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Annual Survey of Virginia Law: Commercial Law

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COMMERCIAL LAW

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I. Introduction

This survey of commercial law discusses all Supreme Court of Virginia cases interpreting Virginia's version of the Uniform Commercial Code (the "Code") during the previous year, as well as statutory changes made to the Code in the most recent session of the General Assembly. It also reviews significant Code cases decided in the Virginia circuit courts and in the various federal courts sitting in Virginia. It is current as of about May 1, 1989.

II. Sales

A. *Foreclosing Secured Party's Remedies Against Seller/Manufacturer*

In *Bryant v. Winnebago Industries, Inc.*,[1] the Circuit Court of the County of Henrico partially dealt with an issue that straddles Article Two and Article Nine: what rights does a foreclosing secured party have against the seller or manufacturer of the collateral? In other words, does the secured party, upon foreclosure, acquire the rights that the buyer-debtor had against the seller or manufacturer with regard to the goods upon which the secured party foreclosed? In *Bryant*, the debtors purchased a Winnebago camper, and financed the purchase through Chase Manhattan Bank. The camper was seriously defective. The Bryants revoked their acceptance of it and returned it to the seller. Chase repossessed the camper and sold it.[2]

The Bryants then sued Winnebago Industries, Inc. (the manufacturer), McGeorge Camping Center, Inc. (the seller), and Chase for breach of warranty under the Code and for violation of the Magnuson-Moss Warranty Act. Chase cross-claimed against Winnebago and McGeorge. The Bryants settled their claims; thus, the

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1. 15 Va. Cir. ___ (1989).
2. *Id.* at ___.

only remaining dispute was between Chase and Winnebago/McGeorge.[3]

The central issue was whether Chase, as a successor in interest to the Bryants, acquired the warranty rights against Winnebago and McGeorge. This issue was broken down into two sub-issues. Unfortunately, only one was resolved by the court.

The first, unresolved, sub-issue was whether Chase benefitted from the provisions of the so-called anti-privity statute, section 8.2-318.[4] That statute eliminates lack of privity as a defense "in any action brought against the manufacturer or seller of goods to recover damages for breach of warranty . . . if the plaintiff was a person whom the manufacturer or seller might reasonably have expected to use, consume, or be affected by the goods."[5] Since Chase was not in privity with Winnebago or McGeorge, it could not sue for breach of warranty unless it, as a purchase money financier, "might reasonably have been expected to use, consume or be affected by the goods." A decision that Chase satisfied this standard would have sketched out an extraordinarily wide boundary for section 2-318; however, the court set the matter aside.

This was because the court held for Winnebago and McGeorge on the second sub-issue: whether the remedies of a third party beneficiary under section 2-318 are subject to contractual limitations. Under the contract with the Bryants, their exclusive remedies were repair or replacement of the camper. In addition, there was a specific exclusion of consequential damages.[6] Chase could not make use of the exclusive remedies because it had sold the camper after the foreclosure. Chase attempted to argue its way out of the limited remedies by asserting that the remedies had "failed of [their] essential purpose" and were thus invalid under section 8.2-719(2).[7] The court rejected this for a very simple reason: one remedy had already been used and it had worked. "The remedy provided for in the warranty from Winnebago did not fail of its essential purpose since the Bryants followed the remedy of revocation and returned the camper to McGeorge."[8] For the same reason,

3. *Id.* at ___.
4. VA. CODE ANN. § 8.2-318 (Add. Vol. 1965).
5. *Id.*
6. *Bryant*, 15 Va. Cir. at ___.
7. *Id.* at ___; *see also* VA. CODE ANN. § 8.2-719(2) (Add. Vol. 1965).
8. *Bryant*, 15 Va. Cir. at ___.

the court rejected Chase's Magnuson-Moss Claim.[9]

The court was slightly off-center in its reasoning. The revocation remedy was not a remedy provided for in the contract, which permitted only repair or replacement.[10] However, its view appears to be essentially correct; it appears that McGeorge and Winnebago ultimately provided the Bryants with an effective remedy (revocation) and Chase was attempting to broaden the remedy still further.

