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Uniform Commercial Code Recent Developments

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UNIFORM COMMERCIAL CODE RECENT DEVELOPMENTS

DOUGLAS R. HEIDENREICH†

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The Minnesota Supreme Court's recent handling of Uniform Commercial Code issues has been generally steady but occasionally erratic. Rarely has the court deviated from the true path although two or three opinions are unfortunately opaque. The following material discusses cases that have been decided since 1977 by the Minnesota Supreme Court and the Minnesota federal district courts.¹

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1. Code citations are to the 1978 Official Text. Minnesota's Uniform Commercial Code is codified at MINN. STAT. ch. 336 (1982).

I. SALES OF GOODS

A. Contract Creation

One recent Minnesota Supreme Court case deals with 2-207 problems of contract formation. While the result is good, some of the logic is questionable.² *Lemmer v. IDS Properties, Inc.*,³ deals with questions of indemnity among defendants in a negligence action. The court deals in part with 2-207, determining whether a hold-harmless clause in a delivery receipt signed by the recipient of goods could become part of the contract. The result—that such a clause did not become part of a previously created oral contract when the delivery receipt was signed by the buyer's building superintendent—is accurate.⁴ This, as the court points out, is basically a question of agency law.

The court, however, also looks at whether the buyer, IDS, was a merchant within the meaning of 2-207. The court says, erroneously, that IDS was not a merchant for purposes of 2-207 because it did not deal in scaffolding, the subject matter of the transaction. Merchant status with respect to the goods involved is not the question under 2-207. It is general merchant status that counts.⁵ IDS was certainly "in business" and was thus a merchant for 2-207 purposes.

B. Statute of Frauds

The court has recently considered two cases involving the Code's sale of goods statute of frauds.⁶ One case, *Associated Lithographers v. Stay Wood Products, Inc.*,⁷ was decided on the basis of the "specially manufactured goods" exception.⁸ It is a case in which the goods involved, printed material, clearly met the requirements for this exception: The printed material was manufactured for the buyer, it was not suitable for sale to others in the ordinary course of the seller's business, and there had been no effort by the buyer

2. A good, straightforward analysis of 2-207 appears in *Northern States Power Co. v. International Tel. & Tel. Corp.*, 550 F. Supp. 108, 112 (D. Minn. 1982).

3. 304 N.W.2d 864 (Minn. 1980).

4. *Id.* at 871.

5. The official comments to 2-104 provide that "[f]or purposes of these sections [including 2-207] almost every person in the business world, therefore, be deemed to be a 'merchant'" U.C.C. § 2-104, comment 2; *see also* *Josten's, Inc. v. National Computer Sys., Inc.*, 318 N.W.2d 691 (Minn. 1982).

6. U.C.C. § 2-201.

7. 279 N.W.2d 787 (Minn. 1979).

8. U.C.C. § 2-201(3)(a).

to repudiate.⁹

The buyer raised a statute of frauds defense. The goods had been delivered to the buyer, who had made no attempt to reject them for some time.

Under 2-201(3)(c) the contract would be enforceable in the absence of a writing, irrespective of the special nature of the goods, because the goods had been received and accepted. Indeed, although the facts in the opinion are sketchy, there may have been writings sufficient to satisfy the statute.

A more curious application of 2-201 principles appears in *W.H. Barber Co. v. McNamara-Vivant Contracting Co.*¹⁰ The dispute concerned an alleged oral promise of "price protection" on orders of asbestos paving material. The buyer claimed that the seller had promised to deliver "uninvoiced" loads of material in 1974 to compensate the buyer for rises in the price of material for contracts bid on in previous years but "carried over" into the 1974 construction year. The seller pled the statute of frauds and the case was resolved on that issue, the buyer being too late in his effort to argue that "price protection" was a separate term which would not be affected by the statute.

Apparently the court believed that the aspect of the transaction involving the delivery of the "uninvoiced" material was a "sale of goods" for 2-201 purposes; thus the absence of a writing precluded enforcement of the alleged agreement.¹¹ The statute of frauds argument might have been defused by a vigorous argument by the buyer that "price protection" is a term which need not be in writing for statute of frauds purposes, since the code requires only that the quantity term appear in the writing.¹² It is a close distinction. The buyer might have made one further argument: even if the court treated the delivery of the uninvoiced material separately, that aspect of the transaction is not a sale because a sale, by definition, requires a price.¹³

The court continued to shy away from the use of estoppel to satisfy the statute of frauds. Equitable estoppel was not present in *Barber* because there was no representation or concealment of material facts. The buyer failed to show that at the time the alleged

9. 279 N.W.2d at 791.

10. 293 N.W.2d 351 (Minn. 1979).

11. *Id.* at 356.

12. U.C.C. § 2-201(1).

13. *Id.* § 2-106(1).

price protection promise was made the seller intended not to give the protection. Thus while the court recognized that estoppel could "take an oral contract out of the statute of frauds" it adhered to its strict estoppel requirements.¹⁴ The court has not allowed the statute of frauds to be circumvented by estoppel in any recent case.

C. Parol Evidence and Usage of Trade

The court made deft use of the Code's usage of trade rules in resolving a parol evidence question in *Action Time Carpets, Inc. v. Midwest Carpet Brokers, Inc.*¹⁵ The contract called for the goods and carpeting to be delivered "at once" for resale to the ultimate user. The goods were tendered about a month later and refused, the buyer "cancelling" the contract because its buyer had cancelled.

When the seller sued for breach the buyer responded that the seller had failed to make timely delivery because, before the signing of the written agreement, the seller had orally promised that it would deliver within seven to ten days. The court concluded that the parol evidence rule of 2-202 would prevent the alleged oral statements from becoming part of the contract because the seven to ten day delivery promise would contradict the "at once" term.

The most interesting part of the opinion follows: the trial court properly allowed the seller's evidence of usage of the trade to show that "at once" in the carpet business means "as soon as possible."¹⁶ There was no showing that the lapse of time between the execution of the contract and the tender of delivery had been unreasonable. Thus the seller had complied with the written "at once" term because it had delivered as soon as possible.

The court's reading of section 2-202 is exactly on target. A writing can be "explained or supplemented" by usage of trade, course of dealing or course of performance. The writing cannot be "contradicted" by evidence of a prior agreement.¹⁷

However, where express terms of an agreement can not be reconciled with usage of trade the express terms will prevail.¹⁸ The court recognizes this in *Northwestern State Bank of Luverne v. Ganges-*

14. *See* *Del Hayes & Sons, Inc. v. Mitchell*, 304 Minn. 275, 230 N.W.2d 588 (1975).

15. 271 N.W.2d 36 (Minn. 1978).

16. *Id.* at 39; U.C.C. § 1-205.

17. 271 N.W.2d at 39-40 (judgment reversed in part on question of damages but parol evidence determination is clear and accurate).

18. U.C.C. § 1-205(4).

tad,¹⁹ a case dealing with a demand note, in which the court observed that neither course of dealing nor usage of trade could undermine the “demand” character of the instrument.²⁰

D. Warranties

The Minnesota court continues to address thorny products liability issues. Professor Steenson has exhaustively discussed these problems in two recent articles²¹ and therefore it is necessary to mention only a few recent warranty cases, most of which deal with economic loss.

When only commercial economic loss is at issue, the Uniform Commercial Code provisions will determine the rights and liabilities of the parties. The court recently held in *Superwood Corp. v. Siempelkamp Corp.*,²² a case in which the federal district court had certified questions to the Minnesota Supreme Court, that in commercial transactions neither negligence nor strict liability in tort is available to the plaintiff who seeks to recover only for economic loss. The court, believing that to allow recovery under these circumstances would “emasculate” the warranty provisions of the Code, held that “economic losses that arise out of commercial transactions, except those involving personal injury or damage to other property, are not recoverable under the tort theories of negligence or strict products liability.”²³ Whether a consumer could recover for purely economic loss under negligence or strict liability is not clear.

In *Peterson v. Bendix Home Systems*²⁴ the court, dealing with a jury finding of seventy-five percent fault on the part of the plaintiff buyer, held that the Minnesota comparative fault statute²⁵ would not preclude the buyer from recovering the economic loss arising out of the defect. “[W]hile the buyer’s acts may bring on or avoid certain consequential harms from the product and thus bar recov-

19. 289 N.W.2d 449, 452-53 n.6 (Minn. 1979).

20. See also *Wabasso State Bank v. Caldwell Packing Co.*, 308 Minn. 349, 251 N.W.2d 321 (1976) (questionable use of these doctrines in an earlier Article 9 case).

21. See Steenson, *The Anatomy of Products Liability in Minnesota: The Theories of Recovery*, 6 WM. MITCHELL L. REV. 1 (1980); Steenson, *The Anatomy of Products Liability in Minnesota: Principles of Loss Allocation*, 6 WM. MITCHELL L. REV. 243 (1980).

22. 311 N.W.2d 159 (Minn. 1981).

