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A PROBLEM INVOLVING ASSIGNMENTS OF ACCOUNTS UNDER ARTICLE 9

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Suppose that the Owner of real property decides to have a building erected on a parcel of land. On completion the building will be used for commercial purposes. Owner enters into a construction contract with Contractor, and the contract provides for periodic payments by Owner to Contractor of ninety percent of the value (however "value" may be measured) of the work completed. In order to get the funds necessary to perform the contract, Contractor enters into an agreement with Bank under which Bank agrees to lend to Contractor an amount equal to eighty percent of Contractor's outstanding receivables, and Bank receives a security interest in all of Contractor's receivables. Bank then notifies Owner that periodic payments due to Contractor should be paid to Bank, and Contractor joins in the notification. Owner makes payments to Bank in accordance with the construction contract and the notification. When construction is completed, Owner discovers that the funds it has paid have not in fact been used to pay some subcontractors involved in the project, and the failure to pay these subcontractors has resulted in substantial liens being asserted against the real property, contrary to the terms of the construction contract. Owner sues Bank to recover progress payments made to Bank, which Bank applied toward its loans to Contractor which Contractor had diverted.[1]

Under the 1962 Uniform Commercial Code (1962 Code) the collateral assigned by Contractor to Bank would have been contract rights, and a contract right was defined in the 1962 Code as "any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper."[2] When Article 9 was being revised there was some feeling that the concept of contract rights was perhaps an over-refinement,[3] an unnecessary category which simply led to some confusion when lawyers had to advise clients on the kind of security they were taking. After all, when the contract was performed, the contract

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[1] The facts stated in the text are basically the facts in Michelin Tires (Canada) Ltd. v. First Nat'l Bank of Boston, 666 F.2d 673, 32 U.C.C. Rep. Serv. 657 (1st Cir. 1981).

[2] U.C.C. § 9-106 (1962) (second sentence). Hereinafter references to the Uniform Commercial Code will be by section only. References will be to the 1972 Code unless the 1962 Code is specifically mentioned, but in both versions U.C.C. § 9-318(1), to which this article is primarily directed, is the same.

[3] Permanent Editorial Board for the Uniform Commercial Code, Review Committee for Article 9 of the Uniform Commercial Code, Preliminary Draft No. 2, at 21 (1970).

rights turned into either accounts[4] or general intangibles,[5] and this dual possibility might not have been recognized by the lawyers or the clients, for a claim to "proceeds" was a general requirement in the 1962 Code if the security interest was to continue into the transformed collateral.[6]

Under the 1972 Official Text of Article 9, the term "contract right" was dropped and the definition of "account" was expanded to include "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, *whether or not it has been earned by performance*."[7] This change made what would have been contract rights under the 1962 Code turn into "accounts" when not earned by performance as well as after being earned, so long as the collateral involved a right to payment for goods sold or leased or for services rendered under a contract, in general terms, not embodying negotiable paper or a lease or conditional sale contract or the like. If the right to payment did not arise from the covered transactions, then it presumably would be a general intangible before it was earned as well as after. While subject to varying opinions, of course, in retrospect the concept of contract rights appears to have been valuable, and perhaps it should have been retained. There is much to be said for not over-refining categories of collateral, but rights to payments to be earned under performance contracts are naturally spoken of as contract rights in ordinary English, and when the rights have not been earned yet they are not conventionally thought of as accounts.

Within the context of our problem, can Owner recover from Bank those payments made to Bank which ought to have been applied by Contractor toward claims of subcontractors but which were diverted to other purposes? In Code terminology, the Owner is an "account debtor," the Contractor is an assignor, and the Bank is an assignee. While assignor and assignee are not defined in the Code, "account debtor" was defined in section 9-105(1)(a) of the 1962 Code as "the person who is obligated on an account, chattel paper, contract right or general intangible," and the same definition appears in the 1972 Code except that the term "contract right" is deleted. The Code solution to our problem apparently falls within section 9-318(1) which states:

> (1) Unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out

[4] Under the 1962 Code "accounts" were defined in U.C.C. § 9-106 as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper."

[5] Under the 1962 Code "general intangibles" were defined in U.C.C. § 9-106 as "any personal property (including things in action) other than goods, accounts, contract rights, chattel paper, documents, and instruments."

[6] U.C.C. § 9-306(3)(a) of the 1962 Code required the filed financing statement to cover proceeds as well as the original collateral for the security interest in proceeds to continue as a perfected security interest beyond ten days after the receipt of the proceeds.

