

# MORTGAGE WAREHOUSING— A MISNOMER

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Mortgage financing is usually more complex than a simple transaction between mortgagor and mortgagee. A typical financing situation involves a mortgagor and three credit institutions: Mortgage Company *M*, Bank *B* and a permanent investor, often Insurance Company *I*. After the creation of the mortgage but before it is transferred by Mortgage Company *M*, the original mortgagee, to Insurance Company *I*, which will take it over as a permanent investment, time is required for the completion of construction, recording of the mortgage, issuance of title insurance, and the examination of the credit and legal aspects of the mortgage loan, including review of the papers by the Federal Housing Administration or the Veterans Administration. During this interval, Bank *B* extends credit to Mortgage Company *M* in order that *M* may make loans to other mortgagors.

Reliable authorities have estimated that the amount of credit extended by commercial banks to mortgage lenders such as Company *M* more than doubled in the year following August, 1954. Of the total credits outstanding in August, 1955, approximating \$1,300,000,000, over \$900,000,000 represented loans to mortgage lenders intended to be secured by the pledge of the mortgages thus created. Additional unused commitments for loans or purchases aggregated \$1,200,000,000.<sup>1</sup> The growing volume of this credit is such that its significance is now being examined by economists and those concerned with problems of money and credit. Several aspects of these transactions should also be a matter of concern to those interested in the legal arrangements.

Until comparatively recently, the interval of time between the creation of the mortgage and its acceptance by the permanent investor generally approximated two to four months. The recent policy of permanent investors to postpone their obligations on purchase commitments to periods as long as a year after the creation of the mortgages exposes Bank *B*, as interim financier, to a multiplication of the risks

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1. 41 FED. RESERVE BULL. 980 (1955).

involved in certain types of financing arrangements. Since the possibility is always present that the prevailing economic climate may change, it should be emphasized that the essential purpose of the security arrangement in the mortgages should be the validity of the collateral position of Bank *B* against third parties and creditors of Mortgage Company *M*.

Such interim financing transactions may take the form of a purchase of the mortgage in exchange for an agreement of repurchase, or they may retain the usual aspects of collateral security transactions. Many variations may be employed when the transaction is in security form, but a very popular one is the "mortgage warehousing" device. Although the term "mortgage warehousing" is used to refer to all types of lending and purchase commitments in the real estate mortgage market, in its narrower sense it signifies a loan by a commercial bank or other lending institution to the owner of mortgages, the mortgages representing the security for the loan. A typical transaction takes the following form:

1. Bank *B* appoints an employee of Mortgage Company *M* as its "custodian" to hold in his control and for the account of Bank *B* the notes or bonds of the mortgagors, the mortgages securing those obligations, policies of title insurance, and such other collateral papers as may be involved dealing with FHA insurance, VA guarantee, etc. The bank may or may not pay the salary of this "custodian."

2. Mortgage Company *M* executes and delivers to the "custodian" individual, unrecorded assignments of the mortgages which remain in the name of *M* on the records in the recording office.

3. The "custodian" holds these documents in filing cabinets located on the premises of Mortgage Company *M*, where they are not segregated from other furniture and equipment of *M*. The cabinets may or may not bear identifying labels advising that: "The documents contained herein are in the possession of the custodian for the account of Bank *B*, to whom all right, title, and interest of Mortgage Company *M* has been assigned," or words to that effect.

4. Mortgage Company *M* executes and delivers to Bank *B* an assignment of the commitments of the permanent investor. Notice of the assignment may or may not be given by the bank to Insurance Company *I* directing that payment of the purchase obligations under the commitments be made to the bank.

5. During the period of the interim financing, Mortgage Company *M* usually continues to receive amortization payments on account of principal, taxes, interest and other obligations payable by the mortgagors. Such payments may be made by the mortgagors as a natural consequence of the fact that the mortgages

remain payable to *M* or by reason of a notice from Bank *B*, directing that such payments be made to *M* as the authorized agent of the bank.

It is obvious that all such transactions will not exactly coincide with this description since the totality of the arrangement comprises many factors susceptible to variance. However, the essential elements creating the hazards in the transaction are too widely practiced for comfort. These include the retention of the mortgage documents in the hands of the "custodian" on the premises of Mortgage Company *M* and the failure to record the assignments of the mortgages to Bank *B*. Bank *B* sometimes considers itself protected as a practical matter because, from its examination of the financial statements of the mortgage company, it can assure itself of being the sole principal creditor in the event of insolvency proceedings. On the other hand, Bank *B* does not usually have any sure means of controlling the other commitments of its debtor, and the practice appears to be growing for Mortgage Company *M* to maintain at least two such lines of credit at different lending institutions.