23. *Id.* at 162. Justice Yetka’s partial dissent urging that commercial buyers have for many years been able to recover in negligence for economic loss failed to convince the other members of the court. *Id.* at 162-63.

24. 318 N.W.2d 50 (Minn. 1982).

25. MINN. STAT. § 604.01 (1982).

ery for such consequential harms, this conduct should not affect the buyer's right to recover money paid for the defective goods."²⁶ This seems to be a questionable application of the statute; on the other hand perhaps the court was saying that it is almost impossible to conceive of a buyer being contributorily at fault for this kind of a loss.²⁷

The federal district court addressed a complicated damages question in *Industrial Graphics, Inc. v. Ashahi Corp.*²⁸ The court resolved the question, holding in part that an absence of privity does not, in Minnesota, preclude recovery of damages for solely economic loss.²⁹ Some damages claims such as loss of sales of other product lines were properly rejected as being too speculative.

In *Chatfield v. Sherwin-Williams Co.*³⁰ the buyer of defective barn paint recovered in part on a theory of breach of express warranty, the express warranty being that the paint involved was "good barn paint."³¹ The plaintiff, a professional barn painter, used the paint on several jobs and sued when the paint faded. The supreme court upheld a jury verdict for the plaintiff. The defendant manufacturer, who apparently did not vigorously contest the existence of express and implied warranties, relied on a defense of misuse or failure to follow instructions. These theories persuaded neither the jury nor the appellate court.

The case is noteworthy only for the latitude the court was willing to give to the plaintiff. The *Chatfield* plaintiff did not introduce expert testimony about the nature of the alleged defect. He only showed that the paint had faded. The court cited a line of pre-code cases to the effect that expert testimony is not always necessary and quoted with approval from *Nelson v. Wilkins Dodge, Inc.*³² In that case the court reversed a directed verdict for the defendant as to some alleged defects, saying that even though no direct evidence had been introduced about the cause of certain defects,

[i]t is reasonable to suppose, however, that vehicles that are fit for ordinary purposes probably do not display these defects this early, even if they are driven a great deal within a short period of time. Thus, the causes of the faulty paint, windshield wiper,

26. 318 N.W.2d at 54.

27. 318 N.W.2d at 54 & n.2.

28. 485 F. Supp. 793 (D. Minn. 1980).

29. *Id.* at 804.

30. 266 N.W.2d 171 (Minn. 1978).

31. *Id.* at 176.

32. 256 N.W.2d 472 (Minn. 1977).

horn bracket, and shift lever were questions that should have been decided by the jury.³³

The buyers in both *Chatfield* and *Nelson* met the 2-607(4) burden of establishing a breach with no expert testimony.

*Barrows v. Mazaltov's, Inc.*³⁴ is a straightforward application of the warranty of merchantability and fitness sections and the damages provisions of 2-714. The buyer bought materials to make a large rug. When she had completed the rug it had an undesirable appearance because of color variations in the materials. The value of the rug as warranted was \$14,000 and the value as completed was \$7,000. The court sustained the plaintiff's judgment for \$7,000.³⁵

*O'Laughlin v. Minnesota Natural Gas Co.*³⁶ involved more important issues. The Minnesota Supreme Court held that a subcontractor who had purchased a furnace and improperly installed it in the buyers' home could be liable in either breach of warranty or strict liability without a showing of negligence. The trial court's refusal to instruct the jury on those theories was reversible error.³⁷ Thus, a middle-man who resells a product may be liable for a breach of warranty when the defect arises out of his improper installation of the product.³⁸

*Alafoss v. Premium Corp. of America*³⁹ involved a breach of an express warranty by sample, the goods being winter coats. The trial court allowed damages based on 2-714, the difference between the value of the goods as delivered and their value as warranted, together with the costs incurred by the buyer in attempting to remedy the problems. The appellate court rejected challenges on the question of liability but found that basic computation should have taken into consideration the fact that even if the goods had conformed to the warranty the buyer, who was reselling the coats through a special promotion, would have had a number of coats left over unsold.

33. *Id.* at 476.

34. 312 Minn. 586, 252 N.W.2d 130 (1977).

35. *Id.* at 587, 252 N.W.2d at 131.

36. 253 N.W.2d 826 (Minn. 1977).

37. *Id.* at 832. The vigorous dissents related to other aspects of the verdict and did not quarrel with this policy.

38. For a brief discussion of this decision see, *Le Sueur Creamery, Inc. v. Haskon, Inc.*, 660 F.2d 342, 346 n.6 (8th Cir. 1981).

39. 448 F. Supp. 95 (D. Minn. 1978), *aff'd in part, rev'd in part*, 599 F.2d 232 (8th Cir. 1979).

The court discussed disclaimers in *Wenner v. Gulf Oil Corp.*⁴⁰ An attempted blanket disclaimer on a can of herbicide conflicted with an express warranty that there would be no "carry-over" damage to crops planted the following year. The Code provides that a disclaimer which conflicts with an express warranty is ineffective⁴¹ and the court so held.⁴²

E. Remedies and Damages

Many of the court's Code decisions have addressed damages and remedies questions. The case of *Durfee v. Rod Baxter Imports, Inc.*,⁴³ is one of the more interesting consumer cases to attract the court's attention in recent years. *Durfee* demonstrates that the Minnesota court is sensitive to the basic philosophy of the Code and is willing to take a step beyond the strict language of the statute if that is necessary to accomplish the results that Code policies dictate.

The buyer had trouble from the day that he received his new car. After about 7,000 miles of trouble-filled driving he revoked his acceptance pursuant to 2-608. The seller raised the usual defense of lack of substantial impairment. The trial court's finding of lack of substantial impairment was reversed. The value of the car was substantially impaired by problems which included some minor annoyances but also included a serious stalling problem.

The court commented that revocation must occur before any substantial change in condition of the goods unrelated to the defect; however "in this circumstance" the fact that the buyer had put 6,300 miles on the car did not preclude revocation.⁴⁴

The court had little trouble with the contractual limitation of remedies to repair or replacement. Invoking 2-719(2) the court agreed with many other courts: When the seller can not or will not repair according to his contractual obligation the limited remedy "fails of its essential purpose" and the buyer may take advantage of any Code remedy including revocation of acceptance.

The court faced an additional practical problem. The dealer, the seller of the car, Rod Baxter, did not appear in the appeal. The distributor, Saab-Scandia, was "unable to assure" the court of the continuing existence of the dealer. The buyer sought to re-

40. 264 N.W.2d 374 (Minn. 1978).

41. U.C.C. § 2-316(1).

42. 264 N.W.2d at 383-84.

43. 262 N.W.2d 349 (Minn. 1978), noted in 5 WM. MITCHELL L. REV. 241 (1979).

44. *Id.* at 353 n.4.

cover his purchase price and to revoke acceptance against the distributor. Acknowledging that other courts have denied revocation of acceptance against anyone other than the immediate seller, the court refused to allow the distributor to avoid responsibility on this basis. "The distributor of the automobile, who profits indirectly from retail sales, must take responsibility for the solvency of its dealers when its warranty is breached."⁴⁵

Buyers can take comfort from the court's willingness to interpret the Code's remedies liberally and from its refusal to frustrate, by a literal interpretation of the Code's provisions, the buyer's efforts to achieve relief.

The court addressed similar problems in *Jacobs v. Rosemount Dodge-Winnebago South*,⁴⁶ a consumer case involving the sale of a motor home. The dealer failed to correct the many defects; thus the manufacturer's limited warranty failed its essential purpose. Since the buyers could not use the motor home to make the trips they had planned the nonconformity substantially impaired the value of the goods to the buyer. Although a year had elapsed between acceptance and revocation, during which time the seller was attempting to make repairs, the court found that under the circumstances the delay was not unreasonable.⁴⁷

The motor home had been driven over 5,500 miles at the date of the trial, 1,000 of those miles having been put on during a trip to the factory where repairs were attempted, and 900 having been put on by the buyers after the letter of revocation had been sent. The court noted that the mileage in *Durfee* had been considered "troublesome" but, "under the circumstances," not a substantial change. The court cited a couple of other cases in which vehicles had rather high mileage at the time of revocation and then simply dropped the whole matter.⁴⁸

The court avoided the problem of the buyers having driven the motorhome 900 miles after the revocation by explaining that this could have been an effort to determine whether the last efforts at repair had been successful. The jury finding there had been no "reacceptance" was affirmed.⁴⁹

The court made several interesting determinations about dam-

45. *Id.* at 357-58.

46. 310 N.W.2d 71 (Minn. 1981).

47. *Id.* at 76.

48. *Id.*

49. *Id.* at 77.

ages. Insurance and license fees were proper elements of incidental damages; the jury's award of "finance charge interest" and "equity interest" was proper.⁵⁰

Because of the failure of the limited remedy of its essential purpose the buyers could recover consequential damages which include loss of use as measured by reasonable rental value. Considering "this specific buyer's needs and circumstances," the court refused to interfere with the jury award for loss of use. Thus the case was remanded for reinstatement of the jury verdict for consequential damages which the trial judge had stricken.

