BYU Law Review

Volume 1998 | Issue 3 Article 4

9-1-1998

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I. INTRODUCTION

The concept of negotiability of promissory notes is solidly entrenched in American commercial law. It derives from the English common law notion that a negotiable instrument is a reification of the obligation it describes; the instrument is regarded as a tangible form of the obligation.[1] This notion has multiple ramifications, but three stand out. The first is the holder in due course doctrine which asserts that, when a negotiable instrument is transferred by the correct process (negotiation, which requires delivery of the paper)[2] to someone with the right qualities (good faith, lack of notice, and payment of value),[3] the maker of the instrument may not raise against the holder most of the common defenses to payment that would have been assertable against the original payee.[4] This doctrine

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1. The idea is that the piece of paper on which the bill "was written or printed should be treated as if it—the piece of paper—was itself the claim or debt which it evidenced. This idea came to be known as the doctrine of merger—the debt was merged in the instrument." Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 449 (1979); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 338 cmt. h (1981) ("Certain writings are treated in the ordinary course of business as symbols of contractual rights."); E. ALLAN FARNSWORTH, CONTRACTS § 11.7 (1982) ("[T]he right is regarded as intimately connected with the writing . . . .").

2. *See* U.C.C. § 3-201 (1990).

3. *See id.* § 3-302.

4. The defenses that can be raised even against a holder in due course are known as "real" defenses and are listed in UCC section 3-305(a)(1) (1990). They include infancy, duress, lack of capacity, illegality, fraud in the execution, and discharge in insolvency. Defenses not on this list are known as "personal" defenses and cannot be raised against a holder in due course. They include "failure or lack of consideration, breach of warranty, unconscionability and garden variety fraud (fraud in the inducement)." JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL

is firmly (if complexly) established by Article 3 of the Uniform Commercial Code (UCC).[5] Negotiability has traditionally been regarded as a great aid to commerce, since it relieves the secondary market purchaser of the instrument of the need to investigate its enforceability by contacting the maker.[6] Thus, reification of the debt in the paper has been thought to serve a useful commercial purpose.[7]

A second ramification of the "reified obligation" principle involves competing transfers of the instrument. In general, the right to payment under the instrument may be gained only by acquiring possession of the paper document. Even if some other form of transfer (e.g., a separate written document of assignment) might be enforceable for some purposes, it is clear that as between competing assignees, the one who has acquired the document itself will prevail. This principle is embodied in Article 3 for holders in due course,[8] but is also widely followed for instruments that are not technically negotiable or that are not held in due course as defined in Article 3.[9]

CODE § 14-9 (3d ed. 1988).

5. The original negotiable instruments were "inland bills of exchange," typically issued by merchants, but the concept was extended to promissory notes by the end of the eighteenth century. The history of the holder in due course doctrine is described in M.B.W. Sinclair, *Codification of Negotiable Instruments Law: A Tale of Reiterated Anachronism*, 21 U. TOL. L. REV. 625 (1990) and Edward L. Rubin, *Learning From Lord Mansfield: Toward a Transferability Law For Modern Commercial Practice*, 31 IDAHO L. REV. 775 (1995).

UCC Article 3 deals only with negotiable instruments, since under UCC section 3-104(b) (1990), "'[i]nstrument' means a negotiable instrument." Thus, non-negotiable notes are outside Article 3's scope. *See* U.C.C. § 3-104 cmt. 1 (1990).

6. In the absence of the holder in due course doctrine, the secondary market investor can demand that the maker of the note give an estoppel statement before the investor makes the purchase. Such a statement avers that the note is enforceable and that the maker has no defenses to it. In some respects the estoppel statement is better protection for the investor than the holder in due course doctrine; it protects the investor against "real" as well as "personal" defenses, and it is not subject to attack on the technical ground that some errant language in the note renders it non-negotiable. Nonetheless, such statements seem to be obtained only in closely-negotiated, non-routine purchases of notes from parties other than consumers. *See* Ronald J. Mann, *Searching For Negotiability in Payment and Credit Systems,* 44 UCLA L. REV. 951, 975 n.80 (1997).

7. *See id.* at 957-58.

8. *See* U.C.C. § 3-301 (1990); GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 5.34 (3d ed. 1993). Pre-U.C.C. law was the same. *See* United States Nat'l Bank v. Holton, 195 P. 823 (Or. 1921).

9. *See* NELSON & WHITMAN, *supra* note 8, § 5.34; Fidelity & Deposit Co. v. Ticor Title Ins. Co., 943 P.2d 710 (Wash. App. 1997); RESTATEMENT (SECOND) OF

The third result of viewing a negotiable instrument as a "reified obligation" is the subject of this article. I refer to it here simply as the "payment rule." In substance, this rule holds that once an instrument has been delivered to an assignee, one who makes payment on the debt represented by the instrument to anyone other than the possessor of the instrument does so at his or her peril. The payment is not binding on the possessor unless actually forwarded to him or her. This is so despite the fact that the payor may not know of the transfer, having never been notified of it by either the original payee or the transferee. This view seems required by Article 3 for notes that fit its definition of negotiability,[10] but is commonly adopted with respect to non-negotiable notes as well.[11]

The first of these three results of "reification" of the obligation, the holder in due course rule, is under strong attack[12] on the grounds that it is irrelevant, unnecessary, and out of touch with modern commercial practice. Little has been said about the second rule, which treats transfer of the paper as the best or only way to transfer the obligation. My purpose in this article is to address and attack the third rule, which in effect requires the payor of a note to make no payments without first demanding to see the note itself, in order to confirm that the payee still holds it.[13] I propose to deal with the rule principally

CONTRACTS § 342(b)(iv) (1981). An exception is sometimes made if the first assignment is recorded without delivery of the note, and the note is subsequently delivered to a second assignee. *See* NELSON & WHITMAN, *supra* note 8, § 5.34.

10. *See* discussion *infra* Part III.A.

11. *See* FARNSWORTH, *supra* note ?, § 11.7 ("[T]he obligor who renders performance to a person who does not produce the writing does so at his peril, regardless of the lack of notification.").

12. For consumer transactions, the holder in due course doctrine was effectively eliminated in 1975 by the Federal Trade Commission's rule on "Preservation of Consumers' Claims and Defenses." 16 C.F.R. § 433.1-.2 (1997). Broader attacks on the doctrine, suggesting that it has no important role even in non-consumer transactions, are found in Mann, *supra* note 6, at 1003. *See also* James S. Rogers, *An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision*, 31 IDAHO L. REV. 689 (1995); James Steven Rogers, *The Irrelevance of Negotiable Instruments Concepts in the Law of the Check-Based Payment System*, 65 TEX. L. REV. 929, 945 (1987).

13. The payment rule may be seen as a corollary of the holder in due course doctrine itself. *See* Sinclair, *supra* note 5, at 625 n.16 (discussing Gilmore, *supra* note ?, at 448-50). But in modern law there is an important difference, for the holder in due course doctrine only applies to negotiable instruments, while the payment rule is widely applied to both negotiable and non-negotiable notes. *See infra* Part III.A-B.

in the context of mortgage law, since that is where it nearly always causes trouble in practice.

The payment rule arises in the following scenario. Mortgagor borrows money from Mortgagee, giving a promissory note secured by a mortgage. The note calls for regular monthly payments of principal and interest, which Mortgagor pays in a timely manner. Subsequently, Mortgagee transfers the note to Assignee, delivering possession of it and perhaps executing and recording an assignment of the mortgage as well. Assignee does not make Mortgagee an agent for purposes of collection of the debt. No one gives Mortgagor notice of the assignment, and Mortgagor continues to make regular payments to Mortgagee. Later, Mortgagor decides to pay off the debt in full and makes the payment to Mortgagee. When making the final payment, Mortgagor does not ask to see the note, but relies on Mortgagee's assurance that the note will be returned and a formal discharge of the mortgage will be forwarded to Mortgagor in due course. However, Mortgagee does not forward the final payment to Assignee. Instead, Mortgagee absconds with the funds or becomes insolvent. Assignee contacts Mortgagor and demands that Mortgagor pay the debt in full to Assignee; if Mortgagor fails to do so, Assignee threatens to foreclose the mortgage or bring an action against Mortgagor on the debt. Under the payment rule, there is an excellent probability that Assignee will prevail in a foreclosure action or a suit on the debt.

Many variations on this scenario may occur. Among them are the following:

a. The obligation undertaken by Mortgagor may or may not be a negotiable instrument.[14]
b. The note may be assigned outright, or may instead be pledged as a "collateral assignment" to secure some other obligation owed by Mortgagee to Assignee.[15]
c. Mortgagee may be an individual, a general business corporation, or a commercial lending institution.[16]

14. *See infra* Part III.A-B.
15. *See infra* Part III.C.5.
16. *See infra* Part III.C.1-3.

d. When Mortgagee receives the installment payments from Mortgagor, Mortgagee may or may not establish a pattern of forwarding them to Assignee.[17]
e. The controversy between Mortgagor and Assignee may focus on installment payments that Assignee has not received, or on the final payment, or on both.[18]

The payment rule seems bizarre in light of the virtually universal view of lawyers and academics (not to mention lay persons who are asked to express an opinion on the matter) that allowing Assignee to collect the debt a second time is unjustifiable and unconscionable. I believe that permitting Assignee to prevail is wrong, irrespective of any or all of the factors mentioned above. In allowing Assignee to collect the debt a second time the law is, I suggest, seriously out of touch with modern reality. The payment rule is not merely out of date and useless; it is affirmatively noxious and harmful. It places a potentially devastating risk on the payor, and imposes an effective duty on the payor that virtually no lay person and relatively few lawyers would understand or expect.[19] That risk could be eliminated by requiring the assignee to take the inexpensive and simple step of giving mailed notice of the transfer to the note's maker.

As one of the two co-reporters of the *Restatement (Third) of Property (Mortgages)*, which was published in 1997, I have attempted to encourage change in this area of the law, both in the content of the *Restatement* and otherwise. This article is the story of that effort.

II. THE HISTORIC ORIGIN OF THE "SYMBOLIC WRITING" DOCTRINE

At common law, bills of exchange (given in payment for the sales of goods) were regarded as negotiable,[20] but at the end of

17. *See infra* Part III.C.3.

18. *See infra* Part III.C.4.

19. I have taught the payment rule in many continuing legal education courses, and lawyers in the audience have often expressed incredulity that it is or could be the law. This lack of awareness seems borne out by the fact that in many of the reported cases, the person erroneously making the payment without demanding to see the note is a lawyer. *See* cases cited *infra* note ?.

