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LAMBERT v. BARKER AND LOST NOTE AFFIDAVITS

by Lynda L. Butler

In 1986 the Supreme Court of Virginia decided a dispute involving commercial paper taken as payment in a real estate closing that has troubling implications for real estate attorneys. That dispute, Lambert v. Barker, raised the issue of "whether payment by the obligors of a note to a party not in possession of the note discharged the obligation of the makers and precluded recovery on the note by the party in possession." 232 Va. 21, 22 (1986). In holding that such payment did not discharge the makers and thus did not preclude recovery by the holder of the note, the Court calls into question the practice of real estate attorneys of relying on lost note affidavits in residential closings.

In Lambert defendants W. Barker and B. Barker executed a note, secured by a second deed of trust and payable to the vendor or his order, as payment for a tract of real estate. About six months later the purchasers conveyed the tract to a third party, who in turn conveyed the land to another couple, the Harwoods. That couple agreed to pay the maker's note. Subsequent to these conveyances, the payee of the note transferred the note to plaintiff pursuant to a loan agreement which provided that monthly payments on the note would continue to be paid to the payee, while any prepayment was to be made to the plaintiff. When the land was again conveyed, the original seller falsely asserted in an affidavit that he still was the holder of the note but that it has been lost. The outstanding balance then was withheld from the sale proceeds and paid to him.

In 1981 plaintiff brought an action against the Barkers and the Harwoods for recovery of the unpaid balance on the note. Plaintiff alleged that she was the holder of the note and therefore entitled to payment. Defendants responded by arguing that the balance had already been paid to the original seller/payee and that therefore they were discharged on the obligation. The trial court ruled for the defendants, holding that § 8.9-318(3) of the Virginia Code required the plaintiff to notify the obligors of the note of the assignment of the note. Since plaintiff had failed to give such notice, the defendants could continue to pay the assignor. Plaintiff appealed the ruling only with respect to the makers.

On appeal the Virginia Supreme Court reversed, ruling that the plaintiff was entitled to the outstanding balance. As the Court explained, § 8.9-318(3) did not apply to the disputed transaction. That section defined "the rights of account debtors following the assignment of certain contracts." Id. at 24. Under § 8.9-105(1)(a) an account debtor is a party obligated on an account, chattel paper, or general intangibles. The note executed by defendants did not fall into any of those three categories. The definitions of "account" and "general intangibles" expressly exclude instruments. See id. at 24. Further, the definition of chattel paper only includes writings evidencing both a monetary obligation and a security interest in or lease of goods. Because the note in question "established a security interest in real property," the note did not qualify as chattel paper. Id. Section 8.9-318(3) therefore had "no relevance" to the disputed transaction and plaintiff did not have to meet the section's notice requirement. Instead, commercial law principles relating to negotiable instruments governed the dispute.

In applying those principles, the Court focused on the concept of holder: on its meaning and its relationship to a maker's obligation. According to the Court, a party's right to receive payment on a negotiable instrument depends on his status as a holder. Id. (citing Va. Code § 8.3-301). Under § 8.1-201(20), a holder is a party who is in possession of a negotiable instrument issued or endorsed to him or to his order, to his
bearer, or in blank. Further, under § 8.3-603, a party liable on an instrument will be discharged only if the party pays or satisfies the holder. No notice is required under § 8.3-603 for the obvious reason that payment can only be made to the party in possession of the instrument for discharge to occur. To ensure that the party demanding payment is the holder, the payer has the right to demand production of the instrument before payment. 232 Va. at 24-25.

In the instant case, the original seller/payee was not the noteholder at the time of payment by the defendants. By that time the payee had negotiated the instrument to the plaintiff, making the plaintiff the holder. Thus, payment to the payee could not discharge the maker's liability on the instrument unless the payee was the authorized agent of the plaintiff. Because the defendants had failed to raise or establish such an agency relationship, plaintiff was entitled to payment.

Unfortunately for the real estate attorney, the Lambert Court's application of the Uniform Commercial Code seems correct. In addition to the article 9 provisions discussed by the Court, § 8.9-309 clearly states that nothing in article 9 is to limit the rights of a holder in due course. Although the Court in Lambert did not have to decide whether the plaintiff was a holder in due course, see id. at 26, most parties purchasing a note from the payee prior to the payee's false statement should not have difficulty establishing their holder in due course status. Further, the Court's analysis of article 3 is based on fairly straightforward provisions that clearly make the holder concept crucial to payment of negotiable instruments.

The clarity of the commercial law provisions, however, does little to minimize the impact of the Lambert decision on real estate attorneys. Reliance on a lost note affidavit provides a convenient way to accommodate commercial law principles with the interests of parties to a real estate transaction. Although the practice does encourage a dishonest seller/payee to misrepresent his status as a noteholder, the actual holder of the note could easily avoid the problem by notifying the maker of the assignment. After Lambert, however, the real estate attorney cannot rely on the lost note affidavit to assure his client that payment to the party making the affidavit will discharge the client's liability on the instrument. Before the client could be discharged, the party making the affidavit would either have to find the instrument and establish his status as the holder or bring a § 8.3-804 lost instrument action to recover on the note. Although such an action may not pose a serious problem to an honest owner of a lost instrument, it is at the very least time-consuming.

Because of the serious implications of the Lambert case for real estate attorneys, we would like to solicit comments on the decision. In particular, we would like to know how members of the Real Estate Section are handling the problems presented by Lambert with respect to the use of lost note affidavits in residential closings. Please feel free to send your comments to the Editor of the Newsletter or to any other member of the Board of Governors.