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Impact of Revised UCC Article 9 on Sales and Security Interests Involving Promissory Notes and Payment Intangibles

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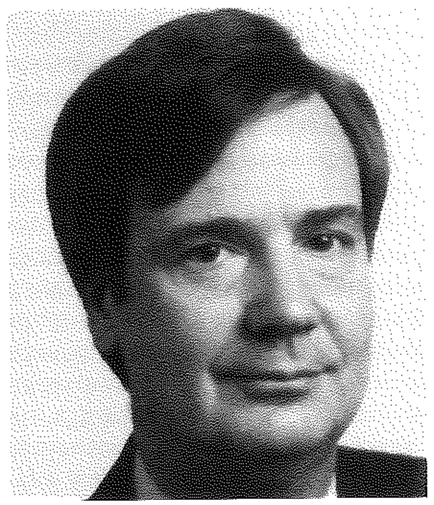

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I. Introduction—Scope of Article 9[1]

A. Expanded Scope of Article 9

1. Summary of the Revisions

The Comment to revised section 9-101 notes that the scope of revised Article 9 is expanded with respect to such things as security interests in commercial (but generally not consumer) deposit accounts,[2] sales of payment intangibles[3] and promissory notes,[4] health-care insurance receivables,[5] nonpossessory statutory agricultural liens,[6] true consignments,[7] and security interests in supporting obligations[8] and commercial tort claims[9] (among other things). For the first time, Article 9 also will apply to certain transfers and security interests of state and local governments, except those specifically governed by other statutes.[10] Security interests in accounts, payment intangibles, health-care insurance receivables, letter-of-credit rights, and general intangibles (such as contracts, permits, licenses and franchise rights) are permitted despite otherwise applicable contractual or statutory limitations (or prohibitions) on assignment.[11]

2. General Impact of the Scope Revisions

The expanded scope of revised Article 9 brings with it an expansion of the entire Article 9 world (as applicable) to new ranges of transactions. For example, parties drafting or executing commercial deposit agreements will need to contemplate the possibility that such agreements may now create a security interest as well as a deposit relationship.[12] Sellers and buyers of promissory notes will need to contemplate the impact of Article 9 as such sales will generally be deemed to create a perfected security interest in the buyer (under section 9-309, perfection occurs upon attachment, which generally means upon execution of the security agreement).[13] Similarly, sales of health-care insurance receivables (now treated as Article 9 "accounts") and payment intangibles (a newly defined category of collateral) will be covered by revised Article 9,[14] as sales of other accounts and chattel paper always have been.[15] Agricultural lienors will need to learn to comply with Article 9, in order to take advantage of the Article 9 perfection, priority and remedies provisions. Likewise, with exceptions, "true" consignments will be within Article 9, requiring some consignors to comply with Article 9.[16] Letter of credit transactions (involving a "supporting obligation") may now involve Article 9,[17] and a new field of lending on commercial tort claims may develop, with an impact on tort claimants and the plaintiffs' bar.[18] State and local governments also will need to learn to comply with Article 9.[19] With this expanded scope comes the potential for more cases like *Octagon Gas Systems, Inc. v. Rimmer*,[20] where a buyer of accounts ran afoul of Article 9 in part because he did not realize he had an Article 9 transaction.[21]

II. Promissory Notes, Payment Intangibles, and Related Issues

A. Summary of the Revisions

Revised Article 9 provides special rules governing perfection and priority as to certain classes of collateral: deposit accounts, letter of credit rights, electronic chattel paper, investment property, instruments, agricultural liens, tort claims, payment intangibles, promissory notes, and certificate of title goods.[22] Interested parties must distinguish between these and other Article 9 categories, and understand the permissible methods of perfection for each.

Briefly, security interests in deposit accounts and letter of credit rights can be perfected only by the secured party taking "control" of the collateral.[23] Electronic chattel paper and investment property are subject to either filing or control, though control is safer (and has a higher priority).[24] Security interests in accounts, instruments, commercial tort claims, general intangibles, and agricultural liens are perfected by filing.[25]

The definition of "account" is expanded to include some receivables that old Article 9 would have treated as general intangibles (*e.g.*, health-care insurance receivables), thereby covering genuine *sales* of such receivables and possibly requiring a filing for the first time.[26] However, these should be distinguished from "payment intangibles," a new residual category defined at section 9-102(a)(61) to mean a general intangible representing an obligation for the payment of money not related to a sale or other disposition of goods or services. Sales of payment intangibles are covered by revised Article 9, but perfection is automatic (and therefore does not require a filing).[27] This should include sales of loan syndication and securitization interests. Sales of promissory notes likewise are covered by revised Article 9, in contrast to old Article 9, and perfection is automatic.[28] Under old Article 9, *security interests* in payment intangibles (as a form of general intangible)[29] and most promissory notes (as instruments)[30] were covered by Article 9,[31] and were subject to perfection by filing (general intangibles) or possession (instruments).[32] Revised Article 9 continues this coverage but expands it to include *sales* of payment intangibles and promissory notes, with perfection automatic upon attachment; but sales of other general intangibles are still excluded,[33] and *security interests* in payment intangibles and promissory notes are not automatically perfected.[34]

Revised Article 9 also expands perfection by filing to cover instruments, so a buyer of promissory notes (though automatically perfected) may be subject to a prior security interest perfected by filing, unless the buyer has taken possession and met the other requirements of section 9-330 or 9-331. Perfection by filing as to promissory notes and other instruments facilitates mortgage warehousing finance, by allowing a mortgage banker to pledge its inventory of mortgage loans to a lender pending a secondary market sale, without requiring that lender to take possession of every instrument in order to be perfected (as under old Article 9). But as noted above and again below at Part II. B., this may enable such a lender to have priority over a buyer of such loans, unless the buyer qualifies for a higher priority under section 9-330 or 9-331.

