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Annual Survey of Virginia Law: Commercial Law

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COMMERCIAL LAW

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I. Introduction

It has been a quiet year in the Commonwealth of Virginia, at least in the area of commercial law. There have been only a smattering of cases, for the most part routine, and slight amendments to Virginia's Uniform Commercial Code (the "Code"). The most significant commercial law development occurred neither in the General Assembly nor the courts, but at the Federal Trade Commission, which is again busying itself with the regulation of consumer credit.

This article covers all important changes made to the Code during the 1986 session of the General Assembly. It also covers all significant Virginia Supreme Court cases dealing directly with the Code, together with significant reported Virginia law cases from the Court of Appeals for the Fourth Circuit, the various Federal District and Bankruptcy Courts sitting in Virginia, and the Virginia Circuit Courts. Highly unsystematic attention is also given to some developments that indirectly affect the Code. This article is current through approximately May 1, 1986. The goals of the article are twofold: to give practitioners ready access to recent commercial law developments and to encourage a deeper understanding of the policies and intricacies of the Code.

II. Sales

A. *Contract Formation and Terms*

One of the most radical changes made to the Code was the abandonment, in Article Two transactions, of traditional contract rules governing the formation and terms of contracts. The drafters of the Code thought that the traditional approach placed too much emphasis on the parties' objective manifestations of assent (e.g., the words in the document they signed) and too little on their

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"agreement in fact" (what they meant by the words in the document they signed).[1] A number of provisions in the Code now require the courts to focus much more closely than before upon the "agreement in fact." For example, it is now possible for the stated terms of the offer and acceptance to vary, yet still create a contract, provided that the offeree intended to accept the offer.[2] Similarly, the statute of frauds has been pared to a bare minimum; little is needed to meet the requirement of a writing evidencing a contract, and more exceptions have been added to those previously recognized at common law.[3] The common thread uniting these and many other provisions is the de-emphasis of legal technicalities which preclude a court from determining whether the parties had a contract and, if so, what it was.

The Virginia Supreme Court case of *Armco, Inc. v. New Development Co.*[4] provides virtually a textbook example of the difficulties created by the Code's approach to contract formation and terms. Unfortunately, the court's effort to effectuate the policies underlying the Code, and its success in reaching what was quite possibly the correct result, were not matched by a technical proficiency in elucidating the relevant provisions of the Code. Several related but distinct provisions of Article Two were compressed in such a way as to risk serious confusion regarding the proper approach to contract formation and terms. This problem appears to have arisen primarily because the focus of the parties (and thus of the court) was on other, less complex, issues.

The plaintiff, New Horizon Development Company of Virginia, Inc. ("New Horizon"), ordered a quantity of corrugated water pipe from Armco, Inc. ("Armco"). Although the pipe was ordinarily used in a horizontal position, New Horizon used it in a vertical position. The pipe leaked. New Horizon corrected the leaks by welding seams and joints in the pipe, and then sued Armco for the

1. This aspect of Article Two has been exhaustively discussed in the law reviews; the author's favorite study is undoubtedly Herbert, *Contracts of Accretion: A Modest Proposal for U.C.C. Section 2-207*, 14 MEM. ST. U.L. REV. 441 (1984).

2. VA. CODE ANN. § 8.2-207(1) (Add. Vol. 1965) states: "A definite and seasonable expression of acceptance . . . operates as an acceptance even though it states terms additional to or different from those offered . . . unless acceptance is expressly made conditional on assent to the additional or different terms." Under limited circumstances, those additional terms can even become part of the contract. *Id.* § 8.2-207(2).

3. *See infra* notes 19-22 and accompanying text.

4. 229 Va. 561, 331 S.E.2d 456 (1985).

cost of the repairs.[5]

It appears, although it is not expressly stated in the case, that New Horizon's purchase order was oral.[6] Armco responded with a lengthy Acknowledgment form which contained, among other things, a warranty limitation and a provision excluding consequential damages.[7] The question perceived by the court as the central issue in the case was whether the jury should have been allowed to determine whether there existed warranties extending beyond those expressly stated in the Acknowledgment.[8]

The court's primary determinations are unobjectionable. First, the court noted that the Article Two parol evidence rule bars most evidence contradicting the terms of a written, "final expression" of the parties' agreement.[9] Second, the court held that a pre-Code Virginia statute which sets forth certain typeface and disclosure requirements in contracts for sale of personal property[10] had been superseded by the Code.[11] Third, while noting that the Code requires certain warranty disclaimers or limitations to be conspicuous,[12] the court held that the warranty terms of the Acknowledgment form met this requirement because they were printed in larger type than was used for most of the other terms in the contract.[13] As a result, the warranty limitations (which did not comply with the pre-Code statute) were sufficient as a matter of law to exclude warranties beyond those given in the Armco document. Thus, the question regarding the scope of Armco's warranties should not have been submitted to the jury; the lower court's deci-

5. *Id.* at 562-65, 331 S.E.2d at 457-59.

6. The court stated that "[t]he purchase order *was memorialized by* an acknowledgement . . . from Armco." *Id.* (emphasis added). This certainly suggests that the original order was not in writing. Moreover, a significant portion of the case was concerned with the contract compliance with the Statute of Frauds, an issue that should not have arisen if the order was in writing. *See infra* notes 19-22 and accompanying text.

