LAW101DL, COMMERCIAL LAW, Secured Transactions, Professor Widen **[draft-02-16-2020 | 12:30 pm]**

NOTES: CHAPTER 8, TEXT P. 543 and ff.

OUR STORE Acquires and Transfers Rights to Payment (Including Deposit Accounts)

The term "account", as used in Article 9 of the UCC includes a right to payment for the sale of a good or the provision of a service. An account arises when a creditor provides a service or sells a good to a debtor on unsecured credit. A sale on credit means that payment is not due at the time the service is provided or the good is delivered. When a creditor provides a service or sells a good to its customers on unsecured credit, the creditor is often said to be selling or servicing on "open account." A customary credit term you have learned about is "2% 10, net 30." A creditor who sells on "2% 10, net 30" is selling on open account. When the credit terms require payment within a fairly short period of time (such as 30, 60 or 90 days) parties typically do not incur the transaction costs to create any material documentation to evidence or memorialize the transaction. A debtor might send a purchase order and the creditor might ship goods together with an invoice. The debtor is not expected to further execute and deliver a note evidencing its obligation to make payment. Consider the following partial definition of "account"--

UCC s.9-102:

(2) "Account", except as used in "account for", means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered,. . .

The debtor who owes payment on a monetary obligation satisfying the definition of "account" is known as an "account debtor." In common business jargon, a right to payment constituting an "account" under the UCC definition is often referred to as an "account receivable" or simply as a "receivable."

When a creditor sells a good or provides a service on open account, the accounts created are property of the creditor. Accounts are an important financial asset of a business which the business may use as collateral to secure a loan from its bank or other lenders. An account is considered a near cash item because, in the ordinary course of business, the account will convert to cash in a short amount of time when the account debtor makes payment to its creditor (e.g. the business who sold it inventory). An account is not as secure an item of collateral as money or currency because there is always a risk that the account debtor will not pay (perhaps the account debtor will become insolvent or will dispute the amount owed or will have a defense to payment). For this reason, a bank or other lender typically will not loan a business an amount equal to the full face amount of its accounts. Rather, the lender will "haircut" the face amount of the pool of receivables by a discount rate--often 20%. Thus, the "advance rate" on the pool of accounts would be 80% if the haircut or discount rate is 20%.

Significantly, a number of important items are excluded from the definition of "account." One important exclusion from the definition of "account" is "rights to payment evidenced by chattel paper."

UCC s.9-102:

(2) ... The term does not include (i) rights to payment evidenced by chattel paper or an instrument, (ii) commercial tort claims, (iii) deposit accounts, (iv) investment property, (v) letter-of-credit rights or letters of credit, or (vi) rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge card or information contained on or for use with the card.

It might help to think of "chattel paper" as simply a secured version of an account generated by the sale of a good. If a creditor sells inventory on credit (typically making a loan for longer than 30, 60 or 90 days) it may require the debtor to sign a note evidencing the right to payment, together with a security agreement granting a security interest in the good sold to secure repayment. This note and security agreement, taken together, constitute "chattel paper". When credit is extended for a longer term, the risk associated with the longer payment term often justifies incurring the transaction costs to provide better evidence of the payment obligation and to provide security for that payment obligation. Confusingly, perhaps, the debtor on chattel paper also is known as an "account debtor" under UCC Article 9. Chattel paper is another important financial asset of a business which the business may use as collateral to secure a loan from its bank or other lenders. Note, however, that chattel paper is a broad definition which includes not only monetary obligations arising from the sale of goods on credit but also covers monetary obligations due for the lease of goods. As a financial matter, it is possible to structure transactions which differ in form (a sale versus a lease) but which have very similar economic terms. Also note that the term "record" is broad enough to include not only physical paper documents, but also electronic records which evidence chattel paper.

UCC s.9-102:

(11) "Chattel paper" means a record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods and license of software used in the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods. In this paragraph, "monetary obligation" means a monetary obligation secured by the goods or owed under a lease of the goods and includes a monetary obligation with respect to software used in the goods. The term does not include (i) charters or other contracts involving the use or hire of a vessel or (ii) records that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card. If a transaction is evidenced by records that include an instrument or series of instruments, the group of records taken together constitutes chattel paper.

(31) "Electronic chattel paper" means chattel paper evidenced by a record or records consisting of information stored in an electronic medium.

