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THE FNMA/FHLMC UNIFORM HOME IMPROVEMENT LOAN NOTE: THE SECONDARY MARKET MEETS THE CONSUMER MOVEMENT

PATRICK A. RANDOLPH, JR.†

In this Article Professor Randolph explores the implications of the language used in the new uniform Home Improvement Loan Note that is required by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. The significance of the uniform instrument extends beyond transactions with either the FNMA or the FHLMC; the instrument is in fact likely to become the "industry standard" within a short time. Professor Randolph has provided an extensive analysis of the instrument, one which should prove valuable to courts and practitioners alike. Professor Randolph examines the HIL note in light of North Carolina law in the final section of the Article. In conclusion Professor Randolph argues that the uniform HIL note will be a welcome addition to the field.

As inflated interest rates and prices continue to bar American homeowners from relocating to the "home of their dreams," many may seek to realize some of those dreams by remodeling their existing houses. Money for such remodeling will also be expensive, but remodelers at least can continue to benefit from existing lower interest fixed payment loans that they undertook when they purchased their homes.[1] Because of the existence of first lien mortgages

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1. Due to the recent frantic escalation of mortgage interest rates, homeowners who bought houses as recently as one year ago would be unable to afford to buy the same home today. In fact, today's home loan industry has abandoned, perhaps permanently, the 30-year, fixed rate mortgage that has been the market staple for the past 45 years. Today's mortgage rates include provisions which permit increases in rates as the cost of money grows. See, e.g., Adjustable Mortgage Loan Instruments, 46 Fed. Reg. 24,148 (1981) (to be codified in 12 C.F.R. § 545). Even these "wide open" mortgage terms may be superseded by short term "balloon" loans or loans whose principal amount grows, rather than reduces, over time. See Balloon Payment Mortgage Loans and Reverse Annuity Mortgage Loans, 46 Fed. Reg. 37,714 (1981) (proposed rule).

Homeowners fortunate enough to have avoided today's "creative financing" quagmire may enjoy their good fortune only so long as they keep their present homes. Most home mortgages written in the last ten years include some form of "due on sale" clause, which gives lenders the right to terminate existing interest rate arrangements when the property is sold. Although a few states have restricted state chartered lenders from using the clause to raise interest rates, most of the recent decisions have upheld the clause. See Dunn & Nowinski, Enforcement of Due-On-Transfer Clauses: An Update, 16 Real Prop., Prob. & Tr. J. 291 (1981); Randolph, The FNMA/FHLMC Uniform Home Improvement Loan Instruments, A Commentary and Critique, 16 Real Prop., Prob. & Tr. J. 546 (1981). Further, the current weight of authority recognizes

or deeds of trust which secure these earlier purchase money loans, however, potential home remodelers may find that lenders are unwilling to take the risk of lending substantial amounts secured by junior security positions,[2] even when the purpose is to improve the security. If lenders are willing to take such risks, they may do so only at interest rates or terms substantially more onerous than those available for first lien loans.

To the aid of such hapless homeowners have come the two central characters in the formerly booming money market for the first lien purchase money loans: the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (Mortgage Corporation or Corporation).[3]

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federal savings and loan associations, by far the largest single source of conventional home purchase loans, as exempt from state law regulation of due-on-sale clause enforcement. Dunn & Nowinski, supra, at 292-300. A few recent cases have cast some doubt upon this issue. See De la Cuesta v. Fidelity Fed. Sav. & Loan Ass'n, 121 Cal. App. 3d 328, 175 Cal. Rptr. 467, pet. denied, — Cal. 3d —, — P.2d —, — Cal. Rptr. —, appeal docketed, No. 81-750 (U.S. Oct. 20, 1981); Panko v. Pan Am. Fed. Sav. & Loan Ass'n, __ Cal. App. 3d __, 174 Cal. Rptr. 240 (1981); Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981).

The North Carolina Supreme Court, in a relatively early opinion in the due-on-sale controversy, upheld the validity of the clause under most circumstances. Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976), noted in 55 N.C.L. Rev. 310 (1977) and 13 Wake Forest L. Rev. 490 (1977).

2. Mortgagees with a junior priority status often find themselves in a delicate position when the borrower defaults on a senior lien. Since they are secured only by the surplus available after foreclosure of prior liens, such mortgagees are much more affected by a slight depreciation in the value of the security, a phenomenon which often accompanies the financial embarrassment of the borrower. In order to protect their position, such junior mortgagees often must postpone the senior lien foreclosure or pay off the senior lien (becoming subrogated to it). See G. Osborne, G. Nelson & D. Whitman, Real Estate Finance Law §§ 7.2-.5, at 426-35 (1979) [hereinafter cited as Osborne & Nelson]. The junior mortgagee must evaluate its options and produce the necessary funds to protect itself in a relatively short period of time and in the shadow of the encroaching senior foreclosure.

In light of the special risks of junior priority, it is not surprising that home improvement lenders traditionally have been specialists, equipped to evaluate the risks inherent in their security and to respond when these risks become real dangers. These "specialists" have included some commercial banks and savings and loan associations, but have also included a variety of mortgage bankers and consumer loan specialists. The market for home improvement loan money, then, has tended to bear little relationship to that for home purchase loan money. Although conditions have varied, home improvement loans in excess of $10,000 have been rare, maximum terms have tended to range from 6 to 10 years, and interest rates have been considerably higher than purchase money first lien loans.

3. FNMA and the Mortgage Corporation are distinct entities with different organizational structures and business approaches, although they perform a similar function in purchasing home mortgages. Their present role in the conventional mortgage market began with the Emergency Home Finance Act of 1970, Pub. L. No. 91-351, 84 Stat. 450 (1970) (codified as amended in scattered sections of 12 U.S.C.), which implemented a plan to establish a secondary market for conventional mortgages, primarily first lien mortgages on single-family homes. The Act gave FNMA the authority to buy conventional mortgages from mortgage companies, commercial and savings banks, savings and loan associations and a variety of other sellers. The newly created Mortgage Corporation, on the other hand, was restricted generally to purchasing from federally chartered or insured savings and loan associations, federally insured banks, the Federal Home Loan Banks themselves, Federal Savings and Loan Corporation (FSLIC), and Federal Deposit Insurance Corporation (FDIC). FNMA traditionally has been most active in purchasing loans from mortgage bankers or other loan originators that are not primarily dependent on savings. In addition to buying conventional mortgages, FNMA has continued in its role as the major secondary market purchaser of VA and FHA insured loans. The Mortgage Corporation, with more limited scope of authority but a close relationship with the federally chartered and insured savings and loans who make up the Federal Home Loan Banking System, has purchased the bulk of its loans from these savings and loan associations. See Osborne & Nelson, supra note 2, § 4.3, at 660.

Over the past two decades, using money drawn from capital rich sectors of the economy, these organizations have fueled the money market for conventional purchase money loans by purchasing such loans from originating lenders.[4] Although other "secondary market makers" have appeared in recent years, FNMA and the Mortgage Corporation continue to dominate the secondary market for home loans. Now, after painstaking market research and a lengthy development process, both organizations have announced programs[5] to acquire home improvement loans—in most cases loans secured by more risky second or third lien security instruments on owner occupied homes. These purchase programs will increase the money supply for such loans, and the loan amounts and payment schedule of permissible loans under the programs likely will be more attractive than those currently available.[6]

A key element in all FNMA and Mortgage Corporation purchase programs is the requirement that originating lenders use the uniform note and mortgage or deed of trust forms that FNMA and the Mortgage Corporation developed jointly. Thus when FNMA and the Mortgage Corporation resolved to prepare programs for the purchase of Home Improvement Loans (HILs), one of their first projects was the development of a uniform note and deed of trust or mortgage instrument that would provide adequate security in every state, be attractive to traditional home improvement lenders and respond to

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In 1978, Congress extended the market areas of the Mortgage Corporation, giving it authority to purchase mortgages from mortgage bankers and other sources traditionally reserved to FNMA. Act of Oct. 31, 1978, Pub. L. No. 95-557, § 321(b), 92 Stat. 2080 (1979) (codified at 12 U.S.C. § 1454(a)(1) (Supp. III 1979)).

FNMA is a federally chartered private corporation whose stock is traded publicly. Osborne & Nelson, supra note 2, § 11.3, at 659. Its primary source of outside funds for its mortgage purchase activity has been debt financing. Id. at 660. The Mortgage Corporation is an income tax-exempt corporation owned by the Federal Home Loan Banks. Id. It has both private and public features and legally is categorized as a corporate instrumentality of the United States. See id. Its primary source of funds is its sale of "mortgage pass through" securities of various types. See id., §§ 5.35, 11.3, at 363, 661; Sivesind, Mortgage-Backed Securities, The Revolution in Real Estate Finance, Fed. Res. Bank N.Y. Rev., Autumn 1979, at 1-10. These securities transfer an ownership interest in mortgages purchased and packaged for resale by the Mortgage Corporation, which additionally guarantees principal and interest payments. Osborne & Nelson, supra note 2, § 11.3, at 661.

Recently, both organizations have been considering structural changes that will broaden their activities and make each more like the other. See [1981] 8 Hous. & Dev. Rep. (BNA) 661; [1981] 9 Hous. & Dev. Rep. (BNA) 197.

4. See Osborne & Nelson, supra note 3, § 11.3, at 658-59. In most cases, originating lenders continue to "service" loans sold on the secondary market. Id. § 11.1, at 640. Borrowers typically are unaware that their mortgage loan has been sold.

5. See generally Randolph, supra note 1, at 547 n.2, 551-60. FNMA has developed plans for a program. [1981] 8 Hous. & Dev. Rep. (BNA) 865. The FNMA program had not been implemented as of this writing because FNMA has elected to use variable interest rate provisions in lieu of the fixed rate provisions in the Note form discussed herein, and is still in the process of drafting these provisions. Id. There is some likelihood that both FNMA and the Mortgage Corporation will expand their junior lien programs by early 1982 to include junior lien loans for purposes other than home improvement. FNMA has approved plans to buy junior lien loans secured by properties in which it also holds the senior lien position. [1981] 8 Hous. & Dev. L. Rep. (BNA) 782.

6. The Mortgage Corporation's current program includes Home Improvement Loans (HILs) with maximums of $60,000 for two-to-four family homes (owner occupied), $40,000 for single family homes and $15,000 for condominium units. Maximum terms will run to 20 years for loans of more than $30,000, or 15 years for smaller loans. Interest rates have hovered around 17%, about one point higher than the market price for fixed-rate, first-lien loans.

the varying customs and legal requirements in each jurisdiction.[7]

Other secondary market purchasers, recognizing the value of having uniform instruments in evaluating risks and remarketing loans they purchase, also customarily require that FNMA/Mortgage Corporation uniform instruments be used in loans they buy. Because originating lenders desire the flexibility of being able to place loans on the secondary market, and because the uniform instruments themselves are of excellent quality, many lenders customarily use the uniform instruments in all their loan transactions. The drafters of the HIL instruments, therefore, were aware that their product might well become the "industry standard" within a short time.[8]

Perhaps the most significant obstacle facing the drafting team was that in many jurisdictions home improvement loans, unlike purchase money home loans, are regarded as "consumer loans," subject to the complex and demanding consumer protection statutes developed by state legislatures in response to the abuses in the consumer credit industry in recent decades. Although many consumer credit abuses occurred in credit sales outside the home improvement industry, such as in sales of furniture and automobiles, and in various door to door solicitations, there can be no denying that the siding, storm window, home insulation and other home improvement contractors have earned their share of just criticism for harsh credit practices. In most states consumer protection laws have been clearly drawn to apply to home improvement loans, and the drafters were forced to find ways to develop a marketable program with uniform language that nevertheless responded to these restrictive consumer protection provisions.

This Article outlines the drafters' response to these challenges in the development of the uniform HIL note. The descriptive portions of the Article contain exhaustive historical analysis: the author's objective was to provide all information available about the reasons the drafters used the language they did. If the HIL instruments achieve the prominence of the FNMA/FHLMC first lien purchase money instruments, this historical data may prove helpful to practitioners or courts in dealing with the many problems of application which will arise. In the short run, of course, the close descriptive analysis will be of benefit primarily to practitioners advising lenders who are considering using the HIL instruments in a home improvement lending program. There is particular emphasis on the Mortgage Corporation's HIL program, the only program actually functioning when the Article was completed. There are frequent references to the basic contract documents affecting the program—the Sellers' and Servicers' Manuals.[9]

7. For a detailed discussion of the drafting objectives and the tactics used to achieve them, see Randolph, supra note 1, at 555-59.

8. FHLMC analysts estimate that 80% of the conventional first lien mortgage loans in 1980 were written on the FNMA/FHLMC uniform instrument forms. Due to the current proliferation of "creative financing" interest provisions, the impact of the first lien forms likely will decline, at least until practices again become more standard. Secondary market considerations continue to press the need for uniformity. See, e.g., [1981] 8 Hous. & Dev. Rep. (BNA) 747 (comments of a representative of the Mortgage Bankers Association).

9. These publications are available to persons eligible to sell loans to the Mortgage Corpo-

The evaluative aspects of the Article provide a commentary on the acceptability of the instruments as consumer lending tools. The author believes that FNMA and the Mortgage Corporation must recognize the significance of their drafting decisions on prevailing lending practices, and must attempt, within practical limits, to acheive as much fairness to the borrower as is consistent with adequate protection for the lender.

The Article is based upon research undertaken by the author in the files of the Federal Home Loan Mortgage Corporation and its counsel during the summer of 1980. The author enjoyed less access to drafters representing FNMA but did have complete freedom to explore the written record of the joint drafting enterprise. This Article discusses issues primarily relating to the HIL note instrument alone. A companion article, providing a similar descriptive and evaluative approach to the mortgage and deed of trust instruments, has been published elsewhere.[10]

I. "PLAIN LANGUAGE" DRAFTING

An important difference between the uniform HIL Note form[11] and the first lien note[12] is apparent immediately. The HIL Note is written in "plain language."[13] Only five jurisdictions presently have statutes in effect requiring that consumer instruments be written in "plain language."[14] The first "plain language" statute, New York's, specifically exempts the FNMA/FHLMC in-

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ration. They constitute a part of the contract of sale. See Federal Home Loan Mortgage Corp., Home Improvement Loan Sellers' Manual 1 (1980) [hereinafter cited as Sellers' Manual]; Randolph, supra note 1, at 554. Those participating in the program should be aware particularly of the warranty contained in Sellers' Manual § 1.102s, to the effect that all federal, state and local laws, including any consumer disclosure laws, have been complied with. Thus, the Seller, not the Mortgage Corporation, bears the ultimate responsibility to establish that the HIL uniform instruments conform to laws affecting that Seller's business.

10. Randolph, supra note 1. That Article contains considerably more detail about the Mortgage Corporation's HIL program as well as a discussion of each major covenant in the Mortgage/Deed of Trust instrument itself.

11. See North Carolina Uniform Note Instrument, infra Appendix A [hereinafter cited as N.C. Note].

12. FNMA/FHLMC Uniform First Lien Note Instrument (copy on file in N.C.L. Rev. office) [hereinafter cited as First Lien Note].

13. For a summary of the drafting techniques used in the development of the uniform first lien "plain language" instruments, see Browne, Development of the FNMA/FHLMC Plain Language Mortgage Documents—Some Useful Techniques, 14 Real Prop., Prob. & Tr. J. 696 (1979). See generally Kellogg, A Plan for Drafting in Plain English, Cal. St. B.J. 154 (1981); Plack, The Plain Language Movement: An Overview with Recent Developments, 36 J. Mo. B. 40 (1980).

14. Conn. Gen. Stat. Ann. §§ 42-151 through -158 (West Supp. 1980); Hawaii Rev. Stat. §§ 487A-1 through -3 (Supp. 1980); Me. Rev. Stat. Ann. tit. 10, §§ 1121 through 26 (1980); N.J. Stat. Ann. §§ 56:12-1 through -13 (West Supp. 1981); N.Y. Gen. Oblig. Law § 5-702 (McKinney Supp. 1980).

The Connecticut statute contains quite precise guidelines for "plain language" drafting, including: maximum average words per sentence (21), maximum sentence length (50 words), average syllables per word (1.55), and length restrictions on longest and average paragraph. Id. The requirements, however, are "softened" somewhat by the "substantial compliance" provisions of Conn. Gen. Stat. Ann. § 42-152 (West Supp. 1980). In several instances, the HIL Note does not precisely comply with the Connecticut requirements, but the drafters sought substantial compliance. Of course, rigid guidelines for "plain language" drafting in each jurisdiction would destroy the uniformity goal of the FNMA/FHLMC enterprise.

struments from its requirements.[15] Nevertheless, FNMA and the Mortgage Corporation voluntarily complied with the New York statute and used "plain language" instruments in the single family first lien program in that state.[16] The HIL Note is modeled after the New York first lien note. Changes were made to suit the special requirements of a junior lien instrument. The drafters of the New York first lien note had no intention of altering in any way the substantive rights created by the first lien uniform note language used in other jurisdictions. Obviously, the HIL Note should be interpreted in the same manner.

The drafters did not write the HIL Mortgage[17] in "plain language" because of the concern that such a document would have far exceeded the length restrictions they had established. The New York "plain language" HIL Mortgage, for instance, is eight pages long in contrast to the four-page uniform instrument. Connecticut's statute exempts such security instruments from its requirements.[18] Others do not.

II. HIL Note Paragraph 1: Borrower's Promise to Pay[19]

Consistent with industry practice, the drafters used two basic instruments: a negotiable note and a separate mortgage setting forth the real estate security. The drafters have taken special care throughout the documentation to insure that the benefits of negotiability are preserved wherever possible. This practice will be of scant significance in the Corporation's HIL pilot program, since the Corporation will buy only participations and will buy only from originating lenders. Since the HIL forms quite possibly will be used later by FNMA or the Corporation for whole loan purchases in subsequent programs, or by lenders who sell to other secondary market purchasers, the Article will discuss the negotiability provisions in the instruments.