[7] The language in italics was added in the 1972 revision of U.C.C. § 9-106.

of a sale as provided in Section 9-206 the rights of an assignee are subject to

(a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and

(b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.

It should be noted that the part of the title of section 9-318 applicable to the first subsection states "Defenses Against Assignee," and section 1-109 states that "Section captions are part of this Act." This suggests, of course, that it is not the purpose of section 9-318(1) to give an affirmative cause of action to the account debtor, but rather to state what defenses the account debtor may assert when sued by the assignee. However, the language of the statute is not very clear.

Section 9-206 provides, in substance, that in a commercial context a good faith assignee for value, who takes an assignment without notice of a claim or defense, may enforce against a buyer or lessee of goods an agreement given by such a person that defenses or claims will not be asserted against an assignee, unless the defense is of a type which may be asserted against a holder in due course of negotiable paper.[8] (A different rule may be established by statute or decision for buyers or lessees of consumer goods, and those problems will not be considered here.) In an ordinary commercial situation, a lessee or buyer is quite likely to agree not to assert against an assignee any defenses to payment, for otherwise such contracts would be difficult to finance. This leaves the lessee or buyer with the contractual obligation to pay an assignee for what may turn out to be relatively worthless goods, and any claims must be asserted against the lessor or seller directly. Although this may not be a happy situation, it is, after all, a matter of contractual agreement. There is, unfortunately or otherwise, some possible slippage between sections 9-318(1) and 9-206. Section 9-318(1) refers to an account debtor who has made an enforceable agreement not to assert claims or defenses arising out of a sale, while section 9-206 refers to buyers and lessees and to both sales and leases, and of course "account debtor" is a much broader term than merely "buyer." Based on the language of section 9-318(1), only buyers of goods can waive defenses or claims, leaving out the possibility of waivers by persons obligated on accounts not arising out of sales, or general intangibles, and such persons are covered in the definition of "account debtor" in section 9-105(1)(a), along with obligors on chattel paper and, under the 1962 Code, obligors on contract rights. In

[8] The so-called "real" defenses which may be asserted even against a holder in due course are stated in U.C.C. § 3-305.

appropriate circumstances persons who cannot waive defenses against assignees under section 9-206 could effectively accomplish a waiver by executing a negotiable note or by accepting a negotiable draft. But in the context of an assignment of rights under a construction contract, it would be highly unusual for an owner to waive, for the benefit of an assignee, any rights the owner might have against the contractor.

It seems to be generally assumed that under a construction contract the rights to progress payments are accounts, before as well as after being earned. (Under the 1962 Code they would be contract rights under the contract which would turn into accounts as performance takes place.) In fact, when "account" is defined as a "right to payment for goods sold ... *or* for services rendered . . .,"[9] it is not entirely clear that we are talking about "accounts" rather than "general intangibles,"[10] for building construction contracts involve in some sense a sale of goods *and* the rendition of services. Still, one does not, superficially at least, perhaps consider a construction contract as involving a sale of goods by the contractor to the owner. Insofar as a " 'sale' consists in the passing of title from the seller to the buyer for a price,"[11] and a seller is "a person who sells or contracts to sell goods"[12] and a buyer is "a person who buys or contracts to buy goods,"[13] the concept of a construction contract just does not quite seem to fit neatly into the picture. In a construction project of any size, any conventional sale probably involves an unrelated seller who transfers an interest in goods to a subcontractor, who might be viewed in turn as selling to the general contractor, with the owner ultimately buying the completed building, at which time the "goods" are generally or wholly immovable, if the sale takes place at that time. As defined in Article 2, " 'Goods' means all things ... which are movable at the time of identification to the contract for sale . . ."[14] although for Article 9 purposes the term refers, aside from exclusions, to "things which are movable at the time the security interest attaches . . . ."[15]

It would appear that a better category for rights to payment, earned or unearned, under construction contracts might well be "general intangibles" which are defined in section 9-106, more or less, as whatever falls under Article 9 but does not fit into the other recognized

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[9] U.C.C. § 9-106 (first sentence) (emphasis added).

[10] U.C.C. § 9-106 (second sentence in the 1972 Code or third sentence in the 1962 Code).

[11] U.C.C. § 2-106(1).

[12] U.C.C. § 2-103(1)(d).

[13] U.C.C. § 2-103(1)(a).

[14] U.C.C. § 2-105(1).