What cannot be determined from the judge's opinion is the reason why Chase was still pursuing a claim against McGeorge and Winnebago. If the settlement with the Bryants resulted in a full refund of the purchase price (and this should have, if it indeed resulted in a revocation of acceptance), then Chase should have been made whole, or nearly so. The refund should certainly have been treated as proceeds of the camper and thus subject to Chase's security interest.[11] The refund, added to the proceeds of Chase's sale of the camper, ought to have been enough to cover, or nearly cover, the principal and interest on the loan. Therefore, it must be assumed either that no refund was made, that the refund was of less than the purchase price, that Chase failed to get its hands on the refund, or that the debt was for some reason much greater than would ordinarily be expected.

If either of the first two assumptions is correct, the opinion can be seriously questioned. If the Bryants did not get back the full purchase price in the settlement with Winnebago and McGeorge, then it is arguable that there was no adequate remedy; the buyers did not get the benefit of their bargain. In other words, the buyers bargained for a functioning camper within a reasonable period of time. If the seller/manufacturer could not provide that within the scope of the exclusive, limited remedy (repair or replacement) then that remedy failed of its essential purpose (which was to provide the buyers with the benefit of their bargain) and some reasonably equivalent Article Two remedy should then have become available to them. Revocation of acceptance, coupled with refund of the purchase price, would be such a remedy; it would give the Bryants the reasonable equivalent of their bargain. If they got a full refund, Chase should have had nothing to complain about. If they did not,

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9. *Id.*
10. *Id.* at ___.
11. *See* VA. CODE ANN. § 8.9-306(1)-(2) (Add. Vol. 1965).

Chase should have won the case.

B. *Scope of "Anti-Privity Statute"*

Several other cases dealt with the scope of section 8.2-318. Two federal cases reiterated the Fourth Circuit's earlier decision in *Farish v. Courion Industries*[12] in which the court held that the elimination of privity as a defense does not apply to goods sold before July 29, 1962, the effective date of former section 8.01-223 (predecessor of section 8.2-318). These cases, however, also held that, even under the common law of Virginia, privity would not be a defense in a negligence-based personal injury action.[13] This latter (and much more significant) holding should provide considerable cheer to the plaintiffs' bar.

A Supreme Court of Virginia case, *Hersel Corp. v. Canney*,[14] could have been equally cheering.[15] In *Hersel*, the court held that a lessee of defective goods could sue the manufacturer and other sellers of the goods for damages caused by breach of any warranties made by the manufacturer or other seller. In other words, section 8.2-318 gives a lessee the benefit of any warranties which the *lessor* has been given or of which the lessor has the benefit. This case opens up a significant new avenue of recovery for lessees of goods who have suffered loss or injury because of defects in the goods; it also parallels developments in lease law generally. Unfortunately for personal injury lawyers and their clients, the opinion is unpublished.

III. COMMERCIAL PAPER

Under section 8.3-401(1) of the Code, no person has any contractual liability on a negotiable instrument unless that person's signature appears on the instrument.[16] The signature, of course, can be placed on the instrument either by the person or by the person's

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12. 754 F.2d 1111 (4th Cir. 1985). For a brief discussion of *Farish*, see Herbert, *Commercial Law: Annual Survey of Virginia Law*, 19 U. RICH L. REV. 717, 730 (1985).

13. Derflinger v. Ford Motor Co., 866 F.2d 107 (4th Cir. 1989); Wilkes v. F.L. Smithe Mach. Co., 704 F. Supp. 680 (W.D. Va. 1989).

14. Hersel Corp. v. Canney, No. 870152 (Va. Apr. 21, 1989) (LEXIS, VA. library, cases file).

15. *See* Fletcher, *Lessee May Sue Products Maker under U.C.C.* 3 VLW 1009, May 8, 1989.

