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Security Transactions—Mortgage on Shifting Stock of Merchandise—Mortgagor's Duty to Account

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able.[30] Both the *Norway* and the *Henningsen* cases are thus consistent with Section 2-719, although the reasoning of the New Jersey case does not depend on the fact of injury to the person.

The law of warranty is obviously in flux, resolving conflicts between the elements it derives from tort and contract. The observable trend in favor of buyers raises the further problem of the "third-party victim" —one who sustains damage because of defects in the product of a total stranger. The implied warranty of merchantability should in theory extend to him equally with the buyer and his household, since the law imposes this warranty to protect the public, rather than to implement a sales contract. Where injury to the public is a foreseeable consequence of a breach, other implied warranties and warranties based on sellers' representations seem likewise open to extension.

Finally, the changing state of warranty law calls attention to the relationship between disclaimers and privity. If, in the same situation, one seller is allowed to defend with the disclaimer clause and another with the privity requirement, then the first seller escapes liability because there is a contract and the second because there is not a contract. This unfairness can be avoided by confining the disclaimer defense to situations where there is privity of contract.[31]

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SECURITY TRANSACTIONS

Mortgage on Shifting Stock of Merchandise—Mortgagor's Duty to Account. Washington businessmen using mortgages on shifting stocks of merchandise as a security arrangement received encouragement from *United States Rubber Co. v. Young*,[1] that more liberal agreements and procedures may be allowed. However, by failing to expressly overrule certain prior judicial restrictions on the use of this type of security, the Washington Supreme Court has left some unnecessary confusion to be resolved in the future.[2]

The case arose when U.S. Rubber Co., a creditor, sought the appointment of a receiver for Glen Young's sporting-goods store. The purchase

[30] See also UNIFORM COMMERCIAL CODE § 2-302 (authorizing refusal to enforce unconscionable or clauses generally).

[31] Jolly v. C. E. Blackwell & Co., 122 Wash. 620, 211 Pac. 748 (1922). Pelletier v. Brown Bros. Chevrolet & Oldsmobile, Inc., 164 N.Y.S.2d 249 (N.Y. Sup. Ct. 1956); Ford Motor Co. v. Switzer, 140 Va. 383, 125 S.E. 209 (1924). *But cf.* Odom v. Ford Motor Co., 230 S.C. 320, 95 S.E.2d 601 (1956).

[1] 57 Wn.2d 686, 359 P.2d 315 (1961).

[2] For a brief history and development of the Washington position see Kerr, *Chattel Mortgages on Shifting Stocks of Goods in Washington*, 11 WASH. L. REV. 199 (1936).

money mortgagee, Hunky Shaw, intervened, asking that the mortgage on the fixtures and the shifting stock of merchandise be foreclosed. The receiver attacked the mortgage as void because Shaw had failed to supervise the monthly accounting required by the mortgage terms and because he had permitted the mortgagor to deduct his personal living expenses as a necessary expense of the business. The terms of the mortgage provided that the mortgagor would: 1) Pay a minimum of $250.00 per month from the business proceeds after deducting necessary business expenses and purchasing new stock; 2) Make an accounting on or before the tenth of each month; and 3) Keep the inventory at a minimum of $10,000.00.[3]

The trial court found that Shaw had never required a formal accounting[4] from the mortgagor although he had been generally aware of both the gross sales figures and the cost of operating the business. Shaw neither policed the collection of the $250.00 per month to be applied to the mortgage debt nor ascertained whether the dispositions of the proceeds had been made for business expenses. The trial court upheld the mortgage on the fixtures but found it fraudulent in law as to the inventory because of the mortgagee's failure to collect the payments and supervise the dispositions.

The Washington Supreme Court reversed the trial court in part, holding the mortgage on the inventory valid. It reiterated the rule[5] that the terms of shifting stock mortgages should provide for the manner of maintaining and handling the stock, and for an accounting and payments on the mortgage debt from the proceeds of sale after allowing for the expenses of maintaining the business.[6] However, it held that such

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[3] "The controlling provisions of the mortgage were contained in the following paragraph: 'It is understood and agreed that until the total indebtedness secured by this mortgage is fully paid and satisfied, said mortgagor shall pay unto said mortgagee a minimum amount of $250.00 per month from the proceeds of the sale of said goods, wares and merchandise remaining after deducting the necessary expenses of operating the business of the mortgagor and the purchase of new merchandise stock for cash, sufficient for the needs of said business, . . . and for the above purpose a true and correct accounting shall be had between said mortgagor and mortgagee on or before the 10th day of each and every month, . . . of the proceeds of the said business for the preceeding month. The mortgagor also agrees to . . . keep an inventory of merchandise . . . of at least Ten Thousand and No/100 Dollars ($10,000)'." United States Rubber Co. v. Young, 57 Wn.2d 686, 687-88, 359 P.2d 315, 316 (1961).

