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Sales--Trust Receipts in Automobile Financing

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SALES—TRUST RECEIPTS IN AUTOMOBILE FINANCING.—The increased use of the trust receipt for financing domestic sales transactions, particularly in the automobile industry, has placed upon the courts the necessity of making the formal differences between trust receipts on the one hand, and pledges, conditional sales, and chattel mortgages on the other,¹ recognize the transaction as an exception to the rule of policy underlying the Statute of Elizabeth,² by which separation of title from possession is held either evidence of fraud or fraudulent *per se*; or shall they refuse thus to uphold a secret lien, by the use of which the chances for deception are as great as in the case of an unrecorded chattel mortgage, *etc*?

“The financing agencies defense is that credit today is not given on the basis of apparent chattel assets, but on a financial statement, which shows the facts. Further, that this type of financing has grown so common in the auto line that there, as in importing, all prospective creditors take account of it. The opposing argument turns partly on the number of insolvencies in that line: partly on the fact that it is precisely the dealer who is in financial stress whose financial statement is unreliable, partly on

¹ (a) The security of a pledge depends on possession in the party secured, and when possession is lost the security is lost. Title is assumed to be in someone other than the pledgee. In a trust receipt the pledgee has title and not possession.

(b) In a conditional sale the vendor cannot retake possession until a default; he is interested in selling goods as a business and in case of a breach the vendor sues for breach of contract in failing to buy and pay for goods. Conversely the holder of a trust receipt can retake possession of the goods at any time from the receptor; he is not interested in selling goods and if the loan is not repaid he sues for money loaned.

(c) Historically a mortgage is a security dependent on title as distinguished from a pledge which rests on possession. A chattel mortgage as generally understood means a conveyance of property by a borrower as security for his own obligation and the policy of the recording acts is directed at the apparent ownership based on previous and continued possession by such borrower of property which formerly belonged to him. “The trust receipt is distinguishable”, says Mr. Frederick, “because title does not pass to the holder of the trust receipt from the receptor, but rather from the manufacturer-seller”. Frederick, *The Trust Receipt as Security* (1922) 22 COL. L. REV. 395, 546. Therefore at the time the financing agency's rights are fixed the dealer has had neither possession nor title.

² 13 Eliz., c. 5 (1571). The statute recites that gifts of land and goods to defraud creditors are “more commonly used and practiced in these days than hath been seen or heard of heretofore” and enacts that such conveyances shall be void as against creditors whose actions are thereby defeated or delayed. “How was such fraudulent intent to be proved? The courts adopted the practice of inferring fraud as a matter of law from certain facts, whether or not there was any actual intent to deceive. One characteristic from which fraud was presumed was separation of title from possession. HOLDSWORTH, A HISTORY OF ENGLISH LAW (1924) Vol. 4, 480.

the relatively simple filing or recording procedure with single identifiable chattels of value, as contrasted with fungibles losing their identity in manufacture, which are the typical importing case."³ The present financing agent is often a subsidiary corporation of the seller-manufacturer organized expressly to finance the sale of the product to dealers and consumers, in which case the credit is *in fact* the credit of the manufacturer. Thus relief of credit strain on the seller is a necessity that often cannot now be urged to the courts as a reason for upholding trust receipts.

In the typical transaction the financing agency receives the bill of lading, with sight drafts for ten or twenty per cent attached, direct from the manufacturer. At about the same time the manufacturer executes and delivers to the financing agency a bill of sale for the autos. The dealer then pays the sight draft, signs a note for the remainder of the purchase price, executes a trust receipt, and receives the bill of lading. The trust receipt is in use in West Virginia as a method of financing automobile dealers. The effect of peculiar local law is hereinafter considered.

Upon the delivery of the bill of lading the troubles of the financing agency may begin. West Virginia has not adopted the Uniform Bills of Lading Act, by which a dealer in possession of a negotiable bill of lading may mortgage, pledge, or sell such bill, or deliver it in payment of, or as security for, an existing obligation, and defeat the financing agency's title as to any transferees in good faith. Due to the size and geographical location of our cities, making unnecessary local distributors, shipments of cars involved will usually be interstate shipments, and the Pomerene Act, based on the Uniform Bills of Lading Act, will apply and protect innocent purchasers, *etc.* of the bills. The financing agency will therefore be vulnerable until the bill of lading is spent; unless a non-negotiable bill of lading is used, or the dealers power to deal with the bills is restricted by the endorsement on it by the financing agent.

The Uniform Warehouse Receipts Act,⁴ in effect in West Virginia, places the same power in the hands of a dealer who holds a negotiable warehouse receipt, if power to warehouse the goods is express or can be implied.⁵

Let us assume, however, that the dealer takes the cars to his show-room and places them on display. The financing agency's

³ LLEWELLYN, CASES AND MATERIALS ON THE LAW OF SALES (1930) 764 ff.

⁴ W. VA. REV. CODE (1931) c. 47, art. 5.