[15] U.C.C. § 9-105(1)(h). The complete definition states: " 'Goods' includes all things which are movable at the time the security interest attaches or which are fixtures (Section 9-313), but does not include money, documents, instruments, accounts, chattel paper, general intangibles, or minerals or the like (including oil and gas) before extraction. 'Goods' also includes standing timber which is to be cut and removed under a conveyance or contract for sale, the unborn young of animals, and growing crops." *Id.*

categories.[16] In general, what falls under Article 9 is any transaction "which is intended to create a security interest in personal property . . . ."[17] In the ordinary commercial construction contract, the place of filing for either accounts or general intangibles would presumably be the same,[18] so the distinction, if one should be made here, may be immaterial in the perfection context. Within the restricted context of owner-contractor-financer, filing for perfection may not be of any consequence so long as the assignor stays out of bankruptcy.[19]

Assuming our problem does not involve an enforceable agreement not to assert defenses or claims falling within section 9-206, then the rights of Bank as assignee are subject to all of the terms of the construction contract and defenses or claims arising from it.[20] This brings us back to the question whether the Owner can recover from the Bank for payments made by Owner as account debtor to Bank as assignee of Contractor. If the title of section 9-318 is taken as controlling, the provision in section 9-318(1) cannot apply because the assignee is not suing the account debtor, and the issue of available "defenses against assignee"[21] cannot arise. If the title is not taken as controlling, then the statutory provision may be thought to be ambiguous when it states that the assignee's rights are "subject to . . . all of the terms of the contract between the account debtor and the assignor and any defense or claim arising therefrom . . . ."[22] The *terms* of the contract, to which the assignee's rights are subject, will certainly contain nothing giving the account debtor an affirmative right to recover any payments made to the assignee, for the contract rights (or accounts) would not be usable as collateral if such a provision were expressed in the underlying contract. No assignee would become involved in such a situation. The term "defense" suggests that the assignee must be suing the account debtor, not the reverse. The use of the word "claim" is ambiguous, but this would appear, in the context, to refer to a claim made by the account debtor prior to payment, in a situation where the assignee is suing to recover payments alleged to be due and owing. Instead of the word "claim," the term "set-off" is used

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[16] The definition in U.C.C. § 9-106 states: " 'General intangibles' means any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money."

[17] U.C.C. § 9-102(1)(a).

[18] *See* U.C.C. § 9-401(1).

[19] U.C.C. § 9-201 provides that "a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors" except where the Act provides otherwise, as of course it does in U.C.C. § 9-301(1)(b) where a person becomes a lien creditor before the security interest is perfected, and a trustee in bankruptcy is a lien creditor under U.C.C. § 9-301(3).

[20] U.C.C. § 9-318(1)(a).

[21] The portion of the title of U.C.C. § 9-318 applicable to the first subsection is "Defenses Against Assignee." U.C.C. § 1-109 states: "Section captions are part of this Act."

[22] U.C.C. § 9-318(1)(a).

as a synonym in Official Comment 1 to section 9-318, and it would have saved a lot of trouble if this term had been used in the statute.

In the leading Code case on the point, *Michelin Tires (Canada) Ltd. v. First National Bank of Boston*,[23] after a careful analysis of earlier cases, the court concluded that section 9-318(1) preserves the account debtor's defenses against the assignee but does not authorize a suit against the assignee for affirmative relief.[24] This would appear to be the correct result, but the Code cases on the point are by no means unanimous.

The pre-Code case which seems to be the main source for the view that in some circumstances the assignee may be liable to repay funds previously collected from the account debtor is *Firestone Tire & Rubber Co. v. Central National Bank*.[25] According to Professor Gilmore, the principal holding in the case is that "where the assignor fails to perform the contract, the assignee cannot retain mistaken, or even negligent, payments made to it by the obligor unless there has been a subsequent change of position by the assignee."[26] Oddly enough, Professor Gilmore's statement of the holding has been quoted in cases following that view as if it were his personal view of the proper result.[27] The quoted statement appears in a footnote, and the footnote appears to bear no relation to the material in the text to which it is appended, for the text makes the point that an assignee could surely not seriously hope to sue an account debtor successfully when the assignor has either not performed or else has attempted performance which was rightfully rejected; no waiver of defenses was involved. Where an enforceable waiver of defenses has been given and relied on or where a negotiable instrument has been given for future performance which did not take place, but the instrument is in the hands of a holder in due course, the obligation should be enforceable. These situations, however, will surely not be present in construction financing cases.

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[23] 666 F.2d 673, U.C.C. Rep. Serv. 657 (1st Cir. 1981).

