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Texas Bank of Beaumont v. Bozorg: The Supreme Court Addresses Collateral Mortgages

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TEXAS BANK OF BEAUMONT V. BOZORG: THE SUPREME COURT ADDRESSES COLLATERAL MORTGAGES

On August 12, 1975, Kazem Bozorg executed a collateral mortgage note and mortgage in the amount of $200,000. On the same day he pledged the collateral mortgage note to First Metropolitan Bank of Jefferson Parish to secure a loan of $200,000, represented by a hand note. This mortgage was subsequently recorded. Later, on September 11, 1978, Bozorg executed another collateral mortgage note and mortgage in the amount of $344,406.59. He pledged the collateral mortgage note to Massey-Ferguson, Inc., on that same day, to secure a loan of $344,406.59, also represented by a hand note. The mortgage was subsequently recorded. On January 4, 1980, by notarial act and for the stated consideration of $88,025.34, the balance then due on Bozorg's hand note, First Metropolitan transferred and assigned to Texas Bank of Beaumont "all its rights, title, interest, priority, and privilege in connection with a certain collateral mortgage note, dated August 12, 1975, in the principal sum of [two hundred thousand] dollars, . . . and a collateral mortgage . . . mortgaging in favor of any person, firm, or corporation the following described real estate. . . . " Mr. Bozorg executed a hand note for $200,000 on February 4, 1980 and repledged to Texas Bank the 1975 collateral mortgage note that it had had acquired from First Metropolitan. Texas Bank made an advance to Mr. Bozorg on this new hand note. When Bozorg later defaulted on the hand note, Texas Bank foreclosed and sought to enforce the 1975 mortgage. Massey-Ferguson intervened seeking recognition of its 1978 mortgage, claiming that this mortgage was superior in rank to Texas Bank's mortgage. The trial court found that Texas Bank had paid off and extinguished the original debt and therefore was not entitled to retroactive ranking. The court of appeal reversed, concluding that First Metropolitan had assigned the entire collateral mortgage package, including the hand note, and therefore Texas Bank was entitled to retroactive ranking. The Louisiana Supreme Court reversed in part, concluding that Texas Bank had established that the January 4, 1980 transaction was at least a payment with subrogation which preserved the 1975 collateral mortgage ranking as to Bozorg's then existing principal obligation, but had failed to establish that the parties agreed in the 1975 contract of pledge that the pledge

was intended to secure any future obligations of Bozorg; therefore, there could be no retroactive ranking for the amount in excess of $88,025.34. *Texas Bank of Beaumont v. Bozorg*, 457 So. 2d 667 (La. 1984).

The Collateral Mortgage in Louisiana

A mortgage is an accessory right which is granted to a creditor over the property of another as security for a debt.[1] There are three possible types of mortgages: conventional, legal, and judicial.[2] Within the area of conventional mortgages, Louisiana recognizes three different forms: an ordinary conventional mortgage,[3] a mortgage to secure future advances,[4] and a collateral mortgage.[5] A collateral mortgage, unlike the other forms of conventional mortgages, is not a "pure" mortgage; rather, it is the result of judicial recognition that one can pledge a note secured by yet another obligation.[6]

The collateral mortgage combines the concepts of both pledge and mortgage.[7] The mortgage indirectly secures an obligation via a pledge. A negotiable note, usually referred to as a collateral mortgage note or a *ne varietur* note, is made payable on demand[8] to bearer.[9] This note is paraphed for identification with an act of mortgage, known as the "collateral mortgage," which provides the creditor with security in the enforcement of the note.[10]

Up to this point, a collateral mortgage appears to be identical to the ordinary conventional mortgage and the mortgage to secure future advances. The difference, however, is that in the ordinary conventional mortgage and the mortgage to secure future advances, the money is

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1. La. Civ. Code arts. 3278 and 3284.

2. La. Civ. Code art. 3286.

3. This is also commonly referred to as a mortgage to secure a particular debt. La. Civ. Code art. 3292.

4. La. Civ. Code art. 3290.

5. Thrift Funds Canal, Inc. v. Foy, 261 La. 573, 260 So. 2d 628 (1972).

6. First Guaranty Bank v. Alford, 366 So. 2d 1299, 1302 (La. 1978) [hereinafter cited as *Alford*].

7. Nathan & Marshall, The Collateral Mortgage, 33 La. L. Rev. 497, 498 (1973).

8. The note is made payable on demand because of Louisiana Civil Code article 3170. This article provides that if a credit which has been given in pledge becomes due before it is redeemed by the pledgor, the creditor shall be justified in enforcing payment of the credit. By making the collateral mortgage note payable on demand, the collateral mortgagee is entitled to foreclose on the collateral mortgage note at any time.

