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The North Dakota Factors Lien Act

J. F. Bierstedt

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NOTES

THE NORTH DAKOTA FACTORS LIEN ACT

In 1959, the North Dakota Legislative Assembly enacted a Factors Lien Act.¹ This was new legislation in North Dakota, though similar legislation in New York is currently nearing its fiftieth birthday.² In the short time that the statute has been on the books it appears to have been used only sparingly in eastern North Dakota.³ This paper is submitted for the purpose of broadening the view of the attorneys of the state with regard to the operation of the law, and possibly encouraging its use in advantageous situations.

I. HISTORY AND SUMMARY OF THE ACT

The current pattern of business operations involving factors had its inception in the Industrial Revolution and was developed out of the English textile industry.⁴ During the period of heavy population increases in the United States there was a heavy demand for English textiles. The English textile mills commenced the practice of shipping goods on consignment to New York factors, who in turn acted as sales agents for the English mills. The factors sold the goods on a commission basis whereby they offered both credit and collection functions to their clients. The credit factor in these operations was the source of greatest difficulty, since in many cases the only security which the factors could rely on for the money advanced to their clients were the accounts receivable of the clients and the goods which those clients received on consignment.⁵ Since the factor could not rely on a possessory lien or a chattel mortgage he was confronted with little protection for the money which was advanced.⁶ This was the basic situation which caused the enactment of the first Factors Lien Act.⁷

Since a manufacturer needs working capital and his only collateral is often his inventory, the possession of such inventory be-

1. N.D. Sess. Laws 1959, c. 271.

2. New York Pers. Prop. Law, § 45.

3. In a personal survey made with the bankers in Grand Forks, Fargo, East Grand Forks, Minn. and Moorhead, Minn., it was observed that the First National Bank of Fargo had used it once. The bankers in this area seemed very reluctant to use the Factors Act since warehouse receipts and trust receipts were handling their problems quite adequately.

4. For a complete account of the development of the factor, see, Steffen and Danziger, *The Rebirth of the Commercial Factor*, 36 Colum. L. Rev. 745 (1936).

5. See Silverman, *Factoring Its Legal Aspects and Economic Justification*, 13 Law & Contemp. Prob. 593 (1948).

6. See Skilton, *The Factor's Lien on Merchandise*, 1955 Wis. L. Rev. 356, 370, 371.

7. New York Pers. Prop. Laws, § 45. This was enacted in 1911.

comes of prime importance. If this inventory cannot be processed into finished goods, the business will not survive. However, through the mechanism of the Factors Lien Act, the factor is given a lien upon the general inventory of the manufacturer but not upon the individual components of that inventory. Thus the manufacturer is put in a position whereby he can process and sell his goods in the normal course of business and use the proceeds to re-invest in inventory and at the same time repay his loan.⁸

In the 1920 period the factors began to render their services to businesses outside the textile industry. Many businesses received a shot in the arm from the factors, the automobile industry being one of the first to benefit.⁹ The use of the factors lien enabled the industry to break out of a network of restrictive credit practices, since bankers at that time were reluctant to finance the automotive manufacturer except by such devices as the trust receipt and the warehouse lien.¹⁰ Both these devices involved specific liens upon items of inventory rather than a general lien upon the revolving contents of a general inventory itself.

The principal functions of the factors were and still are (1) the purchasing of accounts receivables, (2) the guarantee of the seller against customer credit failures, (3) billing, ledgering and collection of accounts receivables, and (4) the financing of their client's operations by advancing money on the security of a factors lien.¹¹ How far a factor will go in performing these various functions depends on the type of financing in which he is engaged. Thus, where the factor depends for his security primarily on the accounts receivables, he ordinarily does not lend on these accounts but buys them outright. If the account then fails the factor rather than his client suffers the loss. In order to assume such a risk, the factor must pass on all credit extended by the client, which makes it necessary for him to have a highly perfected and efficient credit information service. There is no recourse for credit losses and the factor cannot hold the client liable by compelling him to refund a proportionate amount of the purchase price paid for the account. In such situations the factor assumes the accounts receivable bookwork and takes all steps necessary to collect.

8. 34 Minn. L. Rev. 119, 120 (1950).