(79) "Tangible chattel paper" means chattel paper evidenced by a record or records consisting of information that is inscribed on a tangible medium.

A security interest in accounts as original collateral is, of necessity, perfected by filing a financing statement because accounts by their very nature are intangible. Perfection by possession is not an option for accounts. In contrast, a security interest in physical or "tangible" chattel paper may be perfected either by filing a financing statement or by taking possession of the paper records evidencing the chattel paper. A security interest in electronic chattel paper may be perfected by "control." Further, it is possible to note the existence of a security interest in the chattel paper by making a stamp or other mark or notation on the chattel paper. Specific rules govern the priority of conflicting interests in accounts and chattel paper.

Importantly, UCC Article 9 governs not only security interests in accounts and chattel paper BUT ALSO sales of accounts and chattel paper. In business jargon, a person who purchases accounts is often called a "factor" and the business practice of purchasing accounts is called "factoring". A factor purchases accounts at a discount--with the discount designed to cover credit losses as well as provide an investment return to reflect the time value of money (i.e. to function like interest on a loan secured by accounts). Similarly, chattel paper may be purchased. In form a sale of monetary obligations differs from a loan secured by monetary obligations--but the economic structure of the two transactions might be virtually identical. The key difference between a secured loan and a sale transaction is that, in a true sale transaction, the purchaser takes the credit risk of the account debtors. Such a sale is said to be made "without recourse". However, some sale transaction are made "with recourse" back to the seller if credit losses exceed the discount. UCC Article 9 does not attempt to distinguish between a true sale and a disguised secured financing--other law determines whether an actual sale took place. This is relevant in the case of a bankruptcy of the seller. In a true sale, the asset is no longer in the bankruptcy estate of the seller. The purchaser is free to collect the monetary obligations and apply the

proceeds despite the automatic stay. In a secured financing, the collections on the monetary obligations are property of the bankruptcy estate. However, under UCC Article 9, a transaction which is a sale of chattel paper (at least in form) may have priority over a transaction which is (at least in form) structured as a loan secured by chattel paper. See UCC s.9-330.

TEXT P. 544. 2. PROBLEMS: accounts and chattel paper

1. OUR STORE sells landscaping services and offers “affordable payment plans, including interest free credit.” Are its claims against current and former customers “accounts” or “chattel paper?”

Accounts. It does not matter that the monetary obligation arose from the provision of a service rather than from the sale of a good.

How can OUR STORE collect its claim if a customer does not pay?

Sue on the debt the customer owes. This is the basic collection procedure outlined at the start of Chapter 7 [TEXT P. 481, 1. SUE ON THE DEBT]

2. OUR STORE supplies food and tobacco products to convenience stores on credit. Is OUR STORE’s right to collect from its customers “accounts” or “chattel paper?”

Accounts. Here the payment obligation arose from the sale of a good, and not from the provision of a good. However, just because the monetary obligation arose from the sale of a good does not mean that the payment obligation is chattel paper.

Would your answer change if OUR STORE requires that all orders be in writing and signed by its customer?

No. It would be ordinary for an account debtor to send a written purchase order to a vendor/creditor and for the vendor/creditor to respond by shipping the goods, together with mailing an invoice.

3. OUR STORE manufactures and sells automotive lifts. If OUR STORE sells a lift on credit to OUR BUYER and retains a security interest in the lift, is OUR STORE's right to be paid by OUR BUYER an "account" or "chattel paper?"

Chattel paper. However, take care on these facts to make sure that the record or records evidence both a right to payment and a security agreement.

How can OUR STORE collect its claim if OUR BUYER does not pay?

Repossess and dispose of the collateral pursuant to Article 9, in addition to filing suit to collect the debt.

What if OUR STORE leases a lift to OUR BUYER?

Still chattel paper and can still go after the lift but how and on what authority depends on whether the deal is a true lease or a lease intended as security.

TEXT P. 546. 3.2 PROBLEMS: enforcement against the “account debtor” in accounts deals and chattel paper deals

1. OUR STORE sells furniture on credit. Some of its sales are unsecured; others are secured. OUR STORE wants to use its rights to payment from these sales as collateral for a loan. Who are the account debtors?

All of OUR STORE's customers are "account debtors." Go to the definition of "account debtor" in 9-102. Acknowledge that it might have been clearer if Article 9 had used the phrase "account and chattel paper debtor" or both the phrase "account debtor" and "chattel paper debtor."