7. *Armco*, 229 Va. at 562-64, 331 S.E.2d at 457-58.

8. *Id.* at 566-67, 331 S.E.2d at 459-60.

9. *Id.* at 566, 331 S.E.2d at 459. The court was interpreting VA. CODE ANN. § 8.2-202 (Add. Vol. 1965).

10. The statute, VA. CODE ANN. § 11-4 (Repl. Vol. 1985), requires a vendor using its own form to use clear printing or writing and to state certain terms in ten point type. It was enacted in 1920. Act of March 16, 1920, Ch. 257, 1920 Va. Act 362.

11. *Armco*, 229 Va. at 567, 331 S.E.2d at 460; *see also* VA. CODE ANN. § 8.10-103 (Add. Vol. 1965).

12. VA. CODE ANN. § 8.2-316(2) (Add. Vol. 1965).

13. *Armco*, 229 Va. at 567, 331 S.E.2d at 460. This position corresponds with most courts' approach. *See generally* J. WHITE & R. SUMMERS, HANDBOOK OF LAW UNDER THE UNIFORM COMMERCIAL CODE § 12-5, at 440-44 (2d ed. 1980).

sion was reversed and judgment entered for Armco.[14]

The weakness in this case is not that these determinations are wrong, but that they are based upon a series of predicates that are incompletely stated and inadequately analyzed. These include the application of the parol evidence rule (and its relationship to the provisions on contract formation and the statute of frauds) and the scope of the warranty disclaimer. These problems are addressed in order.

To begin with, the exclusionary parol evidence rule only applies if the parties' confirmatory memoranda agree or there is "a writing intended by the parties as a final expression of their agreement."[15] Even then, evidence of consistent additional terms is not barred "unless the court finds the writing to have been intended also as a *complete and exclusive* statement of the terms of the agreement."[16] In its discussion of the parol evidence rule questions, the court failed to discuss adequately three major issues. First, was the Armco Acknowledgment form intended by the parties to be the final expression of their agreement? Second, assuming it was, did they further intend it to be a complete and exclusive expression of their agreement? Finally, who (the judge or the jury, the supreme court or the trial court) is to decide what it was that the parties intended?

The third, and least complex question, is implicitly answered by the court's entry of judgment in favor of Armco, i.e., that the intent predicates of the parol evidence rule are questions of law, to be decided by the trial judge in the first instance subject to unlimited review by the appeals court. Other states seem to be divided on this question.[17] A leading treatise takes the position that the issue of finality is a factual question (presumably to be decided by a jury in a jury case) unless there is no factual dispute about the parties' intent, whereas the issue of exclusivity is a question of law.[18]

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14. *Armco*, 229 Va. at 567, 331 S.E.2d at 460.

15. VA. CODE ANN. § 8.2-202 (Add. Vol. 1965).

16. *Id.* (emphasis added).

17. *See, e.g.*, Conner v. May, 444 S.W.2d 948 (Tex. Civ. App. 1969) (judge question); Peter Pan Seafoods, Inc. v. Olympic Foundry Co., 17 Wash. App. 761, 565 P.2d 819 (1977) (question for trier of fact).

18. 2 R. ANDERSON, UNIFORM COMMERCIAL CODE § 2-202:33, at 155 (3d ed. 1982). Anderson further states that the trial court, not an appeals court, should make the necessary determinations—obviously an additional question mark against the *Armco* decision. *Id.* at 157-58;

The first two questions, those concerning the intent of Armco and New Horizon, raise more troubling issues. All that the court had before it in determining the predicate intentions was the Armco Acknowledgment and the fact that New Horizon accepted, paid for, and used the goods. While this raises a strong, and perhaps compelling inference that New Horizon agreed that Armco's form would constitute the contract, the court's stated conclusion is based on a serious misreading of the Article Two statute of frauds.

Article Two requires written evidence as a predicate to enforcement of many sales contracts.[19] Without such evidence, the contracts are unenforceable. However, the Code does not require the entire contract to be in writing; it only requires an indication that a contract has been made, a quantity term, and the signature of the party to be charged.[20] Even these modest requirements are unnecessary in many circumstances. Two of the Code's exceptions applied in the *Armco* case. First, the statute of frauds does not bar enforcement of fully performed contracts such as the Armco-New Horizon contract.[21] Second, if a merchant sends a confirmation to another merchant, and that confirmation is sufficient to bind the sender, it also binds the recipient unless written notification of objection is given within ten days after the confirmation is received.[22] In *Armco*, New Horizon received a sufficiently binding form from Armco. New Horizon did not object to this form and consequently, as of the eleventh day after receiving the form, New Horizon was also bound by the contract and could not raise the statute of frauds as a defense.

All well and good. The court, however, stretched this "merchant confirmation rule" far beyond its proper bounds. It held that New Horizon was not only bound by the contract, but that the Armco *form* was the contract. This is not what Article Two directs. The merchant confirmation rule was not designed to determine contract terms, but merely to permit contract enforcement.[23] In other

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see also VA. CODE ANN. § 8.2-202 comment 3 (Add. Vol. 1965) (exclusivity is a question for the court).

