A baker borrowed funds from an investor to purchase a plot of land on which the baker planned to build a new bakery. In order to secure repayment of the loan, the baker signed a nonnegotiable promissory note and executed a mortgage to the investor.

Five years later, the investor sold her promissory note to a credit union by endorsing the note and promptly delivering it to the credit union. Due to a downturn in business, the baker was unable to make payments on the mortgage. The credit union now seeks to foreclose on the baker's plot of land.

If the court denies the credit union's foreclosure, what is the most likely reason?

A. The mortgage required a separate written assignment in order for the transferee-credit union to enforce the mortgage.

B. The nonnegotiable promissory note required a separate document for assignment to the credit union, so neither the note nor the mortgage transferred.

C. The transfer of the nonnegotiable promissory note modified the terms of the loan, resulting in a release of the baker's personal liability.

D. The transfer of the nonnegotiable promissory note without the mortgage was void.

Explanation:

Transfer of promissory note & mortgage

Transfer of both documents	*Both* documents are transferred unless:
Transfer of note without mortgage	expressly prohibited in note/mortgage forbidden by statute or public policy *or* increases mortgagor's duties, burdens, risks
Transfer of mortgage without note*	Transfer is void

*Jurisdictions are split as to effect of transfer.

To **finance the purchase** of real property, a borrower typically executes two documents that serve as **evidence of the debt**:

Promissory note – a formal "IOU" that sets forth the terms of the loan. It is the primary evidence of the debt and is not recorded in the deed records.

Mortgage (or deed of trust) – a lien that secures the loan by attaching the debt to a real property interest and providing a means of enforcement (eg, foreclosure). It is recorded in the deed records to provide notice of an outstanding debt attached to the real property.

A promissory note can be **assigned** to another (an assignee) **independent** of the mortgage **(Choice D)**. The mortgage automatically transfers with the note once the note has been properly assigned (unless the parties agree otherwise) **(Choice A)**. A negotiable promissory note can be assigned by simply **endorsing and delivering** the note to the assignee. However, a nonnegotiable promissory note requires a **separate assignment** document to transfer ownership.

Here, the investor sought to assign her *nonnegotiable* promissory note by endorsing and delivering it to the credit union. However, this type of promissory note requires that a separate document be executed to assign this interest. The investor failed to execute such a document, so the note (and therefore the accompanying mortgage) did not transfer to the credit union. And since the credit union has no security interest in the land, it cannot initiate foreclosure proceedings against the baker.

(Choice C) A transfer of the mortgagee's interest in the promissory note changes the party who receives payment on the note, but it does not change the terms of the mortgagor's obligation. Therefore, the transfer of the note did *not* modify the terms of the loan or release the baker's personal liability.

Educational objective:

Although a negotiable promissory note can be transferred by endorsing and delivering the note to another, a nonnegotiable promissory note requires that a separate document of assignment be executed to transfer ownership.

References

Restatement (Third) of Property: Mortgages § 5.4 (Am. Law Inst. 1997) (transfer of mortgages).