Revised Article 9 also provides new rules governing perfection as to collateral in the hands of a bailee. The security

1. *See also* Alvin C. Harrell, *Drafting Contracts Under Revised Article 9*, 53 Consumer Fin. L. Q. Rep. 138 (1999).

2. *See* § 9-109(a)(1), (d)(13), and Comment 16, excluding assignments of deposit accounts in consumer transactions. Citations herein are to revised Article 9 unless otherwise noted.

3. Defined at revised § 9-102(a)(61) as "a general intangible under which the account debtor's principal obligation is a monetary obligation."

4. *See* § 9-109(a)(3). "Promissory note" is defined for Article 9 purposes at § 9-102(1)(47), (65), to include non-negotiable notes.

5. *See* § 9-109(d)(8). A health-care insurance receivable is within the definition of "account" at § 9-102(a)(2). A sale of accounts is covered under § 9-109(a)(3). *See also* revised § 9-408.

6. *See* §§ 9-109(a)(2), 9-102(a)(5).

7. *See* §§ 9-109(a)(4), 9-102(a)(19)-(21).

8. *See* §§ 9-109(a), (b), 9-203, 9-308.

9. *See* §§ 9-109(d)(12), 9-102(a)(13).

10. *See* § 9-109(c)(2) (narrowing the exclusion of state and local government security interests).

11. *See* §§ 9-408, 9-409; *infra* note 18.

12. Under § 9-203(b)(3)(D), this security agreement need not be authenticated, because the depository institution will have "control" under § 9-104. Thus the security interest can be created by a "statement stuffer" changing the terms of the deposit agreement without the debtor's authentication. Other secured parties can continue to trace proceeds into deposit accounts, but may be met with new claims by the depository institution having a higher priority. *See* §§ 9-104, 9-207, 9-327, *infra* Pt. VIII.

13. *See* §§ 9-201, 9-203, 9-309(4). As noted *infra*, however, automatic perfection is not the same as automatic priority.

14. *See* § 9-102(a)(2), (46), (61). A sale of a payment intangible is automatically perfected upon attachment. *See* § 9-309(3). A sale of accounts is perfected by filing. *See* § 9-310(a). *See also infra* Pt. II.

15. *See* old § 9-102(1)(b); *cf.* revised § 9-109(a)(3).

16. *See* §§ 9-308(a), 9-310(b)(4), 9-312(d), and 9-313(c).

17. *See* §§ 9-102(a)(51), (61), (77), 9-109(a).

18. *See, e.g.*, Craig H. Ulman, *Scope of Revised Article 9: The Effects of Inclusions and Exclusions*, 54 Consumer Fin. L.Q. Rep. 156 (2000); *supra* note 11.

19. *See* § 9-109(c)(2).

20. 995 F.2d 948 (10th 1993), *cert. denied*, 114 S. Ct. 554 (1993).

21. *See, e.g.*, Thomas E. Plank, *When a Sale of Accounts is Not a Sale: A Critique of* Octagon Gas, 48 Consumer Fin. L.Q. Rep. 45 (1994); Harrell, *supra* note 1.

22. *See* §§ 9-308 through 9-316 (Part 3, subpart 2 of revised Article 9); *supra*, Pt. I; Harrell, *supra* note 1.

23. Revised §§ 9-312, 9-314. "Control" is defined at revised §§ 9-104 and 9-107.

24. Revised §§ 9-102(31) and (40); §§ 9-105, 9-106 (control); § 9-312 (definitions); and § 9-314 (perfection).

25. Revised §§ 9-308 through 9-312. Instruments and certain other collateral are also subject to perfection by possession, under § 9-313, which may have a higher priority, *e.g.*, under § 9-330 or § 9-331. A promissory note is an instrument. *See* § 9-102(a)(65).

26. *See* revised §§ 9-102(a)(2) (definition of "account"), 9-109 (scope of Article 9). *Cf.* old § 9-102.

27. Revised §§ 9-109, 9-309. However, note again that automatic perfection is not the same as priority.

28. *Id.* Also note that perfection is not automatic for a *security interest* in payment intangibles or promissory notes. *Cf.* §§ 9-309, 9-310.

29. *See* old § 9-106.

30. *See* old § 9-105(1)(i).

31. Old § 9-102.

32. Old §§ 9-302(1), 9-304(1), 9-305. There is also the possibility of *temporary* automatic perfection for instruments, under old § 9-304(4), (5).

33. Revised § 9-309(3), (4).

34. Generally, perfection is by filing. *See* revised § 310(a). However, there are exceptions, such as temporary automatic perfection for instruments at revised § 9-312(e), and perfection by possession for instruments at revised § 9-313(a). Thus, security interests in promissory notes are now subject to perfection by either filing or possession. For a security interest in general intangibles (including payment intangibles), perfection is by filing only. *See* revised § 9-310.

interest is perfected only when the bailee acknowledges in an authenticated record that it holds the collateral for the benefit of the secured party.[35] This may affect a security interest in promissory notes that is perfected by possession.