16. VA. CODE ANN. § 8.3-401(1) (Add. Vol. 1965).

representative.[17] The signature requirement was examined by the Supreme Court of Virginia in *Curtis v. Lee Land Trust*.[18] Curtis and his spouse sold an option to buy certain land to a real estate broker, Drucker & Falk. Drucker & Falk later transferred the option to Segaloff and Roos, who organized a land trust named Lee Land Trust, to which they apparently transferred the option. Segaloff and Roos were the beneficiaries of the land trust and United Virginia Bank/Citizens & Marine was the trustee.[19]

The option was exercised, and Curtis conveyed the property to the trust for a partial cash payment, plus a promissory note and a deed of trust, both of which were signed by the bank as trustee of Lee Land Trust. The note went into default and the deed of trust was foreclosed. Since the foreclosure sale resulted in a deficiency of $183,018.42, suit was filed on the note against Lee Land Trust, Segaloff and Roos.[20]

The signatures on the note and the deed of trust were unambiguous. It was clear that the bank was signing as the trustee of Lee Land Trust and there was no indication anywhere in the documents that the beneficiaries of the trust intended to be bound.[21] The plaintiff was able to point only to the lack of any language in the documents which explicitly exculpated the beneficiaries. Of course, the lack of exculpatory language was entirely irrelevant because the plaintiff could not establish that the bank's signature had any power to bind the beneficiaries in any event. In other words, only if the bank was the agent of the *beneficiaries* could its signature be construed as their signature; only in that situation could the beneficiaries be contractually liable on the instrument. Thus, only if such an agency relationship existed would there be any need for a disclaimer of personal liability to shield the beneficiaries.

The crucial question in the case, therefore, was whether the land trust was an entity sufficiently distinct from its beneficiaries to have liabilities independent of them. In other words, was the land trust (as the plaintiff argued) merely a kind of informal partnership?[22] If so, it would not be an entirely separate legal entity, and

17. *Id.* § 8.3-403(1).
18. 235 Va. 491, 369 S.E.2d 853 (1988).
19. *Id.* at 492-93, 369 S.E.2d at 853.
20. *Id.* at 493, 369 S.E.2d at 853-54.
21. *Id.* at 495-98, 369 S.E.2d at 855-56.
22. *Id.* at 496, 369 S.E.2d at 855.

its partners would ultimately be liable for its debts. Or was it a "real" trust, an entity whose assets and obligations were separate from those of its beneficiaries? Without much discussion, the court decided that the land trust was a sufficiently distinct entity from the beneficiaries to shield them from personal liability on its debts. The court stated, "Initially, we reject summarily plaintiffs' contention that this land trust created under Code § 55-17.1 is not a trust at all but some type of business organization such as a partnership.[23] The court further stated, "Because of the nature of the land trust, before personal liability can be imposed upon the beneficiaries they must expressly or by implication promise to pay."[24]

IV. Secured Transactions

A. *Scope of Article Nine*

Article Nine, by its terms, deals with security interests in personalty (and certain sales of intangible rights); it does not encompass interests in real property other than fixtures.[25] This, of course, has created some difficulty in determining whether borderline collateral which involves both realty and personalty is subject to Article Nine. In a decision which reversed a case discussed in last year's survey,[26] the Fourth Circuit held that a buyer's rights under a real estate contract are real property rights, not personal property rights, and thus not subject to Article Nine.[27] The debtor, Wilson, had exercised an option to purchase realty. After the exercise of the option, Wilson granted Dominion Bank a security interest in all his "accounts receivable . . . and contract rights."[28] Because of the doctrine of equitable conversion, Wilson's interest in the contract after the exercise of the option was treated by the court as real property; it was thus not subject to the security interest.[29]

23. *Id.* at 496, 369 S.E.2d at 855.

24. *Id.* at 498, 369 S.E.2d at 857.

25. Va. Code. Ann. §§ 8.9-102(1), 9-104(j) (Add. Vol. 1965 & Cum. Supp. 1989).

26. See discussion of *In re Wilson*, 86 Bankr. 871 (W.D. Va. 1988) in Herbert, *Commercial Law: Annual Survey of Virginia Law*, 22 U. Rich. L. Rev. 499, 515 (1988).

27. Dominion Bank v. Wilson, 867 F.2d 203 (4th Cir. 1989).

28. *Id.* at 204.

29. *Id.* at 206.

