

Foreclosing on Nothing: The Curious Problem of the Deed of Trust Foreclosure Without Entitlement To Enforce the Note

Dale A. Whitman*
Drew Milner**

In this article we propose to examine the extent to which a party conducting a nonjudicial foreclosure of a mortgage or deed of trust must establish that it is entitled to enforce a promissory note that the mortgage or deed of trust secures. It may seem patently obvious that such a showing is required, but that proposition turns out to be far from true.

In Part I, we provide background on the law governing the transfer of the right to enforce notes, particularly negotiable notes under UCC Article 3. We also describe the nature and structure of nonjudicial foreclosure in the United States. Part II looks at seven western states that use nonjudicial foreclosure of deeds of trust and investigates whether and how those states require proof of the right to enforce the note. In Part III, we consider the same issue across the rest of the nation, but rather than engage in a state-by-state analysis, we examine only recent judicial decisions addressing this point. Part IV discusses the related issue of enforcement of notes that have been lost, a problem that is addressed by UCC Article 3 but largely ignored by the nonjudicial foreclosure statutes. Finally, our overall conclusions are set out in Part V.

*Distinguished Visiting Professor of Law, University of Arkansas School of Law, Fayetteville, Arkansas.

**Second-year law student, University of Arkansas School of Law, Fayetteville, Arkansas.

I. THE FORECLOSURE CRISIS

The foreclosure crisis that began in the latter half of 2007 has been a bitter pill to swallow for the American economy at large and for many thousands of families who have lost, or are in the process of losing, their homes to foreclosure.¹ But even such pervasively bad news has a good side, for there are many lessons of law, economics, and policy to be learned from this experience. This article addresses one such lesson.

Before the crisis began, most lawyers familiar with the process of mortgage foreclosure in the United States would probably have regarded it as a satisfactory, if not somewhat dull, area of the law. Foreclosure did not generate much appellate litigation, and those few lawyers who specialized in the field, mostly representing lenders, had little difficulty in getting the results they needed from the mechanisms of foreclosure.

That process has now changed radically. The foreclosure crisis resulted in the creation of a new kind of lawyer: the foreclosure-defense specialist. As these specialists began to poke and prod at the foreclosure process, they found plenty of weaknesses. They raised dozens of questions about precisely what sort of evidence or proof, and in what form, needed to be adduced by those instigating foreclosure, particularly when the loan had been sold on the secondary-mortgage market. For example, they forced the courts to focus on issues such as whether a chain of mortgage assignments (recorded or not) was required as a prerequisite to foreclosure.²

1. Nearly twenty million home foreclosures are estimated to have occurred in 2007-2012. See *Home Foreclosure Statistics*, STAT. BRAIN (Oct. 15, 2012), <http://www.statisticbrain.com/home-foreclosure-statistics/>. The rate of loss of homes due to foreclosure finally seemed to have bottomed out in 2012. See Morgan Brennan, *Why the New Wave of Foreclosures Is Good News for Homeowners*, FORBES (June 14, 2012, 5:34 PM), <http://www.forbes.com/sites/morganbrennan/2012/06/14/heres-why-the-new-wave-of-foreclosures-is-good-news-for-homeowners/2/>.

2. Compare *U.S. Bank Nat'l Ass'n v. Ibanez*, 941 N.E.2d 40, 54-55 (Mass. 2011) (chain of assignments required for nonjudicial foreclosure but not needed to be recorded), and *Barnett v. BAC Home Loan Servicing, L.P.*, 772 F. Supp. 2d 1328, 1336 (D. Or. 2011) (recorded chain of assignments required for nonjudicial foreclosure), with *MetLife Home Loans v. Hansen*, 286 P.3d 1150, 1158 (Kan. Ct.

In addition, the impact of the Mortgage Electronic Registration System (MERS) became highly controversial.³ MERS was created by a group of major mortgage-market participants in the mid-1990s as mortgage loans were traded on the secondary market, primarily to avoid the necessity of repeated recordings of mortgage assignments.⁴ MERS holds mortgages as “nominee” for the loan owner, but the scope of MERS’s authority as nominee was unclear.⁵ For instance, could MERS foreclose in its own name?⁶ Was it entitled to notice of foreclosures or other actions affecting the property?⁷ Did the fact that MERS held the mortgage while an investor held the note create a separation of the two documents that would somehow be fatal to the effort to foreclose?⁸ A whole constellation of related issues arose around MERS’s involvement in the foreclosure process.

While plenty of uncertainty existed, one concept clearly emerged from litigation during the 2008-2012 period: in order to foreclose a mortgage by judicial action, one had to have the right to enforce the debt that the mortgage secured.⁹ It is hard to imagine how this notion could be controversial. From its earliest beginnings,

App. 2012) (formal assignment not necessary), *and* Bank of Am. v. Kabbia, 276 P.3d 1006, 1008-09 (Okla. 2012) (chain of assignments is unnecessary to foreclose).

3. See, e.g., Christopher L. Peterson, *Two Faces: Demystifying the Mortgage Electronic Registration System’s Land Title Theory*, 53 WM. & MARY L. REV. 111, 118 (2011). Peterson’s depiction of MERS is, in our view, hypercritical, but he correctly identifies the major controversies in which MERS has been embroiled.

4. See Carson Mullen, *MERS: Tracking Loans Electronically*, MORTGAGE BANKING, May 2000, at 63, 64.

5. *Hansen*, 286 P.3d at 1158.

6. In fact, MERS did foreclose in its own name until mid-2011. Compare *Niday v. GMAC Mortg., LLC*, 284 P.3d 1157, 1169 (Or. Ct. App. 2012), *and* *Bain v. Metro. Mortg. Grp., Inc.*, 285 P.3d 34, 47 (Wash. 2012) (en banc) (holding that MERS lacked the authority to foreclose in its own name), with *In re Mortg. Elec. Registration Sys. (MERS) Litig.*, MDL Docket No. 09 2119 JAT, 2011 WL 251453, at *5 (D. Ariz. Jan. 25, 2011), *and* *Ferguson v. Avelo Mortg., LLC*, 126 Cal. Rptr. 3d 586, 593 (Ct. App. 2011) (holding that MERS was entitled to foreclose in its own name).

7. See *Mortg. Elec. Registration Sys., Inc. v. Sw. Homes of Ark., Inc.*, 2009 Ark. 152, at 8, 301 S.W.3d 1, 5 (holding that MERS, as a mere nominee, was not entitled to notice of pending judicial actions); *Landmark Nat’l Bank v. Kesler*, 216 P.3d 158, 168 (Kan. 2009).

8. This argument was little short of silly, and the courts roundly rejected it. See *Hansen*, 286 P.3d at 1157-58; *Bank of N.Y. v. Raftogianis*, 13 A.3d 435, 450 (N.J. Super. Ch. Ch. Div. 2010).

9. 59 C.J.S. *Mortgages* § 399 (2012).

American mortgage law held that a mortgage must secure an obligation, and since foreclosure is a means for the creditor to realize on the obligation, the foreclosing creditor must be entitled to enforce that obligation.¹⁰ As the Restatement explains, “The mortgage becomes useless in the hands of one who does not also hold the obligation because only the holder of the obligation can foreclose.”¹¹ In the case of a loan that has been sold on the secondary market, this means that the right to enforce the obligation must have been transferred to the party now purporting to foreclose the mortgage, or if the foreclosing party is an agent, to its principal.¹²

Observe that the obligation must be explicitly transferred, not the mortgage. For this reason, in the absence of a contrary statute, an assignment of the mortgage is not necessary to transfer the power to foreclose.¹³ As the old cases put it, the mortgage follows the note¹⁴ and will automatically inure to the benefit of the party to whom the obligation is owed.¹⁵

10. *Long v. O’Fallon*, 60 U.S. (1 How.) 116, 122 (1856).

11. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.4 reporters’ note (1997).

12. *Hansen*, 286 P.3d at 1156 (MERS became an agent of the current holder of the mortgage by virtue of the mortgage language); *Eaton v. Fed. Nat’l Mortg. Ass’n*, 969 N.E.2d 1118, 1131 (Mass. 2012) (“[W]e interpret [the Massachusetts nonjudicial foreclosure statutes] to permit one who, although not the note holder himself, acts as the authorized agent of the note holder, to stand ‘in the shoes’ of the ‘mortgagee’ as the term is used in these provisions.”).

13. *Hansen*, 286 P.3d at 1156-57.

14. *Carpenter v. Longan*, 83 U.S. (1 Wall.) 271, 274 (1872) (“The note and mortgage are inseparable An assignment of the note carries the mortgage with it, while an assignment of the latter alone is a nullity.”).

15. See, e.g., *Horvath v. Bank of N.Y.*, 641 F.3d 617, 623 (4th Cir. 2011) (noting that transfers of secured debt also bring the security without formal assignment); *In re Bryant*, 452 B.R. 876, 880 (Bankr. S.D. Ga. 2011) (“In South Carolina, a mortgage travels with the promissory note even without a written assignment.”); *Deutsche Bank Trust Co. Ams. v. Codio*, 943 N.Y.S.2d 545, 546 (App. Div. 2012). A few title-theory states take a slightly different view, although the ultimate result is the same. See *U.S. Bank Nat’l Ass’n v. Ibanez*, 941 N.E.2d 40, 54 (Mass. 2011) (“[T]he holder of the mortgage holds the mortgage in trust for the purchaser of the note, who has an equitable right to obtain an assignment of the mortgage, which may be accomplished by filing an action in court and obtaining an equitable order of assignment.”).

A. What Must Be Transferred: Ownership or PETE Status?

Transferring the obligation is a bit more complex than might first appear. The reason is that under the UCC there are two quite distinct sets of rights in a promissory note and they need not necessarily be held by the same party. One set of rights, commonly termed “PETE status,” refers to the right to enforce the note; “PETE” is an acronym for “person entitled to enforce,” a term used by UCC § 3-301.¹⁶ UCC Article 3 deals exclusively with negotiable instruments; however, if the note is nonnegotiable and is not ordinarily transferred by delivery, the right of enforcement (or PETE status) is governed by the common law.¹⁷

The other set of rights, termed “ownership” by the Code, is governed by UCC Article 9 regardless of whether the note is negotiable.¹⁸ Ownership means the right to economic benefits of the note and includes monthly payments, the proceeds of a voluntary payoff or short sale, and foreclosure proceeds.¹⁹ The significance of these two sets of rights, ownership and PETE status, is sharply distinct. PETE status refers to rights against the maker of the note—the borrower. Thus, a borrower can negotiate with the party having PETE status to modify the loan, accept a payoff for less than the face amount owed, or approve a “short sale” or a deed in lieu of foreclosure and be assured that any agreement reached with the PETE in any of these negotiations will be binding. On the other hand, the borrower is typically unconcerned with the identity or separate existence of the owner—the party to

16. U.C.C. § 3-301 (2002).

17. *Morgan v. Farmers Merchs. Bank*, 856 So. 2d 811, 819 (Ala. 2003).

18. U.C.C. § 9-203(b) provides that a security interest is enforceable only if the transferee gives value, the transferor holds the rights being transferred, and there is either a written agreement of transfer or a delivery of possession of the note to the transferee. See *Morgan*, 856 So. 2d at 825-26 (holding that a nonnegotiable note may be considered an “instrument” for purposes of Article 9 so that a security interest in it could be perfected by possession).

19. See Dale Whitman, “*The Person Entitled to Enforce*”: Lessons Learned from *BAC Home Loans Servicing v. Kolenich*, ABA REAL PROP. NEWS, Dec. 2012, at 1.

whom the proceeds of the loan will ultimately be paid.²⁰ If the borrower pays the PETE, the borrower's obligation is satisfied.

