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## Annual Survey of Virginia Law: Commercial Law

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## COMMERCIAL LAW

*Michael J. Herbert\**

### I. INTRODUCTION

This survey of commercial law in Virginia discusses significant Uniform Commercial Code ("Code") cases decided by the Virginia Supreme Court during the past year, as well as all significant statutory changes made to the Code during the 1991 session of the General Assembly.<sup>1</sup> It also reviews selected Code cases decided in the Virginia circuit courts and in the various federal courts sitting in Virginia.

### II. GENERAL PROVISIONS OF THE CODE

Article 1 of the Uniform Commercial Code contains a number of definitions and general provisions that are controlling in all Code contracts, unless they are displaced by the provisions of a particular substantive article.<sup>2</sup> In *Charles H. Thompkins Co. v. Lumbermans Mutual Casualty Co.*,<sup>3</sup> the court, in a footnote, significantly extended the coverage of Article 1 beyond its traditional scope. The case involved a common law suretyship contract, specifically, a payment and performance bond which was not covered by the Code at all.<sup>4</sup> Nevertheless, in construing the terms of the contract, the court cited section 8.1-205(4) of the Code, which deals with the proper relationship between express and non-express terms of a Code contract. The court justified this reliance by holding: "this Uniform Commercial Code provision is enacted in Article 1, the General Provisions. Accordingly, it is not limited merely to contracts for the sale of goods, but extends to all commercial con-

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1. This survey is current as of April 1, 1991.

2. VA. CODE ANN. § 8.1-103 (Add. Vol. 1965).

3. 732 F. Supp. 1368 (E.D. Va. 1990).

4. The Code only covers suretyship contracts to the extent that they are made part of a negotiable instrument. See, e.g., VA. CODE ANN. §§ 8.3-415, -416 (Add. Vol. 1965).

tracts.”<sup>5</sup> The court’s decision was technically in error, but certainly justifiable; the application of Code rules to comparable non-Code transactions is well established under the rubric “application by analogy.”

### III. SALES

#### A. *Applicability of Article 2*

Article 2 applies only to “transactions in” goods, a phrase which almost exclusively means “sales of” goods.<sup>6</sup> One of the many issues which arises under this provision is the circumstances under which Article 2 applies to “mixed” contracts. A mixed contract is one which involves some combination of goods, services, realty or other property. For example, a contract under which one party is to design, manufacture, and deliver goods to another involves *services* (the design and manufacture) as well as *goods* (the finished product). Is the contract an Article 2 contract? A common law contract? Or some hybrid of the two?

In analyzing the distinction between services and goods, most courts follow the “predominant purpose test.”<sup>7</sup> If the primary function of the contract is the rendition of services for a price, the contract is a common law contract for services. If the focus of the contract is on the end product, the contract is an Article 2 contract.

Construction contracts are obviously mixed contracts, involving both the transfer of goods and the rendering of services. *W.E. Brown, Inc. v. Pederson Construction and Tile Co.*<sup>8</sup> provides a good basic overview of the application of the “predominant purpose test” to construction contracts. In its analysis, which was derived from an earlier Fourth Circuit case,<sup>9</sup> the court considered three main factors: “(1) the language of the contract, (2) the principal business of the supplier, and (3) the intrinsic worth of the materials involved.”<sup>10</sup> Of these factors, the third consideration appears to have been the most significant. The court found that a

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5. *Charles M. Topkins Co.*, 732 F. Supp. at 1375 n.7.

6. VA. CODE ANN. § 8.2-102 (Add. Vol. 1965).

7. See generally 1 B. ZARETSKY, G. McLAUGHLIN & N. COHEN, COMMERCIAL LAW & PRACTICE GUIDE ¶ 3.02[1][d] (1991).

8. 20 Va. Cir. 280 (City of Charlottesville Cir. Ct. 1990).

9. *Coakley & Williams, Inc. v. Shatterproof Glass Corp.*, 706 F.2d 456 (4th Cir. 1983).

