

# A Stroll Through The UCC

**In the last issue of *Commercial Factor*, Steven Kurtz explained that factors filing claims under UCC §9-406 need to take care to correctly structure their lawsuits. This month, he continues discussing issues that factors need to take into account when engaged in litigation.**

Factors will invariably find themselves in litigation with account debtors for many reasons. Most commonly, they are attempting to collect invoices paid over notice; to collect upon the account receivable portfolio when the factor client is in a liquidation situation; or simply to collect the account because the factor is in a better position to do so than its client.

While the last article focused primarily on Article Nine, it also alluded to other provisions of the Uniform Commercial Code (UCC) which are helpful and necessary to understand. The UCC is a work of art, and touches upon virtually every type of business transaction. In this article, we will focus on collecting from the account debtor and some common litigation situations with account debtors. Here is a rapid-fire overview.

## **STARTING WITH THE BASICS**

Whether you are studying math, learning a new language, or taking up a sport, you always have to start with the basics. Once you learn and master the foundation, you can branch into more advanced topics. Article One is the foundation of the UCC. This article explains the policy and purpose of the code and discusses several different legal concepts that apply throughout the UCC. Whenever one works

with other articles of the UCC, it is essential to know the basic concepts in Article One. In fact, when dealing with a problem contained in a UCC Article, other than Article One, you should always review Article One to see how it fits your problem. More likely than not, you will find helpful guidance.

The UCC general provisions are set forth in Article One, which explains the purpose of the UCC is to simplify, clarify and modernize law; permit expansion of commercial practices; and make uniform the laws amount the various jurisdictions. (§1-103). The UCC is definitionally based. Words and phrases, even common ones that are used in different articles, are often defined here. Therefore, it's important to get your foundation set with an understanding of the definitions. Each article of the UCC contains a list of definitions, and it is important to understand these definitions

when dealing with UCC situations. §1-201 contains a list of definitions, and includes terms such as buyer in the ordinary course of business, contract, fault, money, record and remedy. The definitions are worth reading to get your bearings straight.

§1-202 establishes when a party has notice of a fact. Knowledge of a fact occurs when one actually knows the fact, receives a notification or it is inferred from the facts and circumstances. There is a discussion of time in §1-205. There are evidentiary presumptions in §1-206 which will put the burden of proof on the other side when certain things are presumed in a particular UCC section.

## **EVIDENTIARY PRESUMPTION**

Here is a simple example of the evidentiary presumption in practice. The factor sends an email to the



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account debtor's account payable department head, which notifies the company that payment on all obligations owed to the factor client are to be paid to the factor — a basic notice of assignment under §9-406. This email was authenticated by the factor within the meaning of §9-102(a)(7) and constitutes a record within the meaning of §9-102(a)(70), because the email is a tangible medium, stored in the "cloud". It is also a "notification" within the meaning of §1-202. After receipt of the notice of assignment, the account debtor's account payable person responds with a "winky face" emoji. The account debtor is now on notice of the assignment, and there is an acknowledgment. There is also an evidentiary assumption of notice of the assignment under §1-206.

In a trial, this presumption of the notice of assignment is with the factor. The account debtor has the burden of proof to show the court, with admissible evidence, that it did not have notice. This presumption would still hold true even if a "winky face" emoji was not sent in a response to the notice of assignment. Also, there are rules of admissibility for certain items, which, for example, allows you to admit into evidence bills of lading without having to set a detailed foundation to the court of a third person's business records. Pursuant to §1-307, the court should admit the bill of lading from the factor's business records. Finally, there is a discussion of when a party has waived its rights. (§1-308).

Article Two of the UCC is basically a codification of contract law, under the guise of Sale of Goods. When I was a first-year student at McGeorge School of Law, Article Two was required reading, and all first year students had better haul their UCC Article Two book into class or face getting called upon by our brutal contracts professor. Article

Two discusses the form, formation, and readjustment of a contract (§2-201, etc.); the general obligation and construction of a contract (§2-301, etc.); title, creditors and good faith purchasers (§2-401, etc.); performance (§2-502, etc.); breach, repudiation and excuse (§2-601, etc.); and remedies (§2-701, etc.).