20. *See* Hussey v. Jacob, 91 Eng. Rep. 954, 955 (1696) ("[A] bill of exchange once accepted by a responsible man, is of such credit among traders, that it passes as

the seventeenth century, the common law courts, rather surprisingly, held that promissory notes were not negotiable.[21] Notes were regarded as mere "choses in action," and hence were not assignable at all, much less assignable in a way that would free the assignee from the maker's defenses.[22] This result conflicted with broadly-held commercial expectations. Parliament responded immediately by enacting the Statute of Anne,[23] which made promissory notes assignable, although it did not give assignees express immunity from the maker's defenses. The holder in due course doctrine, giving a holder freedom from the maker's defenses, was recognized by the common law courts in 1696,[24] but was not enshrined in statute until 1882 in the English Bills of Exchange Act.[25] In the United States, John W. Crawford was appointed in 1895 by the Conference of Commissioners on Uniform State Laws to draft what became the Negotiable Instruments Law (N.I.L.), which closely followed the Bills of Exchange Act and ultimately imposed the holder in due course doctrine in every American state.[26]

The origins of the payment rule in America are obscure, probably because it was regarded as intrinsically related to the holder in due course doctrine. The earliest American case applying it appears to be *Brown v. Blydenburg*,[27] decided by the

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current as ready money, and is negociated [sic] from one to another through all Europe, and exchanged upon valuable consideration . . . .").

21. *See* Clerke v. Martin, 92 Eng. Rep. 6 (1700); *see generally* JAMES STEVEN ROGERS, THE EARLY HISTORY OF THE LAW OF BILLS AND NOTES 177-86 (1995) (explaining the reasoning of seventeenth century courts holding that promissory notes are not negotiable).

22. *See* Nicholson v. Seldnith, 91 Eng. Rep. 695, 695 (K.B. 1692).

23. 3 & 4 Anne, ch. 9 (1704).

24. *See Hussey*, 91 Eng. Rep. at 954.

25. 45 & 46 Vict., ch. 61 (1882).

26. *See* JOHN W. CRAWFORD, THE NEGOTIABLE INSTRUMENTS LAW, Preface (1st ed. 1897); JAMES BARR AMES ET AL., THE NEGOTIABLE INSTRUMENTS LAW WITH COMMENTS AND CRITICISMS iii (1908). Both of these sources summarize the history of the Negotiable Instruments Law.

27. 7 N.Y. 141 (1852). The Massachusetts Supreme Court had applied the payment rule even earlier in *Wheeler v. Guild*, 37 Mass. (20 Pick.) 545 (1838). However, the case involved an unsecured promissory note, not a mortgage loan, and the payment by the debtor was made, not to the original payee of the note, but to an individual member of the law firm to which it had been collaterally assigned. The court found that the individual lawyer had no authority to receive payment on behalf of the firm and that "the payment must be considered as made at the risk of the party paying; and as the party receiving, in fact had no right to receive payment,

New York Court of Appeals in 1852. There the mortgagee had assigned the debtor's bond and mortgage, but the debtor was not notified of the assignment.[28] The debtor purported to pay off the debt by a transfer of the real estate to the mortgagee[29] — in other words, a deed in lieu of foreclosure. The court held that the purported payment was ineffective against the assignee.[30] The court regarded the debtor as negligent in making the payment without verifying that the mortgagee still had the bond: "[I]t is against all probability that [the mortgagor] would have paid the debt . . . without inquiry for his bond."[31]

This negligence rationale was employed by most of the other early cases. The courts reasoned that by failing to demand surrender or display of the note when making the payment, the mortgagor had "not used due diligence in protecting his rights"[32] and hence could not complain of having to pay twice. This view was firmly established by the beginning of the twentieth century.[33]

The fact that the debt in *Brown v. Blydenburg* was represented by a bond, rather than a promissory note, is of some interest. During the nineteenth century opinions varied as to whether the payment rule was limited to negotiable instruments, or whether it also applied to non-negotiable evidences of debt, such as bonds.[34] During the twentieth

such payment and receipt did not discharge the note, as against the true owner." *Id.* at 554.

28. *See Blydenburg*, 7 N.Y. at 145.

29. *See id.*

30. *See id.* at 146

31. *Id.*

32. Garrett v. Fernauld, 57 So. 671, 672 (Fla. 1912); *see also* Brayley v. Ellis, 32 N.W. 254, 255 (Iowa 1887).

33. *See* MELVILLE M. BIGELOW, THE LAW OF BILLS, NOTES, AND CHEQUES 273 (1900) ("[T]he party paying should require the paper to be delivered up to him as the final assurance of his discharge. If he should fail to do so, . . . the true owner . . . could enforce another payment."); M. D. CHALMERS, THE LAW OF BILLS OF EXCHANGE 234 (1881) ("Payment in order to operate as a discharge of the bill must be made to the holder or to some person authorized to receive payment on his behalf."); *see also* WILLIAM EVERETT BRITTON, BILLS AND NOTES § 270 (1943).

34. *See* Foster v. Carson, 28 A. 356, 356 (Pa. 1894) (holding the payment rule inapplicable to bonds); *see generally* Brown v. Blydenburgh, 7 N.Y. 141 (1852) (holding the payment rule applicable to bonds). The rationale of the payment rule was confined to negotiable instruments in *Wheeler v. Guild*, 37 Mass. (20 Pick.) 545, 554 (1838); *Hollinshead v. John Stuart & Co.*, 77 N.W. 89, 93 (N.D. 1898); and *Koen v. Miller*, 150 S.W. 411, 412 (Ark. 1912).

century that debate has largely disappeared, supplanted by the fairly consistent view that the payment rule applies to all promissory notes, whether negotiable or not.[35]

III. THE PAYMENT RULE

A. *Negotiable Notes*

In the United States, the payment rule has been an intrinsic component of the law of negotiable notes since negotiability began to receive uniform statutory recognition.[36] The 1990 version of UCC Article 3, currently in effect, governs negotiable instruments. Article 3 is widely understood as adopting the payment rule, although the logic of its language is fairly convoluted. Three different sections must be read together. Section 3-602 provides that an instrument is paid "to the extent payment is made . . . to a person entitled to enforce the instrument."[37] Under UCC section 3-301, "person entitled to enforce" an instrument means (with certain exceptions not here relevant) either "the holder of the instrument" or "a nonholder in possession of the instrument who has the rights of a holder."[38] Thus, section 3-301 ties the enforcement right to possession of the paper. Finally, UCC section 3-203(a) provides

35. *See* discussion *infra* Parts III.A & B. The use of bonds as evidence of mortgage debt has been supplanted by promissory notes in most jurisdictions, so that it is difficult to find modern cases dealing with bonds.

36. The Negotiable Instruments Law (N.I.L.), adopted in 1897, embodied the payment rule in the following sections: "The holder of a negotiable instrument may sue thereon in his own name; and payment to him in due course discharges the instrument." N.I.L. § 51 (1897). It is interesting that this section, like the 1990 version of U.C.C. § 3-602, does not say that *only* payment to the holder can discharge the instrument, but that seems to have been its intent. The N.I.L. buttressed this understanding by expressly authorizing the payor to demand the note: "The instrument must be exhibited to the person from whom payment is demanded, and when it is paid must be delivered up to the party paying it." N.I.L. § 74 (1897). Finally, payment in due course was defined as payment "to the holder thereof in good faith and without notice that his title is defective." N.I.L. § 88 (1897).

Article 3(**I changed from 2)** of the Uniform Commercial Code was originally promulgated in 1952. In its pre-1990 versions, the U.C.C. adopted the payment rule in § 3-603(1): "The liability of any party is discharged to the extent of his payment or satisfaction *to the holder* . . . ." U.C.C. § 3-603(1) (emphasis added). Once again, this language does not make it clear that payment to the holder is the sole method of discharging the debt, but it is generally so understood.

37. U.C.C. § 3-602(a) (1990).

38. *Id*. § 3-301. Of course, payment to an authorized agent of such a person will also suffice. *See* text accompanying *infra* notes 49-54.

that "[a]n instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument."[39] Rather oddly, Article 3 never overtly states what seems to be its well-accepted premise: that payment can be made *only* to the person with possession of the instrument. The previous version of Article 3 was similarly silent on that precise point.[40] Nevertheless, virtually all those who deal with Article 3 read it as if Section 3-602 said "only."[41]

Some decisions reason that the payment rule stems from the holder in due course doctrine. They assert that since "payment" is a personal defense and hence cannot be raised against a holder in due course, only such holders are entitled to make the payor pay again.[42] However, this view reflects a misunderstanding of the holder in due course doctrine. The sort of "payment" to which this doctrine refers is payment made *before* the transfer of the instrument, which is not the type of payment with which we are concerned.[43] It is not the holder in due course doctrine, but the "reified obligation" concept embodied in the sections of Article 3 quoted above, that imposes the payment rule for negotiable notes. A "person entitled to enforce," who is required to possess the note, has the benefit of the payment rule whether or not he or she is "in due course."

B. Non-Negotiable Notes

Two distinct themes are represented in the non-Article 3 cases adopting the payment rule. One theme, by analogy to Article 3, is the "symbolic writing" doctrine. The note is the reified obligation and can be discharged only by paying the person who has possession of the *res*.[44] The second theme is

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39. U.C.C. § 3-203(a) (1990).

40. *See supra* note 36.

41. For evidence of the wide acceptance of that premise, *see infra* note 137.

42. *See, e.g.*, Taylor v. Roeder, 360 S.E.2d 191, 193-94 (Va. 1987); Groover v. Peters, 202 S.E.2d 413, 414 (Ga. 1973).

43. *See, e.g.*, Goetz v. Selsor, 628 S.W.2d 404, 406 (Mo. Ct. App. 1982) (holding that where payment was made prior to assignment, assignee who was not holder in due course was bound by payment).

44. *See* RESTATEMENT (SECOND) OF CONTRACTS § 338(4) (1981); *In re* Columbia Pac. Mortg., Inc., 22 B.R. 753, 755 (Bankr. W.D. Wash. 1982). An interesting counterpoise to this widely-held position is provided by *Taylor v. Roeder*, 360 S.E.2d 191 (Va. 1987). The court conceded that payment to the mortgagee would have been

negligence. It is said to be negligent for the payor to pay without demanding to see the original note, thereby verifying that it is still in the hands of the original payee. Perhaps the leading case taking this view is *Assets Realization Co. v. Clark*,[45] where the court observed that when final payment is made, "the evidence of the debt naturally and ordinarily is produced and delivered, and therefore the failure to do this in the absence of sufficient explanation constitutes notice which makes the payment or transaction unavailing as against a prior assignment although unrecorded."[46]

These two themes are alter egos of one another. Since the note itself represents and reifies the debt, it is supposedly

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ineffective if the note had been negotiable and hence covered by UCC Article 3. *See id.* at 193. However, the note provided for a variable interest rate, and the court concluded that it was not negotiable. *See id.* at 194-95. The court refused to apply the symbolic writing doctrine, commenting:

> Assuming the abstract correctness of that argument, it does not follow that the makers undertook the further obligation of making a monthly canvass of all inhabitants of the earth in order to ascertain who the holder might be. In the absence of notice to the makers that their debt had been assigned, they were entitled to the protection of the rule in *Evans v. Joyner* in making good-faith payment to the original payee of these non-negotiable notes.

