INTER-STATE PROBLEMS IN SECURITY TRANSACTIONS

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The problem to be discussed concerns the conflict in the rights, on the one hand, of a creditor, who by reserving title in a conditional sales contract or by taking back a purchase money mortgage as security for a credit advance, obtains a security interest in a chattel, and the rights, on the other hand, of an innocent purchaser for value of that chattel, who has bought it in another state to which the chattel has been removed by the debtor unlawfully and without the consent of the holder of the security interest. A typical fact situation would be the following:

X, while residing in the State of A (hereinafter in this article called the "Contract State") buys a chattel from the Y Company on the instalment plan. To secure the balance of the purchase price, the Y Company either reserves title under a conditional sales contract or takes back a purchase money chattel mortgage. The Y Company either records the instrument or does whatever is necessary under the laws of the Contract State to perfect its security interest as against purchasers for value from X. Before X completes his instalment payments and without the consent or knowledge of the security interest holder, X wrongfully removes the subject chattel to State B (hereinafter in this article called the "Removal State") and there sells the chattel to Z, an innocent purchaser for value. Not receiving the payments still due under the contract, the Y Company, tracing X and the chattel to the Removal State, seizes the chattel there and contends that its security interest prevails over the rights of Z, the innocent purchaser. To whom should judgment be given?

To avoid repetition, unless the context shows otherwise, the term "security interest holder", when used in this discussion, will mean a party who advances credit and by contract with the debtor in the Contract State obtains a security interest in a chattel which, under the laws of the Contract State, he perfects as against innocent purchasers from the debtor, the chattel remaining in the possession of the debtor. The term "innocent purchaser" will mean a party who for value purchases the chattel from such debtor in the Removal State to which the debtor has brought the chattel unlawfully, and without the consent of the security interest holder.

The Restatement[1], reflecting prevailing opinion throughout the United

[1]American Law Institute, *Restatement of Conflict of Laws*, Chap. 7, Secs. 265-269.

States (44 states)[2], provides in substance (1) that the validity of the security interest is to be determined by the laws of the Contract State not only as between the original parties to the contract, but also as against third persons acquiring interests in the Removal State; and (2) that the security interest prevails regardless of failure to follow the local law procedures in the Removal State for perfecting like security interests created therein.

While the Restatement does not use the expression, the opinions of the courts frequently base the rule specifically on the principles of comity. A typical opinion is that of *Shapard v. Hynes*[3], where the court says:

"There has been much discussion concerning the effect of the removal of mortgaged goods and chattels from the state where the mortgage was made and recorded, to another state. The general consensus of judicial opinion seems to be that when personal property, which at the time is situated in a given state, is there mortgaged by the owner, and the mortgage is duly executed and recorded in the mode required by the local law, so as to create a valid lien, the lien remains good and effectual, although the property is removed to another state, either *with or without* the consent of the mortgagee, and although the mortgage is not rerecorded in the state to which the removal is made. The mortgage lien is given effect, however, in the state to which the property is removed, solely by virtue of the doctrine of comity."

The courts holding the prevailing view, however, frequently seem not quite satisfied to rest their judgments wholly on the pure principle of comity. They will find, for example, that as between two innocent parties—the security interest holder and the innocent purchaser—the latter was "negligent" in not diligently pursuing his search for a possible out-state security interest encumbering the chattel.[4] Or, as in Florida, the statutes, as regards automobiles at least, place a burden of inquiry on the Florida purchaser, requiring him to obtain written assurance from the outstate recording authorities that no outstanding encumbrance exists, before he can claim to be an "innocent purchaser".[5] Another view, as expressed in one New York State opinion,[6] is in substance that while there is no rule of comity which requires New York State to subordinate its own public policy as to the creation of security interests in a chattel located in New York State to security interests arising by common law in another state,

[2]The Court so states in Mosko v. Mathews, 87 Colo. 55, 284 P.1021 (1930). But more than four states have from time to time upheld the rights of the innocent purchaser. For example, see