The court refused to hold that attorney's fees could be recovered as incidental or consequential damages under 2-715 but, through a tortuous application of several consumer protection statutes, found a way to give the plaintiffs attorney's fees.⁵¹

Because the manufacturer was the warrantor it had to bear the loss; its attempt to shift the loss to the dealer, who failed to make the repairs, was rebuffed.

In *Peterson v. Bendix Home Systems*⁵² the buyer sued under 2-714 for damages but recovered the full purchase price on the theory that the mobile home which she had purchased was worthless in the condition in which it was delivered. The supreme court, unimpressed by the argument that because the buyer had used the mobile home it must have been worth something, upheld the jury verdict for the full purchase price.

The 2-719(2) provision on failure of a limited remedy of its essential purpose proved to be a powerful weapon in the Minnesota commercial case of *Soo Line Railroad v. Fruehauf Corp.*⁵³ Soo Line purchased a number of railroad hopper cars from Fruehauf. When structural defects appeared Soo Line sought to have the cars repaired pursuant to a one-year "repair or replacement" warranty which was to be the exclusive remedy. Fruehauf claimed that the cars were not defective but that the cracks which had developed

50. 310 N.W.2d at 77. *But see* *Parkside Mobile Estates v. Lee*, 294 N.W.2d 327 (Minn. 1980) (non-sale of goods case raising questions about awarding interest).

51. 310 N.W.2d at 79-80. The logic of the court was that the Minnesota statute provides for the recovery of attorney fees by a person injured by a violation of MINN. STAT. §§ 325F.68-.70, dealing with prevention of consumer fraud. *See* MINN. STAT. § 8.31(3a) (1982). The failure to honor the terms of a consumer express warranty, as required by MINN. STAT. § 325G.19(2) constitutes a violation of MINN. STAT. § 325F.69. *See id.* § 325G.20. Since the manufacturer violated its express warranties for repair and replacement, it violated MINN. STAT. § 325F.69 and accordingly became liable for attorney fees.

52. 318 N.W.2d 50 (Minn. 1982).

53. 547 F.2d 1365 (8th Cir. 1977).

were attributable to the specifications furnished by Soo Line and refused to make the repairs.

At trial the jury found that the seller had breached its warranty. Thus, because the limited remedy failed of its essential purpose, the buyer was entitled to pursue all Code remedies, including consequential damages. The appellate court observed in a footnote that “[a] limited remedy fails of its purpose whenever the seller fails to repair goods within a reasonable time. Section 2-719(2) becomes operative when a party is deprived of its contractual remedy and it is unnecessary to prove that failure to repair was willful or negligent.”⁵⁴

In *Northern States Power Co. v. International Telephone & Telegraph Corp.*⁵⁵ the court held that the question whether a limited remedy had failed of its essential purpose was a fact question but, citing *Fruehauf*, observed that in Minnesota a plaintiff may recover consequential damages when the exclusive remedy does fail.⁵⁶

The court’s unwillingness to allow a seller to escape his obligations is further exemplified by *Barbarossa & Sons, Inc. v. Iten Chevrolet, Inc.*,⁵⁷ in which the dealer, who failed to deliver a truck ordered by his buyer, sought refuge in 2-615, the Code’s “impracticability” section. The dealer argued that the factory had cancelled the dealer’s order and that this had made the dealer’s performance of the contract “impracticable” thus excusing the dealer from performance.

The court reviewed 2-615’s formidable requirements and concluded that the factory’s cancellation of the seller’s order was not a contingency which the parties could not have foreseen.⁵⁸ Although the factory from which the dealer planned to obtain the goods did not deliver, the contract did not specify a source of supply and did not provide an excuse to the dealer who could have obtained a truck elsewhere.

The Minnesota court follows the trend of reading 2-615 rather stringently. The lesson for sellers is clear: if a source of supply is meant to be exclusive the seller must say so in the contract; if he does not, a failure of that source will almost surely not justify a failure to deliver the goods to the buyer.

54. *Id.* at 1371 n.7.

55. 550 F. Supp. 108 (D. Minn. 1982).

56. *Id.* at 112-13.

57. 265 N.W.2d 655 (Minn. 1978).

58. *Id.* at 659-60.

The court, while affirming the finding of liability of the seller in *Barbarossa*, refused to allow the buyer to recover damages that he did not establish. The court's analysis of the Code's cover provision⁵⁹ enabled the seller to claim credit for the depreciation on the new truck that it would have delivered had it performed. This depreciation between the date for performance and the date of cover apparently constituted "expenses saved as a consequence of the seller's breach."⁶⁰

The aggrieved party must establish his loss. The Minnesota court will not allow the buyer to recover for a loss which he can not prove nor will it allow recovery for a loss which the buyer could have prevented.⁶¹

However, the Minnesota court is not unreasonable. *Leoni v. Bemis Co.*⁶² provides an example of the court's willingness to be flexible. "Once the fact of loss has been shown, the difficulty of proving its amount will not preclude recovery so long as there is proof of a reasonable basis upon which to approximate the amount."⁶³

In *Leoni* the Minnesota Supreme Court reversed the trial court which had granted a new trial after a jury award of substantial damages based in part on lost profits in a new market. The plaintiff's claim was premised on the fact that his seller had failed to provide proper plastic bags. When the bags failed the buyer lost his market in California for the sale of peat moss which was delivered in the bags. The court observed that while future profits of a new business are sometimes inherently speculative, experience in other states could provide a sufficient basis upon which the jury could make the award.

In *Johannsen v. Minnesota Valley Ford Tractor Co.*⁶⁴ the court focused on questions that arise in nearly every revocation of acceptance case. The plaintiff bought a tractor which caused problems from the date of delivery. Although he formally revoked acceptance the buyer continued to use the tractor, apparently because it was the only way in which he could do his farming work. The buyer sued when the seller refused to accept the return of the tractor. The court summarily rejected the defendant's routine argu-

59. U.C.C. § 2-712.

60. *Id.*

61. *See Bemidji Sales Barn, Inc. v. Chatfield*, 312 Minn. 11, 250 N.W.2d 185 (1977).

62. 255 N.W.2d 824 (Minn. 1977), noted in 5 WM. MITCHELL L. REV. 280 (1979).

63. *Id.* at 826.

64. 304 N.W.2d 654 (Minn. 1981).

ments: insufficient evidence to support a jury finding of substantial impairment and failure to revoke within a reasonable time. The court also addressed briefly two issues that are subject to different resolutions in various jurisdictions.

In a single paragraph the court rejected the seller's contention that the buyer had not given the seller a reasonable opportunity to cure the defects. The Code provision on cure⁶⁵ contemplates cure only when the buyer has rejected. A buyer who qualifies for the right of revocation of acceptance must show that the defect substantially impairs the value of the goods to the buyer. The court held that the right to cure should not be extended to a seller whose buyer properly revokes: "[T]he seller has no right to cure defects which substantially impair the goods value."⁶⁶

The court also considered (a) whether a revoking buyer must stop using the goods and (b) if he continues to use them, whether he must compensate the seller for use or depreciation of the goods. The court chose a flexible rule to apply to the first question: While the buyer's use of the goods after revocation could be wrongful under some circumstances, the reasonableness of the buyer's conduct must be measured against the facts and circumstances of each case. The court mentioned as examples of significant facts and circumstances: the seller's instructions; the degree of hardship, economic or otherwise, that the buyer would incur if he stopped using the goods; and the possibility that use of the goods may be a way of mitigating damages.⁶⁷

The court answered the question whether the buyer must compensate the seller for use of the goods by invoking, through 1-103, the equitable principle that a party who rescinds a contract must return what he has received in order to restore both parties to the positions they held before the making of the contract.⁶⁸ Requiring the revoking buyer to compensate the seller for use of the goods achieves this result.⁶⁹

It is not always easy to tell when a party has repudiated a contract. The court in *Unique Systems v. Zotos International*⁷⁰ discussed repudiation under Minnesota law, pointing out that, while a secret intention not to perform does not constitute repudiation, a de-

65. U.C.C. § 2-508.

66. 304 N.W.2d at 657.

67. *Id.* at 658.

68. *Id.*

69. *See also* *Iten Leasing Co. v. Burroughs Corp.*, 684 F.2d 573 (8th Cir. 1982).