While these two sets of rights may well be, and often are, held by the same party, they can also be separated.²¹ For example, Fannie Mae and Freddie Mac, two large government-sponsored secondary-market purchasers of mortgage loans, normally deliver possession of a note to the servicer when it is necessary to foreclose. Hence, the servicer becomes the PETE, while Fannie or Freddie remains the owner and has the right to the proceeds of foreclosure.

The distinction between ownership and PETE status has been widely misunderstood in the past and has been responsible for considerable confusion in judicial decisions²² and statutes.²³ In November 2011, the

20. Foreclosure-defense lawyers sometimes argue that it is indeed important to know the identity of the loan's owner because the owner's rules and procedures may determine how much authority the PETE has to negotiate loan modifications. This is, we think, a legitimate point, but it does not stand in the way of the basic principle that, whatever agreement the PETE makes will be binding so far as the borrower is concerned.

21. See PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, APPLICATION OF THE UNIFORM COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTGAGE NOTES 4 n.15 (2011) [hereinafter PEB REPORT], available at http://www.uniformlaws.org/Shared/Committees_Materials/PEBUCC/PEB_Report_111411.pdf ("The concept of 'person entitled to enforce' a note is not synonymous with 'owner' of the note. A person need not be the owner of a note to be the person entitled to enforce it, and not all owners will qualify as persons entitled to enforce." (citation omitted)).

22. See, e.g., CPT Asset Backed Certificates, Series 2004-EC1 v. Cin Kham, 278 P.3d 586, 592 (Okla. 2012) (providing a meticulous analysis of the PETE doctrine and concluding that the PETE is the party entitled to foreclose the mortgage and ownership of the note is controlling). Even well-crafted opinions by judges who understand the distinction are, to some extent, captives of earlier opinions by judges who did not. See, e.g., *Eaton v. Fed. Nat'l Mortg. Ass'n*, 969 N.E.2d 1118, 1125-26 (Mass. 2012). There, the court consistently and correctly employs the term "holder" to refer to the foreclosing party, but the court also cites to *Weinberg v. Brother*, 160 N.E. 403 (Mass. 1928), where the court called the foreclosing party the "owner" of the note. *Eaton*, 969 N.E.2d at 1126.

23. Washington's nonjudicial-foreclosure statute, for example, conflates "owner" and "holder." WASH. REV. CODE § 61.24.030(7)(a) (West 2012) ("[T]he trustee shall have proof that the beneficiary is the *owner* of any promissory note or other obligation secured by the deed of trust." (emphasis added)). However, the statute then requires the trustee to provide the homeowner with "the name and address of the *owner* of any promissory notes or other obligations secured by the deed of trust" before foreclosing on an owner-occupied home. WASH. REV. CODE §

Permanent Editorial Board (PEB) of the Uniform Commercial Code issued a report that sought to explain these UCC concepts insofar as they directly relate to the transfer and enforcement of notes secured by mortgages on real property.²⁴ The report is in many ways a brilliant exposition of an exceedingly complex topic, and since its release, courts have generally improved at the task of understanding and applying the distinction between ownership and PETE status.²⁵

The potential bifurcation of ownership and PETE status raises the following question: given the truth of the aphorism that “the mortgage follows the note,” if ownership and PETE status are separated, which of those rights does the mortgage follow? Or to put it differently, in order to have standing to foreclose a mortgage, does the foreclosing party need to be the owner, the PETE, or both? Finding case authority on this question is not easy. Most of the older judicial opinions do not recognize or understand the distinction and, hence, are useless in resolving this issue.²⁶ Since the publication of the PEB Report, however, a fair number of courts have addressed the question knowledgeably, and their answers are consistent: PETE status, and not ownership *per se*, confers the right to foreclose.²⁷ This result is perfectly sensible, since

61.24.030(8)(1) (emphasis added). Further, the statute defines the beneficiary as “the *holder* of the instrument or document evidencing the obligations secured by the deed of trust.” WASH. REV. CODE § 61.24.005(2) (emphasis added); *see also* Bain v. Metro. Mortg. Grp., Inc., 285 P.3d 34, 36-39 (Wash. 2012) (en banc) (attempting to reconcile the statute’s confusing terminology).

24. *See* PEB REPORT, *supra* note 21.

25. *See, e.g.*, Bank of Am. v. Kabba, 276 P.3d 1006, 1008 n.2 (Okla. 2012) (citing the PEB Report and understanding it thoroughly).

26. Not all are useless, however. In 1923, the Oklahoma Supreme Court noted that “the mortgage securing the payment of a note is merely an incident and accessory to it, and the indorsement and delivery of a note carries with it the mortgage without any formal assignment thereof.” Chase v. Commerce Trust Co., 224 P. 148, 149 (Okla. 1923).

27. The decisions often use the term “holder” as synonymous with PETE, although, as we will discuss below, being a holder is only one way of being a PETE. The clearest statements that the PETE has the right to foreclose are provided by courts in Nevada and Ohio. *See* BAC Home Loans Servicing, LP v. Kolenich, No. CA2012-01-001, 2012 WL 5306059, at *6 (Ohio Ct. App. Oct. 29, 2012) (“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.”); Edelstein v. Bank of N.Y. Mellon, 286 P.3d 249, 257 (Nev.

foreclosure is simply one way for a creditor to realize payment of the debt that the note represents. Any payment received by virtue of the foreclosure must be applied against the balance owed on the note, and if foreclosure results in payment in full, the note is discharged.²⁸ Hence, to view the power to foreclose as dependent on a creditor's right to enforce the note—or PETE status—is entirely logical.

B. Who Can Enforce a Negotiable Note?

This brings us to the discussion of how a party becomes a PETE. UCC Article 3 provides the answer but is applicable only if the note is negotiable. The concept of negotiability is complex, with the consequence that it may sometimes be unclear whether Article 3 or the common law governs a particular mortgage note.²⁹ Indeed, despite considerable litigation, it remains uncertain whether the standard Fannie Mae or Freddie Mac residential-mortgage note is negotiable.³⁰ Courts often apply a presumption that

2012) (“Indeed, to foreclose, one must be able to enforce *both* the promissory note *and* the deed of trust. Under the traditional rule, entitlement to enforce the promissory note would be sufficient to foreclose . . .” (citation omitted)); *see also In re Tikhonov*, BAP No. CC 11 1698 MKBePa, 2012 WL 6554742, at *7-8 (B.A.P. 9th Cir. Dec. 14, 2012) (explaining that a party must show it is the holder of the note in order to have standing to seek relief from an automatic stay of foreclosure in bankruptcy); *Nelson v. Fed. Nat’l Mortg. Ass’n*, 97 So. 3d 770, 779 (Ala. Civ. App. 2012) (“[T]he owner of the debt may foreclose on property that is the subject of a mortgage securing that debt if the owner is the holder of the promissory note at the time the owner initiates foreclosure proceedings.”); *Eaton*, 969 N.E.2d at 1129 (“[W]e construe the term ‘mortgagee’ in [the foreclosure statute] to mean a mortgagee who also holds the underlying mortgage note.”); *CPT Asset Backed Certificates*, 278 P.3d at 591 (“To commence a foreclosure action in Oklahoma, a plaintiff must demonstrate it has a right to enforce the note . . .”); *Bain*, 285 P.3d at 44 (relying on the definition of PETE in UCC § 3-301).

28. *See* PEB REPORT, *supra* note 21, at 4 (“(1) [T]he maker’s obligation on the note is to pay the amount of the note to *the person entitled to enforce the note*; (2) the maker’s payment to *the person entitled to enforce the note* results in discharge of the maker’s obligation; and (3) the maker’s failure to pay, when due, the amount of the note to *the person entitled to enforce the note* constitutes dishonor of the note.” (footnotes omitted)).

29. *See* U.C.C. § 3-104 (2002) (defining negotiability).

30. Several recent cases have found these notes to be negotiable, but the courts’ reasoning is hardly overwhelming. *See* *HSBC Bank USA Nat’l Ass’n v. Gouda*, No. F-20201-07, 2010 WL 5128666, at *3 (N.J. Super. Ct. App. Div. Dec. 17, 2010) (concluding that the clause obligating the mortgagor to notify the mortgagee of an intent to prepay the loan did not render the note nonnegotiable). One federal

mortgage notes are negotiable, perform a cursory analysis of the issue, or completely refrain from any analysis at all.³¹ This situation is, to put it mildly, unsatisfactory; it is absurd that in a modern industrialized society, it is unclear what law governs the largest financial transaction most households will ever make. But that is a problem that cannot be resolved here. For the moment, let us assume that the note in question is negotiable and, therefore, is covered by UCC Article 3.

Article 3 provides three ways by which a party can become a “person entitled to enforce.”³² The first is to be a “holder,” which requires the person to be in possession of the note.³³ In addition, the note must either be made payable or endorsed to the person in possession, made payable to bearer, or endorsed in blank.³⁴ Endorsements on the note must be examined because an endorsement may be “special”—that is, to a particular endorsee—or may be in blank, so that the note becomes bearer paper and anyone in possession will be considered the bearer.³⁵

Second, one may become a “nonholder with the rights of a holder.”³⁶ This occurs if possession is delivered without an endorsement (and without the note being bearer paper), and “for the purpose of giving to the person receiving

district court, several bankruptcy courts, and an Alabama appellate court agreed with this approach. See *Picatinny Fed. Credit Union v. Fed. Nat'l Mortg. Ass'n*, No. 09 1295 (GEB), 2011 WL 1337507, at *7 (D.N.J. Apr. 7, 2011); *In re Walker*, 466 B.R. 271, 283-84 (Bankr. E.D. Pa. 2012); *In re Kain*, No. 08-09404-HB, 2012 WL 1098465, at *5 (Bankr. D.S.C. Mar. 30, 2012); *In re Edwards*, No. 11 23195, 2011 WL 6754073, at *5 (Bankr. E.D. Wis. Dec. 23, 2011); *Thomas v. Wells Fargo Bank, N.A.*, ___ So. 3d ___, ___, 2012 WL 3764729, at *6-7 (Ala. Civ. App. 2012); see also Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What To Do About It*, 37 PEPP. L. REV. 737, 749-50 (2010).

31. Whitman, *supra* note 30, at 754; see also *CPT Asset Backed Certificates*, 278 P.3d at 591. In *CPT*, the court said, “Because the note is a negotiable instrument, it is subject to the requirements of the UCC” without the slightest analysis of the note’s content. *Id.* At least one reason for the evident preference of courts to assume that mortgage notes are negotiable is that UCC Article 3 provides a clear set of rules for the transfer of PETE status for negotiable notes, while the transfer of PETE status for nonnegotiable notes is governed by the common law, and there are few modern cases explicating it.

32. U.C.C. § 3-301 (2002).

33. U.C.C. § 1-201(b)(21)(A) (2001).

34. U.C.C. § 1-201(b)(21)(A).

35. U.C.C. § 3-205.

36. U.C.C. § 3-301.

delivery the right to enforce the instrument.”³⁷ Thus, both holder and “nonholder with the rights of a holder” status require *possession* of the note; the difference is that the former requires an appropriate endorsement (if the note was not originally to bearer, as mortgage notes rarely are, and has not previously been endorsed in blank) and the latter does not.

