University of Richmond Law Review

Volume 22 | Issue 4 Article 3

1988

Annual Survey of Virginia Law: Commercial Law

Michael J. Herbert
University of Richmond

COMMERCIAL LAW

*Michael J. Herbert**

I. Introduction

This survey of commercial law reviews all Virginia Supreme Court cases interpreting the Virginia Uniform Commercial Code (the "Code") and all statutory changes made to the Code in the 1988 session of the General Assembly. It also reviews significant Code cases decided in the various federal courts located in Virginia and in the Virginia circuit courts. It is current as of approximately May 1, 1988.

II. Sales

A. *Scope of Article 2*

By and large, Article 2 of the Code covers only sales of goods.[1] Hundreds of cases attempt to define the precise boundaries of this definition. One of those boundaries separates "sales" of goods from "services" that involve the incidental use or transfer of goods.

In *Gressman v. Peoples Service Drug Stores, Inc.*,[2] the Richmond Circuit Court examined the dispensing of prescription drugs by a pharmacy to determine whether that activity was a service or a sale. The court held, alternatively, that (1) it is a service and (2) liability for such transactions is, in any event, exclusively determined under the Medical Malpractice Act.[3] The decision is in accordance with the theory underlying most cases dealing with a mixed contract for goods and medical services.[4]

The court placed great stress on the professional nature of the

---

* Professor of Law, T.C. Williams School of Law, University of Richmond; B.A., 1974, John Carroll University; J.D., 1977, University of Michigan.

1. Va. Code Ann. § 8.2-102 (Add. Vol. 1965).
2. 10 Va. Cir. 397 (Richmond 1988).
3. *Id.* at 405-09.
4. However, none of the cases cited in *Gressman* are firmly on point and several are pre-Code cases. Only one case actually involved an independent pharmacy—and that case addressed strict liability in tort rather than Article 2 warranty liability. Murphy v. E. R. Squibb & Sons, Inc., 40 Cal. 3d 672, 710 P.2d 247, 221 Cal. Rptr. 447 (1985).

pharmacist's activity in dispensing prescriptions. Quoting a California case, the *Gressman* court stated:

> It is pure hyperbole to suggest, as does plaintiff, that the role of the pharmacist is similar to that of a clerk in an ordinary retail store. With a few exceptions, only a licensed pharmacist may dispense prescription drugs, and as indicated there are stringent educational and professional requirements for obtaining and retaining such a license. The pharmacist must not only use skill and care in accurately filling and labeling a prescribed drug, but he must be aware of problems regarding the medication, and on occasion he provides doctors as well as patients with advice regarding such problems.[5]

In short, the court ruled that those activities of a pharmacist which are fundamentally professional should be regulated by the tort-based malpractice law applicable to professionals, not the warranty-based law applicable to merchants of goods. By inference, however, it can be assumed that other activities of a pharmacist or pharmacy (such as selling over-the-counter drugs, watches, lawn furniture and beer) would be governed by Article 2. With regard to those activities, the pharmacist is acting merely as a merchant of goods, not as a professional subject to special training and licensing requirements.

B. *Limitation of Remedies/Failure of Essential Purpose*

Freedom of contract is as central to the Uniform Commercial Code as it is to the common law. With few exceptions, competent parties are permitted to enter into any agreement they want. The scope of this freedom, of course, is especially broad in commercial transactions.

The ability of parties to vary the standard remedies set out in the Code is one aspect of this freedom. Under section 8.2-719(1)(a) of the Code:

> [T]he agreement may provide for remedies in addition to or in substitution for those provided in this title and may limit or alter the measure of damages recoverable under this title, as by limiting the buyer's remedies to return of the goods and repayment of the price

5. *Gressman*, 10 Va. Cir. at 406-07 (quoting *Murphy*, 40 Cal. 3d at 678-79, 710 P.2d at 251, 221 Cal. Rptr. at 451).

or to repair and replacement of nonconforming goods or parts . . . .[6]

This provision is qualified in two ways. First, if an exclusive or limited remedy "fail[s] of its essential purpose" then the limitation is avoided and other Article 2 remedies become available.[7] Second, a limitation or exclusion of consequential damages is inoperative if it is unconscionable.[8]

The most common method of limiting remedies is for the seller to exclude liability for consequential damages resulting from the seller's breach. In many contracts, an exclusion of consequential damages is coupled with a provision setting out an exclusive, limited remedy (typically repair or replacement). A difficult question arises if that limited remedy fails of its essential purpose: Can the injured party recover consequential damages?