Id. at 195.

45. 98 N.E. 457 (N.Y. 1912).

46. *Id.* at 461. More recent New York case law has apparently limited *Clark* to negotiable notes, although it was certainly not so limited by its terms. *See* Felin Assoc., Inc. v. Rogers, 326 N.Y.S.2d 413, 415 (App. Div. 1971) ("[P]ayment to such a payee [on a non-negotiable instrument] binds the transferee." (quoting 42 N.Y. JUR., *Negotiable Instruments* § 582 (1965)).

Older case law was divided with respect to mortgages securing bonds as distinct from notes. (A bond is non-negotiable.) *Compare* Drobney v. Sullivan, 266 N.Y.S. 245 (Sup. Ct. 1933) (applying symbolic writing rule to mortgage bonds; and holding that payment to one who does not hold the bond is negligent and not binding) *with* Foster v. Carson, 28 A. 356 (Pa. 1894) ("[A]ctual notice of the assignment is essential to the completion of the contract relations between the assignee and the mortgagor, and consequently, until that has been given, the mortgagor does no wrong in making payments to the mortgagee.").

Professor Hanna commented on the distinction between notes and bonds:

> [D]oes the actual practice of men in the case of bond and mortgage go as far as the practice as to negotiable paper[?] There the practice is clear, both of requiring delivery on purchase, and of requiring surrender on payment. How with bond and mortgage? To what end require the papers, or require to see them—apart from bringing oneself within these cases, i.e., apart from practices which follow rather than precede the legal rules?

JOHN HANNA, CASES AND MATERIALS ON SECURITY 849-50 (2d ed. 1940). The importance of the distinction is largely dissipated, since bonds are so rarely used as evidence of mortgage debt today.

obvious that discharge of the debt without getting the paper is impossible; hence it is said to be negligent for the payor to fail to demand the note.

C. *Variations on the Theme: Agency, Non-Final Payments, and Collateral Assignments*

It is universally agreed that payment to the authorized agent of the note's assignee will count against the assignee. Thus, if the assignee makes the original mortgagee an agent for collection of the note, a payment made to the mortgagee after the assignment has occurred will be effective and binding on the assignee. Early cases were extremely parsimonious in finding an agency relationship in the absence of a formal agreement,[47] while more recent cases seem to bend over backward to find an agency relationship or an estoppel against the assignee.[48]

When can an agency relationship be found? The most obvious case is that of express authority, where the assignee of the note has in fact authorized the mortgagee to collect the note.[49] Two other forms of authority are also recognized: implied (or as the *Restatement (Second) of Agency* calls it, "inferred") authority[50] and apparent authority. Although the distinction between implied and apparent authority is often not rigorously observed by the courts, it is nonetheless noteworthy.

Implied authority is simply the authority that an agent must reasonably be regarded as having in order to carry out his or her express authority.[51] For example, an agent with express authority to collect a debt on behalf of the principal has implied authority to give the payor a receipt and, if the payment is in full, to return the payor's promissory note and release any collateral that was held to secure payment.[52] These acts are

47. *See, e.g.*, Tilton v. Boland, 31 P.2d 657, 660 (Or. 1934) (noting that authority from assignee to collect interest does not authorize agent to collect principal).

48. *See infra* Part III.C.2-3.

49. *See, e.g.*, Frei v. Hamilton, 601 P.2d 307, 309 (Ariz. Ct. App. 1979) (holding that the authorized agent can accept payments on behalf of assignee of note but does not have power to waive acceleration of the note).

50. The *Restatement (Second) of Agency* § 72 (1958) refers to this type of agency relationship as "inferred authority."

51. *See* WARREN A. SEAVEY, HANDBOOK ON THE LAW OF AGENCY § 8C (1964).

52. *See* RESTATEMENT (SECOND) OF AGENCY § 72 (1958).

understood by the business community to be a natural part of the process of receiving payment; the principal is bound by these acts even if the agent had no specific express authority with respect to them, or even if the principal had, without the payor's knowledge, forbidden the agent to do them.

Apparent authority is conceptually quite different. It can exist when no actual authority, express or implied, has been granted by the principal to the agent. It arises instead from some conduct of the principal that leads a third party reasonably to believe that a transaction with the agent will bind the principal.[53] For example, if the holder of a note and mortgage writes a letter to a borrower, telling the borrower that payments on the loan may be made to XYZ Financial Services Co., any payments made by the borrower to XYZ will bind the holder even though the holder has in fact never authorized XYZ to collect anything, and indeed has never communicated with XYZ at all. Apparent authority is similar to estoppel, but there is a theoretical difference: to establish apparent authority, the third party who deals with the agent must show that he or she reasonably believed in the agent's authority, but need not show any detrimental change of position in reliance on that belief. In most cases, of course, there is indeed detrimental reliance, so that the difference between apparent authority and estoppel is seldom of much practical importance.[54]

The *Restatement (Second) of Agency* takes the view that apparent authority can never arise when the existence of the principal is undisclosed.[55] This seems unduly narrow and appears to stem from the view that the third party must believe that an agency relationship exists, instead of merely assuming that the agent is properly acting on his or her own behalf. However, the *Restatement* recognizes that many courts do not read the concept so narrowly and that they often find apparent authority even though the existence of the principal is

53. *See id.* at § 8; *see also* SEAVEY, *supra* note 51, § 8D.

54. *See* RESTATEMENT (SECOND) OF AGENCY § 8 cmt. d (1958) ("In the usual agency case, however, little turns upon the distinction. In fact, the elements of estoppel are so frequently present that the courts have repeatedly stated that apparent authority is based upon estoppel.").

55. *See id.* at § 8 cmt. a ("[A]pparent authority exists only with regard to those who believe and have reason to believe that there is authority; there can be no apparent authority created by an undisclosed principal.").

undisclosed.[56] This is an important point in the present analysis, since the adverse consequences of the payment rule often arise in a context in which the payor knows nothing about the assignment of the note and mortgage, but instead assumes that the original mortgagee still holds them and is acting for its own account.

It is significant that both implied and apparent authority are tied to the ordinary expectations of people engaged in the sort of business that the supposed agent is conducting. In the case of implied authority, business expectations are useful in establishing the sorts of ancillary acts that the agent will typically engage in while performing under his or her express authority. In the case of apparent authority, business expectations help to show the scope of the authority that the principal's conduct leads others to believe the agent possesses. I will suggest below that in light of the very widespread practice of secondary mortgage market assignees delegating full servicing authority to their mortgagee-assignors, and in light of the equally widespread failure of mortgagors and their closing agents to demand exhibition of promissory notes before paying off mortgagees, courts should be virtually compelled to find that mortgagees have implied or apparent authority to accept payment on behalf of their assignees in all cases in which the assignment is undisclosed to the mortgagor. First, however, I turn to an analysis of the three types of authority and consider how they have fared in the case law dealing with the payment rule.

1. *Express authority*

Of the various types of agency, express authority, when present, is usually the easiest to prove. It is created by an oral or written delegation of power by the principal to the agent. If the assignee has entered into a written servicing agreement with the original mortgagee, as is very commonly the case,

56. *See id.* at § 8, cmt f ("The term 'apparent authority' has been broadly used by the courts to describe the power which agents have in creating liability against their principals, although without authority. Thus, it has been used as a basis for imposing liability upon an undisclosed principal (see § 195), as well as in a variety of other situations dealt with in Chapter 6, where policy considerations require that the principal should be liable for unauthorized conduct.").

payment to the mortgagee presents no problem, for such agreements expressly authorize the servicer to collect principal and interest. Such agreements are almost universally used by the Federal National Mortgage Association ("FNMA"), the Federal Home Loan Mortgage Corporation ("FHLMC"), and by nearly all other large-scale secondary market investors, with respect to loans they purchase or securitize.

Even in the absence of a standardized servicing agreement, modern courts routinely find express authority from the parties' documents. For example, in *Tedesco v. Bekker*,[57] the servicer's agreement was "home-grown" and not standardized, but it provided that the servicer "was appointed as exclusive agent to manage said loan for Lender" and that the servicer was to use "all reasonable efforts to collect all funds due under the terms of said Note and Deed of Trust."[58] Despite the somewhat vague phraseology of the agreement, the court was satisfied that it authorized the servicer to collect not only monthly installment payments but the mortgagor's final payoff as well.[59] The court was unimpressed with the argument that the language, which spoke of collecting "all funds due," did not authorize collection of funds *before* they were due.[60]

In a similar vein, in *Skott v. Bank of America Illinois*[61] there were two indications of the agent's authority. First, the note itself required payments to be made to the original mortgagee "as servicing agent."[62] This phrase certainly suggests that a secondary market transfer was anticipated and that the mortgagee would become the servicer for the secondary market investor. Second, the secondary market purchaser admitted that he had authorized the mortgagee to service the loan.[63] The court noted that "there was no evidence of any limitation on that authority."[64]

57. 741 S.W. 2d 896 (Mo. Ct. App. 1987).
58. *Id.* at 897.
59. *See id.*
60. See *id.*
61. 468 S.E.2d 359 (Ga. 1996).
62. *Id.* at 361.
63. *See id.*
64. *Id.* at 360-61.

2. Implied authority

As noted above, implied authority can arise only when there is first some express authority; implied authority is simply an extension to acts that were not specifically mentioned in the grant of authority but are closely and reasonably connected with it.[65] Strictly speaking, when a mortgage and note are assigned on the secondary market, the mortgagee's implied authority to collect payments can arise only when the mortgagee has been given express authority to do other similar or related acts. Several examples come to mind. If the mortgagee has express authority to collect monthly installment payments, authority to collect a final payoff can be implied. If the mortgagee has express authority to collect payments of interest, authority to collect payments of principal as well can be implied. In essence, the courts hold that the principal cannot expect third parties to split hairs and to guess that one who is authorized to perform act A is unauthorized to perform closely-related act B.