#### THEORY OF FIELD WAREHOUSING

Those familiar with the traditional arrangement known as "field warehousing" will notice the similarity and also the differences between that arrangement and "mortgage warehousing" as described above. In true field warehousing the transaction includes not only the appointment of the custodian, but also the segregation of the commodities on a portion of the premises of the borrower which are then leased to the lender, and the erection of conspicuous signs notifying the public and other parties dealing with the borrower that the goods located on the leased premises are the property of the lending institution.<sup>2</sup> The element of the lease is intended as a substitute for physical delivery of the pledged goods. The appointment of the custodian is intended to insure that the "pledgee" actually maintains control over the goods, and he is instructed that no goods may be removed without his prior consent. The signs supply the answer to the still prevailing policy against the validity of secret liens. Such an arrangement is said to be necessitated by practical business considerations and was in fact an ingenious legal method of making a pledge of commodities for which there was no room in the vault of the bank because of their nature or their number.<sup>3</sup>

2. Kane, *The Theory of Field Warehousing*, 12 WASH. L. REV. 20 (1937).

3. See *Union Trust Co. v. Wilson*, 198 U.S. 530 (1905) (leather); *Pittman v. Union Planters Nat'l Bank*, 118 F.2d 211 (6th Cir. 1941) (cottonseed); *Commonwealth Trust Co. v. RFC*, 120 F.2d 254 (3d Cir. 1941) (pig iron); *Manufacturers Acceptance Corp. v. Hale*, 65 F.2d 76 (6th Cir. 1933) (lumber); *Philadelphia Warehouse Co. v. Winchester*, 156 Fed. 600 (C.C.D. Del. 1907) (steel).

Traditional field warehousing involves hazards which arise from the required physical arrangements. While the identity of the custodian as an employee of the borrower is not a determining factor, failure of the custodian to exercise control will invalidate the arrangement.<sup>4</sup> The fact that the premises are accessible to other parties militates against the alleged dominion over the pledged property,<sup>5</sup> while if the signs intended as notification to the public are in obscure locations, the pledge is said not to be open and notorious.<sup>6</sup>

One outstanding difference between traditional field warehousing and mortgage warehousing is the latter's lack of any notice to the public except possibly the label on the filing cabinets. The absence of a lease of any premises and lack of segregation of the "pledged" mortgages is also significant. In addition, it should be noted that Mortgage Company *M* often urges that the mortgages must stay in its possession for purposes of having its billing clerks service the instalment payments to be made by the mortgagors. This plea is contradictory to the intent that the custodian maintain complete and exclusive control over the documents. Such control would seem to be illusory in these cases.

In addition to these risks, the few treatises on the subject limit the use of "field warehousing" to commodities and goods of a nature which are not readily susceptible of delivery.<sup>7</sup> Section 6 of the *Restatement of Security* restricts the theory to "bulky goods."<sup>8</sup> No authority has been found sustaining such an arrangement in the case of documents which may easily be delivered to the files of a bank.

Furthermore, a state like Pennsylvania which has adopted the Uniform Commercial Code has rejected the theory of field warehousing of commodities by its notice filing system and has thereby destroyed any basis for asserting that it is applicable to mortgage documents.<sup>9</sup> It is now necessary under the Code for a secured party to obtain actual

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4. See *In re Rodgers*, 125 Fed. 169, 178 (7th Cir. 1903), *rev'd on other grounds sub nom.* First Nat'l Bank v. Chicago Title & Trust Co., 198 U.S. 280 (1905).

5. See *Security Warehousing Co. v. Hand*, 206 U.S. 415, 426 (1907) (hosiery and raw materials).

6. See *Security Warehousing Co. v. Hand*, *supra* note 5, at 421; *In re Spanish-American Cork Products Co.*, 2 F.2d 203 (4th Cir. 1924), *cert. denied*, 266 U.S. 634 (1925); *American Can Co. v. Erie Preserving Co.*, 183 Fed. 96 (2d Cir. 1910).

