1998

Third-Party Defenses to Mortgages

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I. INTRODUCTION

When the holder of a note and mortgage[1] asserts its rights, well-established law delineates what defenses are available to those who are liable for the debt. However, in some cases a person who is not liable for the debt—a "third party" to the loan transaction—may have a defense against the holder's action. Although the third party is not liable for the debt, it may have an interest in the mortgaged land or in the mortgage itself. Unfortunately, the law is not nearly as clear in this situation. The confusion arises in large part because the laws concerning notes and mortgages have evolved with little regard for each other, despite their close association in commercial transactions.

To resolve the conflict between the two bodies of law, courts state that, because the mortgage is a mere ancillary of the note, it should be governed by the same law as the note—Article 3 of the Uniform Commercial Code (UCC) or the common law of contracts. This reliance on commercial law is completely misplaced when deciding issues concerning title to land or to a mortgage and leads to untoward results. Although commercial law defines which defenses are available to a person liable on the note, titles to land and to mortgages are governed by the land laws and by the recording acts in particular. Pursuant to those laws, a third party's claim to land or to a mortgage is governed by one criterion—notice. That one factor is the correct basis for decision in all the third-party defense cases.

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1. For ease of reference, the term "mortgage" will be used throughout this Article to refer generically to all forms of real estate security. Although the various types of real estate security and the documents by which they are created differ, those differences are irrelevant to the discussion in this Article, except where noted otherwise.

II. CATEGORIES OF THIRD-PARTY DEFENSE CASES

Another source of confusion in these cases is the morass of facts involved in each case. Because the cases almost always involve fraud or other wrongful conduct, the facts are often quite complicated. Wrongdoers often act through a series of nominees, designees, straw people, and shell corporations; engage in conduct that wrongfully enables them to collect payments on loans they no longer own or to sell the same loan more than once; and otherwise act to obfuscate and cover their tracks. However, order does exist within this chaos of facts. Distilled to their essentials, the third-party defense cases virtually all involve one of the following six fact patterns:[2]

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2. A seventh category of case exists, but it is so different from the other categories as to be inapposite. This category involves cases in which a third party, such as a junior lienor, asserts the borrower's defenses against enforcement of the mortgage. The defenses include failure of consideration, fraud in the inducement, expiration of the statute of limitations, the one-action rule, unconscionability, and usury. Although third parties have asserted these defenses against enforcement of a mortgage in a substantial number of cases, the great bulk of these cases involve the original mortgagee so that notice is not an issue as it is in the other six categories. Moreover, these defenses do not address ownership of a mortgage or of the mortgaged land. Instead, they usually are asserted to prevent elimination of that ownership interest by foreclosure or execution of a senior lien. Therefore, these cases will not be considered in the text of this Article. However, because they are defenses asserted by third parties, they will be examined briefly in this footnote.

A purchaser of property subject to a mortgage generally is barred from asserting any defense of the original borrower when the purchase price for the land was reduced to reflect the secured debt. *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 5.17 (3d ed. 1994). Additionally, third parties usually cannot assert these defenses against a holder in due course because they normally are characterized as personal defenses. *See infra* notes 10-11 and accompanying text; *see also, e.g.*, FDIC v. Wood, 758 F.2d 156 (6th Cir. 1985) (usury); City Lumber Co. v. Park, 58 P.2d 403 (Cal. Ct. App. 1936) (failure of consideration); Wilson Bros. v. Cooey, 247 A.2d 395 (Md. 1968) (failure of consideration); Katz v. Simcha Co., 246 A.2d 555 (Md. 1968) (usury). On the other hand, when a nonholder in due course holds the note and mortgage, a third party generally can assert the following defenses: (1) expiration of the statute of limitations, *see, e.g.*, Billingsley v. Pruitt, 291 S.W.2d 498 (Ark. 1956); Flack v. Boland, 77 P.2d 1090 (Cal. 1938); Kaichen's Metal Mart, Inc. v. Ferro Cast Co., 39 Cal. Rptr. 2d 233 (Ct. App. 1995); O'Neil v. General Security Corp., 5 Cal. Rptr. 2d 712 (Ct. App. 1992); (2) fraud in the inducement, *see, e.g.*, Kirk v. MacDonald, 483 N.E.2d 832 (Mass. App. Ct. 1985); (3) payment of the debt, *see, e.g.*, Woods v. Bournes, 309 S.W.2d 309 (Ark. 1958); Hart v. Louis S. Levi Co., 22 N.E.2d 30 (Mass. 1939); (4) the foreclosing party does not own the mortgage, *see, e.g.*, V.S. Cook Lumber Co. v. Harris, 71 P.2d 446 (Okla. 1937); and (5) the one-action rule, *see, e.g.*, O'Neil v. General Sec. Corp., 5 Cal. Rptr. 2d 712 (Ct. App. 1992).

Some courts have characterized other defenses as being personal to the borrower and, therefore, unavailable to third parties, including unconscionability, *see, e.g.*, County of Tioga v. Solid Waste Indus., 577 N.Y.S.2d 922 (App. Div. 1991), and failure of

A. Fraud

Owner (Third Party) $\xrightarrow{\cancel{\text{Deed}}}$ Grantee $\xrightarrow{\text{Mortgage}}$ Mortgagee

In a typical fraud case, a landowner is fraudulently induced to convey title to a grantee who then gives a mortgage on the land to secure a debt. If a court voids the deed because of the fraudulent conduct and the former owner thereby reacquires title, is the title still encumbered by the mortgage or can the former owner successfully assert the fraud to eliminate the mortgage?

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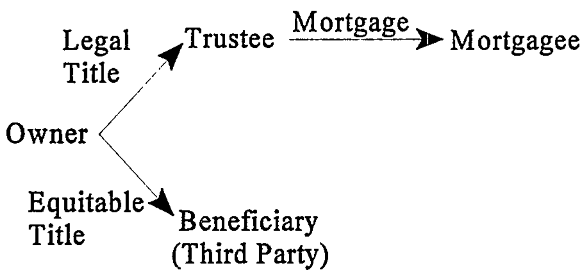
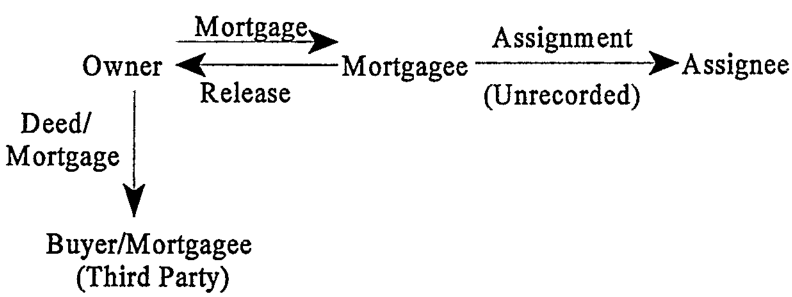
consideration, *see, e.g.*, 527-9 Lenox Ave. Realty Corp. v. Ninth St. Ass'n, 606 N.Y.S.2d 699 (App. Div. 1994); County of Tioga v. Solid Waste Indus., 577 N.Y.S.2d 922 (App. Div. 1991). *But see* Hart v. Louis S. Levi Co., 22 N.E.2d 30 (Mass. 1939); *In re* Levine, 23 B.R. 410 (Bankr. S.D.N.Y. 1982). The defense that has caused the greatest division of authority is usury. The majority of cases, including most of the more recent cases, characterize the defense as being a personal defense of the borrower that is unavailable to junior lienors. *See, e.g.*, Federal Sav. & Loan Ins. Corp. v. Griffin, 935 F.2d 691 (5th Cir. 1991); United States v. Desert Gold Mining Co., 433 F.2d 713 (9th Cir. 1970); Maestro Music, Inc. v. Rudolph Wurlitzer Co., 354 P.2d 266 (Ariz. 1960); Sosin v. Richardson, 26 Cal. Rptr. 610 (Ct. App. 1962); Commonwealth Trailer Sales v. Bradt, 87 N.W.2d 705 (Neb. 1958); Tanner v. Mobley, 354 S.W.2d 446 (Tenn. 1962); Allee v. Benser, 779 S.W.2d 61 (Tex. 1988). Other courts, however, permit junior lienors to assert the defense of usury, particularly when the junior wants to exercise its equity of redemption with respect to the senior mortgage. *See, e.g.*, National Sur. Corp. v. Inland Properties, Inc., 286 F. Supp. 173 (E.D. Ark. 1968); *In re* Langer, 6 F. Supp. 651 (E.D.N.Y. 1934); Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251 (Alaska 1975); Cole v. Bansemer, 26 Ind. 94 (1866); Broadhurst v. Brooks, 113 S.E. 576 (N.C. 1922). In at least two states, usury is classified as a real defense that is available even against a holder in due course. *See, e.g.*, Andrews v. Martin, 436 S.W.2d 285 (Ark. 1969); Lucas v. Beco Homes, Inc., 494 S.W.2d 417 (Mo. Ct. App. 1973).

