



Fall 9-1-1963

Effect of the Uniform Commercial Code on Virginia Commercial Law: Factor's Lein and Accounts Receivable Financing and Article 9

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Recommended Citation

Effect of the Uniform Commercial Code on Virginia Commercial Law: Factor's Lein and Accounts Receivable Financing and Article 9, 20 Wash. & Lee L. Rev. 306 (1963).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol20/iss2/10>

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One important provision in the UCC which probably will cause some trouble is the classification of goods into various categories. For example, when a refrigerator is sold to a doctor it may be consumer goods or equipment, depending on where the doctor uses it. As consumer goods it is subject to special treatment. If it is equipment, the normal UCC procedures must be followed. The problem which must be avoided will arise when the seller and possibly the buyer think the goods are consumer goods but a court resolving the problem considers the goods to be equipment. Not having filed a financing statement to protect his security interest, the seller would lose the full protection he thought he had. If there is a solution to this problem, it is that in any case where the secured party is in doubt, he should file. This will insure full protection and avoid needless litigation.

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FACTOR'S LIEN AND ACCOUNTS RECEIVABLE FINANCING AND ARTICLE 9

In recent years the area of secured transactions has become more complicated for lawyers and business men alike; a maze of statutes, with wide variations from state to state, clouds the picture. The UCC has brought some order to this chaotic situation. Specifically, what effect does the UCC have upon dealer financing in Virginia, particularly in the areas of factor's liens and accounts receivable financing?

FACTOR'S LIENS

Virginia passed a "new style" factor's lien act in 1944,¹ but the Supreme Court of Appeals of Virginia has never had occasion to decide a case under it.² The Virginia legislation defines factoring as "financing . . . a manufacturer in his purchases, manufacture and sale of goods and merchandise."³ A factor includes banks, persons, corporations who lend on the security of a manufacturer's goods or merchandise, and consignees and pledgees who advance money on goods

¹Va. Code Ann. §§ 55-143 - 50 (Repl. Vol. 1959).

²The only reported case that involves this legislation is *In the Matter of Lincoln Industries, Inc.*, 166 F. Supp. 240 (W.D. Va. 1958). In that case a company in the business of loaning money and discounting invoices had a factor's lien on all the bankrupt's inventory and accounts receivable.

³Va. Code Ann § 55-143 (Repl. Vol. 1959).

or merchandise consigned or pledged to them.⁴ If a writing so provides, the factor has a continuing lien on all the goods and merchandise of the borrower for all loans made from time to time.⁵ As soon as a notice of this agreement has been recorded, the lien is valid and covers after-acquired property of the borrower.⁶ The notice that is to be recorded must contain the name of the lender, that is the factor, his principal place of business, the names of the partners if it be a partnership, or the state of incorporation if it be a corporation.⁷ The notice must also contain the name of the borrower and his interest in the merchandise.⁸ A description of the general character of the goods and merchandise covered by the lien must be included, as well as the period of time that advances are to be made under the terms of the agreement.⁹ The notice is to be recorded in the county where any of the goods or merchandise is located.¹⁰ However, if the factor has possession of the merchandise, he has a continuing general lien without recording.”

The lien is effectual from the time it is admitted to record against all later claims against the merchandise, except common law and statutory possessory liens.¹² Any liens which were recorded or in existence prior to the recordation of the factor's lien take precedence over the factor's lien.¹³ The landlord's lien for rent is by express statutory provision made superior to the factor's lien.¹⁴ Purchasers for value in ordinary course of business from the borrower take free of the factor's lien whether or not they know of the lien, but the factor's lien attaches to the accounts receivable or proceeds of this sale without any additional act on the part of the factor.¹⁵ The lien is released when it is marked satisfied in the book where it is recorded.¹⁶

The floating lien is validated in the UCC.¹⁷ Under the UCC a

⁴Ibid.

⁵Va. Code Ann. § 55-144 (Repl. Vol. 1959).

⁶Ibid.

⁷Va. Code Ann. § 55-144(a) (Repl. Vol. 1959).

⁸Va. Code Ann. § 55-144(b) (Repl. Vol. 1959).

⁹Va. Code Ann. § 55-144(c) (Repl. Vol. 1959).

¹⁰Va. Code Ann. § 55-145 (Repl. Vol. 1959).

¹¹Va. Code Ann. § 55-148 (Repl. Vol. 1959).

¹²Va. Code Ann. § 55-146 (Repl. Vol. 1959).

¹³Ibid.

¹⁴Ibid.

¹⁵Ibid.

