The Transactional Lawyer

A Publication of the Commercial Law Center

GONZAGA UNIVERSITY SCHOOL OF LAW

Chattel Paper Buyers Beware: You Have More to Lose Than Your Investment

Stephen L. Sepinuck

Buyers of chattel paper generated in consumer transactions face a risk that purchasers of most other assets do not: they may be on the hook for more than the purchase price. Consider the following illustration:

> Consumer buys mobile home from Dealer, paying $10,000 down and signing a negotiable note and security agreement for the $30,000 balance. After Dealer assigns the chattel paper to Bank for $27,000, Consumer makes $5,000 in payments to Bank. Thereafter, the mobile home is destroyed as a result of latent defects and Consumer suffers personal injury of $50,000 plus loss of the entire mobile home.

Absent the intervention of federal law, Consumer would be liable to Bank for the $25,000 remaining due if either Bank qualified as a holder in due course, *see* U.C.C. § 3-305, or Consumer waived in the purchase agreement the right to assert defenses against an assignee, *see* § 9-404(a).

However, because of perceived unfairness to consumers in such situations, in 1975 the FTC promulgated a rule to change this result. **16 C.F.R. § 433.2**. Under the FTC Rule, which is now obliquely referenced in the UCC itself, Bank remains subject to Consumer's defenses. *See* U.C.C. §§ 3-305(e), 9-404(c).

The FTC Rule was designed to protect consumers who buy defective goods and who would normally have a defense to payment against the seller but were barred from asserting defenses against a lender for any of three reasons: (i) the lender qualified as a holder in due course of a negotiable instrument; (ii) in connection with the purchase, the consumer signed a waiver of claims and defenses; or (iii) the seller arranged for direct financing from the lender. *See* **FTC Pamphlet** at 2.

Contents

Chattel Paper Buyers Beware: You Have More to Lose Than Your Investment 1

A Look at the Fraud Exception to the Parol Evidence Rule 2

Recent Cases 3

However, the FTC Rule does more than preserve the consumer's *defenses*. It expressly makes the lender subject to "all *claims* and defenses which the debtor could assert against the seller," with recovery limited to the amount paid under the contract (emphasis added).

Thus, on the facts of the hypothetical, Consumer not only has a defense to payment for the $25,000 balance due but is apparently entitled to recover from Lender the amounts Consumer has already paid. In other words, the FTC Rule means not only that Bank stands to lose the ability to collect the $25,000 balance due, but is liable to Consumer for both the $5,000 that Consumer paid to Bank *and the $10,000 that Consumer paid to Dealer*. Thus, Bank stands to lose not only its full $27,000 investment, but an additional $10,000 on top of that! *See, e.g., Lafferty v. Wells Fargo Bank*, **2013 WL 412900** (Cal. Ct. App. 2013) (lender that received assignment of retail installment sales contract for the purchase of a mobile home was, under the FTC Rule, not merely subject to the debtors' defenses to payment but also liable for any claim that the debtors had against the dealer, limited to the amount the debtors had paid under the installment contract).

It is worth noting how significantly the FTC Rule changes otherwise applicable law. A person who accepts an assignment of "[a] contract" or of "all rights under" a contract is normally regarded as both an assignee of rights and a delegate of duties, and thus becomes obligated to perform the assignor's unperformed duties. *See* Restatement of Contracts (Second) § 328(2), U.C.C. § 2-210(5). Such a person is therefore affirmatively liable for the assignor's nonperformance. However, an assignment for security is treated differently. *See* Restatement (Second) of Contracts § 328(1), U.C.C. § 2-210(5). Thus, absent application of the FTC Rule, a purchaser of chattel paper is not liable for the unperformed promises of the debtor to the account debtor – and this is true regardless of whether the purchaser loaned against the chattel paper or bought the chattel paper outright. *See*

Restatement (Second) of Contract § 328 cmt. b & ills. 2 & 3. Even more to the point is U.C.C. § 9-404(b), which expressly limits an account debtor's claim against a secured party to a reduction of the amount owed, thus preventing an affirmative recovery from the secured party. However, § 9-404(b) is expressly subject to other law, such as the FTC Rule. *See* U.C.C. § 9-404(c) & cmt. 4.

To be sure, not all courts have interpreted the FTC Rule as the *Lafferty* court did. Some have concluded that the primary purpose of the FTC Rule is to provide a defense to the creditor's claims and limited the availability of affirmative recovery to rare situations when the seller's breach rendered the transaction practically worthless to the consumer. *See, e.g., Irby-Greene v. M.O.R., Inc.*, **79 F. Supp. 2d 630**, 635-36 (E.D. Va. 2000). However, the FTC Rule expressly allows consumer to recover the amounts paid and the FTC itself has recently rejected the argument that affirmative recovery of such amounts is limited in any other way. **FTC Advisory Opinion** (May 3, 2012).