In theory, the mortgagor might demand to see the mortgagee's servicing agreement and might scrutinize it carefully in order to detect any limitations on the mortgagee's authority to make collections. But life is simply too short to expect mortgagors to spend this sort of time and energy. Examining the servicing agreement will be impossible if the mortgagee's authority is merely oral. Must the mortgagor telephone or write to the assignee to verify that the mortgagee has the necessary authority and that it has not been modified since the last time the mortgagor made a payment? Must such an inquiry be made repeatedly before every payment to ensure that no change in the agent's authority has been made since the last inquiry? Such proposals are absurd, of course. From the viewpoint of the mortgagor, payments are payments.

This point is well illustrated in *United Missouri Bank v. Beard*.[66] There, the assigning mortgagee was admittedly given express authority to collect regular monthly payments of principal and interest from the mortgagor; the issue was

65. Apparent authority, on the other hand, exists where there is no express authority at all. However, the courts often disregard this distinction and almost randomly mix the terms "implied" and "apparent."

66. 877 S.W.2d 237 (Mo. Ct. App. 1994).

whether that authority extended to the collection of a final payoff of the loan, an authority that had not been granted expressly.[67] The court was faced with old case authority stating that the power to collect installments did not include the power to receive a full payment of the balance.[68] The court quite properly rejected this view as "the vestige of a prior time."[69] It observed that since the note permitted prepayment without the holder's consent, the assignee could hardly be disadvantaged economically by the mortgagee's accepting a payoff. But the court's *coup de grace* was the following comment:

> Finally, the principal always has the ability, indeed the duty, to check on the doings of his agent without regard to whether the note the agent is to collect contains a prepayment clause. The existence of such a clause in no way deprives the principal of the opportunity and responsibility to keep track of such matters.[70]

The message of the *Beard* case is clear: it is the assignee's responsibility to inform the mortgagor of unexpected nuances in the agent's authority. In the absence of such notice, the mortgagee's full authority as a servicing agent to collect all sorts of payments ought to be recognized. Technical distinctions between installment and final payments, or between installments of principal and those of interest only, simply must be disregarded; one cannot expect the borrower to guess that such variations exist.

3. Apparent authority

Apparent authority arises when there is an oral or written manifestation made by the principal to a third party, creating the appearance that the agent is authorized to act on behalf of the principal. In the context of mortgage payment, two

67. *See id.* at 239-40.

68. *See id.* at 242 (citing Hochrein v. Balthasar, 361 S.W.2d 315 (Mo. Ct. App. 1962)); Hamilton v. Hecht, 283 S.W.2d 894 (Mo. Ct. App. 1955). For a thorough review of the earlier cases, see *Ulen v. Knecttle*, 58 P.2d 446 (Wyo. 1936). A similarly archaic line of cases holds that authority to collect interest does not include authority to collect principal. *See, e.g.*, Koen v. Miller, 150 S.W. 411, 412 (Ark. 1912); Hagen v. Silva, 293 P.2d 143 (Cal. Dist. Ct. App. 1956); Steadman v. Foster, 92 A. 353, 354 (N.J. 1914); Tilton v. Boland, 31 P.2d 657, 660 (Or. 1934).

69. *United Missouri Bank*, 877 S.W.2d at 243.

70. *Id.*

situations often arise in which the mortgagor can argue persuasively that the mortgagee has apparent authority. One such case is when the mortgagee and the assignee establish a pattern of conduct under which the mortgagee receives installment payments and forwards them to the assignee. The mortgagor is typically unaware that an assignment has occurred or that the payments are being remitted to the assignee; the principal's existence is undisclosed. Nonetheless, the mortgagor receives no notice of default and reasonably assumes that the payments are being made to the proper person. It is easy to find apparent authority on these facts, arising from the principal's inaction in failing to correct the mortgagor's impression that the mortgagee is the proper payee.

These were precisely the facts in *Skott v. Bank of America Illinois*.[71] In addition to finding express authority,[72] the court in an alternative holding found that the mortgagee had apparent authority to receive the mortgagor's payoff.[73] Quoting an earlier Georgia case, the court held that

> where a principal has "placed an agent in such a situation that a person of ordinary prudence conversant with business usages and the nature of that particular business is justified in assuming that such agent has authority to perform a particular act and deals with the agent upon that assumption, . . . [a principal] will not be permitted to prove that the agent's authority was, in fact, less extensive than that with which he apparently was clothed."[74]

This is an easy case. Somewhat more difficult are cases in which no installment payments are due, so that there is pattern of collection that can lead the mortgagor to believe that the mortgagee is the proper recipient of the payments. For example, *Holsclaw v. Catalina Savings & Loan Ass'n*[75] involved a six-month note which required only a single payment of all

71. 468 S.E.2d 359 (Ga. 1996).

72. *See supra* Part III.C.1. The mortgagor had made monthly payments to the mortgagee for more than a year after the assignment occurred. *See Skott*, 468 S.E.2d at 360.

73. *See Skott*, 468 S.E.2d at 361.

74. *Id.* (quoting Commercial Credit Corp. v. Noles, 69 S.E.2d 309 (Ga. 1952) (alterations in original)).

75. 476 P.2d 883 (Ariz. Ct. App. 1970).

principal and interest at the end of the term.[76] The court found an "implied" (more accurately, "apparent"[77]) agency from the long and repeated course of dealing between these same assignees and the mortgagee under which the mortgagee had accepted payments on other mortgages for the assignees, had run the funds through its accounts, and had then paid the assignees. These operations had been carried out repeatedly with respect to many mortgages without objection by the assignees.[78]

Suppose, however, there is no history of collection of payments by the mortgagee on behalf of this particular assignee. Can apparent authority be found from the mortgagee's similar actions on behalf of *other* assignees? In *Meretta v. Peach*,[79] the mortgagor, Peach, was instructed to make payments to Diamond Mortgage Co., which was authorized to service the loan for the original mortgagee and for three affiliated companies to which the loan was successively assigned. When the last of those companies assigned the loan to Meretta, an independent investor who had no affiliation with the mortgagee, Peach argued that Diamond's continuing authority to receive payments could be implied[80] from the "usual practice in the mortgage industry for servicing companies to accept prepayments"[81] and that this practice was a part of "the general custom, usage and procedures in that

76. The mortgagee assigned the note and mortgage to a secondary market investor but retained possession of the note. *See id.* at 885. This in itself should have been enough to convince the court that the payment rule was inapplicable and that the mortgagors' payment to the mortgagee was good; the symbolic writing was in the hands of the person who was paid. The court, for no apparent reason, refused to accept this view. *See id.* at 887.

77. The facts recited by the court give no hint of any grant of express authority whatever to the mortgagee. Hence, the court's characterization of the authority as "implied" is technically incorrect.

78. *See Holsclaw*, 476 P.2d at 885. The weakness in the court's analysis is the absence of any evidence that the mortgagors in the instant case had the slightest knowledge of the mortgagee's past pattern of dealing with the assignees. Clearly, the court knew where it wanted to go and was not inclined to let technicalities bar its path.

79. 491 N.W.2d 278 (Mich. Ct. App. 1992).

80. Once again, the argument is more properly one for apparent than for implied authority; the court recited no evidence of any express agency relationship at all between the assignee and the mortgagee.

81. 491 N.W.2d at 280.

business."[82] The court agreed that this argument was at least sufficient to survive a summary judgment motion, although it held that the argument could succeed only if Meretta, the assignee, had knowledge of the business practice and custom in question.[83]

Another version of this "mortgage industry custom" argument is found in *Weigell v. Gregg*.[84] There, the mortgagee, a trust company, transferred the note that represented the right to payment of principal, but a set of coupons representing the right to interest payments was left with the mortgagee, who collected the interest on a routine basis. However, the mortgagor made several principal payments to the mortgagee as well—payments which the assignee argued the mortgagee was not authorized to accept and did not bind the assignee.[85] The court placed considerable reliance on the Wisconsin statute giving trust companies broad powers to "'act as agent or attorney for the transaction of business, . . . the collection of . . . mortgages, bonds, bills, notes, and other securities or moneys.'"[86] The court observed:

> The custom of dealing with trust companies on the assumption that they possess plenary authority to do the things they hold themselves out as having authority to do is so general that incalculable hardships would ensue if their authority to act had to be established by the same strict rules that obtain in the case of an individual acting as an agent. Where to the knowledge of a principal they assume full charge of a business matter, he must be held to have constituted them his agent for that purpose, even though they may exceed express authority,

82. *Id.*

83. *See id.* This last requirement seems a bit extreme. Why should the mortgagor's right to continue paying the original servicer depend on the level of sophistication of the assignee? Is it not more sensible to say that an investor who buys a mortgage on the secondary market must assume the mortgagor will continue to make payments in the same manner as before the assignment if no notice to change is given to the mortgagor?

84. 154 N.W. 645 (Wis. 1915).

85. *See id.* at 646. The court might have resolved the case by use of the implied authority argument discussed earlier: that the mortgagor cannot be expected to make fine distinctions between the authority to receive one type of payment and another. *See supra* Part III.C.2. But the court did not employ this tack.

86. *Weigell*, 154 N.W. at 647 (quoting WIS. STAT. § 2024—77k, subd. 7 (1913)).

> so long as their action is fairly germane to the subject-matter entrusted to their hands.[87]

This statement surely gives trust companies more than their due. All commercial mortgage lenders are in precisely the same position, and the court's reasoning can plausibly be extended to reach the conclusion that every commercial mortgagee has apparent authority to collect payments for assignees whose existence is undisclosed to the mortgagor.

This was precisely the position taken by the Supreme Court of Nebraska in *Department of Banking & Finance v. Davis*,[88] in which the assignee permitted the original mortgagee to collect monthly payments over a protracted period without any express servicing agreement.[89] When the mortgagor refinanced the loan and the remaining balance was paid to the mortgagee, the mortgagee became insolvent and failed to remit the funds to the assignee.[90] The mortgagor had never been notified of the assignee's existence.[91] The court held:

> As a general rule, one who contracts with the agent of an undisclosed principal, supposing that the agent is the real party in interest, and not being chargeable with notice of the existence of the principal, is entitled, if sued by the principal on the contract, to set up any defenses and equities which he could have set up against the agent had the latter been in reality the principal suing on his own behalf. Various reasons have been assigned for this rule, such as the estoppel of the undisclosed principal. . . .[92]

This is remarkably close to a *per se* rule: if the mortgagor is given no notice of the assignment, the mortgagee is automatically regarded as the assignee's agent.