10. *W.E. Brown, Inc.*, 20 Va. Cir. at 282.

series of contracts in which most of the cost was allocated to material and equipment, and less than half to labor, were Article 2 contracts.<sup>11</sup>

### B. *Passage of Title*

Generally speaking, Article 2's substantive rules place little or no significance on the passage of title, even though it is an integral part of an Article 2 sale.<sup>12</sup> It is also often necessary to determine when title passed to the buyer. In *United States v. Rapoca Energy Co.*,<sup>13</sup> the court had to determine when a sale was completed and title passed, to determine the seller's obligations under the federal Surface Mining Control and Reclamation Act of 1977. The goods involved, coal, had been shipped to customers in a "raw," uncleaned state.<sup>14</sup> The price of the coal was determined after the coal was cleaned. The issue was whether the sale occurred before or after the customers cleaned the coal.<sup>15</sup>

The court noted that under the Code, "[u]nless otherwise explicitly agreed title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods. . . ."<sup>16</sup> The seller had no duties regarding the coal after its delivery; nor was delivery a mere incident to cleaning the coal, for "[the seller] was not shipping this coal to its customers for the purpose of cleaning but for the purpose of selling the coal to the customers."<sup>17</sup> Based on these facts, the court held the sale was completed as of the time of shipment.<sup>18</sup>

## IV. A NEW PROVISION FOR LEASES

The General Assembly passed and the Governor signed legislation which added a new article to the Code, effective January 1, 1992.<sup>19</sup> The new article, Article 2A, adds a new range of transactions to the Code — leases of personal property and fixtures. The

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11. *Id.* at 283-84.

12. VA. CODE ANN. § 8.2-106(1) (Add. Vol. 1965).

13. 751 F. Supp. 565 (W.D. Va. 1990).

14. *Id.* at 566.

15. *Id.* at 568-69.

16. *Id.* at 568, quoting VA. CODE ANN. § 8.2-401(2) (Add. Vol. 1965).

17. *Id.* at 569.

18. *Id.*

19. S. Bill 667, Feb. 2, 1991, Va. General Assembly (to be codified at VA. CODE ANN. § 8.2A).

addition of Article 2A marks the first major expansion of the Code's scope since its initial adoption in Virginia in the mid-1960's. It is likely to become one of the more important articles of the Code. The following is a short summary of the most significant features of Article 2A.<sup>20</sup>

Most of Article 2A is based on Article 2 (Sales). However, some provisions of the new article, such as those dealing with third party rights and the lessor's right to repossess, are borrowed from Article 9 (Secured Transactions). Article 2A "applies to any transaction, regardless of form, that creates a lease."<sup>21</sup> A lease involves the transfer of use and possessory rights in goods.<sup>22</sup> The term goods, as used in Article 2A, includes fixtures.<sup>23</sup> Finally, Article 2A only applies to true leases. It does not apply to transactions that are in the form of a lease but are actually secured transactions.<sup>24</sup>

The unconscionability provision in Article 2A not only encompasses the matters dealt with under Article 2, but also expands unconscionability protection in consumer transactions. Consumer lessees are specifically protected from unconscionable inducement to enter into lease contracts and from unconscionable collection actions by the lessor.<sup>25</sup> In addition, consumer lessees who are successful in their claims of unconscionability are entitled to an award of attorney's fees.<sup>26</sup> However, if the consumer lessee's claim of unconscionability is groundless, the article entitles the lessor to attorney's fees.<sup>27</sup>

The warranty rules of Article 2A are similar to the warranty rules of Article 2. As under Article 2, the lessee has the benefit of

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20. For more substantial treatments of Article 2A by the author of this article, see Herbert, *Getting Better All the Time: The Official (Revised) Remedy Provisions of the Uniform Commercial Code's Article 2A*, 96 Com. L.J. 1 (1991); Herbert, *Unconscionability Under Article 2A*, 21 U. Tol. L. Rev. 715 (1990); Herbert, *A Draft Too Soon: Article 2A of the Uniform Commercial Code*, 93 Com. L.J. 413 (1988). For other general studies of Article 2A from the perspective of Virginia law, see Herbert, *Introducing Article 2A: The New Personal Property Leasing Provisions of the Uniform Commercial Code*, 15 VA. BAR A. J. Spr. 1989, at 16 (1989).

21. S. Bill 667, February 2, 1991, Va. General Assembly (to be codified at VA. CODE ANN. § 8.2A-102).

22. *Id.* (to be codified at § 8.2A-103(1)(j)).

23. *Id.* (to be codified at § 8.2A-103(1)(h)).

24. *Id.* (to be codified at § 8.2A-103(1)(j)).

25. *Id.* (to be codified at § 8.2A-108(2)).

26. *Id.* (to be codified at § 8.2A-108(4)(a)).