For example, suppose the buyer purchased a widget under a contract that contained *both* an exclusive remedy of repair *and* an exclusion of liability for consequential damages. The widget does not work and the seller is unable to repair it. The limited remedy has clearly failed of its essential purpose and some additional remedy must be given. Should the court invalidate both the exclusive remedy and the consequential damage exclusion? Or should the court merely avoid the exclusive remedy provision and allow the buyer to pursue remedies for direct damages such as revocation of acceptance[9] or difference money damages?[10] It is not a trivial question as the direct damages may be only a fraction of the consequential damages.

Two distinct schools of thought have developed on this issue. In *Envirotech Corp. v. Halco Engineering, Inc.*,[11] Virginia aligned itself with those states in which a failure of essential purpose does not automatically permit recovery of consequential damages. If a commercial contract contains wholly distinct provisions regarding (1) an exclusive remedy and (2) an exclusion of consequential damages, a failure of essential purpose avoids only the exclusive rem-

6. VA. CODE ANN. § 8.2-719(1)(a) (Add. Vol. 1965).
7. *Id.* § 8.2-719(2).
8. *Id.* § 8.2-719(3). Because of the primary unconscionability provision, *Id.* § 8.2-302, this provision is, in part, technically redundant. It does, however, also create a presumption of unconscionability with regard to disclaimers of consequential damages in consumer transactions.
9. *Id.* § 8.2-608.
10. *Id.* § 8.2-714.
11. 234 Va. 583, 364 S.E.2d 215 (1988).

edy provision. The separate consequential damage exclusion will remain effective unless it is shown to have been unconscionable at the time the parties entered into the contract.[12]

The court's logic is that since the parties put two independent provisions in the contract, they have demonstrated a conscious allocation of risk. In other words, one party agreed to bear the risk of consequential damages *regardless* of the adequacy of the limited remedy: "[F]rom a practical standpoint, where, as here, experienced parties agree to allocate unknown or undeterminable risks, they should be held to their bargain; courts, or juries, should not be permitted to rewrite the agreement."[13]

The court's holding in *Envirotech* is very narrow and should ordinarily apply only in a commercial setting, since a consumer buyer is not likely to have consciously accepted the risk that consequential damages could not be recovered even if the limited remedy failed. *Envirotech* probably does not apply if the contract does not contain clearly separate provisions on exclusive remedy and exclusion of consequential damages. And, of course, proof of unconscionability will avoid the consequential damage provision.

C. *Specific Performance*

A federal circuit court case, *Klein v. Pepsico, Inc.*,[14] made a few minor but significant points about the availability of specific performance for breach of contract under Article 2. Under section 8.2-716(1) of the Code, "[s]pecific performance may be decreed where the goods are unique or in other proper circumstances."[15] The primary issue in *Klein* was whether this section supercedes prior Virginia law concerning general equitable requirements for the grant of specific performance. The court held that it did not.[16] In particular, the traditional equity-based rule that specific performance will not be decreed if money damages adequately compensate the injured party continues in effect.[17]

---

12. *Id.* at 591-94, 364 S.E.2d at 219-20.
13. *Id.* at 593, 364 S.E.2d at 220.
14. 845 F.2d 76 (4th Cir. 1988).
15. VA. CODE ANN. § 8.2-716(1) (Add. Vol. 1965).
16. *Klein*, 845 F.2d at 80.
17. *Id.*

III. Leases

The American Law Institute and the National Conference of Commissioners on Uniform State Laws have recently promulgated a new Uniform Commercial Code Article which covers leases of personal property.[18] Many states are already actively examining the new article; adoption by most or all of the states is expected within a few years. The article, denominated 2A, is largely derived from Article 2. Many of the same reforms already made in the law of sales are extended to leases. If and when Article 2A is adopted in Virginia, it will have a substantial impact on existing law. While it is perhaps premature to discuss the proposed article in depth, it is important to note the most significant change it will make—the extension of implied warranties to leases of goods. The Article 2 implied warranties of merchantability and fitness for particular purpose (so significant in products liability law) will, with some modifications, be applied in lease transactions as well. It is reasonable to suppose that this will be the most controversial aspect of the article.[19] It should be noted, however, that one Virginia circuit court opinion, *Gentry v. Ryder Truck Rental, Inc.*,[20] has already extended the Article 2 warranties to some personal property leases.[21]

IV. Commercial Paper

A. *Negotiability*

1. Variable Interest Rates

Negotiability is fundamental to commercial paper law under Article 3. With one minor exception, if an instrument is non-negotiable, it is not covered by Article 3.[22] Negotiability is simply a shorthand word for the form of the instrument. If an instrument contains certain terms (and omits other terms) it is negotiable. In general, to be negotiable: 1) an instrument must be signed, and in writing; 2) contain an unconditional promise or order to pay a sum certain in money; 3) be in order form or bearer form; 4) be payable

18. U.C.C. §§ 2A-211 to -216 (1988).

19. This will be the most controversial aspect for the very simple reason that it is likely to spark the most litigation.