Preservation of the benefits of negotiability is a difficult task in a home improvement loan program. The FTC has adopted regulations[20] that require that a consumer borrower's claims and defenses against a contractor be available against any assignees of the debt instrument. The regulations require that the debt instrument in such cases contain a legend appraising assignees that the borrower's claims and defenses remain available, thus making it impossible for assignees to become holders in due course. These regulations are aimed primarily at debts arising from an original contract between the contractor and the homeowner, rather than from independent loans made by a

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15. N.Y. Gen Oblig. Law § 5-702a2 (McKinney Supp. 1980).

16. See Browne, supra note 13, at 698.

17. See North Carolina Uniform Deed of Trust Instrument, infra Appendix B [hereinafter cited as N.C. Deed of Trust].

18. Conn. Gen. Stat. Ann. § 42-156 (West Supp. 1980).

19. See N.C. Note, infra Appendix A, Para. 1.

20. Preservation of Consumers' Claims and Defenses, 16 C.F.R. § 433 (1981). The Federal Trade Commission's Holder in Due Course Rule took effect on May 14, 1976. 40 Fed. Reg. 53,506 (1975). Section 433 by its terms applies to financing of the cost of "goods and services" and does not apply to purchase money loans for acquisition of the property itself. See also note 31 infra.

lending institution. Since the pilot HIL program will not involve contractor paper,[21] the uniform documents do not include the required FTC legend. The regulations are nevertheless broad enough to require the legend when certain affiliations exist between the contractor and the lender,[22] and under the Seller's Manual sellers are permitted to amend the uniform note instrument to include the FTC legend when appropriate.[23]

Even when the FTC regulations do not apply, various forms of state consumer regulation[24] restrict the assignability of consumer paper. There is particular emphasis placed upon the preservation of the defenses of the homeowner rising from inadequate performance of the home improvement contract.[25] In some cases these statutes also turn on an "affiliation" between the lender and contractor.[26] In other cases, there is an absolute prohibition

21. Sellers' Manual, supra note 9, at § 1.102i.

22. The "affiliation" necessary to fall within the rule consists of common control ownership between contractor and lender or else "any understanding, procedure, course of dealing or arrangement, formal or informal between a [lender] and [contractor] in connection with the sale of goods or services to consumers or the financing thereof." 16 C.F.R. §§ 433.1(d), (g), (f), .2b. Preservation of Consumer's Claims and Defenses, Statement of Enforcement Policy on Trade Regulation Rule, 41 Fed. Reg. 34,594 (1976). The burden of enforcement falls upon the contractor, not the lender. The regulations make it an unfair trade practice for the contractor to accept the proceeds of a loan which violates the requirement. Comments received after circulation of the HIL exposure drafts, however, indicated that many lenders uniformly have included the FTC legend on all their consumer loan note instruments.

23. Sellers' Manual, supra note 9, at Exhibit 18c, at 75.

24. E.g., the Uniform Consumer Credit Code (U.C.C.C.), which has been adopted in some form in eleven states, restricts the negotiability of consumer paper in some circumstances. The original version of the U.C.C.C. was approved by the National Conference of Commissioners on State Laws and the American Bar Association in 1968, and has been adopted, with a variety of modifications, in seven states. See Colo. Rev. Stat. §§ 5-1-101 to -12-105 (1973 & Supp. 1978); Idaho Code §§ 28-31-101 to -39-108 (1980); Ind. Code §§ 24-4.5-1-101 to -6-203 (1976); Okla. Stat. tit. 14A, §§ 1-101 to 9-103 (1971); Utah Code Ann. §§ 70B-1-101 to -9-103 (1980); Wis. Stat. §§ 421.101 to 428.106 (1979); Wyo. Stat. §§ 40-14-101 to -702 (1972). A new version of the U.C.C.C. was adopted by the National Conference in 1974 and by the American Bar Association in 1975. This version has been adopted in three states. See Iowa Code Ann. §§ 537.1101-.7103 (West Supp. 1980); Kan. Stat. Ann. §§ 16a-1-101 to -9-102 (1974); Me. Rev. Stat. Ann. tit. 9-A, §§ 1.101 to 7.127 (West Supp. 1980). South Carolina's Consumer Protection Code, S.C. Code §§ 37-1-101 to -9-102 (1976 & Supp. 1980), is based on a combination of the 1969 and 1974 versions of the U.C.C.C.

Individual states' limitations on the holder in due course doctrine are referred to in Osborne & Nelson, supra note 2, § 5.30, at 327-28.

25. The usual statutory approach is to prohibit the use of negotiable instruments in seller-financed consumer transactions. E.g., Mass. Gen. Laws Ann. ch. 255, § 12C (West Supp. 1980); Uniform Consumer Credit Code § 3.307. Another approach is to make the assignee or holder of an instrument subject to the borrower's defenses in some circumstances. E.g., Cal. Civ. Code § 1804.2(a) (West Supp. 1980); Mo. Rev. Stat. § 408.405 (1979).

Some statutes permit the consumer to cut off the holder in due course status if the consumer gives the assignee or holder proper notification of the consumer's defenses within the period prescribed in the statute. E.g., Ohio Rev. Code Ann. § 1317.031 (Page 1979).

26. When a direct loan rather than seller financing is involved, the use of negotiable instruments is not prohibited, but the consumer may be allowed to assert defenses against the holder if the consumer can show a close relationship between the seller and the lender. See Uniform Consumer Credit Code § 3.405. The 1968 version of the U.C.C.C. prohibited negotiable consumer paper only if the deal was seller financed. This section of the 1974 version makes the direct loan lender subject to the consumer's defenses if there is a close relationship between the lender and the seller and the lender either acts in a manner or receives benefits of a kind that ties the lender closely to the particular sale transaction. See also Wis. Stat. Ann. §§ 422.406 to -.408 (West 1974), which provides that a lender in an "interlocking" consumer loan may be subject to the claims and

upon certain aspects of negotiability.[27] Some of these statutes[28] would permit consumer defenses against the note only when the note is in the hands of the lender, while others[29] would also affect the note as it passes through the hands of subsequent purchasers, such as the Mortgage Corporation. Finally, case law[30] in certain states, like the FTC rule, restricts holder in due course status when an affiliation exists between contractor and lender.

The FTC is proposing more extensive holder in due course regulations, which may require another form of response in the uniform instruments.[31] The status of these proposed regulations remains uncertain, although it is possible they will become effective even before this article is published. Included in these proposed regulations is a requirement that the preservation of defense language be included in consumer loan instruments whenever the loan proceeds will pay for consumer goods and services, even when there is no "affiliation" between the lender and the contractor supplying the goods and services. Pending the FTC's action, the uniform instruments continue to be drafted to preserve negotiability. Notwithstanding the extensive warranties[32] it will obtain from sellers, the Corporation continues to rely upon negotiability because the status of holder in due course of a negotiable instrument gives different protection and may insulate the secondary market buyers when warranties fail due to financial distress of the warrantor. Certain forms of borrower defenses likely would occur, if at all, throughout the portfolio of the particular lender or group of lenders. For instance, the lender might have originated a large number of loans relating to a home improvement program by a particularly

defenses of the consumer. An "interlocking relationship" may arise, *inter alia*, if the lender is aware that the contractor sometimes fails to perform his contracts.

27. See note 25 supra; see generally Hudak and Carter, The Erosion of the Holder in Due Course Doctrine: Historical Perspective and Development—Part II, 9 U.C.C.L.J. 235 (1977) (summarizing holder in due course legislation in each of the states).

28. Uniform Consumer Credit Code § 3.405 subjects the lender who is closely related to the seller to the consumer's defenses, but nothing prevents that lender from selling to a holder in due course. The same result obtains under Wisconsin's "interlocking" loan statute, Wis. Stat. Ann. § 422.408 (West 1974).

29. Under Mo. Rev. Stat. § 408.410(1) (1979), the consumer's defenses are preserved if the seller arranged the loan. Unlike Uniform Consumer Credit Code § 3.405, which subjects only the "closely related" lender to the consumer's defenses, the Missouri statute makes all holders or assignees of the instrument subject to the consumer's defenses if the loan was arranged by the seller. Arizona has similar legislation in this area, Ariz. Rev. Stat. Ann. § 44-145 (West Supp. 1980).

30. See, e.g., Jones v. Approved Bancredit Corp., 256 A.2d 739 (Del. 1969); Armetta v. Clevetrust Realty Investors, 359 So. 2d 540 (Fla. Dist. Ct. App. 1978), cert. denied, 366 So. 2d 879 (Fla. 1979).

31. 44 Fed. Reg. 65,771 (1979). The amendment would extend the rule's application to creditors who finance purchases of goods or services. On September 21, 1979, the Commission approved in substance the proposed amendment and decided to make a number of changes in the text of the rule. Id. Comments on the drafting of the language changes were to be accepted through January 14, 1980, after which the amendment was to be promulgated and an effective date set. As of June 1981 this amendment is still pending; the Commission has taken no action, although it was scheduled to consider the proposals in March 1981. 46 Fed. Reg. 10,502 (1981).

32. The Seller must warrant that the HIL is a valid lien, fully enforceable, free of any right of setoff or counterclaim or other claim or defense, Sellers' Manual, supra note 9, at § 1.102q; that all applicable requirements of federal, state and local laws, including truth in lending, consumer lending and usury have been met, and any rescission period has expired, id. § 1.102s; that the total loan balance has been advanced, id. § 1.102r; and that all construction is complete, id. § 1.102j.

large contractor who has engaged in a uniform financing or construction practice that later has led to a large number of consumer complaints. Perhaps even more dangerous would be a lender's misinterpretation of certain provisions of the local usury laws. Again, such misinterpretation could be common among lenders in a particular geographical area. In many jurisdictions, violation of usury laws can lead to sanctions that diminish or destroy the lender's anticipated return beyond the amount attributable to usury. When consumer defenses lead to major losses on a large number of loans originated by a particular lender, that lender's financial position could be so adversely affected that it might not be able to meet its obligations under its "repurchase" warranties on those loans it had sold in the secondary market.[33]

In many jurisdictions some consumer defenses arising from the construction project will "pass through" regardless of the attempt in the instruments to make the assignee a holder in due course of a negotiable instrument.[34] It is nevertheless possible that language purporting to make the HIL notes negotiable would protect holders in due course from defenses unrelated to the construction.[35] Again, the best example would be the usury problem. Depending upon the nature of the usury violation, a secondary market purchaser could acquire the obligation in good faith without actual knowledge that the interest return was too high. Assuming that for reasons discussed above the note is still subject to certain defenses that the borrower has against the contractor, the note purchaser can argue that it still is insulated from the usury defense because the note remains negotiable. There is some support for this argument in the U.C.C.,[36] but a recent Texas decision suggests that once a note becomes

33. At present, most of the Mortgage Corporation's Sellers are federally insured depository institutions and most FNMA Sellers are substantial mortgage bankers. Thus, the likelihood of failure of warranties for failure of the warrantor is not great.

34. Some statutes simply nullify any negotiable status of a consumer instrument. Others negate any possibility that one could become a holder in due course of such an instrument. See note 25 supra. This latter result would arise under the prospective new FTC regulations. See cases cited note 30 supra.

35. The U.C.C.C., for example, preserves under certain circumstances claims and defenses ". . . of the consumer against the seller or lessor arising from that sale or lease of the property or services." U.C.C.C. § 3.405(i) (1974 version). The FTC legend preserves "all claims of defenses against the seller of goods or services obtained pursuant hereto . . . ." 16 C.F.R. § 433.2 (1981). Neither provision explicitly applies to defenses available to the consumer against the affiliated lender who made the consumer loan. Thus, defenses against the *lender*, the argument would run, are cut off by negotiation of the note to a holder in due course.

36. U.C.C. § 3-104(1)(b) requires that a promise to pay in a negotiable instrument must be unconditional. U.C.C. § 3-105(1)(a) indicates, however, that a promise may still be "unconditional" although subject to implied or constructive conditions. See U.C.C. § 3-105, Official Comment A; Mansion Carpets Inc. v. Marinoff, 24 A.D.2d, 947, 165 N.Y.S.2d 298 (1965) (check remains negotiable although maker's promise is subject to condition that performance is forthcoming). An argument can be made that the consumer's claims and defenses against a contractor are "indirect conditions" insofar as the obligation of the consumer to the lender are concerned.

In the case of the FTC rule or state statutes requiring a legend on the note, there is an additional problem for one desiring some of the benefits of negotiability: the legend itself may make it impossible for any holder of the instrument to become a holder in due course. One cannot become a holder in due course if one has knowledge of any claims or defenses. U.C.C. § 3-302(1)(c). But U.C.C. § 3-304(4)(b) indicates that knowledge of a separate agreement related to the debt evidenced by the note is not knowledge of a claim or defense under U.C.C. § 3-302(1) if one has no knowledge that any claims or defenses have arisen under that agreement. U.C.C. § 3-304,

subject to some borrower's defenses its negotiable character is lost completely.[37]

Under the U.C.C. negotiability is generally created by "terms of art"—such language as "pay to order".[38] The note is payable "to the order of" the identified payee, the lender. Such technical language might seem inappropriate in "plain language" documents like the HIL Note. Under the New York and Connecticut versions of the "plain language" statute, the Note may satisfy legal requirements because the statute permits the use of necessary technical language.[39] In any event, the words "pay to order" themselves are not technical. The problem is that they create a special legal status that would not be immediately apparent to a consumer borrower unversed in the law.

The drafters could have included, along with the technical language, a "plain language" discussion of the negotiable character of the instrument and its meaning. They elected not to take this course primarily because they believed that negotiability is a familiar concept to consumers. Consumers regularly sign personal checks made out "to the order of" the payee. In addition, the drafters were concerned that the description of negotiability in "plain language" would necessarily be quite extensive, leading to an overlong note form. Finally, there is always a danger in translating technical language into "plain language" that the reiteration of the party's rights will alter them in some fashion. Negotiability was a sufficiently important concern of the drafters that, on balance, the risk was not worth the benefit.

None of these rationales for omitting a "plain language" discussion of negotiability seems adequate. Even if consumers do understand that personal checks that they execute pass in commerce free of defenses against the payee, they can hardly be held to the knowledge that this result arises from the language "to the order of" appearing on the face of the printed check. Nor would they likely be aware that such language on the face of a fifteen-year installment note would have the same consequences. If there is doubt whether a consumer would understand the technical meaning of terms used in an instrument he signs, then considerations of length, or even preservation of legal meaning, should not take precedence over the fundamental policy of a "plain language" statute in favor of consumer comprehension. If the concept of negotiability is too difficult to describe in simplified terms, the appropriate response perhaps should be to eliminate this concept from consumer documents altogether.

Official Comment 9, states that notice of the separate agreement may appear even *in the instrument*.

37. Insurance Agency Managers v. Gonzales, 578 S.W.2d 803 (Tex. Civ. App. 1979) (consumer home improvement contract obligation; contractual provision preserving some of maker's claims and defenses rendered obligation "conditional" under U.C.C.).

38. U.C.C. §§ 3-104(1)(d), -110(1)-(3). See generally J. White & R. Summers, Uniform Commercial Code § 14-4 (2d ed. 1980) [hereinafter cited as White & Summers].

39. Conn. Gen. Stat. Ann. § 42-156(a) (West Supp. 1981); N.Y. Gen. Oblig. Law § 5-702 (McKinney Supp. 1980). The New York version reads: "This subdivision shall not . . . prohibit the use of words or phrases or forms of agreement required by state or federal law, rule or regulation or by a governmental instrumentality." Id.

III. HIL Note Paragraph 2: Interest[40]

A. *Usury*

This Paragraph states the interest rate. Sellers must warrant to the Mortgage Corporation that the rate meets applicable usury restrictions.[41] Usury will be a problem for HIL sellers in some states notwithstanding the preemption of state usury loans contained in the Depository Institutions Deregulation and Monetary Control Act of 1980.[42] Section 501(a)(1) of the Act preempts state usury legislation and removes all usury restrictions as to first lien loans on residential real property unless a specific subsequent state law reestablishes usury limits.[43] The preemption under this section applies to loans made by federally insured banks, savings and loan associations, credit unions, mutual savings banks, and mortgage bankers who are HUD approved lenders under the National Housing Act, and even individual sellers of their own homes, but relates only to first mortgage loans.[44] Most HIL loans, of course, will not be first mortgage loans and will not be affected by this section of the Act.

Sections 521 through 523 of the Act apply the usury preemption to all loans made by federally insured depository institutions.[45] Notwithstanding the preemption, however, there is a "federal usury" limitation as to this section of the new Act restricting interest rates on loans protected by the preemption to one percent over the discount rate on 90 day commercial paper in the lender's federal reserve district unless the state usury limit would be higher. Most HIL loans the Corporation will buy during the pilot program likely will come from "federal lenders," so the "federal usury" standard, at least, will apply. FHA Title I property improvement loans are exempt from state usury laws under the Housing and Community Development Act amendments of 1979.[46]

During the 1979-80 nationwide inflation in interest rates, mortgage lending was significantly curtailed by low state usury ceilings.[47] In many states, access to the secondary market, and thus to lendable funds, was destroyed by

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40. See N.C. Note, infra Appendix A, Para. 2.

41. Sellers' Manual § 1.102s.

42. Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended in scattered sections of 12, 15 U.S.C.A.) [hereinafter cited as Deregulation Act].

43. This state preemption has occurred already in at least eight jurisdictions. See, e.g., Colo. Rev. Stat. § 5-13-101 to -105 (1981); Hawaii Rev. Stat. § 478-12 (Supp. 1980); Kan. Stat. Ann. § 16-207(a) (Supp. 1980); Act of June 4, 1981, [1981] 4 Mass. Adv. Serv. 57 (to be codified at Mass. Gen. Laws Ann. ch. 183, § 63 (West)); Minn. Stat. Ann. § 47.203 (West 1981); Puerto Rico Laws 1980, Act 3, 8th. Extraord. Sess. § 1, 4 Cons. Cred. Guide (CCH) ¶ 6411; 1981 S.C. Acts, H.B. 2164 § 3, 4 Cons. Cred. Guide (CCH) ¶ 6415; S.D. Comp. Laws Ann. § 54-3-15 (Supp. 1981).