[4] *Compare* Puget Sound Pulp & Timber Co. v. Clear Lake Cedar Corp., 15 Wn.2d 707, 132 P.2d 363 (1942), *with In re* McLean, 270 Fed. 348 (W.D. Wash. 1920) in regard to what is meant by accounting.

[5] Miller v. Scarbrough, 108 Wash. 646, 185 Pac. 625 (1919).

[6] Originally stated in Miller v. Scarbrough, 108 Wash. 646, 651, 185 Pac. 625, 626-27 (1919). "The proper rule to be applied to mortgages hereafter executed should be that, for a chattel mortgage on a shifting stock of goods, which is to remain in the possession of the mortgagor to be disposed of in the usual course of trade, to be valid the mortgage

mortgages are valid, unless actual fraud is shown, even though the mortgagee fails to enforce the accounting as provided in their terms.

The validity of a chattel mortgage which permits the mortgagor to remain in possession and to apply the proceeds to the mortgage debt has never been disputed in Washington,[7] as it has been in some jurisdictions.[8] Prior to *Miller v. Scarbrough*,[9] the court only questioned whether the mortgage relationship was in fact fraudulent. If the mortgage was properly recorded, oral evidence proving an agreement between the parties to apply the proceeds to the mortgage debt would be entertained.[10]

In *Miller v. Scarbrough*,[11] the court abruptly reversed its position and announced that evidence of oral collateral agreements would no longer be entertained. Instead, a double burden—as was applied by the trial court in the *Young* case—has been placed on those who wish to do inventory financing. First, the terms of the agreement are required to be in the mortgage instrument *itself*. Second, the mortgagee has a duty to see that the mortgagor complies with the terms of the mortgage and properly applies the proceeds of sale to the mortgage debt. Nothing short of fulfilling these requirements has been sufficient to create a valid mortgage[12] until *Young*. In the *Young* case the court appears to have relaxed the second of these requirements, stressing that the validity of shifting stock mortgages should depend upon notice and fraudulent intent; not on strict enforcement of accounting provisions.

Like many other courts, the Washington court at an early time un-

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itself should provide the manner of maintaining and handling the stock, with provisions for an accounting and payments on the mortgage debt from the proceeds of the sale, after allowing for the expenses of the business and of the keeping up or building up thereof, to the end that creditors can, by an examination of the record, discover the real terms and obligations of the mortgage."

[7] Wineburgh v. Schaer, 2 Wash. Terr. 328, 5 Pac. 299 (1884). The court held invalid a mortgage which left the mortgagor in possession but intimated that a mortgage in which the proceeds were used to extinguish the debt would be valid. Langert v. Brown, 3 Wash. Terr. 102, 13 Pac. 704 (1887), expressly held that such a mortgage was valid. See cases cited in Kerr, *supra* note 2, 199 n.2.

[8] 2 Glenn, Fraudulent Conveyances & Preferences §§ 589, 590 (rev. ed. 1940). Glenn calls it the New York rule—the arrangement is fraudulent because the mortgagee in holding the mortgagor out as the ostensible owner, gives the mortgagor false credit which is a fraud on the creditors.

[9] 108 Wash. 646, 185 Pac. 625 (1919).

[10] Warren v. His Creditors, 3 Wash. 48, 28 Pac. 257 (1891); Ephraim v. Kelleher, 4 Wash. 243, 29 Pac. 985 (1892). In this case an oral agreement that the mortgagor could sell the goods, replace the stock, pay business expenses, and apply the balance to the debt—terms similar to those in the *Young* case—was approved.

[11] 108 Wash. 646, 185 Pac. 625 (1919).

[12] *E.g., In re* McLean, 270 Fed. 348 (W.D. Wash. 1920); General Mercantile Co. v. Waters, 127 Wash. 481, 221 Pac. 299 (1923); Spokane Merchants Ass'n v. Mussellman, 134 Wash. 116, 234 Pac. 1033 (1925); Tahoma Fin. Co. v. Shannon, 138 Wash. 90, 244 Pac. 271 (1926); Warner v. Hibler, 146 Wash. 651, 264 Pac. 423 (1928).

questioningly[13] followed the mistaken trend begun by *Twyne's Case*[14] and extended by *Benedict v. Ratner*.[15] These courts viewed suspiciously, as a fraud on creditors, any transaction in which the mortgagor retained all the apparent incidents of ownership by remaining in possession with power to sell and use the proceeds. Once committed, some courts unwaveringy continued to follow this position although systems of recording developed and the concepts of financing expanded.