The third method of establishing the right of enforcement expressly does *not* depend on possession of the paper; rather, the right of enforcement is established by providing a lost-note affidavit.³⁸ The requirements for the affidavit are quite strict: the note must have been destroyed, its whereabouts not discoverable, or it must be in the wrongful possession of an unknown person or one who cannot be served.³⁹ Before accepting such an affidavit, a court might well demand evidence as to the efforts that have been made to locate the note. In addition, the court can require the enforcing party to provide assurance, typically in the form of a bond or indemnity agreement, against the possibility that the borrower will have to pay twice.⁴⁰

The Code’s lost-note provisions were quite obviously drafted with judicial enforcement of the note in mind. These provisions state that persons seeking enforcement must prove the terms of the instrument and the right to enforce, and they speak of “the court” providing protection against the possibility of a double claim against the note’s maker.⁴¹ The possibility that the note might be enforced by

37. U.C.C. § 3-203(a); *see* *Leyva v. Nat’l Default Servicing Corp.*, 255 P.3d 1275, 1281 (Nev. 2011) (requiring the servicer to provide specific, affirmative proof that the note was delivered for the purpose of transferring the right of enforcement).

38. U.C.C. § 3-309.

39. U.C.C. § 3-309.

40. U.C.C. § 3-309.

41. U.C.C. § 3-309(b). The party enforcing the note must also prove its terms, which may or may not be possible if the note has been lost. *See, e.g.*, *JPMorgan Chase & Co. v. Casarano*, 963 N.E.2d 108, 111 (Mass. App. Ct. 2012) (holding that if the original note is lost and no photocopies can be found, it may be impossible to determine the terms of the original note and enforcement may be denied); *Howard v. PNC Mortg.*, 269 P.3d 995, 997 (Utah Ct. App. 2012) (correctly accepting a photocopy of the note as proof of its possession, where the mortgagor admitted the note had been transferred, and a photocopy showed that the mortgage had been properly endorsed).

way of a nonjudicial proceeding does not seem to have been contemplated by the drafters and raises an interesting dilemma which we will address below.

Before we leave the matter of establishing the right of enforcement, we need to comment briefly on nonnegotiable notes, to which UCC Article 3 is completely inapplicable. Here, as with negotiable notes, it seems entirely possible to separate ownership and PETE status, but such a separation can follow only from an agreement or set of agreements, and not from the method of transfer *per se*, as it can with negotiable notes. How does a secondary-market purchaser of such a note acquire the right of enforcement? It is clear that, unlike a negotiable instrument, enforcement rights in a nonnegotiable note can be transferred by a separate document of assignment.⁴² These rights can also be transferred by delivery of the note, which has the same effect as an assignment.⁴³ However, modern case authority is sparse, and beyond these general principles, not much can be said.

C. Foreclosing Deeds of Trust

We turn now to a consideration of the interaction between the rules for transfer of PETE status discussed above and the procedure for nonjudicial foreclosure. This form of foreclosure is comparatively new; it became popular in the United States over the course of the twentieth century.⁴⁴ Nonjudicial foreclosure was developed to afford a quicker, cheaper, and more efficient process than was provided by the traditional method of foreclosure by judicial action, which originated in England.⁴⁵

42. *Margiewicz v. Terco Props. of Miami Beach, Inc.*, 441 So. 2d 1124, 1125 (Fla. Dist. Ct. App. 1983); *Bank of N.Y. v. Raftogianis*, 13 A.3d 435, 438 (N.J. Super. Ct. Ch. Div. 2010).

43. *Poirot v. Gundlach*, 1 N.E.2d 801, 804 (Ill. App. Ct. 1936); *Hayter v. Dinsmore*, 265 P. 1112, 1113 (Kan. 1928); *Va. Lee Homes, Inc. v. Schneider & Felix Const. Co.*, 395 P.2d 99, 100-02 (Wash. 1964).

44. The earliest nonjudicial foreclosure statute seems to have been adopted in California in 1872. *See* CAL. CIV. CODE § 2924 (West 2012). The most recent state to adopt nonjudicial foreclosure is New Mexico, effective May 17, 2006. *See* N.M. STAT. ANN. § 48-10-10 (West 2012).

45. There is no doubt that nonjudicial foreclosure achieves these objectives. One study, based on 2010 data, found that the average time to process a residential

Nonjudicial foreclosure is now authorized in thirty-five states and the District of Columbia.⁴⁶ In twenty-three of those jurisdictions, the preferred, or sometimes only, security instrument is the deed of trust, while the remaining thirteen states permit the use of a mortgage with a “power of sale” (that is, a power to foreclose) vested in the mortgagee.⁴⁷

The introduction of the deed of trust has an odd history. It was initially developed in England around the turn of the nineteenth century as a method of foreclosure that would avoid the delays and intricacies for which the English equity courts had become infamous.⁴⁸ The idea was to cause the borrower to convey title to trustees and vest in them a power to sell the property without the intervention of the equity courts if a default on the obligation occurred.⁴⁹ However, within a short time, English lawyers realized that the use of trustees was unnecessary, and they shifted to the practice of simply including in mortgages a power of sale, exercisable by the mortgagee.⁵⁰ That remains the British custom today,⁵¹ so the deed of trust is no more than a historical footnote in Britain.

foreclosure in nonjudicial states was 141 days, compared with 504 days in judicial states. BEACON ECONS., FORECLOSURE REFORM IN CALIFORNIA: AN ECONOMIC ANALYSIS 8 (2012). The same study found that foreclosure rates toward the end of the period of 2007-2012 had declined much faster in nonjudicial states than in judicial states. *Id.* at 12.

46. AM. COLL. OF MORTG. ATT’YS, MORTGAGE LAW SUMMARY (2012).

47. *Id.* All of the states where deeds of trust are authorized by statute permit them to be foreclosed nonjudicially. Arkansas is counted here as a “mortgage with power of sale” state, but it is actually agnostic as to the use of mortgages or deeds of trust. ARK. CODE ANN. § 18-50-102 (Supp. 2011). Georgia uses the “security deed,” classified here as a mortgage. GA. CODE ANN. § 44-14-162.2 (West 2012). The use of a mortgage with power of sale is restricted in Vermont and Maine to nonresidential properties. ME. REV. STAT. ANN. tit. 14, § 6203-A(1) (2011); VT. STAT. ANN. tit. 12, § 4961 (West 2012). Other restrictions may also apply; for example, nonjudicial foreclosure is limited to nonagricultural property in Arkansas and to parcels of forty acres or less in Montana. ARK. CODE ANN. § 18-50-116 (Supp. 2011); MONT. CODE ANN. § 71-1-302 (West 2011).

48. Charles Dickens indicted equity practice in *The Pickwick Papers* and *Bleak House*. See generally WILLIAM S. HOLDSWORTH, CHARLES DICKENS AS A LEGAL HISTORIAN (1929).

49. John A. Gose & Aleana W. Harris, *Deed of Trust: Its Origin, History and Development in the United States and in the State of Washington*, REAL PROP., PROB. & TR., Summer 2005, at 8, 8 (2005).

50. *Id.*

51. Law of Property Act, 1925, 15 Geo. 5, c. 20, §§ 101-107 (Eng.).

Given that the British long ago forsook the deed of trust, why it became the predominant model for nonjudicial foreclosure in the United States is unclear. Perhaps the presence of the trustee, a purportedly independent party with duties to both borrower and lender, gave an air of greater fairness to the foreclosure process. In practice, this has turned out to be a dubious proposition. We know of no evidence that foreclosure by a trustee offers the borrower any benefit over foreclosure by a mortgagee with a power of sale,⁵² and questions about the precise nature of the trustee's duties have proven a fruitful generator of litigation.⁵³

Conceptually, it is perfectly clear that the trustee is not meant to act unless and until instructed to do so by the holder of the obligation that the deed of trust secures. This notion is spelled out in many of the foreclosure statutes. The Arkansas statute, for example, permits foreclosure to be initiated only by the "beneficiary or mortgagee"—not the trustee.⁵⁴ Likewise, the Nevada statute provides that the notice of default and election to sell must recite that "the trustee has the authority to exercise the power of sale with respect to the property pursuant to the instruction of the beneficiary of record and the current holder of the note secured by the deed of trust."⁵⁵ But not all of the statutes

52. As one experienced real-estate lawyer recently put it, "It seems hard to argue that one nonjudicial foreclosure system is inherently better than another. From the borrowers' perspective, the real issues are how much time the borrowers have to refinance or relocate, and how much protection they have against deficiency liability. Those protections are created, or not, by substantive law, regardless of whether an ostensible third party administers the disposition of the mortgaged property." Charles Calvin, Fagre Baker Daniels, Denver, CO, comment in nyclarealprop@googlegroups.com, Dec. 10, 2012.

53. See *Shuster v. BAC Home Loans Servicing, L.P.*, 149 Cal. Rptr. 3d 749, 753 (Ct. App. 2012) (the deed of trust is not void despite its failure to name a trustee); see also NEV. REV. STAT. ANN. § 107.028(5) (West 2012) ("The trustee does not have a fiduciary obligation to the grantor or any other person having an interest in the property which is subject to the deed of trust."); *Spires v. Edgar*, 513 S.W.2d 372, 378-79 (Mo. 1974) (en banc) (in the absence of unusual circumstances, the trustee has no duty to verify that default has occurred). Compare *Cox v. Helenius*, 693 P.2d 683, 686 (Wash. 1985) (en banc) (the trustee has fiduciary duties to borrower and lender), with *Monterey S.P. P'ship v. W.L. Bangham, Inc.*, 777 P.2d 623, 628 (Cal. 1989) (en banc) (the trustee is not bound by the fiduciary duties that characterize a true trustee).

54. ARK. CODE ANN. § 18-50-103 (Supp. 2011).

55. NEV. REV. STAT. ANN. § 107.080(2)(c)(4) (West 2012).

make this principle clear. The California statute, for example, authorizes either the beneficiary or the trustee to commence the foreclosure, and the statute contains no express statement that the trustee can act only upon the beneficiary's instruction.⁵⁶ This raises the somewhat bizarre possibility that a trustee might foreclose a defaulted deed of trust even if the beneficiary has failed to request foreclosure or told the trustee not to foreclose!⁵⁷

Consider for a moment what a trustee is obligated to do before foreclosing on the instruction of the purported holder of the promissory note. Does the trustee have any due-diligence duties? Not many, it seems. For example, Missouri caselaw holds that the trustee need not make any investigation of whether the debt is actually in default⁵⁸ or whether the debtor has a defense or offset that would make foreclosure improper.⁵⁹ The trustee usually does not have the same sort of fiduciary duties to the borrower as a traditional, common-law trustee, but instead simply has a duty to conduct a fair sale.⁶⁰

There is one duty, however, that seems logically inescapable. If the party requesting the foreclosure is not the named beneficiary or mortgagee in the deed of trust or mortgage—thus indicating that a secondary-market transfer has occurred—then surely the trustee has a duty to verify that the foreclosing party is the PETE of the promissory note. Otherwise, there would be nothing to prevent a complete imposter from directing a foreclosure sale to occur! In such a case, the trustee would literally be foreclosing on nothing. Moreover, it seems plausible to assume that the borrower who is about to be foreclosed upon should be entitled to see and review the evidence that the foreclosing party is the PETE. Of course, if the foreclosure is wrongful, the borrower may be entitled to enjoin it or set it aside after the fact, but these actions require the hiring of counsel, judicial intervention, and the

56. CAL. CIV. CODE § 2924(a) (West 2012).

57. We hasten to add that we know of no such case, and that such a “rogue trustee” would be unlikely to be named as a trustee in future transactions.

58. *Spires*, 513 S.W.2d at 378-79.

59. *Killion v. Bank Midwest, N.A.*, 987 S.W.2d 801, 813 (Mo. Ct. App. 1998).

60. *Madden v. Alaska Mortg. Grp.*, 54 P.3d 265, 270 (Alaska 2002); *Warner v. Clementson*, 492 S.E.2d 655, 657 (Va. 1997).

expenditure of substantial amounts of money. The borrower's opportunity to verify the foreclosing party's PETE status should be built into the standard process.

