nonetheless bound by the language of the provision requiring possession of the note at the time it was lost. (See *Dennis Joslin Co., LLC v. Robinson Broadcasting Corp.*, 977 F.Supp. 491, 495 (D.D.C. 1997). To address this seemingly unjust result, the UCC has since been amended to "eliminate the requirement of possession" and to specifically include a transferee of a lost instrument who has "acquired ownership of the instrument from a person entitled to enforce the instrument when loss of possession occurred." However, New Jersey has not adopted this amendment, leaving this sore open.

In *Bank of America, N.A. v. Alvarado*, No. BER-F-47941-08, 2011 N.J. Super. Unpub. LEXIS 107 (Ch. Div. Jan. 7, 2011), the Chancery Division recently revisited this issue. It held that the UCC did not preempt all common law remedies.

Specifically, the court found that the doctrines of unjust enrichment and equitable assignment permit a transferee of a lost note to enforce it under certain circumstances, even if they never possessed it. There, the defendant's note was lost by the original lender, who subsequently executed an affidavit certifying to this. The defendant's loan was pooled and securitized with others and sold to the foreclosing lender. After the defendant defaulted on the loan, the foreclosing lender filed a foreclosure suit. The defendant challenged the lender's standing to enforce the note. She argued that the lender could not be considered a "person … 'in possession and entitled to enforce [the note] when the loss of possession occurred'" because it was never in possession of the note. Nevertheless, the court held that the lender was entitled to enforce the note.

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The court noted that the UCC has "eliminate[d] the requirement of possession" for transferees of lost notes, but New Jersey has not adopted this amendment. The court noted that the defendant's argument would result in a ruling that "no entity now exists that can enforce defendant's" obligation, "thereby leading to a windfall to defendant." The court explained that the defendant has admittedly defaulted on the note and that to prevent the enforcement of the obligation would unjustly enrich the defendant. Further, pursuant to N.J.S.A. 12A:3-309(b), a defendant must be protected against any "loss that might occur if another person should seek … to enforce the note."

In this particular case, however, the passage of more than four years since the note was lost, the fact "that it was lost almost immediately after execution," and the absence of any other entity making a demand for payment, made it unlikely that the defendant would be faced with such an issue. Finally, the court also held that the common law doctrine of assignment could permit the assignment of the right to enforce a lost note "when the equities of a circumstance so compel."

CONCLUSION

These decisions make clear that banks and other lending institutions seeking to foreclose on a property must present proof that they are in possession of the note at the time the complaint is filed. Thus, great care must be exercised in transferring notes, as an improper transfer will result in the transferee being unable to enforce the note in foreclosure. These decisions will inevitably make it more difficult for lending institutions and their transferees to foreclose on their mortgages, leaving some unable to recoup their losses after a borrower defaults. ■

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