9. The note is made out in bearer form so that it can be transferred by mere delivery. La. R.S. 10:3-202 (1983). If made payable to order, an indorsement would be required for a transfer. In order to use executory process, the indorsement would have to be in authentic form. See La. Code Civ. P. art. 2635, comment; Miller Lyon & Co. v. Cappel, 36 La. Ann. 264 (1884).

10. *Alford*, 366 So. 2d at 1302.

advanced directly on the note that is paraphed for identification with the act of mortgage. In the collateral mortgage situation, the money is not directly advanced on the collateral mortgage note; rather, the collateral mortgage note and the mortgage which secures it are *pledged* to secure another obligation.[11] This obligation is generally evidenced by another promissory note, which is referred to as a "hand note;" however, there is no requirement that such a hand note exist.[12]

Because the collateral mortgage is in essence, a pledge, it differs in another respect from the other forms of conventional mortgage. The Louisiana Civil Code provides that "it is essentially necessary to the existence of a mortgage, that there shall be a principal debt to serve as a foundation for it . . . in all cases where the principal debt is extinguished, the mortgage disappears with it."[13] When the promissory note which is paraphed with the ordinary conventional mortgage or future advance mortgage is paid off, the mortgage ceases to exist. The collateral mortgage, as do the other forms of conventional mortgage, requires the existence of a principal obligation; the principal obligation is the collateral mortgage note. The collateral mortgage note, secured by the collateral mortgage,[14] is pledged to secure another obligation.[15] According to the principles of pledge, when this latter obligation is extinguished, the pledged item is neither valueless nor extinguished—only the privilege which arises from the pledge is extinguished. For example, when one pledges $50,000 of General Motors stock to secure a specific $25,000 loan, the stock does not become valueless when the debt is paid. Only the pledgee's right to have his debt satisfied out of the proceeds of the stock is extinguished.[16] Upon payment of the $25,000 debt, the pledgor is entitled to possession of his General Motors stock. This stock can then be repledged to secure other obligations. Similarly, when the specific obligation which is secured by the pledge of the collateral mortgage package is extinguished, the privilege of the pledgee is extinguished, but the collateral mortgage package remains in existence and can be repledged to secure other obligations.

A collateral mortgage package may be pledged as security for either a pre-existing obligation, an obligation created simultaneously with the

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11. Id.

12. There is no requirement that a hand note exist because a pledge can secure an oral obligation. See La. civ. Code arts. 3136, 1756 and 1760.

13. La. Civ. Code art. 3285.

14. The collateral mortgage note and collateral mortgage which secures it are sometimes referred to collectively as a collateral mortgage package.

15. This obligation could be a specific debt, a specific series of debts, or all obligations that the pledgor owes to the creditor, whether these obligations exist now or may arise in the future. La. Civ. Code art. 3158; *Alford*, 366 So. 2d at 1299.

16. La. Civ. Code art. 3157.

mortgage, or for future obligations.[17] These future obligations may be binding or non-binding.[18] If the collateral mortgage is given to secure a particular obligation, either pre-existing or created simultaneously with the collateral mortgage, the mortgage is effective against third parties upon recordation of the mortgage and pledge of the collateral mortgage note.[19] If it is pledged to secure future obligations, the issue presented is when the collateral mortgage securing each of these will be effective against third parties. Louisiana Civil Code article 3158 provides that any pledge (which would include the pledge of a collateral mortgage package) to secure future obligations will rank from the date the item (including a collateral mortgage package) was originally pledged,[20] rather than from the date that the obligations are fulfilled, as long as the parties agree initially that the pledge will secure future obligations. In a collateral mortgage package there is no requirement that this pledge agreement be in writing;[21] however, for purposes of proving the parties' intent, the agreement should be reduced to writing.[22]

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17. Nathan, supra note 7, at 498.

18. Note, Security Devices—Ranking of Collateral Mortgage Security Reissued Mortgage Note, 25 La. L. Rev. 789, 792 (1965) [hereinafter cited as Note, Ranking of Collateral Mortgage]; the author's reference to non-binding future obligations refers to the situation in which the creditor is not obligated to make any advances to the debtor. Cf. Vetter, The Validity and Ranking of Future Advances Mortgages in Louisiana, 21 Loy. L. Rev. 141 (1975).