¹⁶Va. Code Ann. § 55-147 (Repl. Vol. 1959).

¹⁷UCC §§ 9-204 and 9-205 and Comment.

security interest in the inventory¹⁸ or merchandise of a manufacturer is created by a written security agreement.¹⁹ This agreement must be signed by the debtor²⁰ and must contain a description of the security²¹ which reasonably identifies the collateral.²² It is immaterial, as far as rights and remedies under the agreement are concerned, whether the debtor or secured party has legal title to the collateral.²³

The security interest of the secured party is said "to attach" after an agreement has been made, value has been given, and the debtor has rights in the collateral.²⁴ However, one or the other of two further steps is needed to perfect the security interest of the secured party. Either he must take possession of the inventory,²⁵ or file a financing statement.²⁶ For obvious reasons, the latter method will probably always be used in the case of inventory. The financing statement must contain the signatures and addresses of both the debtor and secured party, and a description of the collateral.²⁷ As to place of filing the financing statement, the UCC employs central notice filing in almost all instances.²⁸

The UCC has a comprehensive system of rules to determine priorities, but while the rules are more elaborate than those found in the

¹⁸See UCC § 9-109(4) for the definition of "inventory." UCC § 9-109(1) defines "consumer goods," and UCC § 9-109(2) defines "equipment." These subsections distinguish the three terms from one another as they are used in the UCC.

¹⁹UCC § 9-203(1)(b). UCC § 9-203(1)(a) provides that a security interest is enforceable if the secured party has possession of the collateral. Where the collateral is inventory of the debtor; the secured party will not have possession of it. See also UCC § 9-201, which provides that the "security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors."

²⁰UCC § 9-203(1)(b).

²¹*Ibid.*

²²UCC § 9-110.

²³UCC § 9-202.

²⁴UCC § 9-204(1).

²⁵UCC § 9-302(1)(a).

²⁶UCC § 9-302(1).

²⁷UCC § 9-402(1).

²⁸UCC § 9-401(1). The UCC has three alternative arrangements for filing. The first alternative subsection provides for central notice filing in all cases, except where fixtures are involved. This exception is found in all three alternative subsections. The second alternative subsection requires local filing when the collateral is farm equipment, farm products, accounts or contract rights arising from the sale of farm products, or consumer goods. The recording is to be where the goods are located. Central notice filing is sufficient in all other cases. The third alternative subsection has the same requirements as the second, but requires local filing where the debtor has a place of business in only one county in the state, or lives in the state but has no place of business here. This third alternative seems to be closer to the recording requirements of the Virginia factor's lien statute than the first two. See Va. Code Ann. § 55-145 (Repl. Vol. 1959).

Virginia factor's lien legislation, they are basically the same. Under the UCC, a security interest that has attached is perfected when the financing statement is admitted to record.²⁹ The artisan's possessory lien arising by operation of law is superior to even a perfected security interest.³⁰ A purchaser from the debtor in the normal course of business takes free of any perfected security interest, even though he may know of the security interest.³¹ If the financing statement covers the proceeds from the sale of collateral, the security interest continues in such proceeds.³² All of these rules are substantially the same as in the factor's lien legislation of Virginia.³³

The above rules and procedures are similar to Virginia practice. However, the UCC is more detailed than the Virginia statutes and covers a few situations untouched by the factor's lien act. A creditor who has a purchase money security interest in inventory collateral covered by his security agreement has priority over conflicting and perfected security interest in the same collateral if three requirements are met:³⁴ Firstly, the purchase money security interest must be perfected at the time the debtor receives possession of the inventory.³⁵ Secondly, the purchase money secured party must notify all other creditors of whom he knows, who have a recorded financing statement covering the same debtor's inventory collateral, that he, the purchase money secured party, is obtaining a purchase money security interest in this inventory.³⁶ Thirdly, the purchase money secured party must give this notice before the debtor obtains possession of the inventory.³⁷

Another situation covered by the UCC, but omitted by the Virginia factor's lien act, is the return of goods by the buyer or repossession by the seller. The UCC states the rules that determine the priorities of the parties in this situation.³⁸ If the goods were collateral

²⁹UCC § 9-302(1).

³⁰UCC § 9-310.

³¹UCC § 9-307(1).

³²UCC § 9-306(2).

³³See notes 12-15 *supra*. One difference is that the UCC does not provide for an express priority of a landlord's lien for rent as provided in Va. Code Ann. 55-146 (Repl. Vol. 1959). Yet Virginia law remains unchanged. The landlord's lien is expressly excluded from Article 9 of the UCC. See UCC § 9-104(b).