B. Resulting Trust



A resulting trust is created when a landowner conveys title to a trustee but does not designate the trustee's status on the deed so that the deed appears to be an outright conveyance of fee title. Despite the failure to express the trustee's status on the deed, the trustee holds the property in trust for the beneficiary. If the trustee violates the trust by mortgaging the land to secure a personal loan, can the beneficiary successfully assert the existence of the resulting trust to eliminate the mortgage?

C. Wrongful Release by the Original Mortgagee



When an assignee fails to record a mortgage assignment, the original mortgagee still appears from the property records to own the mortgage. If the landowner sells the land after the assignment and uses the sale proceeds to pay the debt to the original mortgagee in exchange for its execution of a mortgage release, is the buyer's title subject to the mortgage? Similarly, if the landowner borrows money to pay the mortgage debt and gives a mortgage to secure the new loan, is the new mortgage subject to the prior mortgage or is the prior mortgage eliminated?

D. Wrongful Release by a Mortgagee that Acquired Fee Title

(1) Owner $\xrightarrow{\text{Mortgage}}$ Mortgagee $\xrightarrow[\text{(Unrecorded)}]{\text{Assignment}}$ Assignee

(2) Owner $\xrightarrow{\text{Deed}}$ Mortgagee

(3) Mortgagee $\xrightarrow{\text{Deed}}$ Buyer (Third Party)

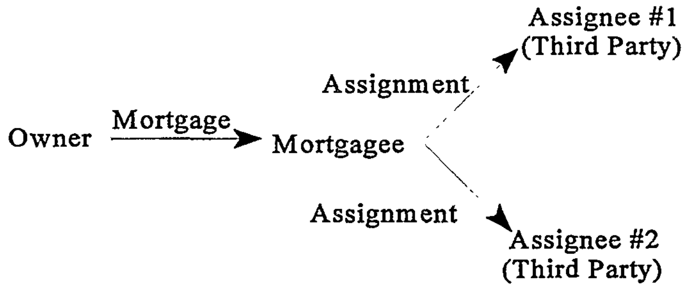
This category of cases is similar to the third category but differs in legally significant ways. As in the last category, the original mortgagee purports to release a mortgage after having assigned it to someone else. Unlike the last category, however, the original mortgagee has acquired title to the encumbered land after assigning the mortgage. Because the mortgage assignment is unrecorded, the original mortgagee appears to own both the mortgage and the fee title to the encumbered land. Therefore, this category of cases implicates the doctrine of merger, which potentially applies when a person owns more than one interest in a parcel of land. In contrast, the cases in the third category involve a written release. As in the preceding category, the issue in these cases is whether the buyer is subject to the mortgage or can use the wrongful release as a defense against it.

E. Mortgage as a Fraud on Creditors

Owner $\xrightarrow{\text{Mortgage}}$ Mortgagee $\xrightarrow{\text{Assignment}}$ Assignee (Third Party)

This type of case typically arises when a landowner attempts to shelter its land from creditors by granting a mortgage in favor of an ally for little or no consideration. After the mortgage is assigned, can it still be invalidated as a fraudulent conveyance?

F. Mortgage Assigned Twice



If the original mortgagee assigns the same mortgage twice, which assignee owns it? If one assignee brings an action to foreclose the mortgage, can the other assert its claimed ownership of the mortgage as a defense?

III. APPROACHES FROM COMMERCIAL LAW: THE COMMON LAW OF CONTRACTS AND UCC ARTICLE 3

Courts and commentators often state that the answers to the questions presented by these cases are governed by one of two bodies of law—the common law of contracts or Article 3 of the UCC Article 3 applies if the note is a "negotiable instrument" as defined by the Code. The common law applies otherwise. As described below, the common law and Article 3 employ very different approaches to the availability of defenses.

A. Common Law of Contracts

Under the common law of contracts, defenses to the note and mortgage are divided into "patent equities" and "latent equities."[3] This division is based on whose defense it is to assert. The borrower's defenses are called patent equities because they are discoverable by the exercise of reasonable diligence. An assignee of the note and mortgage knows the borrower's identity; after all, this is the person from whom it expects to receive loan payments. Therefore, the theory is that the assignee simply can ask the borrower whether it has any defenses to enforcement of the note or mortgage.

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3. *See* NELSON & WHITMAN, *supra* note 2, § 5.32.

Unfortunately, as happens too often in this hoary area of law, practice has diverged from theory.[4] The number of outstanding mortgage loans has increased exponentially since the era during which the patent/latent distinction was drawn. Loans from around the country are sold and resold in pools of hundreds or thousands on the secondary mortgage market. Rather than ask each borrower whose loan is in the pool whether it has any defenses, secondary market purchasers typically rely on the seller's representations and warranties that no defenses exist. Despite this transformation of the mortgage market, which makes questioning each borrower impracticable, the common law of contracts subjects mortgage assignees to patent equities.

In contrast to patent equities, latent equities are third-party defenses. They are latent because they are generally undiscoverable by the exercise of ordinary diligence. The prospective mortgage assignee normally will not know the third party's identity because, by definition, the third party was not involved in the loan transaction. Therefore, the assignee cannot inquire of the third party whether it has any defenses.

Courts deciding cases involving latent equities appear to reach dramatically different results. In some cases, courts hold that a mortgage assignee is subject to latent equities because the original mortgagee is subject to them; the original mortgagee can convey no greater rights to enforce the mortgage than it had.[5] In other cases, courts categorically state that assignees are not subject to latent equities because of the difficulties that otherwise would be created for purchasers of loans.[6] As will be described below, however, a single factor—notice—unifies and harmonizes virtually every one of these cases.

B. *Article 3 of the UCC*

If the note conforms with the requirements of Article 3 of the UCC, it is a "negotiable instrument"[7] and is governed by the

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4. *See, e.g.*, Dale A. Whitman, *Reforming the Law: The Payment Rule as Paradigm*, 1998 BYU L. REV. 1169.

5. *See, e.g.*, *In re* Levine, 23 B.R. 410 (Bankr. S.D.N.Y. 1982); Owen v. Evans, 31 N.E. 999, 1000-01 (N.Y. 1892); Trustees of Union College v. Wheeler, 16 Sickels 12 (N.Y. 1874).

6. *See, e.g.*, Bloomer v. Henderson, 8 Mich. 395 (1860); Simpson v. Del Hoyo, 94 N.Y. 189 (1883).

7. *See* U.C.C. § 3-104 (1995) (specifying the requirements for a negotiable

provisions of the Code, rather than by the common law of contracts.[8] With respect to defenses to enforcement of a negotiable instrument, Article 3 distinguishes between an instrument held by a holder in due course (HDC) and an instrument held by someone who is not a holder in due course (non-HDC). A non-HDC is subject to all the defenses that can be asserted under the common law of contracts.[9] Therefore, in a case involving a non-HDC, a court will apply the common law distinction between patent and latent equities.

In contrast, an HDC is insulated from many defenses. Unlike the common law, which categorizes defenses as patent or latent equities, Article 3 categorizes defenses as real or personal.[10] Whereas the common law's distinction is based on whose defense it is to assert, Article 3's distinction is based on the type of defense. The most serious defenses—those that go to the very heart of the transaction's validity—are real defenses, such as duress, lack of legal capacity, and illegality. The less serious defenses, such as failure of consideration, are personal defenses. An HDC is subject only to real defenses. It can enforce the negotiable instrument without being subject to personal defenses.[11] This special protection for HDCs is designed to facilitate the flow of capital throughout the country by insulating secondary loan market purchasers from most defenses.[12]

In categorizing defenses based on their substance, rather than on the person asserting them, Article 3 overlooked third-party defenses. Although predecessor legislation appeared to apply to both obligors' and third parties' defenses, Article 3's provisions concerning real and personal defenses refer only to

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instrument).

8. *See id.* § 3-102(a).

9. *See id.* § 3-305(a)-(b).

10. *See* 2 THOMAS D. CRANDALL ET AL., UNIFORM COMMERCIAL CODE § 16.13.2 (1996).

11. *See* U.C.C. § 3-305(b) (1995). The D'Oench, Duhme doctrine provides equivalent protection to the FDIC and RTC. The United States Supreme Court created this federal common law doctrine in *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942). *See also* Resolution Trust Corp. v. Maplewood Invs., 31 F.3d 1276, 1290-94 (4th Cir. 1994); Milligan v. Gilmore Meyer, Inc., 775 F. Supp. 400, 403-05 (S.D. Ga. 1991); Barbara A. Bailey, *Giving D'Oench its Due: A Comment on the D'Oench, Duhme Doctrine After* O'Melveny & Meyers v. FDIC, 28 ARIZ. ST. L.J. 1259 (1996); J. Michael Echevarria, *A Precedent Embalms a Principle: The Expansion of the D'Oench, Duhme Doctrine*, 43 CATH. U. L. REV. 745 (1994).

