

THE MARKETABILITY OF LOANS UNDER ALABAMA LAW
WHERE THE ORIGINAL LOAN DOCUMENTS WERE LOST,
DESTROYED OR STOLEN

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I. INTRODUCTION

It is a common practice among lenders to make loans to consumers and then subsequently sell those loans to other lenders.¹ The market for these loans, often referred to as the secondary loan market, has exploded over the past ten years.² Generally, the originating bank (the assignor), in exchange for payoff of the loan, transfers its rights of enforcement against the borrower under the note to the purchaser (the assignee). Article 3 of the Uniform Commercial Code and Title 7, Arti-

1. See, e.g., AMSOUTH BANCORPORAION, 1999 ANNUAL REPORT 36 (2000) (noting that most of its consumer loans are subsequently sold).

2. *Secondary Loan Market to the Rescue?*, AM. BANKER, Jan. 16, 2001, at 1, available at 2001 WL 3908739.

cle 3 of the Alabama Code, as adopted, govern the transfer of these instruments in the secondary market.³

In most cases, these laws provide for a seamless transition of rights from assignor to assignee. However, problems may arise in cases where the original loan documents were lost, destroyed, or stolen before the loans were sold in the secondary loan market.

Under Alabama law, it is generally understood that the original document evidencing an obligation is not required to enforce the obligations contained in the document.⁴ However, the plain language of section 3-309 seems to provide to the contrary for negotiable instruments.⁵ Per the statute, only the party in possession of the note at the time the note was lost, destroyed, or stolen may enforce the note. Therefore, if a lender loses the original promissory note and then subsequently assigns that note, the purchaser has no enforcement rights against the borrower.

At least one court has interpreted the statute in this way. In *Dennis Joslin Co. v. Robinson Broadcasting Corp.*,⁶ a United States District Court for the District of Columbia found many reasons supporting enforceability, but could not escape the plain language of section 3-309 requiring possession at the time the note was lost.⁷

While *Joslin* may be the minority view, the plain language of section 3-309 may have a negative effect on the ability of lenders in Alabama to sell loans in the secondary market without the original loan documents. Without a clear statement by the legislature, the Drafting Committee, or the appellate courts on this issue, buyers in the secondary loan market face a greater risk when purchasing these obligations from Alabama lenders.

This Comment takes the position that it was not the intent of the drafters of section 3-309 to prevent enforcement by an assignee under these circumstances. Part II of this Comment discusses the secondary loan market. Part III briefly discusses the statutes governing this issue. Part IV outlines the reasoning of the decisions in other jurisdictions

3. For brevity, unless otherwise specified, all "section" citations in this Comment are to Article 3 of the Uniform Commercial Code, as adopted in Alabama in Title 7, Article 3 of the Code of Alabama.

4. See, e.g., *Bradley v. Nall*, 505 So. 2d 1062 (Ala. 1987) (applying a standard used to admit evidence of lost documents); 52 AM. JUR. 2D *Lost and Destroyed Instruments* § 2 (2d ed. 1970).

5. ALA. CODE § 3-309(a)(iii) (1997).

6. 977 F. Supp. 491 (D.D.C. 1997).

7. *Joslin*, 977 F. Supp. at 495. While the Alabama appellate courts have not directly addressed this issue, courts in other jurisdictions have interpreted identical Uniform Commercial Code provisions. See, e.g., *Yeager v. Gen. Motors Acceptance Corp.*, 719 So. 2d 210, 211-12 (Ala. 1998) (looking to other jurisdiction's interpretations of a similar UCC statute on a case of first impression in Alabama). The analysis of this statute by other jurisdictions may be persuasive in an argument to the Alabama courts.

allowing enforcement notwithstanding the plain language of the statute.