The purpose of this article is not to weigh in on this issue but to alert chattel paper buyers – and their counsel – to the danger they face. From the transactional perspective, there is not really anything that can be done to reduce this risk in the debtor/dealer's agreements with its customers. Failure to include the required notice in the agreement will not impact the consumer's ability to raise claims and defenses against an assignee. *See* U.C.C. §§ 3-205(e), 9-404(d). The best the chattel paper buyer can do is be cognizant of the risk, factor that risk into the price it pays for the chattel paper, and make sure it has recourse against the debtor/dealer.

Stephen L. Sepinuck *is a professor at Gonzaga University School of Law and director of the Commercial Law Center.*

■ ■ ■

A Look at the Fraud Exception to the Parol Evidence Rule

Chris Hogue

The parol evidence rule provides that once parties reduce their agreement to a writing that they intend to be the final and complete expression of that agreement, no extrinsic evidence of prior or contemporaneous understandings is admissible to supplement or contradict the writing. Evidence offered to prove a defense to formation of the contract is admissible in spite of the rule, including evidence offered to prove fraud. *See* **Cal. Civ. Proc. Code § 1856(g)**; Restatement (Second) of Contracts §§ 213 and 214 (1981). The fraud exception, however, has itself been subject to a significant limitation.

For nearly seventy-eight years, California courts followed a ruling that limited the fraud exception to the parol evidence rule. Under this limitation, parties attempting to offer evidence of fraud could not introduce as evidence "a promise directly at variance with the promise of the writing." *Bank of America v. Pendergrass*, **48 P.2d 659**, 661 (Cal. 1935). The Supreme Court of California recently revisited this issue in *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n*, **291 P.3d 316** (Cal. 2013) and elected to better protect parties from fraud by overruling *Pendergrass*, terming it "an aberration."

In *Riverisland*, the plaintiff borrowers had fallen behind on their loan payments and entered into a new agreement with the defendant lender that restructured the debt. Due to alleged oral promises by the vice president of the lender prior to the signing of the new written agreement, the borrowers understood that the agreement would extend the loan for a period of two years and that the loan would be secured by two parcels of real property as additional collateral. Two weeks later, the borrowers signed the agreement without reading it. The borrowers later failed to make the required payments, leading the lender to record a notice of default against them. In fact, the terms of the written agreement provided that the period of forbearance was only three months and that the borrowers pledged eight parcels of real property as additional collateral.

Although the lender eventually dismissed its foreclosure proceedings after the borrowers repaid the loan, the borrowers filed an action for damages, asserting that the terms concerning forbearance and collateral had been misrepresented. The trial court granted the defendant's motion for summary judgment on the grounds that under *Pendergrass*, evidence of the alleged promises would not be admissible because it was directly at variance with the terms of the written agreement.

In holding that evidence of the alleged fraud was admissible, the Supreme Court gave due consideration to the fact that evidence of fraud is not limited by the parol evidence rule as found in the California statutes, the Restatement of Contracts, most treatises, and the majority of other jurisdictions. The Court was also concerned with the implications of continuing to follow *Pendergrass*, mainly uncertainty in the case law and the potential for using the limitation of the fraud exception as a "shield to prevent the proof of fraud."

Not all jurisdictions have joined California in eliminating this limitation on the fraud exception to the parol evidence rule. In another recent case, *Richards v. JTL Group, Inc.*, **212 P.3d 264** (Mont. 2009), the Supreme Court of Montana rejected a business owner's invocation of **Mont. Code Ann. § 28-2-905(2)**, which allows parol evidence to establish illegality or fraud based on the same statutory language at issue in *Riverisland*. The business owner asserted that he was fraudulently induced into entering an agreement with JTL because of the corporation's promise of non-competition. In its analysis, the court noted that the fraud exception to the parol evidence rule "only applies when the alleged fraud does not relate directly to the subject of the contract. Where an alleged oral promise directly contradicts the terms of an express written contract, the parol evidence rule applies." When the court focused on the express terms of the contract, it found that the fraud alleged by the business owner related directly to the subject of the contract and, therefore, was inadmissible in spite of the fraud exception.

The Supreme Court of California has taken a step that will allow parties the opportunity to present greater evidence of fraud. In the court's attempt to prevent the parol evidence rule from being used as a shield to prevent the proof of fraud, however, it may have opened the door to parties asserting fraud claims with questionable validity, though the court did stress that the party offering evidence of fraud would still need to prove elements such as intent and justifiable reliance. Regardless of their jurisdiction's stance on the fraud exception to the parol evidence rule, attorneys will best serve their clients by practicing preventive law – being cognizant of the written terms of their agreements and making sure their clients do not rely on any promises made outside the four corners of the document. By doing so, they can avoid having to ask a court to hear a claim under the fraud exception.