19. Namely, written evidence must be present for sales contracts with a purchase price of $500 or more. VA. CODE ANN. § 8.2-201(1) (Add. Vol. 1965).

20. *Id.*

21. *Id.* § 8.2-201(3)(c).

22. *Id.* § 8.2-201(2).

23. A long line of New York cases, ultimately overruled, followed the same reasoning as the *Armco* court. Those cases are ably reviewed and scathingly criticized in Duesenberg, *Contract Creation: The Continuing Struggle with Additional and Different Terms Under*

words, the rule means that New Horizon could not refuse to comply with the contract, whatever it was. The rule does not mean that the terms proposed by Armco were the terms by which New Horizon was bound.

The Code provision which should have been consulted is section 8.2-207,[24] which governs contract formation and terms in the so-called "battle of the forms."[25] Unfortunately, this Code section was not even mentioned in the case, perhaps because the parties discounted its significance. This section is almost unrivaled in the Code for complexity, yet several possible resolutions of the Armco-New Horizon contract could have been justified by its wording and underlying policies. Curiously, with regard to the question of the contract's warranty terms, the two most likely resolutions of the section 2-207 issue would probably have led to the same result that the court reached by its misapplication of the statute of frauds.

Section 8.2-207 states that an acceptance can vary from an offer, yet still create a contract, if the acceptance is "definite and seasonable."[26] Assuming that New Horizon was the offeror, did the acceptance vary its terms? If so, was it a definite acceptance? Curiously, there is little indication that the offer and acceptance differed with regard to what the court viewed as the crucial disputed term at issue—the scope of the warranty. The case is silent as to what, if any, warranty terms were included in New Horizon's offer. If none were expressly included, the offer would still contain the warranty of merchantability, which is implied by the Code itself.[27] The Armco Acknowledgment, on the other hand, contained a functionally identical *express* warranty of merchantability.[28] Thus, there was no conflict over this term. There were, however, other provisions that differed from the offer, perhaps most significantly those that excused Armco from liability for consequential damages. Presumably, the offer was silent on this issue and thus implicitly incorporated the Code-provided remedy of consequential damages. The Acknowledgment entirely eliminated that remedy. In addition,

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Uniform Commercial Code Section 2-207, 34 BUS. LAW. 1477, 1480-83 (1979).

24. VA. CODE ANN. § 8.2-207 (Add. Vol. 1965).

25. A somewhat misleading name because it applies even when, as in *Armco*, the first party made an oral, rather than written form, purchase order.

26. VA. CODE ANN. § 8.2-207(1) (Add. Vol. 1965).

27. *Id.* § 8.2-316; *see also* J. WHITE & R. SUMMERS, *supra* note 13, at 30.

28. The form stated, in pertinent part: "Seller warrants that products bought on the basis of the description thereof, as appears or is referred to on the face hereof, *are of merchantable quality.*" *Armco*, 229 Va. at 563, 331 S.E.2d at 458 (emphasis added).

the offer's inclusion of the implied warranty of merchantability did not exclude other warranties of quality while, of course, the Acknowledgment did.[29]

Thus, there was a variance in terms. Was the Acknowledgment still an acceptance? Quite possibly not because it did contain conspicuous language stating that the acceptance was "valid only with the inclusion of all 'conditions of sale' (including but not limited to limited warranties, limitation of buyer's remedies, and limitations of liability for failure or delay in delivery) on the back hereof."[30] This language seems to render the "acceptance" a nullity by conditioning it upon the acceptance by New Horizon of Armco's other terms.[31]

There are two likely scenarios for the resolution of this conflict. The first would treat the Acknowledgment as a counter-offer, accepted by performance. Under this approach, the Acknowledgment would be the source of the contract's terms or, to rephrase it in parol evidence rule language, the acceptance of the counter-offer would also evidence an intention by the buyer to treat the document containing the counter-offer as a final and exclusive expression of the parties' agreement.

The second scenario would agree that no contract was created by the initial offer and acceptance, but would further hold that the Acknowledgment was a mere rejection rather than a counter-offer. The rationale for this approach is that Article Two has a specific provision for dealing with situations in which the contract is not created by the parties' forms but rather by the parties' conduct.[32] The situation presented in *Armco*, where the parties' expressions of the contract were in hopeless conflict, may be an appropriate one in which to apply this provision. The terms of a contract created by the parties' conduct include those "on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this act."[33] Since the war-

29. *Id.*

30. *Id.* at 562, 331 S.E.2d at 457.

31. *See* VA. CODE ANN. § 8.2-207(1) (Add. Vol. 1965).

32. *Id.* § 8.2-207(3) states:

> Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case, the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this act.

33. *Id.*

ranty of merchantability is supplied by the Code, it would have been part of the contract; however, the parol evidence rule would not apply with regard to the other terms of the Acknowledgment because there would be no manifestation of intent to make the document a final or exclusive statement of agreement.

Note, however, that in either case there would be a warranty of merchantability. This leads us to the most peculiar feature of the case—the fact that the Virginia Supreme Court not only reversed but entered judgment for Armco. This was done in spite of the complete absence of any discussion about the merchantability of the pipe. The simple truth is that the warranty was made. Was it breached? The opinion is silent. Similarly, the court failed to address a further critical contract terms issue: was the provision excluding recovery for consequential damages enforceable? New Horizon, after all, was suing for consequential damages, namely, the cost of the repairs it made to the pipe.