12. *See* 2 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 150 (4th ed. 1995).

defenses "of the obligor"; no other provision addresses third-party defenses.[13]

Article 3's legislative history sheds no light on this issue. The available legislative histories for both the 1952 and 1990 versions of Article 3 are silent on the issue of third-party defenses. Although an early draft of Article 3 provided that an HDC takes free of "all defenses" other than a few enumerated types of defenses, the Reporter's Note does not indicate that the drafters considered the issue of third-party defenses.[14] The Reporter's Note for this section contains the only reference to mortgages. It states that one subsection of this provision "is intended to meet the problem of the note and mortgage."[15] However, the drafters' concern appears to have been whether the purchaser of a note can be an HDC despite knowledge that a mortgage "purports to affect the note," rather than with the issue of third-party defenses.[16]

The apparent absence of any mention of third-party defenses may be attributable at least in part to the dearth of legislative

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13. Section 58 of the Uniform Negotiable Instruments Law (N.I.L.), which was the immediate predecessor of Article 3, provided that a non-HDC of a negotiable instrument "is subject to the same defenses as if it were nonnegotiable." 5 U.L.A. § 58 (1996). This provision was not limited expressly to defenses of the obligor but apparently included third-party defenses as well. *See* James J. Morrison, *Equities of Ownership and Equities of Defence in Overdue Paper,* 5 TUL. L. REV. 287, 297-301 (1931). *But see* Meriwether v. New Orleans Real Estate Bd., 162 So. 208, 210-11 (La. 1935). In contrast, section 57 of the N.I.L. provided that an HDC held the instrument "free from defenses available to prior parties among themselves." 5 U.L.A. § 57 (1996). This provision does not include third-party defenses.

When Article 3 was promulgated in 1952 to replace the N.I.L., the more expansive language of section 58 was replaced with language that did not include third-party defenses. Both section 3-305(2), which dealt with HDCs, and section 3-306(b), which dealt with non-HDCs, provided only for "defenses of any party." The Code's definition of "party" expressly excluded third parties, *see* U.C.C. § 1-201(29) (1952), even though the Official Comment to section 3-306 states that section 3-306(b) merely "restates the first sentence of the original [s]ection 58." U.C.C. § 3-306 (1997) Official Comment.

The original version of Article 3 was completely revised by the version promulgated in 1990. The 1990 Official Edition provisions concerning HDCs and non-HDCs again addressed only defenses "of the obligor." U.C.C. § 3-305(a), (b) (1997). Third-party defenses are not mentioned.

14. *See* U.C.C. Art. III, Third Preliminary Draft § 47 (Feb. 9-12, 1946), *reprinted in* 2 E.S. KELLY & A. PUCKETT, UNIFORM COMMERCIAL CODE: CONFIDENTIAL DRAFTS 93, 154 (1995) [hereinafter CONFIDENTIAL DRAFTS]. Tentative Draft No. 3, dated August 20, 1947, changed this language. It provided that HDCs took free from "all defenses of any party" with the exception of certain enumerated defenses. *Reprinted in* 3 E.S. KELLY, UNIFORM COMMERCIAL CODE DRAFTS 357 (1984).

15. 2 CONFIDENTIAL DRAFTS, *supra* note 14, at 349.

16. *See id.* at 349-50.

history and of publicly available materials in particular.[17] But the larger problem—if not the entire problem—is that the UCC and the common law of mortgages have remained largely separate bodies of law despite their close association in commercial transactions. While mortgage law readily traces its lineage to twelfth-century England, Article 3 and its predecessor, the Negotiable Instruments Law (N.I.L.), have thoroughly modernized and codified the laws affecting negotiable instruments. With respect to security for the debt evidenced by the instrument, Article 3 was drafted to intermesh with Article 9 of the UCC, which deals with security interests in personal property. However, Article 3 appears to have been drafted without reference to mortgage law or to land law more generally. In fact, the Code's definition of "security interest"—"an interest in personal property or fixtures"[18]—clearly reveals the Code's disregard of real estate and mortgages.

IV. MAKING THE LINK: NOTICE

Because negotiable instruments and mortgages are so frequently linked in practice, courts have had to find a way to harmonize the laws governing them. To bridge the gap between them, courts in all but one state hold that a negotiable instrument imparts its quality of negotiability to the mortgage.[19] Courts reason that because the mortgage is an incident of and dependent on the debt, it should be enforceable to the same extent as the debt.[20] As a result, courts state that the mortgage

17. Legislative history for the UCC is scarce. Materials such as unpublished proceedings, minutes, and debates concerning the drafting of the UCC are essentially unavailable. *See* SPECIALIZED LEGAL RESEARCH § 2.4.1., at 2-32 (Leah F. Chanin ed., 1997). Therefore, the primary sources for interpreting the drafters' intent comes from the texts of the Official Editions and the preliminary drafts and from the Official Comments included after each provision in the text. Locating even these sources can be difficult, because some of the drafts are confidential or otherwise unpublished. *See id.* § 2.4.1, at 2-31 & n.7, § 2.4.4., at 2-39 to 2-41.

18. U.C.C. § 1-201(37) (1997).

19. *See* NELSON & WHITMAN, *supra* note 2, § 5.31 n.13 and accompanying text. Minnesota is the lone holdout. *See* Lundberg v. Northwestern Nat'l Bank, 216 N.W.2d 121 (Minn. 1974); Johnson v. Howe, 223 N.W. 148 (Minn. 1929). In a few states in which courts adhered to the minority position, the state legislature acted to adopt the majority rule. *See, e.g.*, LA. CIV. CODE ANN. art. 3296 (West 1994) (Revision Comments-1991); OHIO REV. CODE ANN. § 1309.17 (West 1998) (Legislative Service Comm'n).

20. *See, e.g.*, Carpenter v. Longan, 83 U.S. 271, 275 (1872); Anchor Loan Co. v. Willett, 137 N.E.2d 532, 535 (Ohio 1956); First Nat'l Bank v. Brotherton, 84 N.E. 794, 797 (Ohio 1908); Ashland Bldg. & Loan Co. v. Kerman, 155 N.E. 245, 246 (Ohio Ct.

is subject only to those defenses available against the note. If the note is held by an HDC, the mortgage—like the note—is insulated from personal defenses. Some of the courts protecting mortgages in this way express an intent to facilitate the secondary mortgage market by protecting its purchasers from defenses to the mortgages.[21]

Extending the note's protections to the mortgage is analytically and practically sound when dealing with a person who is liable on the note. If the mortgagee could sue on the note free of a personal defense but was barred from enforcing the mortgage because of it, the mortgagee usually could circumvent this rule by getting a judgment on the note and then executing the judgment against the mortgaged land.[22] Therefore, to avoid creating both a multiplicity of actions and an unseemly method for accomplishing indirectly that which cannot be accomplished directly, it is best to allow the mortgagee to enforce the mortgage free of defenses whenever it can enforce the note.

However, the same considerations do not apply with respect to a third party's defenses. First, Article 3 does not expressly cut off a third party's defenses; it expressly addresses only the obligor's defenses. Section 3-305(b) provides that an HDC's right to enforce an instrument "is subject to [real] defenses of the obligor . . . but is not subject to [personal] defenses of the obligor."[23] An argument that this language subjects an HDC only to the obligor's real defenses but, by negative implication, not to a third party's defenses is exceedingly weak. The absence of any reference to third-party defenses in Article 3 or in its legislative history strongly supports the conclusion that Article 3's drafters simply did not consider the situation in which a third party has a claim to the mortgaged land or to the mortgage. This omission

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App. 1926); Van Burkleo v. Southwestern Mfg. Co., 39 S.W. 1085, 1088 (Tex. App. 1896).

21. *See, e.g.*, Carnegie Bank v. Shalleck, 606 A.2d 389, 400 (N.J. Super. Ct. App. Div. 1992).

22. *See Carpenter*, 83 U.S. at 274. In some situations, however, the mortgagee would be unable to execute a judgment against the land even if it could have foreclosed its mortgage but for the personal defense. For example, in some states, homestead legislation permits the foreclosure of certain mortgages against a homestead but will not permit a judgment creditor to execute its lien against the land. *See* 2 RICHARD R. POWELL, POWELL ON REAL PROPERTY § 18.03(5) (1997).

23. U.C.C. § 3-305(b) (1997).

is unsurprising because Article 3 is concerned with actions on the note and not with actions on the mortgage.