Much the same approach was adopted in *Rodgers v. Seattle-First National Bank*.[93] There, the mortgagee had made a collateral assignment of the note and mortgage in question as

87. *Id.*
88. 416 N.W.2d 566 (Neb. 1987).
89. *See id.* at 568.
90. *See id.*
91. *See id.*
92. *Id.* at 569 (quoting 3 AM. JUR. 2d *Agency* § 341 (1986)); *see also* Chesire Provident Inst. v. Fuesner, 88 N.W. 849 (Neb. 1902).
93. 697 P.2d 1009 (Wash. Ct. App. 1985).

security for a line of credit advanced by the assignee, a commercial bank.[94] The assignee had never collected any payments; indeed, since the loan in question was a construction loan, it is likely that no regular payments were due. Neither party gave the mortgagor any notice of the assignment.[95] When the mortgagor refinanced the loan, the new lender remitted the balance due to the mortgagee, which failed to forward it to the assignee.[96]

The court found the payment binding on two grounds. The first was a very thin case of estoppel.[97] The court noted testimony of the assignee's employee at trial that, *if* the closing agent had asked the assignee, the latter would have instructed the closing agent to pay the mortgagee directly.[98] However, no such question was ever asked in fact nor any such answer given. It is a little difficult to see how an estoppel can arise from a statement that was never made!

The court's alternative theory, agency, is far more plausible and is completely consistent with the other "apparent authority" holdings described above. The court quotes with approval the writings of the me**(correct?)** and Professor Grant Nelson: "'The agency relationship is too typical, too widely expected, and too consistent with business practices to be denied by the assignee who has not taken the trouble to send an appropriate notice to negate it. Absent such a notice, it should be presumed.'"[99]

If all courts were willing to take the view found in the *Weigell*, *Davis*, and *Rodgers* cases just discussed, this article could end here.[100] Unfortunately, that is not the case. Other

94. *See id.* at 1110.

95. *See id.*

96. *See id.*

97. *See id.* at 1012.

98. *See id.*

99. *Id.* at 1012 n.4. (quoting GEORGE OSBORNE ET AL., REAL ESTATE FINANCE LAW 350 (1979)).

100. Several of those who sent written comments to the reporters on the tentative draft of *Restatement (Third) of Property (Mortgages)* § 5.5 suggested that the law of agency was indeed uniformly in agreement with these cases, and hence that the payment rule was not a problem and that § 5.5 was unnecessary. *See, e.g.*, Letter from Fred H. Miller, Professor, The University of Oklahoma, to Dale A. Whitman, Professor, Brigham Young University Law School (July 30, 1996) (on file with author). He states:

Admittedly, the last point in the memo (who to pay) is troublesome courts have disregarded or flatly rejected arguments based on implied or apparent authority and on apparent authority's virtual twin, estoppel.[101] In some cases, the courts have failed even to consider the existence of an agency relationship, perhaps because it was not competently argued by the mortgagor's counsel.[102] In other cases, courts have simply

> theoretically, but it has not been practically (no doubt due to agency, estoppel, and the like, including overriding consumer statutes in some states). And, of course, it would not appear the Restatement, absent statutory codification, could override Article 3.

Professor James S. Rogers expressed much the same idea during the floor debate on § 5.5 at the annual meeting of the America Law Institute. He said,

> [I]t seems to me that you may well be able to say a great deal more about the impact of the agency rules here in that, if we've got a holder of the mortgage who has not caused the mortgage to be assigned on the real estate records or, for example, has accepted payments from the maker, couldn't those acts themselves suffice under apparent agency doctrines to serve as an estoppel of a contention that that person has not authorized the person who has retained the position as recorded mortgagee to receive payments on behalf of.

James S. Rogers, *Annual Meeting Floor Debate*, 73 A.L.I. PROC. 37 (1996). Professor Rogers's reference to the fact that the mortgage assignment may be unrecorded is not apt, for it is clear that the mortgagor has, in most jurisdictions, no obligation to examine the records before making payments. *See* NELSON & WHITMAN, *supra* note 8, § 5.34. But his suggestion that the acceptance of payments by the assignee may constitute apparent authority in the mortgagee is entirely consistent with the cases discussed. *See supra* Part III.C.3. My response to him was, "Obviously, we very much agree with where you are going on this." Dale A. Whitman, *Annual Meeting Floor Debate*, 73 A.L.I. PROC. 37 (1996).

101. *See* Hagen v. Silva, 293 P.2d 143, 146 (Cal. Dist. Ct. App. 1956) ("[A]uthority to collect interest does not establish agency to collect principal, nor does it give rise to an estoppel" (citing Schomaker v. Petersen, 285 P. 342 (Cal. Dist. Ct. App. 1930))); Steadman v. Foster, 92 A. 353, 354 (N.J. 1914) (holding that no estoppel existed because the mortgagor was not led to change its position by any act of the assignee); Leonard v. Leonia Heights Land Co., 87 A. 645 (N.J. 1913); Tilton v. Boland, 31 P.2d 657, 661-62 (Or. 1934) (holding that there was no support for the mortgagor's assertion that the circumstances operated to estop the assignee from asserting that the mortgagee lacked authority to receive payment of principal on the note); Ulen v. Knecttle, 58 P.2d 446, 455 (Wyo. 1936) (noting that no implied or apparent agency existed despite a long pattern of mortgagee collecting payments on behalf of the same assignee on other loans).

102. *See, e.g.*, *In re* Columbia Pac. Mortg., Inc., 22 B.R. 753, 755-56 (Bankr. W.D. Wash. 1982); Rucker v. State Exch. Bank, 355 So. 2d 171, 174 (Fla. Dist. Ct. App. 1978); Culbertson State Bank v. Dahl, 617 P.2d 1295, 1297 (Mont. 1980); Lambert v. Barker, 348 S.E.2d 214, 217 (Va. 1986) ("[I]t was the [mortgagors'] responsibility to raise and establish this affirmative defense. The [mortgagors], however, never asserted payment to [the assignee]; nor did they allege that payment to [the mortgagee] constituted payment to [the assignee] under an actual or implied agency theory." (citation omitted)).

dismissed the idea on the ground that the mortgagor has not proven an agency relationship.[103]

A further factor that makes agency a weak reed for mortgagors to rely upon is the fact that the burden of proof of agency is nearly always said to be on the mortgagor.[104] Whether overcoming that burden is easy or difficult varies with the court, as the discussion above suggests. Nonetheless, the fact that the mortgagor has the burden plainly makes success in proving agency less certain than it would otherwise be.

4. Installment payments

Whether the payment rule applies to non-final payments is disputed. The widely-cited opinion in *Assets Realization Co. v. Clark*[105] expressly limits the payment rule to final payments,[106] presumably on the ground that it is not negligent for the payor to fail to demand production of the note before making each regular installment payment.[107] However, several cases apply the payment rule to non-final payments.[108] Under the current language of Article 3, it is clear that the payment rule applies to installment as well as final payments, since section 3-602 provides that an instrument is paid "*to the extent* payment is made . . . to a person entitled to enforce the instrument."[109]

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103. *See* National Credit Union Admin. Bd. v. Metzler, 625 F. Supp. 1551, 1553 (E.D. Mo. 1986); *see also* Hagen v. Silva, 293 P.2d 143 (Cal. Dist. Ct. App. 1956) (holding that no authority of mortgagee to collect principal payments can be found despite evidence that (1) note was payable at mortgagee's office, (2) assignee had designated mortgagee as agent in other similar transactions, and (3) mortgagee had possession of the note).

104. *See* Lambert v. Barker, 348 S.E.2d 214, 216 (Va. 1986); *see generally* National Credit Union Admin. Bd. v. Metzler, 625 F. Supp. 1551 (E.D. Mo. 1986); Hagen v. Silva, 293 P.2d 143 (Cal. Dist. Ct. App. 1956).

105. 98 N.E. 457 (N.Y. 1912).

106. *See id.* at 461 ("We do not desire to be regarded as holding that the rule applied in this case to a final payment would necessarily be applicable to a partial payment of principal or a payment of interest, and that the payer in such latter cases would always be under obligation to call for the production of the bond. While that question is not here for decision, it is apparent that quite different reasoning might be applied to the case of full and final payment and to that of one which was only partial and did not entitle the payer to surrender of the instruments.").

107. *See* Weigell v. Gregg, 154 N.W. 645, 646-47 (Wis. 1915).

108. *See* Brayley v. Ellis, 32 N.W. 254, 255 (Iowa 1887); Steadman v. Foster, 92 A. 353, 354 (N.J. 1914); Foster v. Beals, 21 N.Y. 247, 252 (1860); Tilton v. Boland, 31 P.2d 657, 660 (Or. 1934).

109. U.C.C. § 3-602(a) (1990) (emphasis added).

5. *Outright v. collateral assignments*

Whether the mortgage and note are being assigned outright or merely pledged as collateral for some other obligation of the mortgagee to the assignee is theoretically irrelevant; the payment rule applies in both cases.[110] However, when a collateral assignment is made, it is much more likely that the assignee expects the assignor to continue to collect the payments on the underlying mortgage debt, at least until the assignor defaults in payment to the assignee on the obligation that the mortgage loan collateralizes. The facts in *Rodgers v. Seattle-First National Bank*[111] are illustrative:

> [The assignee] did not have a mechanism to receive payments directly on loans made by [the assignor]; [the assignor] as the actual maker of the loans received the payments. The testimony disclosed that even if [the closing agent] had called [the assignee's] head branch, it would have been told to pay [the assignor].[112]

Hence, in determining whether an implied agency relationship exists between the assignor and the assignee, courts can and should take into account the fact that the assignment was as collateral.[113] That fact is helpful to the mortgagor. Still, there is no guarantee that a court will do so, given the fact that the burden of proof of agency is on the payor.[114]

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110. *See, e.g.*, *In re* Columbia Pac. Mortg., Inc., 22 B.R. 753 (Bankr. W.D. Wash. 1982); Culbertson State Bank v. Dahl, 617 P.2d 1295, 1296 (Mont. 1980).

111. 697 P.2d 1009 (Wash. Ct. App. 1985).

112. *Id.* at 1010. Based on these facts, the court found that an agency relationship existed. *See id.* at 1012.

113. *See, e.g.*, Nichols v. The Cadle Co., 139 F.3d 59 (1st Cir. 1998). The holder of the mortgage in that case assigned it as collateral to a creditor but continued to service it and collect all payments. Upon the mortgagor's default, the assignor foreclosed the mortgage. The mortgagor argued that this foreclosure was improper, since Massachusetts law requires the holder of a mortgage to foreclose it in its own name. However, the court held that the assignee received "something less than the ordinary full 'ownership' of a mortgage," and thus that the assignor retained a sufficient interest in the mortgage to foreclose it.

114. *See supra* note 104 and accompanying text.