B. *Requirements of Attachment*

1. Change of Debtor's Entity Status

In *In re Q.T., Inc.*,[30] a case which may have a major impact on lending practices, the Bankruptcy Court for the Eastern District of Virginia, Richmond Division, explored the degree to which a security agreement survives a change in the entity status of the debtor. This case significantly, and perhaps critically, limits the degree to which a secured party will have rights in property acquired by the new entity. In *In re Q.T., Inc.*, P.D.Q. Corporation ("P.D.Q.") sold certain assets of its tractor-trailer repair business to Richard Bain. Bain in turn granted P.D.Q a security interest to secure the payment of $130,000 of the purchase price. The collateral included, among other things, "accounts hereafter arising." Bain transferred the purchased assets to his wholly-owned corporation, Q.T., Inc. ("Q.T.") which actually operated the business. Q.T. was included on the financing statements but did not sign the security agreement. Thomas Russell & Company succeeded to the rights of P.D.Q. Q.T. subsequently went bankrupt, and, in the course of the bankruptcy proceedings, challenged the validity of Thomas Russell's claim to its accounts receivable.[31]

The key question before the court was whether it should limit the apparent scope of section 8.9-203(1), which requires, for the attachment of a security interest in accounts receivable that:

> (a) the . . . debtor has signed a security agreement which contains a description of the collateral . . .; and
> (b) value has been given; and
> (c) the debtor has rights in the collateral.[32]

Q.T. did not sign the security agreement. Thus, the security interest could not attach to property acquired by it from someone other than Bain[33] unless the court found some exception to the signature requirement.

Several out-of-state cases have dealt with this problem. Gener-

30. 99 Bankr. 310 (Bankr. E.D. Va. 1989)

31. *Id.* at 311.

32. VA. CODE ANN. § 8.9-203(1) (Cum. Supp. 1988).

33. Property subject to the security interest granted by Bain would remain subject to that security interest even though it was transferred to Q.T. *See id.* § 9-306(2). Thus, any accounts that Bain had transferred to Q.T. would have been subject to Thomas Russell's security interest; but there apparently were no such accounts.

ally, when the debtor has merely changed its entity structure, and not the actual ownership and control of the business, the courts have found some way to enforce the security agreement even though it was not signed by the new entity. In other words, when a proprietor or partnership incorporates, and the proprietor or partners become the sole owners and managers of the new corporation, the courts are likely to hold that the security agreement binds the corporation. For example, in *In re Pubs, Inc. of Champaign,*[34] an informal partnership which had granted a security interest subsequently incorporated. The court held the corporate entity was estopped from raising the fact that it had not signed the security agreement.[35] The court in *In re West Coast Food Sales, Inc.*[36] did not even bother with an estoppel; it held outright that the conversion of a proprietorship into a corporation primarily owned and controlled by the former proprietor did not destroy the effectiveness of a security agreement previously executed by the proprietor.[37]

The out-of-state precedents were rejected by the court in *In re Q.T., Inc.*, which found them inapplicable because, at the time of the transaction, the secured party apparently knew that Bain was about to transfer the collateral to Q.T.:

> In contrast to *West Coast* and its companions, in this case the secured party knew a transfer of its debtor's assets to another party was to take place, and by the very language of its security agreement contemplated such a transfer . . . . In these circumstances, the Court concludes that Thomas Russell had the responsibility to protect itself. Because Thomas Russell was aware of the prospect of immediate disposition of its collateral, it could have required as a condition of the sale to Bain that Bain's transferee execute a security agreement.[38]

It is certainly true that Thomas Russell could easily have protected itself; it is equally true that the decision fits within the "plain meaning" of the statutory provision. What is less clear is why, under the facts of *In re Q.T., Inc.*, Thomas Russell should have suffered the loss it did. There is no indication that any other

34. 618 F.2d 432 (7th Cir. 1980).
35. *Id.* at 438.
36. 637 F.2d 707 (9th Cir. 1981).
37. *Id.* at 709.
38. *In re* Q.T. Inc., 99 Bankr. 310, 312-13 (Bankr. E.D. Va. 1989).

creditor was misled by or injured by the failure to get Q.T.'s signature on the security agreement; indeed, given the fact that Q.T. was listed on the financing statement, it is exceedingly unlikely that any creditor could have been misled. Nor is there any doubt about the fact that the parties intended Q.T. to be bound. The only beneficiaries of the decision were the general unsecured creditors (who received a windfall, unanticipated and unearned).

The *In re Q.T., Inc.* decision will be of relatively little significance if it is confined to situations in which the secured creditor knew before the execution of the security interest that the debtor was going to make an immediate change of its entity status. If it is read more broadly, it will create a serious problem for secured creditors. If, for example, a change of entity status to which a creditor has no notice will preclude the creditor's claim to after acquired property, *In re Q.T., Inc.* will impose a significant monitoring burden on secured creditors.