Second, the types of defenses that the Code classifies as real or personal reflect a failure to consider claims to mortgages or to mortgaged land. The real and personal defenses deal with situations such as the obligor's lack of capacity and fraud that was exercised upon the obligor. These types of defenses are qualitatively different than the defenses that arise concerning title to the mortgage and to the mortgaged land, such as resulting trusts and merger.

However, the most important reason that Article 3 should not be interpreted to cut off third-party defenses is the fundamental unfairness of eliminating an owner's title to a mortgage or to mortgaged land based on a loan transaction to which it was not a party. Absent a clear expression of legislative intent, this outcome should not be considered a possibility. However, courts have stated in a variety of cases that a mortgage is subject only to real defenses and not to personal defenses when held by an HDC.[24]

An examination of these cases reveals, however, that although courts frame the issue as involving a real or personal defense, the case actually is decided on a different ground–the presence or absence of notice of a conflicting interest.

A. *Notice as the Key Element*

By focusing on notice, the results in the Article 3 cases mirror the common law cases in which courts apply the patent and latent equity distinction. In both the Article 3 cases and the common law cases, notice or the absence of notice dictates the result of the case even when a court states the issue as involving a real or personal defense, or a patent or latent equity. Notice preserves the defense; absence of notice destroys it.

The following discussion of the six categories of third-party defense cases demonstrates that notice is the key factor. The

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24. *See, e.g.*, Milligan v. Gilmore Meyer Inc., 775 F. Supp. 400 (S.D. Ga. 1991); Gribble v. Mauerhan, 10 Cal. Rptr. 296 (Ct. App. 1961); City Lumber Co. v. Park, 58 P.2d 403 (Cal. Ct. App. 1936); Hayward Lumber & Inv. Co. v. Naslund, 13 P.2d 775 (Cal. Ct. App. 1932); Resolution Trust Corp. v. Berman Indus., 637 A.2d 1297, 1299 (N.J. Super. Ct. App. Div. 1993); Carnegie Bank v. Shalleck, 606 A.2d 389 (N.J. Super. Ct. App. Div. 1992); *Willett*, 137 N.E.2d at 535; North W. Mortgage Inv. Corp. v. Slumkoski, 478 P.2d 748 (Wash. Ct. App. 1970).

necessary notice can be actual or constructive, such as that provided by the public land records. In fact, courts often cite their concern for the integrity of the land records as a reason for protecting both the person who examined the records and found no conflicting claim and the person who recorded evidence of its claim.[25] By protecting those who rely on the records and by rewarding those who record evidence of their interests, the courts are pursuing a policy of making the land records as complete and reliable as possible. In some cases, the pursuit of this policy injures an otherwise blameless person, but that outcome is not uncommon when a particular community good is viewed as being more important than protecting any given individual.

1. *Fraud*

In virtually every case involving a deed, mortgage, or mortgage assignment obtained by fraud, courts have held that the fraud could not be asserted against a mortgage assignee that did not have notice of it.[26] The result is the same whether the secured note is negotiable or nonnegotiable and whether the holder is an HDC or non-HDC. Courts routinely give two reasons for this result. First, as between the person who was defrauded and the innocent assignee, the former is more culpable because it was a participant, albeit unwittingly, in the fraud. As the less culpable party, the assignee is protected. Second, courts stress their concern for the reliability of the recording system. Because the fraud could not be discovered from an examination of the property records, an innocent assignee takes title to the mortgage free of the defense.

Courts adhere to this rule even when facing very hard facts, as vividly illustrated by *Bell v. Canal Bank & Trust Co.*[27] In *Bell*, Manuel Bell and his brother, Pleasant, owned forty arpents of

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25. *See, e.g.*, Carpenter v. Longan, 83 U.S. 271 (1872); Gregory v. Savage, 32 Conn. 250, 261 (1864); Jenks v. Shaw, 68 N.W. 900, 904 (Iowa 1896); Bell v. Canal Bank & Trust Co., 190 So. 359, 364 (La. 1939); Ames v. Miller, 91 N.W. 250 (Neb. 1902); Landis v. Robacker, 169 A. 891 (Pa. 1933).

26. *See, e.g.*, Humble v. Curtis, 43 N.E. 749 (Ill. 1895); Robertson v. United States Live Stock Co., 145 N.W. 535 (Iowa 1914); Bell v. Canal Bank & Trust Co., 190 So. 359 (La. 1939); Bloomer v. Henderson, 8 Mich. 395 (1860); Smith v. Holdoway Const. Co., 129 S.W.2d 894 (Mo. 1939); Knickmeier v. Fleer, 185 S.W.2d 57 (Mo. Ct. App. 1945); Simpson v. Del Hoyo, 94 N.Y. 189 (1883); North W. Mortgage Investors Corp. v. Slumkoski, 478 P.2d 748 (Wash. Ct. App. 1970).

27. 190 So. 359 (La. 1939).

land as tenants in common. Manuel Bell owned an undivided one-fourth interest, and Pleasant Bell owned the remaining three-fourths interest. When the property taxes were due each year, the Bells contributed their respective shares, and one of them would go to the sheriff's office to pay the taxes. When Pleasant Bell mortgaged his three-fourths interest to Joseph Staring, Staring took responsibility for paying Pleasant Bell's share of the taxes in order to protect the mortgage lien. The first year that Staring took over Pleasant Bell's tax payment, Manuel Bell went to the sheriff's office to pay his one-fourth share of the taxes. The sheriff refused to accept his partial payment. Therefore, Manuel Bell and Staring agreed that Bell would give Staring one-fourth of the taxes each year and that Staring would deliver the tax payment to the sheriff.

Two years after this agreement, Staring deliberately failed to pay the taxes, though he accepted Manuel Bell's payment, and bought the property at the resulting tax sale. Manuel Bell was given no direct notice of the sale and remained unaware of it. For the next fifteen years, he continued paying his share of the taxes to Staring and then, after Staring's death, to his son who inherited the property. Staring's son gave a mortgage on the property, which was assigned to Canal Bank. When the loan went into default, Canal Bank began a foreclosure action.

Manuel Bell defended against the action by arguing that the mortgage was fraudulently given with respect to his one-fourth interest because Staring's son knew that he owned only a three-fourths interest. Even though the Starings had committed a "terrible fraud and injustice"[28] upon "apparently uninformed people [who] trusted the Starings and placed implicit faith in their honesty and integrity,"[29] and even though the Bells had lived on the land for sixty-five years,[30] the court held that Canal Bank was not subject to the fraud defense. The court reasoned that the Bells could have protected themselves from the Starings' wrongdoing by checking the property records or by demanding to see the paid tax receipts. Because they failed to do

28. *Id.* at 364.

29. *Id.*

30. Pursuant to Louisiana's public records doctrine, possession does not provide constructive notice. *See* Manion v. Pollingue, 524 So. 2d 25, 34 (La. Ct. App. 1988); Max Nathan, Jr. & Anthony P. Dunbar, *The Collateral Mortgage: Logic and Experience*, 49 LA. L. REV. 39, 44 n.22 & 45 n.23 (1988).

so, they could not assert a defense against the innocent mortgage assignee that had relied on the public property records. "[I]t was due to [the Bells'] fault that this deplorable and unfortunate situation was made possible and as between these victims and the bona fide parties who dealt with the property on the faith of the public records, they must bear the loss."[31]

The court in *Bell* imposed a high standard of care on the property owner. Though the Bells were unaware of any change in the property title and were undisturbed in their possession, the court said that they were at fault for failing to either check the property records or demand production of the tax receipts. Not surprisingly, then, courts do not permit a fraud defense in the more usual case in which the defrauded owner knowingly executed and delivered a deed or mortgage. For example, in *Bloomer v. Henderson*,[32] a landowner was the subject of a "gross fraud"[33] that caused him to convey his property to a person who subsequently gave a mortgage. The mortgage was assigned to an innocent assignee. The court held that the mortgage could not be invalidated on the basis of fraud for the same two reasons given in *Bell*: (1) as between an innocent assignee and a landowner who acted carelessly, the assignee should be protected; and (2) a person who relies in good faith on the property records should be protected. This outcome is consistent with the decisions in every jurisdiction except New York.

2. *Resulting trust*

Courts have been as unyielding to claims by beneficiaries of resulting trusts as they have been to victims of fraud. As in the fraud cases, courts have protected a person who purchased land or a mortgage from a trustee when the purchaser did not have notice of the beneficiary's interest.[34] Also like the fraud cases,

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31. *Bell*, 190 So. at 364.
32. 8 Mich. 395 (1860).
33. *Id.* at 405.
34. *See, e.g.*, Gregory v. Savage, 32 Conn. 250, 262 (1864); American Metro. Mortgage, Inc. v. Maricone, 423 So.2d 396 (Fla. Dist. Ct. App. 1982); Woodbury v. Connecticut Mut. Life Ins. Co., 166 S.W.2d 552 (Mo. 1942); George F. Perry & Sons v. Mand, 158 A. 378 (N.J. 1932); International State Bank v. Bray, 533 P.2d 583 (N.M. 1975); Haynesworth v. Bischoff, 6 S.C. 159 (1874); Van Burkleo v. Southwestern Mfg. Co., 39 S.W. 1085 (Tex. App. 1896); North W. Mortgage Investors Corp. v. Slumkoski, 478 P.2d 748 (Wash. Ct. App. 1970).

courts often express an overriding concern with protecting the land recording system and those who rely on it.