9. Ayers, *The Economic Function of the Sales Finance Company*, Times Sales Financing, January, 1938, p. 5.

10. Rogers, *Sales Finance Companies in Our National Economy*, Times Sales Financing, July, 1951, p. 8.

11. Silverman, *Factoring Its Legal Aspects and Economic Justification*, 13 Law & Contemp. Prob. 593 (1948).

However, this is not the prime function the normal factor accomplishes. His primary function is to finance a business by lending money on the ever-changing inventory of raw materials, work in process, finished goods, and ultimately on the accounts receivable. This is generally accomplished by advancing money needed for manufacturing. In these cases the work of collections and book-keeping is generally left to the borrower and in this way the borrower can carry on the business as though no lien were present.¹²

The business of factoring grew because there was a need for credit advice and credit warranty on the part of manufacturers who lack the organization to handle their own credit problems efficiently. The need for working capital, which arises at one time or another in the conduct of most businesses, makes the factor a very valuable resource.¹³ The factor's services are not given gratuitously, and since a higher rate of interest is paid by the borrower many services are rendered to him that would otherwise run into considerable expense, e. g., the hiring and organization of departments to handle such transactions.

The adoption of factors lien laws has been widespread following general recognition of the advantages of this type of operation. Approximately half of the states have enacted such legislation.¹⁴

II. OPERATION OF THE FACTORS LIEN ACT

The factor, as pointed out earlier, was originally a sellers agent.¹⁵ However, he is currently defined in the North Dakota act and the statutes of other states as ". . . any person, firm, bank or corporation, United States small business administration or other governmental agency, their successors or assigns, engaged in whole or in

12. *Id.* at 598.

13. *Id.* at 595, 596.

14. Up to 1960, the following states have enacted similar statutes, differing in some features but all designed to fulfill the same economic and commercial need. Ala. Code tit. 47, § 132 (Supp. 1953); Conn. Stat. tit. 58, § 7256 (1949); Del. Code tit. 25, §§ 3301-3310 (1953); Fla. Stat. c.85, §§ 29-35 (1959); Ga. Code tit. 67, §§ 2214-2221 (1957); Ind. Stat. tit. 43 §§ 1201-1210 (1949); Ill. Ann Stat. tit. 82 §§ 102-112 (Supp. 1959); Me. Rev. Stat. c 181, §§ 1-11 (1954); Md. Ann Code art. 2 §§ 21-29 (1951); Mich. Comp. Laws §§ 570.501-512 (1948); Minn. Stat §§ 514.80-91 (1953); Miss. Code §§ 382-11—382-20 (1942); Mo. Rev. Stat. §§ 3621, 101-107 (Cum. Supp. 1950); N.H. Laws 1951, c. 218; N.J. Rev. Stat. §§ 2:60-252 (Supp 1941-44); N.Y. Pers. Prop. Law, § 45 (1959); N.C. Gen. Stat. §§ 44-70-76 (1950); Ohio Gen. Code Ann tit. 1311, §§ 59-68 (1955); R.I. Gen Laws, 34-32-1 to 34-32-16 (1956); S. C. Code Ann. § 45-401-410 (1952); S.D. Sess. Laws 1957, c. 200 p. 269; Tenn. Code Ann. §§ 64-1801-1807 (1956); Tex. Rev. Civ. Stat. Ann. art. 5506, (1948); Vt. Rev. Stat. tit. 9, §§ 1852-1864 (1959); Va. Code § 55-144 (1950); W.Va. Code Ann. §§ 3946 (17) (24) (1955); Wis. Laws Ann. §§ 241.145 (1) (17) (1957).

15. Silverman, *Factoring. Its Legal Aspects and Economic Justification*, 13 Law & Contemp. Prob. 593 (1948).

part, in the business of lending or advancing money on the security of merchandise"¹⁶

Under the old factors lien law, which was built about a possessory lien,¹⁷ certain types of financing were impossible. The new statute, however, declares that possession of the merchandise is not a prerequisite to the validity of the lien.¹⁸ As between the factor and borrower¹⁹ the new act allows creation of a continuing lien upon the general merchandise of the borrower, such merchandise being generally described in the lien agreement. However, this lien does not extend to machinery, trade fixtures, or equipment not intended for sale.²⁰ When merchandise is acquired by the borrower after execution of the lien agreement, it becomes subject to the lien so long as it falls within the class of goods described in the original agreement.²¹ To be effective, the lien must be filed with the register of deeds within fifteen days after execution of the lien agreement.²² The agreement need not be witnessed or acknowledged to be valid.²³ The lien may be secured to cover advances made within one year after the date of filing.²⁴ This period may be extended by amending the original notice.²⁵ If within a three-year period the factor executes an affidavit under oath that the debt has not been satisfied, the lien can be extended for an additional one-year period. If these steps are not taken the lien will expire at the end of a three-year period as a matter of law.²⁶

A purchaser for value of the finished product, buying in the regular course of business, takes free and clear of the factors lien

16. N.D. Sess. Laws, 1959 c. 271, § 1. In Michigan the factor is called a lender, Mich. Comp. Laws, (1948) § 570.501 (b).