Union Securities Co. v. Adams, 33 Wyo. 45, 236 Pac. 513 (1925).
Turnbull v. Cole, 70 Colo. 364, 201 Pac. 887 (1921).
Bank v. Carr, 15 Pa. Super. 346 (1900).
Boydson v. Goodrich, 49 Mich. 65, 12 N.W.913 (1882).
Delop & Co. v. Windsor, 26 La. Ann. 185 (1874).
Consolidated Garage Co. v. Chambers, 111 Texas 293, 231 S.W.1072 (1921).
Farmer v. Evans, 111 Texas 283, 233 S.W. 101 (1921).
Judy v. Evans, 109 Ill. App. 154.

[3]104 Fed. 449, 452; 45 C.C.A. 271, 274; 52 L.R.A. 675.

[4]Motor Investing Co. v. Breslauer et al., infra, Note 16.

[5]Laws of Florida, Acts of 1953, Sec. 319.27 (3); followed in Vincent v. G.M.A.C., 75 So. 2d 778 (1954).

[6]Goetschius v. Brightman, 245 N.Y. 186, 156 N.E. 660 (1927).

nevertheless, if no specific provision of common law or statute in New York State provides for reperfecting a security properly created outside the state, in a chattel thereafter brought into New York State without the consent of the security interest holder, New York will consider its common law to be similar to the common law of the Contract State and will support the outstate security interest as though it were created in New York, thereby granting it extra-territorial validity not through comity but by reason of identical common law principles. Finally, it has been asserted that a security interest properly perfected in a Contract State becomes a "vested interest" which no Removal State may disturb, since to do so would be to violate the "full faith and credit" or "due process of law" causes of the United States Constitution.[7]

The architects of the Uniform Conditional Sales Act appear likewise not to have been wholeheartedly in favor of applying the rule of comity to every situation of the kind under discussion. For example, they provide that despite the removal of a chattel to a Removal State without the consent of a conditional vendor, the latter is nevertheless to have protection for his security interest in the Removal State, as against innocent purchasers in that state, only for a period of ten days after the conditional vendor acquired knowledge of the place of removal.[8]

After such ten-day period comity ceases; the security interest holder who wishes to have continued protection is required to rerecord his security interest in the Removal State.

The legislatures of some states have gone still further and favored the outstate security interest holder as against innocent purchasers for an arbitrary fixed period only, such as for four or six months after the chattel arrives in the Removal State, even though at the end of the time limit the security interest holder still is ignorant of the place of removal.[9]

The diversity of reasons given by courts and writers for upholding the rights of the outstate security interest holder as against the innocent purchaser creates the impression that they are moved by their views of social expediency rather than any well defined legal doctrine. Professor Stumberg, in his 1937 edition of *Principles of Conflict of Laws,* apparently came to this conclusion when he said at p. 366:

"A majority of the courts feel that preferences should be given the conditional vendor or mortgagees when the chattel is wrongfully removed from the state where it was originally sold and the law there has been complied with, because they think that it is better social policy to protect him against a person

[7]See 37 *Yale L.J.* 966, 968, citing E.M. Dodd, "The Power of the Supreme Court to Review State Decisions in the Field of Conflict of Laws" (1926) 39 *Harv. L.R.* 531; Cook, "The Logical and Legal Bases of the Conflict of Laws" (1924) 33 *Yale L.J.* 457; Lorenzen, "Territoriality, Public Policy and the Conflict of Laws" (1924) 33 *Yale L.J.* 736 Yntema, "The Horn Book Method and the Conflict of Laws" (1928) 37 *Yale L.J.* 468, 474 et seq., the consensus being that the constitutional clauses do not apply. But in Beale, "Jurisdiction Over Title of Absent Owner," 40 *Harv. L.R.* 805 (1927), the author seems to take a contrary view.

[8]Uniform Conditional Sales Act, Sec. 14.

