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Priority Between Morgagee and Creditor of Mortgagor in an Unrecorded Chattle Mortgage

Gordon H. Sweany

PRIORITY BETWEEN MORTGAGEE AND CREDITOR OF MORTGAGOR IN AN UNRECORDED CHATTEL MORTGAGE

> "A mortgage of personal property is void as against all creditors of the mortgagor, *both existing and subsequent, whether or not they have or claim a lien upon such property,* and subsequent purchasers, pledgees, mortgagees, and incumbrancers of the property for value and in good faith, unless it is accompanied by the affidavit of the mortgagor that it is made in good faith, and without any design to hinder, delay, or defraud creditors, and unless it is acknowledged and filed within ten days from the time of execution thereof "[1] Rem. Stat., sec. 3780, P C., sec. 9747.

The interpretation of this statute by the Washington Supreme Court has not always been uniform or certain. In determining the priority of the respective claims of a mortgagee under a defective mortgage[2] and of a creditor of the mortgagor, several questions may be raised which can not be answered with certainty as the law stands today [3]

However some aspects of the contest between the creditor and the mortgagee are definitely settled. Thus it is clear that one who extends credit to another without notice, actual or constructive, of a chattel mortgage upon the latter's property acquires an *in personam* claim against the debtor-mortgagor which he is entitled to prosecute to judgment, and upon which he may proceed by levy or attachment against the property in disregard of the mortgage.[4] Contrary to the general rule elsewhere,[5] receipt of actual

[1] Italics ours. The italicized portion was added by the Legislature in 1915. Wash. Laws, 1915, ch. 96, p. 277.

[2] There are three requirements—acknowledgment, an affidavit of good faith, and filing or recordation. Failure to comply with any one of these brings the instrument within the scope of the statute. *Smith v. Allen,* 78 Wash. 135, 138 Pac. 683, Ann. Cas. 1915D, 300 (1914). The term "defective" as used in this discussion means failure to meet any or all of these requirements.

[3] The rights of subsequent purchasers are well defined. Unless they purchase for value and in good faith, they take subject to the mortgage. *Darland v. Levins,* 1 Wash. 582, 20 Pac. 309 (1889) *Mendenhall v. Kratz,* 14 Wash. 453, 44 Pac. 872 (1896) *Clark v. Kilian,* 116 Wash. 532, 199 Pac. 721 (1921) *Fleming v. Lincoln Trust Co.,* 124 Wash. 317, 214 Pac. 5 (1923) *West American Finance Co. v. Finstad,* 146 Wash. 315, 262 Pac. 636 (1928) *Sullivan v. Lewis,* 170 Wash. 413, 16 Pac. (2d) 834 (1932) *Morton v. Armour* 173 Wash. 462, 23 Pac. (2d) 887 (1933).

[4] *Baxter v. Smith,* 2 Wash. Terr 97, 4 Pac. 35 (1882) *Willamette Casket Co. v. Cross, etc. Co.,* 12 Wash. 190, 40 Pac. 729 (1895) *Manhattan Trust Co. v. Seattle Coal Co.,* 16 Wash. 499, 48 Pac. 333 (1897) *Kato v. Union Oil Co.,* 92 Wash. 473, 159 Pac. 592 (1916) *Pacific States Securities Co. v. Austin,* 146 Wash. 494, 263 Pac. 732 (1928). Any doubt as to whether subsequent creditors were protected was banished by the 1915 amendment. See on that point *Roy & Co. v. Scott, Hartley & Co.,* 11 Wash. 399, 39 Pac. 679 (1895) *Urquhart v. Goss,* 60 Wash. 249, 110 Pac. 1001 (1910).

[5] *Fiegel v. 1st Nat. Bank,* 90 Okla. 26, 214 Pac. 181 (1923) *Soehrin v. Hein,* 214 Iowa 1060, 243 N. W 330 (1932)

[6] *Bonneviere v. Cole,* 90 Wash. 526, 156 Pac. 527 (1916).

notice before a judgment lien or levy is obtained will not defeat that lien. And, by virtue of that portion of the statute protecting incumbrancers for value and in good faith, any mortgage or other incumbrance which is innocently acquired upon the property is prior to the defective mortgage.[6]

If the extension of credit was made without notice, but actual notice was received before the creditor acquired a mortgage or other incumbrance upon the property, the creditor's incumbrance has been held to be superior. Early cases stated that in the inception of the transaction, the defective mortgage was void as to the creditor, and he might thereafter disregard it, any claim he acquired would necessarily be superior to the mortgage which was as to him a nullity.[7] The recent case of *Seaboard Dairy Credit Co. v. Paulsen*[8] reached the same result by somewhat different reasoning. It was said that notice of an existing mortgage at the time credit is extended rather than the time security is taken governs priority The Court stated that when a creditor extended credit in good faith without notice, the character of his subsequent incumbrance should be determined as of that time, since that is the time at which value is given.

In these situations the innocent creditor has achieved a prior claim upon his debtor's property, whether it takes the form of a judgment lien, statutory lien, or incumbrance by act of the parties. If credit were extended with actual notice of a defective mortgage, would the same results be reached?