These suppositions may be sensible, but, remarkably, they are often ignored in nonjudicial foreclosure statutes. In examining this phenomenon, we focus primarily on the statutes of seven western states that use deeds of trust in nonjudicial foreclosure: Arizona, California, Idaho, Nevada, Oregon, Utah, and Washington.⁶¹ We chose to examine these statutes because they are similar to one another in operation (if not in detailed wording) and because the issue was first called to our attention by a cluster of federal-district-court rulings in the western United States—rulings that initially seemed patently wrong, but that have, in some cases, been confirmed by the appellate courts of those states.

Before we begin our analysis, we might observe that the issue we are confronting is the nonjudicial foreclosure analogue of the “show me the note” defense in a judicial foreclosure. As we have suggested above, it is standard doctrine in a judicial foreclosure of a mortgage that the foreclosing party must provide proof that it has the power to enforce the note.⁶² In a nonjudicial foreclosure by a trustee under a deed of trust, only the trustee acts as a proxy for the judge in a judicial foreclosure. And if neither the trustee nor anyone else is obligated to verify that the foreclosing party holds the note, then the borrower is exposed to the very real and potentially serious risk of losing the real estate in foreclosure and subsequently being sued on the note by its actual holder. Surely, it seems to us, no sensible legal system would expose borrowers to such a risk.

61. *See infra* Part II.

62. *See, e.g.*, *Chase Home Fin., LLC v. Fequiere*, 989 A.2d 606, 611 (Conn. App. Ct. 2010); *Harvey v. Deutsche Bank Nat'l Trust Co.*, 69 So. 3d 300, 304 (Fla. Dist. Ct. App. 2011); *MetLife Home Loans v. Hansen*, 286 P.3d 1150, 1154-55 (Kan. Ct. App. 2012); *Bank of N.Y. v. Raftogianis*, 13 A.3d 435, 459 (N.J. Super. Ct. Ch. Div. 2010); *U.S. Bank Nat'l Ass'n v. Baber*, 280 P.3d 956, 958-59 (Okla. 2012); *see also* Alan M. White, *Losing the Paper—Mortgage Assignments, Note Transfers and Consumer Protection*, 24 LOY. CONSUMER L. REV. 468, 476 (2012).

II. CONSTRUING NONJUDICIAL FORECLOSURE IN THE WESTERN “DEED OF TRUST” STATES

In this Part, we present the state of nonjudicial foreclosure law in the seven western states identified above, with particular reference to whether a party that does not have the right to enforce the promissory note might nonetheless successfully foreclose the deed of trust securing that note.

A. California

We begin our analysis with federal cases in California, since it was there that this issue was first raised. The earliest decision seems to be the 2007 case of *Neal v. Juarez*, where the court merely held that “the allegation that the trustee did not have the original note or had not received it is insufficient to render the foreclosure proceeding invalid.”⁶³ That statement does not quite address our point; the issue is whether the trustee must determine that the purported holder of the note actually holds it, not whether it has been given to the trustee. A more relevant early decision is *Candelo v. NDex West, LLC*, where the Eastern District of California emphasized the view of the California state courts that the nonjudicial foreclosure statute is a “comprehensive statutory framework” and “is intended to be exhaustive.”⁶⁴ The court then observed that “[n]o requirement exists under the statutory framework to produce the original note to initiate non-judicial foreclosure.”⁶⁵ In other words, because it is not an explicit requirement of the foreclosure statute, production of the note is not required at all. The same theme was followed by the Northern District of California in the 2009 case of *Gamboa v. Trustee Corps.*⁶⁶ Since *Candelo* was published, it has been cited by federal district courts in California at least thirty-three times for the proposition that production

63. Civil No. 06cv0055 J(JMA), 2007 WL 2140640, at *8 (S.D. Cal. July 23, 2007).

64. No. CV F 08-1916 LJO DLB, 2008 WL 5382259, at *4 (E.D. Cal. Dec. 23, 2008) (quoting *Moeller v. Lien*, 30 Cal. Rptr. 2d 777, 785 (Ct. App. 1994)).

65. *Id.*

66. No. 09-0007 SC, 2009 WL 656285, at *4 (N.D. Cal. Mar. 12, 2009).

of the note is not required to foreclose nonjudicially.⁶⁷ However, all of these decisions are unpublished. In 2012, the Bankruptcy Appellate Panel for the Ninth Circuit published an opinion that agreed with *Candelo* and went even farther in the case of *In re Cedano*.⁶⁸ There, the court stated, “Under Cal. Civ. Code § 2924, the party initiating foreclosure proceedings is not required to have a beneficial or economic interest in the note in order to foreclose.”⁶⁹ Observe the leap: the foreclosing party not only is not required to *produce* the note, but need not even hold an *interest* in it!

None of these decisions cite to any controlling state-court case, leaving one to wonder if the federal courts got it right. It appears that they did. Finally, in 2012, in *Debrunner v. Deutsche Bank National Trust Co.*,⁷⁰ the California Court of Appeal fully endorsed the aforementioned federal cases in construing California law:

Plaintiff’s reliance on the California Uniform Commercial Code provisions pertaining to negotiable instruments is misplaced.... “There is no stated requirement in California’s non-judicial foreclosure scheme that requires a beneficial interest in the Note to foreclose. Rather, the statute broadly allows a trustee, mortgagee, beneficiary, or any of their agents to initiate non-judicial foreclosure. Accordingly, the statute does not require a beneficial interest in both the Note and the Deed of Trust to commence a non-judicial foreclosure sale.”⁷¹

This language is more revealing than it may first appear. When the loan has been sold on the secondary market, the foreclosing party is not the “mortgagee, beneficiary, or any of their agents.”⁷² These parties have parted with their interest in the loan. Rather bizarrely, the statute does not seem to recognize that anything like the

67. This count is based on the citing references listed in Westlaw as of February 9, 2013.

68. 470 B.R. 522, 530 (B.A.P. 9th Cir. 2012).

69. *Id.*

70. 138 Cal. Rptr. 3d 830 (Ct. App. 2012).

71. *Id.* at 835-36 (quoting *Lane v. Vitek Real Estate Indus. Grp.*, 713 F. Supp. 2d 1092, 1099 (E.D. Cal. 2010)).

72. *Id.*

secondary-mortgage market exists or that mortgage loans are routinely transferred by the original deed of trust beneficiary.⁷³ There is no reference to transfers of the note or obligation or even to assignments of the deed of trust.

Under the statutory language, the trustee holds the power to foreclose when the loan has been sold.⁷⁴ The trustee is an agent⁷⁵ and is empowered by the statute to represent whom? Logically, we want to answer that the trustee must now represent the current holder of the note, but the court in *Debrunner* has explicitly told us that the trustee has no responsibility to determine whether the party being represented holds the note or not.⁷⁶ Perhaps the statute contemplates that the trustee represents the holder of an assignment of the deed of trust, but it is far from clear in saying so, and in any event, there is no assurance at all that the assignee of the deed of trust will also have possession of, or the right to enforce, the note. The trustee is thus represented by the *Debrunner* reasoning as a sort of legal Don Quixote, foreclosing on his or her own initiative when a default is discovered. The result is potential legal chaos!

To reach this position, the court needed to ignore UCC Article 3, and that is precisely what it did:

Likewise, we are not convinced that the cited sections of the California Uniform Commercial Code (particularly § 3301) displace the detailed, specific, and comprehensive set of legislative procedures the Legislature has established for nonjudicial foreclosures. “Although Article 3 of the UCC governs negotiable instruments, it does not apply to nonjudicial foreclosure under deeds of trust.”⁷⁷

73. CAL. CIV. CODE § 2924 (2012).

74. CAL. CIV. CODE § 2924.

75. *Lancaster Sec. Inv. Corp. v. Kessler*, 324 P.2d 634, 638 (Cal. Ct. App. 1958) (“The trustee of a trust deed is not a trustee in the strict sense of the word. The role of such a trustee is more nearly that of a common agent of the parties to the instrument.”).

76. *Debrunner v. Deutsche Bank Nat’l Trust Co.*, 138 Cal. Rptr. 3d 830, 836 (Ct. App. 2012).

77. *Id.* (citations omitted) (quoting *Padayachi v. IndyMac Bank*, No. C 09-5545 JF (PVT), 2010 WL 4367221, at *3 (N.D. Cal. Oct. 28, 2010)).

Suppose a trustee conducted a nonjudicial-foreclosure sale on the instruction of a party who had an assignment of the deed of trust but who did not hold the note. A *judicial* foreclosure under these circumstances would be inappropriate, but a nonjudicial foreclosure is depicted by *Debrunner* and the prior federal cases as perfectly appropriate. Apparently a California court would not enjoin the sale (the actual context of the *Debrunner* case), would not set it aside after it had occurred, and would not award damages against the foreclosing party or the trustee for their actions (the context of most of the federal cases discussed above).

In July 2012, after *Debrunner* was decided, the California legislature amended the nonjudicial-foreclosure statute as part of the package of bills known as the California Homeowner Bill of Rights.⁷⁸ One provision of the amendment may bear on the present issue. A new subsection (a)(6) was added to California Civil Code § 2924:

No entity shall record or cause a notice of default to be recorded or otherwise initiate the foreclosure process unless it is the holder of the beneficial interest under the mortgage or deed of trust, the original trustee or the substituted trustee under the deed of trust, or the designated agent of the holder of the beneficial interest. No agent of the holder of the beneficial interest under the mortgage or deed of trust, original trustee or substituted trustee under the deed of trust may record a notice of default or otherwise commence the foreclosure process except when acting within the scope of authority designated by the holder of the beneficial interest.⁷⁹

Because under common-law principles only the party who can enforce the note can be the *beneficial* holder of the deed of trust,⁸⁰ irrespective of who the nominal assignee is, the first sentence might be read to say that an assignee of a deed of trust can commence a nonjudicial foreclosure only

78. A.B. 278, 2012 Leg., Reg. Sess. (Cal. 2012); S.B. 900, Reg. Sess. (Cal. 2012).

79. CAL. CIV. CODE § 2924(a)(6) (West 2012).

80. CAL. CIV. CODE § 2936 (West 2012) (“The assignment of a debt secured by mortgage carries with it the security.”).

if the assignee also holds the right to enforce the note. However, even if this meaning is assigned to the language of the statute, the text still independently authorizes the original or substituted trustee to commence foreclosure—apparently with no instruction from the holder of “the beneficial interest under the mortgage or deed of trust” at all.⁸¹

The second sentence of the new subsection is no help; it simply limits the actions of an *agent* of the holder of the beneficial interest (presumably, a servicer) to those acts authorized by the holder. In sum, if the amendment was intended to require that the party instigating foreclosure must be entitled to enforce the note, then it is an incredibly inept effort to say so. Indeed, aside from providing that servicers must act within their authority as agents (an obvious proposition that would seem to require no legislative reinforcement), it is hard to see why subsection (a)(6) was added to the statute. The basic premise of *Debrunner* still seems to be intact in California.

Can this result really have been the intention of the California state legislature? After all, California enacted UCC Article 3 as well as the foreclosure statute. Would it be so difficult to read the two in harmony and to hold the trustee to a duty that ensures the demands of Article 3 are satisfied before proceeding with foreclosure? It is true that the foreclosure statute does not incorporate or refer to Article 3 specifically, but the statute likewise does not dismiss Article 3.