³⁴UCC § 9-312(3).

³⁵UCC § 9-312(3)(a).

³⁶UCC § 9-312(3)(b).

³⁷UCC § 9-312(3)(c).

³⁸UCC § 9-306(5). The official comment of this section makes it explicitly clear that Article 9 of the UCC rejects the rule of the case of *Benedict v. Ratner*, 268 U.S. 353 (1925). Under the rule of that case where the debtor was given control over returned goods, the security arrangement might be invalidated. See also UCC

for a debt which the debtor owed to the secured party, and the debt is still unpaid, then the security interest attaches once again and is a perfected interest, if such interest was perfected when the goods were sold.³⁹ If the perfection was originally accomplished by filing a financing statement, no further filing is necessary.⁴⁰ However, if the perfected security interest was created by other means, such as possession of the inventory, then the secured party must take possession of the returned or repossessed goods, or file a financing statement.⁴¹

Once the secured party has perfected his security interest, he can assign that interest, and the assignee obtains the superior position of the secured party without any further filing.⁴² Any creditors of or transferees from the original debtor are subordinate to the assignee of a secured party having a perfected security interest.⁴³ The security interest is terminated⁴⁴ or released⁴⁵ when such fact is recorded.

ACCOUNTS RECEIVABLE

The UCC effects few changes in the accounts receivable financing area. Moreover, these changes will not be as significant as might appear at first glance. Accounts receivable may be assigned as security for a loan in Virginia; such an assignment in writing expressly is authorized by the Virginia Code.⁴⁶ However, there is no recording requirement in Virginia, and the assignment may be oral.⁴⁷ The general rule as to priorities is that the first assignee will prevail against subsequent assignees.⁴⁸ However, since a 1956 amendment of the

§ 9-205 and Comment. For a discussion of the effect *Benedict v. Ratner* has had on bankruptcy cases in Virginia, see *Brasfield, Reservation of Dominion over Property Given as Security—The Virginia Rule*, 49 Va. L. Rev. 192 (1963).

³⁹UCC § 9-306(5)(a).

⁴⁰*Ibid.*

⁴¹*Ibid.*

⁴²UCC § 9-302(2). For the procedure required when assigning a security interest, see UCC § 9-405.

⁴³UCC § 9-302(2).

⁴⁴UCC § 9-404.

⁴⁵UCC § 9-406.

⁴⁶Va. Code Ann. § 11-5 (Repl. Vol. 1956).

⁴⁷The Virginia Code does not require the assignment to be written, but only states the legal effect of a written assignment. Nothing is said of oral assignments or recording requirements for assignments.

⁴⁸Va. Code Ann. § 11-6 (Repl. Vol. 1956). The statute imposes a constructive trust in favor of the first assignee upon anyone who might have received payment from the obligor. The UCC does not have a similar provision. But under both the UCC and the Virginia statute, if the obligor pays the wrong person, he is pro tanto released if he acted in good faith. See UCC § 9-318(3). For Virginia cases following the rule based on the first in time, see: *Evans v. Joyner*, 195 Va. 85, 77 S.E.2d

factor's lien act in Virginia, accounts receivable may be security for a factor's lien along with inventory.⁴⁹ When the collateral for the loan, subject to the lien, is sold in the ordinary course of business, the lien attaches to the proceeds of the sale or the accounts receivable without any further act on the part of the factor.⁵⁰ As shown above, the provisions of the UCC and the Virginia factor's lien act are very similar. If accounts receivable financing is handled by this procedure, there is little change here.

Article 9 of the UCC contemplates the abolition of the distinctions among the various kinds of presently used security devices.⁵¹ Therefore, the creation of a security interest in accounts receivable will be accomplished the same way as outlined above.⁵² There must be a written security agreement,⁵³ a copy of which signed by the secured party may be filed as a financing statement.⁵⁴ The assignment of accounts receivable for security purposes is subject to the filing requirements of the UCC, a change in long established Virginia law.⁵⁵ There must be a written security agreement, and usually a recording of the financing statement.⁵⁶ The exception of the recording requirement is an assignment which does not transfer a significant part of the assignor's outstanding accounts to the same assignee.⁵⁷ It should be noted that a financing statement covering inventory does not automatically cover proceeds or accounts receivable when the inventory is sold.⁵⁸ Unless these are included in the description in the original financing statement, the secured party does not have a perfected security interest in them.⁵⁹

As to priorities under the UCC, whoever records his financing

⁴⁹420 (1953); *Waynesboro Nat. Bank v. Smith*, 151 Va. 481, 145 S.E. 302 (1928); *Paxton v. Rich*, 85 Va. 378, 7 S.E. 531 (1888).