6. Statutory help for mortgagors

In a few isolated cases mortgagors have been able to argue successfully for relief from the payment rule on the basis of statute. For example, in *Young v. Hawks*,[115] the promissory note signed by the borrowers recited that it was subject to the provisions of the Uniform Consumer Credit Code (U.C.C.C.).[116] The U.C.C.C., which is in effect in only eleven states, provides that the debtor is authorized to pay the original lender until he receives notification of assignment of rights to payment pursuant to a consumer loan and that payment is to be made to the assignee.[117] This language would apply whether or not the mortgage note was negotiable. However, because the U.C.C.C. has been adopted in so few jurisdictions, and because it applies only to "consumer loans,"[118] it offers only a very fragmentary respite to borrowers.

The Connecticut, Georgia, and Maryland legislatures have adopted similar language. Connecticut's statute simply amends UCC Article 3 to provide that payment of an instrument may be made "to the assignor in the case of a mortgage debt that is assigned without sufficient notice to the party obliged to pay."[119] The statute also provides detailed procedures for giving "sufficient notice." Georgia's statute also amends UCC Article 3, reversing the payment rule for all negotiable notes that are payable in installments.[120] Maryland's statute is limited to notes secured by mortgages and applies only when the assignment of the mortgage has been recorded.[121] No other state seems to have enacted any similar amendment to Article 3.[122]

115. 624 P.2d 235 (Wyo. 1981).

116. *See id.* at 238.

117. *See* U.C.C.C. § 3.201 (1974); U.C.C.C. § 3.406 (1968); WYO. STAT. ANN. § 40-14-337 (Michie 1997).

118. *See* U.C.C.C. § 1.301(15) (1974).

119. CONN. GEN. STAT. § 42a-3-602, as amended by 1998 Conn. Acts. 98-147 (Reg. Sess.).

120. *See* GA. CODE ANN. § 11-3-602(c) (1997); Skott v. Bank of America Illlinois, 468 S.E.2d 359, 361 (Ga. 1996) (Fletcher, P.J., concurring) (applying the statute to conclude that mortgagors properly made payments to mortgagee absent notice from assignee that payments should be made to assignee). The statute, enacted in 1981, appears to have been based on earlier cases such as *Northside Building & Investment Co. v. Finance Company of America*, 166 S.E.2d 608, 612 (Ga. Ct. App. 1969), which treat the mortgagee as the assignee's "secret agent" for collection purposes.

121. *See* MD. CODE ANN., REAL PROP. § 7-103(b) (1996).

122. A special committee on mortgagor liability has recommended a similar

A third form of statutory relief for mortgagors may arise in a few states from construction of their recording acts. In nearly all states mortgage assignments are recordable, but a few states go farther and hold that recordation of an assignment gives notice of its existence to the mortgagor.[123] This notion makes little sense, for it assumes that the mortgagor will examine the record title to the real estate before making each and every payment. In reality, to expect the mortgagor to do so would be to impose an intolerable burden, and there is no general practice of mortgagors making such title examinations.[124] Nonetheless, the notion is ingrained in the law of several states. Its corollary is that, in the absence of recordation of an assignment, the mortgagor can continue safely to pay the original mortgagee.[125] This is equally nonsensical; it is a rule that benefits the mortgagor when the assignee has failed to perform an act that, from the mortgagor's point of view, is entirely useless.[126] Nonetheless, in a few

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statute to the Connecticut Law Revision Commission. *See Report of Mortgagor Liability Committee* (Jan. 9, 1998) (on file with author).

123. *See* NELSON & WHITMAN, *supra* note 8, § 5.34; Rucker v. State Exch. Bank, 355 So. 2d 171, 174 (Fla. Dist. Ct. App. 1978) ("[A]s [the assignee] properly recorded the assignment of the mortgage from [the mortgagee], [the mortgagor] satisfied the mortgage at her peril because she was on constructive notice of [the assignee's] interest."); Verle R. Seed, *Mortgage "Payment" Statutes in Kansas and New Mexico*, 3 KAN. L. REV. 87 (1954).

124. Thus, the prevailing view is that recordation of the assignment provides no notice to the mortgagor. *See, e.g.*, Thomas v. Zahka, 164 N.Y.S. 193, 197 (Sup. Ct. 1917) ("Constructive notice of the assignment by merely recording it is not sufficient. The debtor is not bound by it."); *see generally* Annotation, *Recording Laws as Applied to Assignments of Mortgages on Real Estate*, 89 A.L.R. 171, 193 (1934), *supplemented by* 104 A.L.R. 1301 (1936).

125. Kansas and New Jersey are the principal proponents of this view. *See* Anthony v. Brennan, 87 P. 1136 (Kan. 1906), (citing KAN. L. 1899, ch. 168 (now KAN. STAT. ANN. § 58-2301)), *cited with approval in* Bank Western v. Henderson, 874 P.2d 632, 637 (Kan. 1994); Army Nat'l Bank v. Equity Developers, Inc., 774 P.2d 919, 927 (Kan. 1989); Pletcher v. Albrecht, 350 P.2d 58, 62 (Kan. 1960); *see also In re* Kennedy Mortg. Co., 17 B.R. 957, 965 (Bankr. D.N.J. 1982); Leonard v. Leonia Heights Land Co., 87 A. 645, 646-47 (N.J. 1913); Marling v. Milwaukee Realty Co., 106 N.W. 844, 846 (Wis. 1906) (holding that the assignee is estopped by failure to record; payment to mortgagee discharges mortgage).

126. The court got it right in *Equity Bank v. Gonsalves*, 691 A.2d 1143, 1145 (Conn. Super. Ct. 1996), when it stated, "The owner of the property . . . has no obligation or even occasion to check the land records for an assignment of a mortgage he has given. The recording of the assignment, therefore, is not notice to him." As Professor Durfee put it, "We have seen that [the mortgagor] is not charged with notice by record of the assignment, and in the name of consistency he should not have the benefit of non-record." EDGAR N. DURFEE, I CASES ON SECURITY 422 (1951);

jurisdictions it may save the mortgagor's bacon in the odd case where the assignee fails to record.

The three statutory arguments just discussed are merely of passing interest; I have included them only for the sake of completeness. None of them has sufficiently widespread application to be regarded as a general solution to the mortgagor's dilemma under the payment rule.

There is plenty of precedent in a variety of model statutes for changing the payment rule, but they offer little practical help for mortgagors. Both the Uniform Land Transactions Act and the Uniform Land Security Interest Act reverse the common law rule and allow the mortgagor to pay the mortgagee until notice of the assignment is given, but neither has been adopted in any American jurisdiction. Article 9 of the UCC adopts the same approach for accounts and for debts secured by chattel paper,[127] but it cannot properly be applied to negotiable or non-negotiable instruments secured by mortgages.[128]

IV. THE CASE FOR CHANGING THE PAYMENT RULE

A. *Why the Payment Rule No Longer Makes Commercial Sense*

It may well once have been true that borrowers routinely demanded to see their notes before making final payments on their mortgage loans and conceivably may even have made the same demand before making installment payments. Today, such a request is almost unthinkable as a practical matter and would be met at most lending institutions with incredulity or an imperious explanation that it is impossible for the lender to

accord Chase v. Commerce Trust Co., 224 P. 148 (Okla. 1924).

127. *See* U.C.C. § 9-318(3) (1995) ("The account debtor is authorized to pay the assignor until the account debtor receives notification that the amount due or to become due has been assigned and that payment is to be made to the assignee."); *see also* Commercial Sav. Bank v. G & J Wood Prods. Co., 207 N.W.2d 401, 404 (Mich. Ct. App. 1973).

128. U.C.C. § 9-318 was *improperly* applied to a note secured by real estate in *Kirby v. Palos Verdes Escrow Co.*, 227 Cal. Rptr. 785, 787 (Cal. Ct. App. 1986), a suit by a borrower against an escrow company for paying the mortgagee despite the fact that the note had been assigned. The court seems not to have recognized the limited scope of the section. However, it made no difference in the outcome, since the court held the escrow company had notice of the assignment by virtue of the fact that a corresponding assignment of the mortgage had been recorded, and because a copy of a title insurance policy showing the recordation had been forwarded to the escrow company. *See id.* at 789-90.

honor the request. Three factors make this so. The first is the broad expansion of branch banking. Most financial institutions probably centralize the storage of their mortgage documents in their main offices in order to maintain better control of them. But this means that a borrower who makes a payment in person in a branch office simply cannot expect, without causing a great deal of inconvenience, to have his or her promissory note produced.

The second factor is the growth of payment of notes by mail, and increasingly by electronic transfer. In many cases, the lender is authorized to draw the monthly payments directly from the borrower's bank account, so that not even a paper check need be mailed. Even when making a final payment, few borrowers walk into the lender's office to tender their checks. In these circumstances, the payor's demand to see the note before paying is completely impractical.

The third factor is the enormous growth of the secondary market in mortgages. The two principal federally-chartered secondary market agencies, FNMA and FHLMC, routinely require that they receive and hold possession of the original notes on all loans they purchase. Similarly, if the loan becomes part of a pool of mortgage-backed securities, the original notes will be transferred to an independent custodian to be held until final payment is received on them. In either case, the notes are not left with the original mortgagee, even though the original mortgagee is usually designated as their "servicer." Of course, the "servicing" designation is beneficial to most borrowers, since it means that their continued payments to the mortgagee will count, but it has also caused a vast change in expectations on the part of both borrowers and lenders. No one seriously thinks that it is feasible today for the original mortgagee to display the note at a moment's notice, whether on an installment payment or on a final payment. The note is more likely held in a vault in Washington or New York.

For these reasons—branch banking, mail and electronic payment, and the growth of the secondary market—the practice of exhibiting the note upon payment, to the extent that it once existed, has been swept away. Hence, no one asks to see the note any more, even in cases in which the mortgagee has no servicing agreement.[129] The notion that it is negligent for the borrower to fail to demand production of the note, even on a final payment, is simply absurd. Upon receiving a final payment, a lender will likely inform the payor that the note will be marked "paid" and returned, along with a recorded satisfaction, in a few weeks. Even when the final payment is made by an attorney or an escrow agent, both of whom should presumably understand the rules governing such matters, it is extremely rare for them to demand advance exhibition of the note. In recent years, in fact, most of those "burned" by the payment rule have been professional closing agents, not individual borrowers.[130]

B. *The Practical Hardships Imposed by the Payment Rule*

Despite the payment rule's potential for causing damage to innocent mortgagors (and to their lawyers and escrow companies), cases that actually result in such damage are relatively rare. The principal reason is the well-nigh universal practice, when a mortgage note is sold outright on the commercial secondary market or is securitized, of designating the original mortgagee as "servicer" with full authority and duty to collect payments on behalf of the secondary market investor or the purchasers of the securitized pool interests. The

129. *See In re* Columbia Pac. Mortg., Inc., 22 B.R. 753, 754 (Bankr. W.D. Wash. 1982) ("[I]t is the local [Portland, Oregon] custom of escrow companies, when dealing with institutional lenders, to close escrows without having the original loan documents in their possession. This custom is premised upon the assumption that institutional lenders will forward the documents upon receipt of the funds.").

