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The Assignment of Merchants' Book Accounts as Security

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The Washington Law Review does not seek to add further congestion to an already crowded field. There are many excellent Reviews, general in scope.

But we feel that there is room, and need, for a legal publication which will serve as a medium of expression for the jurists of the Northwest, and will be devoted particularly to the interpretation and advancement of Northwest law.

Since there is no statutory or common law restriction on shooting starward, we frankly confess our hope of making the Review so useful that the attorneys of the Northwest will consider it indispensible.

THE ASSIGNMENT OF MERCHANTS' BOOK ACCOUNTS AS SECURITY.—Repudiating the rule commonly attributed to the famous case of *Dearle v. Hall*,[1] a rule which for at least 70 years had been understood to be the rule of the Federal courts, the United States Supreme court decided[2] in 1924 that as between successive assignees of the same chose in action, mere priority of notice did not give priority of right.

The decision by Mr. Justice Butler serves to clarify the Washington law and the decision in the early case of *Bellingham Bay*

1 3 Russ. 1.

2 Salem Trust Co. v. Manufacturers' Finance Co., 264 U. S. 182, 31 A. L. R. 867.

Boom Co. v. Bribois,[3] by citing the latter case as holding that as between successive assignees, where notice is given by the later assignee, without more, the prior assignee prevails. It thus seems that the Federal and state holdings are in harmony

Where the second assignee makes no inquiry of the debtor and thus does not suffer from the failure of the prior assignee to give notice, it seems that such a decision is correct.

Neither the Supreme Court nor the Washington decision goes beyond this. Suppose the second assignee does inquire of the debtor, and not learning of any prior assignment, purchases the chose? There is an intimation in the Supreme Court opinion that a case of equitable estoppel would arise as against the prior assignee.[4]

The English doctrine of "reputed ownership" makes failure of the assignee to give notice to the debtor equivalent to the failure to deliver a pledge res to the pledgee. The American courts generally do not apply this doctrine to choses in action, since they are not visible.[5]

Nor do the recording acts applying to "personal property" include choses in action.[6] Recording, since not provided for by statute, will not give constructive notice.[7]

Bankers taking assignments of accounts as security often do not wish to notify the debtors but desire to have collections made by the assignor, at least until trouble develops. Unless notice is given, the debtor will be discharged by payment to the assignor or his creditor.[8] And if he pays or becomes bound to pay a later assignee he is not liable to an earlier assignee who failed to give notice.[9] If notices of the assignments are simultaneous, even in England the earlier assignee has priority[10]

The banker is often willing to take the risk as to the integrity of the assignor. It is the unknown which he fears,—receivers or trustees in bankruptcy representing subsequent creditors. Can the banker have the privilegs he wants and still have his security prevail as against these troublesome parties?

Is a provision requiring the assignor to make collections, reserving that right, however, for the assignee if the latter desires it, valid? In analogy to the rule as to tangible chattels, it has sometimes been thought that this invalidates the assignment, except as between the parties.[11] The right of the assignee to appoint the assignor as his

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3 14 Wash. 173, 181, 44 Pac. 153, 155.

4 264 U. S. 198.

5 In re Hub Carpet Co., 282 Fed. 12, 16.

6 Heermans v. Blakeslee, 97 Wash. 647, 167 Pac. 128; Petition of National Discount Co., 272 Fed. 570, 574.

7 State Bank of Black Diamond v. Johnson, 104 Wash. 550, 558, 177 Pac. 340, 342; Burck v Taylor, 152 U. S. 634, 653.

8 14 Wash. 177, 44 Pac. 153.

9 264 U. S. 199.