44. Deregulation Act, supra note 42, § 501(a)(1). See 12 U.S.C.A. § 1735f-7, note (Supp. 1981).

45. Deregulation Act, supra note 42, §§ 521-23 (codified at 12 U.S.C.A. §§ 1831(d), 1730g, 1785(g) (1980)).

46. Housing and Community Development Act Amendments of 1979, Pub. L. No. 96-153, 93 Stat. 1104 (codified in scattered sections of 5, 12, 15, 40, 42 U.S.C.A.).

47. One notable state experiencing such problems was New York.

inflexible usury restrictions.[48] Since usury is a difficult political issue for state legislatures, the federal preemption legislation was an important step in reopening the secondary market to many states. The usury statutes will continue to plague the HIL program in the case of those sellers who are not federally insured depository institutions. Even as to sellers who are federally insured depository institutions, the "federal usury" limit may be lower than the market rate for junior liens, which likely will remain higher than the first lien rate.[49] Further, many states have separate, often more restrictive, usury provisions relating to second mortgages or similar consumer loans.[50]

A purchaser of a negotiable note cannot become a holder in due course when the note on its face violates the usury laws.[51] Thus, in many cases the secondary market purchasers will be subject to available usury defenses. Nevertheless, as indicated, the warranties made by the seller in the HIL program transfer the risk of a usury violation to the seller. In this world of rapidly easing usury restrictions sellers may take some comfort from case law that holds that the usury limits at the time of suit, not at the time of the transaction, provide the relevant test.[52]

B. "Add On" Interest

As Paragraph 2 makes clear, the pilot program has departed from the standard consumer loan practice in many jurisdictions of using "add-on" or "prepaid" interest. This decision engendered considerable comment from lenders in many jurisdictions. Perhaps the foremost reason for this decision was that, as a matter of policy, neither FNMA nor the Mortgage Corporation desired to invoke prepayment penalties in connection with any consumer loan program. The prepayment provision had already been deleted from the single-family mortgages and the HIL Note later provides for prepayment without penalty in this program.[53] The traditional method of computing the refund of interest when an add-on loan is prepaid is the Rule of 78s.[54] This method

48. See, e.g., Nosari & Lewis, How Usury Laws Affect Real Estate Development, 9 Real Est. L.J. 30, 35 (1980).

49. Of the jurisdictions noted in note 43, only Colorado, Massachusetts and Puerto Rico have overriden that portion of the federal act that applies to loans by federally insured lenders other than first lien, purchase-money loans.

50. Perhaps the best example of such legislation is the U.C.C.C. See note 24 supra.

51. The U.C.C. indicates that one takes an instrument with knowledge of defense if he "has reason to know" of such defenses. See Osborne & Nelson, supra note 2, § 5.29, at 325-26. For a recent discussion of this provision, see Note, Commercial Law: Holders in Due Course and the Interstate Land Sales Act, 21 Ariz. L. Rev. 140 (1979). See also U.C.C. § 3-304; White & Summers, supra note 38, at 476.

52. See Northwestern State Bank v. Gangestad, 289 N.W.2d 449 (Minn. 1979).

53. See N.C. Note, infra Appendix A, Para. 6.

54. To calculate a rebate under the Rule of 78s, the finance charge is multiplied by a fraction derived from the sum of the periods to be rebated, which is the numerator, and the sum of the total periods of the loan, which is the denominator. If a five-month rebate of a one-year, 12-period loan is to be made, the following calculations would be made:

$$\frac{5+4+3+2+1}{12+11+10+9+8+7+6+5+4+3+2+1} = \frac{15}{78}$$

gives the lender an unstated bonus upon prepayment—in effect a prepayment penalty to the borrower.[55] Both the existence and the disguised nature of the prepayment penalty made the device unattractive.[56] Coupled with the basic concern about prepayment was the realization that many HIL loans would have substantial terms—fifteen to twenty-five years. Computing the Rule of 78s for such loans is a difficult matter. Add-on interest is not the practice in first lien mortgages, and as a result the Corporation's staff and accounting systems would have required further modifications to account for prepayment on "add on" loans. Permitting use of the Rule of 78s necessarily would have interfered with uniform processing since some states require simple interest.[57] Permitting add-on interest without use of the Rule of 78s might have created a confused situation for sellers used to accounting for add-on loans pursuant to the Rule. Finally, several states have identified add-on interest as the hallmark of harsh consumer practices and have tied their strongest consumer legislation to loans that involve add-on interest.[58] The drafters were interested in avoiding the reach of these restrictive statutes.

In a few jurisdictions, the usury laws permit a higher effective interest rate if the add-on device is used.[59] An add-on rate results in a higher effective return because the borrower pays interest on the whole principal at the stated rate over the life of the loan, instead of paying interest only on the declining balance. As a result most states set different usury rates for add-on interest loans.[60] In those that do not, the add-on device obviously would allow the lender more leeway with the usury limits. If the interest market again skyrockets, institutions that do not have the benefit of the federal preemption

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The finance charge would then be multiplied by this figure to determine the appropriate rebate. See Note, Consumer Law: The Effect of Partial Prepayment on Precomputed Interest Loans, 29 Okla. L. Rev. 731, 732 (1976).

55. The Cost of Personal Borrowing in the United States 60 (C. Gushee ed. 1970); Note, supra note 54, at 731.

56. A related problem is when and how the impact of the Rule of 78s should be disclosed to borrowers under federal and state consumer disclosure laws. See, e.g., Note, supra note 54, at 734.

57. See, e.g., Alaska Stat. § 06.20.230, .250 (Supp. 1980) (applicable to loans less than $25,000); Fla. Stat. Ann. § 516.031 (West Supp. 1980) (applicable to loans less than $25,000); Md. Com. Law Code Ann. § 12-404(b) (Supp. 1980); N.H. Rev. Stat. Ann. § 398-A:2 (Supp. 1979); N.J. Stat. Ann. § 17:11A-44(1) (West Supp. 1980).

> Florida's provisions are of a very limited application, since the law is inapplicable to any person doing business under, and as permitted by, any law of this state or of the United States relating to banks, savings banks, trust companies, building and loan associations, credit unions, or industrial loan and investment companies or to any bona fide pawnbroking business transacted under a pawnbroker's license.

Fla. Stat. Ann. § 516.01(2) (1979).

58. See, e.g., Ohio Rev. Code Ann. § 1321.57(3) (Page Supp. 1980); see also Ariz. Rev. Stat. Ann. § 44-1205 (Supp. 1980), which removed usury limitations on most credit transactions and simultaneously abolished the use of the Rule of 78s if "add-on" interest computation is used.

59. See, e.g., Ala. Code § 8-8-2 as amended by 2 Cons. Cred. Guide (CCH) ¶ 6402 (1981) and W. Va. Code § 47-6-5A (Supp. 1981), both of which allow 6% add-on interest on installment loans. Assuming 12 equal monthly payments, the 6% add-on is equivalent to more than 11% simple interest, which is significantly higher than the maximum 8% simple interest that both statutes allow parties to contract for in writing.

60. Typically state usury statutes set a simple or add-on interest rate limit and authorize the equivalent of that rate as the maximum limit in the alternate system. See, e.g., Ga. Code Ann. § 57-101.1 (Supp. 1981); Ill. Ann. Stat. ch 74. § 31 (Smith-Hurd Supp. 1981).

of usury laws may be unable to take advantage of the HIL program for certain periods of time. In some jurisdictions this disability will occur earlier than it would have if add-on interest were permitted.

C. *Other Loan Terms*

Paragraph 2 is designed to establish a contract interest rate for the entire period during which principal is unpaid, including the period following default and the period following judgment (if applicable). In at least one jurisdiction, the case law required an even more specific reference to post judgment interest.[61]

The Paragraph provides that "interest will be charged beginning on the date of this Note . . . ." The drafters contemplated that HIL loans would be fully funded on the date of the Note. When disclosure laws require a "rescission period," the program contemplates that the Note will be executed and funded at the beginning of that period. If rescission occurs, the lender will have to seek restitution of the funds and, when appropriate and desired, daily interest.

Some lenders undoubtedly will desire to control disbursements of the loan throughout the construction period to ensure that the loan proceeds are used for the purposes intended and that the project is completed within budget and as originally specified. Indeed, all sellers will be required to warrant that the proceeds have been so used, that the improvement is complete and that there are no outstanding lien claims. Although Paragraph 2 makes no reference to a controlled advances loan, lenders are free to undertake such a loan arangement if they deem it necessary. The Sellers' Manual contains an optional change in the documentation to provide for such loan disbursement.[62] The permitted language allows deferment of principal payments during the disbursement period, with interest accruing only from date of disbursement. The proceeds of the loan must be fully disbursed, at any event, by the time it is delivered to the Corporation. Mortgage Covenant 15 additionally aids the lender by requiring compliance by the borrower with the "home rehabilitation, improvement, repair or other loan agreement which Borrower enters into with the Lender."[63] Thus any violation of the loan agreement becomes an event of default under the mortgage.

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61. See Turner Coleman, Inc. v. Ohio Constr. & Eng'r, Inc., 272 S.C. 289, 251 S.E.2d 738 (1979) (statutory rate for post-judgment interest does not apply where the parties have expressly contracted upon a different rate). Compare with Little v. United Nat'l Investors Corp., 160 Conn. 534, 542, 280 A.2d 890, 894 (1971), in which the court found that

> since the agreement of the defendant was that "interest shall accrue at the rate of nine per cent (9%) per annum on unpaid principal balances, before or after maturity, by acceleration or otherwise" the rate of 'legal interest' was thus fixed by the agreement of the parties and . . . the plaintiffs were entitled to interest on the judgment at that rate.

Id. However, the drafters of the HIL Note concluded that *Little* does not require a separate specification of interest.

62. Sellers' Manual, supra note 9, Exhibit 18f, at 76.

63. See N.C. Deed of Trust, infra Appendix B, Covenant 15.

IV. HIL NOTE PARAGRAPH 3: PAYMENTS[64]

This Paragraph creates an unfortunate ambiguity that continues through Paragraph 4 and certain covenants in the HIL Mortgage as well. The ambiguity relates to when the late payment charge is payable. It is clear that under Note Paragraph 4 the late charge potentially is incurred as soon as a payment is late for a specified number of days—no notice is required. The instruments are unclear, however, as to when the borrower must pay this charge. The Paragraph sets forth the required level debt service payments and states that the borrower agrees to

> make these payments every month until I have paid all of the principal and interest *and any other charges*, described below, that I may pay under this Note. If, on [date of the last payment], I still owe amounts under this Note, I will pay all those amounts, in full, on that date.[65]

The intent of the drafters was that the late charge (provided in Note Paragraph 4) be paid when incurred. The Servicers' Manual makes this clear.[66] Note Paragraph 3, however, by specifically referring to these late charges (the only "other charges" described in the Note), permits a construction that level debt service payments will continue for the full term and that any additional charges will be paid at the end of the term.[67]

Similarly, the preamble of the HIL Mortgage does not mention that the mortgage secures the borrower's late charge obligation per se; it discusses only an "indebtedness evidenced by [the] Note," described as "monthly installments of principal and interest, with the balance of the indebtedness, if not sooner paid, due and payable on [the end of the debt term]."[68] This language indicates either that the mortgage does not secure the late charge obligation at all or that it secures the obligation as a sum payable at the end of the term. Other mortgage language confirms that the mortgage does secure the late charges in some fashion. Mortgage Covenant 1 includes a promise to pay late charges "as provided in the Note,"[69] and Mortgage Covenant 17 permits acceleration and foreclosure for failure to perform "any covenant or agreement . . . in this Mortgage."[70]

The problem is compounded by the application of the payments covenant in Mortgage Covenant 3. (There is no application of payments provision in the Note itself). This Covenant provides that payments received by the lender shall be applied first to payment of escrow charges, then to interest, and then

64. See N.C. Note, infra Appendix A, Para. 3.

65. See id. (emphasis added).

66. Federal Home Loan Mortgage Corp., Home Improvement Loan Servicers' Manual § 1.209 (1980) [hereinafter cited as Servicers' Manual].

67. Note Paragraph 4C adds to the confusion in the Note. It provides that the borrower is in default if he fails to pay the overdue installment within 10 days of notice. See N.C. Note, infra Appendix A, Para. 4(C); id. Para. 4(B). It does not provide that failure to remit a late payment penalty at the same time will be a default.

68. See N.C. Deed of Trust, infra Appendix B, preamble.

69. See id., Covenant 1.

70. See id., covenant 17 ("Deed of Trust" substituted for "Mortgage").

to principal.[71] The Covenant purportedly refers to "*all* payments received by Lender under the Note . . . ."[72] A late charge is clearly "payable under the Note," but the Covenant does not require that an amount be allocated to reduce the late charge claim. The late charge is not included as part of a regular payment obligation. This is understandable since the parties do not anticipate that the borrower will be consistently late and thus regularly incur late charges. When the late charge is payable, however, the instruments make no provision for how it is to be received and accounted for.

The amount of the late charge penalty seems insignificant, but such penalties often cumulate to a significant income item for a lender. The late charge ambiguity is also important because confusion in this area can confuse the lender/servicer's accounting at the critical moment of incipient or actual default, depending upon the lender's accounting methods. The only sensible resolution of the ambiguities here is that the charges are payable when incurred—and are not simply added to the loan balance. The best way to deal with late charges under the instruments would be to collect them as separate items when incurred, not to deduct them from ensuing level debt service payments. Obviously, the lender should consider carefully whether it is appropriate or desirable to attempt foreclosure when the only default is with respect to late charges.

V. HIL Note Paragraph 4: Borrower's Failure to Pay as Required[73]

The default and remedies provisions are the functional heart of any security arrangement. Like most real estate security instruments, the HIL instruments include separate default and remedy provisions for the Note and Mortgage, with the Note referring to (but not incorporating) the Mortgage. This arrangement is designed to preserve to whatever extent possible the advantages of negotiability. Not surprisingly, recent consumer legislation has focused upon the creditor's rights respecting the declaration of default and ensuing remedies. Thus, the tension between consumer protection and commercial viability that pervades the HIL documents played a major role in shaping the provision of Note Paragraph 4.

Even the basic structure of Paragraph 4 was influenced by consumer legislation. The first lien note, which served as the starting point for the HIL instrument, provides the lender with an acceleration right without ever actually identifying an event that is defined as "default." Instead the instrument simply states that if the borrower has not paid an overdue installment within a given period of time following notice, the lender has the right to accelerate.

71. See id., covenant 3. This allocation is required of federally chartered savings and loan associations by regulation. Federal Home Loan Bank Board regulations provide: "The association shall not deduct late charges from regular periodic installment payments on the loan, but shall collect them as such from the borrower." 12 C.F.R. § 545.8-3(d).

72. See N.C. Deed of Trust, infra Appendix B, Covenant 17 (emphasis added).

73. See N.C. Note, infra Appendix A, Para. 4.

The intent of the drafters of the first lien provision was to avoid the automatic creation of a default or acceleration since the lender's subsequent failure to take action in a particular case might operate as a waiver if the borrower again failed to meet his obligations at some later time. The drafters of the first lien instruments included a clause providing that prior forebearance does not waive rights relating to subsequent defaults,[74] but were aware that some courts do not feel bound by such language if it would require a result perceived to be "inequitable."[75] The HIL Note, unlike the first lien note, does include an identified event of default. The drafters would have preferred to use the format followed in the first lien note, but were constrained to identify an event of default because so many consumer statutes have provisions that turn upon the specific declaration of default.[76] Commonly, these statutes exempt first lien purchase money loans from their provisions, but apply fully to HILs.

In addition to the basic structure of the Paragraph, the drafters' commitment to uniformity necessarily was modified, if not abandoned, under the pressure of a wide variety of state consumer protection statutes. Although uniformity was abandoned in a number of sections, there were sections of uniform language that were preserved. Upon analysis, it is often difficult to discern the reason for the adherence to uniform language in one instance in light of the abandonment of uniformity in others. Perhaps the best explanation is that the drafters were caught up in an ongoing process marked by severe deadlines and constant input from local counsel in fifty-four jurisdictions. Decisions were made as problems arose and consistency could not be guaranteed. As the HIL program evolves through the pilot stage, it is likely that more consistency will appear in the drafting decisions. This Article cannot identify all the specific changes made to "tailor" Paragraph 4 to each jurisdiction, but will note only highlights.

A. Late Charges

The standard form permits the lender to impose a late charge without

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74. The language appears in the body of the First Lien Note, supra note 12, which does not have numbered paragraphs. This language is equivalent to that in the first Lien Deed of Trust, Covenant 11 (copy on file in N.C. L. Rev. office).

75. See, e.g., Soltis v. Liles, 275 Or. 537, 543, 551 P.2d 1297, 1300 (1976) (court found that nonwaiver provisions of an installment sales contract were "ineffective and [did] not prevent the promisor from waiving the conditions of the contract through his conduct."); see also 3A A. Corbin, Contracts § 763 (1960); cf. J.E.M. Enterprises, Inc. v. Taco Pronto, Inc., 145 Ga. App. 573, 244 S.E.2d 253 (1978) (nonwaiver provision in contract may itself be waived); Universal C.I.T. Credit Corp. v. Greyhound Rent-A-Car, Inc., 39 Misc. 2d 163, 240 N.Y.S.2d 205 (1963), aff'd 20 A.D.2d 635, 246 N.Y.S.2d 1012 (1964) (same); contra, Federal Nat'l Mortgage Ass'n v. Walter, 363 P.2d 293 (Okla. 1961); Zeller v. Universal Sav. Ass'n, 580 S.W.2d 658 (Tex. Civ. App. 1979). See generally Rosenthal, The Role of Courts of Equity in Preventing Acceleration Predicated Upon a Mortgagor's Inadvertent Default, 22 Syracuse L. Rev. 897 (1971).