⁵ G. M. A. C. v. Sharp Motor Sales Co., 25 S. W. (2d) 405 (Ky. 1930).

title may be defeated by the sale to a buyer who relies on the dealer's apparent ownership, and pays value without notice, even though such sale was expressly forbidden by the trust receipt.⁶

It seems the financing agency's interest may also be defeated if an attempt is made to protect it by means of a recorded chattel mortgage. In *Boice v. Finance and Guaranty Corporation*,⁷ a recent Virginia case, the dealer secured a loan from the financing agency to meet a draft on cars purchased, and in return executed a note and a chattel mortgage which expressly provided that if the dealer should attempt to sell, secrete, convert, or remove the property without the written consent of the financing agency that the financing agency might immediately take possession of the property. The mortgage was duly recorded. The dealer placed the cars in his show-room, later sold one of them for cash to Boice, who had no *actual* notice of the mortgage. In an action of detinue brought by the financing agency the Supreme Court of Appeals of Virginia held that "property bought for the express purpose of daily indiscriminate sale to the general public, exposed for such sale at the place of business of a licensed dealer, and over which the dealer is permitted to exercise the dominion of owner, cannot be made the subject of a valid chattel mortgage, regardless of its size, value, or capacity for identification." The financing agency is estopped to exercise its power to take possession.

Although the common law rule seems to have been that a factor could not make a valid pledge his power has been enlarged by statute in New York and Massachusetts, thereby diminishing the protection afforded by trust receipts in those jurisdictions.⁸ A

⁶ *Jones v. Commercial Invest. Trust*, 64 Utah 151, 228 Pac. 896 (1924); *Glass v. Continental Guaranty Corp.*, 81 Fla. 687, 88 So. 876 (1921); *Simons v. N. E. Finance Corp.*, 171 N. E. 643 (Mass. 1930).

⁷ 127 Va. 563, 102 S. E. 591 (1920).

⁸ MCKINNEY'S CON. LAWS OF N. Y. (1917) Vol. 7, Book 40, § 43; MASS. GEN. LAWS (1921) Ch. 104, §§ 1-6. "Every factor or other agent entrusted with a bill of lading, warehouse receipt, or possession of any merchandise for the purpose of sale . . . shall be deemed to be the true owner thereof, so far as to give validity to any contract made by such agent with any other person for sale or disposition . . . of such merchandise, for any money advanced or negotiable instrument or other obligation in writing given by such other person upon the faith thereof". The purpose of the act has been defined as being "to protect persons dealing in good faith with the apparent owners of property . . . and to make certain the general common law rule, that, where one of two innocent persons must suffer loss, such loss shall be born by him who placed the third person in the position which enabled him to do the act causing the loss." *Dorrance v. Dean*, 106 N. Y. 203, 12 N. E. 433 (1887). See as to effect in trust receipt cases, *Frederick, The Trust Receipt as Security* (1922) 22 COL. L. REV. 546-549 and cases cited.

similar result would seem to be effected in West Virginia and Virginia by virtue of what are called the Traders Acts,⁹ which provide that "if any person shall transact business as a trader, with the addition of the words 'factor,' 'agent,' 'and Company,' or 'and Co.' and fail to disclose the name of his principal or partner. . . . or if any person transact business in his own name, without any such addition all the property, stock, and choses in action acquired or used in such business shall, as to the *creditors* of any such person, be liable for his debts." Our court has held that the placing of autos in the hands of a dealer, with limited power of sale, comes within the Act and the *levying creditor* will be protected.¹⁰

In the common law trust receipt transaction it seems clear there is a power in the dealer, either express or implied, to sell, for it is out of the dealer's ultimate sale that the debt will be liquidated and he will make his profit. The Uniform Conditional Sales Act provides that "When goods are delivered under a conditional sales contract and the seller expressly or impliedly consents that the buyer may resell them prior to performance of the condition the reservation of property shall be void as against purchasers, *etc.*"¹¹ Goods put into the retailer's stock with the consent of the wholesaler are treated as conclusive evidence that they are there for sale and that the retailer has title or the right to convey.¹²

Other states have shown a tendency to bring the transaction within the terms of a recording act, and place the loss on the financing agency. An Iowa case where the trust receipt authorized sale if the proceeds were applied to the financing agency's account holds that although the transaction is in the nature of a conditional sale a purchaser must be *without notice* of the unrecorded trust receipt.¹³ A financing agency holding a trust receipt is pro-

⁹ W. VA. REV. CODE (1931) c. 47, art. 7, § 1; VA. CODE ANN. (1930) §5224.

¹⁰ *Midland Invest. Corp. v. May*, 104 W. Va. 289, 140 S. E. 5 (1927).