Considering first the position of an unsecured creditor of the mortgagor, it appears that he is entitled to prosecute his claim to judgment and attach or levy upon the property regardless of his actual notice of the defective chattel mortgage already upon the property The language and arrangement of the statute seems to indicate that the restrictions of "for value and in good faith" are attached only to subsequent purchasers and encumbrancers. That was the early interpretation placed upon the statute by the Court. As to a creditor, a defective mortgage was regarded as "absolutely void," regardles of notice.[9] In interpreting the statute after the 1915 amendment,[10] the Court apparently adhered to this view, since the possibility of tardy recordation serving as actual notice was not extended to subsequent creditors. The inference is that as to creditors, such actual notice would be immaterial. It is contended, however, that subsequent cases have changed the law In a note in 68 A. L. R. 274, Washington is classified as following

[7] *Smith v. Allen*, 78 Wash. 135, 138 Pac. 683, Ann. Cas. 1915D, 300 (1914) *Belcher v. Young*, 90 Wash. 303, 155 Pac. 1060 (1916) *Embagi v. Northwestern Imp. Co.*, 101 Wash. 558, 172 Pac. 834 (1918).

[8] 74 Wash. Dec. 539, 25 Pac. (2d) 974 (1933)

[9] *Baxter v. Smith*, 2 Wash. Terr. 97, 4 Pac. 35 (1882) *Blumauer v. Clock*, 24 Wash. 596, 64 Pac. 844, 85 Am. St. Rep. 966 (1901) and see notes 3, 4 and 7, *supra*.

[10] *Clark v. Kilian*, 116 Wash. 532, 199 Pac. 721 (1921). See note 1.

the usual rule that actual notice supplies any deficiency in recording and that one who deals with knowledge of a prior defective mortgage can take only subject thereto, whether he be creditor, purchaser, or encumbrancer. As authority for that proposition, *Asbury v. Miller*[11] is cited. Jones in his treatise on Chattel Mortgages[12] similarly classifies this jurisdiction, solely upon the basis of the decision of *North Pacific Bank v. Pacific Merc. Agency*.[13] If such classification is accurate, apparently the construction of the statute has undergone a decided change. Do the cases cited by the authorities necessitate that result?

In *Asbury v. Miller*,[14] the mortgagee of an improperly recorded mortgage brought suit and obtained a judgment of foreclosure. After decree of foreclosure but before sale, another and subsequent mortgage of the same property brought suit to contest the superiority of the prior lien. In that action, general creditors of the mortgagor intervened, attempting to assert the invalidity of the first mortgage. According to the rules of practice in this state, intervention in any cause must be made before trial,[15] and since the general creditors had no *in rem* claim against the property they could not attack the validity of a judgment of foreclosure by subsequent intervention, and certainly not by intervention in another action. Their rights had been foreclosed and terminated so far as that property was concerned. Unfortunately, the Court cited on this point only cases which had been largely overruled by the amendment of 1915 and *Clark v. Kilian*.[16] As suggested, the result is sound, and the case need not be taken either as restoring that portion of decisional law which the Legislature desired to terminate, or as changing the law insofar as creditors' rights are concerned. The creditors met defeat not because they extended credit with notice, but because they failed to assert their claims in a timely and proper manner.[17]

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[11] 132 Wash. 235, 232 Pac. 360 (1925). Two other cases cited involve rights of subsequent purchasers (note 6).

[12] Vol. I (Bower's Ed.), sec. 317, p. 503.

[13] 153 Wash. 37, 279 Pac. 103 (1929).

[14] Note 11, *supra*.

[15] Rem. Rev. Stat., sec 202; *State ex rel Williams v. Superior Court*, 91 Wash. 40, 157 Pac. 28 (1916) *Longmire v. Yakima Highlands Co.*, 95 Wash. 302, 163 Pac. 782 (1917) *Nevin v. Pacific Coast & Norway Packing Co.*, 105 Wash. 192, 177 Pac. 739 (1919).

[16] *Heal v. Evans Creek Coal and Coke Co.*, 71 Wash. 225, 128 Pac. 211 (1912) *Pacific Coast Biscuit Co. v. Perry*, 77 Wash. 352, 137 Pac. 483 (1914) *Watson v. 1st Nat. Bank*, 82 Wash. 65, 143 Pac. 451 (1914) *Spokane Merc. Ass'n. v. 1st Nat. Bank*, 86 Wash. 367, 150 Pac. 434, L. R. A. 1918A, 323 (1915) *Haskins v. Fidelity Nat. Bank*, 93 Wash. 63, 159 Pac. 1198 (1916). These cases, overruling *Willamette Casket Co. v. Cross, etc., Co.*, note 4, *supra*, stated that an unrecorded chattel mortgage was good as to creditors who had acquired no lien, and later recordation or taking possession of the property by the mortgagee would revive and validate the mortgage as against all general creditors. In *Clark v. Kilian*, note 10, *supra*, it was said that the amendment of 1915 was passed with the obvious purpose of rendering liens unnecessary and subsequent recordation ineffective.