17. N.D. Rev. Code § 35-2006 (1943); *Rosenbaum v. Hayes*, 5 N.D. 476, 67 N.W. 951 (1896).

18. N.D. Sess. Laws 1959, c. 271, § 2. In a somewhat similar statute, *Irving Trust Co. v. Commercial Factors Corp.*, 68 F.2d 864 (2d Cir. 1934), held where goods were sent directly to a bailee without coming into the possession of the factor claiming a lien, the court stated that the factor could have a lien under this section where the bailee was notified that it held for the factor. Under the N.J. statute it provides that all factors shall have a continuing general lien upon all goods and merchandise consigned to or pledged with them, whether or not in their constructive, actual or exclusive occupancy or possession, the word goods generally include all personal chattels other than things in action and money. *In re Tele-Tone Radio Corp.*, 133 F.Supp. 739 (D.N.J. 1955).

19. Under the N.D. Sess. Laws 1959, c. 271, § 1 the borrower is defined as "... the owner of the merchandise, or his agent, who creates a lien in favor of the factor."

20. N.D. Sess. Laws 1959, c. 271, § 1.

21. N.D. Sess. Laws 1959, c. 271, § 2. For a factors agreement see *Colbath v. Mechanic's Nat'l Bank*, 96 N.H. 110, 70 A.2d 608 (1950).

22. N.D. Sess. Laws 1959, c. 271, § 4. Section 11 provides that when the possession is retained by the factor he has a general continuing lien and § 4 need not be complied with.

23. N.D. Sess. Laws 1959, c. 271, § 4.

24. N.D. Sess. Laws 1959, c. 271, § 3. In a statute similar to North Dakota's, the lien may be terminated prior to one year. *In re Comet Textile Co.*, 15 F.Supp. 963 (S.D. N.Y. 1936). *Aff'd*, 91 F.2d 1008 (2d Cir. 1937).

25. N.D. Sess. Laws 1959, c. 271, § 3.

26. N.D. Sess. Laws 1959, c. 271, § 5.

whether he has notice of the lien or not.²⁷ Upon repayment of the obligation secured by the lien, notice of discharge is given in the same manner as when the lien agreement was executed and filed.²⁸

Foreclosure procedures are consistent with those used in the case of chattel mortgages, though the parties may specify different methods of foreclosure in the lien agreement if they wish.²⁹ The lien is not invalidated by (1) return of the merchandise to the borrower, (2) granting credit to a purchaser of the goods, or (3) failure of the factor to require the borrower to account to the factor for the proceeds of the merchandise sold, or to account to the factor for money received on any account receivable resulting from the sale of the merchandise covered by the lien.³⁰

Section 12 of the North Dakota Factors Act points out that it shall in no way repeal the present statutes regarding factors³¹ or pledges.³² A liberal construction is given to the act.³³ In this way it plugs the old loop holes and secures the beneficial interests of the factor which is the primary reason for the original designing of the act.

III. EFFECT OF BANKRUPTCY ON LIEN

Section 60(a) (2) of the Bankruptcy Act provides that a transfer of personal property "shall be deemed to have been made or suffered at the time when it becomes so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."³⁴ The lien of the factor is valid under this section, since the filing of the lien makes the lien take effect as of the date of the agreement's execution, providing the filing occurs within the fifteen days period allowed by the act.³⁵ Assuming the filing requirements

27. N.D. Sess. Laws 1959, c. 271, § 5. The factors act was designed to protect persons dealing in good faith with apparent owners of property and could have no application to cases where protection would secure to a wrongdoer the fruits of fraud. *People v. Rosenfeld*, 83 N.Y.S.2d 691 (1948).

28. N.D. Sess. Laws 1959, c. 271, § 8. If the factor should fail to deliver the certificate of discharge he is subject to the double damages clause in this section providing any person is injured due to his neglect.