In short, the Virginia Supreme Court can be commended for its effort to reach the agreement-in fact between Armco and New Horizon. Quite possibly, that agreement was encompassed in the Acknowledgment form. If so, the elimination of consequential damages means that the court was quite correct in finding for Armco. However, because of its cursory review of the difficult Article Two questions, the *Armco* case muddies, rather than clarifies, important aspects of Virginia sales law. While this is largely a by-product of the parties' apparent lack of concern for the main Article Two issues in the case, it still leaves us with a somewhat bewildering opinion, and the hope that the confusion unintentionally created will be ameliorated in the future.

B. *Miscellaneous Cases*

A group of unremarkable federal court cases round out the Sales part of this article. One case held that the implied warranty of merchantability attaches to *used* goods (not merely to new goods) sold by a merchant, but that the scope of the warranty is narrower in that it obviously takes into account normal wear and tear.[34] An-

34. Whittle v. Timesavers, Inc., 614 F. Supp. 115, 118 (W.D. Va. 1985). The court held that a pre-Code Virginia Supreme Court case, Smith v. Mooers, 206 Va. 307, 142 S.E.2d 473 (1965), which can be read to say that used goods carry no merchantability warranty, was superseded by the Code. *Whittle*, 614 F. Supp. at 118. In fact, the discussion in the *Smith* case about warranties is technically dicta, because there had never been a sale of the alleg-

other case discussed the requirement that a buyer who has accepted defective goods must give the seller notice of any breach of warranty within a reasonable time, or be barred from any remedy.[35] A third case noted that Article Two contains no general choice-of-law rules and thus, in the absence of any valid contractual choice-of-law provision, normal state rules apply to determine applicable law.[36]

The last case in this group noted that Article Two applies to *all* sales of goods, not just to sales made by merchants.[37] This small but not irrelevant bit of sales lore is forgotten with astounding frequency by students, at least, and lawyers, perhaps.

III. Commercial Paper

A. *Holder-in-Due-Course*

The Virginia Supreme Court undertook an extended and largely fruitful excursion through the wilds of the holder-in-due-course doctrine in the case of *Lawton v. Walker*.[38] In *Lawton*, the defendant, Walker, had executed a $12,000 note in 1976 for the purchase of an automobile. Walker subsequently claimed that the purchase price was actually $7,200 (including interest). In 1980, the original holder of the note (Swersky) sold the note and Walker's certificate of title to Lawton, along with two mortgages on houses owned by Walker. Lawton paid $5,000 for the note, which had a balance due of $7,500. Walker continued to pay Lawton until October 1981, at which time there was a balance due of $4,950.[39]

The key issue was whether Lawton was a holder-in-due-course (HDC) of the note. If he were, Lawton would take free of Walker's fraud defense.[40] Walker argued that Lawton was not an HDC, because: (1) an HDC must take the instrument in good faith; (2) an HDC must take without notice of any claim or defense to the instrument;[41] and, (3) the HDC cannot take the instrument as part

edly defective goods. The plaintiff had been injured while test driving a used car he was thinking about buying. *Smith*, 206 Va. at 313, 142 S.E.2d at 477.

35. Smith-Moore Body Co. v. Heil Co., 603 F. Supp. 354 (E.D. Va. 1985).

36. Udo Madaus v. November Hill Farm, Inc., 630 F. Supp. 1246 (W.D. Va. 1986).

37. Sprague & Henwood v. Johnson, 606 F. Supp. 1564 (W.D. Va. 1985).

38. 231 Va. ___, 343 S.E.2d 335 (1986).

39. *Id.* at ___, 343 S.E.2d at 336.

40. Va. Code Ann. § 8.3-305(2) (Add. Vol. 1965).

41. *Id.* § 8-302(1)(a)-(b).

of a non-ordinary course bulk transfer.[42]

The Virginia Supreme Court rejected all three arguments. It noted that the test for good faith is a wholly subjective one, and found no evidence of subjective bad faith.[43] In addition, the court held that the "bulk purchase" limitation did not apply, as it extends only to situations such "as when a reorganized or consolidated corporation takes over in bulk the assets of a predecessor."[44] The mere fact that Lawton purchased several items at the same time (the note and the two mortgages) did not make the transfer a bulk transfer.[45]

The court's treatment of the notice issue is somewhat troubling. The Code has a non-standard provision which narrowly defines notice of a claim or defense as existing only when "the purchaser [has] knowledge of the claim or defense or knowledge of such facts that his action in taking the instrument amounts to bad faith."[46] In *Lawton*, the only evidence that Lawton had notice of a defense was that he knew that the note related to the sale of a 1976 Ford automobile, that the original amount owed on the note was stated as $12,000, that he paid $5,000 for a note with a $7,050 balance, and that he was given no evidence that "financing or disclosure statements required by consumer protection laws" had been given to Walker.[47] In Walker's view, "it should have been obvious to Lawton that the loan was made at a usurious rate of interest."[48] The court brushed aside this evidence.