Finally, at the time this article is going to press, *In re Q.T.* is on appeal. There is some reason to believe it will be reversed.

2. Miscellaneous Attachment Requirements

Grossmann v. Saunders[39] dealt with two of the basic requirements for attachment of a possessory security interest: the secured party must have possession of the collateral pursuant to agreement and the debtor must have rights in the collateral.[40] In *Grossmann*, the plaintiff, Grossmann, had been in business with Saunders. When their partnership was dissolved, Grossmann transferred his interest to Saunders in exchange for Saunders promise to "set aside" certain promissory notes payable to Saunders (the "Grossmann notes"). The principal and interest collected from the notes was to be paid to Grossmann as received by Saunders. Saunders remained in possession of the Grossmann notes. Saunders subsequently transferred the former partnership assets (including the Grossmann notes) to his corporation, American Vacation Resorts, Inc. ("AVR"). The court held that AVR effectively assumed Saunders obligations to Grossmann.[41]

AVR and/or Saunders subsequently transferred the Grossmann

39. 237 Va. 113, 376 S.E.2d 66 (1989).
40. VA. CODE ANN. § 8.9-203 (Cum. Supp. 1988).
41. *Id.* at 119, 376 S.E.2d at 69.

notes to Bank of Virginia (the "Bank") and Community Federal Savings and Loan Association ("Community Federal").[42] Thus, the crucial question was whether the Bank and Community Federal had a security interest in the notes which had priority over Grossmann's interest in them.

The first issue was whether the putative secured parties were in possession of the notes "pursuant to agreement;" that is, whether the notes had been placed in their possession as part of a security agreement with AVR/Saunders. Since the case went to the Supreme Court of Virginia on a demurrer to Grossmann's motion for judgement, the only accessible information the court had on this issue were Grossmann's allegations that AVR/Saunders "gave" or "transferred" the notes to the Bank and Community Federal. In the court's view, this was insufficient. The case was remanded for an evidentiary hearing in which the Bank and Community Federal were "required to establish that Saunders provided the Bank and Community Federal with a security interest in the notes for the purpose of securing an obligation he has to each party."[43]

The second issue was whether Saunders had sufficient "rights in the collateral" for a security interest to attach. It is well established that a debtor need not have title to collateral to grant a security interest in it. Any cognizable property right is sufficient. Under the Grossmann/Saunders agreement, Saunders retained a minor interest in the notes. Specifically, the second paragraph of clause two of the agreement provided that:

> During the first two years from the designation and setting aside of the notes as aforesaid, [Saunders] covenants that upon default in the payment of any of the notes by the maker thereof, [Saunders] will cause a replacement note or notes of equal value to be set aside for the benefit of [Grossmann].[44]

Because of the procedural posture of the case, the court did not have to and did not deal with the further question of what rights Saunders had. Although it is certainly true that a debtor can grant a security interest in a limited property right, the rights of the secured party to the property in question cannot be broader than the

42. *Id.* at 118, 376 S.E.2d at 69.
43. *Id.* at 122, 376 S.E.2d at 71.
44. *Id.* at 117, 376 S.E.2d at 68.

rights of the debtor.[45] Saunders' interest rights in the notes appears to have been a form of reversionary interest; if the maker of any note failed to pay, Saunders would replace the defaulted note with a new note from another maker. He would then "own" and be able to collect on the defaulted note. If so, the rights of the Bank and Community Federal would be no greater; they too would have the right to substitute other notes and collect on defaulted notes. Obviously, those rights would be of little value to them.[46]

The case would be clearer in this regard if the court had explicitly characterized the Grossmann-Saunders agreement regarding the notes as a security agreement. The rights of Grossmann clearly met the Code's sweeping definition of a security interest;[47] and the court, elsewhere in the opinion, implicitly dealt with their arrangement as an Article Nine transaction.[48] Under this approach, Saunders would be the "owner" of the notes, subject to the security interest of Grossmann; that security interest was unperfected and thus subject to the perfected security interest of the Bank and Community Federal.[49] Perhaps the court dodged this issue because the case came up on demurrer and the facts were undeveloped.