76. See, e.g., Alaska Stat. § 32.20.070(b) (Supp. 1980); Kan. Stat. Ann. § 16a-5-110 (1974); Me. Rev. Stat. Ann. tit. 9-A, § 5-110 (1980) (amended by Law of May 18, 1981, ch. 281, § 4, 1981 Me. Legis. Serv. (1981), to exclude first mortgages on real estate other than mobile home loans and for which the security interest is granted for the purpose of purchasing or constructing a residence of four units or less); Wash. Rev. Code Ann. § 61.24.040 (1965), as amended by Law of May 14, 1981, ch. 161, 1981 Wash. Legis. Serv. (West 1981) (deed of trust foreclosures); Wis. Stat. Ann. § 425.103, .104 (West 1974 and West Supp. 1981).

specific notice and permits the parties to designate how late a payment must be before the charge is imposed. The form has blanks designating the time when the late charge is incurred and the amount of the charge (as a percentage of the late payment). The Servicers' Manual states that once the loan is sold to the Mortgage Corporation no charge may be imposed for a delinquency of less than ten days and no charge may exceed five percent of the late installment.[77]

In addition to the problems discussed above on the question of when a late charge is payable, the late charge provision presents other pitfalls for the unwary lender. The basic problem is that a large number of jurisdictions prohibit or restrict the use of late charges in consumer loans.[78] In addition to a variety of consumer legislation provisions, the important case of *Garrett v. Coast and Southern Federal Savings and Loan Association*,[79] construes late payment charges to be effectively liquidated damages provisions.[80] Many states have case law or statutes that require that a liquidated-damages provision reflect a reasonable estimate of the actual damages that might be suffered.[81] *Garrett* held that a late charge must be measured by these standards, and thus declared invalid a penalty stated as a percentage of the loan balance, rather than as a percentage of the late payment itself.[82] The language of Subparagraph 4A states the charge as a percentage of the overdue payment, subject to a fixed minimum and maximum. The amount of the charge and the tolerances are left to the discretion of the lender. Thus, although the form of the late payment provision would likely pass muster under the *Garrett* case, no firm conclusion as to the legality of the charge is possible without a comparison of the precise amount of the charge and the likely damages that would be suffered by the lender from a late payment.

Although the Sellers' Manual includes no specific warranty that a late payment penalty satisfies state law, there is a general warranty that all provisions of the Note and Mortgage are in conformance with state law.[83] In any event, the collection and application of the late payment penalty is primarily a matter of concern to the lender, not the Corporation. The lender as servicer,

77. Servicers' Manual, supra note 6, at § 1.209. See also Sellers' Manual, supra note 9, at § 1.102x. The FHLBB regulations prohibit a federal savings and loan association from imposing a late charge for payments which are less than 15 days late. 12 C.F.R. § 454.8-3(e)(i)-(ii) (1981). The regulations also limit the charge to a maximum of 5%. The Corporation's general policy in preparing the Sellers' and Servicers' Manuals was to track the FHLBB regulations. The disparity between the 10-day and 15-day late charge "grace period" is most likely a drafting error.

78. See Alaska Stat. § 06.20.260 (Supp. 1979); Cal Civ. Code § 2954.4 (West Supp. 1981); Cal. Bus. & Prof. Code § 10242.5 (West Supp. 1981); Idaho Code § 28-33-203 (Supp. 1980); Ind. Code Ann. § 24-4.5-3-203 (Burns 1974); Mass. Gen. Laws Ann. ch. 140, § 90A (West 1974); N.J. Stat. Ann. § 17:12B-159(6)(b) (West Supp. 1981); N.Y. Real Prop. Law § 254-b (McKinney Supp. 1980); N.C. Gen. Stat. § 53-175 (1975); Ohio Rev. Code Ann. § 1321.57 (Page Supp. 1979); Okla. Stat. tit. 14A, §3-203 (1971); Or. Rev. Stat. § 86.160-.185 (1980); Tex. Rev. Civ. Stat. Ann. art. 5069-5.02(3) (Vernon 1971); Utah Code Ann. §70B-3-203 (Supp. 1979).

79. 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973).

80. Id. at 737-41, 511 P.2d at 1201-03, 108 Cal. Rptr. at 849-51.

81. See generally Annot., 63 A.L.R.3d 50 (1975).

82. 9 Cal. 3d at 740, 511 P.2d at 1203, 108 Cal. Rptr. at 851.

83. Sellers' Manual, supra note 9, at § 1.102s.

retains late charges.[84]

In light of the fact that a large number of jurisdictions restrict or prohibit late payment penalties, the question arose as to whether Subparagraph 4A should be deleted entirely. Lenders in states that permit the late charges seemed to feel strongly that the device was useful. The desire to make the program as attractive as possible to potential sellers led the drafters to leave the late charge provision in the Note. Further, the Federal Home Loan Bank Board regulations provide that federally chartered savings and loan institutions may impose late charges.[85] Although there has been no specific court decision regarding the preemptive effect of this portion of the regulations, it seems clear from analogous court decisions that these provisions would be regarded as having preemptive effect, permitting the use of a late charge provision by a federal savings and loan association in every state notwithstanding contrary provisions of state law.[86] The preemptive federal regulations plus the desire for uniformity led the drafters to leave the provision in the Note even in those jurisdictions where some types of lenders would be unable to impose such a charge. The Sellers' Manual allows sellers to ascertain whether the charge may be made as to a particular loan or type of loan and either to insert zeros or to strike out the language entirely where a late charge would be inappropriate.[87] The Mortgage Corporation has no requirement that loans it purchases have any late charge provision.

A recent Missouri junior lien statute prohibits the "charg[ing], contract[ing] for or receiv[ing]" of late charges in connection with a second mortgage loan.[88] Violation of the statute results in a forfeiture of all interest under the loan.[89] The severity of this penalty led the drafters to conclude that there was a danger even in having late charge language in the Note notwithstanding that the late charge was set forth as zero. Therefore, the Missouri version of Note Paragraph Four does not contain any late charge language at all.[90] By contrast, note forms in the U.C.C.C. states,[91] and in California, Ohio, North Carolina and Texas, where various aspects of late payment charges are prohibited,[92] still contain the standard language for late charges. Lenders who are not federal savings and loan associations must conform to local law in filling in the blanks.

84. Servicers' Manual, supra note 6, at § 1.209.

85. 12 C.F.R. § 545.8-3(d) (1981).

86. Although there is some question, the mortgage instrument provisions most likely enjoy the "protection" of federal preemption where available. See Randolph, supra note 1, at 587-90.

87. See Sellers' Manual, supra note 9, at § 1.102x.

88. Mo. Rev. Stat. § 408.233 (Supp. 1980).

89. Id. § 408.236.

90. But see Randolph, supra note 1, at 557 n.42, for a discussion of the special arrangements for Missouri federal savings and loans associations.

91. See note 24 supra.

92. See note 78 supra.

B. Notice of Default

Unlike the approach taken regarding the late charge provision, the HIL forms provide the parties no discretion in setting default notice periods. The standard language provides that the lender may send a notice of imminent default[93] as soon as[94] a payment is overdue. If no payment is received within ten days after the notice is mailed Subparagraph 4B provides that a default occurs. Under Subparagraph 4C, the default does not automatically trigger an acceleration, but the lender may proceed to accelerate the loan without giving any further notice.[95] The only further contact the borrower *must* receive from the lender will be a mailed notification of an imminent foreclosure sale. Typically, of course, the contacts between borrower and lender will be much more extensive than the instruments might suggest.[96]

There are several variants of this standard language. The drafters attempted to conform the provision to state law in such a way that acceleration could occur at the earliest possible time following the standard ten day period and with the minimum number of notices. The drafters developed an alternative basic form of Subparagraph 4B for those states, such as Kansas,[97] Maine[98] and Pennsylvania,[99] where notice of delinquency cannot be given for a period of time following a missed payment. Under this variant, the "de-

93. Typically the notice will not be a simple notice of default but will include the foreclosure warnings and information regarding borrower's rights required before the lender resorts to the foreclosure remedy. See N.C. Deed of Trust, infra Appendix B, Covenant 17; Randolph, supra note 1, at 607-11.

94. Although the instruments appear to contemplate the possibility of the Lender mailing an overdue notice immediately, a more plausible construction would be that the Lender should wait until the time has run for triggering the late payment charge to send the notice. See text accompanying note 106 infra.

95. Of course, the lender conceivably could sue on the accelerated debt at this point without proceeding to foreclose—a generally recognized but rarely invoked option. In some states with anti-deficiency protection for certain types of loans, the separate suit on the note would preserve the deficiency right. Oregon prohibits deficiency judgments following foreclosure of purchase money residential mortgages. Or. Rev. Stat. § 88.070 (1977). A separate suit on the note, without foreclosure, would permit recovery of a judgment for the whole amount, but would cost the mortgagee its priority. There is at least an argument that an HIL lender is a purchase money lender for purposes of anti-deficiency legislation. See Prunty v. Bank of Am., 37 Cal. App. 3d 430, 112 Cal. Rptr. 370 (1974) (residential construction lender who did not finance land acquisition is a "purchase money lender" within meaning of California anti-deficiency scheme.) In addition, Washington prohibits deficiency judgements following foreclosures of deeds of trust, Wash. Rev. Code Ann. § 61.24.100 (Supp. 1981); compare with Or. Rev. Stat. § 88.770(2) (1979) (deficiency barred only when property sold at trustee's sale, not when trust deed foreclosed by judicial action). Suit on the note in Washington gives the lender access to the debtor's other assets as well as the property.

A number of states, all in the far West, have "one form of action" statutes which require a secured party to foreclose first. See Osborne & Nelson, supra note 2, at 526-28. Such statutes are sometimes coupled with anti-deficiency legislation. Together, the two devices restrict the secured lender to the property alone, creating a statutory class of "non-recourse" loans. Id.

96. The industry practice involves considerable attention to defaulted accounts. Typically a lender will foreclose only as a "last resort," for both economic and social reasons. The Mortgage Corporation's procedures follow and formalize this industry practice. See note 110 and accompanying text infra.

97. Kan. Stat. Ann. § 16a-5-110 (Supp. 1973).

98. Me. Rev. Stat. Ann. tit. 9-A, § 5-110(1) (1980).

99. 41 Pa. Stat. Ann. § 403 (Purdon Supp. 1980).

fault" occurs immediately upon the borrower's missing the payment date. The language then goes on to provide for notice if the borrower is in default for a stated period (whatever the statutory minimum would be). As discussed above,[100] the drafters were interested in postponing the moment at which a default is identified in order to avoid a determination that the lender had waived its right to insist on prompt payment by its inaction in response to a previous succession of insignificant defaults. The desire to provide for a one-notice acceleration overrode the waiver consideration in those states in which the variant language is used. Only the Maine language, in response to statutory mandate,[101] requires that the lender have evidence that the borrower has received the notice before the default remedies are invoked.

Regardless of when a default technically occurs, the lender has no right to invoke any default remedies until the notice period has run. Wherever possible, this notice period was kept to a period of ten days.[102] In most cases, the notice will be more elaborate than a simple notice of nonpayment, since HIL Mortgage Covenant 17, setting forth the notice requirements necessary for a foreclosure, requires notice of the right to reinstate, notice of the right to seek an injunction of foreclosure when the borrower disputes the legality of the lender's action (in private foreclosure jurisdictions), and whatever other information might be required in a particular jurisdiction.[103] Although there is no cross reference between the notice provision in the Note and the notice provision in the Mortgage, the drafters intended that one notice serve both purposes when the lender intends to accelerate and foreclose.[104]

Once the condition of default has persisted beyond the minimum notice period, the lender may elect to accelerate and, assuming it has given the default/foreclosure notice, can proceed to foreclose.[105] At that point, the instruments provide that the borrower becomes liable for costs and fees. Until a declaration of acceleration, the lender's only compensation for the delinquency is the late charge.[106] Subparagraph 4D, which provides for reimbursement of costs, might be construed to permit the lender to charge costs arising before the acceleration, but this is neither perceived industry practice nor the intent of the drafters.

Lenders who elect to insert a late payment penalty provision in the Note may find it prudent to delay taking further action to establish that a default exists until the late payment period has run. It is possible that a court would

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100. See notes 74-75 and accompanying text supra.

101. Me. Rev. Stat. Ann. tit. 9-A, § 5-110(1)(B) (1980).

102. Some states require a longer minimum notice period before the lender invokes remedies, e.g., Kan. Stat. Ann. § 16a-5-111(3) (1974) (20 days); Me. Rev. Stat. Ann. tit. 9-A, § 5-111(1) (1980) (20 days); Mo. Ann. Stat. § 408.555.1 (Vernon Supp. 1980) (20 days); Wis. Stat. Ann. § 425.105 (West 1974) (15 days).

103. See N.C. Deed of Trust, infra Appendix B, Covenant 17.

104. For a discussion of the lender's other alternative, suit on the note alone, see note 95 supra. Acceleration of the Note for purposes of suit could be accomplished with the simple notice form required by the Note alone.

105. For a discussion of the foreclosure notice, see Randolph, supra note 1, at 607-11.

106. See notes 66-71 and accompanying text supra.

conclude that by establishing the late payment period the lender has indicated to the borrower that only defaults continuing *after* the running of the late payment period will be deemed the kind of defaults that trigger a right to acceleration. Lenders may wish to send the necessary "preacceleration" notice only after the late payment period has ended and thus delay other remedies until the expiration of the notice period following that mailing.

C. Consumer Protection Aspects of Paragraph 4

Paragraph 4 punctiliously complies with the welter of consumer protection laws throughout the country. In addition, the consumer receives several benefits under the Corporation's instruments that go beyond the protections afforded by customary lender practices prevailing in many jurisdictions. Under Mortgage Covenant 18 the borrower may avoid acceleration ("reinstate") by paying the overdue payment and any costs and curing any other breaches under the Mortgage. Further, since the Corporation has voluntarily drafted the Note in plain language for all jurisdictions, a borrower, perhaps for the first time, will be able to ascertain at least some of his contract rights without the benefit of a legal education.[107]

Unfortunately for consumer interests, the drafters' efforts to conform to industry practices required that for the most part they conform the creditors' rights set forth in the instruments to the prevailing practices of responsible lenders.[108] This "prevailing practice" is predicated basically on a notion of

107. In at least one particular, however, the provision for attorneys' fees, the language of the paragraph might be somewhat misleading, although technically in compliance with the law. The relevant language reads:

> Note Holder will have the right to be paid back for all of its costs and expenses to the extent not prohibited by applicable law. Those expenses include, for example, reasonable attorneys' fees.

N.C. Note, infra Appendix A, Para. 4(D).

A number of jurisdictions restrict the collection of attorneys' fees in consumer transactions. See, e.g., Cal. Civ. Code § 2924(c) (West 1980); Neb. Rev. Stat. § 8.823(3) (1977); 41 Pa. Cons. Stat. Ann. § 406(2)(3) (Purdon Supp. 1980); S.C. Code § 37.3-404 (Supp. 1979); Vt. Stat. Ann. tit. 12, § 4527 (1973); Wis. Stat. Ann. § 422.411 (West 1974). The Note language could be read by the unrepresented and untutored consumer to suggest that applicable law authorizes the collection of attorneys' fees. It should be noted that the language appears in the text of what the consumer will perceive to be an authoritative form drafted specifically for use in his jurisdiction.

Most of the statutes cited above apply to foreclosures, not simple note collections. HIL Mortgage Covenant 13 is more specific in restricting the applicability of the attorneys' fees language, see N.C. Deed of Trust, infra Appendix B, Covenant 13; and, since the issue will arise almost exclusively in the context of mortgage foreclosures, it cannot be said that the drafters have overreached their legal rights in this case. On the other hand, if the purpose of the drafting of the note in "plain language" was to give the consumer a clear picture of his legal rights and responsibilities, the drafters can be faulted for phrasing which suggests to the consumer that resistance to the lender's position in any dispute may run up a claim for attorneys' fees which the consumer will have to pay, in addition to extra interest, in the event he ultimately loses the dispute. Faced with the possibility of paying the lender's attorneys' fees, the consumer may be cowed into compliance with the lender's wishes even before consulting an attorney himself to determine the legitimacy of his position in the dispute.

In Kansas, which prohibits the use of language providing for attorneys' fees in notes and mortgages (Kan. Stat. Ann. § 58-2312 (1976)), the uniform language reference to attorneys' fees is eliminated.

108. See Randolph, supra note 1, at 548-51.

lender paternalism, rather than consumer protection. The lender paternalism model provides far more severe remedies to the lender than it will use in the typical case. As one industry official phrased the issue:

> [Lender's remedies] are frequently used as standby, emergency measures to protect the lender in extreme situations. They are nevertheless important. We seem to agree upon the necessity of having fire extinguishers handy even though we fortunately don't need to use them daily.[109]

The model postulates that a lender is able to discern a "bad defaulter" from a "good defaulter" and can temper its remedies accordingly. A "good defaulter" will receive far more consideration than the loan instruments suggest. For example, under the Corporation's Servicers' Manual the servicer must make extensive efforts to contact the defaulting borrower personally and attempt to work out the borrower's financial circumstances without foreclosing.[110] This is consistent with the practices of most insitutional home mortgage lenders. The foreclosure to default ratio generally is very low,[111] since most lenders work hard to resolve a default situation in such a way that the home owner retains his property.

On the other hand, when the borrower is a "bad defaulter," lenders desire to have the right to oust him summarily from his property, both in order to protect their security and to obtain leverage by the threat of immediate foreclosure when less severe forms of persuasion have not availed. The HIL Note and Mortgage give the foreclosing lender some very powerful weapons against "bad defaulters." The Corporation's own control over the foreclosure process for loans it purchases mitigates the potential unfairness, yet the rights under the instruments are not subject to the same controls when used by lenders for their own portfolio. The fact that the instruments are decidedly more generous to borrowers than many of those currently in use should not disguise their potential for severe treatment of consumer borrowers.

This reality is disturbing from the consumer's standpoint in light of the fact that the use of the FNMA/FHLMC forms is becoming so widespread that

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109. Senate Comm. on Banking, Housing and Urban Affairs, 92nd Cong., 1st Sess., Federal National Mortgage Association Public Meeting on Conventional Mortgage Forms (Comm. Print 1971) (statement of Paul Basner) [hereinafter cited as FNMA Public Meeting]. For a fuller discussion of the context of this meeting, see Randolph, supra note 1, at 550, and authorities cited therein.

110. Servicers' Manual, supra note 66, at §§ 1.201-.211. The Manual indicates that the servicer must conduct an extensive analysis of all reasonable alternatives which would permit the borrower to achieve payment stability within a reasonable time. This analysis will take at least 60 days in every case, id. § 1.205, and will involve at least one face-to-face meeting with the defaulted Borrower, id. § 1.204. The Corporation reserves to itself the final decision to accelerate, following the Servicer's recommendation. The recommendation should be submitted only "when Servicer has exhausted all possible means of liquidating the delinquency." Id. § 1.206.

