SUBJECT: Characterizing the sale of accounts receivable as a sale

COMMITTEE: Business and Industry— favorable, without amendment

VOTE: 8 ayes — Brimer, Rhodes, Corte, Elkins, Giddings, Janek, Solomons, Woolley

0 nays

1 absent — Dukes

SENATE VOTE: On final passage, March 5 — voice vote

WITNESSES: For — Paul Johnson, KBK Financial Corp.

Against — None

BACKGROUND: The sale of accounts receivable or other chattel paper is governed by the Uniform Commercial Code (UCC), enacted in Texas in the Business and Commerce Code. The UCC considers the sale of accounts receivable to be a secured transaction, but the comments to the UCC clearly state that the sale of accounts receivable is considered a secured transaction only to the extent that such sales should be subject to the same notice provisions of secured transactions.

When secured transactions are executed, the person to whom the transaction is given is granted a security interest in the property subject to the transaction. Normally a secured transaction is a loan, and the security interest is the collateral for the loan. In order to perfect that security interest, the secured party must file notice of the transaction with a number of record keeping agencies, including the secretary of state and the clerk of the county in which the security interest is located. The ownership of the security interest is not transferred to the buyer, but remains the property of the seller unless the seller defaults on the transaction or declares bankruptcy.

When accounts receivable are sold, the buyer should file notice of the sale so that the accounts receivable cannot be resold or used as security for another transaction, but the ownership of the accounts themselves is transferred to

the buyer. The seller, however, retains possession of the accounts and is responsible for collecting the accounts and passing the proceeds of such collections to the buyer. If the accounts receivable were considered a secured transaction for all purposes, the seller would retain ownership rights in the accounts, and buyers would be required to place their claims in line with other secured parties if the seller declared bankruptcy.

While the comment to the UCC appeared to make it clear that accounts receivable were only considered secured transactions for notice purposes, a recent court decision, *Octagon Gas Systems, Inc v. Rimmer,* 995 F.2d 948 (10th Cir. 1993), *cert. denied,* 114 S.Ct. 554 (1993), has cast doubt over the characterization of the sale of accounts receivable as secured transactions. The court held that the sale of accounts receivable was considered a secured transaction, and thus when the seller declared bankruptcy, the purchaser of the accounts was required to apply to the court for an interest in the bankrupt party's assets with other secured parties. No court has followed the holding of the *Octagon* court, and the decision has been criticized by other courts.

The 74th Legislature enacted HB 3101 by Pitts, which clarified that the sale of accounts receivable is considered a sale, not a loan, and thus not subject to usury laws.

DIGEST:

SB 505 would specify that the sale of accounts receivable should be considered a secured transaction only to protect the purchasers by providing them a notice filing system.

Under SB 505, unless there was a finding of fraud, the characterization of the parties of the transaction would be conclusive regarding whether the transfer of such accounts should be considered a sale or a secured transaction.

SB 505 would take effect September 1, 1997.