[9]See Ayares Small Loan Co. v. Maston, 78 Ga. App. 628, 51 S.E. 2d 699 (1949), and the Georgia Statute followed therein.

who, although he is innocent, is claiming title through a wrongdoer whose wrongful act is beyond the effective control of the vendor or mortgagee. In other words, the point of view of a majority of the courts is that it is better social policy to further the security of credit transactions by protecting, under the circumstances, the holder of the lien."

But even if one suspects that the prevailing rule evidences a general sympathy for the plight of the financer, the rule is frequently abortive of that consideration since the conflict often arises between security interests obtained by two financers, (1) the outstate financer who advances credit for the original purchase, and (2) the instate financer who finances the innocent purchaser.

Whether the almost unanimous allegiance of the courts to the rights of an outstate security interest holder as against the rights of their own state citizen-purchaser is based on law or on social expediency, this viewpoint is astonishing to the writer since, in his opinion, the prevailing rule does not conform to well-established legal tradition, nor is it fair either intrinsically or in the light of the practical realities of modern chattel mobility.

The special application of the rule of comity, which so prevailingly gives protection to outstate security interest holders as against purchasers in the state to which the chattel is removed, seems to have been derived by many courts from a rule of conflict of laws respecting the validity and interpretation of contracts.[10] That is, when a contract is made in one state and the parties to the contract engage in litigation over the contract in another state, the forum will, for purposes of determining the validity and meaning of the contract, adopt the *lex loci contractus*.[11] This rule may be justified by arguing that the parties in entering into the contract had in mind the laws of the state in which they were contracting. Such laws became a part of the contract as though they had been expressly set forth in its terms. When, therefore, the *same* parties are later in legal conflict in another state in respect of the contract, their contractual intentions are properly and naturally spelled out in terms of the law of the state in which the contract was made. But though the logic may be cogent when applied to problems of pure contract, it loses all its force when it is sought to be applied by analogy to rights of property in a chattel created by contract in one state, where such rights are opposed to new interests in the chattel acquired in a removal state by a stranger to the original contract. It cannot be said that the stranger, for example an innocent purchaser of the chattel, had in mind or had any knowledge of the contract creating the security interest in the Contract State, or that he had any knowledge that such a security interest had in fact been created prior to the time of his purchase. Having neither notice nor knowledge of the security interest, the purchaser

[10]Stumberg, *Principles of Conflict of Laws* (2d Ed. 1951), citing Gross v. Jordan, 83 Me. 380, 22 A. 250 (1891). He states at p. 399: "The tendency of the cases has been to deal with problems of title arising between the seller and buyer as involving questions of contracts." 87 A.L.R. 298 (1933).
See also Thomas G. Jewett, Jr., Inc. v. Keystone Driller Co., 282 Mass. 469, 185 N.E. 369,

[11]Baxter National Bank v. Talbot, 154 Mass. 213, 216; 28 N.E. 163, 164. Central Nat. Bank of Washington v. Hume, 128 U.S. 195; 9 S.Ct. 41; 32 L.Ed. 370. Restatement of Conflict of Laws, Sec. 332.

scarcely can be claimed to have made his contract of purchase with regard to it, or the contract which created it.

It is no answer to assert, as some courts do, that by publicly registering the security interest contract in the Contract State, the security interest holder had given constructive notice to the world.[12] In the first place, it is generally held that constructive notice is limited only to the classes of persons specifically referred to in the recording act. For example, a recording of a chattel mortgage may by statute be constructive notice to a purchaser from the mortgagor. It is not constructive notice, however, to a stranger who deals with the mortgagor, for example, a tort feasor who settles with the mortgagor without actual knowledge of the mortgagee's interest.[13]

The writer has found no recording act which expressly provides that the constructive notice which is created by its application shall extend to purchasers outside the state. Indeed a state recording statute, inasmuch as it is a state statute, can apply only to parties within the state of its enactment.[14]

It should also be noted that the words "constructive notice" can have no sensible meaning unless they imply that the person constructively notified had it within his power to achieve actual knowledge of the facts by diligent examination of the pertinent public records.[15] But the innocent purchaser who buys a chattel located in his state, without knowledge that it has been previously removed from another state, cannot reasonably be expected to examine the public records except in the state where the chattel now is, and where the proposed seller resides. Assuming that he has diligently and properly made that examination, and, of course, has found no record of an outstate security interest, how can it be held fair or just to him to construe the outstate recording as notice to him, constructive or otherwise?