B. Impact of the Revisions

As noted *supra*, the expanded scope of revised Article 9 means that some parties previously unaffected by Article 9 will need to become acquainted with the Article 9 perfection and priority rules. For example, sales of promissory notes secured by real estate mortgages, sales of payment intangibles (including loan syndications), deposit contracts, and those claiming agricultural liens or perfection through possession by an agent will be affected by revised Article 9.

Transactions already governed by old Article 9 may also be affected. For example, nonbank secured lenders accustomed to tracing proceeds into deposit accounts may find that avenue blocked by the competing claim of a depository institution with "control" over the deposit account (and therefore priority).[36] Automatic perfection for buyers of payment intangibles and promissory notes may surprise competing parties not familiar with revised Article 9, but may be insufficient as against a prior security interest perfected by filing; and the new rule at revised section 9-308(e) (mortgage securing a note is subject to a perfected security interest in the note), while merely codifying the common law rule that the mortgage follows the note, may be significant in mortgage warehousing transactions.[37]

The new rules governing sales of promissory notes and payment intangibles mean that virtually every secondary market sale of a standard residential mortgage or auto loan will be covered by Article 9. If it is a sale of a whole loan, it will be an Article 9 sale of chattel paper (*e.g.*, a car loan) or a promissory note (if a mortgage loan). If it is a securitization or syndication (*i.e.*, sale of part of a loan), it will be a sale of a payment intangible. Sales of other monetary obligations may qualify as sales of accounts; if not, they likely will qualify as a sale of a payment intangible. All of these sales are covered by revised Article 9, under section 9-109, though each is treated differently in Article 9 for purposes of perfection and priority.

This brings important new ranges of transactions into Article 9. As noted, virtually every secondary market sale of a real estate mortgage loan is now covered by Article 9, either as a sale of a promissory note or a payment intangible. While the buyers in such transactions are automatically perfected, they are subject to the first-in-time priority rule at section 9-322(a) and therefore will be subordinate to a prior security interest perfected by a filing against the seller, unless the buyer of a note can achieve priority under sections 9-330 or 9-331 (and these sections are unavailable to buyers of payment intangibles). While provisions at sections 9-203(b)(2) and 9-318 are designed to protect such buyers from subsequent liens against the seller (including a subsequent trustee in bankruptcy, as in *Octagon*), this offers no protection against a prior perfected security interest claiming under the first-in-time rule of section 9-322(a).

C. Related Perfection and Priority Rules—Proceeds

The expanded scope of revised Article 9 brings with it other new perfection and priority issues. For each example of a newly-recognized Article 9 transaction, there are new perfection, priority, transition and enforcement rules.[38] Some of these are likely to affect sales of promissory notes and payment intangibles.

For example, the rules for deposit accounts may affect proceeds from other collateral.[39] Deposit accounts are subject to perfection and priority rules derived from those for investment property. The priority rules for investment property at section 9-328 are similar to those at old section 9-115 (formulated as part of the 1994 revisions to Articles 8 and 9). Generally perfection by control has priority over perfection by other means, and competing security interests perfected by control rank according to the time of control.[40] This is a change from old section 9-115, which provided for security interests perfected by control to rank equally. However, a securities intermediary with control of a security entitlement will have priority over all others, even those with control.[41]

As noted, deposit accounts are subject to a similar system, under section 9-327. Generally, control will trump perfection by any other means, competing security interests with control will rank according to the first-in-time rule, and the depository institution with control will prevail over most others.[42] A depository institution's right of set-off is given priority over other claims to the deposit account, including Article 9 claims to the deposit account as proceeds of a security interest.[43] However, there is an overriding priority rule in favor of a non-depository lender who obtains control by transferring the deposit account to the name of the lender so that the lender becomes the account holder on the books of the depository institution.[44] Security interests in letter of credit rights are sub-

35. Revised § 9-313(c). *Cf.* old § 9-305. "Record" is defined at revised § 9-102(a)(69) to include written and electronic records. *See also* revised § 9-312(d), (e) (goods in possession of a bailee who has issued a document of title).

36. Revised § 9-327. *See infra* Pt. II.C.

37. *See infra* Pt. III.

38. The revised Article 9 priority rules are at §§ 9-317 through 9-342.

39. *See also* Ben Carpenter, *Security Interests in Deposit Accounts and Certificates of Deposit Under Revised UCC Article 9*, *supra* this issue.

40. *See* § 9-328(2).

41. *See* § 9-328(3).

42. *See* § 9-327.

43. *See* § 9-340. Though not without precedent, this changes the majority view under prior law in most states. *See, e.g.*, Alvin C. Harrell, *Security Interests in CDs: Some Recent Developments and Proposals*, 48 Consumer Fin. L.Q. Rep. 338, 341-42 (1994); Alvin C. Harrell, *Security Interests in Deposit Accounts: A Unique Relationship Between the UCC and Other Law*, 23 U.C.C. L.J. 153, 155-65 (1990).