29. N.D. Sess. Laws 1959, c. 271 § 7.

30. N. D. Sess. Laws 1959, c. 271, § 10. Under a similar statute, a merchant executed a lien to a factor on accounts receivables as provided by law, the merchant upon accepting returned goods from a customer did not keep them separated from the general stock, nor did he comply with the provision of personal property law relating to preservation of factors liens upon merchandise. Court *held*, that returned goods were not proceeds resulting from a sale of merchandise or proceeds resulting therefrom did not entitle the factor to have a lien upon the goods as proceeds. *Block v. Mill Factors Corp.*, 119 F.2d 536 (2d Cir. 1941).

31. N.D. Rev. Code § 3-06 (1943).

32. N.D. Rev. Code § 35-06 (1943).

33. N.D. Sess. Laws 1959, c. 271, § 12.

34. 11 U.S.C.A. § 96(a) (2) (Supp. 1959).

35. N.D. Sess. Laws 1959, c. 271, § 4.

are met, there is no possible period within which subsequent creditors can acquire rights superior to those of the factors; he is thus protected against the possibility of fraudulent conveyances.

Under § 67(a) (1) of the Bankruptcy Act,³⁶ any transfer of property made prior to four months of the initiation of bankruptcy proceedings is safe from the long arm of the trustee and cannot be set aside as a preference to creditors. It is to be noted that § 67(a) (1) invalidates a transfer of property made during the four-month period preceeding bankruptcy if the transferee knew the transferor to be insolvent at the time of the transfer or if the transfer was for the purpose of fraud.³⁷ On the other hand, § 67(b) of the Bankruptcy Act³⁸ states that a statutory lien in favor of employees, contractors, mechanics, landlords, or *other classes of persons* may be valid against the trustee even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition for bankruptcy so long as the filing is in accordance with the provisions of state or federal law. Writers on this topic seem to be split as to whether or not the factor falls within the class of other persons. In the case of *In re Tele-Tone Corp.*,³⁹ the court stated that the factor does not fall within the class of statutory liens, however, the case was not adjudicated on these merits, but they did rule that the factors claim was preferential under § 60(a) (2) of the Bankruptcy Act. Courts, on the other hand, have held that a bankers lien was valid under this section,⁴⁰ and by dictum have said a trust receipt is a statutory lien.⁴¹ It seems that the point is still to be argued and decided upon in the eyes of the law.

It has been pointed out earlier that the factors lien is a lien on a mass of flowing goods. Thus incoming merchandise does not appear to represent an "additional" security for a past debt even though received, making it subject to the lien within the four month period preceeding bankruptcy, since this incoming merchandise would revert back to the original filing of lien. Accounts receivable which fall within the four month period do represent an "additional" security since they were not present at the time of the filing of the lien, but they are coming due and being perfected during the four month period.⁴²

36. 11 U.S.C.A. § 96(a) (1) (Supp. 1959).

37. 11 U.S.C.A. § 107(a) (1).

38. 11 U.S.C.A. § 107(b).

39. 133 F.Supp. 739 (D.N.J. 1955) (dictum).

40. The Ninth Circuit has held that a statutory bankers lien falls within the provisions of 67 (b). *Gogin v. Bank of America Nat. Trust & Sav. Ass'n.*, 183 F.2d 322 (9th Cir. 1950).

41. *In re Rand Mining Co.*, 71 F.Supp. 724, 727 (S.D. Cal. 1947) (dictum).

42. *Manchester Nat. Bank v. Roche*, 186 F.2d 827 (1st Cir. 1951).

It would appear sound practice for the factor to investigate the average four-month turnover of the borrower's inventory and advance a smaller amount than such turnover, since a certain percentage of the factor's advances could be lost in a bankruptcy proceeding.

IV. THE FACTORS LIEN ACT AND THE UNIFORM COMMERCIAL CODE

Since the Uniform Commercial Code (U.C.C.) also contains provisions dealing with factors liens, a comparison between the North Dakota statute and the U.C.C. seems desirable.