Perhaps the real explanation for California state and federal courts' refusal to consider Article 3 in the context of nonjudicial foreclosure is that, after all, the borrower is clearly in default and has no substantive defense to foreclosure. The demand for production of the note is seen as simply a technicality designed to delay the inevitable loss of the real estate and to clog the courts in the process. The chances that someone else has the note and will later try to enforce against the borrower are remote, and, even if it occurred, the borrower would be entitled to a credit for the amount bid at the foreclosure sale. Moreover, deficiency

81. See CAL. CIV. CODE § 2924(a)(6).

judgments on purchase-money mortgage loans and deeds of trust foreclosed by nonjudicial process are barred by statute in California.⁸² The remaining balance would, therefore, be uncollectible. Thus, the probability that anyone holding the note would even attempt to enforce it against the borrower is extremely unlikely.

In light of the fact that deficiency claims are barred against all mortgage loans foreclosed nonjudicially, but only for *some* loans foreclosed judicially,⁸³ there is a rationale supporting California's policy of requiring proof of the right to enforce the note in judicial foreclosures but not in trustee's sales. Nonetheless, there is an unseemly casualness about the distinction. After all, different lenders have different policies and procedures with respect to forbearance, loan modification, mediation, approval of short sales, and a variety of other measures to relieve the harshness of foreclosure. Hence, many consequences may turn on which lender attempts to foreclose. 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.

B. Following in California's Footsteps

Two other western states, Arizona and Idaho, present legal landscapes similar to California. In both states, foreclosure is usually carried out by a trustee's sale under a deed of trust, and neither state's foreclosure statute contains any reference to the UCC or any requirement that the foreclosing party show entitlement to enforce the promissory note.⁸⁴

82. CAL. CIV. PROC. CODE § 580b (West 2012); *see also* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 8.3 (5th ed. 2007). The protection from deficiency liability for purchase-money mortgages was expanded in 2012 to include loans made to refinance original purchase-money mortgages on owner-occupied residences. *See* S.B. 1069, Reg. Sess. (Cal. 2012).

83. Non-purchase-money borrowers remain liable for deficiencies in judicial foreclosures. *See* CAL. CIV. PROC. CODE § 580b.

84. ARIZ. REV. STAT. ANN. § 33-807 (West 2012); CAL. CIV. CODE § 2924; IDAHO CODE ANN. § 45-1505 (West 2012).

1. Arizona

The Arizona statute, even more starkly than California's statute, appears to contemplate foreclosure by the trustee without any instruction to foreclose by the beneficiary of the deed of trust,⁸⁵ thus presenting the possibility of a rogue trustee as discussed above.⁸⁶ As in California, Arizona's drafters seem to have been completely unaware that a secondary market in mortgage loans exists. Before the Arizona state courts addressed the issue, several Arizona federal courts held that the foreclosing party had no duty to show entitlement to enforce the note, reasoning—like California federal courts—that since the foreclosure statutes were silent on the point, no incorporation of the Article 3 requirement to show entitlement to enforce could be implied.⁸⁷

When the matter finally came up on appeal, however, the Arizona Supreme Court followed a slightly different approach.⁸⁸ Rather surprisingly, the court first noted that “a deed of trust, like a mortgage, may be enforced only by, or in behalf of, a person who is entitled to enforce the obligation the mortgage secures.”⁸⁹ Not so fast! Noting that the borrower had failed to allege that the foreclosing party *lacked* the note, the court concluded that nothing in the foreclosure statute placed the burden of proof on the foreclosing lender.⁹⁰ The court then slipped into the comfortable rhetoric used by the prior federal and California cases: “the deed of trust statutes impose no obligation on the beneficiary to ‘show the note’ before the

85. ARIZ. REV. STAT. ANN. §§ 33-807 to -808.

86. *See supra* text accompanying note 76.

87. *Mansour v. Cal-Western Reconveyance Corp.*, 618 F. Supp. 2d 1178, 1181 (D. Ariz. 2009) (“Arizona’s judicial foreclosure statutes . . . do not require presentation of the original note before commencing foreclosure proceedings.”); *Diessner v. Mortg. Elec. Registration Sys.*, 618 F. Supp. 2d 1184, 1187 (D. Ariz. 2009); *Blau v. America’s Servicing Co.*, No. CV-08-773-PHX-MHM, 2009 WL 3174823, at *6 (D. Ariz. Sept. 29, 2009) (“Absent specific and compelling Arizona case law, this Court will not presume that the UCC has any applicability to foreclosure proceedings.”); *Goodyke v. BNC Mortg., Inc.*, No. CV 09 0074 PHX MHM, 2009 WL 2971086, at *4 (D. Ariz. Sept. 11, 2009); *In re Weisband*, 427 B.R. 13, 22 (Bankr. D. Ariz. 2010), *aff’d*, 2011 WL 3303453 (B.A.P. 9th Cir. 2011).

88. *Hogan v. Wash. Mut. Bank, N.A.*, 277 P.3d 781 (Ariz. 2012).

89. *Id.* at 783 (citations omitted) (internal quotation marks omitted).

90. *Id.*

trustee conducts a non-judicial foreclosure.”⁹¹ Moreover, the court, inconsistently, seemed to find that the UCC did not apply. The court stated, “The UCC does not govern liens on real property. The trust deed statutes do not require compliance with the UCC before a trustee commences a non-judicial foreclosure.”⁹²

In summary, the court’s position seems to be that the foreclosing party must have the right to enforce the note but need not prove or provide evidence of it. This gives the borrower a sort of right without a remedy. Perhaps the court’s statements were only about the burden of going forward with evidence. The court pointed out that the borrower “alleges that [the investor and servicer of the loan] have the burden of demonstrating their rights before a non-judicial foreclosure may proceed. Nothing in the non-judicial foreclosure statutes, however, imposes such an obligation.”⁹³ Suppose the borrower had alleged in his complaint that the assignee of the deed of trust lacked possession of the note. Would the court have compelled the assignee to produce it then?⁹⁴

Of course, this position seems nonsensical; it effectively requires the borrower to bring a lawsuit in order to make such an allegation and then places the burden of alleging evidence as to possession of the note on the borrower—the party least likely to have any information or knowledge on the subject. The court’s handling of this issue is, to put it mildly, unsatisfactory.

The Arizona court attempted to buttress its position by referring to the state’s anti-deficiency legislation, but its effort was not very convincing:

91. *Id.*

92. *Id.* (citation omitted).

93. *Hogan*, 277 P.3d at 783.

94. We are unsure whether such an allegation, based on nothing more than suspicion, is improper or sanctionable in Arizona. Arizona’s Rules of Civil Procedures prohibit “the filing of a pleading when the party or counsel knew, or should have known by such investigation of fact and law as was reasonable and feasible under all the circumstances that the claim or defense was insubstantial, groundless, frivolous or otherwise unjustified.” *Gilbert v. Bd. of Med. Exam’rs*, 745 P.2d 617, 631 (Ariz. Ct. App. 1987) (emphasis omitted). What sort of investigation can the plaintiff or his counsel make? Is simply asking the foreclosing party whether it has the original note likely to do any good? It seems probable that such a request would be ignored.

[The borrower] suggests that if we do not require the beneficiary to “show the note,” the original noteholder may attempt to later pursue collection despite a foreclosure. But Arizona’s anti-deficiency statutes protect against such occurrences by precluding deficiency judgments against debtors whose foreclosed residential property consists of 2.5 acres or less, as is the case here.⁹⁵

Fair enough, but Arizona’s anti-deficiency statute for nonjudicial foreclosures is far less comprehensive than California’s.⁹⁶ What about foreclosures on nonresidential property or on houses located on parcels larger than 2.5 acres? Would those borrowers (who have no protection against a later lawsuit for the remainder of the debt) be entitled to demand production of the note as a precondition of foreclosure? Nothing in the opinion suggests that they would. On this point, as on the question of whether the court is merely speaking to the burden of going forward with evidence, the opinion seems maddeningly inconsistent. As a practical matter, Arizona has ended up in the same position as California; the trustee can foreclose the deed of trust without making any inquiry as to whether the foreclosing party holds the note.⁹⁷

2. Idaho

Idaho’s history and results are similar to Arizona,⁹⁸ but the Idaho Supreme Court employed even more radical reasoning. In *Trotter v. Bank of New York Mellon*, the borrower asserted that the foreclosing party (the trustee of

95. *Hogan*, 277 P.3d at 784.

96. See generally Emily Gildar, Comment, *Arizona’s Anti-deficiency Statutes: Ensuring Consumer Protection in a Foreclosure Crisis*, 42 ARIZ. ST. L.J. 1019 (2010).

97. *Hogan*, 277 P.3d at 783.

98. Before the Idaho Supreme Court spoke to the point, the federal district court in Idaho took an innovative and much more pro-borrower position. The court conceded that the Idaho statute made no reference to UCC Article 3’s requirements, but concluded that the borrower’s action to enjoin the foreclosure was “not challenging Defendant’s procedure . . . [but was] challenging Defendant’s right to initiate the procedure.” *Armacost v. HSBC Bank USA*, No. 10 CV 274 EJJ LMB, 2011 WL 825151, at *10 (D. Idaho Feb. 9, 2011). The court continued, “One could not reasonably contend that compliance with a procedure gives substantive rights not otherwise possessed.” *Id.* This view, however, seems to have been firmly rejected by the subsequent Idaho Supreme Court opinion discussed below.

a securitized trust) was obliged to establish its standing to foreclose by proving that it held the loan.⁹⁹ The court was unimpressed, stating that nothing in the statute could “reasonably be read to require the trustee [of a deed of trust] to prove it has ‘standing’ before foreclosing. Instead, the plain language of the statute makes it clear that the trustee may foreclose on a deed of trust if it complies with the requirements contained within the Act.”¹⁰⁰

The Act, in turn, has five requirements: (1) that any assignments of the deed of trust or substitutions of the trustee have been recorded; (2) that there is a default by the borrower; (3) that an appropriate notice of default has been recorded; (4) that no suit on the debt is pending; and (5) that a notice of sale has been given to the proper parties.¹⁰¹ Taking the bare-bones nature of these requirements literally, the court in *Trotter* not only rejected placing a duty on the foreclosing party to show that it held the note, but it also explicitly adopted the “rogue trustee” concept, which we inferred from the California and Arizona statutes, when it found that “a trustee may initiate nonjudicial foreclosure proceedings on a deed of trust without first proving ownership of the underlying note or demonstrating that the deed of trust beneficiary has requested or authorized the trustee to initiate those proceedings.”¹⁰² This statement seems to defy common sense!

Moreover, the risk to a borrower of being subjected to double liability on a promissory note is real and serious in Idaho. The situation is very different than California, where the protection from deficiency judgments after a nonjudicial foreclosure is complete,¹⁰³ and Arizona, where this protection is partial.¹⁰⁴ In Idaho, if the foreclosing party does not hold the note, and the actual holder subsequently brings an action to enforce it against the borrower, there is no anti-deficiency statute to protect the

99. 275 P.3d 857, 862 (Idaho 2012).

100. *Id.*

101. IDAHO CODE ANN. § 45-1505 (West 2012).

102. *Trotter*, 275 P.3d at 862.

103. *See supra* text accompanying note 82.

104. *See supra* text accompanying note 96.

borrower against a judgment.¹⁰⁵ Idaho deficiency judgments are limited to the amount by which the secured debt exceeds the fair market value of the real estate at the date of the foreclosure sale; therefore, presumably the borrower would be entitled to a credit for the greater of the amount bid or the fair market value but would be exposed to potential liability for the remainder of the debt.

C. Oregon and Utah

Two other western states, Oregon¹⁰⁶ and Utah,¹⁰⁷ have nonjudicial foreclosure statutes similar to those of California, Arizona, and Idaho. These statutes make no mention of possession or holding of the promissory note. Although neither Oregon nor Utah has a judicial decision construing its statute on the point, it seems likely that courts in both states would follow the California, Arizona, and Idaho decisions discussed above. Most likely, Oregon and Utah courts would find no obligation on the trustee to verify that the foreclosing party had the right to enforce the note¹⁰⁸ and would give no rights to the borrower to enjoin the foreclosure on account of the absence of proof of the foreclosing party's right to enforce.