In *Miller v. Scarbrough*,[16] the Washington court indicated that its purpose in requiring that the terms of the accounting agreement be included in the mortgage instrument and that the mortgagee exact compliance with them was to protect the mortgagor's creditors from fraud.[17] It is questionable whether these requirements serve their intended purpose in modern times. While they continue to function as ground rules, policing rules are now out of date, are a hindrance to financing,[18] and do not provide protection for creditors. "[T]he rendering of a monthly account, as between mortgagor and mortgagee, would neither decrease the mortgage debt nor apprise the general creditors of its status."[19]

Now that inventory financing is common, general creditors can no longer assume that inventory is free of lien, especially when an examination of the public records would reveal many inventory mortgages.[20] In fact, creditors nowadays generally neither rely on the public records nor trust that the mortgage has been policed. On the contrary, creditors rely either on their own judgment of the debtor's solvency or on credit ratings.[21]

Many writers feel that the courts' failure to keep pace with expanded concepts of inventory financing has placed an undue restriction on

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[13] Wineburg v. Schaer, 2 Wash. Terr. 328. 5 Pac. 299 (1884). "The cases upon each side of the question [whether inventory mortgages with mortgagor in possession and with power to sell is valid] . . . were ably discussed and illustrated by counsel upon both sides. If we were at liberty to do so, it would be profitable to take up these cases, and attempt to extract from them the rule upon the subject that seems to be most consonant with sound reason. We are stopped on the threshold of the investigation, however, by an authority of such great weight, that it would have great force with the Court of any State where the question was still an open one; and that, as to this Court, is binding and authoritative." *Id.* at 334, 5 Pac. at 300.

[14] 3 Co. Rep. 80 b (1601).

[15] 268 U.S. 353 (1925).

[16] 108 Wash. 646, 185 Pac. 625 (1919).

[17] *Id.* at 651, 185 Pac. at 626.

[18] Note, *Policing Accounts Receivable and Inventory Under Modern Factor's Legislation*, 101 U. PA. L. REV. 392, 401 (1952).

[19] United States Rubber Co. v. Young, 57 Wn.2d 686, 689, 359 P.2d 315, 317 (1961).

[20] Note, *Policing Accounts Receivable and Inventory Under Modern Factor's Legislation*, 101 U. PA. L. REV. 392, 401 (1952).

[21] Cohen & Gerbes, *Mortgages of Merchandise*, 39 COLUM. L. REV. 1338 (1939); Dunham, *Inventory and Accounts Receivable Financing*, 62 HARV. L. REV. 588 (1949).

needed economic growth.[22] The problem has been alleviated somewhat by the use of pledge and trust arrangements, and by legislation.[23]

In approving the conditional sales contract in Washington at an early time, its usefulness was balanced against the need to protect third parties.[24] The conflict was resolved by requiring filing and recording only.[25] Subsequently, with the requirement of policing omitted, legislative protection was also given to inventory financing's second cousin, the assignment of accounts receivable.[26] Finally, two other forms were adopted: field warehousing[27] and trust receipts.[28] Unfortunately, these are limited in use. Field warehousing is best adapted to manufacturing situations and the Uniform Trust Receipts Act has been construed to apply primarily to tripartite transactions.[29]

It is anomalous that these methods of financing should receive legislative support while inventory financing should be kept from full-share participation because of the Washington court's failure to abrogate archaic judge-made rules. Inventory financing has been penalized by the *Miller* rule under which the failure to police the proceeds results in loss of the entire lien. In contrast, the underlying theme of the correlative legislation is to sustain the lien, if correctly filed, and to allow loss of the unpoliced collateral only.[30] Thus, the lender does not risk invali-

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[22] Kerr, *supra* note 2; Cohen & Gerbes, *supra* note 21; Dunham, *supra* note 21; Shattuck, *Secured Transactions, (Other than Real Estate Mortgages)—A Comparison of the Law in Washington and the Uniform Commercial Code, Article 9,* 29 WASH. L. REV. 1 (1954); Comment, UNIFORM COMMERCIAL CODE § 9-205; Note, *Policing Accounts Receivable and Inventory Under Modern Factor's Legislation,* 101 U. PA. L. REV. 392 (1952); Kripke, *The "Secured Transaction" Provisions of the Uniform Commercial Code,* 35 VA. L. REV. 577 (1949).