27. *Id.* (to be codified at § 8.2A-108(4)(b)).

any express warranties made by the lessor.<sup>28</sup> Some lessees will have the benefit of implied warranties, such as the implied warranty of merchantability<sup>29</sup> and the implied warranty of fitness for particular purpose.<sup>30</sup> Article 2A implied warranties will probably not be very significant because the lessor may easily disclaim the warranties,<sup>31</sup> and they are not applicable in certain "finance leases."<sup>32</sup>

Although the remedy provisions of Article 2A are far too complex for detailed review in this survey, a brief sketch of the basic principles underlying these provisions is provided. The lessor's primary rights upon the lessee's default are seizure of the leased goods (by self-help if there is no breach of the peace),<sup>33</sup> disposal of the goods, and recovery of money damages for loss of the bargain as measured under several intricate formulae.<sup>34</sup> Lessors are expected to mitigate damages; thus unless they cannot feasibly recover or dispose of the goods, they cannot recover the entire rent due under the lease.<sup>35</sup>

The lessee's rights upon the lessor's default are parallel. The lessee generally does not have the right to obtain the goods from the lessor. If the goods have not been delivered by the lessor, or if the lessee rejects them, the lessee may obtain replacement goods or chose to do without. In either event, the lessee may recover money damages, either to compensate for the extra cost of a replacement lease<sup>36</sup> or for the difference between market rental and contract rental.<sup>37</sup> If the lessee keeps the defective goods, the lessee may recover money damages for the difference between the rental value of the actual goods and the rental value the goods would have had if they had been as warranted.<sup>38</sup>

Along with these statutory rights, parties may craft their own remedies. For example, the lease contract may contain a reasona-

28. *Id.* (to be codified at § 8.2A-210).

29. *Id.* (to be codified at § 8.2A-212).

30. *Id.* (to be codified at § 8.2A-213).

31. *Id.* (to be codified at § 8.2A-214).

32. *Id.* (to be codified at §§ 8.2A-212(1), -213). A finance lease is a three-party transaction in which the "lessor" is actually acting as a financing conduit between the "supplier" and the "lessee." *Id.* (to be codified at § 8.2A-103(1)(g)).

33. *Id.* (to be codified at § 8.2A-525(2), (3)).

34. *Id.* (to be codified at §§ 8.2A-527, -528, -530, -532).

35. *Id.* (to be codified at § 8.2A-529).

36. *Id.* (to be codified at § 8.2A-518).

37. *Id.* (to be codified at § 8.2A-519.(1), (2)).

38. *Id.* (to be codified at § 8.2A-519(3), (4)).

ble liquidation of damages.<sup>39</sup> It may also provide for limited and exclusive remedies, so long as there is some reasonably effective remedy and the limitation or exclusion of other remedies is not unconscionable.<sup>40</sup>

## V. NEGOTIABLE INSTRUMENTS

### A. *Revision of Articles 3 and 4*

The sponsors of the Uniform Commercial Code, the National Conference of Commissioners on Uniform State Laws and the American Law Institute, have completed work on a block of proposed amendments to Articles 3 and 4. No state has acted on the proposed amendments as of Spring, 1991. The amendments are not controversial and are expected to move quickly through the state legislative process. The proposed changes are relatively minor; however, they do modernize existing law and remove some errors and anomalies in the existing Code.

### B. *The Form of the Negotiable Instrument*

An instrument is "negotiable" for purposes of the Code if and only if it meets certain formal requirements. The word "negotiability" in this context has nothing whatsoever to do with the transferability of the instrument. "Negotiability" is merely a shorthand way of saying that the instrument contains what the Code requires it to contain and omits what the Code requires it to omit. For example, the instrument may not contain any condition on payment. If an instrument contains any condition on the obligor's duty to pay the instrument, it is not negotiable.<sup>41</sup> A conditional instrument is not subject to Article 3, but rather to the general law regarding written contracts.

If the instrument contains language which incorporates or makes the instrument subject to the provisions of another agreement, the instrument is conditional and not negotiable.<sup>42</sup> The reason for prohibiting conditions generally, as well as the incorporation of other agreements specifically, is to make it possible for a person

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39. S. Bill 667, February 2, 1991, Va. General Assembly (to be codified at VA. CODE ANN. § 8.2A-504).

40. *Id.* (to be codified at § 8.2A-503).

41. VA. CODE ANN. §§ 8.3-104(1)(b), -105 (Add. Vol. 1965).

42. *Id.* § 8.3-105(2)(a).

taking the instrument to know what he or she is taking. Since a third party has no sure way of knowing whether the condition was met, there is no sure way of knowing whether or not the instrument is payable at its face value or not.

The law, however, draws a clear distinction between the *reference* to another agreement and the *incorporation* of another agreement. If the instrument merely refers to another agreement and does not link payment of the instrument to performance of the other agreement, it is not conditional and thus is negotiable,<sup>43</sup> assuming that the other requirements of negotiability are met.

