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THE COLLATERAL MORTGAGE: A REASSESSMENT AND POSTSCRIPT

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Volume 33 of the Louisiana Law Review¹ contained an article by us that we hoped would be a thorough analysis and exposition of one of the most curious, most obscure, and yet most practical of legal devices in Louisiana credit transactions, the collateral mortgage. Fundamentally, we are satisfied with the organization and analysis of that article, but a reassessment of our own views on an issue discussed in the article has prompted us to write a brief postscript. In addition, the legislature in 1975 adopted an important statutory amendment, the need for which was suggested by the article itself. Consequently, we believe that an update of, or supplement to, the 1973 article is warranted.

CO-ORDINATION OF INTEREST AND ATTORNEY'S FEES

In the 1973 article, we suggested that it is important for "certain terms and conditions of the collateral mortgage note [to] coordinate with corresponding terms and conditions of the hand note."² Our concern was two-fold, attorney's fees and interest rate provisions. Since the hand note is the true evidence of indebtedness, if that note does not provide for attorney's fees, the lender is not entitled to recover attorney's fees, even if the *ne varietur* note provides for them.³ Misled by the verity of that proposition, for which there was judicial authority,⁴ we stated that a kind of converse proposition, for which there is *no* authority, would also be true: if the hand note provided for attorney's fees but the *ne varietur* note did not, then the creditor would be entitled to recover them, but he would not be *secured* by the mortgage as to those fees.⁵ We

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1. Nathan & Marshall, *The Collateral Mortgage*, 33 LA. L. REV. 497 (1973) [hereinafter cited as Nathan & Marshall].

2. *Id.* at 503.

3. *Odom v. Cherokee Homes*, 165 So. 2d 855, 871-73 (La. App. 4th Cir. 1964).

4. *Id.*

5. Specifically, we stated: "If the term (*e.g.*, attorney's fees) is provided

made the same analysis regarding interest rates: if the *ne varietur* note provides for 10% interest, but the hand note provides only for 8% interest, the creditor is only entitled to recover, and is only secured, for 8% interest. We again stated that the converse would be true: if the *ne varietur* note provides for 8% interest, but the hand note provides for 10% interest, the creditor would be entitled to recover the higher rate of 10% provided in the hand note, but he would only be secured by the mortgage at the 8% rate.⁶

In retrospect, and after painstaking analysis, we have concluded that our statements in regard to co-ordination of these terms were too dogmatic and may well be incorrect. A legal principle that applies to the hand note, and thereby the indebtedness, may not necessarily apply to the collateral that is security for that note. Nor are interest and attorney's fees necessarily separate obligations secured by separate collateral. Our chagrin is compounded by the fact that the Fourth Circuit Court of Appeal, in a recent case, *Baton Rouge Bank & Trust Co. v. Subco, Inc.*,⁷ has cited and quoted the very conclusion of this part of our article at the same time that we were in the process of revising our thinking.⁸

The underlying difficulty with our original analysis is the assumption that interest and attorney's fees are separate aspects not only of the indebtedness, but also of the collateral. In retrospect, we believe that neither aspect of the assumption may be correct. Part of the confusion stems from the unique nature of the collateral mortgage, which employs two distinct promissory notes, the hand note and the *ne varietur* note. The fact that the hand note governs *all* the terms of the actual indebtedness does not necessarily imply that all terms

for in the hand note but not in the '*ne varietur*' note, then the creditor is entitled to recover, but is not secured, as to that item; if the term is provided for in the '*ne varietur*' note, but not in the hand note, then the creditor is not only unsecured, but not entitled to recover that particular item because it is not part of the debt." Nathan & Marshall at 503.

6. *Id.*

7. *Baton Rouge Bank & Trust Co. v. Subco, Inc.*, 306 So. 2d 312 (La. App. 4th Cir. 1974).

8. The court split two-to-one, and Judge Redmann declined to join in what he terms the "unexplained obiter suggestion that a pledge to secure a note only secures interest and attorney's fees to the extent that the thing pledged itself carries interest and attorney's fees." *Id.* at 315. Fortunately, the question of such co-ordination of terms was not essential to the outcome of the case, and the quotation from our article is pure obiter dictum.

of the two notes must co-ordinate. For example, suppose a \$25,000 hand note due one year from date provides for 8% interest and 10% attorney's fees, and is secured by pledge of a \$50,000 *ne varietur* note with no provision for either attorney's fees or interest. In that instance, the creditor may be secured up to \$50,000, *i.e.*, the principal amount of the *ne varietur* note, in principal, interest and attorney's fees. Assuming the debtor defaults at maturity of the hand note, he would owe \$25,000 principal, \$2,000 interest, and \$2,700 attorney's fees, for a total debt of \$29,700, all of which is secured by the \$50,000 mortgage and *ne varietur* note.