2. In problem #1, is OUR STORE’s chattel paper, i.e., its right to payment from secured credit sales, “better” collateral than OUR STORE’s accounts, i.e., its right to payment from its unsecured credit sales?

As a general matter, the chattel paper is less risky because it represents a secured payment obligation. A simple account is an unsecured payment obligation. The secured payment obligation typically would receive a higher return in a bankruptcy of the account debtor. And, one might exercise self help remedies to recover a secured obligation. However, if the credit ratings of all of the account debtors were very high, the losses experienced on the pool of accounts could be lower than the losses experienced on a pool of chattel paper. It may also depend on the value of the collateral supporting the chattel paper.

3. Assume that OUR BANK makes a loan to OUR STORE secured by OUR STORE's accounts and chattel paper and OUR STORE defaults. When and how can OUR BANK collect from OUR STORE's customers? UCC §§9-607; 9-406. Does it matter whether the customer granted OUR STORE a security interest?

OUR BANK can recover its loan from its debtor OUR STORE. In pursuing OUR STORE, OUR BANK has all of the remedies of any creditor. Additionally, OUR BANK can look to its collateral for payment. In this instance, OUR BANK's collateral is an intangible asset of OUR STORE, rights to payment. OUR BANK can in essence take OUR STORE's rights to payment.

The point here is to understand that scope of OUR STORE's rights to payment from its debtors and so scope of OUR BANK's right to payment from its account debtors depends on whether the debt to OUR STORE was secured or unsecured. Ask what OUR STORE could do to collect from each kind of customer.

4.3 Questions about Rex Financial (p. 553)

1. Why doesn't Rex Financial simply repossess the four mobile homes from the "certain individuals" who bought the mobile homes from Liberty Mobile Home Centers, Inc.? See 9-320(a).

They were buyers in the ordinary course of business who took free of the security interests.

2. Absent section 9-330, the dispute in Rex Financial would have been decided under section 9-322. Who would have won under section 9-322?

Rex Financial had a security interest in the chattel paper. Article 9 applies to the sale of the chattel paper to Great Western, and thus the nature of Great Western's interest was a security interest. In this conflict between security interests, Rex Financial would likely prevail under section 9-322(a), most certainly if it had filed a financing statement covering the motor vehicle inventory.

3. Would this court have decided this case differently if it had applied section 9-330 set out above the case instead of old section 9-308 set out in the case? What are the differences between subsections (a) and (b) of section 9-330?

The big difference is whether the purchaser's knowledge is relevant. It isn't if the chattel paper is claimed by the competing secured party merely as proceeds of inventory. Otherwise, the purchaser's knowledge is relevant.

4. Do we know how Rex Financial described its collateral in the security agreement? Should the court have decided this case differently if Rex Financial had described its collateral as "mobile homes and chattel paper?"

That alone should not affect the result. What's important is whether the chattel paper is counted in deciding whether and how much to lend.

5. Why should a purchaser of chattel paper have priority over an earlier in time secured party who gave public notice of its security interest by filing a financing statement? Is the following explanation persuasive?

In the article excerpt, Don Rapson argues: “[C]hattel paper financing promotes the sale and leasing of goods and services by facilitating the purchase money financing of the buyers and lessees of those goods and services. Indeed, it is fair to say that chattel paper is a form of purchase money financing.”

2.1 Problems: sales of receivables and Article 9 (p. 556)

1. On January 10, OUR STORE sells its accounts to Factor (F). F does not make a UCC filing. On January 15, D obtains a loan from OUR BANK secured by its accounts. OUR BANK does file a financing statement. Who has priority as with respect to the accounts: F or OUR BANK? See UCC §9-322(a) (perfected security interest trumps unperfected).

Article 9 governs the sale of the accounts to F. F is a secured party with a security interest. It’s a conflict between competing security interests; section 9-322(a) applies; and subsection 9-322(a)(2) provides that a perfected security interest always trumps an unperfected security interest, without regard to the order in which the interests attached to the collateral.

2. How can OUR STORE secure the loan from OUR BANK “by its accounts” when OUR STORE SOLD the accounts to F? Why doesn’t F win simply because OUR STORE had no rights in the accounts to which OUR BANK’s security interest could attach? UCC §9-318(b).