D. Better Drafting in Nevada and Washington

The statutes of California, Arizona, and Idaho are abysmal failures in reconciling the demands of UCC Article 3 and the procedure for foreclosure of deeds of trust. But the task of reconciliation is not difficult, and two other

105. See IDAHO CODE ANN. § 45-1512 (West 2012).

106. OR. REV. STAT. ANN. §§ 86.710-86.795 (West 2012).

107. UTAH CODE ANN. §§ 57-1-19 to -32 (West 2012). The notice of default recorded by the trustee need merely contain "a statement that a breach of an obligation for which the trust property was conveyed as security has occurred, and setting forth the nature of that breach." UTAH CODE ANN. § 57-1-24(1). A separate notice mailed to the borrower must include this information, plus an itemized statement of the amounts that must be paid to cure the default and the contact information for a "single point of contact" designated by the beneficiary or servicer. UTAH CODE ANN. § 57-1-24.3(2)(b).

108. In *Niday v. GMAC Mortgage, LLC*, 284 P.3d 1157, 1164-66 (Or. Ct. App. 2012), the court seemed to assume that it was necessary for the foreclosing party to hold the promissory note. Yet, the servicer in fact had possession of the note, and this was not an issue in the case. *Id.*

western states using deeds of trust, Nevada and Washington, handle it nicely.

1. Nevada

Under the Nevada statute, the power of sale cannot be exercised until:

The beneficiary, the successor in interest of the beneficiary or the trustee first executes and causes to be recorded in the office of the recorder of the county . . . a notice of the breach [that] . . . includes a notarized affidavit of authority to exercise the power of sale stating, based on personal knowledge and under the penalty of perjury . . . [t]hat the beneficiary under the deed of trust, the successor in interest of the beneficiary or the trustee is *in actual or constructive possession of the note* secured by the deed of trust.¹⁰⁹

In 2012, both the Nevada federal district court and the Nevada Supreme Court affirmed that the statute means what it says, and that noncompliance bars the power to foreclose.¹¹⁰ In *Hernandez v. IndyMac Bank*, the federal court granted an order enjoining the foreclosure sale because the evidence showed that the foreclosing party did not hold the note.¹¹¹ The court held that “Nevada law, by including, among other provisions, various recording and notice requirements, places the burden on the foreclosing entity to demonstrate their authority to initiate foreclosure proceedings.”¹¹²

In *Edelstein v. Bank of New York Mellon*, the issue was whether BNY Mellon, the loan’s servicer, was the proper party to engage in the preforeclosure mediation process required by Nevada statutes.¹¹³ The Nevada Supreme Court found that it was, concluding that nonjudicial foreclosure was proper only if the foreclosing party was

109. NEV. REV. STAT. ANN. § 107.080(2)(c) (West 2012) (emphasis added).

110. *Hernandez v. IndyMac Bank*, No. 2:12-cv-00369-MMD-CWH, 2012 WL 3860646, at *4 (D. Nev. Sept. 5, 2012); *Edelstein v. Bank of N.Y. Mellon*, 286 P.3d 249, 252 (Nev. 2012).

111. 2012 WL 3860646, at *4-5, *7 (D. Nev. 2012).

112. *Id.* at *5.

113. 286 P.3d at 253-54.

both the assignee of the deed of trust and entitled to enforce the note.¹¹⁴ If the two documents were split, neither holder could foreclose, but reuniting the deed and note would restore the right to foreclose.¹¹⁵ Because BNY Mellon had an assignment of the deed of trust and its trustee, Recon Trust, held possession of the note, it was the proper party to mediate with the borrower.¹¹⁶

2. Washington

Washington handles the question of whether the foreclosing party must show the right to enforce the note in a manner similar to Nevada. Washington's nonjudicial foreclosure statute provides:

That, for residential real property, before the notice of trustee's sale is recorded, transmitted, or served, the trustee shall have proof that the beneficiary is the owner of any promissory note or other obligation secured by the deed of trust. A declaration by the beneficiary made under the penalty of perjury stating that *the beneficiary is the actual holder of the promissory note* or other obligation secured by the deed of trust shall be sufficient proof as required under this subsection.¹¹⁷

In addition, if the property secured by the deed of trust is residential real property, the notice of default sent to the borrower must include "the name and address of the owner of any promissory notes or other obligations secured by the deed of trust."¹¹⁸ In *Bain v. Metropolitan Mortgage Group, Inc.*, the Washington Supreme Court held that the previous provision was substantive; a party could not be a

114. *Id.* at 252.

115. *Id.*

116. *Id.* at 261.

117. WASH. REV. CODE ANN. § 61.24.030(7)(a) (West 2012) (emphasis added).

118. WASH. REV. CODE ANN. § 61.24.030(8)(l). Observe the apparent inconsistency of the statute. The first subsection cited refers to the "holder" of the promissory note, and the second subsection to the "owner." See discussion *supra* note 23.

“beneficiary” and, hence, could not foreclose under the statute unless it held the note.¹¹⁹

There is a subtle difference between the Nevada and Washington statutes. In Nevada, the notice of breach must include an affidavit “based on personal knowledge” that the beneficiary holds the note.¹²⁰ If the trustee, rather than the beneficiary, records and issues the notice, this presumably means that the trustee is responsible to actually see the note. In Washington, on the other hand, the trustee may accept the beneficiary’s sworn declaration that it holds the note.¹²¹ Some foreclosure defense lawyers would likely argue that the protection provided to the borrower by the Washington procedure is inadequate, and that secondary-market investors and their servicers are apt to lie about holding the note when they do not have it in fact. Perhaps this point is legitimate, but even the Washington process is far more satisfactory than the processes in California, Arizona, and Idaho, where the trustee need pay no attention at all to whether the assignee of the deed of trust also holds the note.¹²²

III. THE REST OF THE COUNTRY: THE BAD NEWS AND THE GOOD NEWS

The initial task we set for ourselves in this article was to analyze the nonjudicial-foreclosure processes of seven western states. The picture that has emerged from this analysis is far from a comprehensive snapshot of American nonjudicial foreclosure. In the present Part, we propose to consider what has happened in the rest of the country, but we do so only by referring to recent case decisions, rather than engaging in a thorough statute-by-statute investigation. Many of these cases involve states where mortgagees have a direct power of sale, so that the use of

119. 285 P.3d 34, 36 (Wash. 2012) (en banc); *see also In re Allen*, 472 B.R. 559, 569 (B.A.P. 9th Cir. 2012).

120. NEV. REV. STAT. ANN. § 107.080(2)(c) (West 2012).

121. WASH. REV. CODE ANN. § 61.24.030(7)(a) (West 2012).

122. *Hogan v. Wash. Mut. Bank*, 277 P.3d 781, 783 (Ariz. 2012) (en banc); *Debrunner v. Deutsche Bank Nat’l Trust Co.*, 138 Cal. Rptr. 3d 830, 835 (Ct. App. 2012); *Trotter v. Bank of N.Y. Mellon*, 275 P.3d 857, 862 (Idaho 2012).

deeds of trust and trustee's sales is unnecessary (and in most of them, unheard of).

The results of this survey, like the results in the seven western states discussed above, present a mixed picture. If one believes, as we do, that proof of entitlement to enforce the promissory note should be an essential prerequisite to the power to foreclose, the holdings of recent cases have produced both bad news and good news. First, we will discuss the bad news.

A. Texas

Texas employs deeds of trust with power of sale, much like the western states discussed above.¹²³ Like most of those western states, Texas's statutes make no reference to the promissory note.¹²⁴ Unsurprisingly, federal courts in Texas have consistently held that possession of the note is entirely irrelevant to the power to foreclose.¹²⁵ For example, one federal court stated:

The current statutory procedure for a deed of trust foreclosure does *not* require mortgage servicers to produce or hold the note. The mortgage servicer need only provide notice of default, with an opportunity to cure, and notice of the actual foreclosure sale. Production of the original promissory note is not necessary. The Property Code also specifically enables mortgage servicers to foreclose if they (1) are authorized to do so by agreement with the mortgagee, and (2) disclose their relationship to the mortgagee in the notices required by section 51.002. Again, there is no requirement to produce or even possess the note, original or otherwise.¹²⁶

There is no clear state-court authority in support of this position, but neither is there reason to expect the state

123. See TEX. PROP. CODE ANN. § 51.002(a) (West 2011).

124. TEX. PROP. CODE ANN. § 51.002; TEX. PROP. CODE ANN. § 51.0025 (West 2011).

125. *Kan v. OneWest Bank*, F.S.B., 823 F. Supp. 2d 464, 469 (W.D. Tex. 2011).

126. *Id.* at 470 (citations omitted); see also *Casterline v. OneWest Bank*, F.S.B., No. 2:12-CV-00150, 2012 WL 6630024, at *1 (S.D. Tex. Dec. 19, 2012); *Knapik v. BAC Home Loans Servicing, LP*, 825 F. Supp. 2d 869, 873 (S.D. Tex. 2011).

courts to disagree. The Texas statute authorizes “a mortgagee” or mortgage servicer to foreclose and defines “mortgagee” as “the grantee, beneficiary, owner, or holder of a security instrument,” with no mention of holding the note.¹²⁷ In light of the federal-court decisions, there is little likelihood that Texas courts will read the statute to require the mortgagee to hold the note.

B. Hawaii

Hawaii has traditionally recognized nonjudicial foreclosures of mortgages containing a power of sale.¹²⁸ The existing caselaw—all of it in the federal courts—is based on a version of the Hawaii statute that was repealed in 2011.¹²⁹ The federal decisions repeatedly rejected the claim that the statute required the foreclosing mortgagee to provide evidence that it held the note.¹³⁰ The statute made no such demand, and the courts refused to adopt it by implication.¹³¹ As one federal judge put it, “[N]on judicial foreclosure statutes may change the common law rule requiring a mortgagee to hold the underlying note, which appears to be exactly what the Hawaii legislature did in enacting [its statute].”¹³²

However, it is unclear whether these decisions have any continuing relevance. In a complex series of actions, the Hawaii legislature first imposed a moratorium upon, and then repealed, the nonjudicial-foreclosure procedure upon which they were based.¹³³ A revised alternative

127. TEX. PROP. CODE ANN. § 51.0001(4)(A) (West 2011); TEX. PROP. CODE ANN. § 51.0025.

128. *Lee v. Mortg. Elec. Registration Sys., Inc.*, No. 10-00687 JMS/BMK, 2012 WL 6726382, at *6 (D. Haw. Dec. 26, 2012).

129. *Id.*; see also HAW. REV. STAT. § 667-5 (repealed 2012).

130. *Lee*, 2012 WL 6726382, at *6; *Nottage v. Bank of N.Y. Mellon*, No. 12-00418 JMS/BMK, 2012 WL 5305506, at *7 (D. Haw. Oct. 25, 2012); *Pascual v. Aurora Loan Servs., LLC*, No. 10-00759 JMS-KSC, 2012 WL 3583530, at *3 (D. Haw. Aug. 20, 2012); *Lindsey v. Meridias Capital, Inc.*, No. 11-00653 JMS/KSC, 2012 WL 488282, at *8 (D. Haw. Feb. 14, 2012).

131. *Lee*, 2012 WL 6726382, at *6; *Nottage*, 2012 WL 5305506, at *7; *Pascual*, 2012 WL 3583530, at *3; *Lindsey*, 2012 WL 488282, at *8.

132. *Nottage*, 2012 WL 5305506, at *7 (citing *In re Veal*, 450 B.R. 897, 916-17 (B.A.P. 9th Cir. 2011)).