Courts have been equally resistant to claims by very sympathetic beneficiaries as to claims by victims of fraud. *North Western Mortgage Investors v. Slumkoski*[35] presents facts as compelling as those in *Bell*, and, as in *Bell*, the court upheld the mortgage assignee's right to foreclose. In *Slumkoski*, Bessie Slumkoski held title to her parents' home in a resulting trust for them. Her parents were sixty-nine and sixty-seven years old, had fourth-grade educations, were unfamiliar with legal matters, and were in poor health. When they wanted to purchase the home, they did not have $500 for the down payment. Therefore, Slumkoski gave them $500 as a gift and took title in her name. Her parents paid the balance of the purchase price over time and lived continuously in the home. Slumkoski never lived there.

Slumkoski subsequently was induced to buy a laundromat by fraudulent representations and concealment. During the sale negotiations, the seller asked Slumkoski if she owned any property. When she replied that she did not, the seller asked if she had any property in her name. She told him about her parents' home. At the hearing, Slumkoski testified that at the closing, the seller had her sign several papers. When she asked him what the papers were, he said: "This is just a formality, just a business agreement."[36] One of the papers was a mortgage on her parents' home, which the seller sold to the foreclosing assignee. Slumkoski testified that she had known that she was signing a promissory note but that she had not known that she was signing a mortgage. Her mother testified that she had not authorized Slumkoski to mortgage the home and had been unaware of the transaction. She did not tell her husband about being served with a complaint in the foreclosure action "because he was suffering from heart disease."[37]

In deciding whether to prevent the foreclosure, the court assumed the strongest facts in favor of the property owners. It assumed that Slumkoski held title to the home as a resulting trustee, that her parents had not authorized her to use their

35. 478 P.2d 748 (Wash. Ct. App. 1970).
36. *Id.* at 750.
37. *Id.*

home as collateral for a loan, and that she had been fraudulently induced to purchase the laundromat. Despite these facts, the court held that the mortgage assignee could foreclose. Unlike *Bell*, however, the court's decision on these facts was incorrect. The court's opinion demonstrates the danger created by a court's application of the law governing negotiable instruments when dealing with mortgages and land titles.

Because the promissory note signed by Slumkoski was a negotiable instrument, the court stated that the mortgage should share the note's immunity to defenses. The court then quoted from the statutory definition of a "holder in due course"; to be an HDC, the mortgage assignee "must have taken the mortgage (armed with the immunities of negotiability) without notice of any 'defect in the title of the person negotiating it.'"[38] State law defined "notice" as actual notice and not mere constructive notice.

The court's reliance on this portion of the HDC definition was mistaken in two ways. First, the quoted language deals with title to the note, rather than with a defense to its enforcement. Entirely different provisions in the state's commercial law deal with the availability of defenses. The court seriously compounded this error by then applying the provision to determine title to the land. The court reasoned that even though state law treats possession of land as providing constructive notice to mortgagees, that law did not apply. Instead, the court held that the mortgage assignee was an HDC and could foreclose because it did not have actual notice of the parents' possession.

The court's reasoning is fundamentally flawed. The extension of the note's immunity from defenses to the mortgage only prevents a landowner from challenging a foreclosure action on the basis that the note is unenforceable because of failure of consideration or some other personal defense. The law concerning negotiable instruments does not apply when determining ownership of mortgaged land. Land titles are determined by the land laws. Unlike *Bell*, which arose in a state where possession does not provide constructive notice,[39] *Slumkoski* arose in a jurisdiction in which possession does provide notice, including to a

38. *Id.* at 751 (quoting WASH. REV. CODE § 62.01.052 (1970)).
39. *See* Bell v. Canal Bank & Trust Co., 190 So. 359, 364 (La. 1939).

mortgagee.[40] On that basis, the court should have prevented the foreclosure. Because the court instead focused on the negotiable instruments law, it reached an incorrect result with devastating consequences for the home owners.

Fortunately, other courts considering resulting trusts have reached the correct result by relying on the land laws. Courts routinely hold that a mortgage holder with actual or constructive notice of a resulting trust is bound by it. If the mortgage holder did not have notice of the resulting trust when it acquired the mortgage, it owns it free of the beneficiary's interest. The result is the same whether the trust property is a mortgage[41] or the mortgaged land.[42]

3. *Wrongful release by the original mortgagee*

When a mortgagee executes a release of a mortgage after having assigned it to someone else, courts normally hold that the release is effective when a purchaser of the land or a subsequent mortgagee did not have notice of the assignment.[43] In reaching this result, courts express an overriding concern for the recording system. For example, in *Jenks v. Shaw*,[44] the court held that a purchaser of land who relied on an apparently valid release from the original mortgagee acquired title free of the mortgage. The court firmly grounded its holding on the necessity for protecting the recording act's integrity.

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40. *See Slumkoski*, 478 P.2d at 751.

41. *See, e.g.*, Gregory v. Savage, 32 Conn. 250 (1864); George F. Perry & Sons v. Mand, 158 A. 378 (N.J. 1932).

42. *See, e.g.*, American Metro. Mortgage, Inc. v. Maricone, 423 So. 2d 396 (Fla. Dist. Ct. App. 1982); International State Bank v. Springer Prod. Credit Ass'n, 533 P.2d 583 (N.M. 1975); Haynesworth v. Bischoff, 6 S.C. 159 (1874); Van Burkleo v. Southwestern Mfg. Co., 39 S.W. 1085 (Tex. App. 1896); *Slumkoski*, 478 P.2d at 748.

43. *See, e.g.*, Ameribank Sav. Banks v. Resolution Trust Corp., 858 F. Supp. 576 (E.D. Va. 1994); Metropolitan Life Ins. Co. v. Guy, 135 So. 434 (Ala. 1931); Federal Land Bank v. Corinth Bank & Trust Co., 107 So. 88 (Ala. 1926); Kansas City Mortgage Co. v. Crowell, 239 So. 2d 130 (Fla. Dist. Ct. App. 1970); Brenner v. Neu, 170 N.E.2d 897 (Ill. App. Ct. 1960); Jenks v. Shaw, 68 N.W. 900 (Iowa 1896); Bacon v. Van Schoonhoven, 87 N.Y. 446 (1882); Trustees of Union College v. Wheeler, 16 Sickels 12 (N.Y. 1874); Henniges v. Johnson, 84 N.W. 350 (N.D. 1900); Kalen v. Gelderman, 278 N.W. 165 (S.D. 1938); Fannin Inv. & Dev. Co. v. Neuhaus, 427 S.W.2d 82 (Tex. App. 1968); Beckman v. Ward, 24 P.2d 1091 (Wash. 1933); Marling v. Milwaukee Realty Co., 106 N.W. 844 (Wis. 1906).

44. 68 N.W. 900 (Iowa 1896).

> The policy of our registry laws is that the records shall disclose the true condition of lands as to title and incumbrances. These laws are for the protection of all concerned in lands, and they should and do apply to transfers of mortgages as well as to the mortgages themselves. It is no greater hardship to require the assignee of a mortgage to record the assignment than to require the mortgagee to record his mortgage. The record in both cases is equally demanded for the protection of persons having dealings with the land.[45]

One court in particular has repudiated strongly the applicability of the UCC in cases involving land titles. In *Federal Land Bank v. Corinth Bank & Trust Co.*,[46] an owner of mortgaged land borrowed money to pay off an existing loan and gave a mortgage to secure the new loan. The owner and lender had no notice that the mortgage had been assigned because the assignment was unrecorded. The owner paid the original mortgagee, and the mortgagee executed a release. In a subsequent action to foreclose the mortgage, the assignee argued that because it was an HDC, it was not subject to the personal defense of payment. In holding that the mortgage release was effective, the court clearly and correctly rejected application of the law of negotiable instruments in determining title to land:

> [A]s a matter of notice to subsequent purchasers, it is immaterial whether the record shows that the note secured is negotiable or nonnegotiable. Very clearly, the question does not involve the rights of a holder in due course of negotiable paper . . . , but only the *effect* of the paper as visible notice to a subsequent purchaser that it may have been transferred.[47]

At least two jurisdictions have created an exception to the general rule that a release from the original mortgagee is effective if the mortgage assignment is unrecorded. In *Kalen v. Gelderman*,[48] the South Dakota Supreme Court held that a mortgagee that personally supervised the payoff of a senior mortgage was not protected from an unrecorded assignment of it. Similarly, in *Metropolitan Life Insurance Co. v. Guy*,[49] the

45. *Id.* at 904.
46. 107 So. 88 (Ala. 1926).
47. *Id.* at 91 (citation omitted).
48. 278 N.W. 165 (S.D. 1938).
49. 135 So. 434 (Ala. 1931).