II. SECONDARY LOAN MARKET

The secondary loan market refers to the marketplace for the purchase and sale of loan obligations.⁸ The secondary loan market is comprised of banks, investors, and other entities specializing in the collection of these loan obligations.⁹ This market evolved largely from the real estate problems in the 1990s and has exploded from a total of \$8 billion in trades in 1991 to over \$95 billion in only the first three quarters of 2000.¹⁰

The vast secondary market and its liquidity makes it much easier for banks to balance the risk in their portfolios.¹¹ Due to the costs associated with collecting and servicing problem loans, banks often utilize the secondary loan market to remove distressed debt from their books.¹² Banks also use the secondary loan market to adjust their loan portfolios after an acquisition. For example, after the acquisition of First American Deposit and Guaranty, AmSouth Bank sold \$27.4 million of credit card loans that "represented an underperforming portion of the credit card portfolio . . . in markets outside of AmSouth's franchise."¹³ Many lenders also utilize the secondary loan market as part of an overall lending strategy that focuses more on collecting the origination fee than collecting interest.¹⁴

III. STATUTES GOVERNING THE ASSIGNMENT OF NOTES

A. Authority to Transfer

Section 3-203 governs the authority to transfer a loan instrument, including a promissory note.¹⁵ Specifically, this statute states that the "[t]ransfer of an instrument . . . vests in the transferee *any right* of the transferor to enforce the instrument."¹⁶

8. *Secondary Loan Market to the Rescue?*, *supra* note 2, at 1.

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.*

13. AMSOUTH BANCORPORTAION, *supra* note 1, at 36.

14. *Id.* Although most of AmSouth's consumer loans are subsequently sold, there is an initiative within the bank to double the consumer banking business in order to generate more fees. The 1999 Annual Report states that "[m]ortgage income represented another area of significant growth for noninterest revenues in 1998. Contributing to the growth were higher origination volume and an increase in income from the sale of mortgage loans and related servicing rights in the secondary market." *Id.* at 31.

15. ALA. CODE § 7-3-203 (1997).

16. *Id.* § 7-3-203(b) (emphasis added).

As discussed below, this statute allows for *any right* to be transferred.¹⁷ Nothing in section 3-203 indicates a limitation on the transfer or assignment of rights for a note where the original loan documents were lost, destroyed or stolen.

B. *Enforcement: Who Can Enforce?*

Section 3-301 defines the parties entitled to enforce the instrument.¹⁸ Generally, a person can enforce an obligation if they are in possession of the original documents.¹⁹ The statute also allows for enforcement by a "person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 7-3-309."²⁰ Section 3-309 applies to the "[e]nforcement of lost, destroyed, or stolen instrument[s]."²¹ According to the statute:

(a) A person not in possession of an instrument is entitled to enforce the instrument if

(i) the person was in possession of the instrument and entitled to enforce it when loss of possession occurred,

(b) A person seeking enforcement of an instrument under subsection (a) must prove the terms of the instrument and the person's right to enforce the instrument The court may not enter judgment in favor of the person seeking enforcement unless it finds that the person required to pay the instrument is adequately protected against loss that might occur by reason of a claim by another person to enforce the instrument. Adequate protection may be provided by any reasonable means.²²

As section 3-309(a)(i) indicates, the party must have been in possession of the original documents at the time they were lost, destroyed or stolen. This language, therefore, prevents an assignee from enforcing the note if the original loan documents were lost, destroyed, or stolen while in possession of the assignor.

According to the Official Comment, it appears that the purpose of the statute was to (1) distinguish between "owners" and those with "enforcement rights," and (2) protect borrowers from being forced to pay multiple times on a single instrument.²³

A comparison with the old section 3-804 (which was superseded in

17. See discussion *infra* Part IV.B.

18. ALA. CODE § 7-3-301 (1997).

19. *Id.*

20. *Id.* at § 7-3-301 (iii).

21. *Id.* § 7-3-309.

22. *Id.* (emphasis added).