The issue is perhaps highlighted by the example of an ordinary pledge situation, removing the use of a second note from the illustration. If the debtor pledges \$50,000 of General Motors stock to secure a note for \$25,000 principal, 8% interest, and 10% attorney's fees, and he defaults one year later, the creditor can indisputably collect the full amount of principal (\$25,000), interest (\$2,000), and attorney's fees (\$2,700) from the pledge of the General Motors stock.

The problem, of course, is that the pledge of a collateral mortgage note is *not* an ordinary pledge.⁹ The collateral mortgage is a hybrid security device, neither fully pledge nor fully mortgage. It utilizes legal rules applicable to both devices, but at the same time it also departs from some very basic legal rules as to each that would otherwise be applicable.¹⁰

Which rules apply and which do not? The *ne varietur* note is nothing more than collateral security and does not represent the indebtedness. The hand note governs the indebtedness; two rules apply. First, irrespective of the principal amount of the *ne varietur* note, the creditor is only entitled to recover the principal indebtedness represented by the hand note.¹¹ Second, irrespective of provisions for attorney's fees

9. *Wallace v. Fidelity Nat'l Bank*, 219 So. 2d 342 (La. App. 1st Cir.), *cert. denied*, 221 So. 2d 517 (1969), holding that a written instrument is not necessary for the validity against third parties of a pledge of a negotiable instrument under LA. CIV. CODE art. 3158; and therefore the pledge of the *ne varietur* note may be a valid pledge not only between the parties but as to third parties even if there is *no* hand note executed.

10. *E.g.*, it departs from the principle that a mortgage is only valid if there is an underlying principal obligation. See Nathan & Marshall at 498.

11. This is true because a security device is merely an accessory obliga-

and interest in the *ne varietur* note, the creditor is only entitled to recover the attorney's fees and interest provided in the hand note.¹²

In every day occurrence, a creditor may be entitled to recover a larger sum than the value of the collateral by which he is secured, as if D pledges \$10,000 worth of General Motors stock to secure a \$20,000 debt. Or the opposite may occur; the creditor may be oversecured and not entitled to recover as much as the value of the security, as if D pledges \$20,000 worth of General Motors stock to secure a \$10,000 debt. There are, then, two eminently practical aspects of the secured transaction which must be carefully distinguished: (1) the debt itself and (2) the security for that debt. In the collateral mortgage situation, the mortgage note is security only; it is not the debt. To determine the value of that security, one must look to the mortgage. The hand note, however, represents the debt, and to determine how much, and what, the creditor is entitled to recover, one can and must look only to the hand note.

On deeper reflection, it now seems to us that interest and attorney's fees are integral aspects of the debt itself and are not separate debts or obligations in and of themselves.¹³ Whether attorney's fees, for example, are stipulated in the *security* for the debt is clearly irrelevant to the issue of the creditor's right to recover them. Whether attorney's fees are stipulated in the *ne varietur* note also seems irrelevant to the issue of whether the creditor is secured as to those fees. If the creditor is entitled to recover attorney's fees by virtue of the hand note, then he is secured as to those fees by *all* of the collateral.¹⁴

Interest is defined in the Louisiana Civil Code as "damages due for delay in the performance of an obligation to pay money,"¹⁵ but more realistically, interest is not damages or a penalty but compensation for the use of one's money. Put bluntly, as to conventional interest at least, the interest rate is nothing more than the price of money.¹⁶ Numerous articles

tion. The hand note is the principal obligation. *E.g.*, LA. CIV. CODE arts. 3136, 3284.

12. *Id.*

13. LA. CIV. CODE arts. 1935-44, 2924-25.

14. *Id.* art. 3164.

15. *Id.* art. 1935.

16. If you do not believe it, see M. MAYER, *THE BANKERS*, 271-95 (1974).

of the Louisiana Civil Code deal with conventional interest and legal interest, and litigation over the years has addressed questions concerning interest, such as when, how and whether it is collectible.¹⁷ A review of some of those articles and cases convinces us that interest is not a separate aspect of the debt, but rather an integral part of it.

For example, Article 2164 provides that if a debt bears interest, every payment that does not extinguish *both* principal and interest must be first imputed to payment of interest.¹⁸ A similar kind of imputation exists in the Code articles on pledge, and indeed the closest support for our original view may be found in Article 3169, which provides that interest paid on a credit that is pledged must be deducted from the interest due on the debt.¹⁹ For example, A executes a note bearing interest and made payable to B; B pledges the note of A to C to secure B's debt; A pays interest on his note and C must credit that interest on the interest owed by B. But Article 3169 also provides that if the debt for which the credit has been pledged does not bear interest, then the payment is deducted on the principal of the debt. The rule of Article 3169 is thus a kind of imputation of payments rule, applying interest to interest. It does not, however, support the proposition that interest provisions of one note are secured only by interest provisions of the other note. On the contrary, the stronger support among the other pledge articles is for the view that interest is simply an integral part of the debt.