10 Calisher v. Forbes, 7 Ch. App. 109.

11 Savage Tire Sales Co. v Stuart, 61 Mont. 524, 203 Pac. 364, 365.

agent to collect is generally upheld, however, where the assignor is to make immediate remittance.[12] Care must be taken that the agreement is not merely one to pay out of a particular fund composed of the proceeds of the accounts, in which case there will be no lien and the purported assignment will be voidable as against a trustee or receiver.[13] And where the proceeds are not kept separate but are commingled with the bankrupt's own funds on deposit and checks to the assignee were drawn on this deposit indiscriminately, it has been held that the trustee may avoid payments made on the ground that they are preferences.[14]

If the assignor need not remit but may, until notified otherwise by the assignee, use the proceeds of the collections in his business, this is regarded as inconsistent with a present assignment.[15]

The case of *Benedict v. Ratner* handed down by the United States Supreme Court on May 25, 1925, and received as this Review went to press, is of importance. The court held that "the assignment must be deemed fraudulent in law if it is agreed that the assignor may use the proceeds as he sees fit." Even the delivery of lists of the accounts was held not to cure the defect.

A simple device may be availed of, however, to preserve the rights of the assignee and still allow the assignor to use the proceeds in his business. If, when such proceeds, the property of the assignee, are appropriated, assignments of new accounts are substituted in their place, it would seem that on principle the assignee should still be protected. The modus operandi, however, must be carefully looked to. A danger lurks in this seeming solution, as brought out by contrasting the two following possible situations.

First, if before or simultaneously with the appropriation by the assignor of the proceeds of the collections the new security is given, the assignee should be treated as a purchaser for value and should be protected. It is equivalent to the taking of security for a present advance and should not fall under the ban of the trust fund doc-

12 Petition of National Discount Co., 272 Fed. 570, 574; In re Hawley Down-Draft Furnace Co., 238 Fed. 122; Robertson v. Hennochsberg, 1 F 2d 604; In re Michigan Furniture Co., 249 Fed. 978; Clark v. Iselin, 21 Wall. 360. The court in In re Letterman, Becher & Co., 260 Fed. 543, 546, said, "As between assignor and assignee and the creditors of the assignor, the validity of the assignment is not affected by the fact that the accounts were allowed to remain in the assignor's possession. In making the collection he acts in a fiduciary capacity, and the money, when collected, becomes the specific property of the assignee or pledgee."

13 In re Stiger, 202 Fed. 791, Poage Milling Co. v. Economy Fuel Co., (Ky. 1910) 128 S. W 311.

14 Radford Grocery Co. v. Haynie, 261 Fed. 349.

15 An analogous line of cases is found in the corporation mortgage cases of which New York Security Co. v. Saratoga Gas Co., 159 N. Y. 137, 53 N. E. 758, is an example. There the mortgage covered the property and book accounts, the trustee being privileged to take possession upon default. It was held that the right of the mortgagor to deal with the earnings as its own was inconsistent with a lien and that accounts arising and money collected before the trustee took possession belonged to the general creditors.

trine or the rule as to preferences within four months of bankruptcy [16]

Secondly, if the proceeds are retained and used in the business and at a later time new security is given to replace the old, the new security is given for a pre-existing debt and would seem to fall under the ban of the trust fund doctrine and the rule as to preferences.

In the rush of business, even with a well meaning assignor who intends to effect a real substitution, this situation is very easy to develop. An acute receiver or trustee might well be able to show in the usual case, that although the agreement and assignments looked all right on their face, in fact the assignment is without present consideration. [17] Even with a valid substitution, if the value of the new accounts exceeds the value of the old ones, a preference will exist as to the excess, and will be voidable to that extent. [18]

So far, only the assignment of existing book accounts has been discussed. Will a purported assignment of future accounts, given, for instance, by a corporation without other assets available for security to secure a loan necessary for starting business, protect the assignee as against subsequent creditors?

As between the parties, although there are decisions, notably in Alabama, [19] holding that an assignment of future accounts is invalid,

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16 Clark v. Iselin, 21 Wall. 360, 370. In In re Reese-Hammond Fire Brick Co., 181 Fed. 641, the court said, " as assigned accounts were paid off, other accounts were substituted for them, and thus the bank's collateral was preserved in a form satisfactory to it the weight of the evidence supports the court's finding that the accounts assigned took the places of accounts paid, and that these transactions did not impair the rights of the general creditors, for the reason that the substitution of new for old securities did not in any wise diminish the debtor's estate for those creditors." It appears that the substitution in this case was effected by delivering revised lists of accounts at intervals, with an assignment thereof, each invoice having also been separately assigned to the bank.