23. ALA. CODE § 7-3-309 at official comment.

1991 by section 3-309), may clarify the distinction between “owners” and those with “enforcement rights.” Old section 3-804 allowed for an “owner” to recover on a lost or destroyed note as long as it could prove the following: (1) it was the current owner; and (2) the facts preventing production of the note.²⁴ However, new section 3-309(a) allows a “person entitled to enforce,” as distinguished from the “owner” of the instrument, to collect on the lost or destroyed note.²⁵ This distinction is necessary because “ownership” can be governed by property law and be independent of section 3-203 which governs the transfer of rights.²⁶

The following example found in the Official Comment to section 3-203 illustrates this difference:

[A] person who has an ownership right in an instrument might not be a person entitled to enforce the instrument. For example, suppose X is the owner and holder of an instrument payable to X. X sells the instrument to Y but is unable to deliver immediate possession to Y. Instead, X signs a document conveying all of X's right, title, and interest in the instrument to Y. Although the document may be effective to give Y a claim to ownership of the instrument, Y is not a person entitled to enforce the instrument until Y obtains possession of the instrument.²⁷

IV. ARGUMENTS FAVORING ENFORCEABILITY

Even the *Joslin* court admitted that there does “not appear to be a logical reason to distinguish between a person who was in possession at the time of the loss and one who later comes into possession of the rights to the note.”²⁸ This section summarizes the reasoning of courts in other jurisdictions adopting the majority view by holding in favor of enforceability despite the plain language of section 3-309.

A. Application in Time

One possible interpretation of section 3-309 is that it only applies at the time the documents are lost, stolen or destroyed.²⁹ Although it was

24. See *Joslin Co. v. Robinson Broadcasting Corp.*, 997 F. Supp. 491, 494 (1997); U.C.C. § 3-804 (superseded 1991 by § 3-309).

25. See *Joslin*, 997 F. Supp. at 494; ALA. CODE § 7-3-309(a) (1997).

26. See ALA. CODE § 7-3-203 (1997).

27. *Id.* § 7-2-203 official comment 1.

28. *Joslin*, 977 F. Supp. at 495; see also *YYY Corp. v. Gadza*, 761 A.2d 395 (N.H. 2000). The editors for the Uniform Commercial Code Reporter Service in *Gadza* describe the *Joslin* decision as “erroneous” and a “much criticized interpretation and application” of section 3-309. *Gadza*, 41 UCC Rep. Serv. 2d 222, 222 (editor's note).

29. See *Joslin*, 977 F. Supp. at 495.

contrary to the holding in the case, the *Joslin* court proposed the following alternative interpretation of the statute supporting recovery by an assignee:

The drafters of the revised provision may have intended only to draw a distinction based on the enforcement rights of the person in possession at the time the note was lost. If this was the intent, then in order for any person to enforce rights based on a lost note, the person in possession at the time the note was lost must have been "entitled to enforce the instrument." If the person in possession of the note at the time it was lost was merely an owner and not entitled to enforce the instrument, then the UCC provision would bar enforcement of the lost note. This reading of the provision is consistent with the commentary to the revised provision, and it also seems consistent with the purpose of protecting the defendant from a person without legitimate claim to enforcement.³⁰

Under this interpretation, the statute allocates enforcement rights to the party entitled to enforce the documents at the time the originals were lost, destroyed or stolen.³¹ This new right to enforce without the original loan documents vests in the party *at that time* and should be treated as any other transferable right.³² Therefore, courts should not look to whether the *assignee* was in possession of the documents at the time of loss, but rather to whether the *assignor* had enforcement rights at the time the documents were lost.³³ If so, the right to enforce the lost, stolen, or destroyed document should be passed on with all other transferable rights.³⁴

B. Common Law of Assignments

Another interpretation of section 3-309 focuses more on what the plain language of the statute does not say. Several courts have held that section 3-309 does not prevent enforceability because it does not expressly prohibit transferring the right to enforce a promissory note

30. *Id.*

31. The Official Comment to section 3-309 states that "[t]he rights stated are those of 'a person entitled to enforce the instrument' at the time of loss rather than those of an 'owner' as in former Section 3-804." ALA. CODE § 7-3-309 (1997). In other words, when the original documents were lost or destroyed, the right to enforce the documents vested with the party that had enforcement rights, which may not necessarily be the owner of the document.

32. See discussion *infra* Part IV.C.

33. *Id.*; see also, e.g., *Gadza*, 761 A.2d at 400-01 (determining as a first step whether the assignor had the right of enforcement).