C. *Perfection and Priorities*

1. Collateral Description

While the attachment of a security interest establishes the rights of the immediate parties to the transaction, the debtor and the secured party, perfection is usually required to establish the secured party's priority *vis-a-vis* other parties who have claims to or against the collateral. Except for certain consumer goods transactions, perfection usually requires that the secured party do a "perfecting act" which will give notice to the world of its interest in the collateral. The most common perfecting acts are the secured party taking possession, the filing of a financing statement or state-

45. *See* J. White & R. Summers, Uniform Commercial Code § 22-6, at 987-88 (3d ed. 1988).

46. Of course, if either the Bank or Community Federal had qualified as a holder in due course, their rights would, *under Article Three,* be greater than those of their transferor; they would take free of Grossmann's claim. *See* VA. CODE ANN. § 8.3-305(1) (Add. Vol. 1965). However, the parties agreed that the notes were non-negotiable, thus not subject to Article Three. *See* 237 Va. at 123, 376 S.E.2d at 72.

47. *See* VA. CODE ANN. § 8.1-201(37) (Add. Vol 1965 & Cum. Supp. 1989).

48. *See infra* notes 63-67 and accompanying text.

49. *Id.*

ments covering the goods, or the notation on a certificate of title. As a general rule, perfection protects the secured party against other interests that arise subsequent to the perfecting act. There are several new Virginia cases dealing with various perfection and priority issues.

One of the issues debated in early Article Nine case law was the degree of specificity required in the financing statement. The drafters of the Code opted for so-called notice filing; the financing statement does not need a detailed description of collateral, but does need "a statement indicating the type, or describing the items, of collateral."[50] Over the years it has become well-established in other states that, insofar as *business* loans are concerned, very broad descriptions (such as "all equipment," "all inventory" and the like) are sufficient, provided that the "types" of collateral are approximately as specific as the categories of collateral set out in Article Nine itself. Federal court cases interpreting Virginia law have assumed this to be true in the Commonwealth as well.[51] In *Hixon v. Credit Alliance Corp.*,[52] the Supreme Court of Virginia confirmed this assumption. It held specifically that "[a] financing statement which describes collateral only as, ' "machinery and equipment" ' provides 'a sufficient description and [is] a valid financing statement.' "[53]

The court also held that the use of a list of specific items of collateral as part of the financing statement did not limit the perfection to those items specifically listed. The actual financing statement consisted of several documents, including a copy of the security agreement. Paragraph eight of the cover document described the collateral as:

> All machinery, inventory, equipment and goods as described in attached entire Agreement &/or in any Schedule prepared in connection therewith. This UCC form together with the attached Security Agreement &/or Schedule are being submitted for filing herewith as a financing statement.[54]

The attached security agreement referred, in a pre-printed provi-

50. Va. Code Ann. § 8.9-402(1) (Add. Vol. 1965 & Cum. Supp. 1989).
51. *See, e.g., In re* Tebbs Constr. Co., 39 Bankr. 742, 746 (Bankr. E.D. Va. 1984).
52. 235 Va. 466, 369 S.E.2d 169 (1988).
53. 235 Va. at 470, 369 S.E.2d at 172 (quoting *In re* Tebbs Constr. Co., 39 Bankr. 742, 746 (Bankr. E.D. Va. 1984)).
54. *Id.* at 468-69, 369 S.E.2d at 171.

sion, to "the goods, chattels and property described in the annexed Schedule A *and all other . . . machinery [and] equipment . . . now or hereafter belonging to the Mortgagor . . . .*"[55] The court correctly held that, given the "mere notice" function of the Article Nine financing statement, the perfection was not limited to the Schedule A items. The question, of course, is one of allocating a burden; do we require the secured party to file an unambiguous financing statement or do we place on subsequent claimants the burden of investigating ambiguities? The Code clearly opts for the latter: "The notice itself indicates merely that the secured party who has filed *may* have a security interest in the collateral described. Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs."[56] Thus, in the court's view:

> We do not think a reasonably diligent title searcher would limit his examination to Schedule A. Instead, we think he would read Paragraph 8 of the financing statement and realize that the security agreement is made part of the financing statement and that the two must be read together to determine what is included in collateral.[57]

2. Misfiled Financing Statement

To perfect a security interest by financing statement, the financing statement or statements must be filed in the right location. There is, however, a slight mitigation of this rule. Under section 8.9-401(2), if a subsequent claimant has actual knowledge of the contents of a financing statement which was filed incorrectly but in good faith, the financing statement will be effective as to that claimant.[58] A recent Fourth Circuit opinion, *Zieg v. United States*[59] examined a further question of whether this savings provision applies to *proceeds* of the original collateral?