111. Although home mortgage defaults and foreclosures have increased recently, they still represent a tiny percentage of loans. During the first quarter of 1981, defaults for more than 90 days existed in 0.65% of all home mortgage loans, and in 0.32% of all conventional home mortgage loans. Equivalent figures for 1979 were 0.46% and 0.24%, respectively. Foreclosures were commenced in the first quarter of 1981 as to 0.16% of the total loans and 0.09% of conventional loans. The equivalent 1979 figures were 0.15% and 0.07%, respectively. Mortgage Bankers Association of America, National Delinquency Survey (1981).

they are establishing a new industry standard. Although the forms do exceed the minimal debtor protections available under existing practices in some jurisdictions, the uniform forms may retard the development of additional needed reforms in those or other jurisdictions. This is because lending industry lobbyists may cite the FNMA/FHLMC forms as the "standard of fair treatment" in resisting consumer efforts to achieve broader consumer protective legislation.

Turning to the language of Note Paragraph Four itself and ignoring the restraints upon overzealous resort to lenders' remedies set forth in the HIL Servicers' Manual, we find a statement of remedies that is at best inconsistent in its concern for the protection of the borrower/consumer. The Paragraph clearly reflects the banking industry belief that a lender should have more legal rights upon default than it is ever likely to use. The Paragraph confers upon the lender the right to accelerate in the shortest possible time. Where there is no state legislation controlling the notice period, the standard period of time following default in payment before the lender can accelerate is 11 days. The only delay is for the ten day notice period.[112] Since the period runs from the mailing of the notice, not from the receipt,[113] it is quite possible that acceleration would be instituted before a borrower actually became aware of the notice. It is difficult to see why, as a minimum standard, the period before acceleration could not be measured from the date indicated on a return receipt form of certified delivery or other actual delivery evidence. Further, the default notice period provided under the Note, like the industry practice and the statutory provisions in several states, does not provide a unsophisticated consumer borrower any reasonable time to deal with the problem and avoid acceleration (assuming—as we do here—that there has been no prior contact with the lender regarding the default). The brevity of the notice period can thus lead to an unconscionably rapid termination of the borrower's rights on the loan. In jurisdictions that otherwise provide for rapid foreclosure after acceleration, the risk is not simply loss of the loan, but loss of the consumer's home.[114]

The drafters can put forward two justifications for the short notice period before acceleration. The first is that junior lenders are in a precarious position

112. This compares to the already short, 30-day notice period in the First Lien Note, supra note 12.

113. The exception to this rule is in Maine, where the statutes require the default period to be measured in most cases from receipt of the default notice. Me. Rev. Stat. Ann., tit. 9-A, § 5-110(1)(A) (1980).

114. Industry spokesmen point to the cost savings resulting from rapid foreclosure. They argue that such savings reduce the cost of borrowing for all consumers in states which have rapid foreclosures. Although studies have demonstrated that there is likely a cost savings in "fast foreclosure" states, see, e.g., McElhone & Cremer, Loan Foreclosure Costs Affected by Varied State Regulations, Fed. Home Loan Bank Board J., June, 1975; Committee on Mortgage Law and Practice, Cost and Time Factors in Foreclosure of Mortgages, 3 Real Prop., Prob. & Tr. J. 413 (1968); the author is aware of no studies indicating that these savings have had an impact on the cost of consumer borrowing in those states. Indeed, the low ratio of foreclosures to loans placed would suggest that any cost savings would have small significance in the overall market although they might improve slightly the financial position of individual lenders.

when a senior lien loan goes into default[115] and that they need to be able to accelerate quickly to protect themselves in the senior's foreclosure as best they can. Even when a senior lien is not yet in default, the junior lender would argue, a default on its secured loan may presage a default on other debts; and the lender will have to move quickly to establish its claims and decide how to pursue them in light of the relative weakness of its security position. In fact, this justification has merit primarily in a few power of sale jurisdictions with rapid foreclosures and inadequate statutory or common law notice requirements[116] to protect junior lien holders.[117] In the vast majority of cases, the HIL lender would be able to deal with any problems with senior liens without need for rapid foreclosure of its own lien. When emergency action is required, HIL Mortgage Covenant 7 permits the HIL lender to displace immediately any threatening senior lien. In addition, other language dealing with default on senior liens could have been drafted that would have protected the Mortgage Corporation as well[118] without exposing the borrower to a rapid acceleration in every case. The Mortgage Corporation's second justification is that in drafting the default and foreclosure language it was simply mirroring the prevailing lender practices in the home improvement loan industry. This defense is inadequate from a consumer standpoint. Harsh and unfair practices cannot be justified merely because they are widespread, and certainly could not have been within the intent of Congress when it mandated the purchase of "investment quality" loans.[119]

115. When the senior forecloses, the junior must produce sufficient cash to at least meet the highest bid at the foreclosure sale—usually the bid of the senior in the amount of the senior debt. The alternative is loss of the junior's security interest in the property. The junior must evaluate its position and act to protect it, when warranted, within a relatively brief period, often no more than 10 days from the time it receives notice of the senior's action.

116. Although the HIL lender might receive some benefit from rapid acceleration rights in jurisdictions which provide no other way for the junior lender to protect itself from senior defaults, the benefit would be insignificant compared to the overall risk undertaken by junior lenders in such jurisdictions. If, indeed, the HIL drafters had believed that, as a practical matter, the HIL lender would not receive adequate notice of an impending senior default in a given jurisdiction, it is likely that they would have prepared no instruments for that jurisdiction. The risk of destruction of the HIL lien by a "surprise" foreclosure of a senior lien simply would be too great. The rapid acceleration rights reserved to the HIL lender, therefore, cannot be justified by reference to these hypothetical "inadequate notice" jurisdictions, but must instead find a basis in some more realistic concern of the FNMA/FLHMC drafters.

117. By far the majority of American jurisdictions provide a framework through which the junior may be assured of notice of any imminent foreclosure by a senior lien. See Randolph, supra note 1, at 613. Notice of an impending senior foreclosure does not resolve all problems, of course. If the junior lienholder wishes to make a claim from the proceeds of the senior foreclosure, it must accomplish acceleration prior to that foreclosure. The HIL instruments presently provide that default on any senior lien is a default under the HIL instruments as well, see N.C. Deed of Trust, infra Appendix B, Covenant 4, thus permitting acceleration within 10 days of the time the HIL lender becomes aware of the senior default.

Although it is true that rapid acceleration is desirable in this case, the provisions of Note Paragraph Four go beyond the need for rapid foreclosure here and provide similarly rapid foreclosure in the case of every default on the HIL loan, the bulk of which will not be violations of Mortgage Covenant 4, but rather failure to pay the HIL note payments on time. As the text indicates, rapid foreclosure in these circumstances is not justified by the argument that the HIL lender would otherwise be unable to deal effectively with a senior foreclosure.

118. For instance, rapid acceleration might be authorized *only* when the borrower has defaulted on an obligation giving rise to a senior lien.

119. This standard derives from the statutory directive of FHLMC to buy only loans "of such

An additional consumer concern is the absence of any reference to the borrower's reinstatement right in the Note. The "plain language" Note explains in simple, easy-to-read detail that the lender may call in the entire principal amount (accelerate) on the basis of a single default.[120] The Note does not explain, however, that the borrower has a right to reinstate. This right is set forth deep in the Mortgage instrument,[121] which is not a plain language document.[122] The ambiguity on the face of the Note is compounded by Paragraph 5, the "reference over" provision of the Note, which identifies the Mortgage as an instrument and states "how and under what conditions I may be required to make immediate payment in full of all amounts I owe under this Note" without indicating that the Mortgage contains a right to reinstate following an acceleration.

A possible explanation for the omission of the right to reinstate from the Note was the concern for preserving negotiability, a status that could be jeopardized by too much detail in the loan provisions. On the other hand, the U.C.C. clearly permits reference to the Mortgage for elaboration of acceleration rights,[123] and it would seem to permit as well reference to circumstances in which such rights are limited.

D. Separate Suit on the Note

In almost every jurisdiction, a secured lender has the option to sue on the note and proceed against the security and any other property of the debtor as a general judgment creditor (waiving the priority provided by the Mortgage). The usual reason for taking this course is to avoid the impact of antideficiency legislation.[124] Under the HIL instruments, the lender might argue that by suing on the Note it could also avoid the borrower's reinstatement right. The absence of any mention of the right to reinstate in the Note suggests this construction. In addition, Mortgage Covenant 18 clearly is intended to apply primarily to the foreclosure situation. In fact, if the borrower does have a right to reinstate absent foreclosure, there is some difficulty in identifying just when the right would end. In mortgage jurisdictions, the standard language provides that the borrower can reinstate at any time prior to entry of judgment enforcing the Mortgage. In deed of trust jurisdictions, the right terminates on

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quality, type, and class as to meet generally the purchase standards imposed by private institutional mortgage investors." 12 U.S.C. § 1454(a)(1) (Supp. III 1976). See Randolph, supra note 1, at 548.

120. The acceleration provision is a critical element of the contract to loan and should be set forth on the face of the note evidencing that contract. In some jurisdictions, failure to set forth the acceleration rights in the note even when the mortgage contains an acceleration clause will deprive the secured lender of any action based upon the accelerated note. E.H. & J.A. Meadows Co. v. Bryan, 195 N.C. 398, 142 S.E. 487 (1928). The majority rule, however, is that the presence of an acceleration clause in the mortgage will suffice. Note, Bills and Notes—Acceleration Clause in Mortgage as Affecting Maturity of Notes—Distribution of Proceeds of Foreclosure Sale, 9 N.C.L. Rev. 201, 202 (1931).

121. See N.C. Deed of Trust, infra Appendix B, Covenant 18.

122. The instrument, however, is written in commendably straightforward and clear prose.

123. See note 133 infra.

124. See note 95 supra.

a lawsuit to enforce the deed of trust or a short period prior to the private sale, whichever is applicable.[125] If the right to reinstate were available when there was no suit to foreclose, it logically would be available up to the entry of the judgment in the suit on the Note, since the judgment would provide the same basis for collection of the accelerated debt. Although this is a logical inference of how the right ought to apply, a suit on the Note is not a suit to enforce a mortgage, and the language of Covenant 18 would not apply precisely.

Notwithstanding these construction problems, there is language in the instruments that supports the interpretation that reinstatement is always available. This result, indeed, appears to have been the construction intended by the drafters. The standard language in the last sentence of Mortgage Covenant 18 suggests that reinstatement is available to reverse the acceleration of the debt, not just to avoid foreclosure:

> Upon such payment and cure by Borrower, this Mortgage *and the obligations secured hereby* shall remain in full force and effect as if no acceleration had occurred.[126]

Further, Note Paragraph 5 refers to the Mortgage language for information concerning "how and under what conditions I may be required to make immediate payment in full of all the amounts that I owe under this Note."[127] In light of this language, the borrower can argue that the Mortgage modifies the lender's rights under the Note by establishing the "conditions" under which acceleration will be effective. In the HIL program, the Mortgage Corporation will seek foreclosure in virtually every case, making this issue relevant only to interpreting the lender's rights when it has used the HIL instruments for loans in its own portfolio.

VI. HIL Note Paragraph 5: This Note Secured by a Deed of Trust[128]

This Paragraph simply refers to the Mortgage securing the Note. Although, strictly speaking, the Mortgage will stand as security even if not referred to in the Note,[129] it makes sense to include the reference. Further, the spirit of the plain language instrument requires a disclosure of the relationship between the instruments. For this reason,[130] the drafters included the second

125. See N.C. Deed of Trust, infra Appendix B, Covenant 18.

126. See id. ("Deed of Trust" substituted for "Mortgage") (emphasis added).

127. See N.C. Note, infra Appendix A, Para. 5.

128. See id.

129. See Osborne & Nelson, supra note 2, at 315-16, and authorities cited therein.

130. An additional reason to incorporate the Mortgage acceleration provisions is to safeguard the mortgagee's right to rely upon the more extensive mortgage acceleration rights in a suit for the debt or for a deficiency. Some jurisdictions require that the note contain its own acceleration clause in order for the mortgagee to recover an accelerated claim outside of foreclosure. See note 120 supra. The HIL mortgage acceleration clause is the only basis for an acceleration for defaults such as due on sale violations, sufferance of prior liens, failure to pay monies into escrow accounts and numerous other borrower defaults for which the lender would surely wish to accelerate, foreclose and, where necessary, recover a deficiency judgment.

A provocative recent opinion in Illinois suggests that the "reference over" technique in the HIL Note, and indeed in virtually all note forms commonly used, may be inadequate. 2140 Lin-

sentence of the Paragraph indicating that the Mortgage contains additional information with respect to the lender's acceleration rights. This language placed the drafters on the horns of a dilemma in certain jurisdictions. Although it is clear that mere reference to a mortgage securing a note does not destroy the negotiability of the note,[131] there was some doubt as to whether negotiability was affected when the note went on to describe (and inferentially incorporate) certain provisions of the mortgage, such as acceleration rights. The general rule, of course, is that a negotiable note must stand by itself and not incorporate any other provisions by reference.[132] A 1962 amendment to U.C.C. section 3-105 (1)(c) made clear that mere reference to the acceleration provisions of the mortgage will not affect negotiability.[133] There are, however, several jurisdictions[134] that have not yet adopted the recent amendments, and in those jurisdictions the second sentence of Covenant 5 was deleted.

VII. HIL Note Paragraph 6: Borrower's Payments Before They are Due[135]

Paragraph 6 permits prepayment at any time without penalty, but (in most jurisdictions) reserves to the lender some control over time and manner of prepayment. The issue of prepayment rights proved to be controversial from several standpoints. The prepayment penalty historically has been one of the major battle grounds of consumer interests. A substantial portion of the testimony taken in the series of "public meetings" in 1971, when the FNMA and the Mortgage Corporation first introduced their uniform one-four family instrument forms, attacked the prepayment penalties contained in those forms.[136] In 1979 FNMA and the Mortgage Corporation elected to eliminate the prepayment penalty from all their one-four family loan instruments. The HIL drafters, already in the midst of their drafting efforts, followed this policy decision.

Comments from lenders on the HIL exposure drafts (with Note Para-

coln Park West v. American Nat'l Bank & Trust Co., 88 Ill. App. 3d 660, 410 N.E.2d 990 (1980) (due-on-sale clause unenforceable unless set forth on face of note). But see Licata, 2140 Lincoln Park West: Bad News for Mortgage Lenders, 63 Chi. B. Rec. 16 (1980), arguing that the case actually turns upon subtle phrasing of the note form involved in that case, which phrasing can be avoided by future drafters. The court's opinion does not set forth the note language, which incorporated the trust deed provisions by referring to "accruals of the right to foreclose" rather than to "defaults." Mr. Licata argues that the court would have permitted incorporation of the due-on-sale clause by reference if the reference language had used the term "defaults."

131. U.C.C. § 3-105(1)(c), (2)(a). See id. § 3-105, Official Comments 3 & 8.

132. Id. § 3-104(1)(b).

133. Id. § 3-105(1)(c). Comment 8 was amended earlier than the statute to the same effect.

134. E.g., Alaska Stat. § 45.03.105(3) (1980); Ga. Code § 109A-3-105(1)(c) (1975); Neb. Rev. Stat. § 3-105(1)(c) (1971); Okla. Stat. Ann. tit. 12A, § 3-105(1)(c) (1971); Or. Rev. Stat. § 73.1050(1)(c) (1979); and R.I. Gen. Laws § 6A-3-105(1)(c) (1970).

135. See N.C. Note, infra Appendix A, Para. 6.

136. Critics of the prepayment penalty included Senators Tunney and Proxmire. FNMA Public Meeting, supra note 109, at 173 (statement of Sen. John Tunney); id. at 34 (statement of Sen. William Proxmire). Virtually every lending industry representative who spoke at any length during the public meeting defended the prepayment penalty as fair and necessary. See, e.g., id. at 44, 125, 184 (statements of Lewis S. Eaton, Roy Blount and Paul G. Basner, respectively).

graph 6 in its present form) indicated that many felt that a prepayment penalty was a valuable protection against "portfolio raiding" in the event of an interest rate downturn. They desired prepayment penalty provisions in their own loan portfolios, and thus would have been uncomfortable originating loans on the FNMA/FHLMC forms if these forms did not contain them. To resolve this problem, among others, HIL lenders may wish to attach riders to the instruments setting up special contract rights and obligations between the original parties. The Corporation's Sellers' Manual requires that these riders be applicable only until the loan is transferred in whole or in part to the Corporation.[137] The Corporation expects that some sellers will take advantage of this provision to establish their own prepayment penalty provisions. The few sellers who retain substantial participations in loans sold to the Corporation, however, will be unable to charge prepayment penalties for their retained portions.

Lenders should be wary of using accounting methods for partial prepayments that effectively result in prepayment penalties. For instance, computing per diem interest on a 360-day year, but charging it on a 31 day month, can result in extra benefit to the lender upon prepayment that is, at least arguably, a "penalty" to the borrower. Similarly, if a lender should receive a prepayment but not credit it against principal until the next payment date, the borrower arguably again suffers a "penalty." Neither of these devices is permitted by the HIL Servicers' Manual,[138] but it is important to keep in mind that they are also inconsistent with the terms of Note Paragraph 6, which permits prepayments of principal "at any time . . . without paying any penalty" (subject to lender's controls discussed below). Thus lenders who originate loans for their own portfolio using the HIL Note instrument may have to modify their internal prepayment accounting practices if they have not already done so in the preparation for sale of loans to the Corporation.