70. 622 F.2d 373 (8th Cir. 1980).

mand by a party for something to which he is not entitled, coupled with a clear statement that he will not perform unless his demand is met, does constitute a repudiation.⁷¹

The court analyzed section 2-609, which allows a party whose expectation of performance has been impaired to demand "adequate assurances," in *Teeman v. Jurek*.⁷² Section 2-609 allows a party who has "reasonable grounds for insecurity" to demand, in writing, adequate assurances of performance by the other party. If those assurances are not forthcoming within a reasonable time, not to exceed thirty days, the contract has been repudiated. Although some courts have overlooked the written demand requirement or have deemed it to have been waived, the Minnesota court in *Teeman* says in dictum that the demand must be written.⁷³

Probably the true basis of the court's holding is that the offered assurances, promises of reimbursement for alleged shortages in shipment, would have been adequate under the circumstances whether or not the demand had been effective. The seller's withholding of further deliveries after the dispute over the shortages arose was wrongful but the buyer's consequent withholding of some payments was justified on the basis of 2-717 which allows a buyer who is the victim of a seller's breach to withhold all or part of the purchase price as a deduction of damages that the buyer has suffered.

The court contrasted this proper use of 2-717 with an improper attempt in *Jurek v. Thompson*.⁷⁴ In that case the buyer withheld payment on a contract unrelated to an earlier contract which the seller had allegedly breached. The buyer's action was a breach of the contract for which he withheld payment.

The Minnesota court has addressed problems of seller's remedies in only two recent cases. In *Wolpert v. Foster*⁷⁵ the seller was allowed, pursuant to 2-709, to recover the purchase price of unsaleable goods which he had bought for sale to the buyer before the termination of the relationship. The buyer urged that the seller's sale of some of the goods to third parties during the course of the dispute was wrongful because the seller had not followed the required 2-706 "resale" procedures. The court properly held that

71. *Id.* at 377.

72. 312 Minn. 292, 251 N.W.2d 698 (1977).

73. *Id.* at 297, 251 N.W.2d at 701.

74. 308 Minn. 191, 241 N.W.2d 788 (1976).

75. 312 Minn. 526, 254 N.W.2d 348 (1977).

the reference in 2-709(2) to resale does not incorporate the procedural requirements of 2-706.⁷⁶ The second case, *Action Time Carpets, Inc. v. Midwest Carpet Brokers, Inc.*,⁷⁷ focused in part on the 2-706 requirements and reversed the trial court on the question of damages because of lack of evidence that all of the goods had been resold.⁷⁸

F. Statute of Limitations

The Code's statute of limitations was invoked in an unusual case, *Leisure Dynamics, Inc. v. Falstaff Brewing Corp.*⁷⁹ The buyer had failed to pay the sales tax to the seller. The seller attempted to recover on a breach of contract theory. The court held that the obligation to pay the tax arises at the time of the sale and that the Code's four-year statute of limitations,⁸⁰ which begins to run at the time of the sale, limits the seller's right to recover the tax.⁸¹

II. LETTERS OF CREDIT

In *Shaffer v. Brooklyn Park Garden Apartments*⁸² purchasers of limited partnership units obtained letters of credit to secure payment of the final 1/4 of their capital contributions. When it appeared that an improper demand for payment would be made the account party sought to enjoin the issuer from paying. The court interpreted 5-114 to mean that, while the issuer is obligated to pay under the terms of the letter of credit if the documents presented are facially correct, a court may properly enjoin payment if the person presenting the drafts is not a holder in due course of the drafts and if the requirements for a temporary injunction are met.

In this case the party presenting the drafts, having been notified of a potential problem before receiving the drafts, could not be a holder in due course. Thus the injunction would be proper if the plaintiff would suffer irreparable harm if the injunction was not granted, while harm to the bank presenting the drafts would be modest if it eventually won.

Because of the fact that the beneficiary appeared to be insol-

76. *Id.* at 530, 254 N.W.2d at 351.

77. 271 N.W.2d 36 (Minn. 1978).

78. *Id.* at 40.

79. 298 N.W.2d 33 (Minn. 1980).

80. U.C.C. § 2-725.

81. 298 N.W.2d at 39-40.

82. 311 Minn. 452, 250 N.W.2d 172 (1977), noted in 4 WM. MITCHELL L. REV. 445 (1978).

vent, the issuer's payment of the drafts would result in irreparable harm to the plaintiffs who, as account parties or customers of the issuing bank, would have to reimburse the issuing bank. On the other hand if the bank presenting the drafts were to prevail in a trial on the merits the loss and inconvenience would be nominal. The court determined that the trial court had abused its discretion and directed it to issue the temporary injunction pending a trial on the merits. Not every court would so readily enjoin payment but the decision in this case probably provides an efficient way of resolving the dispute.

*Prudential Insurance Co. of America v. Marquette National Bank of Minneapolis*⁸³ relies on basic letter of credit concepts: The issuer must pay pursuant to the credit if the beneficiary presents facially correct documents. The issuer, basing its refusal in part on the alleged illegality of the contract between the beneficiary and the account party, dishonored the drafts. The court correctly observed that the letter of credit is a separate contract and that the alleged illegality of the contract between the beneficiary and the account party is not available to the issuer in an action by the beneficiary to enforce the letter.

In this case the account party was not involved in the action and had made no attempt to enjoin payment as was the case in *Shaffer*. Even if an injunction had been sought a court probably would not grant it on this basis. The granting of the injunction in *Shaffer*, where fraud in the documentation was alleged and no holder in due course was involved, makes more sense and does less violence to basic letters of credit concepts.

III. SECURITIES

In *United States v. Doyle*⁸⁴ the court considered whether claimants, victims of an absconding broker who had purchased securities for the claimants, could be bona fide purchasers of bonds held by the broker and not delivered to the claimants. The court looked to 8-313, which, as part of the new text enacted in 1978, was not in effect at the time of the incidents which gave rise to the claims. The court held that a "transfer" of the bonds could only occur upon physical delivery or upon a financial intermediary's identifying specific securities as belonging to the purchaser.⁸⁵

83. 419 F. Supp. 734 (D. Minn. 1976).

84. 486 F. Supp. 1214 (D. Minn. 1980).

85. *Id.* at 1220-21.

Since the broker did not do this the claimants could not qualify as bona fide purchasers.

IV. NEGOTIABLE INSTRUMENTS

Recent Minnesota Supreme Court cases involving negotiable instruments questions address relatively simple problems but two or three have interesting twists.

A. Parol Evidence

Although Article 3 has no general parol evidence rule, most courts hold that parol evidence should not be admitted to vary the terms of a negotiable instrument.⁸⁶ Where only the immediate parties are involved some courts will admit extrinsic evidence.

The Minnesota court takes a rather restrictive approach in *Northwestern State Bank of Luverne v. Gangestad*.⁸⁷ The court, in holding that parol evidence is not admissible to contradict the terms of a demand note, noted that even course of dealing or usage of trade could not contradict the terms of a writing.⁸⁸

The *Gangestad* court considered an alleged oral agreement which ran counter to the written terms of a demand note. The alleged agreement made payment contingent upon the occurrence of certain events. The case differs from *Weather-Rite, Inc. v. Southdale Pro-Bowl, Inc.*⁸⁹ in which the court allowed parol evidence to be introduced to show that a corporate officer who indorsed the corporation's note signed in a representative rather than an individual capacity. In *Weather-Rite* the court perceived an ambiguity arising from the fact that another corporate officer, in indorsing, had designated his corporate office. The immediate parties only being involved, the court stretched the rule which deals with parol evidence of the capacity of a signer.⁹⁰ No ambiguity appeared on the note in *Gangestad*.

More recently, in *St. Croix Engineering Corp. v. McLay*,⁹¹ the court

86. U.C.C. § 3-118, comment 1; *id.* § 3-119, comment 1.

87. 289 N.W.2d 449 (Minn. 1979).

88. *Id.* at 452 n.6. In support of its decision the court cited the case of *Wabasso State Bank v. Caldwell Packing Co.*, 308 Minn. 349, 251 N.W.2d 321 (1976), an Article 9 case which was resolved by reference to the hierarchy of express terms over course of performance over course of dealing over usage of trade but which might more appropriately have addressed questions of waiver.

89. 301 Minn. 346, 222 N.W.2d 789 (1974).

90. *Id.* at 349, 222 N.W.2d at 791; U.C.C. § 3-403.

91. 304 N.W.2d 912 (Minn. 1981).

directly applied the rules governing the liability of one who signs a negotiable instrument in a representative capacity.⁹² The president of a corporation had signed a check bearing the corporation's printed name and logo but he had not noted that he was signing as president. The Code allows parol evidence to be offered under these circumstances to show that the signer signed as a representative when only the immediate parties are involved.⁹³ This parol evidence can, and in this case did, absolve the signer from individual liability.⁹⁴

In *G.G.C. Co. v. First National Bank of St. Paul*⁹⁵ the court invoked a fundamental rule of negotiable instruments law: No person is liable on an instrument unless his signature appears thereon.⁹⁶ In the absence of ambiguity a representative who signs properly on behalf of a principal will not be personally liable.⁹⁷

A signer who simply designates a corporate capacity will not necessarily be free of individual liability if he cannot show that he had authority to bind the corporation and that the corporation had power to incur the obligation. The court so held in *Old Republic Insurance Co. v. Meshbesh*.⁹⁸ A lender lent money to an individual borrower to enable the borrower to make improvements on real estate owned by a corporation in which the individual borrower had an interest. Other corporate officers signed as co-makers, one of them signing his name with the designation "Pres." The opinion does not say whether the note anywhere named the corporation. The court made much of the fact that the lender had not dealt directly with the co-makers, the individual borrower having obtained their signatures, but the court did not address the question whether the lender and co-maker were "immediate parties" under 3-403(2)(b).⁹⁹ Because the president/co-maker had not introduced evidence to show that the parties contemplated that he would sign in a corporate capacity he was held personally liable. The court distinguished *Weather-Rite* in which the individual testified that the payee told him that he was signing for the corpora-

92. U.C.C. § 3-403.

93. *Id.* § 3-403(2)(b).