Kermit Zieg loaned Jeanne Davis, Michael Davis and Davis Properties ("Davis") $50,000, secured in part by certain contract rights owned by Davis. The financing statement was incorrectly filed. Later, Davis sold some of its contract rights to a person iden-

55. *Id.* at 470, 369 S.E.2d at 172 (emphasis and omission in original).
56. VA. CODE ANN. § 8.9-402 comment 2 (Add. Vol. 1965) (emphasis added).
57. 235 Va. at 470, 369 S.E.2d at 171.
58. VA. CODE ANN. § 8.9-401(2) (Add. Vol. 1965).
59. 849 F.2d 898 (4th Cir. 1988).

tified as Eden in exchange for chattel paper.[60] The competing creditor, the Small Business Administration, had actual knowledge of the contents of the financing statement. The court held this was sufficient to protect Zieg's interest in the contract rights but not his interest in the proceeds of those contract rights, the chattel paper.

The question is a close one and appears to have been one of first impression. The rationale of section 8.9-401(2) is of course that a subsequent claimant who in fact knew of the transaction between the debtor and the secured party has no reason to complain about the mere fact that the financing statement was in the wrong place. The *Zieg* court's rationale seems to be that this is intended as an extremely limited exception to the general Article Nine filing rules, which are otherwise a pure "race to the filing office" statute, and that it should therefore be limited to its narrowest possible reading:

> Zieg asks this court to excuse his good faith error on the first filing, which we are willing to do as per § 8.9-401(2). Then he asks us to forgive his failure to file as to the chattel paper because if his first misfiling is given legal effect no second filing need occur, § 8.9-306(3) (footnote omitted). We are simply not willing to take this step, for that would mean that one who incorrectly filed a [financing statement] as to the original collateral and never made any attempt to file as to the proceeds of that collateral could maintain first priority. One who so thoroughly sleeps on his rights is not entitled to so much protection.[61]

This statement, however, is long on rhetoric and short on reasoning. As the court acknowledges, if Zieg had originally filed correctly, the financing statement would have perfected not only the security interest in the original collateral but in the chattel paper proceeds as well.[62] Thus, if we assume that Zieg reasonably believed that the first filing was adequate, he would have had no reason to make a second filing on the proceeds. He was not "sleeping on his rights"; he in good faith believed that his rights were already protected and had no reason to expect that any further act was required. Thus, it is the author's view that the *Zieg* case is,

60. *Id.* at 899.
61. *Id.* at 900-01.
62. *Id.* at 900.

from a policy standpoint, incorrect. However, it can be justified by noting that the Code nowhere states or even suggests that the savings provision should extend to proceeds.

3. First to File or Perfect Rule

Priorities under Article Nine are usually based on "first in time, first in right." With regard to conflicting security interests, priority is generally based on the date of perfection or the date on which a financing statement is filed. The secured party who was either the first to file or the first to perfect usually gets the collateral.[63] This rule was examined in *Grossmann v. Saunders*,[64] discussed above.[65] Grossmann had what appeared to be an unperfected security interest in certain non-negotiable promissory notes payable to Saunders and/or Saunders' company. Two rival creditors had what were alleged to be perfected security interests in the same notes.