¹¹ W. VA. REV. CODE (1931) c. 40, art. 3, § 9. It is interesting to note in this connection that prior to the adoption of the revised code the section of the conditional sales act applicable, Acts 1925, c. 64, § 9, differed from the Uniform Conditional Sales Act in that it provided "When goods are delivered under a conditional sales contract, *trust receipt, or reservation of title, the buyer shall not sell or otherwise dispose of such goods or chattels without the expressed permission in writing of the holder of the conditional sales contract, reservation of title, or trust receipt. Upon securing such permission in writing the buyer may resell such goods or chattels prior to performance,*" *etc.* Such variation was omitted by the revisors, and the section is now identical with the corresponding section of the Uniform Conditional Sales Act.

¹² *ESTRICH, INSTALLMENT SALES* (1930) 998 and cases cited.

¹³ *Ohio Savings Bank and Trust Co. v. Schneider*, 202 Iowa 938, 211 N. W. 248 (1926).

ected against one having *actual notice* even if the trust receipt is unrecorded, and held to come within the terms of a recording statute.¹⁴

In California a trust receipt was held to be a conditional sale, and as unrecorded a transfer by the dealer to a salesman in the ordinary course of business divested the financing agency's title.¹⁵

That the proper use of the trust receipt as a *reservation* of title by the financing agency is even yet not clearly understood is shown by a Texas case where the court refused to protect the agency as the dealer had executed the trust receipt a month after he had received the cars from the manufacturer.¹⁶ In a recent Nebraska case a *dictum* of the court holds that a trust receipt is neither a chattel mortgage, absolute sale, conditional sale, nor lease, and is, therefore, exempt from recording act provisions.¹⁷

Clearly the trust receipt transaction is valid between the parties thereto, but what effect will the dealer's bankruptcy have on their respective rights? In the recent case of *Houck v. G. M. A. C.*¹⁸ the financing agency, by virtue of a trust receipt retook seven cars from the dealer within four months of his voluntary petition in bankruptcy. The court limited the status of the dealer's trustee in bankruptcy to that of a creditor holding a lien by legal or equitable process at the time when the petition in bankruptcy was filed, and not prior thereto, and held the retaking not to amount to a preference under the Bankruptcy Act.

Similarly, under the Kansas conditional sales recording act, which prefers a creditor of the vendee who claims a lien on the property by legal process prior to recording, a conditional vendor who had recorded his contract shortly before the filing of the vendee's petition in bankruptcy, was protected.¹⁹ Since the status of the trustee as lien creditor dates from the time of filing, it seems obvious that a recording thereafter would not protect the conditional vendor. Doubtless the same results would be reached in West Virginia for the courts expressly recognize the fact that the effect of the trust receipt is to be determined by the statutes and

¹⁴ Commercial Credit Co. v. Schlegel-Storseth Motor Co., 23 S. W. (2d) 702 (Tex. 1930).

¹⁵ Commercial Accept. Trust v. Bailey, 87 Cal. App. 117, 261 Pac. 734 (1927).

¹⁶ Carrollton Acceptance Co. v. Wharton, 22 S. W. (2d) 985 (Tex. 1930). See also Hartford Accident & Indemnity Co. v. Callahan, 171 N. E. 820 (Mass. 1930).

¹⁷ G. M. A. C. v. Hupfer, 113 Neb. 228, 202 N. W. 627 (1925).

¹⁸ Houck v. G. M. A. C., 44 F. (2d) 410 (W. D. Pa. 1930).

¹⁹ Baker v. Bailey Ice Mach. Co., 239 U. S. 268, 36 S. Ct. 50, (1915).

decisions of the state where the transfer is made, and our statute on the point is similar to that of Kansas.²⁰

Suppose, however, the dealer has sold the car? A Virginia case holds that the payment, within the four months period, of the proceeds of the sale of an auto, covered by a trust receipt, to the financing agency constitutes an unlawful preference when the dealer was at the time insolvent and had an intention to prefer the agency of which the latter had reasonable cause to be aware.²¹ In such case the holder of the trust receipt has permitted the dealer to dispose of his security title, and he becomes in exchange a creditor, thus losing the special rights which he retained as the holder of a trust receipt.

Although the courts have not been in accord in their classifications of the transaction, they have disregarded the camouflage of paper title and protected bona-fide purchasers who have relied on an automobile dealer's apparent ownership to their detriment. Creditors of such dealers, to be protected, must attach a lien by legal process, or petition the dealer into bankruptcy.²²

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²⁰ W. VA. REV. CODE (1931) c. 40, art. 3, § 9.

²¹ *Nusbaum v. City Bank & Trust Co.*, 132 Va. 54, 110 S. E. 363 (1922).

²² THE FIFTH DRAFT OF A UNIFORM TRUSTS RECEIPTS ACT, 1930, requires recordation to protect the lender against creditors and purchasers. See Handbook of the National Conference of Commissioners on Uniform State Laws, 1930, p. 272, §§ 6-8, 13-15. For a presentation of the arguments against requiring recordation see Hanna, *Trust Receipts* (1931) 19 CAL. L. REV. 257.