7. See, e.g., Friedman, *Field Warehousing*, 42 COLUM. L. REV. 991 (1942); Burman, *Practical Aspects of Inventory and Receivables Financing*, 13 LAW & CONTEMP. PROB. 554 (1948); Koch, *Economic Aspects of Inventory and Receivables Financing*, 13 LAW & CONTEMP. PROB. 566 (1948); Birnbaum, *Form and Substance in Field Warehousing*, 13 LAW & CONTEMP. PROB. 579 (1948); 19 CALIF. L. REV. 333 (1931).

8. "A pledge of bulky goods can be created by an identification of the goods and an assumption of control by the pledgee."

9. See UNIFORM COMMERCIAL CODE §9-305; PA. STAT. ANN. tit. 12A, §9-305 (Purdon 1954).

physical possession of an instrument, such as the note or bond evidencing the obligation secured by the mortgage, before the lender can have any security interest in that obligation.<sup>10</sup>

#### EXPOSURE UNDER OTHER APPLICABLE PRINCIPLES

If the theory of "field warehousing" is not applicable to support a "pledge" of documents, it is necessary to consider the arrangement as a case in which the appointment of the custodian has no effect whatever and as if the "pledged" property consisting of bond, mortgage and accompanying papers had continued in the possession of the borrowing mortgage company. Whether such an arrangement will be recognized as a security device must be examined under other applicable rules of law.

#### *State Law*

The importance of ascertaining the decisions of the particular state in which the arrangements are being carried out cannot be over-emphasized. Such rulings are important not only because of their influence upon problems which might confront the parties in the state courts, but particularly because such decisions will govern the effectiveness of the "pledge" in the federal bankruptcy courts.<sup>11</sup> The problem is one of analyzing the nature of a mortgage transaction in the states concerned, the effect of the recording statutes, and the effectiveness of a "pledge" of mortgage documents without delivery, either with or without recording.

Typical of cases in this area is *Second National Bank v. Dyer*.<sup>12</sup> There Mortgage Company *M* had obtained interim borrowing from Bank *B* to which it delivered an *unrecorded* assignment of the mortgage together with the note of the mortgagor which represented the obligation secured by the mortgage. Without repayment of the loan to *B*, *M* executed and delivered to the permanent investor, *I*, a *recorded* assignment of the mortgage together with the original mortgage and a forged note purporting to represent the obligation. The Connecticut court held that, since *I* had complied with the recording acts, it was

10. PA. STAT. ANN. tit. 12A, § 9-303(3) (Purdon 1954); UNIFORM COMMERCIAL CODE §§ 9-303(3), 9-102(3), 9-105(g) (Supp. I 1955); Funk, *Problems of Classification under Article 9 of the Uniform Commercial Code*, 102 U. PA. L. REV. 703 (1954).

11. See *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938); *McKenzie v. Irving Trust Co.*, 323 U.S. 365 (1945); *Corn Exchange Nat'l Bank v. Klauder*, 318 U.S. 434 (1943); *In re Rosen*, 157 F.2d 997 (3d Cir. 1946), *cert. denied*, 330 U.S. 835 (1947).

12. 126 Conn. 101, 9 A.2d 503 (1939); 6 U. PITT. L. REV. 300 (1940).

the legal owner of the mortgage. The court recognized that normally the transfer to the bank of the mortgage obligation represented by the note would have carried the mortgage with it, but held that application of such a rule would nullify the recording statute.

State decisions, such as the *Dyer* case, usually involve some element of fraud. While the possibilities of fraud are always discounted before it occurs, the decisions are significant in determining the relationships of Bank *B* to third parties who have dealings with Mortgage Company *M*.

The risk of loss of security facing Bank *B* under the arrangement being discussed will be affected by considerations of state law inclusive of the following:

(a) Whether a real estate mortgage represents title or only a security interest in the premises.<sup>13</sup>

(b) Whether a mortgage may exist either without a note or bond or separate and apart from the note or bond it secures.<sup>14</sup>

(c) Whether a transfer of the debt transfers the mortgage.<sup>15</sup>

(d) The necessity of notice of an assignment to the obligor on the mortgage.<sup>16</sup>

(e) Whether priority of time of assignment governs.<sup>17</sup>

(f) Rules of estoppel.<sup>18</sup>

(g) Whether physical delivery of the bond, mortgage,<sup>19</sup> or both is needed to perfect an assignment.

(h) Applicability of recording statutes.