20. 8 Va. Cir. 360 (Richmond 1987).

21. For a discussion of this case, see Herbert, *Commercial Law: Annual Survey of Virginia Law*, 21 U. Rich L. Rev. 693, 696-98 (1987) [hereinafter Herbert].

22. Va. Code Ann. § 8.3-805 (Add. Vol. 1965).

on demand or at a definite time; and 5) contain no extraneous promises, orders or powers.[23]

During the past year, Virginia's courts and legislature examined the negotiability of variable-rate promissory notes; more precisely, notes in which the interest rate is pegged to an external standard, such as the prime rate at a particular bank. In *Taylor v. Roeder*,[24] the Virginia Supreme Court held that such a note was not negotiable because it was not for a sum certain.[25] Of course, the fact that a note is deemed non-negotiable does not mean it is unenforceable or that it cannot be transferred. However, the special Article 3 special rights given to transferees of negotiable instruments are not available. The rights and obligations of parties to, and transferees of, non-negotiable instruments are determined by the general law of contracts.

Thus, *Taylor* created serious problems for lenders. The determination that variable-rate instruments were not covered by Article 3 threatened many accepted commercial practices. For example, transferees of such instruments could not be holders in due course. Hence, they would ordinarily take subject to defenses of the maker,[26] and this in turn would reduce the ready marketability of such instruments.

Justice Compton, in a strong dissent, voiced concerns about the potential impact of the case.[27] The General Assembly, led by the same concerns, amended Article 3 and overturned the *Taylor* decision. Section 8.3-106 of the Virginia Uniform Commercial Code now reads:

> (1) The sum payable is a sum certain even though it is to be paid
> (a) with stated interest, a stated rate of interest or by stated installments; or
> (b) with stated different rates of interest before and after default or a specified date; or
> (c) with a stated discount or addition if paid before or after the date fixed for payment; or

23. *Id.* §§ 8.3-104 to -112.
24. 234 Va. 99, 360 S.E.2d 191 (1987).
25. *Id.* at 103-04, 360 S.E.2d at 194-95.
26. *See* VA. CODE ANN. § 8.3-306 (Add. Vol. 1965). Technically, of course, this section does not apply to non-negotiable instruments because they are not subject to Article 3; however, it essentially restates the common law regarding the rights of assignees. *See also id.* § 8.9-318(1) (defenses of assignee subject to terms of contract).
27. *Taylor*, 234 Va. at 106-08, 360 S.E.2d at 195-96.

(d) with exchange or less exchange, whether at a fixed rate or at the current rate; or
(e) with costs of collection or an attorney's fee or both upon default.

(2) A rate of interest that cannot be calculated by looking only to the instrument is "a stated rate of interest" in subsection (1) of this section if the rate is readily ascertainable by a reference in the instrument to a published statute, regulation, rule of court, generally accepted commercial or financial index, compendium of interest rates or announced or established rate of a named financial institution.

(3) Nothing in this section shall validate any term with is otherwise illegal.[28]

The key provision is subsection (2). This subsection makes it clear that the incorporation of any readily available standard is permissible and the note will be negotiable.

This does not necessarily mean that *Taylor* is a dead letter. The statute does not purport to clarify prior law nor to have retroactive effect. The presumption in Virginia is that legislation is only prospective in nature,[29] and thus, it is highly likely that this legislation will not be given retroactive effect.[30] Consequently, *Taylor* should still apply to variable-rate notes issued prior to the effective date of the amendment.[31] This means that these notes remain nonnegotiable and not subject to the rules of Article 3. The *Taylor* rule will thus be of continued (even if diminishing) importance to lawyers for many years to come.

---

28. VA. CODE ANN § 8.3-106 (Cum. Supp. 1988).

29. "[T]he general rule [is] that retroactive or retrospective legislation is not favored, in the absence of any words expressing a contrary intention . . . . It is reasonable to conclude that the failure to express an intention to make a statute retroactive evidences a lack of such intention." Ferguson v. Ferguson, 169 Va. 77, 86-87, 192 S.E. 774, 777 (1937); *see also* McIntosh v. Commonwealth, 213 Va. 330, 191 S.E.2d 791 (1972) (when legislative history does not manifest the intent to give the statute retroactive effect, the court will not infer such intent); Bain v. Boykin, 180 Va. 259, 23 S.E.2d 127 (1942) (statute is construed to operate prospectively unless a contrary intent is manifested).