Chris Hogue is a second-year student at Gonzaga University School of Law

■ ■ ■

Recent Cases

SECURED TRANSACTIONS

Huntington Village Dental, PC v. Rathbauer,
2013 WL 238493 (N.Y. Sup. Ct. 2013)
Handwritten term in the promissory note executed in connection with the purchase and sale of a dental practice providing that if the buyer fails to pay and remains in default for 90 days, "ownership of the practice and assets shall revert back to the seller with credit to purchaser for all sums paid" did not create an Article 9 security interest in the absence of a pledge of property as security for the debt. The handwritten term also did not create a possibility of reverter that automatically revested the property in the seller; at most it created a basis for rescission, which would require judicial action to enforce.

In re K-V Discovery Solutions,
2013 WL 501721 (Bankr. S.D.N.Y. 2013)
Noteholders did not have a security interest in the debtor's interest in a particular drug because the security agreement expressly excluded all of the debtor's rights in the drug until such time as the debtor had fully paid the seller for rights in the drug and thereby discharged the seller's lien. The exclusion was not limited to the trademark in the drug merely because the indenture, in defining the drug, used a trademark symbol after the drug's name because that would not comport with the plain meaning of the security agreement and, in any event, the security agreement expressly controlled over anything in the indenture to the contrary. Moreover, it makes sense to the read the exclusion consistently with the debtor's contract with the seller, which required the debtor to re-convey all of the debtor's rights in the drug – free and clear of all liens – in the event of nonpayment, and thus the whole point of the exclusion was to avoid a breach of the debtor's agreement with the seller.

Bank of England v. Rice,
2013 WL 427919 (E.D. Ark. 2013)
Bank did not have a security interest in rice that the bank argued was owned by the partnership that had authenticated a security agreement because the joint venture agreement between spouses did not establish a partnership, and thus the rice was owned by the individuals.

In re Duckworth,
2013 WL 211231 (Bankr. C.D. Ill. 2013)

Although the security agreement that misdescribed the secured obligation as a note executed on December 13, 2008, "together with all other indebtedness . . . for which Grantor is responsible under this Agreement or under any of the Related Documents" did secure the note executed and dated December 15, 2008, it did not secure obligations incurred in 2009 because those obligations were not "Related Documents," which was defined somewhat circularly to relate to documents executed in connection with the "Indebtedness," which was in turn defined in reference to the "Related Documents."

In re Motors Liquidation Company,
2013 WL 772863 (Bankr. S.D.N.Y. 2013)

Although agent for term loan lenders approved termination statements prepared and filed by debtor in connection with payoff of other loan, and one of those statements terminated the financing statement for the term loan, the termination statement was nevertheless not authorized and therefore was ineffective because neither the agent nor the term loan lenders knew that the termination statement related to the term loan and neither the debtor nor the lenders intended to affect the term loan in any way. Under traditional principles of agency, a person filing a termination statement on behalf of the secured party does not have actual authority to do so unless the person reasonably believes that the secured party has consented to the filing.

Gardner v. Ally Financial Inc.,
2013 WL 765013 (Md. 2013)

Collateralized vehicles were sold at a private sale, not a public sale, under Maryland's Credit Grantor Closed End Credit law because even though the public was invited through weekly advertisements in the *Baltimore Sun*, non-dealers had to provide a refundable $1,000 deposit to attend, which obscured the transparency that is the hallmark of an open, public sale. As a result, the secured party failed to send the required post-sale disclosure.

UniCredit Bank AG v. Deborah R. Eastman, Inc.,
2013 WL 237810 (D. Kan. 2013)

Noteholder had standing to bring claim on note in part because the sale and servicing agreement between the loan issuer and the special purpose entity created for the securitization transferred all rights to the loan, unlike what occurs in a participation agreement, and these rights were subsequently assigned to the indenture trustee, which assigned them to the noteholder.