Article 3163 states the principle that pledge is indivisible, and that one cannot retake pledged items "without satisfying the whole debt."²⁰ And Article 3164 amplifies that rule in terms that strongly support the revised view:

17. See explanation in note 11, *supra*. See Succession of Cristina, 299 So. 2d 422 (La. App. 4th Cir. 1974) (Interest on inheritance taxes is based on the statute in effect at the time of death of the testator without regard to amendment of the interest rate schedule since his death and since the taxes became due; being "interest" in the true sense, *i.e.* compensation and not a penalty, the later amendment has no effect.). See also Parish of East Baton Rouge v. Harrison, 260 So. 2d 106 (La. App. 1st Cir. 1972); Womack v. Travelers Ins. Co., 258 So. 2d 562 (La. App. 1st Cir. 1972) (The amendment to LA. CIV. CODE art. 1938 to increase legal interest from 5% to 7% was not given retroactive effect.).

18. LA. CIV. CODE art. 2164.

19. *Id.* art. 3169.

20. *Id.* art. 3163.

The creditor who is in possession of the pledge can only be compelled to return it, but when he has received the whole payment of the principal *as well as the interest* and costs.²¹

Under Article 3164, then, the pledgee-mortgagee in the collateral mortgage situation, being in possession of the *ne varietur* note, can only be compelled to return the *ne varietur* note when he has received the whole payment of principal *and* interest as provided in the hand note. Obviously under those terms the hand note is fully secured as to principal and interest by the mortgage, and not interest-for-interest and principal-for-principal. And Article 3164, immediately following Article 3163, plainly implies that interest comprises a part of the "whole debt."

Our earlier analysis assumed that the obligation to pay interest is secured only by the interest provisions of the *ne varietur* note and mortgage; similarly our analysis assumed that the obligation to pay attorney's fees is secured only by the attorney's fees provisions of the *ne varietur* note and mortgage. That assumption is not true for ordinary pledges of any other kind of property, and it is not the general civil law rule.²² Arguably, a different rule could apply to the collateral mortgage, because it is a unique, hybrid device and the collateral is a note. But that analysis requires treating the collateral mortgage note as a debt, which it is not. And it further requires treating interest and attorney's fees as separate aspects of a debt. The sounder analysis seems to us to be to apply the general rule and treat stipulations for interest and attorney's fees in the hand note as being integral parts of the indebtedness, and not to treat them as separate and distinct obligations, secured by separate and distinct collateral or security. The obligation to pay interest differs from the obligation to re-pay principal, because interest accrues and principal does not, but *both* obligations stem from the same indebtedness, evidenced by the hand note. And *both* obligations are secured by the same collateral, *i.e.*, the *ne varietur* note and mortgage.

We have thus revised our views and now suggest that the full principal amount of the collateral mortgage secures the

21. *Id.* art. 3164 (emphasis added).

22. *Id.*

principal of the hand note and any other indebtedness of the hand note, such as interest or attorney's fees. Our earlier view gave rise to a tripartite oddity: principal of one note securing only principal of the other, interest of one note securing only interest of the other; and attorney's fees of one note securing only attorney's fees of the other.²³

In light of our revised thinking we now believe that an additional rule logically follows. If the *ne varietur* note does not provide for interest or attorney's fees, or if it provides for a lesser amount than the hand note, the creditor is nonetheless fully secured by the total mortgage in all its respects, *i.e.*, principal, interest, and attorney's fees, for all obligations provided for in the hand note.

INTERRUPTION OF PRESCRIPTION OF OBLIGATIONS

In the 1973 article, we recommended modification of the inartistically drawn statute, adopted in 1970, that provided that "partial payment" of a promissory note by the maker interrupts prescription on all promissory notes that have been pledged by the maker to secure it. The statute was defective in several respects; it was overly broad and, as written, could apply to notes of third parties, a result obviously not intended. Nor did it clearly define partial payments, which may or may not have included payments of interest only.²⁴

Act 119 of 1975 amended La. R.S. 9:5807 to read as follows:

A payment by a debtor of interest or principal of an obligation shall constitute an acknowledgment of all other obligations including promissory notes of such debtor or his codebtors in *solido* pledged by the debtor or his codebt-

23. An even more sophisticated problem is to hypothesize the situation where the principal of the mortgage note is less than the principal of the hand note, but when coupled with interest and attorney's fees, the value of the *security* equals or exceeds the debt of the hand note. To be consistent, the analysis should conclude that the principal, interest and attorney's fees provisions of the mortgage note all secure the principal debt evidenced by the hand note.