[24] *Id.* at 680, 32 U.C.C. Rep. Serv. at 666. About half of the court's opinion is devoted to a claim for restitution, which the court denied. While U.C.C. § 1-103 provides that principles of law and equity may supplement the Code's provisions, this possibility expressly exists only where particular provisions of the Code do not displace other rules. In *Michelin*, the Code's provisions covered the problem, and resort to other theories, which could possibly have produced a different result, should have been denied.

[25] 159 Ohio St. 423, 112 N.E.2d 636 (1953).

[26] Gilmore, *The Assignee of Contract Rights and His Precarious Security*, 74 YALE L. J. 217, 235 n.35 (1964), *reprinted in* 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 1077, 1096 n.4 (1965).

[27] Benton State Bank v. Warren, 263 Ark. 1, 6, 562 S.W.2d 74, 76, 23 U.C.C. Rep. Serv. 1303, 1307 (1978); Farmers Acceptance Corp. v. DeLozier, 178 Colo. 291, 296, 496 P.2d 1016, 1018-19, 10 U.C.C. Rep. Serv. 1099, 1103 (Colo. 1972). In K Mart Corp. v. First Penn. Bank, 29 U.C.C. Rep. Serv. 701, 703 (Pa. Ct. Comm. Pl. 1980), the opinion, quoting from Gilmore, purports to be quoting from the opinion in *Firestone*. The *Warren* case, *supra*, subsequently recognized that Gilmore's quoted statement was merely his summary of the *Firestone* holding, but this is not the way the quotation appears to be cited in the context of its appearance in the opinion.

As a practical matter, any assignee who collected a dime under an assigned account would change its position. If nothing else, the debt owing would be reduced by the amount received, for the receipt of funds under the assignment to retire a debt is the basic purpose of the assignment. This was not, however, recognized in *Firestone*, where the court thought that the portion of collected funds applied by the bank toward the debt owing did not represent a change of position,[28] possibly on the view that such funds were put into and remained in a box somewhere rather than being put to work immediately in other investments.[29] "The bank, in applying that amount to its loans, is in no worse condition than it would have been if the payment had been refused."[30] That will not turn out to be true, and had the payment received been substantially greater the point would surely be recognized as absurd on its face. Where a payment is not made under an assigned contract, presumably an assignee bank would investigate the reason rather promptly and perhaps as a result might become alerted to its borrower's problems at an earlier point in time, before the descent into the maelstrom makes the bank's position (along with the account debtor's) even more precarious. It makes no sense to say that a lender is no worse off if it must repay money received than if it had never received the funds. The lender will obviously have changed its position in the interim as a result of receiving the money.

Much of the *Firestone* opinion was devoted to a discussion of negotiable instruments law which even the court recognized as irrelevant for purposes of the decision.[31] The court's view that a payee on a check—in this case, the bank as assignee was payee—could not be a holder in due course[32] is no longer an acceptable view. Under the Code a payee may be a holder in due course[33] and will be if the necessary requirements are met,[34] as is possible where the payee is unrelated to the underlying transaction and knows nothing of the performance of the basic contract.[35] So long as the payee is a holder in due course and has not dealt with the drawer, the instrument is taken free of all defenses except "real" defenses.[36] However, once the check has been paid by the payor bank, the problem becomes not one of enforcing the instrument but one of finality of payment. No doubt, in the case of checks, payment is indeed final under section 4-213(1) when final payment is made by the

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[28] 159 Ohio St. at 441, 112 N.E.2d at 645.

[29] Interestingly, the bank was held liable for interest on the amount it applied toward the debt owing, thus suggesting that the *Firestone* court recognized that banks really do something with their money. *See* 159 Ohio St. at 441, 112 N.E.2d at 645.

[30] *Id.* at 441, 112 N.E.2d at 645.

[31] *Id.* at 430, 112 N.E.2d at 640-41.

[32] *Id.* at 431, 112 N.E.2d at 641.

[33] U.C.C. § 3-302(2).

[34] U.C.C. § 3-302(1).

[35] *See, e.g.*, Michelin Tires (Canada) Ltd. v. First Nat'l Bank of Boston, 666 F.2d 673, 681, 32 U.C.C. Rep. Serv. 657, 670 (1st Cir. 1981).

payor bank in one of the approved ways, and the extreme passage of time in *Firestone* would eliminate any possibility of arguing today that payment was not final under Article 4.[37] There is, however, a bit of slippage between Article 3 and Article 4 on this point. Section 3-418 provides for finality of payment—except for recovery of bank payments under Article 4 and except for liability for breach of warranty—where payment is made to a holder in due course *or* to one who has in good faith changed position in reliance on payment. If the bank in *Firestone* would qualify today as a holder in due course, that would be the end of the problem as far as Firestone's getting the money back is concerned, but even if the bank did not so qualify, the bank clearly must have changed its position in reliance on the payment, and this would simply be a matter of the bank proving that point to the satisfaction of the trier of facts.