94. 304 N.W.2d at 914-15.

95. 287 N.W.2d 378 (Minn. 1979).

96. U.C.C. § 3-401(1).

97. *Id.* § 3-403(1), (2), comment 3.

98. 290 N.W.2d 161, 163 (Minn. 1979).

99. *Id.* at 163.

tion.¹⁰⁰ The result is probably right but the opinion is unclear.

B. Underlying Obligation

When an obligor gives a negotiable instrument to pay a debt, unless there is an understanding to the contrary, the debt is suspended—not satisfied—unless the instrument is a bank instrument.¹⁰¹ *Merriman v. Sandeen*¹⁰² holds to this rule: A check itself is “payment” only if the parties explicitly so agree. Otherwise the payment is conditional and will be defeated if the check is not paid; the underlying obligation will no longer be “suspended.”

This is sound but the court tosses off a causal statement which, as a general proposition, is very deceptive. The court says, “contrary to plaintiff’s contention, a check presented to a drawee bank need not be indorsed by the payee for proper presentment.”¹⁰³ While in the check collection process the stamp of the depository bank can serve as a customer’s indorsement even when the customer/payee does not manually indorse,¹⁰⁴ a drawee should refuse to pay unless the check carries either the manual indorsement or the stamp.¹⁰⁵ Even when the payee presents the check for payment over the counter the drawee, while not technically entitled to an “indorsement” may, without dishonor, require “a signed receipt on the instrument” for payment.¹⁰⁶

C. Holder in Due Course

A holder in due course is a holder of a negotiable instrument which he has taken for value, in good faith and without notice that it is overdue, has been dishonored or that there is any claim to it or defense against it.¹⁰⁷ The holder in due course cases most often deal with questions of good faith and notice.

In *Shaffer v. Brooklyn Park Garden Apartments*¹⁰⁸ the court considered whether the lending bank which had taken letters of credit to

100. *Id.*

101. U.C.C. § 3-802; see *Village of New Brighton v. Jamison*, 278 N.W.2d 321 (Minn. 1979); see also *Kampf v. First Nat'l Bank of Minnetonka (In re Henrickson)*, 14 Bankr. 474 (Bankr. D. Minn. 1981).

102. 267 N.W.2d 714 (Minn. 1978).

103. *Id.* at 718 n.7.

104. U.C.C. § 4-205.

105. *Id.* § 3-510, comment 2.

106. *Id.* § 3-505(1)(d).

107. *Id.* § 3-302(1).

108. 311 Minn. 452, 250 N.W.2d 172 (1977).

secure payment of notes signed by its borrower could qualify as a holder in due course of the drafts drawn by the borrower/beneficiary and negotiated to the lender.

The court reviewed earlier cases including *Eldon's Super Fresh Stores, Inc. v. Merrill Lynch*¹⁰⁹ which discussed good faith and notice. The *Shaffer* court distinguished between a holder's failure to inquire "about an unknown fact" (which might be negligence but which would be neither a lack of good faith nor notice of what an inquiry might have yielded) and his failure to inquire further about facts brought to his attention. In *Shaffer* the lawyer for the letter of credit account party had told the lender by letter that the beneficiaries were not entitled to draw under the letter. This put the lender under an obligation to inquire further, especially in light of its knowledge of the borrower/beneficiary's "severe financial difficulties." The lender's failure to inquire under these circumstances put it on notice of facts which an inquiry would have yielded. Thus when the lender took the drafts after receiving the warning letter it could not qualify as a holder in due course.

The result is consistent with *Leininger v. Anderson*¹¹⁰ in which the court discussed the good faith and notice requirements and declined to impose any burden greater than "honesty in fact"¹¹¹ for good faith. The court also discussed the 3-304 notice requirement, holding that the holder's knowledge that the instruments arose from a transaction involving the sale of a business did not impose any duty of further inquiry.

A more recent case, *Wohltrabe v. Pownell*,¹¹² explored the distinction between notice of extraneous facts and notice of a problem concerning the instrument itself. The payee of a cashier's check received the check as reimbursement of embezzled funds. The embezzler had, through fraudulent representations, obtained from the plaintiff the money to buy the cashier's check. The trial court had imposed a constructive trust on the funds. The supreme court reversed. The claim of the plaintiff could only give rise to a constructive trust if the recipient of the funds did not qualify as a holder in due course.¹¹³

The court observed that value, in the form of satisfaction of an

109. 296 Minn. 130, 207 N.W.2d 282 (1973).

110. 255 N.W.2d 22 (Minn. 1977).

111. U.C.C. § 1-201(19).

112. 307 N.W.2d 478 (Minn. 1981).

113. *Id.* at 483; U.C.C. §§ 3-305, -306.

antecedent debt, had been given and went on to reaffirm the “white heart, empty head” standard for good faith, noting that “rarely will suspicious circumstances alone undermine a claim that a negotiable instrument was taken in good faith.”¹¹⁴

The court discussed in detail the question of notice. The circumstances of the case suggested that funds had been embezzled and that the embezzler, a former accountant for the recipient of the cashier’s check, was lying about his activities while serving in that capacity. The court correctly observed that when the cashier’s check that constituted repayment finally arrived there was nothing on the face of the check nor in the circumstances surrounding the delivery of the instrument to suggest that the embezzler had defrauded someone else to get the money. The court held that the trial court’s findings were clearly erroneous, vacated the judgment and remanded with instructions to the trial court to enter judgment for the payee of the cashier’s check.

Three justices dissented, finding “red lights” all over the place because of the deception and prevarication by the embezzler.¹¹⁵ The dissent says that the payee, because of the accumulation of “red lights,” was not entitled to assume that the embezzler had obtained the money legitimately.

The majority opinion properly focused on the instrument itself and is consistent with the Code’s rules. The dissenters’ strongest argument is that the cashier’s check was in an amount somewhat greater than the obligation arising from the embezzlement. The majority’s explanation is a bit thin but on balance the outcome seems to be right.

In *State Bank of Brooten v. American National Bank of Little Falls*¹¹⁶ the court resolved a holder in due course question on the basis of whether the holder had given value. A seller of goods persuaded the buyer to issue a personal check in partial payment even though there was some question about the goods. The buyer/drawer then issued a stop order. Through a mistake the drawee bank, at the request of the payee, issued its bank money order payable to the order of State Bank to whom the seller/payee was indebted, in payment of the personal check. The seller took the bank money order to State Bank and asked that the amount be applied to his loan obligation. State Bank, having credited its customer’s loan

114. 307 N.W.2d at 483.

115. *Id.* at 487-88.

116. 266 N.W.2d 496 (Minn. 1978).

account, presented the bank money order for payment; the issuer, having discovered that payment on the personal check had been stopped, refused to pay the bank money order on grounds of lack of consideration. State Bank notified its customer that the bank money order had been dishonored and charged the loan account with the amount previously credited. The customer did not object and apparently resolved his problems with the buyer of the goods.

State Bank, apparently despairing of recovering anything from its customer, sued the issuing bank, claiming that the issuer could not stop payment on this kind of instrument. The lower court gave judgment to State Bank, holding that the payment of the bank money order in exchange for the personal check was final payment of the personal check and that the payee of the bank money order was a holder in due course of the instrument.

The court properly considered the bank money order, on which the bank was both drawer and drawee, as the equivalent of a cashier's check. The court discussed the question whether an issuing bank may stop payment on such an obligation. Recognizing that there is a split of authority, the Minnesota court concluded that an issuing bank may stop payment on its cashier's check if the instrument is in the hands of someone who does not have the rights of a holder in due course.¹¹⁷

From there on it was all downhill for State Bank. Although a payee can be a holder in due course,¹¹⁸ the payee must qualify in all respects in order to achieve that status. The payee had acted in good faith and without notice and was clearly the holder of a negotiable instrument. The problem was with the requirement of value. The court agreed that value can include the satisfaction of an antecedent debt¹¹⁹ and that when a person takes a bank instrument for an obligation the underlying obligation is satisfied rather than merely being suspended.¹²⁰ However, the court pointed out that 3-802 contains that popular Code phrase "unless otherwise agreed." The court reasoned that because the payee charged the amount of the dishonored bank money order to the customer's loan account and the customer acquiesced in that action the payee and its customer must have "otherwise agreed."¹²¹ Thus the bank

117. *Id.* at 449.