Grossmann argued that the perfected security interests should not have priority over his interest because (he claimed) the other secured parties had "actual notice" of his interest.[66] The court properly rejected this argument. However, it left a cryptic loophole which it labeled "good faith":

> Although lack of notice is not a prerequisite to the operation of Code § 8.9-312(5), Code § 8.1-203 provides that "[e]very contract or duty within this act imposes an obligation of good faith in its performance or enforcement." Accordingly, allegations and proof of "a leading on, bad faith or inequitable conduct" on the part of a secured party may affect the priorities established under Code § 8.9-312(5) by estopping the assertion of a priority."[67]

In one sense, this statement is clearly accurate; any deliberate misleading of another secured party could be the basis for modifying the ordinary priority rules. However, two caveats apply. First, this is not a question of "good faith" under the Code; the Code's good faith requirement applies only to contracts and duties under the Code. With rare exception, there is no contract between two secured parties who merely happen to have claims to the same col-

63. VA. CODE ANN. § 8.9-312(5) (Add. Vol 1965).
64. 237 Va. 113, 376 S.E.2d 66 (1989).
65. See *supra* notes 39-49 and accompanying text.
66. *Id.* at 124, 371 S.E.2d at 72.
67. *Id.* at 124-25, S.E.2d at 72.

lateral. Nor, with regard to the establishment of priorities, does the Code impose any duties between secured parties.

Second, any court-imposed reworking of priority rules should be limited to the most egregious cases. For example, if one secured party fraudulently induces another secured party to lend money based on deliberate misstatements concerning the defrauding secured party's collateral position, an estoppel may be justified. Under no circumstances, rather than those explicitly provided for in Article Nine, should mere notice or even actual knowledge of an unperfected security interest prevent a secured party from obtaining a security interest that will have priority over the unperfected security interest. As noted, the drafters of Article Nine intended it to be a virtually pure "race to the filing office" statute; with extremely rare exceptions, the only question should be which secured party was the first to file or perfect. For these reasons, the "good faith" discussion in *Grossmann* should be given an extremely narrow interpretation by the courts.

4. Effect of Failure to Give Notice of Sale

Part five of Article Nine contains a number of provisions regulating the rights and obligations of the debtor and secured party in the event of the debtor's default. Section 8.9-504 sets out the requirements for the sale of collateral by the secured party; among them is a requirement that in most cases, the debtor must be given prior notice of the sale.[68] Failure to comply with the requirement, or indeed with any requirements of Part five, can subject the secured party to liability for any losses suffered by the debtor; in a consumer transaction, losses are presumed.[69]

One question that has vexed the courts for many years is whether the statutory sanctions are exclusive. This generally arises in the context of an action by the secured party for a deficiency judgement. In other words, if the sale does not raise enough money to pay off the debt, and the secured party sues the debtor for the balance, can the debtor successfully defend against the suit merely by showing that the secured party violated Part five, or does the debtor have to show actual damages as a result of the violation? This question is especially important if the violation is a failure to give proper notice, because the debtor will rarely be able to show

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68. VA. CODE ANN. § 8.9-504(3) (Add. Vol. 1965).
69. *Id.* § 9-507.

that the lack of notice caused any actual damages to it.

The case law is in hopeless disarray; cases can be found supporting three basic positions: first, a violation of Part five never automatically precludes a deficiency judgement; second, a violation always automatically precludes a deficiency judgement; third, a violation creates a rebuttable presumption that the goods, when sold, were worth the amount of the debt.[70] The third approach has the effect of presuming that the damages suffered by the debtor are equal to the amount of the deficiency, which in turn requires the secured party to demonstrate that the price received was the fair market value as a precondition of recovering the deficiency. The Supreme Court of Virginia has yet to rule on the issue; however, the Fourth Circuit has opined that if it did, it would adopt the rebuttable presumption rule.[71] One Virginia circuit court case now agrees with the Fourth Circuit, adopting the rebuttable presumption rule.[72]

D. *Miscellaneous Cases*

Two miscellaneous circuit court cases should be noted; while neither breaks new legal ground, each contains a good discussion of some Article Nine basics. The first is *C. W. Jackson Hauling, Inc. v. Southern Eagle*,[73] a recent case which provides a fine primer on the basic rules regarding accounts financing and priorities. The second is an older, but recently reported case, *Cho v. Lee*,[74] which includes a lengthy and thoughtful discussion of the elements of a "commercially reasonable" foreclosure sale.

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70. For an extensive discussion of the cases in various states, see J. White & R. Summers, *supra* note 45, at § 25-19 pp. 1245-53.
71. *In re* Bishop, 482 F.2d 381 (4th Cir. 1973).
72. First Va. Bank v. Richardson, 13 Va. Cir. 198 (1988).
73. 12 Va. Cir. 401 (1988).
74. 13 Va. Cir. 520 (1982).