30. *See Bain*, 180 Va. 259, 23 S.E.2d 127 (basic Virginia principles regarding the circumstances under which legislation can be given retroactive effect). Whether the legislation could have been given retroactive effect is obviously another question, one beyond the scope of this article.

31. The amendment, which was passed as emergency legislation (its supporters apparently viewed *Taylor* as the moral equivalent of the deluge), became effective on March 16, 1988. VA. CODE ANN. § 8.3-106.

2. Reference to Other Documents

To be negotiable, an instrument must not incorporate outside documents or agreements.[32] However, an instrument may *refer* to an extraneous document or agreement.[33] The distinction between a prohibited incorporation and a permissible reference has obviously created problems in the courts.

Marriott v. Harris[34] involved notes, secured by deeds of trust, each of which contained the following clause:

> Should any default be made in payment of any installment of this note or in the performance of any of the covenants or conditions of the deed of trust, . . . the entire unpaid amount thereof shall become due and payable forthwith at the election of the holder of this note and without notice.[35]

The court held that this was a reference, not an incorporation, and thus, the notes were negotiable.[36]

The *Marriott* decision was entirely correct, on both statutory and policy grounds. The court correctly characterized the provision as an acceleration clause—and the Code specifically permits reference in negotiable instruments to extrinsic agreements which regulate acceleration.[37] In addition, many acceleration clauses are triggered by other agreements. If such acceleration clauses precluded the note from being negotiable, the commercial utility of acceleration clauses would be severely limited. Finally, the Official Comments stress that reference to an extraneous agreement which triggers acceleration is permissible.[38]

B. *Holder-In-Due-Course—Notice of Defense*

To be a holder-in-due-course, a transferee of a negotiable instrument must, among other things, take the instrument without notice that it is subject to any claim or defense. The *Marriott v. Har-*

32. *Id.* § 8.3-105(2)(a) (Add. Vol. 1965).
33. *Id.* § 8.3-105(1)(c).
34. 235 Va. 199, 368 S.E.2d 225 (1988).
35. *Id.* at 223-24, 368 S.E.2d at 238.
36. *Id.*
37. VA. CODE ANN. § 8.3-105(1)(c) (Add. Vol. 1965) states that "[a] promise or order otherwise unconditional is not made conditional by the fact that the instrument . . . refers to a separate agreement for rights as to prepayment or acceleration."
38. *Id.* comment 3.

ris[39] case, previously discussed, also examined this notice requirement. The promissory notes at issue represented obligations for purchase of building lots in a "planned resort community" under development.[40] These notes were acquired by Diversified Mortgage Investors (DMI).[41] DMI was aware when it took the notes that, if various promises regarding the development were not kept, the makers of the notes would have good defenses.[42]

The court held that this knowledge of the background of the transactions was not sufficient to prevent the transferee from being a holder in due course.[43] The *Marriott* decision was based on the provisions of section 8.3-304(4)(b) of the Code which state:

> (4) Knowledge of the following facts does not of itself give the purchaser notice of a defense or claim
>
> . . . .
>
> (b) that [the instrument] was issued or negotiated in return for an executory promise or accompanied by a separate agreement, unless the purchaser has notice that a defense or claim has arisen from the terms thereof.[44]

The makers of the notes pointed to section 8.3-304(1), which states that "[t]he purchaser [of an instrument] has notice of a . . . defense if . . . the purchaser has notice that the obligation of any party is voidable in whole or in part."[45] However, this provision was inapposite because, at the time it took the notes, DMI had no notice of any breach of the executory promises (indeed, no such breach had as yet occurred).[46] All that DMI knew or had notice of was that there could be a breach (and thus a defense) in the future. The notes were not voidable when they were taken; they were merely potentially voidable if something happened (or failed to happen) later. Consequently, DMI had no notice of any defense in the sense that the term is used in section 8.3-304 of the Code.[47]

This decision is obviously correct. The whole point of the provision stating that knowledge of the executory nature of the underly-

39. 235 Va. 199, 368 S.E.2d 225 (1988); *see supra* notes 34-36 and accompanying text.
40. *Marriott*, 235 Va. at 205, 368 S.E.2d at 227.
41. *Id.* at 206, 368 S.E.2d at 227.
42. *Id.* at 220, 368 S.E.2d at 235.
43. *Id.* at 226-27, 368 S.E.2d at 239.
44. VA. CODE ANN. § 8.3-304(4)(b) (Add. Vol. 1965).
45. *Id.* § 8.3-304(1)(b).
46. *Marriott*, 235 Va. at 226-27, 368 S.E.2d at 239.
47. VA. CODE. ANN. § 8.3-304(4)(b) (Add. Vol. 1965).

ing contract is not notice of a defense is that any executory contract may in the future be breached. The breach may give someone a defense on the instrument. No one could be a holder-in-due-course of such an instrument if the possibility of a future breach gave notice of a defense.