The only question raised by this case is a procedural one. It is hard to argue with the court's evaluation of the evidence of notice, which was scant at best, especially in light of Virginia's very restrictive definition of notice. It is possible, however, to quibble over the fact that the supreme court, rather than the trial court, resolved the issue. The trial court, after examining the bulk transfer issue, had found that Lawton was not an HDC.[49] The supreme court not only reversed the trial court, but entered judgment for

42. *Id.* § 8-302(c).
43. *Lawton*, 231 Va. at ___, 343 S.E.2d at 337-38.
44. *Id.* at ___, 343 S.E.2d at 339.
45. *Id.*
46. VA. CODE ANN. § 8.3-304(7) (Add. Vol. 1965).
47. *Lawton*, 231 Va. at ___, 343 S.E.2d at 338. This statement is peculiar since no "financing statements" are required by any consumer law.
48. *Id.*
49. *Id.* at ___, 343 S.E:2d at 337.

Lawton.[50] In doing so, the court effectively held that Walker's evidence was insufficient as a matter of law; in other words, the fact finder could not have found for Walker on the evidence presented. This in turn means that none of the facts presented, singularly or together, were sufficient to demonstrate notice.

B. *Rights of Holders and Liabilities of Parties*

1. Statute of Limitations

Several recent cases explored the rights of holders of negotiable instruments and the liabilities of parties to those instruments. The most complex was *Guth v. Hamlet Associates, Inc.*[51] In *Guth*, the plaintiffs had made four loans, totalling $19,000, to Hamlet Associates, Inc. ("Hamlet") between November, 1973 and March, 1975. The first two loans were evidenced by separate documents, each designated "Corporate Note," and the third by a handwritten receipt on a carbon copy of the second Corporate Note. The fourth loan was not evidenced by any writing at all. The two notes stated no due date, but permitted the lender to "request repayment of the unpaid balance by providing written notification requesting the borrower to arrange for payment after a ninety (90) day period."[52] Both notes were personally guaranteed by Greenberg, the president of Hamlet. The evidence indicated that the terms of the third loan were identical to those of the first two, although there was no written guarantee by Greenberg. It appears from the case that the terms of the fourth loan were identical to those of the third, except that there was specific evidence that its repayment was not guaranteed by Greenberg.[53]

The case deals almost exclusively with the statute of limitations, as to which the court made several important commercial law points. First, the limitations period on a demand obligation (such as the obligations sued on in *Guth*) begins when the obligation is entered into, not when a demand for payment is made by the lender.[54] Second, the limitations period on a guarantee of payment

50. *Id.* at __, 343 S.E.2d at 339.
51. 230 Va. 64, 334 S.E.2d 558 (1985).
52. *Id.* at 67, 334 S.E.2d at 561.
53. *Id.* at 66-69, 334 S.E.2d at 562.
54. *Id.* at 71-74, 334 S.E.2d at 563-65. The court was interpreting VA. CODE ANN. § 8.3-122(1)(b) (Add. Vol. 1965) which states, in pertinent part, that "[a] cause of action against a maker . . . accrues . . . in the case of a demand instrument upon its date or, if no date is stated, on the date of issue."

of a demand obligation begins when the primary obligation is entered into. In other words, the limitations periods on the Greenberg guarantees and the Hamlet loans began at the same time.[55] Third, under Virginia's general statute of limitations, the limitations period on a contractual obligation (including an Article Three contractual obligation) can be extended by a written acknowledgment of the debt.[56] None of these points are controversial.

Missing from the *Guth* case, however, is any discussion of whether Greenberg's guarantee of the third loan was unenforceable because of the statute of frauds.[57] Moreover, the parties merely assumed that Article Three applied to the obligations in question, an assumption that was accepted without comment by the court.[58] Presumably, this assumption was made on the further assumption that the statute of limitations issue would be unaffected by the applicability or non-applicability of Article Three. Its acceptance of these assumptions, however, left the court in the odd position of

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55. *Guth*, 230 Va. at 74-75, 334 S.E.2d at 565. The court did not discuss whether the same rule would apply if the guarantee had been made *after* the obligation was created; nor did it discuss when the limitations period would begin on a guarantee of *collection*. In ruling that the limitations period began on the primary debt and on the guarantee at the same time, the court emphasized the fact that the obligation created by a guarantee of payment is virtually indistinguishable from the obligation of the principal. The obligation of the payment guarantor is simply stated: "[I]f the instrument is not paid when due he will pay it according to its tenor, without resort by the holder to any other party." VA. CODE ANN. § 8.3-416 (Add.. Vol. 1965). On the other hand, the guarantor of collection only promises to pay if the creditor cannot collect from the principal, so no such identity of the principal's and the collection guarantor's obligations exists. It is also worth noting that the obligation of a payment guarantor is not really identical to that of a principal. The payment guarantor has defenses not available to the principal, e.g., impairment of resources or of collateral. VA. CODE ANN. § 8.3-606(1) (Add. Vol. 1965). In addition, the payment guarantor, merely by giving an appropriate written notice to the creditor, can usually force the creditor to pursue the principal first. *See generally* Herbert, *Twisting Slowly, Slowly in the Wind: The Effect of Delay on a Surety's Obligations in Virginia*, 18 U. RICH. L. REV. 781 (1984).