See also Sawyer v. Turpin, 91 U. S. 114, holding that a chattel mortgage given to replace a bill of sale within the four months period was not a preference.

17 In Wolfe v. Bank of Anderson, 238 Fed. 343, the only case which has been found involving this situation, a merchant assigned accounts to the bank as security. He was permitted to collect the accounts and use the proceeds in his business or to apply them on the notes. It was held that a new assignment of accounts within the four months period could not be sustained on the substitution theory, because the proceeds of the first accounts had been expended before the transfer.

18 In re Cutting, 145 Fed. 388.

19 Clanton Bank v Robinson, 195 Ala. 194, 70 So. 270; Purcell v Mather, 35 Ala. 570, 76 Am. Dec. 307.

In Pintsch Compressing Co. v. Buffalo Gas Co., 280 Fed. 830, 835, the court referred to the New York rule as being settled "that a mortgage of after-acquired personal property is ineffective as against creditors of the mortgagor." Cf. Moore v. Terry 17 Wash. 185, 49 Pac. 234.

See also First National Bank of Houston v. Hammill (Tex. 1913), 193 S.W 197, where the court said, "If the contracts were not in existence said earnings had no potential existence and any attempt to assign or mortgage such earnings was void."

generally on the theory that it has no potential existence, it is held by the weight of authority that such accounts are assignable. [20]

Whether the assignee can prevail as against subsequent creditors of the assignor, represented by a trustee or receiver, is a more difficult question. Such assignee might invoke two theories in support of his claim, first, that he acquired an equitable title superior to the right of the receiver; second, that an assignment made pursuant to an agreement made at the time of the advance should be valid.

As to the first theory, since it seems that there is not a case of potential existence and no lien would arise, there is only a contract to assign. The holder of the contract right would be in the same situation as any other creditor.

As to the second theory, the same answer may be made. The lender having only a contract right, is really in no better position than a general creditor. The case is not one in which one lien is replaced with another or a pre-existing general lien defined. Under the bankruptcy act, such conveyances have been held to be voidable preferences. [21] It has been held, however, that where the creditor's advances, which enabled the bankrupt to get the goods, were made upon a promise that he would have a lien covering all book accounts, the creditor who took the security without knowledge of insolvency would be protected. [22]

If, then, the necessities of business require that the property of the borrower assume different forms and that the borrower be appointed agent for collection of accounts, the lender should see to it that he acquires a valid lien at the beginning, as by a recorded chattel mortgage on goods purchased with his advances. When the goods are sold the outstanding books accounts should immediately take their place, and when accounts are paid off the money should be turned over or new accounts substituted, which can be done by delivering revised lists of accounts, with assignments thereof, at short intervals, to perfect the lien.[23]

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20 Tailby v. Official Receiver, 13 App. Cas. 523; Preston National Bank v. Smith Middlings Purifier Co., 84 Mich. 364, 47 N. W 502; Dunn v. Swan, 115 Mich. 390, 73 N. W 386; Buvinger v. Evening Union Printing Co., 72 N. J. Eq. 321, 65 Atl. 482. See Field v. New York, 6 N. Y. 179, 57 Am. Dec. 435.

21 Hayes v. Gibson, 279 Fed. 812, where a mortgage was given within the four months period, pursuant to a prior agreement. In In re Herman, 207 Fed. 594, 599, the court said, in a case in which an advance was made upon a promise that a mortgage would be executed, "That it was made pursuant to an agreement to make the same when the loans were made does not relieve it from operating as a preference, if the other essentials of a voidable preference required by the act are present. " See In re Mandel, 127 Fed. 863. Cf. Chapman v. Hunt, 254 Fed. 768, where the court supported an assignment of accounts in consummation of an earlier agreement.

22 Greey v. Dockendorff, 231 U. S. 513.

23 In re Hub Carpet Co., 282 Fed. 12, 17.