118. *See* U.C.C. § 3-302(2).

119. 266 N.W.2d at 500; *see* U.C.C. § 3-303(b).

120. 266 N.W.2d at 500; U.C.C. § 3-802(1)(a); *see also* *Kampf v. First Nat'l Bank of Minnetonka (In re Henrickson)*, 14 Bankr. 474 (Bankr. D. Minn. 1981).

121. 266 N.W.2d at 500.

money order did not satisfy the obligation. Accordingly the instrument was not taken in payment of an antecedent debt and therefore no value was given. Thus State Bank was not a holder in due course of the bank money order and the issuer could stop payment and assert the defense of failure of consideration.¹²²

The result is disturbing because it depends upon a ministerial action that was probably done automatically and without much thought for any such consequences. Had the bank not charged its customer's loan account the result would have been completely different.

Furthermore, upon dishonor of the bank money order the focus of the decision is shifted from the finality of payment of the personal check which started the whole thing. If the appellate court had concentrated on whether the issuance of the bank money order constituted final payment of the personal check it might have reached a different result. If the drawee had paid the personal check in currency which then was given to State Bank there would be no question of tracing that money into State Bank's hands. Why should the cashier's check be treated differently? The decision does not further the desirable policy of treating cashier's checks as the functional equivalent of cash.

In the mystifying recent case of *Northwestern National Bank v. Shuster*¹²³ the court dealt with holder in due course status but used the concept of estoppel to resolve a negotiable instruments question. The case involved two notes which had been executed by the defendant and made payable to M-G Co., a general partner in a limited partnership which was to assume control of an apartment project. The first note was unequivocal; it was secured by some stock and represented the defendant's initial contribution as a limited partner. Later the defendant executed a second note called an "option note" to be effective when the defendant exercised an option to purchase an additional interest in the limited partnership. The face of the note reflected the option arrangement.

M-G Co. pledged both notes to the plaintiff as security for the repayment of loans made for M-G's general business purposes. When M-G Co. defaulted the bank sued the maker of the notes. The defendant claimed that the notes had been pledged for loans, the proceeds of which had gone to projects other than the limited partnership. The trial court dismissed the complaint.

122. *Id.* at 501.

123. 307 N.W.2d 767 (Minn. 1981).

The supreme court addressed the notes separately and pointed out that the maker knew that M-G Co. was going to pledge the first note as security for a loan. Thus, the court held that the defendant was estopped to raise the issue of the alleged misuse of the funds. The court did not explain what type of estoppel was involved nor did it go into detail about why estoppel was appropriate. The court felt that as between the two parties the maker of the note should more properly have the burden of seeing that the proceeds were properly used. The court held that the bank, "as a secured party," had the right to foreclose on the note and to require the maker to pay, irrespective of the secured party's status (or lack of status) as a holder in due course. This result is either wrong or unclear or both. How can a secured party get rights in collateral superior to those of the debtor unless he can qualify as a holder in due course? The court talked about the creditor being able to recover "as a secured party" as if that status gives a creditor some special status even if he is not a holder in due course. If estoppel can be used to satisfy the requirement, just why was it present here?

The estoppel that was invoked in the case of the first note was not present in the second situation. Apparently there was no evidence to show that the maker knew the use to which the note was being put. The court then explored the bank's possible status as a holder in due course of the second note.

In a questionable determination the court held that the instrument was negotiable notwithstanding the notation that the note was to be payable when an option was exercised. In the court's view this is simply a reference to the underlying transaction which does not make the promise conditional and thus does not destroy negotiability.¹²⁴

The court goes on in a peculiar fashion to hold that, while the bank became a holder, it had not met its 3-302(1) burden of establishing that it was a holder in due course. "Appellant has not overcome its burden of showing that it took the instrument in good faith and without notice of any defense against it"¹²⁵ The bank took the note "with full knowledge that the underlying consideration was the future exercise by respondent of his option."¹²⁶

124. U.C.C. § 3-105.

125. 307 N.W.2d at 771.

126. *Id.*

Thus the maker could show that he did not exercise the option thereby establishing a defense, presumably lack of consideration.

How the conclusion follows is unclear. The court seems to be indulging in something less than sound reasoning. It is difficult to harmonize this brief explanation of good faith and notice with the decision in *Wohlrabe v. Pownell*.¹²⁷

D. Set-Off

The Eighth Circuit in *Olsen-Frankman Livestock Marketing Service, Inc. v. Citizens National Bank of Madelia*¹²⁸ explored the rights of a drawer of a check to set off mutual obligations between the payee and the drawer against a non-holder in due course of the check. The holder of checks called the drawer to ask whether the checks would be honored. The drawer asked whether the payee was in any financial trouble and the holder, knowing that the payee was insolvent, said that there was no financial problem. The drawer later sued the holder for fraud claiming that had the holder not lied the drawer would have stopped payment and set off. The holder argued that there had been no damages because the drawer could not have set off against the holder (not in due course) anyway.

The court analyzed pre-Code law, the set-off statute,¹²⁹ and 3-306 and concluded that the set-off was available. Thus the drawer's claim was well-founded. The circuit court reversed the district court judgment dismissing the action.

In subsequent proceedings the district court examined several questions arising out of this transaction.¹³⁰ One question arises because of the assertion that a stop order on a check issued to a payee who files a petition in bankruptcy results in a voidable preference. The court determined that no voidable preference would occur because the check itself does not constitute "payment" to the payee until it is paid by the drawee. Thus, because the giving of a check to a payee is not a transfer to him, stopping payment on that check can not result in a transfer of property of the estate.

In *State Bank of Rose Creek v. First Bank of Austin*¹³¹ the Minnesota

127. 307 N.W.2d 478 (Minn. 1981).

128. 605 F.2d 1082 (8th Cir. 1979).

129. MINN. STAT. § 540.03 (1982).

130. *Olsen-Frankman Livestock Mktg. Serv., Inc. v. Citizens Nat'l Bank of Madelia*, 4 Bankr. 809 (D. Minn. 1980).

131. 320 N.W.2d 723 (Minn. 1982).

Supreme Court, applying the set-off statute and interpreting the rule of 9-104(i), held that a bank which had issued non-negotiable certificates of deposit which were subject to the issuing bank's right of set-off could set-off in spite of the fact that another bank had taken a security interest in the certificates and had taken possession of them.¹³² The issuing bank's set-off rights had accrued but had not been exercised at the time the security interest was perfected; the issuing bank did not notify the secured party of its right to set-off even when the secured party inquired about possible "assignments or attachments." As stated by the court, "The wording of section 336.9-104(i) is clear insofar as it expresses an intent to exclude set-offs from coverage of Article 9 security and filing requirements. We believe it must also be read as excluding set-offs from the priority provisions."¹³³

E. Accommodation Parties

When a person, in signing a negotiable instrument, lends his name to another party to the instrument the former is called an accommodation party. He becomes liable in the capacity in which he has signed.¹³⁴ Thus a co-maker who is an accommodation party is primarily liable to the holder. Much recent litigation concerns questions of the effect of impairment of collateral on the obligation of the accommodation party who has suretyship defenses available against the holder as a result.¹³⁵

In *LeRoy v. Marquette National Bank of Minneapolis*¹³⁶ the court dealt with a slightly different aspect of the question. An accommodation party who is called upon to pay the obligation is allowed, through subrogation, to proceed against the accommodated party and against any collateral given by the accommodated party as security. The principal debtor tried to prevent the co-maker, who had paid the debt, from proceeding against the stock which had been pledged as collateral for the loan. The court held that even though the accommodation party had possibly received some consideration by virtue of the fact that an earlier note had been renewed, thus extending the time for payment, the co-maker remained an accommodation party. As an accommodation party he

132. *Id.* at 724-25.

133. *Id.* at 726.

134. U.C.C. § 3-415.

135. *Id.* § 3-606.

136. 277 N.W.2d 351 (Minn. 1979).

was entitled to the benefit of "equitable principles" that a surety is entitled to be subrogated to the rights of the creditor upon payment of the debt and to equitable assignment of the security."¹³⁷

F. Lost Instruments

In *First Construction Co. v. Tri-South Mortgage Investors*¹³⁸ the maker deposited funds with a bank pending a determination by the trial court about what to do, the instrument having been lost.¹³⁹ The trial court has discretion as to the amount of security to be required of the holder under these circumstances but the supreme court, reversing in part, held that it was error to permit the bond which acted as security¹⁴⁰ to expire before the statute of limitations had run.¹⁴¹

G. Conversion of an Instrument

In *Denn v. First State Bank of Spring Lake Park*¹⁴² the Minnesota Supreme Court carefully analyzed 3-419(3). Under the Code the owner of a check which is stolen and upon which his indorsement is forged may recover from the drawee bank in conversion.¹⁴³ The drawee in turn may recover from the depository bank for breach of warranty.¹⁴⁴ However, if the owner of the check sues the depository bank directly in conversion, the Code allows recovery only to the extent of "any proceeds remaining in [its] hands."¹⁴⁵ The Minnesota court analyzed cases from other jurisdictions which maneuvered around this language and regretfully concluded that, while judicial economy and common sense might dictate a different result, the plain language of the statute could not be avoided.¹⁴⁶

137. *Id.* at 355. The court discussed another aspect of this matter in *LeRoy v. Marquette Nat'l Bank of Minneapolis*, 306 N.W.2d 815 (Minn. 1981).