130. Professional closing agents have made the "mistake" of failing to demand production of the note before making payment in several cases. *See id.* at 753 (title insurance company); Holsclaw v. Catalina Sav. & Loan Ass'n, 476 P.2d 883 (Ariz. Ct. App. 1970) (title insurance company); Kirby v. Palos Verdes Escrow Co., 227 Cal. Rptr. 785 (Ct. App. 1986) (escrow company); Skott v. Bank of Am. Ill., 468 S.E.2d 359 (Ga. 1996) (finance company); Meretta v. Peach, 491 N.W.2d 278 (Mich. Ct. App. 1992) (federal savings and loan association refinancing existing loan); United Mo. Bank v. Beard, 877 S.W.2d 237 (Mo. Ct. App. 1994) (escrow company); Department of Banking and Fin. v. Davis, 416 N.W.2d 566 (Neb. 1987) (mortgage company refinancing existing loan); Taylor v. Roeder, 360 S.E.2d 191 (Va. 1987) (attorney); American Sec. & Trust Co. v. John J. Juliano, Inc., 127 S.E.2d 348 (Va. 1962) (attorney); Rodgers v. Seattle-First Nat'l Bank, 697 P.2d 1009 (Wash. Ct. App. 1985) (federal savings and loan association). I assume that in all of these cases the closing agent would have been liable to the mortgagor for the loss if the payment were found to have been negligent and ineffective, and hence that the mortgagor's position in the litigation was financed by the closing agent.

FNMA and the FHLMC, the two largest secondary market purchasers of mortgages, routinely do so, as do other major secondary market purchasers. Moreover, if the servicing rights are later reassigned to a different agent, federal law requires that both the old and new servicer notify the borrower.[131] Hence, the commercial secondary market sale or securitization of a borrower's mortgage is simply a non-event to the borrower, who will continue to make payments to the original mortgagee unless and until he or she receives notice of a transfer of servicing.

A further reason that loss to the mortgagor is rare in commercial secondary market sales is that most mortgagees are solvent financial institutions. If they receive a payment that should have gone to an assignee, they have both the honesty and the necessary assets to reimburse the assignee. Obviously, unjust enrichment will result if the mortgagee is permitted to keep the payment to which it was not entitled.

When is the payment rule a problem? The answer is whenever the insolvency of the mortgagee is combined with the absence of an express agency relationship between the mortgagee and the assignee. Of course, any mortgage lender may become insolvent. But two dangerous situations are apparent. The first is a loan from a non-institutional mortgagee (commonly a former owner of the real estate who has sold it to the present mortgagor and has taken back a purchase-money mortgage). Such a mortgagee may sell the paper to another individual, or to a financial institution, but in either case there is no regularized procedure that designates the mortgagee as the assignee's agent.[132] Moreover, it is entirely possible, and perhaps likely, that the individual mortgagee who unscrupulously collects payments and fails to remit them to the assignee will be insolvent when called to account for the missing funds.

131. *See* 12 U.S.C. § 2605(c)(1) (1994).

132. *See, e.g.*, Groover v. Peters, 202 S.E.2d 413 (Ga. 1973); Stegeman v. First Mo. Bank, 722 S.W.2d 349 (Mo. Ct. App. 1987) (holding that a mortgagor who was notified that her note had been assigned, but not told that she should make her payments to the assignee, was forced to pay a second time to the assignee, despite the fact that she dutifully made her payoff to the original mortgagee (a local real estate brokerage company)).

The second problematic case is that of a mortgage banking company that borrows funds from a financial institution (typically a commercial bank) on a "warehouse" line of credit and, as collateral for repayment of the credit, pledges loans from its existing portfolio. The period covered by the pledge is likely to be short—perhaps 30 to 120 days—since the expectation of all parties is that the mortgage banker will find a permanent investor for the loans or will securitize them as soon as a sufficiently large group of them have been originated. When that permanent disposition of the loans is made, the notes will be retrieved from the "warehouse" lender. However, if the mortgage banker accepts payments in the meantime, has no clear authority from the "warehouse" lender to do so, and fails to remit the payments to the "warehouse" lender, its subsequent insolvency may cause the "warehouse" lender to demand payment from the mortgagor a second time.[133] Again, the problem stems from the fact that these transactions are individually negotiated and that there is no standard practice with respect to designation of the mortgagee as the "warehouse" bank's agent for purposes of collection. Moreover, mortgage bankers are typically financially the weakest members of the mortgage originating industry, and hence the most likely to become insolvent in times of financial stress.

C. Changing the Rule for Non-Negotiable Notes: the Mortgages Restatement

When Professor Grant Nelson and I were serving as reporters for the *Restatement (Third) of Property (Mortgages)*, we initially decided to adopt an across-the-board position rejecting the payment rule for both negotiable and non-negotiable notes. In its place, we proposed the principle that "performance of the obligation to the transferor is effective against the transferee if rendered before the obligor receives notice of the transfer."[134] With respect to negotiable paper, the provisions of UCC Article 3 discussed earlier in this article seemed to stand in our way; after all, a Restatement cannot

133. *See, e.g.*, *In re* Columbia Pac. Mortg., Inc., 22 B.R. 753 (Bankr. W.D. Wash. 1982).

134. RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.5 (Tentative Draft No. 5, 1996).

change the UCC. Nevertheless, we decided to make the technical argument that the UCC never makes payment to the possessor of the instrument the *exclusive* means of discharging it, and hence that payment to the original mortgagee should also be regarded as an acceptable method of discharge, even when the note is negotiable and governed by Article 3.[135]

We were able to convince the majority of the Advisors on the project and persuade the Council of the American Law Institute ("A.L.I.") that our position was plausible. However, when the tentative draft[136] was published to the A.L.I. membership in preparation for the annual meeting at which it would be discussed and voted upon, we received a number of comments from commercial law teachers attacking our approach. Our argument, in their view, was simply *too* technical and was contrary to the common understanding of Article 3.[137] When the

135. *See* text accompanying *supra* note ? to ?.

136. *See* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.5 (Tentative Draft No. 5, 1996).

137. The following comments are representative:

> I think that your analysis is a bit disingenuous. The combination of 3-601(b) and 3-602(a) makes it pretty clear that payment to a party that is not entitled to enforce the instrument does not discharge the payor. It is difficult to credit your suggestion that 3-602(a) is articulating a nonexclusive rule: that payment to a holder is but one of the types of payment that will discharge the payor. If that were the case, why would it say there was a discharge "*to the extent* payment is made *** to a person entitled to enforce." Furthermore, your rule produces the odd result that payment to a holder-in-due-course *does not* result in a discharge if the note subsequently is assigned without notice of the payment, but that payment to a person with no interest in the note at all *does* result in a discharge.

Letter from Professor Ronald Mann, Professor, Washington University School of Law, to Grant S. Nelson, Professor, UCLA School of Law 1-2 (Apr. 5, 1996) (on file with the author). "I suspect that your imaginative reading of UCC Article 3 in the effort to reach the result in Restatement Mortgages § 5.5 will strike most readers who are at all familiar with commercial law as at best tendentious, in any event unpersuasive, and at worst, just plain silly." Letter from James Steven Rogers, Professor, Boston College Law School, to Dale A. Whitman, Professor, Brigham Young University Law School 1 (May 8, 1996) (on file with author).

> I think that under article 3, both old and new, payment to a non-holder (or, under the revised article, to a non-person entitled to enforce) is ineffective to discharge an obligation on a negotiable instrument. Article 3 displaces the field here. It reflects one of the traditional distinctions in American law between negotiable instruments and other monetary obligations: the obligation of an obligor on a negotiable instrument runs to the holder (now PETE), whether or not it is a holder in due course; but the obligor on a simple contract may deal with the original obligee until notified to the contrary.

matter came before the house at the annual meeting, the same objections were made. In the face of this opposition, we felt obliged to back down. It is likely that if we had remained adamant, the membership would simply have refused to vote favorably for the section in question.

Our fall-back strategy was to leave the section in place, but to simply exempt negotiable notes from its coverage. Upon our assurance to the membership at the annual meeting that we would do so in the final draft, our section was approved without significant dissent. Interestingly, not one of those resisting our initial inclusion of negotiable notes in the *Restatement* section objected on the merits. Indeed, several of our most vigorous critics freely conceded that what we had attempted to do was desirable;[138] it was, in their view, simply beyond the power of any group except the drafters of the UCC to change. Thus, the effect of section 5.5 is to abrogate the payment rule only in the context of non-negotiable note.

D. Changing the Rule for Negotiable Notes: The UCC Amendment Process

Being right is no guarantee of success. In the discussions I have held with many influential lawyers in the past few years about the payment rule, not one of them has disagreed that it

E-mail from Steven Harris, Professor, University of Michigan Law School, to Dale A. Whitman, Professor, Brigham Young University Law School (April 12, 1996) (on file with author). In addition, the reporters for the Article 9 Drafting Committee prepared a memorandum for William M. Burke, Chairman of the Committee, in which they stated, "Section 5.5 of the Restatement [tentative draft] adopts the notification rule, even as to negotiable instruments. By suggesting that the maker of a negotiable note can discharge its obligation by paying someone other than the person entitled to enforce, § 5.5 conflicts with Article 3." Memorandum from Steven Harris & Charles W. Mooney, Jr., Reporters, to William Burke, Chair, Article 9 Drafting Committee 4 (July 10, 1996) (on file with author).

138. For example, "Insofar as it imposes a risk on an obligor who, before paying, fails to determine who has possession of the paper, the notion of reification (monetary claim travels with the piece of paper) may be undesirable in some settings." E-mail from Professor Steven Harris, *supra* note 137. "[T]he drafting committee recognized that there is some merit to applying the rule of existing and draft § 9-318 ('notification rule'), which § 5.5 of the Restatement adopts for mortgage obligations." Memorandum from Steven Harris & Charles W. Mooney, *supra* note 137, at 3. "I raise the point not because I oppose your substantive reform, which is a good one. I raise it because I fear that your project may run into a headwind of traditional bills-and-notes analysts." Letter from Professor Ronald Mann, *supra* note 137, at 2.

should be reversed. Yet change in the rule with respect to negotiable notes has been surprisingly difficult to attain.