C. *Requirement of Consideration*

Commercial paper law is largely rooted in contract, and, in general, the normal rules of contract law apply. Among these rules is the requirement that there be consideration (or its equivalent) to support obligations arising on negotiable instruments. Generally speaking, the lack of consideration "is a defense [on a negotiable instrument] against any person not having the rights of a holder in due course."[48]

In *First National Exchange Bank v. Johnson*,[49] the defendant, Peggy Mitchell Johnson ("Peggy Johnson"), cosigned two promissory notes with Earl D. Johnson ("Earl Johnson"), her cohabitant. One of the notes was a renewal of a prior obligation owed by Earl Johnson to the bank.[50] Peggy Johnson argued that she was not obligated on the note because she had received no benefit and the bank had suffered no detriment—in short, there was no consideration.[51] The court rejected this argument on the basis of section 8.3-408 of the Code and its Official Comment 2. The last clause of the statutory provision states that "no consideration is necessary for an instrument or obligation thereon given in payment of or as security for an antecedent obligation of any kind."[52] Peggy Johnson argued that this exception should be applied only with regard to the original maker, who had received consideration from the original transaction, not to third parties who had not participated in that transaction. The court, however, determined that this argument was precluded by comment 2, which states:

> The "except" clause is intended to remove the difficulties which have arisen where a note or a draft, or an endorsement of either, is given as payment or as security for a debt already owed by the party giving it, *or by a third person*. The provision is intended to change

48. *Id.* § 8.3-408.
49. 233 Va. 254, 355 S.E.2d 326 (1987).
50. *Id.* at 255-56, 355 S.E.2d at 327.
51. *Id.* at 257-58, 355 S.E.2d at 328-29.
52. VA. CODE ANN. § 8.3-408 (Add. Vol. 1965).

> the result of decisions holding that where no extension of time or other concession is given by the creditor the new obligation fails for lack of legal consideration.[53]

In addition, the *Johnson* court discussed the creditor's duty to explain to the debtor the nature of the instruments being signed. Peggy Johnson asserted that she did not realize that she was signing *two* promissory notes because the bank had not fully discussed the different transactions with her. She asserted that she should not be held liable on the note that she did not realize she was signing.[54] The argument was rejected:

> [T]he Bank owed no duty under these circumstances to explain that which was perfectly obvious to even the most casual reader of these documents.
>
> . . .
>
> [T]he record is devoid of any evidence that [Peggy Johnson] lacked the capacity to understand what she was signing. The record merely contains testimony that she failed to "understand" or "knowingly sign" the note in question. Such evidence is wholly insufficient to establish the duty necessary to support a finding of constructive fraud against the Bank, and the trial court erred in ruling to the contrary.[55]

D. *Cancellation and Discharge*

1. Renewal Notes

It is a fairly common practice in certain kinds of lending for a lender to extend credit for an initially brief period of time, but to routinely "roll over" the loan upon the expiration of the credit extension period. Frequently, the roll over of the loan will be evidenced by a new note. What effect does the new note have with regard to liability under previous notes? This issue was addressed in *Avocet Development Corp. v. McLean Bank*.[56] Unfortunately, it is a rather confusing opinion.

---

53. *Id.* § 8.3-408 comment 2 (emphasis added).
54. *Johnson*, 233 Va. at 258-59, 355 S.E.2d at 329-30.
55. *Id.* at 259, 355 S.E.2d at 329.
56. 234 Va. 658, 364 S.E.2d 757 (1988).

In December, 1979, Avocet Development Corp. executed two ninety-day promissory notes payable to McLean Bank.[57] Andrew Serafin, the president and sole stockholder of Avocet endorsed both notes.[58] Avocat periodically renewed (rolled over) these notes; some but not all of the renewal notes were endorsed by Serafin.[59] At each renewal, except (possibly) the final renewal in the fall of 1981,[60] the prior notes were marked "Paid by Renewal" and returned to Avocet.[61] In the fall of 1981, Avocet delivered renewal notes for the two notes it then owed to the bank. The bank apparently refused to accept a further renewal. The bank retained both the existing notes (the "March 1980" and "May 1981" notes) and the renewal notes (the "fall 1981" notes) tendered by Avocet.[62] Ultimately, the bank filed suit against Avocet and Serafin. The suit was apparently based upon the March 1980 and May 1981 notes rather than the fall 1981 notes, although the statement of facts is not entirely clear on this point.[63] No reason is given in the case for the bank's decision to sue on the earlier, rather than the later, notes.