133. Everett S. Kaneshige & Seth J. Corpuz-Lahne, *The New Foreclosure Law*, HAW. B.J., Oct. 2012, at 4.

nonjudicial process has been authorized by the legislature¹³⁴ but thus far has not been used.¹³⁵

C. Michigan

Two midwestern states using mortgages with power of sale have followed the California-Arizona-Idaho model, concluding that holding the note was not essential to the right to foreclose. The Michigan Supreme Court, in *Residential Funding Co., v. Saurman*, held that MERS, as holder of a mortgage in the capacity of nominee for the noteholder, could foreclose in its own name despite not holding the note.¹³⁶ Unfortunately, the opinion is so badly fractured as to be almost nonsensical:

[A]s record-holder of the mortgage, MERS owned a security lien on the properties, the continued existence of which was contingent upon the satisfaction of the indebtedness. This interest in the indebtedness—i.e., the ownership of legal title to a security lien whose existence is wholly contingent on the satisfaction of the indebtedness—authorized MERS to foreclose by advertisement under MCL 600.3204(1)(d).¹³⁷

The court was clearly determined to uphold foreclosures filed in the name of MERS¹³⁸ and willing to engage in a certain amount of verbal nonsense in order to do so. In any event, the net result seems to be that an assignee of the mortgage need not show that it holds the

134. See HAW. REV. STAT. § 667-22 (West 2012) (stating the requirements for the notice of default and intention to foreclose under the revised procedure). There is still no requirement for proof that the foreclosing party holds the note, but merely a requirement to include a copy of the note and any endorsements or allonges. HAW. REV. STAT. § 667-22(c).

135. See Ron Margolis, *Foreclosure Thoughts on New Hawaii Law Act 182—Hawaii's Reparations and the Foreclosure Mediation Program*, HAWAII LIFE (July 26, 2012), <http://www.hawaiilife.com/articles/2012/07/hawaii-law-act-182/>. The new procedure requires mediation of residential mortgage foreclosures and has been considered burdensome by lenders, who have thus far resorted to judicial foreclosure instead. *Id.*

136. 805 N.W.2d 183, 183 (Mich. 2011).

137. *Id.*

138. Ironically, in July 2011, MERS discontinued the practice of foreclosing in its own name. Policy Bulletin No. 2011-5 from MERS to MERS System Members (July 21, 2011), *available at* foreclosurebu33.files.wordpress.com/2011/07/policy-bulletin-2011-5.pdf.

note to foreclose nonjudicially in Michigan.¹³⁹ The decision indicates no awareness whatsoever of the requirements of UCC Article 3.

D. Minnesota

Likewise, the Eighth Circuit Court of Appeals in *Stein v. Chase Home Finance, LLC* considered whether Minnesota law allowed a party to commence a nonjudicial foreclosure when it arguably had already assigned the promissory note to another party.¹⁴⁰ Based on its interpretation of the Minnesota Supreme Court's decision in *Jackson v. Mortgage Electronic Registration Systems, Inc.*,¹⁴¹ the Eighth Circuit concluded that holding the note was not necessary to commence the foreclosure:

[T]he right to enforce a mortgage through foreclosure by advertisement lies with the legal, rather than equitable, holder of the mortgage. The assignment of the promissory note to another “operates as an *equitable* assignment of the underlying [mortgage],” but the right to enforce the mortgage remains with the legal holder of the mortgage.¹⁴²

This view is consistent with the Minnesota Supreme Court's holding in *Jackson*, and there is no reason to expect state courts to disagree.

Now, the good news.

E. Maryland

Maryland generally employs deeds of trust with a power of sale, but unlike nearly all other states that do so,

139. See *Hargrow v. Wells Fargo Bank N.A.*, No. 11-1806, 2012 WL 2552805, at *2 (6th Cir. July 3, 2012).

140. 662 F.3d 976, 981 (8th Cir. 2011).

141. 770 N.W.2d 487 (Minn. 2009). *Jackson* did not involve the question we are now considering; rather, it dealt with whether an assignment of a secured note (which concededly carried with it the mortgage) had to be recorded as a precondition to foreclosing the mortgage in Minnesota. *Id.* at 501.

142. *Stein*, 662 F.3d at 980 (second alteration in original) (citation omitted); see also *Brinkman v. Bank of Am., N.A.*, No. 11 3240 (JRT/TNL), 2012 WL 6600315, at *3 (D. Minn. Aug. 23, 2012); *Welk v. GMAC Mortg., LLC*, 850 F. Supp. 2d 976, 985-86 (D. Minn. 2012) (citing numerous other federal district court cases following the holding of *Stein*).

foreclosure is commenced by a judicial filing and is governed by court rules.¹⁴³ The applicable rule requires that the filing be accompanied by “a copy of any separate note or other debt instrument supported by an affidavit that it is a true and accurate copy and certifying ownership of the debt instrument.”¹⁴⁴ Construing this language, the Maryland Court of Appeals had no difficulty concluding that the foreclosing party was required to show in the affidavit that it was entitled to enforce the note under UCC Article 3.¹⁴⁵ It was an easy case.

F. North Carolina

North Carolina is similar to Maryland. Foreclosure is ordinarily implemented by a trustee’s sale under a deed of trust, but the foreclosure process must be commenced by filing a “notice of hearing” with the clerk of court, who then schedules a hearing to consider the evidence that foreclosure is proper.¹⁴⁶ The clerk must find, among other things, the existence of a “valid debt of which the party seeking to foreclose is the holder.”¹⁴⁷ In the case of *In re David A. Simpson, P.C.*,¹⁴⁸ the North Carolina Court of Appeals had no difficulty equating the “valid debt” language with entitlement to enforce the note under UCC Article 3.¹⁴⁹ Again, in light of the statutory language, it was an easy case.

G. Georgia

Georgia recognizes a nonjudicial power of sale in the grantee of a security deed (Georgia’s equivalent of a mortgage). In *Morgan v. Ocwen Loan Servicing, LLC*, the

143. MD. R. 14-207 (explaining that a power of sale proceeding is commenced by filing an “order to docket”).

144. MD. R. 14-207(b)(3).

145. *Anderson v. Burson*, 35 A.3d 452, 460 (Md. 2011).

146. N.C. GEN. STAT. ANN. § 45-21.16 (West 2012).

147. N.C. GEN. STAT. ANN. § 45-21.16(d).

148. 711 S.E.2d 165 (N.C. Ct. App. 2011).

149. *Id.* at 171-72. The foreclosing party did have possession of the note, but it did not contain a complete chain of endorsements. *Id.* at 172. Oddly, the court seems to have considered only the “holder” branch of the “entitlement to enforce” principle and failed to consider the “nonholder with the rights of a holder” branch. *Id.*; see also text accompanying note 36.

plaintiff sued in federal court to enjoin the foreclosure and also sought damages for wrongful foreclosure, alleging that Ocwen, the servicer, did not possess the note (an allegation taken as true for purposes of resolving Ocwen's motion to dismiss).¹⁵⁰ The Georgia statute refers to the foreclosing party as the "secured creditor,"¹⁵¹ and the court held (based on less than conclusive prior state-court authority) that one could be a "secured creditor" only by having the right to enforce the note.¹⁵² "[T]he right to foreclose lies with the party that holds the indebtedness."¹⁵³ The court's conclusion makes good sense, but the statute provides no method by which the foreclosing party can notify the borrower that it has the note and no method of making a record of the fact.

H. Virginia

Virginia's situation is murkier. Foreclosure is ordinarily accomplished by a trustee's sale under a deed of trust.¹⁵⁴ The applicable statute provides that "[i]f a note or other evidence of indebtedness secured by a deed of trust is lost or for any reason cannot be produced,"¹⁵⁵ the trustee of the deed of trust must obtain a lost-note affidavit from the lender as a prerequisite to foreclosure and must advise the borrower that he or she may petition the circuit court for an order requiring a bond or other protection.¹⁵⁶ This wording implies, but does not explicitly state, that the trustee should begin this process by verifying that the foreclosing party possesses the note. The federal courts applying Virginia

150. 795 F. Supp. 2d 1370, 1372 (N.D. Ga. 2011).

151. GA. CODE ANN. § 44-14-162(b) (West 2012) ("The security instrument or assignment thereof vesting the *secured creditor* with title to the security instrument shall be filed prior to the time of sale in the office of the clerk of the superior court" (emphasis added)); GA. CODE ANN. § 44-14-162.2(a) ("Notice of the initiation of proceedings to exercise a power of sale in a mortgage, security deed, or other lien contract shall be given to the debtor by the *secured creditor* no later than 30 days before the date of the proposed foreclosure." (emphasis added)).

152. *Morgan*, 795 F. Supp. 2d at 1376.

153. *Id.*

154. VA. CODE ANN. § 55-59.1 (West 2012).

155. VA. CODE ANN. § 55-59.1(B).

156. VA. CODE ANN. § 55-59.1(B). The obvious objective of this wording is to make the nonjudicial-foreclosure process conform to UCC § 3-309, the lost-note-affidavit section. See U.C.C. § 3-309 (2006).

law have referred to this section in determining that the note holder need not appear in court and produce the note as a precondition to foreclosure,¹⁵⁷ but those holdings are not quite to the point. It remains unclear whether the trustee has a duty to see the note, although that would surely be a reasonable construction. In any event, there is no provision in the statute for notifying the borrower or making record of the trustee's findings (unless the note in fact proves to be lost, of course).

I. Massachusetts

We have saved the best for last! A far more satisfactory approach to foreclosure of a mortgage by power of sale is illustrated by the Massachusetts Supreme Judicial Court's opinion in *Eaton v. Federal National Mortgage Ass'n*.¹⁵⁸ The Massachusetts statute, like those in Michigan and Minnesota, makes no explicit reference to any necessity of holding the promissory note.¹⁵⁹ In an action by the borrower to enjoin a nonjudicial foreclosure because the foreclosing party conceded to not possessing the note, the court first recognized the familiar principle that having the right to enforce the note was an essential element of common-law judicial foreclosures in Massachusetts.¹⁶⁰ The court then closely read the nonjudicial-foreclosure statute and recognized in it the implicit assumption that "the holder of the mortgage note and the holder of the mortgage are one and the same."¹⁶¹ Hence, the court concluded that holding the note is essential to the right to foreclose: "[W]e construe the term 'mortgagee' in [the nonjudicial foreclosure statute] to mean a mortgagee who also holds the underlying mortgage note."¹⁶²

157. *Blick v. Wells Fargo Bank, N.A.*, No. 3:11-cv-00081, 2012 WL 1030137, at *5 (W.D. Va. Mar. 27, 2012); *Gallant v. Deutsche Bank Nat'l Trust Co.*, 766 F. Supp. 2d 714, 721 (W.D. Va. 2011).

158. 969 N.E.2d 1118 (Mass. 2012).

159. See MASS. GEN. LAWS ANN. ch. 244, § 14 (West 2012).

160. *Eaton*, 969 N.E.2d at 1125.

161. *Id.* at 1128.

162. *Id.* at 1129.