19. There is some troublesome language in the *Bozorg* opinion which could be construed to mean that the collateral mortgage is effective against third parties from the date of recordation. Within its discussion of the types of collateral mortgages, the court indicates when each mortgage would be effective against third parties, *Bozorg* 457 So. 2d at 671. The court states that a mortgage to secure a particular debt ranks from the date of recordation. A collateral mortgage never ranks from date of recordation alone. The jurisprudence is settled that the privilege resulting from a collateral mortgage, regardless of the type of debt secured, does not arise from the registry of the act of mortgage, but rather from the earliest concurrence of recordation plus the date the note is pledged. This statement in *Bozorg* would only be correct if it referred to an ordinary conventional mortgage to secure a particular debt and not a collateral mortgage to secure a particular debt. See e.g., Walmsley v. Resweber, 105 La. 522, 535, 30 So. 5, 11 (1901) (Provosty, J. concurring); New Orleans Silversmiths, Inc. v. Toups, 261 So. 2d 252, 254 (La. App. 4th Cir. 1972); Wallace v. Fidelity National Bank, 219 So. 2d 342, 344 (La. App. 1st Cir. 1969); Installment Plan, Inc. v. Justice, 209 So. 2d 68, 69 (La. App. 4th Cir. 1968); Odom v. Cherokee Homes, Inc. 165 So. 2d 855, 865 (La. App. 4th Cir. 1964); Rex Finance Co. v. Cary, 145 So. 2d 672 (La. App. 4th Cir. 1962), aff'd., 154 So. 2d 360 (La. 1960).

20. This statement assumes that the mortgage has already been recorded. Louisiana Civil Code article 3342 provides that a mortgage is effective against third persons only when it has been recorded. This requirement would apply to a collateral mortgage.

21. The reason is that Louisiana Civil Code article 3158 provides that a written act of pledge is not necessary for the pledge of a negotiable instrument.

22. In the past, some lower courts have found this intent solely from language found

The jurisprudence appears to be well-settled that a collateral mortgage given with the intent that it secure binding future obligations will rank from the date that both the mortgage is recorded and the collateral mortgage note is pledged.[23] Louisiana courts, however, have for years struggled to decide whether this same rule applies when a mortgage is pledged to secure optional future obligations, such as when the debtor pledges a collateral mortgage package to a creditor, and they agree that if the creditor lends money to the debtor, it will be secured by this package.

There are two lines of authority on this issue. The first takes the position that when a mortgage is given to secure optional future loans, recordation and pledge are not sufficient to make it effective against third parties. There must also be an actual advance of funds. *Bozorg* stated this rule in dicta relying on the 1847 case of *Meeker v. Clinton and P.H.H.R.*[24]

In *Meeker*, the debtor had given a mortgage to his creditor to secure payment for shares of stock and to secure any loan which the debtor borrowed from the creditor up to a stipulated amount. After the mortgage had been given but before a loan was made to the debtor, a third party acquired a security interest in the mortgaged property. A dispute then arose as to the rank of the mortgage securing the later loan to the debtor. The Court stated:

> The stipulation of a mortgage to secure a loan not made, is an obligation on a condition potestative on the part of the debtor. Conventional mortgages of that kind do not take rank from the date of the inscription. It is not the contract itself which forms the *viniculum juris*, but the accomplishment of the condition. The mortgage would have remained inoperative if the credit had not been used, and it can only have effect from the date and for the amount of the loan.[25]

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in the act of mortgage itself. However, it should be noted that the supreme court in *Bozorg* indicated that even if the act of mortgage stated that it was to secure future advances, it may not be sufficient to prove the parties intent to secure future advances because the pledgee is generally not a party to the collateral mortgage instrument and the instrument is frequently executed prior to a contract of pledge. 457 So. 2d at 667. This may cast doubt on language in Acadiana Bank v. Foreman, 352 So. 2d 674 (La. 1977) and People's Bank & Trust v. Campbell, 374 So. 2d 741 (La. App. 3d Cir. 1979), in which the courts appeared to find an intent on the part of the parties to secure future advances solely from the language found in the act of mortgage.

23. See cases cited supra at note 19.

24. 2 La. Ann. 971 (1847). This is only dicta in *Bozorg* because the court ultimately finds that in the pledge of the collateral mortgage package the original parties did not intend for it to secure future obligations. Therefore, there was no need to decide from what date any future advances would be effective against third parties.

25. Id. at 973-74; Langfitt v. Brown, 5 La. Ann. 231 (1850); New Orleans Silversmiths, Inc. v. Toups, 261 So. 2d 252 (La App. 4th Cir. 1972).

It should be noted that *Meeker* did not deal with a collateral mortgage. From the facts of the case, the security device which was utilized appears to be an ordinary conventional mortgage for future advances. The case is arguably wrong in light of Louisiana Civil Code articles 3292 and 3293. Article 3292 provides: "A mortgage may be given for an obligation which has not yet risen into existence." Article 3293 states that "the right of mortgage, in this case, shall only be realized in so far as the promise shall be carried into effect by the person making it. *The fulfillment of the promise, however, shall impart to the mortgage a retrospective effect to the time of the contract.*" (emphasis added). The *Meeker* court did not make reference to these two articles. Under article 3293, once the condition was fulfilled, i.e., the loan was made to the debtor, the mortgage should have been given retroactive ranking back to the date of the original contract.