The standard Note language, used in most jurisdictions, provides that the lender may impose certain restrictions on prepayment in order to facilitate its accounting. First, it may limit prepayment to the same day that an installment payment would otherwise be due. Second, it may require that the amount of a partial prepayment equal the principal amount in the next one or more monthly payments. Last, the lender is not required to modify the payment schedule in the event of a partial prepayment. All of these provisions may have obvious advantages to lenders managing loan portfolios with established payment schedules. The provisions are included for the benefit of the lender/servicer, and are not required by the Corporation, which simply requires that its share of prepayments be accepted[139] and that no penalty be charged to the borrower.[140]

The provision for restricting prepayment is one instance in which the drafters deliberately included contract language that is potentially at odds

137. Sellers' Manual, supra note 9, at § 2.208b(iii).
138. Servicers' Manual, supra note 66, at §§ 2.105, .106.
139. Id.
140. Id.

with controlling laws in jurisdictions for which the forms were designed.[141] This uniform paragraph was drafted to be consistent with the rights of federally-chartered savings and loan institutions. Under the preemptive[142] regulations of the Federal Home Loan Bank Board, these institutions may charge moderate prepayment penalties. Even if the optional restrictions permitted in Note Paragraph 6 could be construed as violative of a state law prohibition of prepayment penalties, the federal savings and loans would nevertheless be able to impose the restrictions.[143] It should also be noted that typical state consumer legislation prohibiting prepayment penalties tends to be somewhat limited in application. For instance, U.C.C.C. statutes typically apply only when interest rates on the loan exceed a certain minimum.[144] Although in 1980 mortgage loan rates were generally in excess of the "trigger rate" for most U.C.C.C. statutes, this has not been the case normally. Further, some U.C.C.C. states raised their "trigger rate" in response to inflation.[145] If the Corporation's HIL program proves successful, it will be buying loans at rates that are lower than typical consumer loans. Therefore, the U.C.C.C. may not apply in some jurisdictions.

In West Virginia, which imposes penalties for violation of its usury laws[146] and which also restricts the imposition of prepayment penalties under

141. At least twelve states restrict the use of prepayment penalties. See Randolph, supra note 1, at 556 n.38.

142. Id. at 587-90.

143. It should be noted that the federal regulations do not authorize unlimited prepayment penalties. Penalties on owner-occupied residential property may not exceed six months' interest on the aggregate amount of all prepayments in any 12 month period which exceeds 20% of the original principal amount of the loan. 12 C.F.R. § 545.8-5(b) (1980). It would be extraordinary if any "penalty" resulting from the use of the prepayment restraints in Note Paragraph 6 would exceed this limit.

144. Under the U.C.C.C. provisions in effect in most U.C.C.C. jurisdictions, typical institutional lenders are classified as unsupervised lenders and may make real estate loans with interest rates up to a stipulated rate without falling under the U.C.C.C. provisions. See generally 1 Cons. Cred. Guide (CCH) ¶ 5165 (1969). This stipulated rate, the "trigger rate," was originally set high to exclude ordinary purchase money mortgages, but in most jurisdictions even the prevailing first lien rate is in excess of the "trigger rate" and will bring the loan transaction within the U.C.C.C. unless some special exemption has been enacted.

In Kansas, prior to 1980, the only way to make a loan at interest rate in excess of the relatively restrictive usury laws was to make the loan under the U.C.C.C. The U.C.C.C. "trigger rate" was actually in excess of the maximum under the usury laws (the Kansas U.C.C.C. rate had its own, higher limits.). In 1980, the Kansas legislature adopted a usury ceiling indexed to the Mortgage Corporation's monthly purchase commitments. Kan. Stat. Ann. § 16-207(b) (Supp. 1980). The same legislation exempted real estate mortgage loans (including first liens and junior liens held by the first lien holder from all of the provisions of the U.C.C.C. Kan. Stat Ann. § 16a-1-301(14)(b) (Supp. 1980), and preempted the federal Monetary Deregulation Act usury provisions (12 U.S.C.A. § 1735f-7, note (Supp. 1981)). Kan Stat. Ann. § 16-207(a) (Supp. 1980). The Kansas HIL instrument, substantially completed before this recent legislation, contains an optional statement to the effect that the loan is made under the provisions of the U.C.C.C. As of this writing, it is unnecessary for the parties to make such an election of U.C.C.C. coverage in order to make a loan at an adequate interest rate. Should the indexed interest ceiling descend, however, parties might want to take advantage of the relatively high fixed ceiling under the U.C.C.C. See generally Comment, The Uniform Consumer Credit Code and Real Estate Financing—A Square Peg in a Round Hole, 28 U. Kan. L. Rev. 601 (1980).

145. For a summary of the U.C.C.C. provisions in various states, showing "trigger rates" ranging from 10% to 18%, see 1 Cons. Cred. Guide (CCH) ¶ 505 (1969).

146. W. Va. Code § 31-17-18 (1975).

the usury laws,[147] the last sentence of Note Paragraph 6 was deleted. However, in many other jurisdictions where exercise of an option to restrict prepayment would violate state law[148] the sentence still appears in the uniform Note form. The Corporation nevertheless requires a warranty that legal documents used in the transaction conform to state law.[149] Thus, in jurisdictions in which the restriction of prepayment would violate state law, a lender who is not operating under the federal regulations would be unable to establish policies leading to the imposition of any prepayment restrictions without violating its warranty to the Corporation. After a sale to the Corporation, the Servicers' Manual would control the relationship between the seller and the Corporation.[150] The Servicers' Manual does not expressly prohibit the lender/servicer from restricting prepayments, but it does require conduct consistent with law.[151] Lenders will have to make an independent determination as to whether their jurisdiction permits separate restrictions upon prepayment.

VIII. HIL Note Paragraph 7: Borrower's Waivers[152]

This provision is the drafters' best effort to turn the standard waiver of rights to presentment, notice of dishonor and protest[153] into "plain language." The U.C.C. clearly recognizes the effectiveness of such waivers.[154] The Paragraph demonstrates the near impossibility of drafting technical legal language in short, concise "plain language." For instance, it is not true, as the Paragraph suggests, that "anyone. . .who agrees to keep the promises made [in the Note] is known as a guarantor, surety *and endorser*."[155] Nevertheless, the language of the Paragraph is clearer than standard "legalese," and will at least apprise the consumer of legal issues for which he should seek legal advice if questions arise.

Presentment, notice of dishonor, and protest, in any event, are defenses of endorsers, not guarantors or non-endorsing sureties.[156] Few, if any, consumer borrowers will find themselves in the position of endorser of an HIL Note.[157]

147. Id. § 47-6-56(f).

148. See note 141 supra.

149. Sellers' Manual, supra note 9, at § 1.102s.

150. See Servicers' Manual, supra note 66, at Forew.

151. Id. § 2.106.

152. See N.C. Note, infra Appendix A, Para. 7.

153. For a discussion of these defenses, see White & Summers, supra note 38, at 506-09; U.C.C. §§ 3-501 to -511.

154. U.C.C. § 3-511.

155. See N.C. Note, infra Appendix A, Para. 7 (emphasis added). The concept of "surety" under the U.C.C. includes all persons liable for the debts of another, including all guarantors, U.C.C. § 1-201(40), and all "accommodation parties," U.C.C. § 3-415, Comment 1. See generally White & Summers, supra note 38, at 517-18. The concepts of guarantor and endorser, however, are more limited and distinct from one another. See L. Simpson, Handbook on the Law of Suretyship §§ 3-17 (1950). On the other hand, the obligations of an endorser who has made the waivers contained in Note Paragraph Seven and those of a guarantor are virtually identical. Id. § 16. Similarly, guarantors and endorsers who validly waive their secondary liability (as Note Paragraph Seven would have them do) are virtually identical to a surety.

156. See U.C.C. § 3-501.

157. There is a possibility that a relative or friend might guarantee the HIL Note by endorse-

A mortgagor who transfers property to a grantee who assumes the mortgage is a surety,[158] probably is not an accommodation party under the U.C.C.[159] and definitely is not an endorser.

Under the Mortgage Corporation's HIL program, originators of HILs will transfer their rights to the Corporation with warranties but without endorsement. They do not guarantee payments. The Corporation, most likely, will guarantee payment to its purchasers, when there are purchasers, just as it does in its first lien programs. But for the most part the Corporation will not "negotiate" the paper representing the HIL loan rights to its purchasers and therefore will not become an endorser under the U.C.C. It is therefore difficult to identify the target of the waiver language in Note Paragraph 7.[160] In light of the language's potential to lead borrowers erroneously to conclude that the waivers have some impact upon them, and in light of the inherent ambiguities contained in the "plain language" translation of the waivers, it might have been best had the drafters eliminated them altogether.[161]

IX. HIL Note Paragraph 8: Giving of Notices[162]

Paragraph 8 contains the notice provision. The lender may provide notice either by certified mail or by personal delivery, while the borrower must provide notice only by certified mail. The reason for this apparent imbalance in notice rights is that lenders in some areas indicated concerns about the effectiveness of mail delivery. They stated that, notwithstanding the contrary protestations of the United States Postal Service, mail carriers were either failing to deliver mail entirely in certain neighborhoods or delivering in such a

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ment, rather than by some other means of expressing the guarantee. See White & Summers, supra note 38, at 426. In such a case the waivers contained in Note Paragraph Seven may have some relevance. Nevertheless, such an endorser also will have the defenses of an accomodation party discussed resulting from a release, extension or suspension of the principal's obligation or an unjustifiable impairment of the security. Id. The Corporation's HIL Sellers' and Servicers' Manuals do not mention the possibility of guarantors, and thus neither prohibit their use nor consider them relevant to the evaluation of the credit of the borrower.

158. That he is a surety is clearly established at common law. See Osborne & Nelson, supra note 2, § 5.19. That he is entitled to suretyship defenses is inescapable under U.C.C. § 3-606. See id., Comment 1; White & Summers, supra note 38, at 434 n.125. Note that the original mortgagor has some suretyship defenses even when the transferee does not assume. Osborne & Nelson, supra note 2, § 5.19.

159. "An accomodation party is one who signs the instrument in any capacity for the purpose of lending his name to another party to it." U.C.C. § 3-415(1). The mortgagor/transferor, though he has signed the note, did so at a time when no transfer had occurred, so he did not sign for the purpose of supporting the transferee's credit. See Peters, Suretyship Under Article 3 of the Uniform Commercial Code, 77 Yale L.J. 833, 838 (1968).

160. Should the instruments ever be used for "dealer paper," of course, situations may arise in which the dealer would endorse a note to a "take-out" lender. The Mortgage Corporation's HIL program does not contemplate the use of "dealer paper." See note 21 and accompanying text supra.

161. In the drafting of the next generation of uniform instruments, the Renegotiable Rate Mortgage first lien one-to-four-family instrument (an early, and now obsolete, version of the variable interest rate mortgages which the Bank Board has approved), the FNMA/FHLMC drafters have responded to these concerns and have modified the scope and clarified the application of this waiver language (copy on file in N.C.L. Rev. office). Subsequent uniform instruments undoubtedly will use the modified language.

162. See N.C. Note, infra Appendix A, Para. 8.

way that communication with the borrower was not assured. These lenders had resorted to the practice of using private delivery services for significant notices, and wished to have that form of notice set forth in the instruments. In addition, certain lenders argued that the most effective form of notice is one delivered to the borrower during a conference in the lender's offices. Lenders who relied upon delivery as their method of providing notice wanted the right to personal delivery as an alternative to mail delivery in the instruments because of the potential confusion in the structuring of loan servicing practices if the instruments provided only for mailed notice. The drafters did not feel it was appropriate to include a parallel right to delivery notice on the part of the borrower. The justifications for permitting the lender to deliver notice do not necessarily apply in the borrower's case. In addition, lenders were concerned that a notice delivered to the improper branch or department of their institution would not find its way to the proper desk as quickly as would a mailed notice.

The most significant problems arising with respect to the notice provisions relate to the Borrower's transfer of the property and foreclosure notices generally. These issues are discussed elsewhere.[163]

X. HIL Note Paragraph 9: Responsibility of Persons Under This Note[164]

This Paragraph deals primarily with the rights of accommodation parties to the Note.[165] The substance of the Paragraph comes from language in the first lien note which was inserted originally in the 1972 instrument to reflect existing conservative practices. In fact, few first lien loans purchased by the Corporation have involved accommodation parties, and the drafters anticipated that there would be few accommodation parties to the HIL Notes. The bulk of the Paragraph thus should be of small significance in the HIL program.

The language includes a "plain language" reiteration of the first lien note provisions imposing joint and several liability upon accommodation parties. The language also purports to bind any guarantor, surety or endorser to be "fully and personally obligated" to perform the obligations contained in the

163. See Randolph, supra note 1, at 593-610.

164. See N.C. Note, infra Appendix A, Para. 9.

165. Under the U.C.C. accommodation parties are primarily guarantors and endorsers, not original mortgagors who later transfer the property and become sureties. See note 159 supra. Although the Note language later defines the responsibilities of "guarantors, sureties or endorsers," those terms are limited by the definitions set forth for them in Note Paragraph 6. Those definitions do not include all possible types of sureties. They go beyond the U.C.C. concept of an accommodation party in only one particular: they apply to one who undertakes in a separate writing to assure the performance of another under the Note, rather than by affixing his signature to the Note. The difference between "accommodation parties" (makers and others who sign the Note) and "guarantors" (potentially persons who do not sign the Note but guarantee it), leads to some ambiguity as to the referent of the pronoun "us" as used in the Paragraph. The discussion hereafter will assume that the Paragraph is designed to impose full personal liability upon anyone who signs the Note in any capacity and anyone else who might accommodate the maker by a separate writing.

Note. This language raises the question whether such parties are to be primarily liable as makers. It would be somewhat unusual for a note provision to attempt to alter in this way the secondary liability of a party who has agreed to become a guarantor or endorser of the note.[166] It does not appear that the drafters really contemplated such an alteration. The questionable phrasing resulted simply from an attempt to reiterate the technical language in the first lien note stating: "this Note shall be the joint and several obligation of all makers, sureties, or guarantors and endorsers . . . ."[167] This technical language in the first lien note made accommodation parties jointly and severally liable amongst themselves, but did not purport to make them primarily liable as makers. Provisions in other parts of the HIL Note and Mortgage extend the rights of the lender against accommodation parties, but none go so far as to impose primary personal liability upon the Note against all such parties. The language of Note Paragraph 9 should not be so construed.

Since the Note already contains the standard waivers of the rights of endorsers,[168] the language of Paragraph 9 would appear to have very little additional impact, even if enforceable as written.[169] In fact, it is quite likely that the attempt to make accommodation parties personally liable will expand their rights because, if successful, it will make them, effectively, "borrowers." If accommodation parties are "borrowers," then they would appear to have the notice rights set forth in Paragraph 4 notwithstanding the waiver of notice of dishonor set forth in Paragraph 7. Of course, the accommodation party would at least have to supply a notice address to the lender in order to ensure that he did receive notice. Accomodation parties probably would be entitled to notice of the original borrower's default before the lender proceeded against the security. Accommodation parties also would have the right to reinstate even though the right does not appear on the face of the Note. Since the borrower has, by separate contract, obtained the right to reinstate, such right arguably

166. If one signs and adds the phrase "payment guaranteed," or equivalent language, then one might assume primary liability. U.C.C. § 3-416(1). The phrase "collection guaranteed," on the other hand, means something different. Basically the signor expects the holder of the note to pursue other security upon default before seeking him. U.C.C. § 3-416(2). In neither case would it necessarily be appropriate to conclude that the signor has waived any available suretyship defenses under U.C.C. § 3-606.

Even when the accommodation party admittedly is liable directly and personally insofar as the holder is concerned, he still has a right against the accommodated party which the holder may not frustrate. If the holder should grant an extension of the secured debt, thereby arguably frustrating the right of the surety/accommodation party to protect his position, the common law—and U.C.C. § 3-606(1)—release the surety from all or part of his obligations. See generally Randolph, supra note 1, at 577-80. Typically a negotiable instrument to which there may be accommodation parties would include language preserving the lender's rights against sureties, notwithstanding the "release rule," as permitted by U.C.C. § 3-606(2). Because there is such small likelihood of suretyship issues arising under the HIL instruments, the drafters omitted this language. For the same reason, they did not include or authorize language waiving statutory or common law suretyship rights such as the *Pain v. Packard* rule. See Osborne & Nelson, supra note 2, § 5.9, at 264; Ariz. Rev. Stat. Ann. § 12-1641 (1956).

167. First Lien Note, supra note 12.

168. See notes 153-54 and accompanying text supra.

169. When an accommodation party uses words of guarantee instead of simply endorsing, he loses the rights of presentment, notice of dishonor and protest by that circumstance. U.C.C. § 3-416(5).

should be available to persons whom the lender seeks to charge as, effectively, co-borrowers.

At another point in the Paragraph, the attempt to articulate technical legal concepts in plain language again creates some ambiguity with respect to the rights of the parties. The Paragraph states that "any person who takes over my [borrower's] rights or obligations under this Note will have all of my rights and must keep all of my promises made in the Note." This is apparently a plain language statement of the concept that persons assuming obligations under the Note will be treated as if they were the original maker insofar as the lender's rights are concerned. The plain language translation blurs the distinction between a simple assumption of an obligation and a novation.[170] The borrower may conclude from this language that someone who buys his property and assumes the obligations under the Note[171] has actually "taken over" the borrower's obligations so that the borrower is no longer bound. This is unfortunate because many institutional consumer loan officers, in this author's experience, make the same error and likely will not be in a position to clarify the borrower's understanding of the situation. Of course, the drafters did not intend this result unless there is a true novation and the lender expressly releases the first borrower in writing. The Corporation expects that most transfers of the property will result in novations or new loans.[172] This is also the intent of the Federal Home Loan Bank Board regulations on the issue.[173] Many lenders, unfortunately, have adopted practices that do not lead to the borrower's release. Thus, a borrower who believes he is released when he sells his property to a grantee who assumes the loan may be mistaken. Needless to say, the older, more technical, language did not make the difference between assumption and novation any clearer for the borrower, but some would argue that intelligibility to the layperson was not the function of that language. Intelligibility is a goal of the plain language Note.

The language of the Paragraph goes on to make cosignors (and others

170. In a simple assumption of a mortgage loan obligation, the assuming party (normally the transferee of the title to the mortgaged property) agrees to be primarily responsible on the loan as between himself and the original borrower. The original borrower remains fully liable to the mortgagee but now can look to the assuming party for recourse if the loan goes unpaid. In such cases, the lender typically is viewed as obtaining additional rights against the assuming party, if for no other reason than to avoid circuity of action. Osborne & Nelson, supra note 2, § 5.10-.18.