In *Sovran Bank, N.A. v. Franklin*,<sup>44</sup> the court examined the following language contained in a promissory note: "If this Note is issued pursuant to a commitment letter, it shall be entitled to its benefits and subject to its terms and conditions, including any amendments thereto and any renewals or substitutions thereof."<sup>45</sup> The court correctly held that this language precluded the instrument from being negotiable.<sup>46</sup> Of particular importance is the fact that an existing commitment letter which conflicted with the note<sup>47</sup> was considered irrelevant. Even if there had been no commitment letter, the instrument would not have been negotiable. What is important is not the existence of the other agreement, but the fact that a third party taking the instrument could not determine from the face of the instrument whether there was or was not another agreement.

### C. *Holder in Due Course — Notice of Defenses*

To qualify as a holder in due course — and thus to take free of all claims to and most defenses on the instrument — the person taking the instrument must act in good faith and be without notice that a party to the instrument has a defense against its enforcement.<sup>48</sup> In most states, "good faith" is measured subjectively and "notice" is measured objectively. However, in Virginia's version of

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43. *Id.* § 8.3-105(1)(b)-(e). As discussed in earlier editions of this Survey, the distinction between reference and incorporation is not always easily made. See Herbert, *Commercial Law: Annual Survey of Virginia Law*, 21 U. RICH. L. REV. 693, 707-09 (1987).

44. 21 Va. Cir. 376 (City of Richmond Cir. Ct. 1990).

45. *Id.* at 377.

46. *Id.* at 377-78.

47. *Id.* at 377.

48. VA. CODE ANN. § 8.3-302(1)(b), (c) (Add. Vol. 1965).

the Code, both good faith and notice are measured subjectively.<sup>49</sup>

The significance of this standard is apparent in *In re Wills*.<sup>50</sup> In *Wills*, the maker of a note argued that the holder could not be a holder in due course because the holder had notice of the maker's defense. Specifically, the holder was aware that the maker was drinking heavily and had marital and psychological problems.<sup>51</sup> The court held that, as a matter of law, this knowledge was *insufficient* to establish that the holder had notice of a defense.<sup>52</sup>

## VI. INVESTMENT SECURITIES

Article 8 governs investment securities and is one of the most obscure articles of the Code. It is the province of a rather small number of specialists, and generates very little reported litigation. In *Young v. Young*,<sup>53</sup> the Supreme Court of Virginia reviewed the Article 8 requirements for transferring ownership in an investment security.

In *Young*, the key allegation was that Lehman H. Young, Sr. had made gifts of stock in The Virginia Press to his daughters. The stock in question was "certificated," or represented by a paper stock certificate.<sup>54</sup> The corporate records noted the transfer, but a physical transfer of the shares never occurred.<sup>55</sup> The court held that no valid gift had been made.<sup>56</sup> The court based its decision largely on section 8.8-313(1)(a) of the Code: "[t]ransfer of a security . . . to a purchaser<sup>57</sup> occurs only . . . at the time he or a person designated by him acquires possession of a certificated security."<sup>58</sup>

49. *Id.* § 8.3-304(7) (Add. Vol. 1965) states:

In any event, to constitute notice of a claim or defense, the purchaser must have knowledge of the claim or defense or knowledge of such facts that his action in taking the instrument amounts to bad faith. If the purchaser is an organization and maintains within the organization reasonable routines for communicating significant information to the appropriate part of the organization apparently concerned, the individual conducting the transaction on behalf of the purchaser must have the knowledge.

50. 126 Bankr. 489 (Bankr. E.D. Va. 1991).

51. *Id.* at 493.

52. *Id.* In addition, the court rejected the claim that the maker's drinking problem and mental illness constituted a defense on the instrument in the first place. *Id.* at 496-97.

53. 240 Va. 57, 393 S.E.2d 398 (1990).

54. *Id.* at 63, 393 S.E.2d at 401.

55. *Id.* at 60, 393 S.E.2d at 399.

56. *Id.* at 64, 393 S.E.2d at 401.

57. Note that the term "purchaser" in this provision includes a donee. See VA. CODE ANN. § 8.1-201(32), (33) (Cum. Supp. 1991).

58. *Id.* § 8.8-313(1)(a). Note, however, that there are several other ways in which a certifi-

## VII. SECURED TRANSACTIONS

A. *Article 9 and Article 2A*

Article 2A, now adopted by Virginia, will partially eliminate the need to determine whether a transaction is a true lease of goods or a sale-and-security interest transaction. Many of the reasons for drawing the distinction no longer exist. For example, now both lessees and buyers may enjoy the benefits of the implied warranties of merchantability and fitness for particular purpose. More precisely, lessees and buyers enjoy those benefits to the extent their lessors and sellers do not disclaim them.