This conclusion makes such obvious good sense that one wonders why the courts in California, Arizona, Idaho, Michigan, and Minnesota did not follow a similar path. However, the Massachusetts court raised a procedural question: how does evidence that the foreclosing party holds the note become a matter of public record and available to the borrower? The court's two-fold answer was creative but also entirely logical. First, the court made its holding prospective only.¹⁶³ This was necessary because prior nonjudicial-foreclosure practice in Massachusetts made no reference to holding the note, so the public record of previous foreclosures would otherwise appear to be incomplete and defective under the court's new holding.¹⁶⁴ Second, the court provided a procedure to be followed in the future:

[A] foreclosing mortgage holder . . . may establish that it either held the note or acted on behalf of the note holder at the time of a foreclosure sale by filing an affidavit in the appropriate registry of deeds The statute allows for the filing of an affidavit that is "relevant to the title to certain land and will be of benefit and assistance in clarifying the chain of title." Such an affidavit may state that the mortgagee either held the note or acted on behalf of the note holder at the time of the foreclosure sale.¹⁶⁵

Thus, the Massachusetts court adopted precisely the same process that is built into the Nevada¹⁶⁶ and Washington¹⁶⁷ statutes to ensure that foreclosures are being conducted by the party who is entitled to enforce the secured obligation and that the record of the foreclosure will reflect that fact.

The *Eaton* opinion is a brilliant reconciliation of the common-law concept that the one who can enforce the obligation can also foreclose the mortgage, the UCC's insistence that one must hold the note or provide a "lost-

163. *Id.* at 1133.

164. *Id.* at 1132-33.

165. *Eaton*, 969 N.E.2d at 1133 n.28.

166. *See supra* text accompanying note 109.

167. *See supra* text accompanying note 117.

note” affidavit in order to have the right to enforce the obligation,¹⁶⁸ and a statute that failed to take these principles explicitly into account. In effect, the court repaired the statute, reading it to say what its drafters would have said if they had possessed a better understanding of the law and the secondary market.

In sum, it appears that the foreclosing party need not provide any proof of entitlement to enforce the note in Texas, Hawaii, Michigan, or Minnesota, but the foreclosing party must adduce such proof in Maryland, North Carolina, Georgia, Massachusetts, and arguably in Virginia. Because deficiency judgments are generally allowed after nonjudicial foreclosures in Texas¹⁶⁹ and Michigan,¹⁷⁰ the risk to the borrower of double liability is particularly significant in those states.¹⁷¹

IV. THE LOST NOTE PROBLEM

As we observed earlier, under Section 3-309 of the UCC, a person who does not have possession of a negotiable note may still enforce it by providing a “lost-note affidavit.”¹⁷² However, this section of the UCC was obviously drafted with judicial enforcement of notes in mind. The provision says the party who seeks to enforce the note must “prove” the note’s terms and the party’s right to enforce, and it provides that “the court” may not “enter

168. It is interesting that the court did not place this holding squarely on the shoulders of UCC Article 3, although it did observe that “[w]e perceive nothing in the UCC 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.” *Eaton*, 969 N.E.2d at 1131 n.26.

169. Texas deficiency claims following nonjudicial foreclosure can be offset by the amount that fair market value of the property exceeded the foreclosure sale bid. TEX. PROP. CODE ANN. § 51.003(c) (West 2012).

170. In Michigan, deficiency judgments are permitted, but if the mortgagee is the successful bidder in a nonjudicial foreclosure, the borrower may attempt to show that the bid at the sale was substantially below true value, in which case a deficiency claim will be barred. MICH. COMP. LAWS ANN. § 600.3280 (West 2012).

171. Hawaii bars deficiency judgments against owner-occupants of residential property following nonjudicial foreclosures if that property is the sole collateral for the loan. HAW. REV. STAT. § 667-38 (West 2012). Minnesota bars deficiency judgments following nonjudicial foreclosures in most circumstances. See MINN. STAT. ANN. § 582.30 (West 2012).

172. See *supra* text accompanying notes 38-40.

judgment” unless the court “finds” that the borrower is adequately protected against double liability.¹⁷³

How do these requirements apply in the context of a nonjudicial foreclosure? If the jurisdiction is one in which the foreclosing party is not required to show entitlement to enforce the note, the question is irrelevant, of course. But, what of the states in which possession of the note is generally required? Common sense indicates that a creditor should have the same opportunity to use the “lost-note” procedure (and the borrower should be given the same protections when the procedure is used) whether enforcement of the note is through a lawsuit on the note or a nonjudicial foreclosure of the mortgage or deed of trust.

Noticeably absent is a process for accomplishing this in the foreclosure context. We know of only one state—Virginia—that has addressed this issue in its foreclosure statute.¹⁷⁴ The Virginia provision was obviously drafted in an attempt to make it work smoothly in conjunction with Section 3-309 of the UCC. If the note has been lost, the foreclosing party must submit an affidavit to the foreclosure trustee, must notify the borrower that the foreclosure will proceed after a fourteen-day delay, and must provide notification that during this period the borrower may petition the circuit court for an order providing “adequate protection” against the risk of double liability on the note.¹⁷⁵ Thus, Virginia’s foreclosure statute recognizes the legitimacy of the “lost-note affidavit” process, and at the same time provides borrowers with essentially the same benefits in a nonjudicial foreclosure that they would have in a judicial action to enforce the note. The one exception, of course, is that in the nonjudicial foreclosure context the borrower must take the initiative to present the issue to a judge.

No other state legislature seems to have thought about this problem. In states employing deeds of trust, a foreclosure trustee might, *sua sponte*, require the foreclosing party to provide a lost-note affidavit if the note

173. U.C.C. § 3-309(b) (2002).

174. VA. CODE ANN. §55-59.1(B) (West 2012).

175. VA. CODE ANN § 55-59.1(B) (“Adequate protection” is typically provided by requiring the foreclosing party to provide a bond or indemnity.)

is missing and might forward that affidavit to the borrower. Of course, nothing in the statutes (except in Virginia) directly requires the trustee to address this issue, and many trustees might be inclined simply to ignore it. In any event, a foreclosure trustee is not a judge and is not likely to feel comfortable telling the foreclosing party that a bond or indemnity must be provided to give the borrower “adequate protection” against double liability. A borrower who becomes aware that the note is lost might apply to a court for such protection, but in the absence of statutory guidance, it is uncertain how the court would react to such a request arising out of a nonjudicial foreclosure. The whole situation is murky and unpredictable.

These complications are worse, of course, in states that use mortgages with power of sale rather than deeds of trust. There, no foreclosure trustee is present to act as an arbiter or insist on the production of a lost-note affidavit in the first place. It beggars belief that mortgage holders will voluntarily prepare such affidavits and send them to borrowers; lenders are not specifically required to do so by statute, and it would obviously complicate the foreclosure process and raise the risk of incurring added cost and delay. That simply isn’t going to happen.

In sum, the lost-note problem is just one more illustration of the failure of most state legislatures to think through the need to coordinate the nonjudicial foreclosure process with the requirements of UCC Article 3. We think legislative amendment is needed to address this point.

V. CONCLUSION

As we have shown, in a number of nonjudicial-foreclosure states, the requirements of UCC Article 3 and the corresponding statutory foreclosure procedures seem to exist in different universes. The problem is larger than a simple mistaken misapplication of the correct statute; the statutes themselves are inadequate.

The Massachusetts Supreme Judicial Court largely solved the problem by creative interpretation.¹⁷⁶ Most of the courts, however, have utterly failed to do so. Two

176. See *supra* text accompanying notes 158-68.

major themes seem to explain the reasoning behind the courts' favoring foreclosure statutes over the UCC—antiquity and a desire for simplicity.

First, we discuss antiquity. Most state nonjudicial-foreclosure statutes were enacted before the widespread development of the secondary mortgage market. The drafters of the statutes could not have foreseen, and thus did not take into account, the broad changes that have taken place in the mortgage industry in recent decades. The fact that the statutes are not clear as to who is entitled to enforce a deed of trust is understandable, since most were drafted at a time when notes were usually held in a portfolio by the original lender, who generally was the party to foreclose in the event of default. The foreclosing party would almost always have been in possession of the note, so the question of who was entitled to enforce the note was not an issue at the time most nonjudicial-foreclosure statutes were drafted.

Second, the courts have an understandable desire to avoid complicating a simple process. It is simple to say that one who has an assignment of the mortgage or deed of trust can foreclose. If we substitute the notion that one must hold the note to foreclose, as UCC Article 3 would demand, then someone must determine whether that requirement has been satisfied. This is not impossible; the determination can be made by the foreclosure trustee, as in Nevada and Washington,¹⁷⁷ or by a preliminary judicial filing, as in Maryland and North Carolina.¹⁷⁸ Doing so, though, deprives the process of some of its simplicity. The California Court of Appeal's opinion in *Debrunner* illustrates this concern well:

The comprehensive statutory framework established to govern nonjudicial foreclosure sales is intended to be exhaustive. Because of the exhaustive nature of this scheme, California appellate courts have refused to read any additional requirements into the non-judicial foreclosure statute. . . . [W]e are not convinced that the cited sections of the Commercial Code (particularly section 3301) displace the detailed, specific, and

177. See *supra* text accompanying notes 109-22.

178. See *supra* text accompanying notes 143-49.

comprehensive set of legislative procedures the Legislature has established for nonjudicial foreclosures.¹⁷⁹

Moreover, the fact that UCC Article 3 requires a complex determination of whether a note is negotiable—merely as a precursor to determining whether Article 3 applies to the note at all—appears only to bolster courts' hesitancy to make additions to statutory foreclosure requirements.

However, Article 3's insistence that the party who enforces a note must possess the note (or comply with the lost-note process) is not a mere technicality; that requirement is there for a reason.¹⁸⁰ It allows the borrower to be sure that he or she is paying, negotiating with, or mediating with the correct party. The borrower who sees proof that the foreclosing party holds the note is ensured against double enforcement, making the borrower certain that any agreement to modify the terms of the loan, engage in a short sale, or compromise the amount owing is an agreement with the appropriate person.

These protections are lost if nonjudicial foreclosures can be completed without holding the note. It is true that if a complete bar to deficiency liability is available under the foreclosure statute (as it is in California), the risk of double liability disappears. But none of the other states that disregard Article 3's requirements fully prohibit deficiency judgments. Moreover, even in the absence of the risk of double liability, the borrower still has a strong interest in knowing for certain that he or she is dealing with the right party, in order to determine that party's policies for loan modification. Beyond this, the orderly administration of justice surely demands that borrowers be able to tell

179. *Debrunner v. Deutsche Bank Nat'l Trust Co.*, 138 Cal. Rptr. 3d 830, 835-36 (Ct. App. 2012) (citations omitted) (internal quotation marks omitted).

180. The use of possession of original promissory notes as an indicium of the right to enforce may seem archaic in an era in which electronic obligations and record-keeping systems have become commonplace. One of the present authors has suggested the creation of a nation-wide electronic registration system for mortgage notes to replace the present system adopted by Article 3. See Dale Whitman, *A Proposal for a National Mortgage Registry: MERS Done Right*, ___ MO. L. REV. ___ (forthcoming 2013). But unless and until such a scheme is adopted, Article 3 is the system we have. We cannot afford to disregard it.

whether the enforcement of their obligations—including enforcement by nonjudicial foreclosure—is being pursued by a party with the legal right to do so.

So, what is to be done? Legislative action is needed. Too many state nonjudicial foreclosure statutes are simply inadequate to address the problems created by the sale of mortgages on the secondary market. The changes brought on by the development of that secondary market have modified the dynamics of the relationship between borrower and lender. When enacted, most state nonjudicial foreclosure statutes afforded adequate protections to the borrower, but the rules have changed. No longer can a borrower obtain a loan and be assured the loan will be held by that lender for the loan's entire life. As the cases above illustrate, courts have, for the most part, displayed an unwillingness to address this problem. Only state legislatures are able to protect borrowers by ensuring that nonjudicial foreclosure statutes are properly amended to require enforcing parties to prove they hold the note and meet the requirements of UCC Article 3.

State legislatures must realize that this can and should be done. This requirement will not significantly hinder the speedy, less expensive alternative provided by nonjudicial foreclosure, and it will afford the protections that borrowers require and deserve in the modern mortgage market.