Avocet argued that its liability on the March 1980 and May 1981 notes had been discharged because the bank had "accepted" the fall 1981 notes together with payment of interest on the March 1980 and May 1981 notes.[64] It is not clear from the case whether the March 1980 and May 1981 notes had been stamped "Paid by Renewal" by the bank or not. Insofar as the discharge issue is concerned, this does not matter. Virginia has long followed a rule that the mere issuance of a renewal note is presumed not to discharge any party to the note renewed, even if the renewal is indicated on the old note.[65] The presumption is particularly strong if, as was the case in *Avocet*, the note is not surrendered.[66] Thus, the retention of a note by the creditor, even if that note is stamped "Paid by Renewal," requires the person claiming discharge to rebut the pre-

57. *Id.* at 662, 364 S.E.2d at 760.
58. *Id.* at 661-62, 364 S.E.2d at 759-60.
59. *Id.* at 663, 364 S.E.2d at 760.
60. The fall 1981 "renewal" may or may not have been a renewal. *See infra* notes 62, 68-69 and accompanying text.
61. *Avocet*, 234 Va. at 661, 364 S.E.2d at 759.
62. *Id.* at 661, 364 S.E.2d at 759.
63. *Id.* at 663, 364 S.E.2d at 760.
64. *Id.* at 663, 364 S.E.2d at 760.
65. *Id.* at 663-64, 364 S.E.2d at 760-61.
66. *See* Gullette v. Federal Deposit Ins. Corp., 231 Va. 486, 344 S.E.2d 920 (1986). For a discussion of *Gullette*, *see* Herbert, *supra* note 22, at 712-13.

sumption of non-discharge. In the court's view, Avocet failed to do so.[67]

There is, however, a missing link in this reasoning. If the bank indeed took the fall 1981 notes as renewals of the earlier notes, the obligations of Avocet under those earlier notes would have been *suspended* until the due date of the later notes. Section 8.3-802(1)(b) of the Code states that "[u]nless otherwise agreed where an instrument is taken for an underlying obligation . . . the obligation is suspended pro tanto until the instrument is due or if it is payable on demand until its presentment."[68]

If the bank took the fall 1981 notes in renewal of the March 1980 and May 1981 notes, then the March 1980 and May 1981 notes were the obligation underlying the fall 1981 notes. Thus, even though those notes would not have been cancelled (and the parties' obligations would not have been discharged), the obligation to make payment on those earlier notes would have been suspended until the due date of the fall 1981 notes. The suit was filed in February, 1982.[69] If that date was before the due date of the fall 1981 notes, and if the fall 1981 notes were taken in renewal for the earlier notes, then the suit was premature and should have been dismissed. Unfortunately, the case is unclear as to two critical factual issues. First, did the bank, in fact, take the fall 1981 notes in renewal of the March 1980 and May 1981 notes? And second, if the bank did so, what was the due date of the fall 1981 notes?

The decision is even murkier with regard to Serafin's liability. Serafin did not endorse the March 1980 note, the May 1981 note or the fall 1981 notes.[70] The court, however, upheld the jury verdict against him, stating as justification:

> Serafin maintains he is no longer liable as an endorser for two alternative reasons: (1) each renewal note was the subject of new negotiations for continued personal endorsement by him and he had not agreed to act as endorser on the renewal notes, or (2) he and Williams reached an agreement releasing him from his prior commitment to endorse the Avocet notes.
>
> Bank witnesses, however, contradicted Serafin on both these factual contentions. It suffices to say that the jury has resolved both

67. *Avocet*, 234 Va. at 664, 364 S.E.2d at 761.
68. VA. CODE ANN. § 8.3-802(1)(b) (Add. Vol. 1965).
69. *Avocet*, 234 Va. at 661, 364 S.E.2d at 759.
70. *Id.* at 661-63, 364 S.E.2d at 759-61.

> these factual issues adversely to Serafin, and its findings are supported by the evidence. Therefore, the trial court did not err in entering judgment against Serafin.[71]

The problem with this statement is that it does not articulate a legal basis upon which Serafin could be found liable. It appears that Serafin was sued as an endorser of the March 1980 and May 1981 notes. He could not possibly lose that suit, for the very simple reason that he was *not* an endorser of either note.[72] While he had been an endorser of some prior notes in the series, those notes had been surrendered to Avocet and thus were almost certainly cancelled. Cancellation of the notes would have discharged Serafin.[73] In any event, he was not sued on those earlier notes.

There is some indication in the opinion that the basis for recovery was not the non-existent endorsements but the *promise* to endorse.[74] If so, this presents another difficulty. It appears that Serafin was an accommodation endorser of the notes—the money went to Avocet, and Serafin was required to endorse merely to assure payment.[75] If so, Serafin was a surety, and as such, his agreement to answer for debts of Avocet had to be in writing.[76] The case is silent on this issue.