A novation is a three-way agreement among the original borrower, transferee and mortgagor whereby the mortgagor releases the original borrower entirely and, in effect, makes a new contract with the transferee. See Storke & Sears, Transfer of Mortgaged Property, 38 Corn. L. Q. 185, 188 (1953).

A third type of transfer of mortgaged property is commonly known as a transfer "subject to" a loan. In these cases, the transferee takes the property encumbered by the mortgage but assumes no personal liability to pay a deficiency judgement should the property be insufficient to cover the debt in the event of default. Whether the transferee can look to his transferor for recourse due to loss of the property in the event of foreclosure depends upon the terms of the transfer. In the typical case the terms would provide no such right. Osborne & Nelson, supra note 2, §§ 5.3, .9.

171. Either directly or indirectly, the transferee of an HIL Note likely will become an "assuming grantee" if there is no novation. See discussions of Mortgage Covenants 11 and 16, Randolph, supra note 1, at 580-82, 601-05.

172. Id.

173. See id. at 164.

who are personally liable) jointly and severally liable. Such language is standard fare for debt instruments. Finally, the Paragraph purports to extend the personal, joint and several liability imposed upon accommodation parties to their assignees. The effectiveness of this language, of course, stands or falls with the issue of the extent to which accommodation parties are liable in the first instance. In any event, it seems superfluous, since one who "takes over" (to use the Note terms) the rights or obligations of another takes them as he finds them even if there is no language to this effect in the document creating the underlying obligation.

XI. CONCLUSION: THE HIL IN NORTH CAROLINA

Although North Carolina extensively regulates consumer lending practices, most of these regulations will have virtually no impact on the HIL program. The North Carolina Consumer Finance Act[174] requires that consumer lenders obtain licenses before doing business in the state.[175] Licensees are severely limited in their lending practices, but are permitted to lend at rates in excess of those available under the general usury laws.[176] The Act identifies several specific classes of loans, and sets different requirements for each. The most general class of loans appears to be loans described in section 53-173 of the Act, loans with maximum principal amounts of $3,000.[177] Loans made under this section are severely limited as to collection terms[178] and may not be secured by real estate.[179] Under section 53-176 of the Act,[180] however, licensees apparently may make loans secured by security interests other than first liens in real property[181] in "installments not exceeding $5,000,"[182] carrying interest not to exceed fifteen percent.[183] Licensees making loans under section 53-176 may not make loans under other provisions of the Act.[184] The Con-

174. N.C. Gen. Stat. §§ 53-164 to -191 (1975 & Cum. Supp. 1979).

175. Id. § 53-168.

176. Id. § 53-173(a) limits the principal amount that licensees may lend to $3000 and sets a maximum interest rate of 3% per month on the first $300 and 1½% per month on the balance up to $3000. These rates, although phrased as maximums, actually are higher than the general usury statute, which is set at a floating rate with a maximum of 12% for loans of less than $25,000. Id. § 24-1.1 (Cum. Supp. 1979).

177. Id. § 53-173(a).

178. Id. § 53-173 itself limits interest on maturity and sets the method for computing charges. Id. § 53-180 limits use of due-on-sale and due-on-insecurity clauses and provisions for attorneys' fees. Practices may be further limited by regulations of the Commissioner of Banks. Id. § 53-185.

179. Id. § 53-180(f).

180. Id. § 53-176.

181. Id. Junior security in real estate apparently is acceptable, since the statute prohibits only first liens and does not fall under the specific prohibition on any real estate liens articulated in § 53-180(f).

182. Id. § 53-176. A recent amendment to sections 53-172 and -180 limits non-commercial loans by licensees under the Act to $25,000. Law of May 28, 1981, ch. 464, §§ 2, 3, 1981 N.C. Adv. Legis. Serv. 498.

183. N.C. Gen. Stat. § 53-176 (1975). When drafted, this rate was an attractive interest rate. Now, however, the rate may be lower than that authorized under the "floating usury rate" provisions for junior lien mortgages set forth in id. § 24-1.2(3) (see note 190 infra) or the preemptive floating rate for insured lenders permitted by the Deregulation Act, supra note 42. See note 46 and accompanying text supra.

184. N.C. Gen. Stat. § 53-176 (1975).

sumer Finance Act, however, exempts from its terms most established institutional lenders, including almost any lender which would be likely to participate in the HIL program or similar programs with FNMA or the Mortgage Corporation.[185]

Another chapter of North Carolina law, the Retail Installment Sales Act,[186] applies to credit advances to secure the price of goods and services provided by the creditor.[187] Again the terms of the credit arrangements are rigidly controlled. Although these provisions may apply to particular home improvement loans when the transactions involve contractor financing, they will have no impact on the Mortgage Corporations's HIL program because the Corporation will not buy "dealer paper" in this pilot program. The HIL instruments themselves may be used by parties to transactions falling under the Retail Installment Sales Act, of course. In the event the instruments are so used, counsel should be careful to conform the provisions of the instruments to meet the limitations imposed by this Chapter.

Article Two of Chapter 24 of the North Carolina General Statutes[188] applies specifically to "secondary or junior mortgages" that secure debts in principal amounts not more than $25,000 and payable in equal monthly installments over a period of no more than 181 months.[189] The apparent purpose of this Article was to provide more generous usury limitations than would otherwise have applied.[190] At one time, this Article also contained certain limitations on provisions in the loan contracts,[191] but these limitations were repealed in 1979.[192] The Article contains a usury limitation that is a bit more permissive than would otherwise apply under the federal usury standard contained in the Federal Monetary Policy Deregulation and Control Act,[193] and therefore may be of some benefit to some HIL lenders. Loans made by most institutional lenders likely to participate in HIL programs with the Mortgage Corporation, however, are exempted from the coverage of these statutes as well.[194]

Deeds of Trust used in the HIL program will be subject to the provisions of Chapter 45 of the North Carolina General Statutes, which control the fore-

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185. Id. § 53-191.

186. Id. §§ 25A-1 to -45 (Cum. Supp. 1979 & Interim. Supp. 1980).

187. Id. §§ 25A-1, -2 (Cum. Supp. 1979).

188. Id. §§ 24-12 to -17 (Cum. Supp. 1979 & Interim Supp. 1980).

189. Id. § 24-12(2), (3) (Interim Supp. 1980).

190. Id. § 24-14, revised in 1979, set the interest maximum for loans under the statute at the higher 1⅓% per month or 5% over the "Federal Discount Rate" (not defined). After more recent amendments this rate does not appear to be higher than that approved for junior lien installment loans generally under the recent revisions to section 24-1.2. Law of May 28, 1981, ch. 464, § 1, 1981 N.C. Adv. Legis. Serv. 498 (sliding scale based upon U.S. Treasury bill's six month rate plus six percent, with minimum of 16%).

191. See Law of July 21, 1971, ch. 1229, § 2(24-15), 1971 N.C. Sess. Laws 1792, as amended by Law of June 23, 1977, ch. 698, § 3, 1977 N.C. Sess. Laws 844, limiting late charges and requiring certain rebates on renewal.

192. Law of June 23, 1980, ch. 1157, § 7, 1979 N.C. Sess. Laws, 2d Sess. 90.

193. See notes 46 & 190 and accompanying text supra.

194. N.C. Gen. Stat. § 24-16.1 (Cum. Supp. 1979). Loans made by licensees under the Consumer Finance Act also are exempted under § 24-16.1.

closure process, but little in this Chapter addresses directly the issues raised by the HIL note. It might be noted, however, that section 45-80, apparently designed to facilitate the use of notes with adjustable interest rate provisions, applies only to first lien instruments, and would not be useful to HIL lenders.[195]

Recent comprehensive revision of the statutes relating to state savings and loan associations[196] gives such lenders extensive power to lend on leaseholds and junior security. In any event the legislation specifically gives state savings and loan associations the same lending authority and the same interest rate flexibility provided to federal savings and loan associations.[197] Although this legislation apparently authorizes variable interest rate loans to the extent permitted by Bank Board regulations, the provision on interest rates is not entirely clear on this point.[198]

State commercial banks are authorized generally to make secured or unsecured loans.[199] Such lenders would be subject to the higher of (1) the federal "floating interest rate" for loans other than first lien residential loans,[200] or (2) North Carolina section 24-1.1(2) which sets another floating rate.[201] Neither state savings and loans or state commercial banks appear to be subject to any specialized consumer legislation other than (for banks) the usury laws. Regulations of the Savings and Loan Division or the Banking Commissioner, as now or later authorized and promulgated, might contain some restrictions on lending practices.

In sum, despite a variety of potentially restrictive statutes, the North Carolina Legislature has seen fit to leave the major lending institutions in North Carolina with an "open market place" to negotiate loans on terms and conditions they find appropriate. The legislative decision mirrors the prevailing attitude in many states that lending institutions do business in a sufficiently competitive environment and possess sufficient social responsibility to insure basic fairness in their loan transactions.

The HIL loan program tests whether this permissive attitude on the part of the North Carolina Legislature and other state legislatures is justified. In general, consumers are fairly treated under all FNMA and Mortgage Corporation programs, the HIL program included. But the careful analyst will draw a distinction between the programs themselves and the instruments which repre-

195. See id. § 45-80 (Interim Supp. 1980).

196. See Law of April 30, 1981, ch. 282, 1981 N.C. Adv. Legis. Serv. 3 (to be codified at N.C. Gen. Stat. §§ 54B-1 to -262).

197. Law of April 30, 1981, ch. 282, § 3 (54B-195, -196), 1981 N.C. Adv. Legis. Serv. 3 (to be codified at N.C. Gen. Stat. §§ 54B-195, -196).

198. The new law states that any association may contract for interest at any *rate* permitted by federal law. Id. § 3 (54B-190) (to be codified at N.C. Gen. Stat. § 54B-190). Whether the term "rate" would be read to include variable rates is unclear, particularly in light of the specific authorizations for variable rate first lien loans authorized in N.C. Gen. Stat. § 45-80 (Interim Supp. 1980).

199. N.C. Gen. Stat. § 53-43(1) (1975) (banks have power of "loaning money on personal security or real and personal property").

200. See note 46 and accompanying text supra.

201. See note 190 supra.

sent the ultimate statement of the consumer's rights. The instruments must be evaluated on the "worst case" basis, as the consumer borrower has little, if any, control over whether the lender will choose to enforce the very letter of the contract provisions. Judged by this standard, the instruments contain several relatively harsh and arguably unjustified provisions favoring the lender in the event of a dispute. Notice periods are extremely short,[202] the borrower's rights are spelled out with a far less clarity than the lender's[203] and the instruments, because of the requirement of uniformity, occasionally appear to provide the lender with greater rights than it might really have under state law.[204] All of these deficiencies may force consumers to be less forthright in asserting their interests if and when disputes arise during the loan term.

On the positive side, the uniform instruments probably are superior from the consumer's standpoint than most typical home improvement loan instruments now in use. They do provide for actual notice prior to acceleration, and apparently they permit the borrower to avoid acceleration merely by making up back payments. Further, the instruments spell out the essence of the contract relationship in clear, readable prose. In light of the needs of FNMA and the Mortgage Corporation to respond to their primary constituencies—lender/sellers, investors, and repurchasers—the secondary market makers have done a creditworthy job in looking after America's consumers. Although consumers may have little choice as to the language in the loan contract, they do, of course, have the choice not to take out a loan at all. Most will find that the HIL program will offer fewer risks and greater benefits than other loan programs for major home improvements. The benefits the secondary market will provide in the rates and terms for home improvements loans will lead most consumers to applaud FNMA and the Mortgage Corporation for their efforts to bring the national money market into the home repair business.

202. See notes 112-114 and accompanying text supra.

203. See notes 120-123 and accompanying text supra.

204. See note 107 supra. Because there are few limitations on the practices of most major North Carolina lenders, this criticism is less valid in the North Carolina context.

APPENDIX A

NOTE

______________________, 19___ ______________________, North Carolina
City

____
Property Address City State Zip Code

1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay U.S. $______________ (this amount will be called "principal"), plus interest, to the order of the Lender. The Lender is ______________ ______________ I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note will be called the "Note Holder."

2. INTEREST

I will pay interest at a yearly rate of __________%.

Interest will be charged on that part of principal which has not been paid. Interest will be charged beginning on the date of this Note and continuing until the full amount of principal has been paid.

3. PAYMENTS

I will pay principal and interest by making payments each month of U.S. $______________.

I will make my payments on the ______ day of each month beginning on ______________, 19___ I will make these payments every month until I have paid all of the principal and interest and any other charges, described below, that I may owe under this Note. If, on ______________, ________, I still owe amounts under this Note, I will pay all those amounts, in full, on that date.

I will make my monthly payments at ______________________________ ______________ or at a different place if required by the Note Holder.

4. BORROWER'S FAILURE TO PAY AS REQUIRED

(A) Late Charge for Overdue Payments

If the Note Holder has not received the full amount of any of my monthly payments by the end of ______ calendar days after the date it is due, I will pay a later charge to the Note Holder. The amount of the charge will be __________% of my overdue payment, but not less than U.S. $______________ and not more than U.S. $______________ I will pay this late charge only once on any late payment.

(B) Notice From Note Holder

If I do not pay the full amount of each monthly payment on time, the Note Holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date I will be in default. That date must be at least 10 days after the date on which the notice is mailed to me or, if it is not mailed, 10 days after the date on which it is delivered to me.

(C) Default

If I do not pay the overdue amount by the date stated in the notice described in (B) above, I will be in default. If I am in default, the Note Holder may require me to pay immediately the full amount of principal which has not been paid and all the interest that I owe on that amount.

Even if, at a time when I am in default, the Note Holder does not require me to pay immediately in full as described above, the Note Holder will still have the right to do so if I am in default at a later time.

(D) Payment of Note Holder's Costs and Expenses

If the Note Holder has required me to pay immediately in full as described above, the Note Holder will have the right to be paid back for all of its costs and expenses to the extent not prohibited by applicable law. Those expenses include, for example, reasonable attorneys' fees.

5. THIS NOTE SECURED BY A DEED OF TRUST

In addition to the protections given to the Note Holder under this Note, a Deed of Trust, dated __________ __________, 19___, protects the Note Holder from possible losses which might result if I do not keep the promises which I make in this Note. That Deed of Trust describes how and under what conditions I may be required to make immediate payment in full of all amounts that I owe under this Note.

6. BORROWER'S PAYMENTS BEFORE THEY ARE DUE

I have the right to make payments of principal at any time before they are due. A payment of principal only is known as a "prepayment." When I make a prepayment, I will tell the Note Holder in a letter that I am doing so. A prepayment of all of the unpaid principal is known as a "full prepayment." A prepayment of only part of the unpaid principal is known as a "partial prepayment."

NORTH CAROLINA-HOME IMPROVEMENT-1/80-FNMA/FHLMC UNIFORM INSTRUMENT

I may make a full prepayment or a partial prepayment without paying any penalty. The Note Holder will use all of my prepayments to reduce the amount of principal that I owe under this Note. If I make a partial prepayment, there will be no delays in the due dates or changes in the amounts of my monthly payments unless the Note Holder agrees in writing to those delays or changes. I may make a full prepayment at any time. If I choose to make a partial prepayment, the Note Holder may require me to make the prepayment on the same day that one of my monthly payments is due. The Note Holder may also require that the amount of my partial prepayment be equal to the amount of principal that would have been part of my next one or monthly payments.

7. BORROWER'S WAIVERS

I waive my rights to require the Note Holder to do certain things. Those things are: (A) to demand payment of amounts due (known as "presentment"); (B) to give notice that amounts due have not been paid (known as "notice of dishonor"); (C) to obtain an official certification of nonpayment (known as a "protest"). Anyone else who agrees to keep the promises made in this Note, or who agrees to make payments to the Note Holder if I fail to keep my promises under this Note, or who signs this Note to transfer it to someone else also waives these rights. These persons are known as "guarantors, sureties and endorsers."

8. GIVING OF NOTICES

Any notice that must be given to me under this Note will be given by delivering it or by mailing it by certified mail addressed to me at the Property Address above. A notice will be delivered or mailed to me at a different address if I give the Note Holder a notice of my different address.

Any notice that must be given to the Note Holder under this Note will be given by mailing it by certified mail to the Note Holder at the address stated in Section 3 above. A notice will be mailed to the Note Holder at a different address if I am given a notice of that different address.

9. RESPONSIBILITY OF PERSONS UNDER THIS NOTE

If more than one person signs this Note, each of us is fully and personally obligated to pay the full amount owed and to keep all of the promises made in this Note. Any guarantor, surety, or endorser of this Note (as described in Section 7 above) is also obligated to do these things. The Note Holder may enforce its rights under this Note against each of us individually or against all of us together. This means that any one of us may be required to pay all of the amounts owed under this Note. Any person who takes over my rights or obligations under this Note will have all of my rights and must keep all of my promises made in this Note. Any person who takes over the rights or obligations of a guarantor, surety, or endorser of this Note (as described in Section 7 above) is also obligated to keep all of the promises made in this Note.

Witness the signature(s) and seal(s) of the undersigned.

______________________________(Seal)
Borrower

______________________________(Seal)
Borrower

______________________________(Seal)
Borrower

(Sign Original Only)

APPENDIX B

DEED OF TRUST

THIS DEED OF TRUST is made this ______________________ day of ______________________
19____, among the Grantor ____
______________________________ (herein "Borrower"), __________________________________
____ (herein "Trustee"), and the Beneficiary
____, a corporation organized and
existing under the laws of ____
whose address is ____
____ (herein "Lender").