The second line of authority takes the opposite position of *Meeker*. In 1852, the Louisiana Supreme Court spoke on the issue of ranking in *Pickersgill & Co. v. Brown*,[26] a decision which casts doubt on the viability of the *Meeker* rationale. In this case, a mortgage was given to secure future advances. An argument was made that the mortgage securing the future advances could not rank from the date of the original contract because the principal obligation did not exsist at the time of the contract. The court recognized the general rule that a principal obligation must exist since a mortgage is an accessory right, but noted that the legislature carved out an exception to the rule in Civil Code articles 3292 and 3293.[27] The legislature allowed a wider range for conventional mortgages by declaring that a conventional mortgage may be given for an obligation which has not yet risen into existence. The court noted that the reason for this exception was that a strict construction of the general rule would be inadequate for the practical purposes of business and the necessities of commerce.[28] Therefore, a mortgage can be given to secure a conditional obligation.[29]

Finally, the *Meeker* argument was made that the mortgage to secure future advances was one in which the lender was not entitled to retroactive ranking because it contained a potestative condition. The court disagreed: "This theory is not a new one, and involves difficulties, which the framers of the code, perhaps, intended to put at rest, when they introduced the Article 3259 (now article 3292) into the Amendments of

26. 7 La. Ann 297 (1852).

27. Id. at 307.

28. Id.

29. See also New Orleans Silversmiths, Inc. v. Toups, 261 So. 2d 252 (La. App. 4th Cir. 1972); Collins v. His Creditors, 18 La. Ann. 235 (1866).

the Code of 1808."[30] Arguably, the *Pickersgill* court recognized that articles 3292 and 3293 allow a creditor to accomplish what the *Meeker* court had held he could not do; the creditor can get retroactive ranking to the date of the pledge even though the creditor was not bound to make the advance.

Since the *Pickersgill* decision, there have been few cases on this issue. In one case, the court followed *Meeker*, while in another, the court followed *Pickersgill*.[31] Louisiana courts have not made an attempt to reconcile these decisions in light of *Meeker* and *Pickersgill*. The Louisiana Supreme Court has established two conflicting resolutions for the problem of rank when a mortgage is given to secure non-binding future advances. Perhaps the legislature intended to resolve this conflict, at least insofar as pledges (and therefore collateral mortgages) are concerned, when they amended Louisiana Civil Code article 3158 in 1952. The amended article provides, in part:

> Whenever a pledge of any instrument . . . is made to secure . . . advances to be made up to a certain amount, and, if so desired . . . to secure any other obligations of the pledgor to the pledgee, then existing or thereafter arising, up to the limits of the pledge, and the pledged instrument remains . . . in the hands of the pledgee, the instrument . . . may . . . be repledged to the pledgee to secure any new or additional loans, even though the original loan has been . . . paid, . . . and the pledge shall be valid as well against third persons as against the pledgor thereof, if made in good faith, and such . . . advances . . . shall be secured by the collateral to the same extent as if they came into existence when the instrument or item was originally pledged and the pledge was made to secure them.[32]

Future advances, therefore, rank from the date of the original pledge. The article does not draw any distinction between a binding obligation to make future advances and those which are optional. It merely states that if the intent was that it secure future obligations, these obligations should rank from the date of the initial pledge.[33]

Another method of resolving this conflict is to focus on the actual concern involved and how the courts are handling this concern. The

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30. See also 2 M. Planiol, Treatise on the Civil Law Pt. II, No. 2652, at 473 (11th ed. La. St. L. Inst. trans. 1959); Note, Ranking of Collateral Mortgage, supra note 18, at 791 n.12; Sachse, Report to the Louisiana Law Institute on Article Nine of the Uniform Commercial Code, 41 Tul. L. Rev. 785, 798 (1967); D'Menza v. Generes, 22 La. Ann. 285 (1870).

31. See, e.g., Langfitt and Perry v. Brown, 5 La. Ann. 231 (1850 (citing *Meeker*); In re York, 30 Fed. Cas. 811 (C.C.D. La. 1870) (No. 18, 138) (citing *Pickersgill*).

32. La. Civ. Code art. 3158.

33. See Sachse, supra note 30, at 798.

main concern in the *Meeker* line of cases appears to be that the promise to lend is optional on the part of the creditor; therefore, he can refuse to make the loans at his whim. One could hardly imagine a situation in which someone would prepare a collateral mortgage and collateral mortgage note, record the mortgage, and hand over the note to another party with the agreement that it would secure any advances made by that party, if there was reason to believe that the party would not make a good faith effort to make the future loans to him. Although the lender is not obligated to actually make a loan, he usually will not deny the request for a loan at his whim. There are other factors involved. One can expect that a lender will make a loan if he is holding a valuable security interest. In exchange for making the loan, the lender will make a profit through interest.