Alabama Supreme Court held that a purchaser of encumbered land that required that the mortgage be discharged as a precondition to purchasing was not protected from an unrecorded assignment. In both cases, the court reasoned that a person responsible for a loan payoff has a duty to insist on production of the note and mortgage. By failing to do so, the balancing of the equities shifted in favor of the relatively less blameless assignee. In contrast, a subsequent purchaser of the land or mortgage would be protected by the wrongfully executed release. A person who was not a party to the loan payoff cannot be expected to demand to see notes secured by a mortgage that appears from the property records to have been released.

An alternative rationale for these cases that is more consistent with recording act reasoning is that a subsequent purchaser has constructive notice not only of recorded documents, but also of any matters that would be revealed by a reasonable inquiry. Demanding production of a note and mortgage as a condition of a loan payoff reasonably could be construed as being within the scope of inquiry notice. As with the balancing of equities approach employed by the courts in *Kalen* and in *Guy*, the duty of inquiry would not require a subsequent purchaser to demand to see a note and mortgage that previously had been discharged. The benefit of this recording act rationale over the balancing of equities approach is that it more directly addresses the notice aspect of third-party defense cases rather than creating a spurious exception.

Of course, neither the recording act rationale nor the balancing of the equities rationale applies if the state recording act does not include mortgage assignments. In those few states in which assignments are not included, the absence of an assignment from the public records does not protect a subsequent purchaser or mortgagee that relies on an apparently valid recorded release.[50] Instead, a recorded mortgage that has not previously been satisfied of record gives notice that the mortgage is an outstanding lien that can be released only by its actual owner and not by its record owner. Similarly, even in those states in which mortgage assignments are included in the recording act, a

50. *See, e.g.*, Borgess Inv. Co. v. Vette, 44 S.W. 754 (Mo. 1898). The *Borgess* decision does not state that the applicable recording act did not apply to mortgage assignments. However, the following cases establish that fact: Hellweg v. Bush, 74 S.W.2d 89, 93 (Mo. Ct. App. 1934); De Laureal v. Kemper, 9 Mo. App. 77 (1880).

wrongful release will be effective only if it complies with the statutory requirements for a release.[51]

4. *Wrongful release by a mortgagee that acquired fee title*

The cases in this category arise when a mortgagee acquires fee title to the mortgaged land after assigning the mortgage and then purports to convey the fee title free of the lien. Although this category is similar to the previous one, it differs in two significant respects. First, when an apparent mortgagee acquires fee title, the doctrine of merger becomes relevant. Pursuant to the doctrine of merger, when one person holds two interests in property in the same right and without an intervening interest, the two interests will coalesce into one unless the holder intends to keep them distinct. Thus, when a mortgagee acquires fee title to the mortgaged land, the mortgage can merge into the fee and be extinguished.[52] Second, the prior category of cases normally involves a written mortgage release. Because the cases in category four rely on merger, no written release is given and recorded. The following analysis of the cases in this category will demonstrate the importance of these two factors.

The cases demonstrating this fourth fact pattern have been described as "divided."[53] On their face, they do appear to be in conflict. The conflict stems in large part from a difference in the courts' analysis of the merger issue. In the majority of cases, the courts hold that when the property records indicate that the original mortgagee owns the fee title and the mortgage, merger "presumptively" applies, and the mortgage is extinguished. Many cases buttress this conclusion with the fact that, in response to an inquiry by the bona fide purchaser, the mortgagee/owner represented that the mortgage was no longer a lien.[54] Some courts also analogize this type of case to the previous category of cases.[55] They reason that because a mortgage

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51. *See, e.g.*, Merchants' Trust Co. v. Davis, 290 P. 383, 386 (Idaho 1930); Curtis v. Moore, 46 N.E. 168 (N.Y. 1897); Thauer v. Smith, 250 N.W. 842, 844 (Wis. 1933).

52. *See* Ann M. Burkhart, *Freeing Mortgages of Merger*, 40 VAND. L. REV. 283, 284-85 (1987).

53. *See* NELSON & WHITMAN, *supra* note 2, at 384 & n.17.

54. *See, e.g.*, Gregory v. Savage, 32 Conn. 250 (1864); Artz v. Yeager, 66 N.E. 917 (Ind. Ct. App. 1903); Ames v. Miller, 91 N.W. 250 (Neb. 1902); Landis v. Robacker, 169 A. 891 (Pa. 1933).

55. *See, e.g.*, *Ames*, 91 N.W. at 252.

release from a mortgagee that does not have fee title is effective, the result should not be different when the mortgagee owns the fee.

In contrast, courts holding that the mortgage is not extinguished take a contrary view of the issue of merger and of the land purchaser's duty of inquiry. These courts generally take a narrower approach to the issue of merger. They hold that because the original mortgagee did not in fact own the mortgage and the fee title at the same time, merger could not apply and, therefore, the mortgage was not extinguished.[56] Although their view of merger is crabbed, their conception of the buyer's duty of inquiry is quite expansive. These courts state that because the mortgage is uncancelled of record, the prospective land purchaser is on notice that the mortgage is a lien in the hands of anyone to whom it has been transferred and must make an appropriate inquiry concerning its ownership.[57]

The focus on merger and on the related issue of the duty of inquiry has led courts following both the majority and minority positions seriously astray. As stated in the Restatement of Mortgages, the doctrine of merger should not apply to mortgages.[58] This conclusion is supported by a wide variety of considerations.[59] Of perhaps most importance in the context of wrongful releases is that merger is inconsistent with a system of recorded documents, because merger is primarily a matter of intent. Generally, the interests will merge only if the owner so intends. As stated by the Wisconsin Supreme Court:

> The recording act was not passed for the purpose of enabling a prospective purchaser to judge for himself whether there has been a merger of two outstanding estates. . . . Whether there is a merger or not oftentimes depends upon considerations extraneous [to] the record. . . . To permit the prospective purchaser to conclusively decide for himself whether a merger of the two interests resulted from the execution and delivery of a deed from the original mortgagor to the apparent record holder of

56. *See, e.g.*, Curtis v. Moore, 46 N.E. 168, 170 (N.Y. 1897); Thauer v. Smith, 250 N.W. 842, 844 (Wis. 1933).

57. *See, e.g.*, *Curtis*, 46 N.E. at 168; Purdy v. Huntington, 42 N.Y. 334 (1870).

58. *See* RESTATEMENT (THIRD) OF PROPERTY MORTGAGES § 8.5 (1997).

59. *See* Burkhart, *supra* note 52, at 329-68.

the mortgage is going farther than was intended by the recording act.[60]

Rather than rely on a mortgage owner's off-record intent concerning the lien's continued vitality, recording acts provide on-record methods for releasing mortgages. Depending on the state statute, a mortgagee can release a mortgage by recording a release document or by making a notation on the recorded mortgage. In fact, a court normally will treat a property title as being unmarketable unless the mortgage release appears in the public property records.[61] Therefore, in the interests of protecting the reliability of the property records, merger should be irrelevant in determining whether the original mortgagee's wrongful release is effective to discharge the mortgage lien.

For the same reason, the land purchaser's inquiries or lack of inquiries concerning the status of the mortgage also should be irrelevant. First, whatever facts the buyer could discover by such an inquiry still will not appear on the property records. The controlling rule of law for these cases should promote a public record of the mortgage's status. Second, the recording act's basic operating principle is to subordinate actual ownership to the appearance of ownership on the records; this principle provides the carrot (or stick) for a person acquiring an interest in land to make it a matter of public record. Third, the duty of inquiry has never been extended to require a prospective purchaser to ask an apparent owner whether it *really* owns that interest; instead, the duty applies only to nonrecord matters, such as the rights of a person in possession whose interest does not appear on the public property records. Finally, if the original mortgagee is willing to give a deed that purports to convey fee title free of the mortgage, the mortgagee seems unlikely to admit the fraud in response to the buyer's inquiry. If the mortgagee asserts that it has destroyed the note and mortgage, the buyer would not know

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60. *Thauer*, 250 N.W. at 844 (citations omitted). In *Thauer*, a mortgagee assigned its mortgage to a third party and subsequently acquired fee title to the mortgaged land. Because the assignment was unrecorded, the original mortgagee appeared to own the fee title and the mortgage. A subsequent mortgagee argued that the prior mortgage merged into the fee and was extinguished.