2. Reacquisition by a Party

If a party who has no right of recourse against any other party on an instrument reacquires that instrument in its own right, all other parties are discharged.[77] Put simply, this means that if a person who is liable on an instrument, but who cannot sue anybody else on that instrument, regains possession of the instrument, all liabilities on the instrument are discharged. Of course, this does

---

71. *Id.* at 664, 364 S.E.2d at 761.

72. *Id.* at 661-63, 364 S.E.2d at 759-61.

73. *See supra* notes 59-62 and accompanying text. The cancellation of the instrument discharges parties. VA. CODE ANN. § 8.3-605(1)(a) (Add. Vol. 1965). In addition, any discharge of the principal discharges any surety on the instrument, unless the discharge is made with the surety's consent or with reservation of rights. *Id.* § 8.3-606(1)(a). Thus, even if the return of the prior notes was only intended to discharge Avocet, Serafin, as an accommodation endorser (a form of surety), was almost surely discharged as well.

74. *Avocet*, 234 Va. at 664, 364 S.E.2d at 761.

75. *Id.* at 661, 364 S.E.2d at 759. The Code defines an accommodation party as "one who signs the instrument in any capacity for the purpose of lending his name to another party to it." VA. CODE ANN. § 8.3-415(1) (Add. Vol. 1965).

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

77. *Id.* §§ 8.3-208, -601(3)(a) (Add. Vol. 1965).

not mean that liabilities "off the instrument," such as common law liability for indemnification or contribution, are discharged. It merely means that the contractual liabilities created by signing the instrument are no longer enforceable (except by a subsequent holder-in-due-course who has no notice of the discharge).[78]

This somewhat obscure provision was interpreted in *Roark v. Hicks*.[79] Hicks was the comaker of a note who reacquired the note and subsequently sought to sue his comakers on the note. The court held that he could not do so because he had no right of recourse against the comakers and his reacquisition of the note discharged them.[80] In so deciding, the court implicitly decided another question: Does the right of recourse include a right of contribution between ordinary comakers? *Roark*'s implicit answer is no. The out-of-state case law is divided, but the majority position agrees with *Roark*. The right of recourse does not include the rights that exist between ordinary comakers.[81]

The case also held that, although Hicks thought of himself as an endorser, he was liable as a comaker because he signed in the lower right-hand corner of the note, in the space provided for the makers' signatures.[82] Hicks' assumption that he was merely an endorser caused him to ignore, until too late, a far more plausible argument—that he was in fact an accommodation maker.[83] This may well have been a fatal error. If Hicks had raised his possible accommodation status in a timely fashion and convinced the court that he was indeed an accommodation maker; he *would* have been able to sue his co-makers. An accommodation comaker, unlike a "true" comaker, does have a right of recourse against the other comakers.[84] Thus, the discharge provision which released the comakers would not have applied and Hicks could have recovered from them.

78. *Id.* §§ 8.3-208, -305(2).

79. 234 Va. 470, 362 S.E.2d 711 (1987).

80. *Id.* at 476, 362 S.E.2d at 714-15.

81. *See, e.g., In re* Boyd, 73 Bankr. 122 (Bankr. N.D. Tex. 1987); Godfrey State Bank v. Mundy, 90 Ill. App. 3d 142, 412 N.E.2d 1131 (1980); People's Bank v. Pied Piper Retreat, Inc., 209 S.E.2d 573 (W. Va. 1974). *But see* Crimmins v. Lowry, 691 S.W.2d 582 (Tex. 1985) (true comaker has right of recourse to extent of right of contribution from other comaker).

82. *Roark*, 234 Va. at 476 note, 362 S.E.2d at 715 note.

83. *Id.*

84. *See, e.g.,* El-Ce Storms Trust v. Svetahor, 724 P.2d 704 (Mont. 1986); Federal Land Bank v. Taggart, 31 Ohio St. 3d 8, 508 N.E.2d 152 (1987).

V. SECURED TRANSACTIONS

A. *Applicability of Article 9*

One of the distinguishing features of Article 9 is that it applies to any transaction that, in effect, creates a security interest.[85] This functional test means that the applicability of the Article does not depend upon the parties' characterization of their transaction, but rather upon the substance of that transaction. Much of the litigation over this scope of the provision involves "leases" that are, in fact, sales of goods with a retained security interest.