Even if the concern in *Meeker* that the creditor could refuse to make the loans at his whim is valid, the courts, by holding that collateral mortgages to secure optional future advances rank only from the date of the advance, are protecting the wrong party. In light of the above concern, one would think that the court's holding would inure to the benefit of the debtor. However, it actually works to the debtor's detriment. If a lender cannot receive retroactive ranking to the date of the actual pledge of the collateral mortgage note for optional future advances, lending institutions may be inclined to make fewer loans of this type, since it is possible that other creditors may acquire security interests between the date of the mortgage and the date of the advance which would outrank the lender's interest.

A close analysis of the *Meeker* rationale reveals that ranking actually inures to the benefit of creditors who acquire security interests between the time the note is pledged and the funds are advanced. These creditors benefit from the fact that the collateral mortgagee has the ability to turn down a request for a loan to the collateral mortgagor. There does not appear to be any justification for this result. These secured creditors are already provided adequate protection. When they acquire their security interests, they do so in reliance upon the public records. The public records reveal to these creditors the extent to which the property is encumbered by a collateral mortgage. As additional protection to these third party creditors, the Louisiana jurisprudence requires that there be actual delivery of the collateral mortgage note to the mortgagee before it is effective against third parties.[34]

The Louisiana Supreme Court has held on two occasions that a mortgage need not state on its face that it is to secure future advances.[35]

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34. See cases cited supra at note 19.

35. *Pickersgill*, 7 La. Ann. 297 (1852); Thrift Funds Canal, Inc. v. Troy, 260 So. 2d 628 (La. 1972).

These holdings imply that the court recognizes that as long as the third parties are aware of the potential total security interest held by the mortgagee (as shown by the amount stated in the act of mortgage) they are not prejudiced when the future advances are actually made. It follows that a third party creditor relies only on the fact that the mortgage is for the amount stated on its face as it appears in the public records. According to the Louisiana Supreme Court, the creditor is not entitled to notice that the mortgage may secure future advances; therefore, he does not know whether the mortgage secures future advances, regardless of whether the obligation to advance is binding. The *Meeker* holding as supported by the court in *Bozorg*, albeit dicta, allows the third party creditor to gamble for a benefit. If the result is that according to the pledge agreement the mortgage secures binding future advances, the creditor is in no better and no worse of a position than what the public records revealed to him. However, if the agreement was to secure optional future advances, the third party creditor receives a bonus; he will outrank the collateral mortgagee.

There is no reason to give this benefit to third party creditors. As stated above, the court's concern is that the mortgagee will have the unfair advantage of being able to reject a request for a loan from the mortgagor at his whim. From a practical standpoint, this concern is not valid, given the fact that it is to the mortgagee's advantage to make the loan. Even if it is valid, the holding that the collateral mortgage to secure future advances will rank only from the date that the actual advances are made does not solve the problem. This holding merely acts to confer a bonus on a third party who has acquired a security interest in property knowing that the property was potentially encumbered to the full extent of the recorded mortgage value and not expecting that his security interest would outrank the collateral mortgagee's.

The *Meeker* "holding," cryptic as it is, does not serve to minimize any valid concern. The better position is for the courts to hold that, once the collateral mortgage has been recorded and the collateral mortgage note has actually been delivered to the mortgagee, the future advances which the parties agreed would be secured by the the collateral mortgage will rank from the date of the original pledge whether the mortgagee was bound to advance or not. This position is supported by the concept of pledge which only requires an agreement to pledge[36] and delivery of the pledged item to the pledgee to affect third parties.[37] This position is also supported by Louisiana Civil Code articles 3292 and 3293 which state that a mortgage given to secure obligations not yet in

36. This agreement need not be in writing for a pledge of a collateral mortgage package. La. Civ. Code art. 3158.

37. La. Civ. Code art. 3152.

existence ranks from the date that the mortgage was originally contracted. Lastly, the language of article 3158 which states that future advances are secured as if they came into existence when the instrument was originally pledged, supports this position.

The Bozorg Decision

An issue which has perplexed the lower courts in Louisiana is whether a collateral mortgagee can transfer the collateral mortgage package to a third party in such a way as to allow the third party transferee to rank from the date that the collateral mortgage was initially pledged to the collateral mortgagee. These cases have focused on the concept expressed in Louisiana Civil Code article 2645 which provides: "The sale or transfer of a credit includes every thing which is an accessory to the same; as suretyship, privileges and mortgages."