Nevertheless, the distinction between the true lease and the security lease is significant. Section 8.1-201(37) of the Code, which sets out the distinction, has been amended into a statute of considerable prolixity and complexity.<sup>59</sup> Buried in a mass of prose, however, is a remarkably simple concept. The distinguishing mark of the true lease is that the lessor retains valuable residual rights in the goods.<sup>60</sup> Essentially, this means that at the end of the lease term the goods will still be valuable (i.e., their useful life will not be exhausted) and the lessee will either return the goods to the lessor or pay their fair value to retain them.<sup>61</sup> If the lessor does not retain valuable residual rights, the transaction is a security lease subject to Articles 2 and 9. Although this does not significantly change existing law,<sup>62</sup> it does focus the courts' attention on the one crucial factor of valuable residual rights.

B. *Classification of Collateral*

Article 9 contains rather detailed definitions of particular types of collateral, such as "consumer goods"<sup>63</sup> and "inventory."<sup>64</sup> In many circumstances these classifications are quite significant. Mat-

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cated security may be transferred; however, none of these were relevant to the case. For the other methods of transferring a certificated security, see *id.* § 8.8-313(1)(c)-(e), (g)-(j).

59. *Id.* § 8.1-201(37) (Cum. Supp. 1991).

60. *Id.*

61. *Id.* § 8.1-201(37)(a)-(b).

62. See, e.g., *Mercedes-Benz Credit Corp. v. Commercial Business Sys., Inc.*, 22 Va. Cir. 403 (County of Chesterfield Cir. Ct. 1991) (agreement under which lessee had the right to possess and use car for lease term, at the end of which goods were to be returned to lessor, was a true lease).

63. VA. CODE ANN. § 8.9-109(1) (Add. Vol. 1965).

64. *Id.* § 8.9-109(4) (Cum. Supp. 1991).

ters such as the rights of the secured party upon foreclosure<sup>65</sup> and the proper method of perfection<sup>66</sup> are to a great extent determined by the classification of the secured party's collateral.

*In re Beacon Light Marina Yacht Club, Inc.*<sup>67</sup> illustrates the importance of classification. Beacon Light was the owner of two houseboats. First Community Bank (FCB) claimed a security interest in these boats under a security agreement that described the collateral as all the debtor's "furniture, fixtures, machinery, equipment, inventory, and accounts receivable."<sup>68</sup> The crucial question was not the sufficiency of the security agreement, but whether the security interest had been perfected. Because the collateral was watercraft, the perfection rules of Article 9 did not apply; rather, perfection was determined in accordance with Virginia's boat certification, titling and registration law.<sup>69</sup> This particular law requires perfection by notation on the certificate of title, unless the boat is held as inventory. There was no notation on the certificate of title in favor of FCB.<sup>70</sup> FCB claimed that the boats were held as inventory because time-shares in them were sold by Beacon. Noting that Beacon kept both title to and substantial control over the houseboats, the court rejected this argument and thus classified the boats as "equipment" rather than inventory.<sup>71</sup>

The court, however, did not fully consider another possibility. Inventory includes goods held for sale *or lease*.<sup>72</sup> Obviously, a time-share arrangement has more than a passing similarity to a lease.

### C. *Place of Filing*

Article 9 financing statements must be filed in particular locations so that subsequent buyers and creditors will know exactly where to look to determine whether the seller or borrower has granted a security interest to someone else. The rules are stringent and require strict adherence, as illustrated in the recent bank-

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65. VA. CODE ANN. § 8.9-505(2).

66. VA. CODE ANN. § 8.9-302(1)(d).

67. 125 Bankr. 154 (Bankr. W.D. Va. 1990).

68. *Id.* at 156.

69. *Id.* at 157.

70. *Id.* at 158. No certificate of title had been issued for one of the two boats. Because of this, the court also discussed the possibility that a security interest in the boat could be perfected by taking possession of the certificate of origin. Since FCB never took possession of the certificate of origin, the issue was moot. *Id.*

71. *Id.* at 157.