56. *Guth*, 230 Va. at 75-78, 334 S.E.2d at 565-67. The court was interpreting VA. CODE ANN. § 8.01-229(G) (Repl. Vol. 1984) which states, in pertinent part:

> If any person against whom a right of action has accrued on any contract . . . promises, by a writing signed by him or his agent, payment of money on such contract, the person to whom the right has accrued may maintain an action for the money so promised, within such number of years after such promise as it might be maintained if such promise were the original cause of action. An acknowledgment in writing, for which a promise of payment may be implied, shall be deemed to be such promise within the meaning of this subsection.

It is also important to note that *Guth* reaffirmed prior Virginia cases which held that the mere payment of principal or interest by check does not constitute an acknowledgment sufficient to revive the cause of action. *Guth*, 230 Va. at 77-78, 334 S.E.2d at 567.

57. VA. CODE ANN. § 11-2(4) (Repl. Vol. 1985).

58. *Guth*, 230 Va. at 71, 334 S.E.2d at 563.

applying Article Three to two obligations to which it unquestionably does not apply, and to two others to which it probably does not apply.

Generally, Article Three applies only to negotiable instruments.[59] Among other things, a negotiable instrument must be in writing.[60] This means that the fourth obligation, which was not evidenced by a writing, was not a negotiable instrument subject to Article Three. A negotiable instrument must also contain an unconditional promise or order to pay money.[61] This requirement clearly excludes the third obligation, which was evidenced by a mere acknowledgment of receipt rather than a promise to pay.

There is also a strong argument that the first two obligations were not evidenced by negotiable instruments. A negotiable instrument is "a courier without baggage," since it may not, in general, contain any terms beyond those necessary to express an obligation to pay.[62] This rule is subject to few exceptions.[63] It is arguable that provisions in the notes which permitted the borrower to vary the repayment terms at will violated the prohibition against additional terms.[64] If so, they too were not negotiable instruments.

These criticisms, like those of *Armco*, may seem picayune, since they relate to issues that are at most secondary in the case. The problem is that, given the scarcity of commercial law precedent in Virginia, lower courts and lawyers are likely to seize upon the dicta and implications of a supreme court case as firmly as they do its

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59. This limitation is explicit in virtually every section of Article Three, because of the use of the word "instrument" throughout the Article and the definition of the word "instrument," as used in Article Three, to mean "negotiable instrument." VA. CODE ANN. § 8.3-102(e) (Add. Vol. 1965). The one exception to this rule is found in § 8.3-805, which provides for partial applicability of Article Three to instruments that are not negotiable solely because they are not payable to order or to bearer.

60. *Id.* § 8.3-104(1).

61. *Id.* § 8.3-104(1)(b).

62. *Id.*

63. *Id.* § 8.3-112.

64. The borrower was given the option of permitting interest to accrue on the notes or of paying the interest on a monthly basis. In addition, if the note was called by the lender, the borrower was given the option of paying the note in full or of paying it in twelve monthly installments. *Guth*, 230 Va. at 67, 334 S.E.2d at 561. The latter provision may be implicitly permitted by the provision of VA. CODE ANN. § 8.3-109(1)(d) (Add. Vol. 1965), which specifically approves a provision permitting the maker of a note to extend payment from its initial due date "to a further definite time." However, such a reading would contradict the court's ruling that the obligations were demand obligations rather than time obligations, a determination that was fundamental to the resolution of the statute of limitations issue. *Guth*, 230 Va. at 71-74, 334 S.E.2d at 563-65.

holding. *Guth* carries with it the unfortunate implication that an oral promise can be subject to Article Three, an implication to which the court should have been sensitive, even if counsel were not.

2. Miscellaneous Cases

The remaining cases that are concerned with the rights and liabilities of parties are uniformly rather simple ones. A holder-in-due-course (HDC) can enforce an originally incomplete instrument in accordance with its completed tenor, even if the completion was unauthorized. Conversely, even an HDC can ordinarily enforce an instrument that was altered after its completion only in accordance with its *original*, unaltered tenor.[65] As was true prior to the enactment of the Code, extrinsic evidence is admissible to explain the parties' intent, if an instrument is ambiguous.[66] Finally, the Circuit Court of the City of Richmond correctly held that an accommodation party on an instrument is not discharged by reason of the principal's discharge in bankruptcy proceedings.[67] Since an accommodation party is a surety, and it is practically the essence of a suretyship contract to protect the creditor against the principal's inability (or unwillingness) to pay, this rule is, of course, virtually self-evident (except, it seems, to the losing party in the case).

IV. Secured Transactions

A. *Statutory Changes—Buyers of Farm Products*

The General Assembly made one major change to a minor provision of Article Nine; the new policy provides protection to the buyers of farm products which are subject to a security interest. Article Nine attempts to strike a balance between the interests of the

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65. Virginia Capital Bank v. Aetna Casualty & Sur. Co., 231 Va. ___, 343 S.E.2d 81 (1986). The court was interpreting VA. CODE ANN. § 8.3-407 (Add. Vol. 1965). An exception to the second rule exists if the issuer of the instrument was negligent in filiing it out and this negligence substantially contributed to the alteration. VA. CODE ANN. § 8.3-406 (Add. Vol. 1965).