State cases cannot be conveniently classified under these issues since they are discussed by the courts in varying combinations and with varying emphasis. For purposes of discussion, the conflict in the decisions seems to resolve itself into the fundamental questions of

13. See *Artisti-Kote Co. v. Benefactor B. & L. Ass'n*, 64 F.2d 407 (3d Cir. 1933); 5 *TIFFANY, REAL PROPERTY* § 1380 (3d ed. 1939); Lloyd, *The Mortgage Theory of Pennsylvania*, 73 U. PA. L. REV. 43 (1924).

14. See *Orman v. North Alabama Assets Co.*, 204 Fed. 289 (N.D. Ala. 1913); *Sanford v. Kane*, 133 Ill. 199, 24 N.E. 414 (1890); *Johnson v. Clark*, 28 Atl. 558 (N.J. 1894); *In re Pirie*, 198 N.Y. 209, 91 N.E. 587 (1910); 5 *TIFFANY, op. cit. supra* note 13, § 1451; *WALSH, MORTGAGES* § 64 (1934).

15. See *Carpenter v. Longan*, 83 U.S. (16 Wall.) 271 (1872); *Mack v. Wetzlar*, 39 Cal. 247 (1870); *Waterbury Trust Co. v. Weisman*, 94 Conn. 210, 108 Atl. 550 (1919); *Morris v. Bacon*, 123 Mass. 58 (1877); *Roberts v. Halstead*, 9 Pa. 32 (1848); 5 *Tiffany, op. cit. supra* note 13, § 1449.

16. See notes 35, 36 and 41 *infra*; *Kinch v. Fluke*, 311 Pa. 405, 166 Atl. 905 (1933); *Foster v. Carson*, 159 Pa. 477, 28 Atl. 356 (1894); *Kisinger v. Pennsylvania Trust Co.*, 119 Pa. Super. 16, 180 Atl. 79 (1935).

17. See notes 22, 23 and 25 *infra*.

18. See note 12 *supra*, and notes 22, 27 and 28 *infra*.

19. See notes 27 and 28 *infra*.

whether recording of the assignment of the mortgage is sufficient to protect Bank *B*, whether delivery of possession of the documents will suffice, or whether both acts are required.

### *Necessity of Recording Assignment of Mortgage*

In most states the recording statutes seem to be sufficiently comprehensive to permit or require the recording of an assignment of a mortgage.<sup>20</sup> It is said to be the general rule that such recording affords protection against subsequent purchasers of the same mortgage or encumbrancers of the real estate.<sup>21</sup> In such jurisdictions the relative rights of two buyers of the same mortgage seem to be determined by which one first records the transaction. Failure to record may subject a first assignee to the rights of later purchasers of the mortgage or encumbrancers of the real estate<sup>22</sup> on the same theory that subsequent encumbrancers of real estate are said not to be subject to latent defenses or equities in real estate.<sup>23</sup> This rule has even been used to protect purchasers of real estate, as in *Landis v. Robacker*,<sup>24</sup> where the unrecorded assignee of a mortgage permitted its assignor to dispose of the pledged mortgages as he chose. Having obtained title to the premises, the assignor sold them to an innocent purchaser who was held thereupon to have acquired title to the real estate free and clear of the secret, unrecorded assignment of the mortgage.<sup>25</sup>

### *Necessity of Delivery of Mortgage Documents*

In some states the recording statutes are not sufficiently broad to permit or require the recording of the assignment of a mortgage, and

20. 5 TIFFANY, *op. cit. supra* note 13, § 1457; Annots., 89 A.L.R. 171 (1934), 104 A.L.R. 1301 (1936).

21. See *Taylor v. American Nat'l Bank*, 63 Fla. 631, 57 So. 678 (1912); *International Bank v. Wilshire*, 108 Ill. 143 (1883); *Watson v. Wyman*, 161 Mass. 96, 36 N.E. 692 (1894); *Murphy v. Barnard*, 162 Mass. 72, 38 N.E. 29 (1894); *Redin v. Branham*, 43 Minn. 283, 45 N.W. 445 (1890); *Pepper's Appeal*, 77 Pa. 373 (1875); 5 TIFFANY, *op. cit. supra* note 13, § 1457.