138. 308 N.W.2d 298 (Minn. 1981).

139. The maker is entitled to surrender of the instrument upon full payment. U.C.C. § 3-505(1)(d).

140. *Id.* § 3-804.

141. 308 N.W.2d at 301.

142. 316 N.W.2d 532 (Minn. 1982).

143. U.C.C. § 3-419(1)(c).

144. *Id.* § 4-207(1)(a).

145. *Id.* § 3-419(3).

146. 316 N.W.2d at 537. The court concluded its opinion with this wistful comment: Although the people of Minnesota would benefit by a change which would hold a depository bank directly liable to the true payee of a check which it has paid over a forged indorsement, we hold that Minn. Stat. § 336.3-419(3), as it was

V. SECURED TRANSACTIONS

A. *Creation of a Security Interest*

The Minnesota Supreme Court has decided only a few Article 9 cases in recent years. Only one of any consequence deals with the creation of a security interest. In *State Bank of Young America v. Vidmar Iron Works, Inc.*,¹⁴⁷ State Bank had taken a security interest in accounts of the debtor and later had taken another security interest which covered, among other things, inventory of the debtor. The defendant delivered raw materials to the debtor for processing and made payments in the form of checks payable to the debtor and one of the debtor's unsecured creditors.

The secured party/plaintiff foreclosed because of the debtor's default and sought a deficiency of \$23,000 against the defendant, who had paid \$31,000 to the debtor after being notified of the secured party's interest in the debtor's accounts. The plaintiff lost in the trial court and appealed.

The court discussed several matters. First it properly rejected the defendant's claim that because there were periods at which the balance due from the debtor was zero the security interest disappeared. The security agreement covered future advances and was never terminated. Thus when new obligations were incurred they were subject to the security interest.

The court also unnecessarily dealt with the question whether the security interest in inventory extended to the raw materials furnished by the defendant for processing by the debtor. The debtor would process the materials, which remained the defendant's property, and reship them in accordance with the defendant's instructions. The defendant argued that the debtor had no "rights in the collateral" as required by 9-203 and thus no security interest could attach to those goods. The court found that the debtor's statutory lien¹⁴⁸ in goods upon which it had worked created rights in the collateral to the extent of the debtor's claim against the goods—the amount of the payment due from the defendant for the processing. It is unclear why the secured party's accounts interest would not have taken care of this; the amounts due for the work

passed by the legislature in 1965, provides defenses which absolve the depository bank of such liability.

Id.

147. 292 N.W.2d 244 (Minn. 1980).

148. *Id.* at 251.

were clearly "accounts" under either the new or old version of 9-106(1).

The court finally concluded that the change in the corporate structure of the debtor did not prevent the secured party from asserting its security interest in accounts that arose after the change. In a murky analysis the court cited 9-402(7) (which was not yet in effect at the time the events of this case occurred, and which may well not have applied anyway) but seemed to rely on the new corporation's express or implied assumption of the debts of the predecessor and its willingness to be bound by the security agreement.¹⁴⁹

The court also summarily rejected the argument that the notice given by the secured party to the defendant/account debtor concerning payment of the accounts was insufficient. The court gratuitously stated that the defendant had not met its general 1-203 good faith obligation because it had ignored the secured party's notice and had made its checks payable to the debtor and another unsecured creditor with whom the defendant did business. The court pointed out that if the defendant had been unsure about conflicting claims it could have added the secured party's name to the check or brought an interpleader action.

The result in the case is satisfactory but the decision goes beyond what would be required to solve the problem and the discussion of the accounts generated after the change in corporate structure is unclear.

B. Perfection

Thorp Commercial Corp. v. Northgate Industries, Inc.,¹⁵⁰ a blunder by the trial court,¹⁵¹ was corrected by the appellate court. The trial court had held that the financing statement's description of security as "assignment accounts receiveable," was not effective to perfect a security interest in after-acquired accounts because it could be read to apply only to certain existing accounts.¹⁵² The Eighth Circuit overturned this erroneous result in an opinion containing a good discussion of the notice filing theory of the Code.

In *Rogers v. United States*¹⁵³ the court decided one of the rare cases

149. Compare this result with *Meyers v. Postal Fin. Co.*, 287 N.W.2d 614 (Minn. 1979), where the court was not so quick to imply an assumption of obligations.

150. 654 F.2d 1245 (8th Cir. 1981).

151. 490 F. Supp. 197 (D. Minn. 1980).

152. *Id.* at 202.

153. 511 F. Supp. 82 (D. Minn. 1980).

in which the rule on perfection by notification to a bailee is applicable.¹⁵⁴ A defendant charged with trafficking in drugs assigned to his lawyer his interest in money seized by the United States Drug Enforcement Administration (DEA). The lawyer notified the DEA of his interest before the IRS levied on the money. The lawyer prevailed since he was properly perfected.

C. Acceleration

*Sheet Metal Workers Local No. 76 Credit Union v. Hufnagle*¹⁵⁵ holds that a note is not subject to automatic acceleration. While the Code recognizes that acceleration clauses are valid¹⁵⁶ subject only to the limitation that they must be exercised in good faith,¹⁵⁷ the right to accelerate exists only if the note so provides. In *Hufnagle* the holder of the note argued that the maker's failure to pay was an anticipatory repudiation and that the holder thus could sue for the entire balance. The court admitted that perhaps if the maker had announced his refusal to make future payments there might be something in this argument. The maker, however, had not refused to make future payments and the court held that in the absence of the acceleration clause the holder was limited to an action for past due installments only. The result is sensible and emphasizes what everybody knows: The note should say what the parties mean. The holder cannot rely on unstated provisions.

The defendant in *Hufnagle* argued that because the note said that the creditor "may at his option . . . sell at public or private sale any and all of the collateral for said note in satisfaction thereof,"¹⁵⁸ the creditor was limited to pursuing the collateral. The court refused to read this provision as a limitation of remedies, pointing out that Article 9 contemplates that the creditor will recover the entire debt. While an agreement to the contrary could be made, the language of this note, drafted, strangely enough, by the debtor, did not clearly establish that the retention or disposition of the collateral by the creditor would satisfy the obligation without other remedies being available to the creditor.

Furthermore the retention of the collateral and refusal to return it to the debtor during the lawsuit could not be construed as an

154. U.C.C. § 9-305.

155. 295 N.W.2d 259 (Minn. 1980).

156. *See, e.g.*, U.C.C. §§ 3-109(1)(c), -105(1)(c).

157. *See id.* § 1-208.

158. 295 N.W.2d at 261.

after-default election of remedies. The creditor is entitled to full payment of the debt by means of a deficiency judgment if the collateral does not satisfy the obligation.

D. Repossession and Disposition of Collateral

Many Article 9 cases deal with repossession and disposition of collateral. In *Cobb v. Midwest Recovery Bureau Co.*¹⁵⁹ the Minnesota Supreme Court discussed the effect of the secured party's consistent acceptance of late payments. Over a two-year period the debtor always paid late, sometimes only a few days and sometimes several months. Although the secured party wrote some threatening letters it never refused a late payment and did not repossess until there were only four payments remaining on the contract and the debtor was two payments behind. The secured party's agents repossessed the collateral, a semi-tractor. During the repossession they damaged the tractor and failed to lock it or otherwise guard the debtor's personal property in the tractor. The debtor was able to get the tractor back by paying one back payment, plus the costs of repossession and signing a release which the trial court later held unenforceable for lack of consideration. The debtor sued and recovered for loss of profits over the period in which he did not have the use of the tractor, loss of his personal property, the repossession costs which he had paid and punitive damages.

The supreme court, after reviewing conflicting cases from various jurisdictions, concluded that the repossession was wrongful because the secured party had established a pattern of accepting late payments and had failed to notify the debtor before repossession that strict compliance would be required. The contract said that a waiver of any breach did not result in a waiver of future breaches or defaults. Nevertheless the court imposed the notice requirement, in part on the theory of estoppel, on the secured party. "We hold that the repeated acceptance of late payments by a creditor who has the contractual right to repossess the property imposes a duty on the creditor to notify the debtor that strict compliance with the contract terms will be required before the creditor can lawfully repossess the collateral."¹⁶⁰ Because the repossession was wrongful the defendant was liable for the actual damages.