44. *See* §§ 9-327(4), 9-104(a)(3), and 9-340(c).

ject to a priority system similar to those for investment property and deposit accounts.[45]

Section 9-322 clarifies the priories of proceeds claims, generally providing a first-in-time priority rule based on the time of filing or perfection as to the original collateral.[46] However, for collateral subject to perfection by means other than filing ("non-filing collateral," *i.e.*, chattel paper, deposit accounts, negotiable documents, instruments, investment property and letter of credit rights), there are special proceeds rules: (1) the original priority in the non-filing collateral continues in the proceeds of that collateral if the security interest in the proceeds is perfected and the proceeds are cash proceeds or the same type of non-filing collateral;[47] (2) perfection in the non-filing collateral by means other than filing (*e.g.*, "control") does not provide continuing priority as to proceeds that are "filing collateral" (accounts, tort claims, general intangibles, goods, nonnegotiable documents and payment intangibles);[48] (3) in the latter case priority is determined by a new version of the familiar first-in-time-of-filing rule.[49]

III. Realty Paper

A. Overview of Section 9-607

Section 9-607 clarifies the collection and enforcement rights of a secured party with regard to account debtors and other persons "obligated on collateral to make payment...." The inclusion of such "other persons" is important, because the term "account debtor" is limited to persons obligated on accounts, chattel paper, or general intangibles, and does not include persons liable on a negotiable instrument.[50] Thus the scope of section 9-607, covering obligors on collateral that include but are not limited to account debtors, is important because it applies to obligors on real estate-secured promissory notes held as collateral, whether or not the notes are negotiable instruments.[51] Section 9-607 clearly permits a secured party holding such a note as collateral to enforce its security interest by notifying the maker of the collateral note to make payments directly to the secured party after default by the Article 9 debtor, among other remedies.[52]

Also importantly, section 9-607(a)(3) allows the secured party in these circumstances to exercise the rights of the Article 9 debtor (*e.g.*, the original mortgagee) "with respect to any property that secures the obligations of the account debtor or other person obligated on collateral...." This allows the Article 9 secured party to assert the rights of the mortgagee and enforce the real estate mortgage that secures the note being held by the Article 9 secured party as collateral.[53] Section 9-607(b) effectuates this by allowing the Article 9 secured party to record a copy of the security agreement and a specified affidavit in the appropriate real estate records, in order to become the mortgagee of record for purposes of nonjudicially foreclosing the real estate mortgage. As noted in the comment to section 9-607:

> **8. Rights Against Mortgagor of Real Property.** Subsection (b) addresses the situation in which the collateral consists of a mortgage note (or other obligation secured by a mortgage on real property). After the debtor's (mortgagee's) default, the secured party (assignee) may wish to proceed with a nonjudicial foreclosure of the mortgage securing the note but may be unable to do so because it has not become the assignee of record. The assignee/secured party may not have taken a recordable assignment at the commencement of the transaction (perhaps the mortgage note in question was one of hundreds assigned to the secured party as collateral). Having defaulted, the mortgagee may be unwilling to sign a recordable assignment. This section enables the secured party (assignee) to become the assignee of record by recording in the applicable real-property records the security agreement and an affidavit certifying default. Of course, the secured party's rights derive from those of its debtor. Subsection (b) would not entitle the secured party to proceed with a foreclosure unless the mortgagor also were in default or the debtor (mortgagee) otherwise enjoyed the right to foreclose.[54]

B. Implications for "Realty Paper"

At various times in the Article 9 revision process, there were discussions of whether the UCC should recognize a separate category of Article 9 collateral in the form of "realty paper," *i.e.*, real estate secured promissory notes that would have special characteristics somewhat like the traditional concept of "chattel paper" under Article 9.[55] The special rules in Article 9 for chattel paper, unlike those for other types of re-

45. *See* §§ 9-329, 9-109(c)(4), and 5-114.

46. *See* § 9-322(b).

47. *See* § 9-322(c).

48. *See* § 9-322(c)(2), (e).

49. *See* § 9-322(d). *See also* § 9-322, Official Comments 7, 8.

50. *See* § 9-102(a)(3). By the scope of the definition, the term "account debtor" also excludes those liable on a non-negotiable promissory note secured by a real estate mortgage.

51. Old § 9-502 covered account debtors and other obligors on instruments, but there was some uncertainty as to the definition of "instrument" at old § 9-105(1)(i). The language at revised § 9-607 is clearer, and perhaps slightly broader. *See generally* Donald J. Rapson, *Default and Enforcement of Security Interests Under Revised Article 9*, 74 Chicago-Kent L. Rev. 893 (1999).

52. *See* § 9-607(a)(1)-(5).

53. *See* § 9-607(a)(3).

54. *See* § 9-607, Comment 8.

55. *See* § 9-102(a)(11) (definition of chattel paper); § 9-330 (priority of purchaser of chattel paper). *See generally* James M. Swartz, *Electronic Commerce and Issues in Buying Chattel Paper*, 53 Consumer Fin. L. Q. Rep. 91 (1999).

ceivables such as accounts,[56] treat the chattel paper as embodying the underlying obligation and the security for that obligation, and typically award priority based on possession of the paper.[57]

This works well in transactions creating chattel paper, such as retail auto sales financing, where transactions are financed individually by dealers and the chattel paper can then be assigned in a secondary transaction to an assignee who relies on possession of the chattel paper for priority, without the need for an individual title or lien search.[58] But this system of quasi-negotiability for chattel paper, which wraps up all of the important rights in the paper itself and awards priority in the whole package to whomever has possession of the paper, is generally deemed inappropriate for certain other types of receivables such as accounts, where individual transactions are often small and not memorialized in a formal piece of paper, and are often assigned in bulk, without an individual review. Accounts therefore are generally deemed suitable for perfection by a blanket filing and a required lien search.