The court's view that Firestone was guilty of no negligence in failing to notice for five months that no goods were received, reinforced, in that aspect of the opinion, Firestone's right to recover money paid to the bank as assignee. The court somehow thought that the bank induced the mistake. However, the documents were sent to Firestone by the seller, not by the bank.[38] There was no warranty of genuineness of documents made by a bank which was neither negotiator nor transferor under prior law,[39] nor is there under the Code.[40] The court recognized that there was no warranty of genuineness made by the bank but found that "delivery was a representation that these papers were on their face all they purported to be and was for the purpose of inducing payment."[41] The difference between a breach of this representation (and its effect) and a breach of warranty (and its effect) would appear to be sub-microscopic, if any difference could possibly be found. But the court found that the bank, having made an innocent but false "representation" to Firestone

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[36] U.C.C. § 3-305.

[37] Firestone made payments on forged bills of lading in the latter part of November, 1946, and did not give notice that no goods evidenced by the bills of lading had been received until late April, 1947. The seller-assignor had filed a bankruptcy petition on February 7, 1947. 159 Ohio St. at 426-29, 112 N.E.2d at 639-40. It would appear that, even in the trusting days of the 1940s, Firestone was guilty of laches in making a claim against the bank five months after goods purportedly were shipped, for nonexistent goods could obviously never arrive, and their failure to arrive should have been promptly known and notification given of the nonarrival.

[38] *Id.* at 426, 112 N.E.2d at 639.

[39] The Uniform Bills of Lading Act, § 35, provided for warranties by the "person who negotiates or transfers for value . . . ." There is a similar provision in the Federal Bills of Lading Act, 49 U.S.C. § 114 (1951).

[40] *See* U.C.C. § 7-508. This provision exempts collecting banks or other intermediaries from the warranties provided in § 7-507 for those who negotiate or transfer documents of title; collecting banks or other intermediaries warrant only their own good faith and authority.

[41] 159 Ohio St. at 440, 112 N.E.2d at 645.

by delivery of the seller's forged documents of title, provided a "clear basis for recovery of the money paid under mistake of fact."[42]

In the last part of the opinion the court concludes that the bank did not, because of Firestone's failure to give prompt notice of nonreceipt of the goods, change its position in any way, and Firestone would be entitled to recover insofar as the bank had credited payments towards debts owing to the bank.[43] Had the bank been promptly notified of the forged documents and the nonreceipt of the goods allegedly shipped, it might have been possible to salvage something from the wreckage before the seller's descent into bankruptcy, from which apparently nothing was payable to creditors such as the bank.[44] Indeed, the decision made it impossible for the bank to retain a payment received in November of 1946, when it was timely, with no hope of future payment after the debtor's bankruptcy, which would seem to be a considerable change of position ex post facto.

The *Firestone* decision was relied on in the earliest Code case dealing with the point, *Farmers Acceptance Corp. v. DeLozier*,[45] where the court concluded that there was no showing that the assignee had changed its position based on the account debtor's payment to it; and in the absence of evidence of detrimental reliance on the sole payment received, the account debtor was entitled to recover the payment made to the assignee, at least to the extent the assignee applied the funds received toward a debt owing to it by the assignor.[46] Not one of the cases cited in *DeLozier*, aside from *Firestone*, supports the proposition that the assignee is liable to pay back money received by it, absent a change of position, if the assignor fails to perform. Four of the cited cases involve unsuccessful attempts by the assignee to get payments which were not earned under the contract involved.[47] One case perhaps is cited because

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[42] *Id.* As noted in the text at *supra* note 38, the bank did not transmit the documents to the buyer Firestone.

[43] *See supra* text accompanying note 28.

[44] 159 Ohio St. at 441, 112 N.E.2d at 646.

[45] 178 Colo. 291, 496 P.2d 1016, 10 U.C.C. Rep. Serv. 1099 (1972). The *DeLozier* court relied on and quoted a part of Professor Gilmore's statement of what the *Firestone* case held, although the formulation of a general principle is attributed to Professor Gilmore. *Id.* at 296, 496 P.2d at 1018-19, 10 U.C.C. Rep. Serv. at 1103. *See also supra* note 27 and accompanying text.