In *Odom v. Cherokee Homes, Inc.*,[38] the plaintiff, Odom, paid $120,000.00 to the collateral mortgagee in exchange for four collateral mortgage notes held in pledge by the mortgagee. The evidence was unclear as to whether any hand notes were given to Odom.[39] This transaction was not evidenced by an act of assignment. The transfer of the collateral mortgage note took place by mere delivery. When Odom foreclosed on the collateral mortgage he claimed his mortgage ranked from the time it was first pledged to the original mortgagee. The Louisiana Fourth Circuit Court of Appeals found that there was no transfer to Odom of the debt secured by the collateral mortgage package and that the transaction between the parties operated as a full extinguishment of that debt. The mortgagee was no longer in possession of the pledged item. Once he surrendered possession, there could be no valid pledge.[40] The delivery of the collateral mortgage notes to Odom constituted a repledge of the notes, and therefore, the mortgage ranked from that date.[41]

Since the *Odom* case, there have been two reported Court of Appeal decisions which held, under similar facts, that the parties successfully transferred the original rank of the collateral mortgage package.[42] These cases relied on the suggestion in *Odom* that if the obligation which was

38. 165 So. 2d 855 (La. App. 4th Cir. 1964).

39. It should be noted that there is no requirement that this obligation be evidenced by hand notes, although it usually is so evidenced. The hand note merely represents an obligation, which need not be in writing.

40. La. Civ. Code art. 3158.

41. See Nathan, supra note 7, at 514.

42. Mardis v. Hollanger, 426 So. 2d 392 (La. App. 2d Cir. 1983); Richey v. Venture Oil & Gas Corp., 346 So. 2d 875 (La. App. 4th Cir. 1977). See also, Rubin, The Work of the Louisiana Appellate Courts for the 1977-1978 Term—Security Devices, 39 La. L. Rev. 719, 725 (1979).

secured by the collateral mortgage package had been assigned to the transferee, the mortgage would rank from its first issuance. In *Richey v. Venture Oil & Gas Corp.*,[43] the parties drafted an agreement transferring, selling, and assigning the hand note which was secured by the collateral mortgage note and collateral mortgage. Relying on *Odom* and a clause in the original pledge agreement which gave the mortgagee the right to transfer the collateral mortgage note in connection with a transfer of the hand note, the court held that there was a valid transfer entitling Richey to the initial ranking date.

In *Mardis v. Hollanger*,[44] the parties again sold the hand note, but took extra precaution in delivering the collateral mortgage note to the transferee by executing a trust agreement making the mortgagor's attorney an "escrow agent" for delivery of the hand note and collateral mortgage note to the transferee. The Louisiana Second Circuit Court of Appeal stated that by doing so the pledge was never returned to the pledgor and, therefore, retained its initial rank.[45] In both *Richey* and *Mardis*, the pledge was no longer in the possession of the original pledgee, but the court recognized that the collateral mortgage maintained its initial rank because the hand notes were validly negotiated or assigned to the new pledgee.[46]

In *Bozorg*, the Louisiana Supreme Court was faced with the transfer issue as well as the issue of whether the transferee could receive retroactive ranking for new monies which the transferee advanced in the future. On the issue of transfer, the court examined the 1980 transaction, in which First Metropolitan transferred and assigned to Texas Bank its interest in the collateral mortgage note and collateral mortgage. The Court stated that Texas Bank would have First Metropolitan's rights in the rank of the collateral if the transaction was: (1) an assignment;[47] (2) a payment with subrogation;[48] or (3) a novation with reservation of the pledge privilege and mortgage.[49] The court reasoned, however, that if the transfer was a payoff of the obligation which was secured by the collateral mortgage package without subrogation or reservation of the

43. 346 So. 2d 875.

44. 426 So. 2d 392.

45. Id. at 397.

46. 449 So. 2d at 1104.

47. La. Civ. Code art. 2645 provides: "The sale or transfer of a credit includes everything which is an accessory to the same; as suretyship, privileges, and mortgages."

48. The Louisiana Civil Code allows a creditor who receives his payment from a third person to subrogate that person to his rights. La. Civ. Code art. 1827 (former article 2160(1)).

49. If the parties agree, the security which was given for the performance of the extinguished obligation may be transferred to the new pledgee. La. Civ. Code art. 1884 (former art. 2195).

privilege and mortgage, the privilege which arose from the pledge of the collateral mortgage package was also extinguished.[50]

In determining whether an assignment had taken place, the court noted that First Metropolitan did not own the collateral mortgage note, but merely held it in pledge. Consequently, it could not sell the collateral mortgage note, but it did own and, therefore, could sell the obligation represented by the hand note. The court found no evidence that there had been an assignment of the hand note, and Texas Bank conceded that the hand note was not part of the act of assignment.[51] The court concluded, therefore, that there was no assignment of the principal obligation.