Shortly after completing work on the *Restatement (Third) of Property (Mortgages)* in 1997, I became a member of the Joint Editorial Board on Real Property Acts (the "JEB"). This small group of experienced real estate lawyers[139] is assigned the task of ensuring that all of the projects conducted by the National Conference of Commissioners on Uniform State Laws take appropriately into account the needs and interests of the real estate market and its participants. In a meeting of the JEB in November 1997, it became apparent that there was strong interest on the part of its members in amending UCC Article 3 to change the payment rule for negotiable instruments along the lines taken in the *Restatement (Third) of Property (Mortgages)*. Richard Goldberg, a distinguished real estate lawyer with the law firm of Ballard Spahr Andrews & Ingersoll in Philadelphia, met with the JEB on that occasion and encouraged it to take a strong stand on the matter.

Unfortunately, Article 3 had been revised only seven years earlier, and there was no active drafting committee assigned to Article 3 at the time. However, a revision of Article 9 was nearing completion under the direction of reporters Charles Mooney of the University of Pennsylvania and Steven Harris of Chicago-Kent College of Law. Harris met with the JEB on the same occasion. The JEB attempted to persuade him to incorporate such a change in Article 9. Harris resisted doing so. He argued that the scope of Article 9 is limited to collateral assignments of notes; it simply does not cover outright assignments or sales of notes, which are dealt with only by Article 3. Hence, if the Article 9 Drafting Committee were to follow the JEB's urging, they would either have to produce a fragmentary solution, covering only collateral assignments, or would have to drastically expand Article 9 in a way that

139. Of the six members of the JEB, two are appointed by the National Conference of Commissioners on Uniform State Laws, two by the Real Property, Probate, and Trust Section of the American Bar Association, and two by the American College of Real Estate Lawyers. My appointment was by the last organization mentioned, but in my experience, the positions taken by the JEB's members have little or no relationship to the particular organization that appointed them.

seriously encroached on Article 3's province. Harris was understandably reluctant to do either.[140]

Professor Fred Miller of the University of Oklahoma, the executive director of the National Conference of Commissioners on Uniform State Laws, then suggested to the JEB that an amendment to Article 3 be prepared to deal with the issue comprehensively. He agreed to work within the Conference to seek its adoption as a part of the package which would contain the new version of Article 9.[141] I prepared a preliminary draft of such an amendment, with input from Miller and several other experienced commercial law teachers and practitioners, and the JEB supported it.[142] The JEB and its supporters sensed that the pendency of the Article 9 draft provided considerable political leverage in obtaining approval of an amendment to Article 3 and that it was important to keep the two tied together.[143]

140. *See* Memorandum from Steven Harris and Charles W. Mooney, Jr., *supra* note 137. Donald J. Rapson, Assistant General Counsel of the CIT Group, a large commercial lender, proposed to the Article 9 Drafting Committee that Article 9 be revised to include all sales of instruments, whether negotiable or non-negotiable. Memorandum from Donald J. Rapson, Assistant General Counsel, CIT Group, Inc., to Article 9 Drafting Committee (Feb. 2, 1998) (on file with author). If this were done, the notice requirement of § 9-318, which currently governs accounts and chattel paper, would presumably apply to instruments as well, thus overriding the payment rule of U.C.C. § 3-603 with respect to negotiable instruments. However, Rapson's proposal would have constituted a rather radical change in the scope of Article 9, and it was not met with enthusiasm by the Article 9 Drafting Committee.

141. Professor Miller suggested that the Article 9 Drafting Committee consider and develop an Article 3 amendment after seeking input from affected industry groups during early 1998. However, he recognized that the Article 9 Committee might ultimately fail to approve the desired Article 3 amendment. *See* Memorandum from Fred H. Miller to K. King Burnett, Chair, Committee on Program and Scope, National Conference of Commissioners on Uniform State Laws (Jan. 5, 1998) (on file with author).

142. *See* Memorandum from Carl H. Lisman, Co-chair, Joint Editorial Board for Uniform Real Property Acts, to the Committee on Scope and Program, National Conference of Commissioners on Uniform State Laws (Oct. 21, 1997) (on file with author).

143. This viewpoint was expressed in a letter to the JEB:

> If the Article 9 Revisions are approved and adopted without the *simultaneous* inclusion in the Code (whether Article 3 or 9) of a provision like the one we have proposed, the practical opportunity to achieve our desired result may be forever lost. I think we must do everything possible to insist that the Article 9 Revisions *not* be finally approved and adopted unless and until our proposal (or another one having the same result) relating to payments on mortgage-secured notes is also approved and adopted with the same degree of formality and finality.

Letter from Robert M. Burger of Mayer, Brown & Platt, Chicago, Illinois, to the JEB

The Article 9 Drafting Committee appointed an internal task force to consider whether and how to adopt an Article 3 amendment. Professor Neil B. Cohen of Brooklyn Law School, a member of that task force, prepared a draft amendment based to some extent on my earlier draft.[144] The amendment was troubling to some members of the task force, however, and ultimately to the entire Article 9 Drafting Committee. They argued that, if the payment rule needed to be modified for promissory notes secured by mortgages, perhaps it should be modified for those secured by personal property as well, or even for unsecured notes.[145] But, no input had been provided by commercial law practitioners outside of the real estate practice, and there was an understandable reluctance to move forward with an amendment covering all notes without giving it this broader consideration. Ultimately the Article 9 Drafting Committee refused to approve any Article 3 amendment.[146]

Professor Miller then devised yet a third approach, and one that seems at this writing to have a good chance of success. A new drafting committee for Article 1 had just been organized, and Miller proposed inviting it to consider that an amendment to the payment rule be inserted in Article 3.[147] This move was

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and other interested parties (Jan. 14, 1998) (on file with author).

144. *See* Memorandum from Neil B. Cohen, Professor, Brooklyn Law School, to the Ad Hoc Subcommittee on Payment of Secured Notes (Feb. 27, 1998) (on file with author). Cohen's draft differed from mine in that he proposed to change the language of existing U.C.C. § 3-602 (and make a few minor modifications in other sections of Article 3), rather than adopt the change in a new section as I had done.

145. *See* Memorandum from Article 3/9 Task Force to the Article 9 Drafting Committee (Mar. 2, 1998) (on file with author).

146. The negative vote occurred during the Drafting Committee's final meeting on March 20-22, 1998. Richard Goldberg, who attended the meeting on behalf of the JEB and other proponents of the change, spoke vigorously in its favor, and was deeply disappointed by the committee's refusal to take action. (Personal conversations between Goldberg and the author).

147. Professor Miller's refocus on the Article 1 Committee had been foreshadowed in January 1998, when he proposed giving initial authority over an Article 3 amendment to the Article 9 Drafting Committee. He had written:

> If [the Article 9 Committee does not act on the proposal], I believe the matter can be further delegated as a matter within the coordination function of the UCC Article 1 committee for further study and appropriate action at a later time (presumably when revised Article 1 and coordinating amendments are ready in 2000).

Memorandum from Fred H. Miller, Professor, University of Oklahoma College of Law, to K. King Burnett, Chair, Committee on Program and Scope, National Conference of Commissioners on Uniform State Laws (Jan. 5, 1998) (on file with author).

not as odd as it may seem, for there is a long tradition among the Commissioners of permitting Article 1 drafting committees to range broadly over the entire UCC, cleaning up matters that need coordination.

Fortunately, Professor Neil B. Cohen, who had prepared the amendment to Article 3 which the Article 9 Drafting Committee refused to adopt, is also the Chair of the Article 1 Drafting Committee. There is good indication that Professor Cohen believes change is needed and that the Article 1 Drafting Committee can accomplish that change without difficulty.[148] That is now where the matter stands. Again, there has been no dissent from the proposition that change is desirable, or at worst harmless, in the context of mortgage notes. The debate is over the breadth and nature of the change.[149]

V. FINAL REFLECTIONS

As several recent writers have observed,[150] Article 3 and the negotiability concept have been remarkably resistant to change. Vast changes have occurred in the technology and customary operation of payment systems since negotiability was fleshed out in the eighteenth and nineteenth centuries, but Article 3 has taken little account of them. This is a strange phenomenon and, perhaps, reflects reluctance to change a set of rules that seem to function satisfactorily most of the time.

Professor Edward Rubin has documented the enormous significance of Lord Mansfield's role in the creation of the present-day law of negotiable instruments.[151] Mansfield assembled a "jury" of experienced business people of his day.

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148. *See* E-mail from Neil B. Cohen, Professor, Brooklyn Law School, to the author (Mar. 25, 1998) (on file with author) (describing Cohen's draft amendment to Article 3). Cohen's draft covered negotiable notes secured by both real and personal property and pledged as collateral but did not cover unsecured notes. He noted:

> There seem to be two schools of thought among those who are paying attention to the issue from the UCC side. One group would prefer a broad brush approach, changing the law in all cases. The other group wants to avoid solutions that are in search of a problem and would prefer to address the matter only in the context where it has been alleged to have caused problems.

Id.

149. *See id.*

150. *See* articles cited *supra* note 5.

151. *See* Rubin, *supra* note 5.

They met regularly at the Guildhall in London to advise him on actual commercial practice, for he wished to be sure that his rulings would not conflict with or impair the legitimate expectations of the business community they affected. As Professor Rubin puts it, Mansfield "understood that commercial law must be based on an understanding of underlying commercial practice, but also that this understanding will not yield significant results unless animated by a sense of social policy."[152] If Mansfield were alive today, and became acquainted with today's commercial practices, I believe he would be appalled at how large a gap separates the payment rule from business expectations and sound social policy.

It is abundantly clear that modern judges are acutely uncomfortable with the payment rule and that they are willing to go a far distance out of the way to avoid it. A recent opinion by a Connecticut judge put it this way:

> To this court that reason [that the maker can protect himself by demanding production of the instrument and refusing to pay a party not in possession of it] does not make sense as to a mortgage note payable monthly. A mortgagor cannot be expected every month he makes a payment to ask a mortgagee bank to prove his possession of the note. Moreover, if the mortgagor pays monthly to the mortgagee a self-amortizing mortgage note to the date of maturity, should not payment in full in that manner fail to be a complete defense to an action by an assignee of the mortgagee who never gave notice of the assignment?[153]

I would not argue that Article 3 is in crisis. I merely suggest that, in its perpetuation of the payment rule, it is seriously out of touch with modern life and that this detachment sometimes imposes real and severe hardships on ordinary people. It must be changed.

152. *Id*. at 786.

153. Equity Bank v. Gonsalves, 691 A.2d 1143, 1146 (Conn. Super. Ct. 1996). The court remanded the case for further findings, but admonished the trial court that since foreclosure proceedings are equitable in nature, it should "consider all the equities in deciding whether to enter a foreclosure." *Id*.