BORROWER, in consideration of the indebtedness herein recited and the trust herein created, irrevocably grants and conveys to Trustee and Trustee's successors and assigns, in trust, with power of sale, the following described property located in the County of ______________, State of North Carolina:

which has the address of ____
[Street] [City]

North Carolina ______________________________ (herein "Property Address");
[Zip Code]

TO HAVE AND TO HOLD unto Trustee and Trustee's successors and assigns, forever, together with all the improvements now or hereafter erected on the property, and all easements, rights, appurtenances and rents (subject however to the rights and authorities given herein to Lender to collect and apply such rents), all of which shall be deemed to be and remain a part of the property covered by this Deed of Trust; and all of the foregoing, together with said property (or the leasehold estate if this Deed of Trust is on a leasehold) are hereinafter referred to as the "Property";

TO SECURE to Lender the repayment of the indebtedness evidenced by Borrower's note dated __________ ______________________________ and extensions and renewals thereof (herein "Note"), in the principal sum of U.S. $__________________________, with interest thereon, providing for monthly installments of principal and interest, with the balance of the indebtedness, if not sooner paid, due and payable on ____________________; the payment of all other sums, with interest thereon, advanced in accordance herewith to protect the security of this Deed of Trust; and the performance of the covenants and agreements of Borrower herein contained.

Borrower covenants that Borrower is lawfully seised of the estate hereby conveyed and has the right to grant and convey the Property, and that the Property is unencumbered, except for encumbrances of record. Borrower covenants that Borrower warrants and will defend generally the title to the Property against all claims and demands, subject to encumbrances of record.

UNIFORM COVENANTS. Borrower and Lender covenant and agree as follows:

1. **Payment of Principal and Interest.** Borrower shall promptly pay when due the principal and interest indebtedness evidenced by the Note and late charges as provided in the Note.

2. **Funds for Taxes and Insurance.** Subject to applicable law or a written waiver by Lender, Borrower shall pay to Lender on the day monthly payments of principal and interest are payable under the Note, until the Note is paid in full, a sum (herein "Funds") equal to one-twelfth of the yearly taxes and assessments (including condominium and planned unit development assessments, if any) which may attain priority over this Deed of Trust, and ground rents on the Property, if any, plus on-twelfth of yearly premium installments for hazard insurance, plus one-twelfth of yearly premium installments for mortgage insurance, if any, all as reasonably estimated initially and from time to time by Lender on the basis of assessments and bills and reasonable estimates thereof. Borrower shall not be obligated to make such payments of Funds to Lender to the extent that Borrower makes such payments to the holder of a prior mortgage or deed of trust if such holder is an institutional lender.

If Borrower pays Funds to Lender, the Funds shall be held in an institution the deposits or accounts of which are insured or guaranteed by a Federal or state agency (including Lender if Lender is such an institution). Lender shall apply the Funds to pay said taxes, assessments, insurance premiums and ground rents. Lender may not charge for so holding and applying the Funds, analyzing said account or verifying and compiling said assessments and bills, unless Lender pays Borrower interest on the Funds and applicable law permits Lender to make such a charge. Borrower and Lender may agree in writing at the time of execution of this Deed of Trust that interest on the Funds shall be paid to Borrower, and unless such agreement is made or applicable law requires such interest to be paid, Lender shall not be required to pay Borrower any interest or earnings on the Funds. Lender shall give to Borrower, without charge, an annual accounting of the Funds showing credits and debits to the Funds and the purpose for which each debit to the Funds was made. The Funds are pledged as additional security for the sums secured by this Deed of Trust.

If the amount of the Funds held by Lender, together with the future monthly installments of Funds payable prior to the due dates of taxes, assessments, insurance premiums and ground rents, shall exceed the amount required to pay said taxes, assessments, insurance premiums and ground rents as they fall due, such excess shall be, at Borrower's option, either promptly repaid to Borrower or credited to Borrower on monthly installments of Funds. If the amount of the Funds held by Lender shall not be sufficient to pay taxes, assessments, insurance premiums and ground rents as they fall due, Borrower shall pay to Lender any amount necessary to make up the deficiency in one or more payments as Lender may require.

Upon payment in full of all sums secured by this Deed of Trust, Lender shall promptly refund to Borrower any Funds held by Lender. If under paragraph 17 hereof the Property is sold or the Property is otherwise acquired by Lender, Lender shall apply, no later than immediately prior to the sale of the Property or its acquisition by Lender, any Funds held by Lender at the time of application as a credit against the sums secured by this Deed of Trust.

3. **Application of Payments.** Unless applicable law provides otherwise, all payments received by Lender under the Note and paragraphs 1 and 2 hereof shall be applied by Lender first in payment of amounts payable to Lender by Borrower under paragraph 2 hereof, then to interest payable on the Note, and then to the principal of the Note.

4. **Prior Mortgages and Deeds of Trust; Charges; Liens.** Borrower shall perform all of Borrower's obligations under any mortgage, deed of trust or other security agreement with a lien which has priority over this Deed of Trust, including Borrower's covenants to make payments when due. Borrower shall pay or cause to be paid all taxes, assessments and other charges, fines and impositions attributable to the Property which may attain a priority over this Deed of Trust, and leasehold payments or ground rents, if any.

5. **Hazard Insurance.** Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss by fire, hazards included within the term "extended coverage", and such other hazards as Lender may require and in such amounts and for such period as Lender may require.

The insurance carrier providing the insurance shall be chosen by Borrower subject to approval by Lender; provided, that such approval shall not be unreasonably withheld. All insurance policies and renewals thereof shall be in a form acceptable to Lender and shall include a standard mortgage clause in favor of and in a form acceptable to Lender. Lender shall have the right to hold the policies and renewals thereof, subject to the terms of any mortgage, deed of trust or other security agreement with a lien which has priority over this Deed of Trust.

In the event of loss, Borrower shall give prompt notice to the insurance carrier and Lender. Lender may make proof of loss if not made promptly by Borrower.

If the Property is abandoned by Borrower, or if Borrower fails to respond to Lender within 30 days from the date notice is mailed by Lender to Borrower that the insurance carrier offers to settle a claim for insurance benefits, Lender is authorized to collect and apply the insurance proceeds at Lender's option either to restoration or repair of the Property or to the sums secured by this Deed of Trust.

6. **Preservation and Maintenance of Property; Leaseholds; Condominiums; Planned Unit Developments.** Borrower shall keep the Property in good repair and shall not commit waste or permit impairment or deterioration of the Property and shall comply with the provisions of any lease if this Deed of Trust is on a leasehold. If this Deed of Trust is on a unit in a condominium or a planned unit development, Borrower shall perform all of Borrower's obligations under the declaration or covenants creating or governing the condominium or planned unit development, the by-laws and regulations of the condominium or planned unit development, and constituent documents.

7. **Protection of Lender's Security.** If Borrower fails to perform the covenants and agreements contained in this Deed of Trust, or if any action or proceeding is commenced which materially affects Lender's interest in the Property, then Lender, at Lender's option, upon notice to Borrower, may make such appearances, disburse such sums, including reasonable attorneys' fees, and take such action as is necessary to protect Lender's interest. If Lender required mortgage insurance as a condition of making the loan secured by this Deed of Trust, Borrower shall pay the premiums required to maintain such insurance in effect until such time as the requirement for such insurance terminates in accordance with Borrower's and Lender's written agreement or applicable law.

Any amounts disbursed by Lender pursuant to this paragraph 7, with interest thereon, at the Note rate, shall become additional indebtedness of Borrower secured by this Deed of Trust. Unless Borrower and Lender agree to other terms of payment, such amounts shall be payable upon notice from Lender to Borrower requesting payment thereof. Nothing contained in this paragraph 7 shall require Lender to incur any expense or take any action hereunder.

8. **Inspection.** Lender may make or cause to be made reasonable entries upon and inspections of the Property, provided that Lender shall give Borrower notice prior to any such inspection specifying reasonable cause therefor related to Lender's interest in the Property.

9. **Condemnation.** The proceeds of any award or claim for damages, direct or consequential, in connection with an condemnation or other taking of the Property, or part thereof, or for conveyance in lieu of condem-

nation, are hereby assigned and shall be paid to Lender, subject to the terms of any mortgage, deed of trust or other security agreement with a lien which has priority over this Deed of Trust.

10. Borrower Not Released; Forbearance By Lender Not a Waiver. Extension of the time for payment or modification of amortization of the sums secured by this Deed of Trust granted by Lender to any successor in interest of Borrower shall not operate to release, in any manner, the liability of the original Borrower and Borrower's successors in interest. Lender shall not be required to commence proceedings against such successor or refuse to extend time for payment or otherwise modify amortization of the sums secured by this Deed of Trust by reason of any demand made by the original Borrower and Borrower's successors in interest. Any forbearance by Lender in exercising any right or remedy hereunder, or otherwise afforded by applicable law, shall not be a waiver of or preclude the exercise of any such right or remedy.

11. Successors and Assigns Bound; Joint and Several Liability; Co-signers. The covenants and agreements herein contained shall bind, and the rights hereunder shall inure to, the respective successors and assigns of Lender and Borrower, subject to the provisions of paragraph 16 hereof. All covenants and agreements of Borrower shall be joint and several. Any Borrower who co-signs this Deed of Trust, but does not execute the Note, (a) is co-signing this Deed of Trust only to grant and convey that Borrower's interest in the Property to Trustee under the terms of this Deed of Trust, (b) is not personally liable on the Note or under this Deed of Trust, and (c) agrees that Lender and any other Borrower hereunder may agree to extend, modify, forbear, or make any other accommodations with regard to the terms of this Deed of Trust or the Note, without that Borrower's consent and without releasing that Borrower or modifying this Deed of Trust as to that Borrower's interest in the Property.

12. Notice. Except for any notice required under applicable law to be given in another manner, (a) any notice to Borrower provided for in this Deed of Trust shall be given by delivering it or by mailing such notice by certified mail addressed to Borrower at the Property Address or at such other address as Borrower may designate by notice to Lender as provided herein, and (b) any notice to Lender shall be given by certified mail to Lender's address stated herein or to such other address as Lender may designate by notice to Borrower as provided herein. Any notice provided for in this Deed of Trust shall be deemed to have been given to Borrower or Lender when given in the manner designated herein.

13. Governing Law; Severability. The state and local laws applicable to his Deed of Trust shall be the laws of the jurisdiction in which the Property is located. The foregoing sentence shall not limit the applicability of Federal law to this Deed of Trust. In the event that any provision or clause of this Deed of Trust or the Note conflicts with applicable law, such conflict shall not affect other provisions of this Deed of Trust or the Note which can be given effect without the conflicting provision, and to this end the provisions of this Deed of Trust and the Note are declared to be severable. As used herein, "costs", "expenses" and "attorneys' fees" include all sums to the extent not prohibited by applicable law or limited herein.

14. Borrower's Copy. Borrower shall be furnished a conformed copy of the Note and of this Deed of Trust at the time of execution or after recordation hereof.

15. Rehabilitation Loan Agreement. Borrower shall fulfill all of Borrower's obligations under any home rehabilitation, improvement, repair, or other loan agreement which Borrower enters into with Lender. Lender, at Lender's option, may require Borrower to execute and deliver to Lender, in a form acceptable to Lender, an assignment of any rights, claims or defenses which Borrower may have against parties who supply labor, materials or services in connection with improvements made to the Property.

16. Transfer of the Property. If Borrower sells or transfers all or any part of the Property or an interest therein, excluding (a) the creation of a lien or encumbrance subordinate to this Deed of Trust, (b) a transfer by devise, descent, or by operation of law upon the death of a joint tenant, or (c) the grant of any leasehold interest of three years or less not containing an option to purchase, Borrower shall cause to be submitted information required by Lender to evaluate the transferee as if a new loan were being made to the transferee. Borrower will continue to be obligated under the Note and this Deed of Trust unless releases Borrower in writing.

If Lender, on the basis of any information obtained regarding the transferee, reasonably determines that Lender's security may be impaired, or that there is an unacceptable likelihood of a breach of any convenant or agreement in this Deed of Trust, or if the required information is not submitted, Lender may declare all of the sums secured by this Deed of Trust to be immediately due and payable. If Lender exercises such option to accelerate, Lender shall mail Borrower notice of acceleration in accordance with paragraph 12 hereof. Such notice shall provide a period of not less than 30 days from the date the notice is mailed or delivered within which Borrower may pay the sums declared due. If Borrower fails to pay such sums prior to the expiration of such period, Lender may, without further notice or demand on Borrower, invoke any remedies permitted by paragraph 17 hereof.

NON-UNIFORM COVENANTS. Borrower and Lender further covenant and agree as follows:

17. Acceleration; Remedies. Except as provided in paragraph 16 hereof, upon Borrower's breach of any covenant or agreement of Borrower in this Deed of Trust, including the covenants to pay when due any sums secured by this Deed of Trust, Lender prior to acceleration shall give notice to Borrower as provided in paragraph 12 hereof specifying: (1) the breach; (2) the action required to cure such breach; (3) a date, not less than 10 days from the date the notice is mailed to Borrower, by which such breach must be cured; and (4) that failure to cure such breach on or before the date specified in the notice may result in acceleration of the sums secured by this Deed of Trust and sale of the Property. The notice shall further inform Borrower of the right to reinstate after acceleration and the right to bring a court action to assert the nonexistence of a default or any other defense of Borrower to acceleration and sale. If the breach is not cured on or before the date specified in the notice, Lender, at Lender's option, may declare all of the sums secured by this Deed of Trust to be immediately due and payable without further demand and may invoke the power of sale and any other remedies permitted by applicable law. Lender shall be entitled to collect all reasonable costs and expenses incurred in pursuing the remedies provided in this paragraph 17.

If Lender invokes the power of sale, and if it is determined in a hearing held in accordance with applicable

law that Trustees can proceed to sale, Trustee shall take such action regarding notice of sale and shall give such notices to Borrower and to other persons as applicable law may require. After the lapse of such time as may be required by applicable law and after the publication of the notice of sale, Trustee, without demand on Borrower, shall sell the Property at public auction to the highest bidder at the time and place and under the terms designated in the notice of sale in one or more parcels and in such order as Trustees may determine. Lender or Lender's designee may purchase the Property at any sale.

Trustee shall deliver to the purchaser Trustee's deed conveying the Property so sold without any covenant or warranty, expressed or implied. The recitals in the Trustee's deed shall be prima facie evidence of the truth of the statements made therein. Trustee shall apply the proceeds of the sale in the following order: (a) to all reasonable costs and expenses of the sale, including, but not limited to, Trustee's fees of ____________ percent (____%) of the gross sale price and costs of title evidence; (b) to all sums secured by this Deed of Trust; and (c) the excess, if any, to the person or persons legally entitled thereto.

18. Borrower's Right to Reinstate. Notwithstanding Lender's acceleration of the sums secured by this Deed of Trust, due to Borrower's breach, Borrower shall have the right to have an proceedings begun by Lender to enforce this Deed of Trust discontinued at any time prior to the earlier to occur of (i) the fifth day before sale of the Property pursuant to the power of sale contained in this Deed of Trust or (ii) entry of a judgment enforcing this Deed of Trust if: (a) Borrower pays Lender all sums which would be then due under this Deed of Trust and the Note had no acceleration occurred; (b) Borrower cures all breaches of any other covenants or agreements of Borrower contained in this Deed of Trust; (c) Borrower pays all reasonable expenses incurred by Lender and Trustee in enforcing the convenants and agreements of Borrower contained in this Deed of Trust, and in enforcing Lender's and Trustee's remedies as provided in paragraph 17 hereof, including, but not limited to, reasonable attorneys' fees; and (d) Borrower takes such action as Lender may reasonably require to assure that the lien of this Deed of Trust, Lender's interest in the Property and Borrower's obligation to pay the sums secured by this Deed of Trust shall continue unimpaired. Upon such payment and cure by Borrower, this Deed of Trust and the obligations secured hereby shall remain in full force and effect as if no acceleration had occurred.

19. Assignment of Rents; Appointment of Receiver; Lender in Possession. As additional security hereunder, Borrower hereby assigns to Lender the rents of the Property, provided that Borrower shall, prior to acceleration under paragraph 17 hereof or abandonment of the Property, have the right to collect and retain such rents as they become due and payable.

Upon acceleration under paragraph 17 hereof or abandonment of the Property, Lender, in person, by agent or by judicially appointed receiver shall be entitled to enter upon, take possession of and manage the Property and to collect the rents of the Property including those past due. All rents collected by Lender or the receiver shall be applied first to payment of the costs of management of the Property and collection of rents, including, but not limited to, receiver's fees, premiums on receiver's bonds and reasonable attorneys' fees, and then to the sums secured by this Deed of Trust. Lender and the receiver shall be liable to account only for those rents actually received.

20. Release. Upon payment of all sums secured by this Deed of Trust, Lender or Trustee shall cancel this Deed of Trust without charge to Borrower. If Trustee is requested to release this Deed of Trust, all notes evidencing indebtedness secured by this Deed of Trust shall be surrendered to Trustee. Borrower shall pay all costs of recordation, if any.

21. Substitute Trustee. Lender may from time to time remove Trustee and appoint a successor trustee to any Trustee appointed hereunder by an instrument recorded in the county in which this Deed of Trust is recorded. Without conveyance of the Property, the successor trustee shall succeed to all the title, power and duties conferred upon the Trustee herein and by applicable law.

REQUEST FOR NOTICE OF DEFAULT AND FORECLOSURE UNDER SUPERIOR MORTGAGES OR DEEDS OF TRUST

Borrower and Lender request the holder of any mortgage, deed of trust or other encumbrance with a lien which has priority over this Deed of Trust to give Notice to Lender, at Lender's address set forth on page one of this Deed of Trust, of any default under the superior encumbrance and of any sale or other foreclosure action.

IN WITNESS WHEREOF, Borrower has executed and sealed this Deed of Trust.

____________________________________ (Seal)
-Borrower

____________________________________ (Seal)
-Borrower

STATE OF NORTH CAROLINA, ________________________ County ss:

I, ________________________, a Notary Public of the County of ____________________________,
State of North Carolina, do hereby certify that ____
__________ personally appeared before me this day and acknowledged the due execution of the foregoing instrument.

Witness may hand and official seal this ____________________ day of ____________________, 19____

My Commission expires: ____________________________
Notary Public

STATE OF NORTH CAROLINA, ________________________ County ss:

The foregoing certificate of ______________________________________, a Notary Public of the County of

________________________, State of ________________________, is certified to be correct.

This ________ day of ________, 19 ___

Registrar of Deeds

Probate fee ______¢ paid. By ________________________

Deputy Assistant

(Space Below This Line Reserved For Lender and Recorder)