The court next examined the record to see whether Texas Bank had paid the hand note with the right of subrogation to First Metropolitan's "privileges and mortgages."[52] Relying solely on the testimony of a loan officer of First Metropolitan that the parties had intended that Texas Bank buy their "collateral position," the court stated that this evidence showed that the debt was paid by Texas Bank on the condition that First Metropolitan's "rights" in the collateral mortgage were transferred to Texas Bank.[53] The supreme court concluded that the $88,025.34 payment by Texas Bank of Beaumont at all times remained secured by the pledge of Bozorg's earlier collateral mortgage note, effective as of August, 1975.

The court then addressed whether Texas Bank was entitled to retroactive ranking with respect to the February, 1980 advance of new monies in excess of the outstanding balance at the time of the transfer. The Court adopted the rule of *New Orleans Silversmiths, Inc. v. Toups*,[54] that, in order for a transferee to be entitled to retroactive ranking to the date of the initial pledge, for all future advances, he must prove that:

(1) The initial pledge was properly confected;

(2) The parties mutually agreed at the time of the original pledge that the pledge would also secure obligations thereafter arising;

(3) Each subsequent loan was especially secured by the pledge of the original collateral mortgage note;

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50. 457 So. 2d at 673; see also *Alford*, 366 So. 2d at 1303.

51. If the hand note had been in bearer form, it could have been transferred by mere delivery, but Texas Bank failed to produce the hand note and there was no evidence to prove that the note was in bearer form. *Bozorg*, 457 So. 2d at 673.

52. La. Civ. Code art. 1827 (former art. 2160 (1)).

53. *Bozorg*, 457 So. 2d at 673.

54. 261 So. 2d 252 (La. App. 4th Cir. 1972), cert. denied, 262 La. 309, 263 So. 2d 47 (1972).

(4) The pledged collateral has continuously remained in the hands of the pledgee, and

(5) The parties acted in good faith.[55]

The *Silversmith* court pointed out that this retroactive effect may apply to new or additional loans, even though the original debt has been fully paid, if the parties mutually consent.

The supreme court did not actually reach the issue of whether Texas Bank would be entitled to retroactive ranking for the advances made to Bozorg after January 4, 1980, because there was no evidence in the record regarding whether the original contract of pledge to First Metropolitan provided that the pledge would secure future obligations.[56] The record showed only an intent to secure the initial loan and therefore Texas Bank failed to prove the second requirement of the *Silversmith* test. Following the rule that a privilege, such as one that arises from a pledge, must be strictly construed, the court concluded that the retroactive ranking could only be claimed for those debts to which it was expressly granted—the initial loan of $88,025.34.[57]

Was the Transaction a Payment With Subrogation?

The Court's conclusion that Texas Bank effectively paid off the hand note in exchange for subrogation to First Metropolitan's rights appears to be an attempt by the court to protect Texas Bank in its effort to acquire a valid security interest. The Louisiana Civil Code allows a creditor who receives payment from a third person to subrogate that person to his rights,[58] however, this subrogation must be express.[59] The *Bozorg* court based its finding solely on the testimony of the First Metropolitan officer who stated that the parties intended for Texas Bank to buy First Metropolitan's "collateral position." There was no testimony that Texas Bank was expressly told that they would be given subrogation to First Metropolitan's rights in the collateral security. The bank officer's testimony referred to an intent to *sell*, not an intent to make a *payoff*

55. Id. at 254.

56. This contract of pledge need not be in writing according to Louisiana Civil Code article 3158; however, the *Bozorg* case illustrates the necessity that it be in writing in order to prove the parties intent should litigation arise. See also *Alford*, 366 So. 2d at 1299.

57. *Bozorg*, 457 So. 2d at 674.

58. La. Civ. Code art. 1827 (former art. 2160(1)).

59. This requirement was stated in former article 2160(1). Although, it is not stated in article 1827, it can be argued that this is still a requirement. The comments to article 1827 state that this article is based on former article 2160(1) and that it changes the law only insofar as it eliminates the distinction between conventional subrogation and assignment of rights.

with subrogation. The requirement of an express subrogation does not appear to have been met on the face of the record.

In *Odom*,[60] plaintiff's witnesses testified that the parties intended that the mortgagee's debt not be extinguished by the transaction and, therefore, the collateral mortgage would not be extinguished. The fourth circuit stated: "What they say their intentions were is of little consequence if their actions had a legal effect different from such intentions."[61] Similarly, in the *Bozorg* case, the court should not have placed as much weight on the officer's testimony regarding the intent of the parties if there was no evidence that they had in fact given effect to that intent.