66. Bankers Credit Servs. of Vermont, Inc. v. Dorsch, 231 Va. ___, 343 S.E.2d 339 (1986). In that case, the maker of a note had written on the note, "WITHOUT RECOURSE per UCC 3-413(2)," admittedly a rather absurd statement, since that provision governs the contractual obligations of endorsers rather than those of makers. The court permitted this ambiguity to be resolved by extrinsic evidence that the parties intended the note to be nonrecourse, i.e., that they did not intend it to create a personal obligation of the maker.

67. Fountain v. First Virginia Bank—Colonial, 4 Va. Cir. Ct. 355 (Richmond 1985).

secured party, who wants the security interest to remain effective even if the collateral is sold by the debtor, and the good faith purchaser, who is obviously dismayed when Friendly Finance or the Twelfth National Bank suddenly repossesses her car simply because the person she bought it from has gone bankrupt. Generally, this balance has been struck in favor of the purchaser. A "buyer in ordinary course of business," (BOCB), who is a good faith purchaser from a person in the business of selling goods of the kind she bought,[68] usually takes free of any security interest granted by the seller of the goods purchased.[69] The general rule is that the secured party, not the buyer, assumes the risk that the debtor will make an illicit sale of the collateral.

Under the "official" U.C.C., an exception to this general rule exists if the BOCB bought farm products from a person engaged in farming operations. In that case, the buyer generally takes subject to any perfected security interest in the farm products.[70] In other words, those who buy from farmers take the risk that what they buy is subject to a perfected security interest. This rule has been in effect in Virginia but, as of December 28, 1986, will be changed.

Virginia's new version of the BOCB rule deletes the exception for buyers of farm products.[71] This means that the secured party will now have the same risk with regard to farm products that it has with regard to other types of collateral. Conversely, buyers of farm products will have the same protection. In exchange, the General Assembly broadened a criminal statute that renders larcenous the fraudulent conversion of collateral by the debtor.[72] The

68. VA. CODE ANN. § 8.1-201(9) (Add. Vol. 1965).

69. *Id.* § 9-307(1).

70. *Id.*

71. *Id.* § 8.9-307(1) (Cum. Supp. 1986). This change was apparently induced by the federal Food Security Act of 1985, 99 Stat. 1354 (1985) (codified at 7 U.S.C.A. § 1631 (West Supp. 1986)) which supersedes § 9-307 of the Code and largely abolishes the farm products exception. With regard to the treatment of the farm products exception by the Food Security Act, *see generally* Comment, *Federal Legislation Provides Protection for Buyers of Farm Products*, 47 U. PITT. L. REV. 749 (1986). Since Virginia's new § 9-307 entirely eliminates the exception, this article contains no further discussion of the federal law.

72. *Id.* § 18.2-115. The Act clearly treats the fraudulent conversion of farm product collateral as larceny, and further imposes the following presumption:

> In the case of farm products, failure to pay the proceeds of the sale of the farm products to the secured party, lienholder, or person in whom the title or ownership of the property is, or his agent, within ten days after the sale or other disposition of the farm products unless otherwise agreed by the lender and borrower in the obligation of indebtedness, note or other evidence of the debt shall be prima facie evidence of a violation of the provisions of this section.

problem of illicit sale of farm products will now be dealt with as a criminal matter between the commonwealth and the farmer rather than as a priority contest between two innocent parties, the lender and the buyer.

B. *Cases*

The few Article Nine cases decided during the past year merit only brief discussion. In *Dominion Bank of the Cumberlands v. Nuckolls*,[73] a case primarily concerned with interpretation of the complex exemption provisions of the Bankruptcy Code, the Court of Appeals for the Fourth Circuit applied a provision of Virginia's U.C.C. which states that "[a] filing which is made in good faith in an improper place or not in all of the places required by this section is . . . effective with regard to collateral covered by the financing statement against any person who has knowledge of the contents of such financing statement."[74]

In *Nuckolls*, the secured party had filed a financing statement on restaurant equipment in the local court clerk's office, but had failed to file an additional financing statement with the State Corporation Commission.[75] Since, in the situation presented by the case, dual filing was (and is) required,[76] the creditor was technically unperfected. However, since the complaining party was the debtor (who obviously had knowledge of the contents of the financing statement that *was* filed), the savings provision set out above meant that the local filing was effective.[77] The creditor's triumph was short-lived, however, because the court held that the security interest was avoidable under the provision of the Bankruptcy Code which permits the avoidance by the bankrupt of a non-purchase money, non-possessory security interest in tools of the trade.[78]

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73. 780 F.2d 408 (4th Cir. 1985).

74. *Id.* at 412 (citing VA. CODE ANN. § 8.9-401(2) (Cum. Supp. 1984)).

75. *Id.* at 411.

76. Under VA. CODE ANN. § 8.9-401(1)(c) (Cum. Supp. 1985), financing statements covering non-farm business collateral must be filed "in the office of the State Corporation Commission, and in addition, if the debtor has a place of business in only one county or city of this Commonwealth, also in the office of the clerk of the court."

77. The Fourth Circuit was probably deciding an unnecessary issue, since the secured party has priority over the debtor even if the security interest is unperfected. VA. CODE ANN. § 8.9-201 (Add. Vol. 1965).