22. See, *e.g.*, *Second Nat'l Bank v. Dyer*, 126 Conn. 101, 9 A.2d 503 (1939); *Blunt v. Norris*, 123 Mass. 55 (1877); *Brooke v. Struthers*, 110 Mich. 562, 68 N.W. 272 (1896); *Greene v. Warnick*, 64 N.Y. 220 (1876); *Brownback v. Ozias*, 117 Pa. 87, 11 Atl. 301 (1887).

23. See *Dulin v. Hunter*, 98 Ala. 539, 13 So. 301 (1893); *Himrod v. Gilman*, 147 Ill. 293, 35 N.E. 373 (1893); *Sweetzer v. Atterbury*, 100 Pa. 18 (1882); *Pryor v. Wood*, 31 Pa. 142 (1858); *Mott v. Clark*, 9 Pa. 399 (1848); 5 TIFFANY, *op. cit. supra* note 13, § 1456.

24. 313 Pa. 271, 169 Atl. 891 (1933).

25. Ordinarily, owners of real estate are said not to have any interest in the recording of an assignment of a mortgage other than to be entitled to make satisfaction to the party from whom notification is received. See 5 TIFFANY, *op. cit. supra* note 13, § 1457.

the rules of assignment and pledge ordinarily observed in those states would apply.<sup>26</sup>

Despite the fact that the recording statutes may apply, recording does not always seem to give complete protection, and the question of the necessity of delivery of the mortgage documents has become important in some cases. It has been held that a first assignee who obtains physical delivery of the mortgage documents without recording the assignment prevails over a second assignee even though the latter records his assignment.<sup>27</sup> The second assignee is said to be estopped to deny the title of the first assignee on the ground that he should have demanded delivery of the documents.

Even more closely allied to the "mortgage warehousing" arrangement is the result when the first assignee permits his assignor to retain possession of the mortgage documents even though he records his assignment of mortgage. If this assignor makes a second assignment to a bona fide purchaser who obtains delivery of the mortgage documents, the second assignee is said to prevail over the first assignment regardless of the fact that the first assignment was recorded.<sup>28</sup> The reason for this result is clear if the obligation secured by the mortgage is in the form of a negotiable note.<sup>29</sup> But the same result has been reached where the mortgage obligation was non-negotiable, either on the theory of estoppel or that the ownership of the mortgage cannot exist separate from the note, and its ownership follows the transfer of the mortgage note or bond.<sup>30</sup>

Cases in various states are not altogether reconcilable, and it is apparent that the same is true of cases within the same state.<sup>31</sup> One line of demarcation would appear to be whether the court will emphasize compliance with the recording act or whether it will place greater importance on the legal theory that ownership of a mortgage follows ownership of the obligation it secures, with the result that pos-

26. See *Reeves v. Hayes*, 95 Ind. 521 (1884); *James v. Morey*, 2 Cow. 246 (N.Y. 1823); *Citizens Nat'l Bank v. Harrison-Doddridge Coal & Coke Co.*, 89 W. Va. 659, 109 S.E. 892 (1921); *WALSH, op. cit. supra* note 14, § 63; 5 *TIFFANY, op. cit. supra* note 13, § 1457.

27. See *Brumbach v. McLean*, 196 Pa. 321, 46 Atl. 418 (1900); *Brumbach v. Johnson*, 187 Pa. 602, 41 Atl. 480 (1898); *Roberts v. Halstead*, 9 Pa. 32 (1848); *Richards Trust Co. v. Rhomberg*, 19 S.D. 595, 104 N.W. 268 (1905); *Fred Miller Brewing Co. v. Manasse*, 99 Wis. 99, 74 N.W. 535 (1898); 5 *TIFFANY, op. cit. supra* note 13, § 1457; *WALSH, op. cit. supra* note 14, § 63.

28. See *Wendling v. Aurelius-Swanson Co.*, 106 Okla. 63, 232 Pac. 932 (1924); *Landis v. Robacker*, 313 Pa. 271, 169 Atl. 891 (1933); *Wood v. Sparks*, 42 S.W.2d 142 (Tex. Civ. App. 1931); Note, *The Negotiable Mortgage Controversy*, 29 NEB. L. REV. 606, 621 (1950).

29. *Wendling v. Aurelius-Swanson Co.*, *supra* note 28.

30. *Wood v. Sparks*, 42 S.W.2d 142 (Tex. Civ. App. 1931).