61. Unless a purchase agreement for land expressly provides otherwise, a purchaser is entitled to receive marketable title, which is a title that is free of question. *See* 4 AMERICAN LAW OF PROPERTY, A TREATISE ON THE LAW OF PROPERTY IN THE UNITED STATES § 18.7, at 670 (A. Casner ed., 1952).

of whom to inquire further because the assignee's identity cannot be discovered from the property records. For these reasons, the buyer's inquiries or lack of inquiry should be irrelevant in determining whether the mortgage is extinguished.

The majority of courts' analogies to the cases in the third category also is misplaced. As stated above, some courts holding that the mortgage lien is extinguished reason that because a mortgage release from an apparent mortgagee that does not have fee title is valid, the mortgage also should be released when the apparent mortgagee does own fee title. However, a crucial distinction exists between these two cases. In the former, the apparent mortgagee has given a written release or otherwise released the mortgage of record; in the latter, it has not. With the completeness of the public property records being of primary concern, the existence of a record release is a critical consideration.

This consideration apparently was determinative in many of the cases adopting the minority position that the apparent mortgagee's deed did not extinguish the mortgage. For example, in *Purdy v. Huntington*,[62] the court held that a buyer acquired fee title subject to a mortgage that appeared from the property records to be owned by the seller of the fee title because:

> [The buyer] is to be charged with constructive notice of the existence of the mortgage, and of the continuance of its lien, by its record in the proper office. By that he was informed not only of the date of the mortgage, the amount secured thereby, and of all its particulars, but that it was open and uncanceled of record, and therefore apparently an outstanding lien and incumbrance on the premises of which he was taking title.[63]

However, this type of statement is deceptive. An examination of the recording statute in effect at the time of this case reveals that the court was not basing its holding on a general concern for the accuracy of the property records. Its holding instead reflects the limited scope of the recording statute with respect to mortgage assignments. Recording was necessary to protect a mortgage assignee only from subsequent assignees and not from purchasers of the fee title.[64] This difference in statutory

62. 42 N.Y. 334 (1870).
63. *Id.* at 338.
64. See *id.* at 338-39.

coverage from the recording acts in the majority states, which cover purchases of both the fee title and the mortgage, explains the apparent division between the courts adopting the majority position and those adopting the minority position. The division is caused by a difference in the scope of the respective state recording statutes, rather than by a theoretical or philosophical difference in the application of similar laws.

But if the doctrine of merger, the purchaser's inquiries concerning the status of the mortgage, and analogies to the third category of cases are irrelevant in deciding these cases, how should they be decided? As is true for the other categories of cases, notice is the determinative factor. If the property purchaser does not have actual or constructive notice of the assignment, the recording act will treat the mortgagee, rather than the assignee, as the owner of the mortgage. As the owner of the mortgage and of the fee title, the mortgagee's deed, whether a warranty deed or a quitclaim deed, will convey both interests to the purchaser. In this way, the purchaser is protected from a foreclosure. Although a future purchaser of the land might demand that a mortgage release be recorded to ensure marketable title, the deed is as effective as a mortgage release to protect the innocent purchaser's title from the mortgage.

Of course, the purchaser will not be protected if the relevant recording act does not apply to mortgage assignments. However, this lack of protection is not unique to the case of a wrongful release and is not attributable to a flaw in the theory that notice is the key to deciding these cases. Instead, the absence of protection stems from a legislative determination that mortgage assignees need not record their assignment to be protected from future purchasers of the fee title.

5. *Mortgage as a fraud on creditors*

These cases are the mirror image of the fraud cases in the first category. While the first category involved situations in which a landowner or mortgagee was fraudulently induced to convey the land or mortgage, respectively, the cases in this category involve a landowner and mortgagee defrauding the owner's creditors by creating a mortgage for inadequate or no consideration. A typical case involves an owner attempting to protect its property from execution by creditors by granting a large mortgage to the confederate mortgagee. In this way, the owner appears to have little remaining equity in the property.

When the mortgage is assigned to an assignee that is unaware of the fraud on creditors, courts uniformly hold that the assignee takes free of the defense.[65] For example, in *McMurtry v. Bowers*,[66] Annie Bowers owed money to a variety of creditors, one of whom obtained a judgment lien against her. A few months before the judgment creditor obtained the lien, Bowers gave a mortgage on land she owned to satisfy a debt for which she was not personally liable. The court held that the mortgage constituted a fraud on her creditors because she had no legal obligation to give it and because she received no consideration for the transfer. Because the mortgage was assigned to a bona fide purchaser without notice of the fraud, however, the junior judgment lienor could not prevent it from being foreclosed on the basis of fraud. The same result has been reached when a mortgage was challenged by a bankruptcy trustee.[67]

The rationale for protecting the innocent mortgage holder is the same as in the first category of fraud cases. To preserve the reliability of the property records, a mortgage assignee must be protected from claims about which it did not have actual or constructive notice. Although, by voluntarily executing a deed, the defrauded owner in the first category of cases is somewhat more culpable than the creditors alleging a fraudulent mortgage in this sixth category, the courts have reached the correct result in these cases as well. The greater good is served by protecting those who rely on the property records and do not have any other notice of conflicting claims.

6. Mortgage assigned twice

This category of cases differs from the others in a crucial respect. In the other categories of cases, a third party to the loan transaction was defending the mortgaged land from a foreclo-

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65. *See, e.g.*, McMurtry v. Bowers, 109 A. 361 (N.J. 1920); Danbury v. Robinson, 14 N.J. Eq. 213 (1862); First Nat'l Bank v. Brotherton, 84 N.E. 794 (Ohio 1908).

66. 109 A. 361 (N.J. 1920).

67. *See* First Nat'l Bank v. Brotherton, 84 N.E. 794 (Ohio 1908). The Bankruptcy Code has codified this result. Section 550(b)(1) of the Code provides that the bankruptcy trustee may not recover a mortgage that constitutes a fraudulent transfer if it has been conveyed to "a transferee that takes for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided." 11 U.S.C. § 550(b)(1) (1994).

sure. Even when the court held that the mortgage holder could not enforce the mortgage, the holder still could enforce the note.[68] In contrast, this category of cases involves the right to enforce the note, as well as the mortgage. Both assignees are claiming title to the note and to the mortgage and the right to enforce them.

Despite this factual difference, if the note is nonnegotiable or if it is held by a non-HDC, the analysis is the same as for the other categories. As in the other categories, if the relevant recording act does not include mortgage assignments, the first assignee owns the note and mortgage.[69] On the other hand, if the recording act does include mortgage assignments, an assignee without actual or constructive notice of a prior assignment will be protected from it.[70] The decision in the latter type of case rests on the terms of the recording act alone. However, some courts state as an additional reason for the holding that, as between two innocent assignees, the prior assignee is more culpable because its failure to record the assignment enabled the assignor's wrongful re-assignment of the note and mortgage.[71]

The court's reliance on the recording act to decide these cases is a straightforward application of the usual rule that a person acquiring an interest in land takes subject to all matters appearing in the public records. The duty to check the records is not excused because the assignee also is acquiring a note. However, this duty, which is so central in land conveyancing, is abrogated when the note is a negotiable instrument. Because title to a negotiable instrument is at issue, Article 3 of the UCC applies. Article 3 expressly rejects the notice provided by the public records: "Public filing or recording of a document does not of itself

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68. *But see* NELSON & WHITMAN, *supra* note 2, at 385.

69. *See, e.g.*, Neal v. Bradley, 384 S.W.2d 238 (Ark. 1964).

70. *See, e.g.*, Guaranty Mortgage & Ins. Co. v. Harris, 193 So. 2d 1 (Fla. 1966); Blunt v. Norris, 123 Mass. 55 (1877); Brooke v. Struthers, 68 N.W. 272 (Mich. 1896) (dictum); Owen v. Evans, 31 N.E. 999 (N.Y. 1892); Fannin Inv. and Dev. Co. v. Neuhaus, 427 S.W.2d 82 (Tex. App. 1968); *In re* Vermont Fiberglass, Inc., 44 B.R. 505 (Bankr. Vt. 1984); *cf.* Syracuse Sav. Bank v. Merrick, 75 N.E. 232 (N.Y. 1905) (holding that assignor's failure to deliver bond to second assignee constituted constructive notice of a prior unrecorded assignment).

Under some state recording acts, the subsequent assignee must record its assignment before the prior assignee records to be protected from the prior assignment.