Some courts, disregarding the wrong done to the purchaser in the Removal State, base their decisions on the theory that to allow the purchaser to prevail would encourage fraudulent mortgagors and conditional vendees to move the subject chattel to a state where they could unlawfully dispose of the chattel free from encumbrances.[16] By giving judgment for the purchaser, say these courts, they would be making the Removal State a party to the fraud. They offer, as analogy, the case of a thief who steals a chattel from its true owner in one state and then sells it in another. Obviously, if the Removal State gave superior rights to the purchaser from the thief, it would, to that extent, be giving legal

[12]Smith v. McLean, 24 Iowa 322 (1868). Sims v. McKee, 25 Iowa 341 (1868). Ord National Bank v. Massey, 48 Kan. 762 (1892).

[13]Motor Finance Co. v. Noyes, 139 Me. 159, 28 A.2d 235 (1942). The contrary holding in Gibbes Machinery Co. v. Niagara Fire Ins. Co., 119 S.C. 1, 111 S.E. 805 (1922), is a minority view.

[14]Griffin, "The Effect of Foreign Chattel Mortgages Upon the Rights of Subsequent Purchasers," 4 *Mich. L. Rev.* 358, 359, taking the opposite view but citing for the view here taken: Montgomery v. Wight, 8 Mich. 142 (1860); Boydson v. Goodrich, 49 Mich. 65 (1882); Corbett v. Littlefield, 84 Mich. 35 (1890); Snyder v. Yates, 112 Tenn. 309 (1903).

[15]"A subsequent purchaser is charged with notice of an instrument only when, if he exercised proper diligence, he would, by searching the records, discover the existence and terms of such instrument." 2 Tiffany, *The Law of Real Property* (2d ed. 1920), at 2186. Cited with favor in Philbrick, "Limits of Record Search and Therefore of Notice," 93 *U. of Pa. Law Rev.* 125, 135.

[16]Motor Investing Co. v. Breslauer, 64 Cal. App. 230; 221 P. 700, 703 (1923).

encouragement to the thief. Such courts are, however, in error on two counts. In the first place, the analogy is ill-founded. The mortgagor or conditional vendee who sells the chattel to the innocent purchaser is not a thief. He has been given lawful possession of the chattel by the holder of the security interest. His sale is fraudulent, it is true, but not without some color of right. In the second place, courts have not shrunk from giving an innocent purchaser good title even though the purchaser acquired his rights from one who obtained title through fraud.[17] In such cases, the courts have not considered judgment for the second purchaser reprehensible as encouraging the fraudulent party to acquire his title by fraud.

If the adoption of the rule of comity, therefore, is not a satisfactory solution of the problem under discussion, is there any other well-established rule on which judgment could have been logically and fairly given in favor of the innocent purchaser? The writer thinks there is—the doctrine of ostensible ownership.

It must be obvious that the innocent purchaser relies on his seller's having good title because he has what seems to be free and unencumbered possession of the chattel. That possession was given to the fraudulent seller by the out-state security interest holder. The latter knew that the chattel was mobile and could easily be brought to another state where there would be no record of the security interest holder's rights over it. Nevertheless, he voluntarily permitted the debtor to have possession, thereby placing it within the debtor's power to take the chattel over the state border and there sell it to an innocent purchaser for value. As between two innocent parties, it is a matter of natural justice to hold against the one who by his act helps to bring about the situation which deceives the other innocent person. Many common-law and statutory pronouncements in relation to property rights have followed this principle. As far back as the reign of Queen Elizabeth I, Parliament upheld the principle by providing that a chattel mortgagee who left possession of the mortgaged chattel in the hands of the mortgagor lost his security interest as against a creditor of the mortgagor and as against a purchaser from him who had no actual knowledge of the security interest.[18]