By finding that the transaction was a subrogation, the court was able to pretermit the issue of novation. A novation takes place when, by the agreement of the parties, a new performance is substituted for that previously owed, such as when a new collateral mortgagee is substituted for the original mortgagee.[62] The supreme court's dicta suggested that, if the parties agree at the time of the transfer of the obligation which is secured by the pledged collateral mortgage package that the pledge is also being transferred, then the transferee is entitled to rank from the date of the original pledge.[63]

Assuming that the court was correct in finding that a payment with subrogation had taken place, it is significant to note that the Louisiana Supreme Court has now provided authorization for two different methods for a collateral mortgagee to transfer its rights in a collateral mortgage. In *Odom* and its progeny, there was no mention of whether there had been a payment with subrogation or a novation with reservation of the pledge privilege and mortgage. The facts in *Odom* were strikingly similar to those in *Bozorg*. If the facts of Odom were before the court today and if payment with subrogation were to be urged by the parties, it is arguable that the result would be different. In light of *Bozorg*, a transferee, who is attempting to acquire the rights of its transferor in the collateral mortgage, should urge in the alternative that the transaction in which the transfer took place was either: (1) an assignment; (2) a payoff with subrogation;[64] or (3) a novation with reservation of the pledge privilege and mortgage.

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60. 165 So. 2d 855 (La. App. 4th Cir. 1964).

61. Id. at 864.

62. La. Civ. Code art. 1881.

63. 457 So. 2d at 672; La. Civ. Code art. 1884. (former art. 2195).

64. It should be noted that Louisiana Civil Code article 1827 which replaced article 2160 (1) (the article in effect at the time the *Bozorg* case was decided) may have an effect on the parties' ability to confect a valid transfer of the security interest by way of a payoff with subrogation. The comments to new article 1827 state that the subrogation need not be made at the same time as the payment. It may be that the supreme court

Can the Transferee Avail Himself of Retroactive Ranking for Future Advances?

The *Bozorg* decision contains some troublesome language with respect to whether the transferee of a collateral mortgage note and collateral mortgage could ever avail himself of retroactive ranking under article 3158 for later loans. The court, in a parenthetical reference, states that it is not deciding the issue of whether an assignee could ever do so.[65] The court has left open the possibility that the answer to this question could be no. However, there is dicta in the opinion which indicates the court's answer to the question would be in the affirmative. In its conclusion, the court stated:

> Therefore, for [Texas Bank] *to establish entitlement to retroactive ranking*, it was necessary to prove that [First Metropolitan] and Bozorg mutually agreed in the 1975 contract of pledge that the pledge would also secure the pledgor's subsequently arising obligations for which the original collateral mortgage could be additionally pledged . . . . [Texas Bank] did not prove its compliance with the requirements of Article 3158 for retroactive ranking.[66]

Certainly, if the court had serious doubts as to the ability of a transferee to acquire retroactive ranking for future loans, it would not have suggested how Texas Bank could have successfully acquired this right.

Conclusion

Texas Bank of Beaumont v. Bozorg is significant for two reasons. First, the Louisiana Supreme Court has authorized two additional means by which a third party may acquire the security interest held by a collateral mortgage other than by an assignment. In addition to an assignment, a transfer may take place by either: (1) a payment with subrogation; or (2) a novation with reservation of the pledge privilege and mortgage. It should be noted that both of these methods require strict formalities. A court should only find that a subrogation or a novation with reservation has transpired when the evidence clearly indicates that the formalities did in fact take place.

Second, the supreme court, in dicta, has raised doubt as to whether a third party, who has validly acquired the security interest from a

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would not be willing to find a valid transfer of the security interest when the note is marked paid and then months later the parties agree that the transferor will grant the transferee subrogation to the rights it had before the note was paid off.

65. 457 So. 2d at 674. The court was able to avoid this issue by finding there was no proof of intent in the original pledge agreement to secure future advances.

66. 457 So. 2d at 674-75 (emphasis added).

collateral mortgagee, may avail himself of the retroactive ranking provided for future advances in Louisiana Civil Code article 3158. There is other dicta in the opinion which indicates that should the issue be presented, the court would allow retroactive ranking provided: (1) the transfer is valid; and (2) the original parties intended that the pledge would secure future advances.

It appears that the safest method to insure that a transferee has acquired the collateral mortgage package entitling him to retroactive ranking for both pre-existing obligations and future obligations is to have the collateral mortgagee execute a conventional act of assignment transferring the hand note and his right in the collateral mortgage package. This act should also transfer the written pledge agreement. If the pledge agreement was not reduced to writing, the transferee should get a written affirmative representation from the collateral mortgagee that, at the time of the initial pledge, the parties intended that the pledge would secure future advances, and the transferee should also obtain a warranty from the mortgagee that this representation is correct. Should a court later hold that there was no such intent, this warranty should entitle the transferee to sue the mortgagee for any damages the misrepresentation might have caused. If the mortgagee cannot make such a representation, the transferee should not make any subsequent advances because they will not be ranked from the date of the initial pledge.

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