A. *Who May Acquire Lien on Inventory?*⁴³ The North Dakota Factors Lien Act limits the acquisition of factors liens to those persons in the business of financing.⁴³ The U.C.C. is not so restrictive and allows any legitimate creditor to obtain such a lien.⁴⁴

B. *What Property Is Subject to the Lien?*⁴⁵ Property subject to the lien under the North Dakota statute is limited to merchandise, i. e., personal property intended for sale either before or after the manufacturing process. This definition does not include machinery, equipment or trade fixtures not intended for sale in the ordinary course of business.⁴⁵ A broader definition is used in the U.C.C. The "inventory" on which such a lien may be obtained is declared to include goods held or being prepared for sale or materials used or consumed in a business.⁴⁶ Equipment or fixtures may also be subject to a factors lien under the U.C.C.⁴⁷

C. *Type of Lien.* Under the North Dakota act the factor is given a continuing lien generally covering merchandise described in the lien agreement, regardless whether such merchandise is in the hands of the borrower.⁴⁸ The same situation is true under the U.C.C.⁴⁹

D. *Filing Notice.* Under the North Dakota act a notice of lien must be filed.⁵⁰ Under the U.C.C. a financing statement is sufficient.⁵¹ Possession is equivalent to filing of a lien both under the North Dakota statute⁵² and the U.C.C.⁵³

E. *Time Limit of Lien After Filing.* Under the North Dakota statute a lien filed by a factor is good for a period of three years,

43. N.D. Sess. Laws 1959, c. 271, § 1.

44. Uniform Commercial Code § 9-105 (i).

45. N.D. Sess. Laws 1959, c. 271, § 1.

46. Uniform Commercial Code § 9-109 (4).

47. Uniform Commercial Code § 9-109 (2).

48. N.D. Sess. Laws 1959, c. 271, § 2.

49. Uniform Commercial Code § 9-201.

50. N.D. Sess. Laws 1959, c. 271, § 4.

51. Uniform Commercial Code § 9-402.

52. N.D. Sess. Laws 1959, c. 271, § 11.

53. Uniform Commercial Code § 9-305.

with a possible extension of time permitted.⁵⁴ Under the U.C.C. the lien may last as long as five years and will secure any advances made during that time.⁵⁵ Continuation statements may also be filed under the U.C.C.⁵⁶

F. Purchasers for Value. Purchasers for value in the ordinary course of the borrower's business take the purchased goods free and clear of the lien whether or not they have notice of the lien, both under the North Dakota statute⁵⁷ and the U.C.C. The U.C.C. also provides an exception to farm products in the same section.⁵⁸

G. Right of Lienor Against Subsequent Creditors. Under the North Dakota act, after the lien is filed it takes effect by attaching the goods described in the agreement. Merchandise of the type thereafter acquired by the borrower is void against all claims of the borrower's unsecured creditors and against subsequent liens, excepting those of prior perfection. However, specific liens for processing, warehousing or shipping of the goods are superior to the lien of the factor.⁵⁹ Under the U.C.C. the financing statement is generally good as against creditors.⁶⁰ A priority is given for liens based on services and materials under the U.C.C.⁶¹ as in the North Dakota act.⁶²

H. Foreclosures. Under the North Dakota act foreclosures of the factor's lien are made pursuant to the procedure used for chattel mortgages, or by any other method specified in the agreement between the factor and borrower.⁶³ The U.C.C. spells out foreclosure procedure in considerable detail and adds a number of compulsory requirements.⁶⁴

V. CONCLUSION

The North Dakota Factors Lien Act appears to be an excellent statute filling a genuine need in the commercial world. The factors lien is a good faith lien and depends a great deal on the integrity of the borrower, which is perhaps the reason for the amount of litigation regarding it.

This type of legislation can bring bigger and better things to our state. Our legislatures must not stop with only one such act, but

54. N.D. Sess. Laws 1959, c. 271, § 8.

55. Uniform Commercial Code § 9-403 (2).

56. Uniform Commercial Code § 9-403 (3).

57. N.D. Sess. Laws 1959, c. 271, § 5.

58. Uniform Commercial Code § 9-307.

59. N.D. Sess. Laws 1959, c. 271, § 6.

60. Uniform Commercial Code § 9-303.

61. Uniform Commercial Code § 9-310.

62. N.D. Sess. Laws 1959, c. 271, § 6.

63. N.D. Sess. Laws 1959, c. 271, § 7.

64. Uniform Commercial Code § 9 (5).

keep moving forward with new and better laws which are needed to fulfill the economic needs of today. If the Uniform Commercial Code is adopted in the coming legislature, North Dakota will be in the ranks of the many states which also feel that there is a need for more uniform laws in the nation.

J. F. BIEDERSTEDT.