⁵⁰See Va. Code Ann. § 55-146 (Repl. Vol. 1959).

⁵¹*Ibid.*

⁵²UCC § 9-101 and Comment.

⁵³See notes 19-22, 24-27 *supra*. See also UCC § 9-104(f). That section provides that Article 9 does not apply to the sale or assignment of accounts for collection purposes only.

⁵⁴UCC § 9-203(1)(b).

⁵⁵UCC § 9-402(1). See also Comment, UCC § 9-302. The statement is made there that filing is the only means available to perfect a security interest in accounts receivable under the UCC.

⁵⁶*Kirkland Chase & Co. v. Brune*, 72 Va. (31 Gratt.) 126 (1878).

⁵⁷UCC § 9-302 and Comment.

⁵⁸UCC § 9-302(1)(e) and Comment. The comment states that the purpose of this exception is to save "casual or isolated" assignments from *ex post facto* invalidation.

⁵⁹UCC § 9-306(3)(a).

⁶⁰*Ibid.*

statement first has the superior interest.⁶⁰ A transferee of the accounts who gives value without knowledge of the security interest and before a financing statement is filed obtains priority to the extent he gives value.⁶¹

The situation of the return or repossession of goods again is outlined in some detail. Whenever the goods are sold by the debtor and an account results, and then they are repossessed or returned, the position of the secured party is the same as outlined above.⁶² However, should the accounts receivable which resulted from this sale be transferred to someone other than the inventory financier, who is the original secured party, then the transferee of the account is subordinated to the perfected security interest of the inventory financier.⁶³ The transferee's security interest is still good against the transferor, but must be perfected again to afford protection against other creditors of the transferor and anyone who might purchase the items which have been returned or repossessed.⁶⁴ However, this transferee of the account can obtain a superior position if the security interest of the inventory financier was not perfected. Upon return or repossession in such a case, whoever perfects first will have priority.⁶⁵

The defenses that can be asserted under the UCC against the assignee of an account are much the same as have been available in Virginia. The assignee is subject to the terms of the agreement between the assignor, who is the debtor in the security transaction, and the account debtor.⁶⁶ The account debtor can assert any defense against the assignee which he might have had against the assignor, if the defense accrues before he had notice of the assignment.⁶⁷ The account debtor is safe in paying the assignor until he receives notification of the assignment.⁶⁸ All of these statements merely reiterate the general principles of the law of assignment. Any agreement made by the account debtor and the account creditor that prohibits assigning the account is ineffective.⁶⁹ An agreement by the buyer of consumer goods, who may well become an account debtor thereby, that he will not assert against an assignee of the account any defenses that

⁶⁰UCC § 9-312(5).

⁶¹UCC § 9-301(1)(d).

⁶²See notes 39-42 *supra*.

⁶³UCC § 9-306(5)(c).

⁶⁴UCC § 9-306(5)(d).

⁶⁵UCC § 9-306(5)(a).

⁶⁶UCC § 9-318(1)(a).

⁶⁷UCC § 9-318(1)(b).

⁶⁸UCC § 9-318(3).

⁶⁹UCC § 9-318(4).

he might have had against the seller is enforceable with the exception of real defenses.⁷⁰ In order for the rule to apply, the assignee must give value, take the assignment in good faith, and not know of the defense.⁷¹

CONCLUSION

In conclusion, the impact of the UCC upon factor's liens and accounts receivable financing is not great. The new legislation is more explicit and more detailed, but the general principles that have existed in Virginia remain. The greatest changes are in the area of assignment of accounts receivable, and are as follows: (1) the assignment must be evidenced by a writing, i.e., a security agreement; (2) a financing statement must be filed; (3) priorities are determined by a rule of diligence rather than the rule based on the first in time. Yet the fact that accounts receivable financing is probably handled through factor's liens minimizes the significance of these changes. The rules regarding defenses are much the same. As for factor's liens, the whole philosophy behind the factor's lien act is retained by the UCC. Except for minor changes as to what is to be included in the financing statement, the Virginia practice remains intact. But this is not to say that Virginia lawyers have no reason to be pleased with the UCC; Virginia courts have never passed on several of the problems covered by the UCC. Under the UCC Virginia lawyers can be more sure of their position on these matters and be secure in their knowledge that the same rules apply in other states.

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⁷⁰UCC § 9-206(1).

⁷¹*Ibid.*