Edgewater Growth Cap. Partners v. H.I.G. Cap., Inc.,
2013 WL 718765 (Del. Ch. Ct. 2013)
2013 WL 749375 (Del. Ch. Ct. 2013)

Foreclosure sale to entity formed by largest holder of the senior secured debt had to be public to comply with Article 9. A sale is public when there is an opportunity to bid accompanied by presale advertising or invitations sent to interested bidders. Secured party's agreement to allow the debtor to market the business for 55 days (later extended to 83 days) with the assistance of a financial consultant hired by the secured party enhanced the commercial reasonableness of the ultimate foreclosure sale, rather than detract from it, because it helped identify the interested parties to whom an invitation to bid was sent. Because two advertisements were placed in the *Wall Street JournaI* and invitations were sent to more than 60 entities identified by the financial consultant as the parties most likely to bid, the sale was public even though no other bidders attended. The commercial reasonableness requirement did not require the secured party to extend the sale process given that the business to be sold was insolvent and losing money. The sale was commercially reasonable even though of the 36 entities that signed a nondisclosure agreement and received confidential information about the business, none made an offer or showed up at the foreclosure sale.

Caterpillar Fin. Servs. Corp. v. Peoples Nat'l Bank,
2013 WL 776813 (7th Cir. 2013)

Lender that refinanced equipment sellers' PMSIs did not acquire a PMSI because the lender did not receive an assignment of the sellers' interests. Although the lender's financing statement was filed after the financing statement of a prior creditor that subordinated its interest to a bank, and thus the bank would normally have priority over the lender for the lesser of the debt owed to the bank or the debt owed to the subordinating creditor, the bank was unable to show that the creditor had a security agreement. Therefore, the lender had priority over the bank's own security interest, which was perfected last, and bank was liable for conversion in refusing to pay the proceeds of the collateral to the lender.

BANKRUPTCY

In re AMR Corp.,
2013 WL 209643 (Bankr. S.D.N.Y. 2013)
Because pre-petition transaction documents for secured financing and equipment leases made the debtor responsible for a "Make-Whole Amount" in connection with a voluntary redemption but not following a default, and the documents made the debtor's bankruptcy petition a default that automatically accelerated the debt, the creditors were not entitled to the Make-Whole Amount even though the debtor proposed to use post-petition financing at lower interest rates to pay off the creditors in a manner that essentially effected a redemption. Any effort to decelerate the debts is barred by the automatic stay.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Avenue CLO Fund Ltd. v. Bank of America,
2013 WL 617060 (11th Cir. 2013)
Clause in credit agreement providing that its provisions were "binding upon and inure to the benefit of the parties hereto and their respective successors and assigns" did not evidence an intent to make the Term Lenders third-party beneficiaries of the Revolving Lender's promise to lend. Clause giving Term Lenders a security interest in deposit account into which Revolving Lender's loan was to be placed made the Term Lenders incidental beneficiaries of the Revolving Lender's promise to lend, not intended or third-party beneficiaries. Thus, the Term Lenders lack standing to enforce the Revolving Lender's promise.

MER, LLC v. Comerica Bank,
2013 WL 539747 (D. Colo. 2013)
Clause in confirmed plan of reorganization authorizing the debtor to "investigate and prosecute or abandon all Causes of Action" belonging to the estate did not give the debtor the authority to assign any cause of action. Additional clause authorizing the debtor to "settle, discontinue, abandon, dismiss or otherwise resolve" causes of action with bankruptcy court approval was inapplicable because no such approval was requested or received. Accordingly, putative assignee of debtor's claim against bank had no standing.

Nassau Beekman, LLC v. Ann/Nassau Realty, LLC,
2013 WL 362816 (N.Y. App. Div. 2013)
Pursuant to NY Gen. Oblig. Law § 15-301, a term in a written agreement providing that the agreement cannot be modified except by a writing signed by the party against whom enforcement is sought is enforceable. As a result, an agreement for the sale of real estate containing such a clause could not have been modified by an alleged oral promise to extend the closing date. While partial performance of an alleged oral modification can circumvent the requirement of a writing, such partial performance must be unequivocally referable to the modification, and that was not the case here. Moreover, the parties' history of agreeing to mutually acceptable written modifications did not justify reliance on an assumption that they would be able to agree on the necessary written modification in the future.

In re Order Certifying Question to Idaho Supreme Ct.,
2013 WL 238798 (Idaho 2013)
Although legal malpractice claims are normally not assignable, they may be transferred to an assignee in a commercial transaction, along with other business assets and liabilities of the client.

■ ■ ■

Follow the link below for prior issues of

The Transactional Lawyer

Edited By:

Stephen L. Sepinuck
Professor, Gonzaga University School of Law
Director, Commercial Law Center

Scott J. Burnham
Frederick N. & Barbara T. Curley Professor
Gonzaga University School of Law

For questions or to submit content to *The Transactional Lawyer*, please contact Vicky Daniels at vdaniels@lawschool.gonzaga.edu

This newsletter is intended to provide accurate information on the subjects covered. The newsletter is provided for informational purposes only; its publication and distribution do not constitute the provision of legal or professional advice or services by either the authors or the publisher. If legal or professional services are required, the services of a competent professional should be sought.