72. VA. CODE ANN. § 8.9-109(4) (Add. Vol. 1965).

ruptcy court case of *In re JJ's Home Style Laundry, Inc.*<sup>73</sup>

Automated Laundry Systems sold a coin operated laundromat to JJ's Home Style Laundry (and its owner) in 1986. The seller's rights under this purchase and security agreement were assigned to Viking Credit Corporation. Viking filed financing statements at the State Corporation Commission and the Alexandria Circuit Court clerk's office. The Alexandria filing was erroneous because the local financing statement should have been filed in Fairfax County.<sup>74</sup>

JJ's and its owner subsequently filed for bankruptcy relief under Chapter 11 and operated the business as a debtor-in-possession.<sup>75</sup> Viking sought relief from the automatic stay and thereby brought the erroneous filing to the court's attention. Viking claimed that the debtors had intentionally misled it into filing in Alexandria rather than Fairfax. Consequently, it argued that the court should excuse the error. Nevertheless, the court held that any misleading of Viking, whether intentional or not, was irrelevant. The filing rules were meant to protect third parties, and the debtors in possession were the representatives of third parties:

As debtors in possession, the debtors stand in the shoes of the trustee, enjoying the same rights and duties. . . . Thus, the debtors act in a fiduciary capacity for the benefit of creditors, and to allow Viking's claim to be treated as secured would work to the detriment of the debtors' other creditors.<sup>76</sup>

The case is well-reasoned, but one caveat should be noted. If the reorganization is successful, the *debtor* could benefit from the avoidance of the security interest. This should not be permitted, because in priority conflicts between the debtor and the secured party, the perfection or non-perfection of the security interest is irrelevant.<sup>77</sup>

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73. 123 Bankr. 22 (Bankr. E.D. Va. 1990).

74. *Id.* at 23-24. Section 8.9-4012(1)(c) of the Code of Virginia requires that "a financing statement be filed with the State Corporation Commission and also, where the debtor has a place of business in only one city or county, in the circuit court clerk's office of that county or city." *Id.*

75. *In Re JJ's Home Style Laundry, Inc.*, 123 Bankr. at 23-24.

76. *Id.* at 24.

77. See VA. CODE ANN. § 8.9-201 (Cum. Supp. 1991); *Felmey v. Household Fin. Corp.*, 6 Bankr. 331 (Bankr. E.D. Va. 1981).

#### D. *Article 9 Rights and Mechanic's Liens*

One of the many disputes that can arise under Article 9 involves the conflicting interests between the secured party and a person holding a mechanic's lien. The same property may be subject to both the Article 9 security interest and the lien. Article 9 does not determine the rights and priorities between those two interests; rather, it is left to local mechanics' lien law.<sup>78</sup>

*Newport News Shipbuilding Employees' Credit Union, Inc. v. B & L Auto Body, Inc.*<sup>79</sup> examines one aspect of this issue: whether the lienor must give notice to the secured party regarding its intent to sell the goods subject to its lien. In a close analysis of section 43-34 of the Code, the court ruled that the statute required notice to be given in either of two situations. First, notice is required if the secured party has filed a financing statement *and* the goods are worth more than \$600.<sup>80</sup> Second, it is also required if the goods are subject to the certificate of title laws *and* the secured party's interest is noted on the certificate of title.<sup>81</sup> In the latter case, mechanic's lien law requires notice regardless of the value of the goods.<sup>82</sup>

#### E. *Formal Sufficiency of Financing Statement*

Many security interests are perfected by the filing of a financing statement in the appropriate filing office. To be effective, the financing statement must meet certain requirements. For example, the debtor and the secured party must be named.<sup>83</sup> Ordinarily, the name must be the debtor or secured party's actual name, not its trade name.<sup>84</sup> However, minor errors in any part of the financing statement, which are not seriously misleading, do not invalidate it.<sup>85</sup>

If the financing statement uses the secured party's trade name and not its legal name, then, according to the recent case of *In Re*

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78. VA. CODE ANN. § 8.9-310.

79. 241 Va. 31, 400 S.E.2d 512 (1991).

80. *Id.* at 37.

81. *Id.*

82. *Id.* at 34-38, 400 S.E.2d at 514-15.

83. VA. CODE ANN. § 8.9-402(1) (Cum. Supp. 1991).

84. *See id.* § 8.9-402(7). Note that by its terms this provision only applies to the debtor.

85. *Id.* § 8.9-402(8).

*Bumper Sales, Inc.*,<sup>86</sup> the court may consider this mistake a minor error. In *Bumper*, the error was not seriously misleading because a subsequent searcher of the records could have easily discovered the secured party's identity, and it was obvious from the financing statement that the debtor's inventory could have been encumbered.<sup>87</sup> The decision is a sound one because the misnamed party was the secured party, not the debtor. The single most important piece of information in a financing statement is the debtor's name; for if the party searching the records finds the name, it is at least alerted to the fact that there is a security interest in the described goods.