Those accustomed to purchasing or lending on chattel paper based on the clear-cut and simple priority rules at old section 9-308 (now, with some changes, revised section 9-330) often regard these chattel paper rules as a good model for other types of transactions as well, perhaps including assignments of real estate-secured notes. Hence the argument is often made for recognition of a new category of Article 9 "realty paper" collateral, based on the chattel paper rules. However, attractive as the chattel paper rules may be (and most everyone would admit that they work beautifully in that context), they have not previously been adopted for real estate, at least not directly, perhaps due to the potential for conflict with the real estate recording acts. The latter consistently award priority based on recordation of transaction-related documents, not possession of pieces of paper.

There is, however, some inevitable interplay (and potential for conflict) between the claims of the holder of a negotiable instrument under UCC Articles 3 and 9,[59] and potentially competing claims under a recorded assignment of the mortgage pursuant to real property law. This interplay can yield some strange results, as in *Matter of Staff Mortg. and Inv. Corp.*,[60] where investors in second mortgage loans recorded an assignment of the mortgage (a deed of trust) but did not take possession of the promissory notes. When the assignor filed bankruptcy, the assignee investors were held to have unperfected security interests in the notes assigned to them, because they did not take possession as required for priority under the UCC.[61] This meant the trustee in bankruptcy had priority as to the notes,[62] and without the notes the recorded assignment of mortgage to the investors was worthless.

Where the opposite problem is encountered, *i.e.*, the assignee has possession of the note but no assignment of the mortgage, most courts have recognized the common law rule that the mortgage follows the note; priority as to the note carries with it a right to enforce the mortgage.[63] As noted by Professors Honnold, Harris and Mooney,[64] even under old Article 9 this suggests a rule similar to that for chattel paper, whereby any purchaser or secured party who becomes the holder of the note also takes priority as to the collateral for that note. They query: "Does the same result obtain with respect to what one might call 'realty paper.'?"[65] Professors Honnold, Harris and Mooney suggested that the answer should be yes in many jurisdictions, even under old Article 9, at least where the competing claimant is a non-reliance party such as a trustee in bankruptcy.[66] But they noted that the result may be different where the competing claimant is a bona fide purchaser of the real estate who has relied on the real estate records.[67] And the uncertainty of the common law rule, as it relates to interests derived from UCC Articles 3 and 9, suggested to many a need to address these matters in revised Article 9.

The Article 9 revisions reflect decisive movement in the direction of recognizing the concept of "realty paper," but without using that term. Priority of a holder of a negotiable instrument under UCC Article 3 continues to be recognized,[68] and the deference to real property law continues largely as before.[69] There is no explicit rule for real estate notes equivalent to the chattel paper rules at old section 9-308 (revised section 9-330), and no separate category of collateral in the form of "realty paper." But the rules for instruments at sections 9-330 and 9-331 clearly apply to mortgage notes, and section 9-607(a)(3) and (b) codify the common law rule of *Carpenter v. Longan*.[70] In most circumstances this will allow the holder of a real estate-secured note to claim first priority and enforce the mortgage securing the note (even without an assignment of mortgage). In conjunction with the common law rule that a mortgage alone (without an obligation to secure) is a nullity,[71] this should allow the holder of the mortgage note to have priority over competing claims to the mortgage (including even a recorded assignee) in most circumstances, creating something like the long-discussed concept of "realty paper."

56. *See* § 9-102(a)(2) (definition of "account").

57. Thus attributing an element of negotiability to all chattel paper, whether or not it is in negotiable form. *See, e.g.*, Donald J. Rapson, *"Receivables" Financing Under Revised Article 9*, The Secured Lender 91 (Sept./Oct. 1999); Swartz, *supra* note 55.

58. *See* Swartz, *supra* note 55; Rapson, *supra* note 57.

59. *See, e.g.*, UCC Article 3 §§ 3-104, 3-201, 3-302, 3-305, 3-601 and 3-602; Article 9 §§ 9-330, 9-331.

60. 550 F.2d 1228 (9th Cir. 1977).

61. 550 F.2d at 1230-31, citing old § 9-304(1) (a security interest in an instrument can be perfected only by possession). This basic scenario was repeated, with similar results, in *In re* Maryville Savings & Loan Corp., 743 F.2d 413 (6th Cir. 1984), *clarified on reconsideration*, 760 F.2d 119 (1985).

62. *See* 11 U.S.C. § 544 (a).

63. *See, e.g.*, Carpenter v. Longan, 83 U.S. (16 Wall) 271, 21 L.Ed. 313 (1872); John O. Honnold, Steven L. Harris and Charles W. Mooney, Jr., Security Interests in Personal Property 500-501 (2d Ed. 1992); *infra* note 67.

64. *Id.*

65. *Id.*, at 501 (discussing old Article 9).

66. *See id.*, citing *In re* Kennedy Mortgage Co., 17 B.R. 957 (Bankr. D. N.J. 1982).