34. See ALA. CODE § 7-3-203(b) (1997) (allowing "any right" to be transferred); see also discussion *infra* Part IV.C.

where the original documents were lost, destroyed, or stolen.³⁵ In *Beal Bank, S.S.B. v. Caddo Parish-Villas South, Ltd.*,³⁶ the borrower claimed that section 3-309 barred the assignee from enforcing a loan agreement where the assignor lost the original loan documents.³⁷ The court disagreed and held that “[w]hile the language of Section 3-309(a) is unambiguous . . . , there is nothing in the language of Section 3-309(a) or the legislative history to indicate that a person entitled to enforce a negotiable instrument under Section 3-309 cannot assign these rights to another party.”³⁸ The court instead relied on Louisiana’s version of 1-103³⁹ of the Uniform Commercial Code to import a state common law principle allowing the assignment of this right.⁴⁰

C. “Any Right”

As discussed above, section 3-203(b) allows for “any right” to be transferred from assignor to assignee.⁴¹ In *NAB Asset Venture II v. Lenertz, Inc.*,⁴² the Minnesota Court of Appeals held that section 3-309 does not limit the rights an assignor could transfer to an assignee because to do so would be contrary to section 3-203(b), the statute governing the transfer of rights in a loan assignment.⁴³ According to the court, “any right” includes the right to “collect under the lost, destroyed or stolen instrument statute [section 3-309].”⁴⁴

Further, nothing in the language, comments, or legislative history of section 3-309 expresses an intent to limit the rights that can be transferred under section 3-203. Therefore, as discussed in Part IV.A of this Comment, if the assignor has the right to enforce the note at the time the original documents were lost, stolen, or destroyed, then the right to transfer should be transferable just as any other right.

35. See *Southeast Invs., Inc. v. Clade*, No. CIV. A. 3:97-CV-1799-L, 1999 WL 476865, at *2 (N.D. Tex. July 7, 1999); *Beal Bank, S.S.B. v. Caddo Parish-Villas S., Ltd.*, 218 B.R. 851 (N.D. Tex. 1998), *appeal dismissed*, 174 F.3d. 624 (5th Cir. 1999); *Nat. Loan Investors, L.P. v. Joymar Assocs.*, 767 So. 2d 549, 551 (Fla. Dist. Ct. App. 2000) (preventing foreclosure would create windfall for defendant); *NAB Asset Venture II v. Lenertz, Inc.*, No. C4-97-2181, 1998 WL 422207, at *3-*4 (Minn. Ct. App. July 28, 1998); *Bobby D. Assocs. v. DiMarcantonio*, 751 A.2d 673, 675 (Pa. Super. Ct. 2000); *Gadza*, 761 A.2d at 401 (“[N]either the plain language nor the official comment to [section 3-309] supports the . . . determination that a person entitled to enforce a negotiable instrument cannot assign that right or that the intent behind section 3-309 was to displace the common law of assignments.”).

36. 218 B.R. at 851.

37. *Id.* at 853.

38. *Id.* at 854.

39. ALA. CODE § 7-1-103 (1997).

40. See *Beal Bank*, 218 B.R. at 854.

41. See ALA. CODE § 7-2-203(b) (1997); see also discussion *infra* Part III.A.

42. 1998 WL 422207, at 3-4.

43. *Id.* at *4. See MINN. STAT. §§ 336.3-309, 336.3-203(b) (1996).

44. *NAB Asset Venture II*, 1998 WL 422207, at *3.