In *North Pacific Bank v. Pacific Merc. Agency*,[18] a garageman performed services on a car which he knew to be encumbered by a purchase-money mortgage. The mortgage was improperly recorded. He retained possession of the car as security for his claim of $65, and assigned his claim to the Mercantile Agency The Agency recovered judgment against the debtor-mortgagor and seized and sold the car on execution sale for $75, far below its market value. The purchaser at the sale knew of the mortgage, and the validity of the judgment and sale were seriously questioned. The car came into the hands of a *bona fide* purchaser, and the mortgagee brought trover for the conversion of the car against the four parties who dealt with the car with knowledge of his claim. Recovery was had for the reasonable value of the car.

At first reading, the decision seems to deny a creditor the right to levy execution upon defectively mortgaged property, and apparently the result is reached solely upon the basis of the knowledge which the defendants at all times possessed. The decisive value of the case, however, is hard to determine. The only issue argued to the Court on appeal was the applicability of Section 3780 and the defendant's admitted liability if the facts were within the scope of that section. Having found that the defendants' contention was without merit, and feeling that the whole transaction smacked of fraud and an utter disregard of the rights of the mortgagor and mortgagee, the Court reached the just and, on the briefs submitted to it, the only possible result. It should be noted that the decision speaks only of the liability and rights of subsequent *purchasers*,[19] and it is certain that the Court did not and was not asked to regard any of the defendants as being a *creditor* It is submitted that this and the *Asbury* case should have little weight in this discussion and are but scant authority for the proposition for which they are cited. The law in this state is apparently unchanged, as to a creditor, a defective mortgage is invalid regardless of any question of actual notice.[20]

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[17] Has an unsecured creditor of the mortgagor such an interest in foreclosure proceedings as to permit intervention by him? Apparently not. *Thompson v. Huron Lumber Co.*, 4 Wash. 600, 30 Pac. 741 (1892) but cf. *State ex rel Williams v. Superior Court*, 91 Wash. 40, 157 Pac. 28 (1916)

[18] Note 13, *supra*.

[19] If, however, the decision rests upon the defendants being subsequent purchasers, two questions are presented. The garageman and his assignee were not purchasers—should they not be entitled to realize their *in personam* right against the debtor without liability for conversion? And unless the purchaser at execution receives similar immunity, it appears the creditor's right of realization will have little practical value; such a purchaser should have the same rights, at least, as the creditor. There are apparently no cases upon the latter point under statutes comparable to section 3780.

[20] See *Robinson, Thieme & Morris v. Whittier* 112 Wash. 6, 191 Pac. 763 (1920) *Pacific States Securities Co. v. Austin*, 146 Wash. 492, 263 Pac. 732 (1928) *Kliks v. Tenet Mortgage Co.*, 162 Wash. 514, 299 Pac. 367 (1931)

The *Asbury* case did decide one pertinent question, however, and its decision is well fortified by authority If a creditor has notice of an existing mortgage at the time he extends credit, and at that time acquires as security a mortgage or other incumbrance upon the already mortgaged property, it is clear that his *in rem* right against the property is inferior to the prior mortgage of which he had notice.[21] There is no extension of credit in good faith upon which his subsequent incumbrance may be based.

If such an incumbrance immediately acquired is inferior to a defective mortgage, *a fortiori* any incumbrance subsequently acquired should be similarly inferior. To permit it to achieve priority would penalize a cautious and diligent creditor and reward dilatory conduct insofar as demanding security is concerned. Yet one case has drawn a distinction of that sort. In *Blumauer v. Clock*,[22] laborers who knew of a mortgage upon their employer's property before they began work filed statutory liens upon that property The mortgage was unacknowledged. It was said that there was a distinction between one who extended credit only upon security and one who extended credit with no thought of security, relying upon his *in personam* claim against his debtor. In the inception of the latter's contract, he was not an incumbrancer but a creditor, as to his, therefore, the defective mortgage was void and his lien was superior thereto. The Court also said that perhaps this distinction should be drawn only in favor of creditors who acquired their subsequent lien by operation of law. Subsequent cases[23] refused to limit this "inception of the obligation" test to statutory liens, and it has been used to grant a subsequent mortgage or deed priority over a prior mortgage, in spite of actual notice. In each, however, the credit was extended in good faith, and apparently prior to the defective mortgage's execution. Such cases, as already suggested, may better be decided upon the rationalization employed in the *Paulsen* case.[24] The *Blumauer* case alone militates directly against the law as stated in the *Paulsen* case and certainly the scope of the earlier decision, if it is to be followed at all, should not be extended beyond statutory liens. GORDON H. SWEANY.

[21] *Roy & Co. v. Scott, Hartley & Co.*, 11 Wash. 399, 39 Pac. 679 (1895) *Hinchman v. Point Defiance Ry. Co.*, 14 Wash. 349, 44 Pac. 867 (1896) *Farmer's State Bank v. McCulley*, 133 Wash. 365, 233 Pac. 661 (1925) Perhaps the annotator in 68 A. L. R. 274 intended to cite the *Asbury* case only for this proposition.

[22] 24 Wash. 596, 64 Pac. 844, 85 Am. St. Rep. 966 (1901).

[23] Note 7, *supra*.

[24] Note 8, *supra*.