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Summit Financial Holdings Redux

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▶***NOTE:*** *When the court of appeal decision in* Summit Fin. Holdings, Ltd. v Continental Lawyers Title Co. (2001) 87 CA4th 1379, 105 CR2d 352, *came down, Dale Whitman and I wrote a joint analysis of it in 24 CEB RPLR 161 (May 2001). Consequently, we felt beholden to do the same for the supreme court opinion* (Summit Fin. Holdings, Ltd. v Continental Lawyers Title Co. (2001) 27 C4th 705, 117 CR2d 541, *reported in the last issue at 25 CEB RPLR 103 (Apr. 2002)). We include our own brief summary to make everything more coherent. —Roger Bernhardt*

Summary

In 1994, Furnish borrowed $425,000 from Talbert, giving Talbert a note and deed of trust on Furnish's real estate. Talbert immediately assigned the note and deed of trust to Summit. The assignment was recorded, but neither Talbert nor Summit informed Furnish of it. The note called for monthly payments, which Furnish presumably paid to Talbert despite the assignment. In 1995, Furnish decided to refinance the loan with a different lender, and instructed Beverly Hills Escrow (BHE) and Continental Lawyers Title Co. (CLTC) to handle the payoff. CLTC issued a title report showing the assignment, but nevertheless BHE asked Talbert for a payoff statement and instructed CLTC to pay off Talbert. At closing, that's just what CLTC did. Talbert never sent the payoff amount to Summit.

Furnish, now in bankruptcy, found himself with a claim by Summit for its money. The bankruptcy court denied the claim on the ground that the mortgage assignment was a "transfer of servicing," as the term is used in CC §2935, and that Summit had never given notice of the transfer to Furnish as that section requires. Hence, the assignment was not binding on Furnish, and Furnish's payment to Talbert fully satisfied the debt. Summit then brought this proceeding in state court against CLTC for the money, arguing that CLTC had breached a duty to Summit by sending the payoff to Talbert.

The California Supreme Court declined to decide whether the assignment of the note and deed of trust was a "transfer of servicing." Instead, it held that an escrow company generally has no duties to third parties, *i.e.*, persons who are not parties to the escrow. Absent clear evidence of fraud, an escrow holder's obligations are limited to compliance with the parties' instructions. Although CLTC had knowledge of the assignment, the court saw no evidence that CLTC was aware of any fraud. Since CLTC followed the instructions of the parties, it had no liability to Summit.

Analysis

As a question of pure escrow practice and liability, this decision is unremarkable, and was probably worth the supreme court's time only to get rid of an older, inconsistent court of appeal decision. If *A* and *B* instruct their escrow agent to pay money to *C* and the agent does

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exactly that, then the fact that *C* had previously transferred his right to those funds to *D* without telling anybody means that *D* has no basis for recovery against the escrow agent because *C* got the money instead of him. As a matter of general tort law, there is no reason to require escrow agents to discover and pay nonparties, and—since *D* was not a party to the escrow—there was no fiduciary reason to do so either. So, as far as escrow law is concerned, escrow agents aren't liable to outsiders for following the instructions given to them by insiders.

But that ruling doesn't make the harm to *D* disappear, and nothing in the court's ruling does very much about that problem. In *Summit*, a mortgage, *i.e.*, a secured right to funds, had been properly created and later properly assigned to *D*, but *D* never received payment. *D* should either have his security or else have his payment. But fairness to *D* may come at the expense of *B*, whose debt was originally owed to *C*. If *B* has already paid *C*, then it seems equally unfair to *B* for *D* to demand payment a second time or to foreclose the mortgage if the second payment isn't made. What's obviously needed here are some rules governing assignments of payment rights that treat both *B* and *D* fairly. Although California has several statutes dealing with this, none of them really solves the problem.

Civil Code §2935 provides that when a mortgage is assigned, recording the assignment is *not* notice to the debtor so as to invalidate any payment "made . . . to the person holding" the mortgage note. (Related CC §2934, which provides that the recorded assignment of a mortgage is constructive notice of the contents to "all" persons, is obviously qualified by the more limiting provisions of CC §2935.) That is supposed to be, we think, a debtor-protection statute: Mortgagors are not required to search the public records every time they make their monthly payments, in order to see whether their notes have been assigned. But the statute charges for that protection: The payment is good only when it is made to the holder of the note. Hence, mortgagors need not go to the recorder's office before paying, but should go to the creditor's office and say "show us the note" before tendering the payment check to the mortgagee.

That peculiar mechanism did not come out of the blue. It derives from the logic of the law of promissory notes, which states that only a person who holds a note (literally and physically) can enforce it. Commercial Code §3602 formalizes it with regard to negotiable notes by requiring that payment be made to the person entitled to enforce the note and defining that person generally (in Com C §3301) as the one in possession of it. Mortgage notes are not always negotiable, but there's a good deal of common law case authority applying the same rule to nonnegotiable notes.

Today, with global and electronic banking, this "payment" rule is sadly out of date. The old branch bank that originally made the loan has sent all of its loan documents down to central filing, where they were probably packaged into a large pool and shipped off to Fannie Mae to be sold into the secondary market as collateralized mortgage-backed securities, and the mortgagors were given a package of envelopes and payment book to use each month to mail their checks to a remote servicing agent (or else arranged to have the payments made automatically and electronically out of their bank accounts). See Whitman, *Reforming the Law: The Payment Rule as a Paradigm*, 1998 BYU L Rev 1169. If lenders really had to produce their notes for exhibit in order to get paid every time, the crash would be catastrophic.

A system that borrowers do not understand and that creditors won't honor is not one that seems worthy of preservation. In 1988, the legislature enacted CC §2937, providing that borrowers are not bound by transfers of loan servicing until they get written notice of the transfers. Unfortunately, the drafters did not consider the fact that two different types of transactions (transfers of servicing and outright assignments of secured notes) raise exactly the same problem—that the borrower is legally obligated to pay someone else now, but has no way of knowing it. The language of CC §2937, on its face, simply doesn't cover assignments of mortgages themselves, although the policy reasons stated in the preamble fit both situations equally well. Life would be easier for everybody if the legislature would consider applying the same principle to both kinds of transfers (of servicing, and mortgages themselves), both kinds of notes (negotiable and nonnegotiable), and both kinds of payments (regular installments and complete payoffs). This long-overdue revision should be made before anyone gets really hurt. A revision of UCC Art I, now in the drafting process, is expected to make the needed change with respect to negotiable notes, but a revision to CC §2937 could clean up the mess more comprehensively.