It may well be that the rule of ostensible ownership is outmoded as against creditors, since creditors today either look to assets which are intangible and hence not logically subject to the rule, or they rely on other methods, such as credit reports, for the determination of the debtor's financial status. But the rule is still fair and logical when applied to the innocent purchaser whose sole interest is concentrated in the chattel he is buying which is in the possession of his prospective seller. In the absence of some feasible procedure by which he can make reasonably sure of that seller's title, he has the right to rely on the

[17] " . . . if, after the seller delivers possession to the buyer pursuant to a sale induced by the buyer's fraud, the property has passed into the hands of a bona fide purchaser for value, the right of the original seller to recover the property is lost." 46 Amer. Juris. Sec. 471, citing, among others: Baehr v. Clark, 83 Iowa 313, 49 N.W. 840; Hickey v. McDonald, 151 Ala, 497, 44 So. 201; Sinclair v. Healy, 40 Pa. 367, 60 Am. Dec. 51; Long v. McAvoy, 133 Wash. 472, 233 P. 930, 236 P. 806, 44 A.L.R. 483; Rice v. Cutler, 17 Wis. 351, 84 Am. Dec. 747.

[18] 13 Eliz. c. 5 (1570), 6 The Statutes at Large 268 and 27 Eliz. c. IV (1585), 6 The Statutes at Large 356.

seller's possession as tantamount to title, or at least as creating an agency to sell, in the nature of estoppel. This doctrine is implicit in that part of the Uniform Sales Act which provides that, if after a sale the buyer, having title, nevertheless allows the seller to retain possession of the chattel, the buyer will have his title defeated if the seller in possession resells to a second buyer.[19] It is the seller's mere retention of possession which gives the second buyer superior rights, undoubtedly because he relies on that posession as tantamount to title, or, at least, as indicating the seller's power to sell free and clear of the first buyer's rights. No person or court, so far as the writer knows, has ever criticized this provision on the ground that the statute, by validating the unlawful and unauthorized second sale, has encouraged the seller in possession to practice fraud. This statutory provision is, in the writer's opinion, a cogent indication of the instinctive feeling of fairness and justice in the doctrine of ostensible ownership as being equivalent to an estoppel against the party who, though having secret property rights in a chattel, permits another by his possession of the chattel to offer to the world the appearance of the chattel's freedom from encumbrance.

Had the courts in the problem under discussion applied the rule of ostensible ownership, instead of the rule of comity, the innocent purchaser would have been adjudged to have good title as against any security interest created in or out of the state of purchase, where the purchaser had no reasonable means, such as record search, for finding out about the outstanding security interest before he parted with his purchase money.

Had the courts, as the writer suggests, adopted the rule that possession implies ostensible ownership and placed the risk of loss on the holder of the security interest (who is for the most part, in modern times, a financial institution with sufficient wealth and power to make itself politically felt), a solution could have been found which would have been fair and practical for the preservation of the rights of both the innocent purchaser for value, on the one hand, and the security interest holder, on the other. This solution is the establishment of a national recording act providing for the registration in one central agency of all security interests in the United States. The idea of national central recordation is not new. It is now established and in practice in relation to the transfer of interests in airplanes,[20] ships,[21] patents,[22] and federal copyrights.[23] While the extension of this procedure to other more numerous security interests creates a larger administrative problem, the only practical difficulty is the size which such an agency must assume in order to be effective. With the currently available machines for handling voluminous detail, these administrative difficulties are not at all insurmountable.

In view of the present mobility of chattels (especially automobiles) covered by security interests, a solution of the problem in the manner the writer suggests is almost a matter of social necessity.

[19]Uniform Sales Act, Sec. 25.
[20]Federal Aviation Program (1958), 49 U.S.C.A. Sec. 1403.
[21]Ship Mortgage Act of 1920, 46 U.S.C.A. c. 25, Sec. 921.
[22]U.S. Patent Act, 35 U.S.C.A. Sec. 47.
[23]U.S. Copyright Act as amended (1947), 17 U.S.C.A. Sec. 30.