31. Compare *Brumbach v. McLean*, 196 Pa. 321, 46 Atl. 418 (1900), with *Pepper's Appeal*, 77 Pa. 373 (1875).



session of the mortgage obligation becomes the deciding factor. The degree of protection of Bank *B*, therefore, usually depends upon the decisions of the state in which the mortgage borrower is located and whether recording an assignment of mortgage is sufficient, whether possession must be taken of the mortgage documents, or whether both acts are required. Nice questions of conflicts of law may also arise.

### *Federal Bankruptcy Act*

The state decisions will control in the more important determination by the bankruptcy courts of whether Bank *B* has sufficiently "perfected" its security interest in the "pledged" mortgages to the extent required by the Bankruptcy Act.<sup>32</sup>

Bankers and other parties dealing in security interests were considerably relieved by the enactment of the 1950 amendment to section 60(a) of the Chandler Act which substituted, for property other than real property, a "lien creditor test" in lieu of a "bona fide purchaser" test.<sup>33</sup> Thus chattel mortgages and trust receipts perfected against creditors by filing are now valid in bankruptcy even though the debtor may transfer good title to a purchaser. The result in *Corn Exchange National Bank v. Klauder*<sup>34</sup> would now be different under the state law as it existed at that time, for while the law of Pennsylvania was that failure of the assignee of accounts receivable to give notice to the

32. See note 11 *supra*; 3 COLLIER, BANKRUPTCY §§ 60.39-50 (14th ed. 1941).

33. "(a) (1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

"(2) For the purposes of subdivisions (a) and (b) of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee. If any transfer of real property is not so perfected against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this title, it shall be deemed to have been made immediately before the filing of the petition.

"(3) The provisions of paragraph (2) of this subsection shall apply whether or not there are or were creditors who might have obtained such liens upon the property other than real property transferred and whether or not there are or were persons who might have become bona fide purchasers of such real property." 30 STAT. 562 (1898), as amended, 11 U.S.C. §§ 96(a)(1)-(3) (1952); 3 COLLIER, *op. cit. supra* note 32, § 60.38.

34. 318 U.S. 434 (1943) (assignee of accounts receivable did not notify obligors and therefore assignments would not have been good against a hypothetical bona fide purchaser from assignor); 3 COLLIER, *op. cit. supra* note 32, § 60.48.

obligors on the account made it possible for a bona fide purchaser of those accounts to obtain good title,<sup>35</sup> an attaching creditor of the assignor was and is still entitled only to those rights retained by the assignor in the accounts. This conforms to the general rule.<sup>36</sup>

However, the generalization that a "lien creditor test" was substituted for the "bona fide purchaser test" in all cases is too broad, since it was also the manifested intention of Congress that secret liens which constitute only equitable liens under state law were not to be recognized in bankruptcy.<sup>37</sup> If state law provides that an equitable lien is not valid against third parties other than buyers from the debtor in the ordinary course of trade until the delivery of an instrument of assignment,<sup>38</sup> delivery of possession,<sup>39</sup> filing or recording,<sup>40</sup> or "other like overt action," the equitable lien is not considered perfected in bankruptcy. "Other like overt action" presumably includes compliance with a state requirement that notice be given to an obligor before an assignment of mortgage may be valid against creditors.<sup>41</sup> It is to be noted that under section 60(a)(3), it is still only the hypothetical possibility that a bona fide purchaser or lien creditor be able to obtain a superior title which prevents the perfection of the equitable interest. The actual existence of such purchaser or creditor is unimportant.<sup>42</sup>

35. Phillips's Estate, 205 Pa. 515, 55 Atl. 213 (1903); *cf.* RESTATEMENT, CONTRACTS § 173 (1932).

36. RESTATEMENT, CONTRACTS § 172 (1932); 2 WILLISTON, CONTRACTS § 434 (rev. ed. 1936); Phillips's Estate, 205 Pa. 525, 55 Atl. 216 (1903).

37. ". . . (a) (6) The recognition of equitable liens where available means of perfecting legal liens have not been employed is declared to be contrary to the policy of this section. If a transfer is for security and if (A) applicable law requires a signed and delivered writing, or a delivery of possession, or a filing or recording, or other like overt action as a condition to its full validity against third persons other than a buyer in the ordinary course of trade claiming through or under the transferor and (B) such overt action has not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning of paragraph (2) of this subsection. Notwithstanding the first sentence of paragraph (2) of this subsection, it shall not suffice to perfect a transfer which creates an equitable lien such as is described in the first sentence of this paragraph, that it is made for a valuable consideration and that both parties intend to perfect it and that they take action sufficient to effect a transfer as against liens by legal or equitable proceedings on a simple contract: *Provided, however,* That where the debtor's own interest is only equitable, he can perfect a transfer thereof by any means appropriate fully to transfer an interest of that character: *And provided further,* That nothing in this paragraph shall be construed to be contrary to the provisions of paragraph (7) of this subdivision." 30 STAT. 562 (1898), as amended, 11 U.S.C. § 96(a)(6) (1952).