D. *Common Law on Unintentional Loss*

As a general principle, the loss of the original document should not affect the rights transferred from assignor to assignee.⁴⁵ Barring recovery by an assignee because of lost documents is contrary to the "well established common law doctrine that an unintentional loss of a written evidence of debt does not extinguish the rights and obligations of the parties thereto."⁴⁶

A treatise on the Uniform Commercial Code supports this position with regard to negotiable instruments:

Furthermore, the owner of an instrument may not be in possession of it, even though someone intended to transfer all of his or her rights to the person. Such non-holder transferees are protected by the property principle that a transferee of property, be it real property, tangible personal property or intangible property, gets all of the rights of his or her transferor as a result of the transfer.⁴⁷

Similarly, allowing assignees to enforce agreements lost by the assignor under section 3-309 is consistent with several federal courts of appeals decisions allowing receiver banks to collect lost notes of failed financial institutions.⁴⁸

E. *Fulfilling the Purpose of the Statute*

One of the main purposes of the revised section 3-309 is to protect borrowers from multiple obligations on a single note.⁴⁹ Most courts addressing this issue have found that an agreement requiring the assignee to indemnify the borrower against subsequent claims on the note would provide "adequate" protection as required by section 3-309.⁵⁰

45. See *Buster v. Gale*, 866 P.2d 837, 843-44 (Alaska 1994).

46. *Buster*, 866 P.2d at 843, (citing 52 AM. JUR. 2D *Lost and Destroyed Instruments* § 2 (2d ed. 1970)).

47. FREDERICK M. HART & WILLIAM F. WILLIER, *NEGOTIABLE INSTRUMENTS UNDER THE UNIFORM COMMERCIAL CODE* § 12.03[1] (1997).

48. See *Sarasota v. Griffiths*, No. CV940361497, 1996 WL 724097, at *2 (Conn. Super. Ct. Dec. 3, 1996) (holding that an assignee "stands in the shoes" of the assignor and accordingly has the same rights as the assignor and citing *RTC v. Love*, 36 F.3d 972, 974-75 (10th Cir. 1994)); *FDIC v. Selaiden Builders, Inc.*, 973 F.2d 1249, 1254 (5th Cir. 1992); *Resolution Trust Corp. v. Camp*, 965 F.2d 25, 29 (5th Cir. 1992); *Southeast Invs., Inc. v. Clade*, No. CIV. A. 3:97-CV-1799-L, 1999 WL 476865, at *2 (N.D. Tex. July 7, 1999).

49. See ALA. CODE § 7-3-309 (1997) (stating that borrower should be "adequately protected against loss that might occur by reason of a claim by another person to enforce the instrument.").

50. See *Beal Bank, S.S.B. v. Caddo Parish-Villas S., Ltd.*, 218 B.R. 851, 855-56 (N.D. Tex. 1998); *Clade*, 1999 WL 476865, at *2 n.4; *Bobby D. Assocs. v. DiMarcantonio*, 751 A.2d 673, 676 (Pa. Super. Ct. 2000).

Therefore, allowing the assignee to enforce a note without the original loan documents does not contravene the purposes of the statute.

V. CONCLUSION

The plain language of section 3-309 appears to prohibit recovery by an assignee without the original loan documents. The Alabama courts have not yet interpreted the statute on this issue. Therefore, the rights of the assignee purchasing a loan without the original documents are uncertain under Alabama law. This uncertainty increases the risk and subsequently decreases the value of negotiable instruments without original documentation held by primary lenders in Alabama's secondary loan market.

The majority of courts in other jurisdictions have upheld the obligations where assignees were not in possession at the time the original documents were lost, destroyed, or stolen, despite the clear language of the statute. These courts found that it was not the intent of the drafters to limit the ability of the last party that possessed the original documents from being able to further assign those obligations. Further, these courts found that the concerns of the drafters regarding multiple obligations under the note can be cured by an indemnification agreement, thereby satisfying the purpose of the statute.

The Uniform Commercial Code Reporter Service Editors to *Gadza* recommend that the Drafting Committee "get rid of the issue once and for all" by correcting the statute.⁵¹ However, enforceability may still turn on the deciding court's rules of statutory interpretation. As in *Joslin*, the periphery surrounding the black letter language of the statute may never be considered. Therefore, the Drafting Committee should change the language to clearly reflect the intent behind the statute.

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51. See *Gadza*, 41 UCC Rep. Serv. 2d at 222 (editor's note). The Drafting Committee for revised U.C.C. Article 9 has attempted to do this by expressly rejecting the *Joslin* holding in Official Comment 5 of the revised Article 9.