67. *See* Honnold, Harris and Mooney, *supra* note 63, at 500, citing G. Nelson & D. Whitman, Real Estate Finance Law § 534, at 401 (2d ed. 1985). This scenario is also discussed in the newer edition of the casebook. *See* John O. Honnold, Steven L. Harris, and Charles W. Mooney, Jr., Security Interests in Personal Property 507-513 (2000).

68. *See* § 9-331 (a). *See also* § 9-330.

69. *See* old § 9-104, revised § 9-109(d)(11).

70. 21 L.Ed. 313; *See supra* note 63. To a degree this also codifies *Staff Mortg.*, 550 F.2d 1228, and *Maryville Savings*, 743 F.2d 413. *See supra* this text and notes 60-61.

IV. Discharge of Liability

A related issue, that arises in the context of mortgage loans being resold in secondary market transactions, is whether payment by the mortgagor to the initial mortgagee will discharge the mortgagor's liability on the note, if the note and mortgage were previously assigned to another holder. There is a split between real property law and the UCC on this issue in some jurisdictions, and there is some disagreement among scholars as to what the rule should be. Moreover, although the issue commonly involves real estate mortgage loans being used as collateral or sold in an Article 9 transaction (*see* Part III, above), this issue is often governed by UCC Article 3 and implicates the whole concept of negotiability, which is central to Article 3. Thus the real conflict is often between UCC Article 3 and real property law, even though the problem may arise in an Article 9 transaction.

The issue commonly arises when the initial mortgagee negotiates or otherwise assigns a real estate note and mortgage,[72] but retains the servicing and therefore does not notify the mortgagor of the change. The mortgagor continues to make payments to the original mortgagee/assignor and may even submit funds to the mortgagee/assignor to pay off the loan. If the mortgagee/assignor forwards these payments to the assignee (who now holds the note and mortgage), all ends well. If not, however, there may be a question as to whether the mortgagor's payments to the original mortgagee discharged the debt represented by the mortgage note (which has been assigned to the subsequent holder), although a servicing contract between the assignor and assignee may resolve the issue.

Under UCC Article 3, payment discharges liability on a negotiable instrument[73] only if the payment is made to "a person entitled to enforce the instrument."[74] "Person entitled to enforce the instrument" is defined at section 3-301 to include the holder[75] and certain others with the rights of a holder, such as the owner of a lost instrument.[76] "Person entitled to enforce the instrument" very likely does not include a transferor, *e.g.*, the original mortgagee who has assigned or otherwise transferred the note and mortgage to a new holder (*see, e.g.*, § 9-318(a)). Thus payment to such a party will not discharge the liability of the mortgagor to the holder of the mortgage note, at least under Article 9 and current Article 3, absent a servicing contract or similar agreement to the contrary.

A purpose of UCC section 3-602, requiring payment to the holder or other party entitled to enforce the instrument, is to preserve the concept of negotiability: Since the negotiable instrument embodies the debt, possession of the instrument carries with it the right to collect the debt, and payment to someone not in possession (and not otherwise entitled to enforce the note) cannot discharge liability to the rightful party. Any other rule would negate the point of negotiability. But this results in a potential conflict with real estate law and practice, since it is common for real estate notes to be sold in secondary transactions while the mortgagor continues to pay the original mortgagee (who "services" the loan).[77]

A variation of this scenario is illustrated in *Lambert v. Barker*,[78] where the Barkers financed the purchase of real estate partly by signing a note and deed of trust (*i.e.*, a mortgage) to Davis, the seller. Later the Barkers conveyed the property, subject to the mortgage, to another buyer who in turn resold the property to the Harwoods, again subject to the mortgage. In the meantime the original seller/mortgagee (Davis) sold the note and mortgage to Lambert. The monthly payments were to continue being made to Davis, with any prepayment going directly to Lambert, the new holder. The negotiable note was endorsed by Davis and delivered to Lambert, making Lambert the holder (and person entitled to enforce the instrument) under Article 3.[79]

When the Harwoods resold the property they attempted to pay off the prior mortgage loan by sending the payoff amount to Davis (to whom they had been making the payments). Unfortunately, Davis apparently absconded with the funds without paying Lambert. Lambert, the holder of the note, then filed suit to collect the note, and the Supreme Court of Virginia ultimately ruled in Lambert's favor.[80] This meant the Harwoods would have to pay the note again, because their first payoff was not made to the holder of the note and therefore did not discharge the mortgage debt.

This rule (that the liability represented by a negotiable instrument is discharged only by payment to the holder), is codified at section 3-602(a), but is disapproved by the *Restatement of the Law of Contracts (Mortgages)* section 5.5 (1996), which allows discharge of debt by payment to the assignor of the debt, if such payment is made before notice of the assignment. Presumably this would

71. *Id.*

72. This is the common context; however, the issue can arise with regard to any negotiable instrument, even a simple check, with or without an underlying real estate transaction. *See, e.g.*, Northside Bldg. & Inv. Co. v. Finance Co., 166 S.E.2d 608 (Ga. Ct. App. 1969) (check cashing scenario).

73. Defined at UCC § 3-104.

74. Section 3-602(a).

75. Holder is defined at UCC § 1-201(20).

76. Section 3-301.

77. If the servicing agreement authorizes the servicer to collect on behalf of the assignee, the servicer could be the person entitled to enforce the instrument, or at least that person's agent, thereby resolving many of these issues.