38. Manchester Nat'l Bank v. Roche, 186 F.2d 827 (1st Cir. 1951).

39. *In re Helicopter Air Transport*, 85 F. Supp. 918 (D.N.J. 1949).

40. Bridgewater v. Schaefer, 164 F.2d 447 (5th Cir. 1947); *In re Cox*, 132 F.2d 881 (7th Cir. 1943); *In re Burton*, 120 F. Supp. 148 (D. Md. 1954); Hawkins v. Dannenberg Co., 234 Fed. 752 (S.D. Ga. 1916). The unrecorded real estate mortgage approved in *Carey v. Donohue*, 240 U.S. 430 (1916), would not now be valid.

41. 3 COLLIER, *op. cit. supra* note 32, § 60.48, § 60.50.

42. See note 33 *supra*.

The equitable lien on negotiable instruments left with the borrower by the lender was once recognized under *Sexton v. Kessler*,<sup>43</sup> but that result was changed by the Chandler Act and is still invalid under the 1950 amendment.<sup>44</sup> A parallel might well be drawn between that situation and the arrangement under discussion whereby Bank *B* as the "pledgee" of mortgage obligations fails to require their delivery or fails to record. The arrangement with Mortgage Company *M* is exposed to the state decisions which hold that even though Bank *B* has recorded an assignment of the mortgages, if it has permitted the mortgage documents to remain in the possession of the custodian (whose possession may be meaningless by reason of the inapplicability of the field warehouse theory), its interest is subject to a transfer of good title by a second assignment to a bona fide purchaser.<sup>45</sup> Likewise, a failure to record the assignment of the mortgages subjects Bank *B* to the possibility that a bona fide purchaser without notice may acquire title to those mortgages under a transfer from Mortgage Company *M*.<sup>46</sup>

It is necessary for lenders to determine whether recording or possession in a given state is sufficient protection or whether both recording and possession are required. Unless the required action is taken more than four months prior to bankruptcy or unless other elements of a preference are missing, the transfer will be deemed to have been made immediately prior to the bankruptcy proceedings and will therefore be voidable as a preferential transfer.<sup>47</sup>

The situation is even more serious in a state which holds that a mortgage represents legal title to the real estate and that the assignment of the mortgage is a transfer of real property.<sup>48</sup> In such a jurisdiction the "bona fide purchaser" test would apply under section 60(a)(2) without first determining whether the interest of the assignee was only an equitable interest under the law of that state.<sup>49</sup>

### *Mortgage Obligations Represent Accounts Receivable*

The assignee or pledgee of a mortgage and its underlying note or bond is exposed to a risk of loss of security even though the particular transaction is recognized as a "valid" assignment or pledge. Whatever theory is used to validate the "pledge," the holder of a note or bond secured by a mortgage is to be regarded as the holder of a chose in

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43. 225 U.S. 90 (1911).

44. 3 COLLIER, *op. cit. supra* note 32, § 60.38.

45. See notes 28, 29 and 30 *supra*.

46. See note 22 *supra*.

47. See notes 33 and 37 *supra*.

48. See note 13 *supra*.

49. See note 33 *supra*.

action.<sup>50</sup> A mortgage lien can exist only if there is an obligation under a bond or note.<sup>51</sup> A purported assignment of the mortgage without the debt is said to be a nullity,<sup>52</sup> while the transfer of the debt is often said to constitute a transfer of the mortgage security.<sup>53</sup> This analysis would require the assignee of the mortgage in most jurisdictions to consider the necessity of complying with requirements ordinarily deemed applicable to the pledge or assignment of accounts receivable. In particular it is important to determine whether dominion and control have been established and maintained by the "pledgee" over the amortization payments if they are to be made by the mortgagor to Mortgage Company *M*. The rule of *Benedict v. Ratner*<sup>54</sup> is not exclusively applicable to accounts receivable but has been applied to property of other types.<sup>55</sup> Even the delivery to the pledgee of the bond with its accompanying mortgage and the recording of the assignment may be vitiated if the assignee makes no attempt to control the disposition of the periodic collections by its debtor on account of interest and principal on the mortgage.<sup>56</sup> It is not a question of additional security only, for the entire transaction is otherwise voided.<sup>57</sup>

#### *Available Alternative Arrangements*

This review may only confirm the present convictions of discerning persons. However, the lack of literature on the subject is a matter of concern in the face of published statements which over-emphasize

50. 5 TIFFANY, *op cit. supra* note 13, § 1412.

