

Don't Lose It over a Lost Promissory Note

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A promissory note, in simplest terms, is the acknowledgment of a debt. It is a written promise to repay an amount owed by one party to another and contains the terms of such repayment. While a promissory note is not typically a “negotiable instrument” as defined in the UCC, it is intended to be and is codified as an instrument that can be easily transferred by the lender to a third party. Because of this easy transferability, losing a promissory note can have serious consequences for a lender since the possessor of the document is likely the only party who can enforce it.

In the commercial mortgage-backed securities market, promissory notes are often transferred from originating lenders to secondary buyers, as lenders bundle mortgages together and then sell them as income-producing investments to institutional buyers. In the balance sheet loan market, lenders commonly sell off portions of their loans to co-lenders or participants in order to reduce their risk or exposure. Since it is an industry standard practice to maintain promissory notes separately from the rest of the mortgage loan documents, when a mortgage loan is sold or its servicing is transferred to another mortgage loan servicer, the mortgage loan file and the note are both shipped to the new owner or servicer and may result in misplaced or lost promissory notes.

Even if a promissory note is lost, the legal obligation to repay the loan remains. The lender has a right to “re-establish” the note legally as long as it has not sold or transferred the note to another party.

States have different requirements for what is necessary to enforce payment under a note that has been lost, depending on whether the state has adopted the 2002 amendment to U.C.C. § 3-309. The prior version of the section requires a lender seeking enforcement to be “in possession of the instrument and entitled to enforce it when loss of possession occurred.” (U.C.C. § 3-309(a)(i)). An assignee seeking recovery under a lost note in states that have not adopted the amendment may need to furnish additional information or involve the original holder of the note in the enforcement proceedings. New York allows recovery if a party can prove: (i) ownership of the debt; (ii) the facts which prevent production of the note; and (iii) the terms of the note. However, the party will be required to deliver security in twice the amount of the alleged obligation, as determined by a court. (N.Y. U.C.C. § 3-804).

U.C.C. Section 3-804 was recently discussed in *Bank of New York Mellon v. Hardt* (2nd Dep’t June 26, 2019). The plaintiff in *Hardt* was a lender foreclosing on a mortgage made by Hardt as borrower. Plaintiff’s summons and complaint contained a lost note affidavit and a copy of the original note. In support of Hardt’s motion to vacate her default, Hardt called plaintiff’s standing into question. The Supreme Court of the State of New York appointed a special referee to determine whether the plaintiff had standing and, in conjunction with the hearing, the parties stipulated that the only issue in contention was “whether, in the absence of physical possession of the original note or valid assignment thereof, the plaintiff, as a matter of law, lacks standing.” After reviewing the facts, the special referee concluded that the lender had standing to pursue the foreclosure action. The Supreme Court agreed.

On Hardt’s appeal, the Appellate Division, Second Department, found that in denying Hardt’s motion to vacate her default, the Supreme Court “in effect, found that the defendant lacked a meritorious defense...” The Second Department agreed with the referee and rejected Hardt’s contention that “a mortgagee cannot, as a matter of law, establish standing where, as here, the original note was lost and there is no valid assignment of the note to the plaintiff.” In its ruling, the Court recognized that U.C.C. 3-804 is an appropriate vehicle to prove ownership of a lost, destroyed or stolen note if the “holder” “prove[s] ownership of the notes, the circumstances of the loss and their terms” (quoting *Marazzo v. Piccolo*, 163 A.D.2d 369, 370 (2nd Dep’t 1990)). The Court also noted that it recently applied U.C.C. Section 3-804 to a foreclosure action “reiterating that “[p]ursuant to U.C.C. 3-804, the owner of a lost note may maintain an action upon due proof of [1] his [or her] ownership, [2] the facts which prevent his [or her] production of the instrument, and [3] its terms” (quoting *U.S. Bank N.A. v. Cope*, 167 A.D.3d 965, 967 (2nd Dep’t 2018)) (brackets in original).

In contrast, the Second Department, in *Deutsche Bank Nat. Trust Co. v. Anderson*, 161 A.D.3d 1043 (2018), did not find lost note affidavits persuasive and denied summary judgment to the foreclosing lender. While the *Anderson* Court found that the copy of the note produced by lender was “sufficient evidence of its terms,” it also found that the lost note affidavits submitted by the lender were “inconsistent with each other and contain[ed] vague and conclusory statements.” *Anderson*, 161 A.D.3d at 1044. Therefore, it was not clear when the loan servicer or its agent acquired possession of the note or which party (*i.e.*, the loan servicer or its agent) acquired the note. Moreover, plaintiff’s affidavit failed to provide sufficient facts as to when the search for the note occurred, who conducted the search, the steps taken in the search for the note, and when or how the note was lost. Thus, the affidavits failed to sufficiently establish the plaintiff’s ownership of the note. *Anderson*, 161 A.D.3d at 1044-45 (citations omitted).

Additionally, the court in *U.S. Bank N.A. v. Cope* found that a lost note affidavit was insufficient because in it the party claimed without providing more information that “she conducted a diligent search of ‘all of our files,’ consisting of ‘a thorough audit of the customary filing locations, inclusive of the original credit file.’” *U.S. Bank N.A. v. Cope*, 97 U.C.C. Rep. Serv. 2d 593, 2018 WL 6626497 (New York Supreme Court, Appellate Division, December 19, 2018)).

Although the New York courts have reviewed Lost Note Affidavits differently, counsel requesting a Lost Note Affidavit from an existing lender that cannot locate its promissory note to be assigned to the future lender should try to obtain the following: (i) a signed and notarized statement that the physical note has been lost, (ii) a clear statement of the amount, interest rate and repayment terms of the loan, the date the original note was signed, and the proper legal names of all parties involved, and (iii) a description of the circumstances surrounding the loss using as much detail as possible. It should be noted that lenders providing a lost note affidavit will rarely provide the foregoing item (iii) and will only provide the bare minimum affidavit. Details describing the lengths taken to look for the document as well as any other details about its disappearance should be included. The lender must represent to the borrower that it has full rights and title to the note which it cannot now produce. In preparing a Lost Note Affidavit, a review of the loan agreement should be conducted (and a copy of the note itself, if available, produced) to determine whether there are any specific requirements to which the lender must adhere in the event of a lost note in the subject transaction.

An indemnification provision may also be requested in the Lost Note Affidavit so that the future lender and the borrower can be assured that they will not be liable for any additional claims arising from (i) the original note, (ii) any prior or subsequent transfer of the original note or any right or interest therein, or (iii) any matter arising out of the Lost Note Affidavit. Many lenders refuse to provide this indemnity.

The marketplace has evolved to a standard where Lost Note Affidavits are typically proffered and accepted, and most contain bare minimum requirements. These include a limited set of representations that the lender owns the note, has not pledged or assigned it and has the authority to transfer the note. While many borrowers request an indemnification, it is rarely given.