[46] 178 Colo. at 296, 496 P.2d at 1018-19, 10 U.C.C. Rep. Serv. at 1103. Some of the payments received from the account debtor had been paid to a supplier of materials to the assignor for use in a construction project. The principal issue in the case was whether the assignee had to repay the balance to the account debtor which the assignee had applied toward repayment of borrowed funds. *Id.* at 293, 496 P.2d at 1017, 10 U.C.C. Rep. Serv. at 1101.

[47] Denver United States Nat'l Bank v. Asbell Bros. Const., 294 F.2d 289 (10th Cir. 1961); McCormick v. Diamond Shamrock Corp., 175 Colo. 406, 487 P.2d 1333 (1971); Matson & Mulhausen Const. Co. v. Boulevard Nat'l Bank, 28 Colo. App. 427, 475 P.2d 356 (1970); Associates Loan Co. v. Walker, 76 N.M. 520, 416 P.2d 529, 3 U.C.C. Rep. Serv. 648 (1966).

it stands for the proposition that "claim," as used in section 9-318(1), presumably includes set-offs and counterclaims.[48] The reason for the citation of one case,[49] an action for an injunction restraining a landlord from interfering with a tenant's quiet enjoyment of farm property, is indeed obscure.[50]

There seem to be only three reported Code cases which have followed the *Firestone* view, and the second to appear was *Benton State Bank v. Warren*.[51] The *Warren* case also involved a construction contract where the owner made progress payments, which had been assigned to the bank as security for a loan, and the funds received were diverted, so that various materialmen asserted liens after the owner had to take over and complete the construction. The owner sued the contractor-assignor and the bank-assignee and recovered judgment against both, from which the bank appealed. The Supreme Court of Arkansas said: "The sole question is whether the loss should be borne by the bank or the Warrens [owners]. As we view the case, that question in turn depends upon which was more seriously at fault in allowing the loss to occur . . . ."[52] While not explicitly stated in the opinion, apparently recovery from the contractor would have been improbable because of financial problems. The Supreme Court affirmed the trial court's judgment against both the contractor and the bank, which presumably left the bank to pay the judgment to the owner for losses arising out of the diversion of funds paid to the bank as assignee, which funds the bank used in part to repay itself for loans on the Warren project and in part to repay itself for other loans, with the balance being deposited in the contractor's general account at the bank. The only cases cited in support of the holding were the *DeLozier* case and the *Firestone* case. There was, however, a dissenting opinion in which the view was expressed that "[t]he effect of the majority holding is to make every Banker, who has taken an assignment of accounts for security purposes, a deep pocket surety for every bankrupt contractor in the state to whom it has loaned money."[53]

These cases support the point for which they are cited in *DeLozier*; that is, the assignee's rights are subject to claims and defenses arising out of the assigned contract, as stated in § 9-318(1)(a). These cases do not involve an effort by an account debtor to recover payments made to an assignee.

[48] Hudson Supply & Equip. Co. v. Home Factors Corp., 210 A.2d 837, 2 U.C.C. Rep. Serv. 910 (D.C. 1965).

[49] Westing v. Marlatt, 124 Colo. 355, 238 P.2d 193 (1951).

[50] The *Westing* case has nothing to do with assignments of accounts in the context of any of the cases dealt with in the text. There was a claim made for recovery of overpayment of crop rental in previous years, and the court concluded that in the case of money paid by mistake, the fact that the person receiving the money acted in good faith would not preclude recovering the money. It should be emphasized that the case involves payments under a real property lease. *See id.* at 359-60, 238 P.2d at 194-95.

[51] 263 Ark. 1, 562 S.W.2d 74, 23 U.C.C. Rep. Serv. 1303 (1978).

[52] *Id.* at 3, 562 S.W.2d at 74, 23 U.C.C. Rep. Serv. at 1304.