The court reversed the award of punitive damages because the secured party had acted in good faith and thought that it was pro-

159. 295 N.W.2d 232 (Minn. 1980).

160. *Id.* at 237.

ceeding lawfully. Now that the court has spoken and the law is clear in Minnesota, a creditor acting as this one did could be exposed to a punitive damages award. No secured party may now safely allow a debtor to regularly make late payments and then repossess without first giving the debtor notice of his intention to demand strict performance and to repossess if the debtor remains in default. Furthermore the court recognizes that more than one notice might be required:

If the creditor sends a letter to preserve its rights and then once again accepts late payments, another notice would be required. The second notice would be required because the acceptance of the late payment after the initial letter could again act as a waiver of the rights asserted in the letter.¹⁶¹

In *LeRoy v. Marquette National Bank of Minneapolis*¹⁶² the accommodating party, who had paid the principal debt and thus become subrogated to the rights of the secured creditor, sold the collateral without notifying the principal debtor. The accommodation party was awarded a deficiency judgment. On appeal the supreme court held that 9-504(3) means what it says: No notice of disposition is required when the collateral is of a type customarily sold on a recognized market.¹⁶³ The collateral was Banco common stock. Therefore no notice was required and the secured party was entitled to the deficiency.

In *Lovett v. Shuster*¹⁶⁴ the Eighth Circuit Court of Appeals applied Code concepts to determine a voidable preference question in a bankruptcy proceeding. The collateral was securities. The secured party took possession of them outside the four-month preference period but the actual assignment occurred within the period. The court concluded that the "transfer" took place at the date of possession rather than when the formal assignment was made.¹⁶⁵

The federal district court in *Fedders Corp. v. Taylor*¹⁶⁶ dealt with a rather complicated repossession and disposition of collateral. The court sidestepped one interesting question and guessed at what the Minnesota rule would be as to another.

When the collateral was sold the guarantors of the obligation

161. *Id.*

162. 306 N.W.2d 815 (Minn. 1981).

163. 306 N.W.2d at 817.

164. 633 F.2d 98 (8th Cir. 1980).

165. *Id.* at 104.

166. 473 F. Supp. 961 (D. Minn. 1979).

apparently knew of the sale but did not receive notice under 9-504. The court held that the failure of the guarantors to raise the question of lack of notice in the pleadings precluded them from raising it later.¹⁶⁷ In dictum Judge Larson said that even though the guarantors had not received a notice, if they in fact knew about the sale but stood by and made no attempt to protect their rights they would have waived any objection they might have had and would have suffered no loss because of the lack of notice.¹⁶⁸

One portion of the collateral was a group of accounts which were taken over and collected by the secured party. The court discussed all sides of the question of what effect a failure to proceed in a commercially reasonable fashion would have on a claim for a deficiency. Recognizing that Minnesota had not yet decided the question, Judge Larson chose the middle ground and presumed that the value of the accounts was equal to their amount at the time the secured party took them over.¹⁶⁹ There being no evidence to rebut that presumption, the debtor received full credit for the paper amount of the accounts irrespective of the amount the secured party ultimately collected.

There is considerable confusion about how a third-party lender can get a purchase money security interest. The question is important because the purchase money secured party is given special priority treatment when others assert conflicting claims to the collateral.¹⁷⁰

In *Northwestern National Bank Southwest v. Lectro Systems, Inc.*¹⁷¹ the court carefully explained the 9-107(b) requirement. The statute "contemplates that the loaned funds be intended, and actually used, for the purchase of an identifiable asset which stands as the secured party's collateral."¹⁷² Thus a loan enabling the debtor to perform work which generated an account could not result in a purchase money security interest in the account. This is a sound analysis which clears up common misunderstandings about purchase money loans.

An unusual question arose in *Van Diest Supply Co. v. Adrian State*

167. *Id.* at 972.

168. *Id.* In a footnote Judge Larson questioned whether the guarantors are "debtors" within the meaning of the 9-504 requirement that notice of the sale be given to the debtor.

169. *Id.* at 978.

170. *See, e.g.*, U.C.C. §§ 9-301(2), -312(3), (4).

171. 262 N.W.2d 678 (Minn. 1977).

172. *Id.* at 680 (footnote omitted).

Bank.¹⁷³ The bank had a security interest in collateral securing an SBA guaranteed loan and another obligation. This security interest was superior to another security interest held by the plaintiff. Upon the debtor's default the bank assigned its security interest to the SBA which had paid on the guarantee. The SBA disposed of the collateral and received proceeds that exceeded the amount of the SBA's interest. Both secured parties claimed superior rights in the proceeds. The plaintiff's theory was that the assignment of the security interest terminated the bank's rights. The Minnesota court, observing that the Code does not address this question, relied on common law principles to conclude that under these circumstances the assignee of the security interest holds the collateral for the benefit of the assignor to the extent that it is not necessary to satisfy the assigned debt.¹⁷⁴ The case was remanded for trial on questions of waiver and estoppel.

*Guaranty State Bank of St. Paul v. Lindquist*¹⁷⁵ involves a dispute between a secured creditor and the United States government claiming an interest in an account pursuant to a federal tax lien. The supreme court, reversing the trial court, observed that while the secured party had collected payments from accounts and the funds were deposited in a special bank account, the secured party had no right to take the funds unless the debtor defaulted.¹⁷⁶ Thus there had not been an assignment of the accounts in question and the debtor retained rights to which the tax lien could attach.

The applicable Internal Revenue Code rule protects a secured creditor as to collateral received by the debtor/taxpayer before the forty-sixth day after the tax lien filing.¹⁷⁷ The accounts in question came into being long after that date and thus the secured party lost to the government.

In re Apollo Travel, Inc.,¹⁷⁸ is a case that reaches a good result through questionable logic. The secured party had financed the debtor travel agency and had taken a security interest in accounts, general intangibles, et cetera. The security interest covered "debts, liabilities, or obligations" including those expenses incurred in enforcing "payment of any collateral." Another provision included a promise by the debtor to pay "all internal, office

173. 305 N.W.2d 342 (Minn. 1981).

174. *Id.* at 346.

175. 304 N.W.2d 278 (Minn. 1980).

176. *Id.* at 281.

177. I.R.C. § 6323(c)(2)(B) (1976).

178. 567 F.2d 841 (8th Cir. 1977).

and out-of-pocket expenses" incurred in the handling or collection of the collateral. Although the secured party had been paid in full no termination statement was ever filed. A third party asserted a questionable claim to some of the collateral and the secured party sought attorney's fees and expenses incurred in settling the claim. The district court assumed that the security agreement was broad enough to include this kind of claim but, in a bankruptcy proceeding, ruled that when the "main indebtedness" had been paid off the security interest had terminated and therefore the secured party could not assert against the collateral a claim arising out of these "secondary obligations."

The appellate court affirmed, referring to the policy of prompt distribution of assets in bankruptcy and saying that to allow this sort of "speculative" debt to be asserted as a secured claim would "impede the administration of the bankruptcy laws."¹⁷⁹

The idea that payment of the initial or principal obligation terminates the security interest is wrong and should not be picked up as a general principle of law. The accurate analysis of this question appears in *State Bank of Young America v. Vidmar Iron Works, Inc.*¹⁸⁰

In one recent case the court held that a clause in a lease was not enforceable notwithstanding an Article 9 provision that says that it is. *Chase Manhattan Bank v. Clusiau Sales & Rentals, Inc.*,¹⁸¹ holds the 9-206 validation of waiver of defenses not applicable in a franchise situation where enforcement of the waiver would unreasonably narrow the remedial reach of the franchise statute¹⁸² which gives an aggrieved franchisee a right of rescission.¹⁸³

VI. SUMMARY

The Minnesota Supreme Court has dealt with most Uniform Commercial Code issues rather well but has, in a few cases, thrown off bits of misleading or downright wrong dictum. Two or three cases are plainly wrong in their reasoning. The federal district courts have been more reliable although they also have slipped occasionally; fortunately the slips have been repaired by the Eighth Circuit.

179. *Id.* at 844.

180. 292 N.W.2d 244 (Minn. 1980).

181. 308 N.W.2d 490 (Minn. 1981).

182. *See* MINN. STAT. § 80C.17(1) (1982).

183. 308 N.W.2d at 494.

The most innovative decision is *Durfee* which allowed the consumer/buyer to revoke acceptance as against a remote party—the distributor—in situations in which the dealer is out of business. Every lawyer who handles a revocation of acceptance case on either side must study *Durfee*, *Johannsen* and *Jacobs*.

Northwestern National Bank v. Shuster is a dangerously wrong decision which would elevate any secured party whose collateral is a negotiable note to the position of a holder in due course.

The criticisms made in this article are not meant to suggest that the Minnesota Supreme Court and the federal district courts are not doing a good job. The Code is a complex piece of legislation which is subject to varying interpretations. Many state courts have records in Code interpretation less impressive than Minnesota's.