78. 348 S.E.2d 214 (S. Ct. Va. 1986).

79. *See* UCC §§ 1-201(20), 3-104, 3-201 and 3-602.

80. *Lambert*, 348 S. E.2d 214.

apply to non-negotiable mortgage notes outside the scope of UCC Article 3. However, the 1990 revisions to Article 3 significantly expanded the scope of Article 3 and the concept of negotiability, so many formerly non-negotiable real estate mortgage notes are now within the scope of Article 3.[81]

The *Restatement* rule is incorporated in the Uniform Consumer Credit Code (U3C),[82] but many real estate loans are outside the scope of this provision.[83] Old Article 9 contains a similar rule at old section 9-318(3), and this was carried forward at revised section 9-406, but this is limited to "account debtors," a defined term that confines the rule to obligors on accounts, chattel paper or general intangibles, thereby avoiding conflict with Article 3 by excluding negotiable instruments from the Article 9 rule.

Thus with regard to negotiable real estate-secured notes, Article 3 and the concept of negotiability have long reigned supreme, including the rule at section 3-602(a), essentially requiring payment to the holder in order to discharge liability on the note. The Article 9 revision process presented an opportunity to revisit this, and the issue was presented to the Article 9 Drafting Committee.[84] However, there was discomfort at the prospect of using Article 9 to revise Article 3, and the revised version of old section 9-318(3) (revised section 9-406(a)) does not expand the scope of the Article 9 rule beyond accounts, chattel paper and payment intangibles.[85] Thus at this writing the primacy of Article 3, including the discharge of liability rules at section 3-602(a), continues with regard to real estate-secured (and other) negotiable instruments. The Article 3 rule was, however, recently reconsidered by a Drafting Committee reviewing UCC Articles 3, 4 and 4A, and may soon be revised. For now however, *Lambert* remains the law with respect to negotiable instruments.

V. The FTC HDC Notice

The Federal Trade Commission (FTC) Holder in Due Course (HDC) Rule requires insertion of a notice (commonly called the FTC HDC notice) in certain consumer credit contracts.[86] However, the scope of this rule is not universal, and some people (including some in the credit industry) don't understand when or whether the rule applies. As a result, it is possible that there are credit contracts (including negotiable promissory notes) that are issued in transactions subject to the FTC HDC notice requirement without including the required notice.

In a somewhat odd example of state legislation designed to implement a federal agency regulation, Article 9 section 9-403(d) provides in effect that if a consumer transaction is subject to the FTC rule and the contract (or "record" in revised Article 9 parlance) does not include the required FTC HDC notice, then for purposes of Article 9 the contract/record will nonetheless be treated as if the required notice was included. As stated at section 9-403(d)(2), this enables the consumer account debtor to assert against an assignee of the contract/record any claims and defenses that could be asserted against the assignor, at least to the extent Article 9 applies.

This provision was included in revised Article 9 at the behest of consumer advocacy representatives, as part of the consumer issues compromise that paved the way for the approval of revised Article 9.[87] It is commonly referred to as implementing the FTC HDC rule, but in fact does not affect a HDC at all.

The HDC rule at UCC sections 3-302–3-305 protects and applies only to the HDC of a negotiable instrument, as per the scope of Article 3.[88] Revised section 9-403(b) recognizes and essentially incorporates the FTC HDC rule, but only where the "record evidences the *account debtor's* obligations."[89] "Account debtor" is defined at section 9-102(a)(3) as: "a person obligated on an account, chattel paper or general intangible. The term does not include persons obligated to pay a negotiable instrument, even if the instrument constitutes part of chattel paper."[90]

Therefore the recognition and incorporation in revised Article 9 of the FTC HDC rule is limited to contractual obligations other than negotiable instruments, and does not apply to a negotiable promissory note. As only a negotiable instrument can give rise to a HDC in the first place, this means that section 9-403(d) will impair HDC status only in cases where there can be no HDC anyway. Of course, the parties to a non-negotiable contract may seek to create HDC-like rights outside the scope of the Article 3 HDC rule (as by a waiver of defenses clause).[91] Section 9-403(d) would make the FTC HDC rule applicable in such a case, despite omission from the contract of the required FTC notice. So section 9-403(d) is far from ineffectual. But it is perhaps misleading to refer to section 9-403(d) as an anti-HDC rule; the revision incorporates the FTC anti-HDC rule but only in cases not involving a HDC.[92]

In reviewing the expanded scope of revised Article 9, it is easy to overlook this limiting point. Section 9-403(d) applies to a "record," defined broadly at section 9-102(a)(69) to include negotiable instruments, and section 9-109(a)(3) extends the scope of Article 9 to cover sales of promissory notes. So the pieces are in place for Article 9 to cover negotiation of a promissory note to a HDC. But the drafters of revised Article 9 were careful to avoid creating conflicts between Articles 3 and 9, and so section 9-403(d) was carefully crafted (by its limitation to "account debtors") to avoid contradiction of the Article 3 HDC rules. As a result, Article 9 applies to sales of promissory notes, including negotiation of a promissory note to a HDC, but does not interfere with any of the Article 3 rules applicable in the transaction. And it appears that a HDC of a negotiable instrument will continue to enjoy the benefits of HDC status under UCC Article 3,[93] even if the instrument was issued in violation of a consumer-protection rule.[94]

VI. Conclusion

The expanded scope of revised Article 9 means that parties not accustomed to dealing with the UCC may need to consider the potential impact on their business or practice. While the impact of revised Article 9 on most real estate and promissory note transactions is somewhat peripheral, that impact can be important in the right circumstances.