[23] The states having Factors Lien Acts or adopting the UNIFORM COMMERCIAL CODE are current examples. Under UNIFORM COMMERCIAL CODE Section 9-205, specific accounting provisions are abolished. Washington's Accounts Receivable Act, RCW 63.16, is another example where the legislature has abolished policing requirements.

[24] "As between the vendor and a third party who has been misled, the law has taken into consideration not merely the objective incidents such as use and possession, but in addition the balance of social, particularly business, convenience to vendors and third parties generally. Sometimes the third party is protected; sometimes the vendor. In the case of the conditional sale, the vendor was with few exceptions protected at common law, the rationalizations of estoppel, apparent ownership, and constructive fraud being urged in vain. With the intention of protecting both the vendor and the third party, so far as possible. resort was made to recording and filing acts for the purpose of giving knowledge to third parties." Comment, *Conditional Sales—Recent Legislation, Particularly Where Personalty is Attached to Buildings on Realty,* 13 WASH. L. REV. 46, 47 (1938).

[25] RCW 63.12.

[26] RCW 63.16.

[27] RCW 22.04.

[28] RCW 61.20.

[29] Skilton, *The Factor's Lien on Merchandise,* 1955 WIS. L. REV. 356. 361.

[30] RCW 63.16.080 provides: "Irrespective of acquiescence, consent or permission by assignee, no act or omission (including the exercise of dominion and control), by the assignor with respect to an assigned account, the proceeds thereof, or goods sold and

dation of his entire lien by choosing not to police his collateral, but loses only the unpoliced proceeds.[31] This adequately protects the creditor by forcing the lender to police for business reasons, yet does not harmfully deter the growth of inventory financing.

The latter approach is the position taken in the Uniform Commercial Code,[32] which has been accepted in sixteen states and which appears to be near adoption in several other states. In attempting to remove the obstacles to inventory financing, the policing formalities of *Twyne's Case*[33] and *Benedict v. Ratner*[34] have been expressly rejected, leaving the extent of the accounting to the dictates of business, not legal necessity.[35]

Results similar to those achieved by use of the Uniform Commercial Code have been reached in the thirty-one states adopting various factor's acts, which have found increasing popularity since World War II.[36] The factor's preferred position began in colonial days when American factors lent money to their English manufacturers for goods shipped to them, and were given a lien by the court, on all goods in their

returned, shall invalidate the right or lien of the assignee upon any balance remaining owing on any such account or on any other assigned account." RCW 63.12.030 provides: "No such assignment shall be deemed invalid as against creditors and subsequent purchasers, pledgees, mortgagees and encumbrancers of assignor by reason of failure of any assignee to assume dominion and control over any such contract so assigned or the proceeds thereof, or to contract against or to prevent the mingling by assignor of the proceeds thereof or collections therefrom amongst his funds or placement of the same in his bank account." RCW 61.20.100 provides: "... the entruster shall be entitled, to the extent to which and as against all classes of persons as to whom his security interest was valid at the time of disposition by the trustee, as follows: .... (3) To any other proceeds of the goods, documents or instruments which are identifiable, unless the provision for accounting has been waived by the entruster by words or conduct . . . ."

[31] Shattuck, *supra* note 22; Dunham, *supra* note 21.

[32] "A security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use or dispose of all or part of the collateral ... or to use or dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral." Comment, UNIFORM COMMERCIAL CODE Section 9-205.

[33] 3 Co. Rep. 80 b (1601).

[34] 268 U.S. 353 (1925).

[35] "The principal effect of the *Benedict* rule has been, not to discourage or eliminate security transactions in inventory and accounts receivable—on the contrary such transactions have vastly increased in volume—but to force financing arrangements in this field toward a self-liquidating basis. Furthermore several Circuit Court cases drew ... from ... [that] opinion ... needless and costly formalities .... The requirements of "policing" is the substance of the *Benedict* rule. While this section repeals *Benedict* in matters of form, the filing requirements ... give other creditors the opportunity to ascertain from public sources whether property of their debtor or prospective debtor is subject to secured claims .... [Thus] business, and not legal reasons will determine the extent to which strict accountability, segregation of collections, daily reports and the like will be employed." Comment, UNIFORM COMMERCIAL CODE Section 9-205.

[36] Note, *Ohio Chattel Mortgages and the Factors Lien Law In Inventory Financing*, 28 U. CINC. L. REV. 99, 101 (1959).

possession, actual or constructive.[37] The more recent acts classify anyone who loans money for merchandise as a factor, and by requiring public notice of the intent to do factoring, provide the requisite "possession" over the merchandise. By not being misclassified as a chattel mortgage (and, thus, sharing its burdens), factoring arrangements have enjoyed the same freedom which other forms of financing have enjoyed.[38]

Several states,[39] by legislation, have solved the dilemma in which Washington mortgagees now find themselves. These acts provide that, upon filing a description of inventory financing, mortgages made within a prescribed subsequent period are valid. Creditors and subsequent mortgagees may demand information from the mortgagee concerning the exact property and the amount of the debt remaining.