#### F. *Self-Help Repossession*

The secured party has a number of rights upon the debtor's default. One right is the right to seize possession of the collateral. Repossession may be accomplished by "self-help" and without the judicial process, *if* there is no breach of the peace.<sup>88</sup> There has been a great deal of litigation over the definition of "breach of the peace." *Wallace v. Chrysler Credit Corp.*,<sup>89</sup> which dealt with the self-help repossession of a truck, is an example of such litigation.<sup>90</sup>

In *Wallace*, the debtor claimed that several actions of the secured party breached the peace. The repossession occurred at 2 a.m. with the repossession agent loudly racing the truck's engine, barrelling down the street and frightening the debtor and his daughter. When the debtor and his daughter subsequently spoke to the repossession agent, he "very hatefully and gritting his teeth pointed his finger at [the debtor] and his daughter" and threatened them with jail.<sup>91</sup> The court rejected the debtor's claim for breach of the peace.

The court made several significant points which were well-supported either in prior Virginia law or in the court rulings of other states. First, the repossessing creditor does not breach the peace by entering private property to seize the goods; however, they generally may not enter locked buildings and must leave the property if

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86. 907 F.2d 1430, 1434-35 (4th Cir. 1990).

87. *Id.*

88. VA. CODE ANN. § 8.9-503 (Add. Vol. 1965).

89. 743 F. Supp. 1228 (W.D. Va. 1990).

90. It also contains a short history of breach of the peace under both the common law and the Code of Virginia. *Id.* at 1231-32.

91. *Id.* at 1230 (citation omitted).

the debtor objects.<sup>92</sup> Second, the creditor does not breach the peace by using "stealth" in the repossession. For example, repossessing an automobile in the middle of the night is not a breach of the peace.<sup>93</sup> Neither is noisy driving.<sup>94</sup> Finally, the court in *Wallace* found that the alleged threat to put the debtor in jail occurred well after the completion of the repossession. Only a breach of the peace which occurs during the course of the repossession precludes self-help under Article 9.<sup>95</sup>

Self-help repossession is permitted because, in theory, it reduces the costs of repossession and consequently may reduce the cost of credit. Article 9 attempts to balance this benefit against at least one of the detriments of self-help — the risk of violence or bloodshed. The decision in *Wallace* is in accord with Article 9's balanced approach: the repossession must occur without any significant risk of violence and without any more disturbance to public tranquility than would occur whenever a somewhat noisy driver passes in the middle of the night.

### G. *Disposition of Collateral*

Article 9 gives the secured party considerable freedom in disposing of the collateral. There are only a few requirements: (1) the disposition must be commercially reasonable; (2) in most cases the debtor must be given notice of the sale and; (3) in some cases other secured parties must be given notice of the sale.<sup>96</sup> The debtor may waive its right to notice, but only in a writing signed *after* default.<sup>97</sup>

What about guarantors? Is a pre-default waiver of notice executed by a guarantor of the obligation effective? In *Chrysler Credit Corp. v. Curley*,<sup>98</sup> the court held that it is.<sup>99</sup> This aspect of the case is somewhat questionable, although it does have support in the statutory language (which speaks only of waiver by the debtor, not

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92. *Id.* at 1232-32.

93. *Wallace*, 743 F.Supp. at 1233 (citing *Ford Motor Credit Corp. v. Cole*, 503 S.W.2d 853, 855 (Tex. Ct. App. 1973)).

94. *Id.*

95. *Id.* at 1233-34.

96. VA. CODE ANN. § 8.9-504(3) (Cum. Supp. 1991).

97. *Id.* § 8.9-504(3) (Cum. Supp. 1991).

98. 753 F. Supp. 611 (E.D. Va. 1990).

99. *Id.* at 616-17.

by guarantors).<sup>100</sup> However, the court's further statement that the guarantor can waive the right to a commercially reasonable disposition of the collateral is problematic for two reasons.<sup>101</sup>

First, while the "notice" provision is of rather little significance, the "commercially reasonable" requirement is not. Notice is designed to give the debtor the ability to participate in the sale or to seek out buyers. Rarely do debtors (or for that matter, closely related guarantors) even attempt to do either. Thus, because absence of notice rarely has any effect, there is significant reason to be too concerned about the loss of the right to notice. There is, by contrast, a much greater risk that a commercially unreasonable sale will cause injury to the debtor or to a guarantor.