It’s generally true that a debtor who sells an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold, but there’s an exception if the buyer of the collateral does not perfect its security interest. In this event, while the buyer's security interest is unperfected, the debtor is deemed to have rights and title to the account or chattel paper identical to those the debtor sold.

3. On January 10, OUR STORE sells its accounts to F. F does not make a UCC filing. On January 15, OUR STORE files a bankruptcy petition. Can the bankruptcy trustee avoid the January 10th sale of accounts to F? See UCC §9-317; Bankruptcy Code 11 U.S.C. §544(a); cf. 2010 Official Text §9-109, cmt. 5.

Yes.

4. Same as # 1, but F files a financing statement when F buys the receivables.

Arguably, in this case, OUR BANK doesn’t even acquire a security interest because OUR STORE lacked any rights in the accounts. In any event, F would win under 9-322(a)(1).

C. WHEN AND HOW CAN A DEAL INVOLVING A TRANSFER OF THE DEBTOR’S RECEIVABLES BE ENFORCED AGAINST THE DEBTOR? (p. 557)

2. Problems: enforcing a transfer of payment rights deal against the debtor (p. 559)

1. OUR STORE sells accounts to Factor (F) for $100,000. F is only able to collect $80,000 from the account debtors. Is OUR STORE liable for the deficiency?

OUR STORE is not liable, unless the F-OUR STORE agreement otherwise provides.

2. D borrows $100,000 from OUR BANK and grants OUR BANK a security interest in its accounts. The loan agreement provides for limited recourse; D's liability is limited to $20,000. OUR BANK is only able to collect $55,000 from the account debtors. Is D liable for the deficiency? If so, how can Or Bank collect from D? What if D is able to show that OUR BANK's efforts to collect from the account debtors were not "commercially reasonable?" Cf. sections 9-607(c), 9-625 ("a person is liable for damages in the amount of any loss caused by a failure to comply with this article").

D's personal liability is, by contract, capped at $20,000. S's noncompliance with section 9-607 triggers a review of both sections 9-625 and 9-626.

2. Virginia Bar Examination, July 2015, Question 4 (p. 562)

a) Should Farmer ignore the Bank's letter and, as directed by Mack, continue making payments to Mack? Explain fully.

No. Once Bank notified Farmer that the amount due or to become due under the contract with Mack has been assigned and that payment is to be made to Bank, Farmer can discharge Farmer's obligations under the contract only by paying Bank.

b) What are the merits of Goolsby's suit to recover the tractor, and how should each of Farmer's affirmative defenses be resolved? Explain fully.

A purchaser of goods acquires only such title which her transferor had or had power to transfer. UCC §2-403(1). Bob acquired no rights to the tractor, and neither did Mack nor Farmer. Goolsby wins. Being an innocent purchaser for value is no defense for Farmer, and Goolsby's right to recover the tractor is not conditioned on any payment to Farmer.

c) If Goolsby prevails in his action against Farmer, is Farmer liable to Mack and the Bank for the remaining payments on the installment sales contract? Explain fully.

Bank's rights as assignee are subject to all terms of the agreement between the Farmer and Mack and any defense or claim in recoupment arising from the transaction that gave rise to the contract. Farmer would have such a claim because Mack breached the warranty of good title implied by Mack in their contract. UCC §2-312.

d) If Goolsby prevails in his action against Farmer, what remedy, if any, does Farmer have against Mack? Explain fully.

Farmer has a breach of warranty of title action against Mack. There is in a contract for sale a warranty by the seller that the title conveyed shall be good, and its transfer rightful. UCC §2-312(1)(a).

2. Account debtor's defenses to payment (p. 564)

2.2 Problem: account debtor's claim under earlier contract (p. 565)

OUR STORE has a contract to do work on a Detroit hotel project for OUR BUYER. OUR BANK makes a loan to OUR STORE secured by OUR STORE's right to payment from OUR BUYER for the Detroit hotel project. OUR STORE defaults. OUR BUYER refuses to pay because of OUR STORE's alleged breaches of a different, earlier contract for work on a Sun City hotel project. What, if any, additional information do you need to determine OUR BANK's rights against OUR BUYER?

The rights of OUR BANK an assignee are subject to: this defense or claim of OUR BUYER against OUR STORE only if it accrued before OUR BUYER receives a notification of the assignment. UCC §9-404(a)(2).