Thus, it would seem that de-emphasis of the accounting requirement and stressing publicity is the better view. Perhaps, in *United States Rubber Co. v. Young*[40] conversion to this view has taken place. However, the position the court intends to take is not clearly stated. Although the *Miller* requirements had always been construed strictly, the court said, "It is not necessary that all of the proceeds from sales should be applied on the debt, *or even all of the net proceeds,* but the agreed terms of payment must be set forth."[41] (Emphasis added.) The court appears to say in *Young* that the mortgagor and the mortgagee may agree to *any* terms and, except for fraudulent reasons, the mortgage will remain valid. This would lead to two conclusions: first, the *Miller* requirements no longer serve a useful purpose except as ground rules, and second, the present test is one of actual fraud. "We think this court has set forth the correct rule . . . that such a mortgage is valid as against general creditors, in the absence of a showing of actual fraud. A mere failure to demand and enforce strict performance is not fraud in itself."[42]

Even though *Young* may indicate a more liberal trend in Washington, as one writer believes,[43] the attorney will be taking a risk if he changes his past procedures. It must be remembered that the court cited verba-

[37] For the development of factoring and its history see Skilton, *The Factor's Lien on Merchandise,* 1955 WIS. L. REV. 356.

[38] *Id.* at 357.

[39] COLO. REV. STAT. ANN. § 20-2-8 (1953); N.Y. LIEN LAW 32 § 230(c) (Supp. 1961); N.J. STAT. ANN. 46:28-5.1.

[40] 57 Wn.2d 686, 359 P.2d 315 (1961).

[41] *Id.* at 689, 359 P.2d at 316.

[42] United States Rubber Co. v. Young, 57 Wn.2d 686, 690, 359 P.2d 315, 317 (1961).

[43] Moore, *Developments in Factoring, Inventory Liens and Accounts Receivable Financing,* 16 BUS. LAW. 818, 825-26 (1961).

tim the *Miller* rule, and thus reaffirmed its past position. Since one can not be certain what *Young* may stand for, the following conclusions should be drawn:

1. Because the court has not seen fit to explicitly overrule *Miller v. Scarbrough*,[44] to file valid mortgages on shifting stocks, the attorney must continue to follow the *Miller* requirements and include the requisite provisions within the mortgage itself.

2. The entire mortgage will be found invalid if the mortgagee fails in his duty to see that the mortgagor complies with the mortgage terms, whereas, in other types of financing, *e.g.*, accounts receivable, mere loss of collateral results.

3. It is still uncertain whether anything except business expenses may be taken from the proceeds, although it appears that the court's concept of what constitutes a business expense has broadened.[45]

4. Although the court indicated that the accounting might be something less than a strict accounting, *e.g.*, a business accounting geared to each situation, it would be wise, to prevent future litigation on the question of fraud, to continue the practice of strict accounting as in the past.

It should be hoped that the future will hold more flexibility for inventory financing. Recording statutes, credit ratings, and other procedures are available to protect creditors. The court should continue to promote inventory financing by discarding needless rules which hamper financing[46] and should resolve the confusion caused by the contradictory positions stated in the *Young* case. However, until it does, a wait-and-see attitude will be necessary.

JOHN E. IVERSON

Priority—Federal Tax Liens and Future Advance Mortgages. In *American Surety Co. v. Sundberg*[1] the Washington Supreme Court

[44] 108 Wash. 646, 185 Pac. 625 (1919).

[45] In *Young*, for example, the court allowed the deduction of Young's personal living expenses, which in this situation was necessary to the business because Young, who devoted his entire time to the business, was unsalaried. U.S. Rubber's argument that, under Income Tax definitions, personal expenses could not be business expenses did not persuade the court. The court realized that in a sole proprietorship business—where salaries are not usually received—it is to the creditor's benefit that the owner be able to devote all his time to making profits rather than using part of it to earn income to meet his personal expenses.

[46] "...the result is that one who extends credit to a merchandiser and attempts to protect himself by a mortgage on a shifting stock of goods as security, even though he complies with the recording statutes, becomes an insurer of the mortgagor's performance of the contract. Such a liability would render the security valueless." United States Rubber Co. v. Young, 57 Wn.2d 686, 689-90, 359 P.2d 315, 317 (1961).

[1] 158 Wash. Dec. 335, 363 P.2d 99 (1961).