[53] *Id.* at 8, 562 S.W.2d at 77, 23 U.C.C. Rep. Serv. at 1308. The principal Code point in

The third case to follow the *Firestone* holding was *K Mart Corp. v. First Pennsylvania Bank.*[54] The *K Mart* case involved a long-term relationship between K Mart and a supplier of goods for sale in K Mart's stores. The supplier had assigned its accounts to the bank in 1970, and the bank had collected its accounts from that time until the supplier became bankrupt in 1977. Because it took some time for K Mart to discover that defective goods had been shipped, when such was the case, the practice had developed of deducting amounts previously paid for defective goods from future payments for then current shipments. Neither the bank nor the supplier had ever objected to this procedure. Of course, when the supplier became bankrupt there were no more shipments and there was nothing owing from which credits due for defective goods could be deducted. This resulted in K Mart suing the bank to recover payments made to the bank for defective goods shipped by the supplier. The court gave judgment for K Mart, relying principally on *Firestone, DeLozier,* and *Warren,* apparently believing that these cases represent the "fairer standard."[55] It is interesting to note that, according to the court, K Mart had cited only one case[56] in support of its view of section 9-318, and that case was irrelevant. The various other cases cited may have come from the court's own research, for surely the bank would not have cited them, except to suggest that they were erroneous, and the Code cases supporting the bank's position are not cited in the opinion.

The court states toward the end of the opinion: "The Bank received funds to which it was not entitled, i.e., for defective merchandise, and, consequently, fairness and logic, no less than the provisions of the UCC previously cited, require that it return those funds to K mart."[57] The "previously cited" Code provisions are: section 2-601 dealing with the buyer's rights on improper delivery, which would be irrelevant in this contest; section 9-317, which will be discussed below; section 9-318(1), which was crucial to the case; several sections of Article 3, which were irrelevant to the case, for rights under commercial paper were not involved;

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the dissent was that § 1-201 (36) states " 'Rights' includes remedies" and that if "remedies" were used instead of "rights," § 9-318(1)(a) would say "the [remedies] of the assignee are subject to (a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom . . . ." *Id.* However, it was not the assignee who was suing here, but rather it was the assignee who was being sued.

[54] 29 U.C.C. Rep. Serv. 701 (Pa. Ct. Com. Pleas, 1980).

[55] *Id.* at 705.

[56] Investment Serv. Co. v. North Pacific Lumber Co., 261 Ore. 43, 492 P.2d 470, 10 U.C.C. Rep. Serv. 486 (1972). In this case a buyer of goods was asserting the right to set off against a payment due for a shipment a claim for defective goods previously paid for, where the seller had assigned accounts to a financer. This right of set off was properly recognized to be authorized by § 9-318(1)(a), and this is quite a different matter from a buyer attempting to assert against an assignee an affirmative claim for a refund which would be good against a seller.

[57] 29 U.C.C. Rep. Serv. at 706.

and section 2-711, which the court thought gave the buyer (K Mart) a right to obtain a refund not only from the seller for "overpayments for defective merchandise"[58] but also from the bank as the seller's assignee. While section 2-711 states the buyer's remedies in certain circumstances, those remedies are the buyer's remedies against the seller, not the seller's financer who is holding an assignment of accounts arising out of sales.

Section 9-317, which the court thought not in point, states: "The mere existence of a security interest or authority given to the debtor to dispose of or use collateral does not impose contract or tort liability upon the secured party for the debtor's acts or omissions." According to the Official Comment to section 9-317, the Code section is based on section 12 of the Uniform Trust Receipts Act which provided that an entruster (i.e., secured party) was not responsible as principal or as vendor, under sales or contracts to sell made by the trustee (i.e., debtor), merely by virtue of having a security interest or because the trustee (debtor) had been given liberty of sale or other disposition. While the Trust Receipts Act's provision was designed to insulate a financer from liability based merely on status—such as liability for breach of warranty in connection with sales of goods whose acquisition by the seller was made possible by the financer—the Code provision is both broader and deeper. The Code refers to both disposition and use of collateral. It refers explicitly to both contract and tort liability. The Code is broad enough that, regardless of any possible underlying basis for section 9-317, it could be read to be in point on the sort of issue involved here. Those cases discussed above holding the assignee liable merely because of the assignee's status as secured party—and that status seems to be the basic reason for liability—are indeed imposing contract or tort liability on the secured party-assignee for the debtor's failure to apply the proceeds of a loan properly or, in the *K Mart* case, for supplying unsatisfactory goods. It would appear that in the *K Mart* case the sole basis for liability was the existence of the security interest. The court views the provision in section 9-317 as meaning that "the Bank cannot be held liable for damages sustained by K mart either in tort on contract actions by reason of the assignor's act or omission."[59] However, the plaintiff filed a complaint in assumpsit, and that was a traditional remedy for the recovery of damages under an implied or express contract not under seal.[60] The security agreement is nothing more or less than a contract[61] between the parties which has the effects stated in Article 9. While the court states

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[58] *Id.*

[59] *Id.* at 707.