Second, the Code does not permit the secured party's obligation to act in a commercially reasonable manner to be excused from the contract. "[T]he obligations of good faith, diligence, reasonableness and care prescribed by this act may not be disclaimed by agreement. . . ." <sup>102</sup> Of course, the guarantor's contract with the secured party is not an Article 9 contract, and unless it appears on a negotiable instrument, it is not even a U.C.C. contract. Nevertheless, there is no reason why the Code's approach should not be adopted by analogy. The net result of the case is that, vis-a-vis the borrower, the secured party must always dispose of the collateral in a commercially reasonable way. However, vis a vis the guarantor, the secured party, under some circumstances, will be held to a much lower standard — it may act unreasonably although not in a fashion that amounts to "bad faith, abusive or grossly negligent conduct."<sup>103</sup>

#### H. *Property Interests Subject to Article 9*

Article 9 applies, by its terms, to security interests in personal property and fixtures, sales of accounts and chattel paper.<sup>104</sup> It

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100. VA. CODE ANN. § 8.9-504(3) (Cum. Supp. 1991). Note, however, that the court's view on this issue is questionable, since the Supreme Court of Virginia has previously extended some of the protections given to principal debtors to co-makers of notes. See *Rhoten v. United Virginia Bank*, 221 Va. 222, 269 S.E.2d 781 (1980).

101. 753 F. Supp. at 616-17.

102. VA. CODE ANN. § 8.1-102(3) (Add. Vol. 1965). Note that the provision does permit the parties to *define* the scope of these duties if their definition is not "manifestly unreasonable." *Id.*

103. 753 F. Supp. at 619.

104. VA. CODE ANN. § 8.9-102(1)-(2) (Cum. Supp. 1991).

specifically does not encompass interests in or liens on any real estate (other than fixtures) "including a lease or rents thereunder."<sup>105</sup> This, of course, creates a significant question concerning whether all payments of money regarding occupancy of real estate constitute rents under a real estate lease. This question was analyzed in *In re Oceanview/Virginia Beach Real Estate Associates*.<sup>106</sup> In *Oceanview* the question was whether hotel guest room receipts were real property lease rents or personal property. Specifically, the question was whether a creditor's interest in those receipts was governed by real estate law or Article 9. The court, after an analysis of both Virginia law and various out-of-state precedents, ruled that hotel room receipts for stays of less than thirty days are personalty. Thus any security interest in them is subject to Article 9.<sup>107</sup>

### I. *Failure to Comply with Collateral Disposition Rules*

As noted above, the secured creditor disposing of collateral must generally give notice of the disposition and must make the disposition in a commercially reasonable manner.<sup>108</sup> Previous editions of this survey have examined the effect of the secured party's failure to meet these requirements.<sup>109</sup> Generally, courts around the country have adopted one of three rules. According to the first rule, the debtor must prove damages in order to obtain any rights against the secured party. Under the second, the secured party is absolutely barred from recovering a deficiency, whether or not the debtor was injured. The third rule takes a more moderate position — it creates a rebuttable presumption that the collateral was worth the amount of the debt, effectively forcing the secured party to prove that the debtor was not injured.<sup>110</sup>

The issue still has not been resolved in Virginia. Many reported cases from Virginia's circuit courts and the federal courts sitting in Virginia have opined that the Supreme Court of Virginia would adopt the third rule. The last year provided further indication that at least the Virginia circuit courts continue to lean toward this

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105. *Id.* § 8.9-104(j).

106. 116 Bankr. 57 (Bankr. E.D. Va. 1990).

107. *Id.* at 58-59.

108. See *supra* note 91 and accompanying text.

109. See e.g., Herbert, *Commercial Law: Annual Survey of Virginia Law*, 24 U. RICH. L. REV. 551, 561 (1990).

110. *Id.* at 561-62.

moderate rule.<sup>111</sup> Of the four well-reasoned opinions, two contain especially useful discussions of the issue.<sup>112</sup>

### VIII. CONCLUSION

Commercial law in Virginia and throughout the country is undergoing rapid change as the Uniform Commercial Code is overhauled. In just the past four years, Virginia has adopted two new articles, Article 4A (Wire Transfers) and Article 2A (Leases). Changes to Articles 3 (Negotiable Instruments) and 4 (Bank Deposits and Collections) are imminent. More change is on the way, a project for revising Article 2 has already begun. Although 1991 saw relatively few significant Code cases, the adoption of Article 2A is the most significant single development in Virginia's commercial law since 1966.

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111. See *G.M.A.C. v. Ears*, 22 Va. Cir. 322 (County of Fairfax Cir. Ct. 1990); *L. C. Arthur Trucking, Inc. v. Evans*, 20 Va. Cir. 460 (City of Richmond Cir. Ct. 1990); *Smith v. Paige*, 19 Va. Cir. 359, 365 (City of Richmond Cir. Ct. 1990); *Tazewell Oil Co. v. Miners & Merchants Bank*, 19 Va. Cir. 245, 253 (County of Buchanan Cir. Ct. 1990).

112. *G.M.A.C.*, 22 Va. Cir. at 323-26; *Smith*, 19 Va. Cir. at 362-66.