2.4 Problem: waiver of defense provision in agreement between debtor and account debtor (p. 565)

[for class discussion]

2.5 Waiver of defenses in agreement among account debtor, debtor, and secured party (p. 566)

[for class discussion]

2.6 Questions about Brookridge (p. 570)

1. What is seemingly the most important fact in this case?It's critical in the court's analysis that the waiver of defense clause was executed after the assignment, not as part of the agreement between the account debtor and assignor. Therefore, in the court's view, the waiver required consideration.

2. To the court, “[i]t appears that §9-206 [9-403] was intended to encompass

waivers contained in contracts between a debtor and an assignor that are assigned--not in separate agreements made in anticipation of such an assignment, as was the Notice in this case.” Is the appearance stronger in new 9-403 than the old 9-206? What’s the argument that neither version precludes a later, separate agreement? What’s the argument that consideration isn’t required?

Section 9-403 refers to “an agreement between an account debtor and an assignor.” Old 9-206 refers only to “an agreement by [an account debtor]”, not an agreement between her and the assignor. In any event, neither 9-206 nor 9-403 explicitly limits the necessary agreement as contemporaneous with the creation of the debt between the account debtor and assignor. Agreement and contract are separate terms under the whole of the UCC. Compare UCC §1-201(b)(3) & (12). A contract requires agreement, but agreement – unlike contract – does not require consideration or substitute imposing resulting in a legal obligation.

3. Suppose an assignee of the debtor’s accounts sends the account debtor a letter asking the account debtor to attest that attached “invoice(s) are in line for payment and the payment obligation of [account debtor] is not subject to any offsets, back charges, or disputes of any kind or nature.” Account debtor signs the letter attesting as asked and returns it to the assignee. Debtor fails to deliver the goods to account debtor; and assignee argues that under 9-403, account debtor nevertheless owes the amount of the invoices. What are

three possible responses to this argument? See Caron Assocs., Inc. v. Southside Mfg. Corp., 788 S.E.2d 610, 613-14 (N.C. Ct. App.), review denied, 2016 WL 7365219 (N.C. 2016) (two responses).

The court disagreed there was an effective waiver of claims and defenses because:

Payment for the cabinets was due within thirty days of delivery. Therefore, Cabinet Maker's duty to deliver is a condition precedent to Purchaser's duty to pay the contract price. “A condition precedent is an event which must occur before a contractual right arises, such as the right to immediate performance. The event may be largely within the control of the obligor or the obligee.” The parties “are bound when the condition [precedent] is satisfied.” Crown does not dispute the terms of the Purchaser–Cabinet Maker contract. Crown does not dispute Cabinet Maker's failure to deliver the cabinets. Therefore, under these facts, Purchaser cannot be a “person obligated” because there is no evidence to suggest the condition precedent, Cabinet Maker's delivery, was satisfied. See N.C. Gen.Stat. § 25–9–102(a)(3) (2015) (emphasis added).

Further, the plain language of the assignment letter does not obligate Purchaser. It merely informs Purchaser that all present or future payments due to Cabinet Maker are due to Crown as Cabinet Maker's assignee. The letter references Cabinet Maker's premature invoice for $45,000.00, and states “[Crown] will be advancing on [the $45,000.00] initially.” The letter states, “the payment obligation ... is not subject to any offsets, back charges, or disputes of any kind or nature.” This Court observes there is no record evidence that Crown gave Purchaser any consideration in exchange for Purchaser's signature on the assignment letter. Therefore, the assignment letter in itself cannot be a contract. You can also argue that the waiver was not enforceable under the literal language of 9-403 because the agreement was not between the account debtor and assignor.

4. The Brookridge case involves an account debtor who is a business entity. Should a secured party be able to enforce a waiver of defense clause against a consumer? Assume for example that OUR BUYER buys a big screen television on credit from OUR STORE and grants OUR STORE a security interest in the television. The security agreement contains a provision in which OUR BUYER agrees not assert any defenses against any assignee. OUR STORE sells the chattel paper to OUR BANK. If the television set is defective, should OUR BUYER have to continue making payments to OUR BANK?

The answer is generally no because of the FTC Preservation of Consumers' Claims and Defenses Rule, 16 CFR §433.2, which is implied by law in consumer transactions even if the required FTC Notice is not actually included in the contract. UCC §§9-403(d) & 9-404(d).

[TEXT P. 571] 2.7 Consumer Protection

[Discuss in class, including Holder rule]