78. *Nuckolls*, 780 F.2d at 412-14, interpreting Bankruptcy Code, 11 U.S.C. § 522(f)(2)(B) (1982). Interestingly, the loan was originally used to buy the collateral. *Nuckolls*, 780 F.2d at 410. This meant that the secured party initially had a purchase-money security interest. VA. CODE ANN. § 8.9-109 (Add. Vol. 1965). Unfortunately for the bank, it refinanced the

Three bankruptcy court cases make significant points. First, goods are classifed by their use. Thus, a computer purchased for business purposes is "equipment" rather than "consumer goods," and the perfection rules relating to equipment must be followed.[79] Second, it is not necessary to make specific mention of proceeds in a financing statement; the filing will include them automatically.[80] Third, in a demonstration that the complexities of Article Nine need not abandon one hopelessly at sea, it was ruled that a security interest in a small, "undocumented" pleasure boat was governed by Article Nine rather than the Federal Ship Mortgage Act.[81]

V. Federal Trade Commission Rules

The Federal Trade Commission (FTC) has again leapt into the consumer credit field with the promulgation of regulations limiting creditor remedies. These regulations became effective in 1985.[82] Five practices have been rendered "unfair"; two others "deceptive or unfair." The unfair practices are the use by consumer creditors of:

(1) cognovit (confession of judgment) provisions;[83]

(2) executory waivers of exemption rights;[84]

(3) wage assignments (except for those that are either payroll deduction plans or similar preauthorized payment plans, such as an automatic mortgage payment plan);[85]

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obligation (and advanced a further $1,000) to the debtors. In the court's view, this meant that the obligation was no longer a purchase-money obligation. *Nuckolls*, 780 F.2d at 411. While this rule, which elevates form over substance, has little logic to support it, it has been widely adopted in a number of different contexts. *See generally* J. White & R. Summers, *supra* note 13, at 1043-45.

79. *In re* Phillips, 55 Bankr. 663 (Bankr. W.D. Va. 1985).

80. *In re* John Deskins Pic Pac, Inc., 59 Bankr. 809 (Bankr. W.D. Va. 1986).

81. *In re* Dean, 55 Bankr. 332 (Bankr. W.D. Va. 1985).

82. The regulations appear in 15 C.F.R. §§ 444.1 to .5 (1986). Parallel rules have been adopted, effective January 1, 1986, by the Federal Homes Loan Bank Board, 50 Fed. Reg. 19,325 (1985) (to be codifed at 123 C.F.R. §§ 535.1 to .5) and by the Federal Reserve Board, 50 Fed. Reg. 16,695 (1985) (to be codifed at 12 C.F.R. §§ 227.11 to .16). A much more comprehensive and acerbic discussion of these regulations can be found in Herbert, *Straining the Gnat: A Critique of the 1984 F.T.C. Consumer Credit Regulations*, 38 S.C.L. Rev. ___ (1986).

83. 16 C.F.R. § 444.2(a)(1) (1986).

84. *Id.* § 444.2(a)(2).

85. *Id.* § 444.2(a)(3).

(4) non-purchase money security interests in certain household goods;[86] and

(5) pyramiding late charges.[87]

The deceptive practices are misrepresentations of the liability of a cosigner (which seems practically self-evident)[88] and failure to inform the cosigner of the scope of liability.[89] A special form was promulgated by the FTC which is supposed to be given in toto or in substance to all cosigners.[90] That statement is as follows:

> Notice to Cosigner
>
> You are being asked to guarantee [sic] this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.
>
> You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount.
>
> The creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of *your* credit record.
>
> This notice is not the contract that makes you liable for the debt.[91]

The rule applies only to "lenders" and "retail installment sellers"[92] and those terms are further limited to professional lenders and sellers.[93] Moreover, it only applies when those parties are deal-

86. *Id.* § 444.2(a)(4).
87. *Id.* § 444.4.
88. *Id.* § 444.3(a)(1).
89. *Id.* § 444.3(a)(2). Actually, the word cosigner is somewhat misleading. The FTC rule really applies with regard to all secondary parties, including guarantors. *Id.* § 444.1(k).
90. *Id.* § 444.3(b).
91. *Id.* § 444.3(c).
92. *Id.* § 444.1(a),(b),(c),(f).
93. *Id.* § 444.1(a) and (b).

ing with "consumers."[94] Not surprisingly, a consumer is defined as "a natural person who seeks or acquires goods, services, or money for personal, family, or household use."[95]

As is true with many recent federal regulations, the FTC rule permits states to seek exemption from coverage if they adopt substantially similar prohibitions.[96] At least two states have already sought such exemption.[97] Since many of the proscribed practices are already prohibited or restricted in Virginia,[98] and since Virginia has some history of asserting its independence from Washington, the General Assembly may well wish to consider pursuing this possibility.

94. *Id.* § 444.1(d).

95. *Id.*

96. *Id.* § 444.5.

97. These are New York, 50 Fed. Reg. 50,178 (1985) and Wisconsin, 50 Fed. Reg. 46,082 (1985). The FTC has promulgated guidelines for state exemption requests at 50 Fed. Reg. 19,327 (1985).

98. For example, the Consumer Finance Act prohibits licensees from taking confessions of judgment, VA. CODE ANN. § 6.1-283 (Repl. Vol. 1983), and certain exemption waivers are unenforceable. *Id.* § 34-22.