[60] *See* H. STEPHEN, TREATISE ON THE PRINCIPLES OF PLEADING IN CIVIL ACTIONS 18-19 (S. Williston ed., 5th ed. 1895).

[61] U.C.C. § 9-102(2) states: "This Article applies to security interests created by contract . . . ."

that "K mart is not attempting to hold the Bank liable for . . . delivery of defective merchandise or any resultant loss,"[62] of course that is exactly what the buyer is attempting to do and what the buyer succeeded in doing.

Aside from the three Code cases which have just been discussed, there have been two Code cases, besides *Michelin*,[63] which denied the account debtor an affirmative right to sue the assignee: *James Talcott, Inc. v. Brewster Sales Corp.*[64] and *Meyers v. Postal Finance Co.*[65] The *Brewster* case holds that, once the assignee is paid (in this case by a guarantor), the account debtor cannot maintain an action against the assignee to recover the amount of the account paid but must seek recovery from the assignor (here several manufacturers of allegedly defective merchandise).[66] The *Meyers* case states that section 9-318(1) merely codifies the pre-Code rule that an assignee's right to collect accounts under an assigned contract is subject to the defenses, set-offs, and counterclaims which could be asserted by the account debtor against the assignor.[67] The case holds that an assignment, where the assignee has not affirmatively assumed the obligations and liabilities of the assignor to the account debtor, does not impose on the assignee the duties or liabilities of the assignor, so that the assignee is not liable to repay funds collected from the account debtor.[68] The court relies for this point, mistakenly it would appear, on *DeLozier*[69] which is discussed above,[70] and on two pre-Code cases.[71]

It is, as must now be obvious, the basic point of this article that section 9-318(1) does not give the account debtor an affirmative right to recover payments made to an assignee. The cases are divided, but the cases giving an affirmative right apparently rely on the judges' views of a "right" or "equitable" result rather than on the express language of

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[62] 29 U.C.C. Rep. Serv. at 707.

[63] Michelin Tires (Canada) Ltd. v. First Nat'l Bank of Boston, 666 F.2d 673, 32 U.C.C. Rep. Serv. 657 (1st Cir. 1981).

[64] 16 U.C.C. Rep. Serv. 1165 (N.Y. Sup. Ct. 1975).

[65] 287 N.W.2d 614 (Minn. 1979).

[66] 16 U.C.C. Rep. Serv. at 1167. The New York court relied on two pre-Code New York cases: Iselin-Jefferson Fin. Co. v. Makel Textiles, Inc., 21 A.D.2d 758, 250 N.Y.S.2d 299 (1964), and McMullen Leavens Co. v. L. I. VanBuskirk Co., 275 A.D. 701, 87 N.Y.S.2d 355, *aff'd*, 229 N.Y. 784, 87 N.E.2d 682 (1949).

[67] 287 N.W.2d at 617.

[68] *Id.* The *Meyers* court rejected several other theories proposed by the plaintiff: the assignee was not liable on the ground that the assignee and assignor were engaged in a joint venture; the so-called "close connection" doctrine, somewhat analogous to joint venture, was not applicable; and the Minnesota Prevention of Consumer Fraud Act, MINN. STAT. §§ 325.78-325.80 (1978), was inapplicable. *See* 287 N.W.2d at 617-20.

[69] Farmers Acceptance Corp. v. DeLozier, 178 Colo. 291, 496 P.2d 1016, 10 U.C.C. Rep. Serv. 1099 (1972).

[70] *See supra* text following note 31.

[71] Pioneer Loan & Land Co. v. Cowden, 128 Minn. 307, 150 N.W. 903 (1915); Walker v. Phillips, 205 Cal. App. 2d 26, 22 Cal. Rptr. 727 (Cal. Ct. App. 1962).

the underlying statute which is the source of those rights. It may be that the swing is now in favor of the Code's provision.[72] If the Code's provision had been more clearly drafted or better understood, surely a misguided pre-Code case would not have been so influential in some recent cases in which earlier, pre-Code decisions really are not relevant.

[72] After this article was written, another decision denying an affirmative right to sue under U.C.C. § 9-318(1) was published and it, too, is in line with Michelin Tires (Canada) Ltd. v. First Nat'l Bank of Boston, 666 F.2d 673, 32 U.C.C. Rep. Serv. 657 (1st Cir. 1981). *See* Gold Circle Stores v. Riviera Finance-East Bay, Inc., 540 F. Supp. 15, 34 U.C.C. Rep. Serv. 347 (N.D. Cal. 1982).