51. See note 14 *supra*.

52. *Ibid.*

53. See note 15 *supra*.

54. 268 U.S. 353 (1925); *cf.* Corn Exchange Nat'l Bank v. Klaunder, 318 U.S. 434 (1943); *In re Rosen*, 157 F.2d 997 (3d Cir. 1946); *In re Pusey, Maynes, Breish Co.*, 122 F.2d 606 (3d Cir. 1941).

55. See *Mount v. Norfolk S. & L. Corp.*, 192 F.2d 286 (4th Cir. 1951) (pledge of conditional sales contracts invalid although possession delivered); *In re Allied Products Co.*, 134 F.2d 725 (6th Cir. 1943) (construction contract); *McCance v. D. A. Schulte*, 91 F.2d 733 (2d Cir.), *cert. denied*, 302 U.S. 743 (1937) (assignment of real estate leases); *Manufacturers Finance Co. v. Armstrong*, 78 F.2d 289 (4th Cir. 1935) (sufficient dominion supported pledge of trade acceptances); *Brown v. Leo*, 12 F.2d 350 (2d Cir. 1926) (grocery stock and fixtures); *In re Gruner's Estate*, 54 N.Y.S.2d 330 (Surr. Ct.), *aff'd*, 269 App. Div. 973, 59 N.Y.S.2d 286 (1st Dep't 1945), *rev'd on other grounds*, 295 N.Y. 510, 68 N.E.2d 514 (1946) (attempted lien on stock exchange seat invalidated due to power of pledgor to subject seat to debt charges).

56. *In re Prudence Co.*, 88 F.2d 420 (2d Cir. 1937) (dictum), *affirming* 15 F. Supp. 1064 (E.D.N.Y. 1936).

57. UNIFORM COMMERCIAL CODE § 9-205 changes the rule of *Benedict v. Ratner* in Pennsylvania in so far as that case voided a pledge because of the power of the debtor to use or dispose of collections from accounts receivable. See note 10 *supra*. Furthermore, the amortization payments due under a mortgage are not included in the definition of an account in the code. UNIFORM COMMERCIAL CODE § 9-106.

the convenience of permitting Mortgage Company *M* to retain possession of the mortgage documents.<sup>58</sup>

There is still time for lenders to make an educated choice between the alternatives of (1) accomplishing recording only, (2) taking possession of the mortgage documents without recording, (3) recording an assignment and obtaining possession of all the mortgage documents, or (4) taking possession of the mortgage obligation only and leaving the mortgage in the hands of Mortgage Company *M* on the theory that its ownership follows the mortgage obligation. The expense of recording an assignment for temporary periods is a practical obstacle which may influence a decision to exercise one of the alternative possessive rights, which appear to be more protective than the mere act of recording. Alternative number (4), of course, would not be available in a state which has already adopted the rule that possession of the mortgage obligation separate from the mortgage does not afford protection unless recording is also accomplished.<sup>59</sup>

An additional alternative exists which under certain circumstances may be even more practical. This consists of having the initial assignment of mortgage recorded in favor of the permanent investor which in turn would agree to pay directly to Bank *B* the price stated in its purchase commitment. Whether such assignment should be accompanied by the delivery of the mortgage papers to the permanent investor in the capacity of a custodian will depend upon the protection afforded under state law by the mere act of recording or whether the continued possession in Mortgage Company *M* could subject Bank *B* or the permanent investor to the rights of an intervening bona fide purchaser of the mortgage documents.

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58. Redfield, "*Warehousing*" *Helps Balance Mortgage Portfolios*, Savings Bank J., Aug. 1955, p. 10.

59. See, *e.g.*, *Second Nat'l Bank v. Dyer*, 126 Conn. 101, 9 A.2d 503 (1939).

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