71. *See, e.g.*, *Harris*, 193 So. 2d at 3 (The prior assignee's failure to record "made the subsequent machinations of the assignor possible.").

constitute notice of a defense, claim in recoupment, or claim to the instrument."[72]

This statute could be interpreted to preserve the relevance of the land records, rather than to reject them. It could be interpreted to mean that, if a prospective assignee is unaware that the note is secured by a mortgage, a recorded mortgage "does not of itself" provide constructive notice of its existence. Similarly, if the assignor previously had assigned the same note and mortgage, a recorded mortgage assignment would not constitute notice of the prior assignment if the subsequent assignee is unaware of the mortgage's existence. Conversely, if a prospective assignee knows about the mortgage, the assignee must conduct a reasonable investigation of title to the mortgage by checking the property records.[73] If the assignee fails to do so, it will be deemed to have constructive notice of a previously recorded assignment.

Despite the availability of an interpretation that would at least partially harmonize the Article 3 provision with the recording acts, at least one court has rejected any role for the land records in resolving conflicting claims to a mortgage. In *Foster v. Augustanna College & Theological Seminary*,[74] a mortgagee assigned the same note and mortgage twice. Even though the first assignee recorded its assignment before the assignor gave the second assignment, the court held in favor of the second assignee. The court held that, because the second assignee had not examined the property records and did not have any other actual notice of the assignment, it was not subject to the first assignee's claim. The court reasoned that, because the note imparts its negotiable character to the mortgage, the purchaser of the mortgage was not subject to the recording act:

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72. U.C.C. § 3-302(b) (1990).

73. A similar interpretation of the statute has been adopted when determining ownership of a note that was purchased after its maturity:

> [T]he mere fact of maturity is sufficient to place the indorsee [sic] after maturity on notice that the instrument may be subject to some defences [sic] or defects, and it is incumbent upon him, in exercising good faith, to make sure that the instrument in the hands of the person from whom he takes it is not subject to claims of ownership. Thus, the purchaser after maturity is forced to trace his title to the instrument.

Morrison, *supra* note 13, at 297-98.

74. 218 P. 335 (Okla. 1923).

> It may be observed that the doctrine of constructive notice is applicable only to a person who is dealing with the land itself, and since the purchaser of a negotiable promissory note, secured by a mortgage, is not dealing in land, there is no field for the operation of the registry laws in cases of this kind. An examination of the authorities discloses to our satisfaction that the doctrine of constructive notice has never been applied to commercial paper; the true test as to negotiable paper being that of good or bad faith.[75]

The *Foster* case was governed by the Negotiable Instruments Law, which was Article 3's predecessor. However, courts have interpreted Article 3's provision concerning the public records in the same way. Courts applying Article 3 routinely hold that the HDC of a negotiable instrument cuts off conflicting recorded interests. Although no reported case involves conflicting claims to a mortgage, courts have applied Article 3 to cut off perfected security interests in personal property[76] and a recorded state tax lien.[77] Moreover, courts regularly hold that an assignee can attain HDC status even if it fails to conduct a reasonably prudent inquiry concerning title to the note and its security.[78]

On its face, this result is completely contrary to the fundamental principle that a purchaser acquires title to a property interest subject to all matters of which it has actual or constructive notice. But Article 3 has not rejected the controlling importance of notice. Rather, it has chosen an alternative source of notice that is more efficient for the negotiable instruments market—possession of the note. The purchaser of a note qualifies as an HDC only by taking possession of the note.[79] If the assignor cannot deliver the note, the prospective assignee can-

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75. *Id.* at 338.

76. *See, e.g.*, Benedictine College, Inc. v. Century Office Prods., Inc., 853 F. Supp. 1315 (D. Kan. 1994); Dallas Bank & Trust Co. v. Frigiking, Inc., 692 S.W.2d 163 (Tex. App. 1985).

77. *See* Soloff v. Dollahite, 779 S.W.2d 57 (Tenn. App. 1989).

78. *See* New Jersey Mortgage and Inv. Corp. v. Calvetti, 171 A.2d 321, 325 (N.J. Sup. 1961) ("As the rule is generally stated, evidence of bad faith on the part of the holder, and not merely proof of circumstances calculated to arouse suspicion, must be shown in order to defeat his recovery on the instrument."); *Frigiking, Inc.*, 692 S.W.2d at 166 ("It is not sufficient that Dallas Bank had knowledge that would put a reasonable person on inquiry which would lead to discovery. There must be actual knowledge of facts and circumstances which amounted to bad faith."); *cf.* NELSON & WHITMAN, *supra* note 2, at 389.

79. *See* U.C.C. § 3-201 (1990). *See* CRANDALL ET AL., *supra* note 10, § 16.2.

not be an HDC because it has notice that the assignor may not own the note. Conversely, if the assignor delivers possession, the assignee is an HDC and is protected from third-party claims of ownership. By protecting possession, Article 3 frees note purchasers from the burden of checking the public records and making other inquiries concerning title, which clearly facilitates the market for negotiable instruments.

Because Article 3 affords this protection to the purchaser of a negotiable instrument, title to the mortgage securing the instrument must be protected as well. Otherwise, Article 3 could vest title to the negotiable instrument in one person, and the recording act would vest title to the mortgage in a different person. This result is unacceptable because a mortgage cannot exist or be enforced independent of the debt. Therefore, unlike the other cases discussed in this Article, this one type of case is governed by the UCC, rather than by the land laws. In this one case, the mortgage's identity is completely subsumed by the note's.

B. Exceptions and Apparent Exceptions

Despite their usual concern for the recording acts, courts sometimes use language that indicates that a mortgage assignee takes free of all third-party defenses, even if it had notice of the defense from the property records. For example, in *Bloomer v. Henderson*,[80] the Michigan Supreme Court had to determine whether a mortgage assignee took the mortgage subject to a third party's defense of fraud. The court rejected the defense, relying on the common law of contracts: "[T]he assignee of a chose in action takes it subject to all equities existing between the parties to the instrument, but not to any latent equities which some third person may have against the debtor, or party bound by the instrument."[81] Similarly, in *Anchor Loan Co. v. Willett*,[82] which involved an HDC of a negotiable instrument, the court stated:

> This Court reaches the conclusion that Anchor Loan was a holder in due course of the negotiable promissory note and as such is entitled to all the rights of a holder in due course and that said chattel mortgage was incident to the promissory note

80. 8 Mich. 395 (1860).
81. *Id.* at 402.
82. 137 N.E.2d 532 (Ohio 1956).

> and would be subject to no equities that the original note was not subject to. In this instant case the Court finds no fact which would have been a defense in a suit upon the promissory note.[83]

In each of these cases, the court based its holding on the difficulty of discovering third-party defenses. However, the quoted language goes beyond this expressed concern by stating that the assignee takes free of all third-party defenses and not just those of which it had no notice. Moreover, the quoted language states a broader rule than was necessary to decide the case before the court. In each case, the assignee did not have actual or constructive notice of the defense. Therefore, to the extent that the courts' statements indicate that all third-party defenses are barred even if the assignee had notice, they should be treated as thoughtlessly created dictum.

Because land law is left to the almost exclusive province of the states, at least one state usually marches to a different drummer. With respect to third-party defenses, New York's law is the exception to the otherwise virtually universal rule. New York's law is the complete opposite of the statements of law in the two prior cases, and it is equally erroneous. Rather than holding that mortgage assignees take free of all third-party defenses, New York courts hold that assignees take subject to all such defenses, even in the absence of notice. For example, in *In re Levine*,[84] the court held that a mortgage assignee was subject to a third party's defense even though the assignee had no actual or constructive notice of it: "[N]ot only is an assignee subject to the equities or defenses in favor of the mortgagor, he is also subject to any latent equities that may exist in favor of unknown third parties."[85] This legal conclusion is based on the determination that a mortgage assignee can acquire no greater rights than the original mortgagee; because the mortgagee was subject to the defense in that case, so is the assignee. The New York rule is well-entrenched, but perhaps the courts eventually will yield to the realities of the modern secondary mortgage market and

83. *Id.* at 535.
84. 23 B.R. 410 (Bankr. S.D.N.Y. 1982).
85. *Id.* at 413.

protect mortgage assignees from defenses of which they had no notice and no reasonable means of discovery.[86]

V. CONCLUSION

In cases involving a third party's defense to a mortgage, notice is the key criterion. If the mortgage holder had actual or constructive notice of the defense when it acquired the mortgage, it took subject to the defense. Conversely, if the holder did not have notice, it took the mortgage free of the defense. When title to a secured negotiable instrument is at issue, notice is defined by Article 3 of the UCC In every other case, notice is defined by the land laws and, in particular, by the jurisdiction's recording act. In those cases, distinctions between negotiable and nonnegotiable instruments, HDCs and non-HDCs, real and personal defenses, and patent and latent equities are irrelevant. These commercial law distinctions are relevant only when determining defenses to enforcement of the secured debt. When a court enters this commercial law labyrinth to decide issues concerning title to land or to a mortgage, the court—and land titles—are lost.

86. A handful of cases in other jurisdictions have followed the New York approach, but all have been repudiated or distinguished to virtual extinction.