24. LA. R.S. 9:5807, as enacted by La. Acts 1970, No. 354, merely referred to "partial payment" of a promissory note, which could have been construed to mean a payment of principal only, since a payment of interest did not reduce the note. This very argument has been raised in proceedings involving a substantial mortgage in New Orleans.

ors in solido to secure the obligation as to which payment is made. In all cases the party claiming an interruption of prescription of such pledged obligation including a promissory note as a result of such acknowledgment shall have the burden of proving all of the elements necessary to establish the same.²⁵

The 1975 amendment changed the law in several important respects. It applies to all "obligations" rather than to promissory notes only. The 1970 act only applied to payments made by the maker on a note. The new phraseology is much broader, but the statute obviously is aimed at collateral mortgage notes and hand notes. Also, payment is deemed to constitute an "acknowledgment" of the other obligations, rather than an interruption of prescription, as under the 1970 statute. By definition, however, an acknowledgment automatically interrupts prescription,²⁶ so that the desired result clearly obtains, but it is expressed in broader civil law terms. Third, the 1975 act specifically defines payment to include payments of either interest or principal, thereby curing the ambiguity that existed in the 1970 statute. This change accords with the general law, since the payment of interest or principal constitutes an acknowledgment sufficient to interrupt prescription on an ordinary promissory note.²⁷ The 1975 act creates an acknowledgment whenever any solidary debtor of the obligation makes a payment. Under prior law the payment had to be made by the maker of the note. The change reaches the same desired results, expressed in broader civil law terminology. The effect of the statute as amended is substantially broadened beyond the collateral mortgage situation and the statute now applies not only to promissory notes but also to all obligations of the debtor or his codebtors in solido that are pledged to secure the obligation on which payment is made.

The 1975 statute removes the rather specific burden of proof in the 1970 act, which required the creditor to prove that the collateral mortgage note was in fact pledged to secure the hand note as to which partial payment was made *and* that

25. LA. R.S. 9:5807, as amended by La. Acts 1975, No. 119.

26. LA. CIV. CODE art. 3520 (1870).

27. See *Zimmer v. Fryer*, 190 La. 814, 183 So. 166 (1938); *Lawrence v. Lawrence*, 172 La. 587, 134 So. 753 (1931); *Cucullu v. Hernandez*, 103 U.S. 105 (1880).

the creditor was the holder of both of the notes at the time of payment. The 1975 act deletes these requirements and simply provides that the party claiming an interruption of prescription as a result of the "acknowledgment" provided in the statute has the burden of proving all of the elements necessary to establish such interruption. The result is to remove highly specific and particularized requirements and refer to the general law on interruption of prescription. Clearly the creditor still maintains the burden of proof and the facts he must prove are similar to the facts he previously had to prove, but the application is broader.

The new act does not contain language making it retroactive, which would be of doubtful validity, and because of the existence of R.S. 9:5807 since 1970, such language was unnecessary as a practical matter. To the authors' knowledge, there have been numerous cases at the district court level since 1970 challenging the applicability of or the effect of the statute, and raising issues as to its proper interpretation, but no such case has yet reached the appellate level. For example, several cases challenged the applicability of the old law where only payments of interest had been made on the hand note, thereby raising the issue that a payment of principal was required to effect an interruption of prescription on the *ne varietur* note.²⁸ Other cases have involved situations where prescription began to run on the *ne varietur* note prior to 1970 (*e.g.*, a collateral mortgage executed in 1967) but payments were made on the hand note after 1970.²⁹ Time, and the new statute, will cure any such problems.

We submit that the new act, adopted in 1975, effectively remedies the defects of the 1970 statute and properly applies broad principles of the general civil law rather than highly technical language to solve a specific, particularized problem. A sound approach in the best civil law tradition, the 1975 amendment to La. R.S. 9:5807 is a major step forward in making the collateral mortgage more effective as a security device.

28. *Alison Mortgage Inv. Trust v. Marie Antoniette Inc.*, Civil Action No. 75-3165 (E.D. La. 1976); *Alison Mortgage Inv. Trust v. Marie Antoniette, Inc.*, CDC# 596-565 (Orleans); *First Toulouse Corp. v. Alison Mortgage Inv. Trust*, CDC# 596-255 (Orleans).

29. *Professional Plaza West v. Int'l City Bank & Trust Co.*, CDC# 584-533 (Orleans); *Int'l City Bank & Trust Co. v. Professional Plaza West*, CDC# 584-479 (Orleans).