A recent bankruptcy case is illustrative. *In re Rex Group, Inc.*[86] involved an alleged lease of horses. The "lease" was a virtual compendium of indicia of a lease-sale. Among other things, the "lessee" assumed the entire risk of loss or damage to the horses, was obligated to pay for all costs for maintenance and care of the horses, and was responsible for taxes and license fees.[87] The court held that these and other factors meant that the lease was not a true lease, but a lease-sale.[88]

B. *Classification of Collateral*

The *Rex Group* case also examined the Article 9 rules for classifying collateral. These rules are important because they determine which filing and priority rules apply to the transaction. The court held that the determination of the classification depends upon external evidence of the goods actual use and not the parties subjective beliefs.[89] In making this determination, evidence contained in the security agreement of the collateral should be given heavy, although not exclusive, weight.[90] Specifically, the horses subject to the security interest were properly classified as "equipment" because they were primarily used for breeding and racing. This primary use was strongly evidenced by a warranty the debtor made in the security agreement. This warranty was that the primary use of

85. VA. CODE ANN. § 8.1-201(37) (Add. Vol. 1965).
86. 80 Bankr. 774 (Bankr. E.D. Va. 1987).
87. *Id.* at 779-80. The court noted that "[t]he 'lease agreement' entered into by Rex and Amvest reads like a model agreement drafted to depict the list of criteria which courts have considered determinative on the issue of a security agreement disguised as a lease." *Id.* at 780.
88. *Id.*
89. *In re* Rex Group, Inc., 80 Bankr. 774, 781-82 (Bankr. E.D. Va. 1987).
90. *Id.* at 782.

the horses would be for "business purposes, including but not limited to, the business of breeding, trading, showing or racing horses."[91]

The court's emphasis on the security agreement is worthy of special note. It is sometimes difficult for a secured party to determine the exact classification of goods. For example, a horse breeder often uses the horses for several purposes. Some horses are raced or bred, others are sold, and still others may be used by the breeder or the breeder's family for recreation. Worse still, the same horses may be used for these different purposes at different times. Are the horses "equipment" because they are raced and bred?[92] Are they "inventory" because they are sold?[93] Or are they "consumer goods" because they are used for personal recreation?[94] A fair reading of *Rex Group* is that a bona fide statement in the security agreement of the collateral's primary use will ordinarily resolve ambiguities in the collateral's classification and may generally be relied upon by the secured party in filing its financing statements.

C. *Collateral Description*

Two federal court cases discussed the adequacy of collateral descriptions. *In re Wilson*[95] held that the term "contract rights," when used in a security agreement, was sufficient to encompass personal property rights under a real estate option contract. *In re Mahon*[96] held that the term "farm equipment" was a sufficient collateral description in a financing statement.

D. *Notice of Sale*

When the secured creditor repossesses collateral for sale, certain procedural requirements must be met. Among these is giving notice of the sale to the debtor. If the sale is by public auction, the debtor must ordinarily receive reasonable notice of both the time and place of the sale.[97] The purpose of this notice is to permit the

91. *Id.* at 781-82.
92. VA. CODE ANN. § 8.9-109(2) (Add. Vol. 1965).
93. *Id.* § 8.9-109(4).
94. *Id.* § 8.9-109(1).
95. 86 Bankr. 871 (Bankr. W.D. Va. 1988).
96. 82 Bankr. 33 (Bankr. W.D. Va. 1988).
97. VA. CODE ANN. § 8.9-504(3) (Add. Vol. 1965).

debtor to participate in the sale or to find prospective purchasers.[98] This may enable the secured party to obtain a higher price and thus reduce the debtor's potential liability for a deficiency.

One aspect of this notice requirement was examined in the Chesterfield County Circuit Court opinion of *First Federal v. Brooks*.[99] If the secured party gives proper notice of an auction sale, but the sale is unsuccessful and the goods are sold at a second auction, must a second notice be given to the debtor? In the court's view, the answer is no. If the notice of the originally planned sale met the Code's requirements, no further notice of the second sale was necessary.[100]

The little out-of-state case law existing on this issue stands for the contrary proposition and requires a second notice.[101] The question is a close one. In one sense, the purpose of the notice is accomplished by the notice of the first sale; the buyer was given the chance to participate in the liquidation of the collateral. Given the fact that the buyer did not participate in the first sale, it is very unlikely that the buyer would participate in the second sale. On the other hand, there is at least a slight chance that the buyer might do so. Since the buyer would know that the first attempted sale had failed, the buyer would have an especially strong incentive to participate in the second sale, in hope of getting at least a minimally acceptable price.

98. *Id.* § 8.9-504 comment 5.

99. 10 Va. Cir. 386 (Chesterfield County 1988).

100. *Id.* at 386-87.

101. *See In re* Lucas, 28 Bankr. 366 (Bankr. S.D. Oh. 1982); Havelock Bank v. McArthur, 220 Neb. 364, 370 N.W.2d 116 (1985).