In many instances, the factor and the account debtor are in litigation

regarding the sale of goods. Often, the sales transactions are not well documented with extensive contracts, and you are dealing just with invoices and the facts as they occurred. Often the factor client has vanished, and no person is available to help you (a good reason to download the IFA approved invoices — get them, please!). But all is not lost. Article Two fills in the gaps.

## Think you know your stuff? **PROVE IT!**

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# LEGAL FACTOR

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## WHEN THE FACTOR CLIENT VANISHES

If, for example, you are in a contested litigation matter with an account debtor for payment on goods sold by the factor client, the account debtor may raise disputes that you suspect are not valid. Normally, this dispute would be charged back to the factor client, regardless of validity. However, because you have no client to charge back the disputed account, you need to collect from the account debtor to be made whole.

First, the buyer should inspect the goods. If no time is specified to inspect, then you look to see whether the buyer raised objections within a reasonable time. (§2-605). If there are legitimate objections to the goods, the buyer should be particular in describing the problems (§2-605). If the buyer did not reject the goods after a reasonable opportunity, or make a proper rejection, or acted inconsistent with the seller's ownership of the goods, like selling them, the goods are deemed accepted (§2-606). Once the goods are accepted, the buyer must pay the seller (or you as the factor) the contract price for the goods. (§2-607). Thus, one can establish a case against the account debtor with any help from the factor client.

## NEGOTIABLE INSTRUMENTS

Article Three deals with negotiable instruments, which applies when the account debtor pays by check. Sometimes account debtors bring affirmative claims against the factors as a result of financing accounts. We've already established that §9-402 does not make the factor liable for the factor client's conduct, merely because of the factor's status as a secured party. But there are

When a factor client goes out of business, it's amazing how often disputes arise. What were once good customers, who timely paid when the factor client was in business, have now ghosted you when it comes time to pay.

situations where the account debtor seeks recovery against the factor. A typical claim which may require the factor to look to Article Three, is when the account debtor has been defrauded by the factor client and pays the factor on accounts that were falsified or paid to the factor by "mistake". Here the Article Three concept of holder in due course applies.

A check is a negotiable instrument. (§3-104(a)(4)). When one receives a check, that person is considered to be a holder of the check. (§3-301). The holder can indorse the check and receive payment. (§3-201 and §3-203). A holder in due course is entitled to various protections and is not held liable for claims caused by others. This requires that the check holder take the instrument for value, in good faith, without notice to any claim, without notice of any defenses or claims in recoupment. (§3-302).

For instance, if the factor client perpetrates a fraud against the account debtor and the factor, causes the factor to purchase phony

invoices, and causes the account debtor to pay the factor on the falsified invoices, all hell will break loose when the fraud unravels. In this situation, the factor is likely going to be sued by the account debtor because the factor has the perceived deep pocket and is still around. Assuming the factor had no knowledge or notice of the fraud (See §1-202); the accounts were purchased by the factor in the ordinary course of its business; and the account debtor paid by check, the factor has a very good "holder in due course defense," and the account debtor should look elsewhere for recovery. For those who receive payments by wire transfers, electronic transfers of funds are set forth in §4A of the UCC. This article does not get into the level of detail of Article Three for holders in due course. But, the factor should be entitled to the same level of protection as a holder in due course for electronic payments, to be covered in more detail in a different article.

The UCC can be very mechanical and offers a vast array of protections. Knowledge of how the code works will be helpful when you are adverse to the account debtor and have nobody around to assist you. When a factor client goes out of business, it's amazing how often disputes arise. What were once good customers, who timely paid when the factor client was in business, have now ghosted you when it comes time to pay. The UCC can be used to fill in gaps and provide you with a statutory and logical method to enforce and protect your rights. Hopefully, this won't happen to you, but in case one of your friends in the industry gets caught up in a bind, then they can read this article. •