This is clearly true for those who deal with secondary-market sales of real estate-secured promissory notes, which are subject to a unique blend of rules under the UCC and real property law. The revision of Article 9 affects this analysis, and provides an appropriate opportunity for interested parties to review the applicable rules.

81. *See* §§ 3-104(a)(general requirements for negotiability), 3-106(b)(nonrecourse notes), 3-106(d) (FTC holder notices), and 3-112(b) (adjustable interest rate notes). Notice, however, that the *Lambert* rule applies only to instruments that are negotiable under Article 3, and not to the expanded definition of instrument in Article 9 § 9-102(a)(74) (which includes some non-negotiable instruments).

82. *See, e.g.*, 14A Okla. Stat. § 3-406.

83. *See id.* §§ 3-104, 3-105.

84. *See, e.g.*, Alvin C. Harrell, *UCC Article 9 Revisions Move Toward Summer 1998 Approval, Pt. I.*, 52 Consumer Fin. L. Q. Rep. 219, at 223 (1998).

85. *See* § 9-406 (a), and Comment 2.

86. 16 CFR Pt. 433.

87. *See, e.g.*, Alvin C. Harrell, *Introduction to the Symposium*, 54 Consumer Fin. L. Q. Rep. 140 (2000); Thomas J. Buiteweg, *New Consumer Provisions of Revised UCC Article 9*, *id.*, at 185.

88. UCC § 3-104.

89. Section 9-403 (b) (emphasis added). As noted *supra*, "record" is defined at revised § 9-102(a)(69) to include written and electronic contracts.

90. Section § 9-102 (a) (3).

91. Old § 9-206; revised § 9-403 (b), (c).

92. *See* § 9-403, Comment 5, noting that the effect is to render certain waiver-of-defense clauses ineffective.

93. *See, e.g.*, UCC § 3-305.

94. *See, e.g.*, Circle v. Jim Walter Homes, Inc., 535 F.2d 583 (10th Cir. 1976). Note that, as a practical matter, HDC status may be difficult to obtain in these circumstances, as the holder may be deemed to have notice of the violation. *See, e.g.*, UCC §§ 3-103 (a) (4), 3-302, 1-201 (25) - (27). But the basic point remains valid: If HDC status is achieved under Article 3, Article 9 does not interfere.

Program Planned on Payment System, Promissory Note, and Credit Contract Issues

The Conference on Consumer Finance Law is organizing a program to be held Oct. 17 – 18, 2002, covering issues relating to UCC Articles 3, 4 and 4A and related state and federal laws. The program will discuss the execution and assignment of credit contracts, including but not limited to promissory notes, as well as checks, drafts, and electronic payment systems. The location is the Royal St. Charles Hotel in New Orleans, LA. Interested parties should contact the Conference CLE office at 405-634-1445 or (FAX) 405-634-3305.

William J. O'Connor, Jr. Presented with Lifetime Achievement Award by American College of Consumer Financial Services Lawyers

The American College of Consumer Financial Services Lawyers presented the second Senator William Proxmire Lifetime Achievement Award to William J. O'Connor, Jr.

Mr. O'Connor is a lawyer who was a senior partner at Phillips, Lytle, Hitchcock, Blaine & Huber and then counsel at Marine Midland Bank in Buffalo, New York. He was formerly Chair of the Committee on Consumer Financial Services Law of the American Bar Association; had leadership roles in the New York State Bar Association, including service as Chair of its Section of Banking, Corporation and Business Law; was a member of the Federal Reserve Board's Consumer Advisory Council, including a one-year stint as its Vice Chair; served on committees of the New York State Bankers Association and the Consumer Bankers Association; was a member of the editorial board of the *Journal of Retail Banking*; authored or co-authored numerous books, articles, commentaries and compliance guides dealing with the Truth in Lending Act, the Equal Credit Opportunity Act, Article 2 of the Uniform Commercial Code and other subjects; was the Chair of the second ABA National Institute on Consumer Credit in 1977; and was a frequent speaker at various continuing legal education and similar programs including those sponsored by the Practising Law Institute, the American Bankers Association, the American Bar Association, the National Conference of State Legislatures, and others.

In addition to his formal accomplishments, Mr. O'Connor is one of the pioneers of the practice of consumer financial services law. His prolific scholarship and tireless dedication influenced both the substance of the law and the careers of many lawyers now in the field.

The award included a cash component, which Mr. O'Connor directed be donated to the Consumer Credit Counseling Service of the Florida West Coast, Inc., to be used to prepare model educational materials on consumer credit for students, nationwide, in grades five through twelve.

Founded in 1994, the American College of Consumer Financial Services Lawyers is a professional association of lawyers dedicated to the improvement and enhancement of the skill and practice of consumer financial services law and the ethics of the profession. Membership in the College is by invitation only and is limited to lawyers who have achieved preeminence in the field and who have made repeated and substantial contributions to the promotion of learning and scholarship through teaching, lecturing and published writings. Congratulations to Mr. O'Conner for this award.